

1 FRIDAY, 7TH SEPTEMBER 2001

2
3 [Hearing commences at 9.05am]

4
5
6 PRESENTATION BY
7 CHRISTCHURCH INTERNATIONAL AIRPORT LIMITED CONTINUES

8
9
10 CHAIR: Good morning, as it's past 9 clock I suggest we
11 start again. Mr Weston, over to you again, please.

12
13 MR WESTON QC: Thank you Chairman. Well, Mr Seed is in the
14 chair, as we know, well seated at our end anyway.

15
16 MR SEED: Mr Chairman, Commissioners, good morning.
17 I'd just like to pick up on where we got to
18 yesterday afternoon, and that was where I was introducing
19 our analysis of the Commission's calculations of CIAL's
20 historic excess returns.

21 Going back and looking at the components, as they
22 had been estimated by the Commission, we had come to the
23 conclusion that airfield revenue was overstated by around
24 about \$8.3 million, airfield depreciation had been
25 understated by around about \$8 million, operating
26 expenses had been understated by around about
27 \$8.8 million and NOPAT was overstated by about
28 \$18.6 million. Now, that was even if we accept the
29 Commission's cost of capital and also the asset
30 valuations before we make any comments on those.

31 There's just one correction to make to that
32 particular slide. On the slide I showed you yesterday
33 afternoon, it had operating expenses below that; if you
34 could just delete the operating expenses on that
35 particular slide please.

36 So, just moving on. We then began to discuss why
37 there was the overstatement of airfield revenue, and the
38 point to note here is that -- and I introduced it
39 yesterday afternoon -- is that there's something of a
40 difference between the definition of "airfield
41 activities" used for pricing, and the definition of
42 "airfield activities" used for financial disclosure, and
43 what seems to be the definition of "airfield activities"
44 used by the Commission in calculating both the costs and
45 also the revenues.

46 So, I think it's important in any reworking of
47 CIAL's excess return numbers that are undertaken by the
48 Commission, that they clearly determine that their asset
49 base that they're using is consistent with the revenue
50 that's been calculated, and that is also consistent with

1 the expenses which are being allocated.

2 Because, at the moment, we have a situation where --
3 for example, quarantine charges, which are actually part
4 of the terminal charge, are being included in the
5 airfield revenue line. And, furthermore, quarantine
6 charges are specifically of specified terminal activities
7 under Section 2 of the Act.

8 Now, that's not an insignificant amount of money.

9 The second main, or item that was leading to the
10 overstatement of airfield revenue was that the
11 Commission's included income and arbitrarily allocated
12 around about \$200,000 a year to airfield, from apparently
13 sources for which it doesn't seem to have included the
14 assets.

15 The third point is that the Commission's assumed
16 that all of the 1989 aeronautical revenue was actually
17 airfield revenue. Now, of the \$9.7 million of
18 aeronautical revenue that CIAL earned in 1989, and just
19 remember that was the year that prices were revised, so
20 those prices, or rather the total CIAL revenue, is
21 somewhat lower in that year because prices had
22 historically been very low. And, during that year they
23 were revised and the new prices came into force. Around
24 about 4 and a half million of that revenue actually
25 relates to terminal, it has nothing whatsoever to do with
26 airfield.

27 So, these are all quite significant overstatements
28 of revenue, and consequently they tend to inflate the
29 estimates of NOPAT and inflate the returns that the
30 question has been calculating

31 Just something of a summary there, this is to give
32 you some idea of the profile of the overstatement. As
33 you can see, in 89 it's approximately a 4 and a half
34 million dollars overstatement of CIAL revenue and, as you
35 come down to the year 2000, now, we've used -- obviously
36 the revenue numbers line up.

37 In terms of the overstatement of airfield costs, as
38 I said yesterday, any kind of back-casting where you're
39 estimating costs going back up to 12 years is going to be
40 fraught with difficulty simply because a lot of the time
41 the numbers just simply don't exist.

42 As I mentioned yesterday, when the Airport Company
43 was corporatised in 1988 it was effectively a part of
44 Christchurch City Council, it did have some financial
45 records; the financial records that were existing at that
46 time obviously do not match up exactly with the
47 definition of "airfield activities" that we are using
48 now, 12 or 13 years later.

49 There are financial records existing, obviously,
50 there's trial balances, and you can actually go back, if

1 you wish, to a line-by-line analysis of the CIAL trial
2 balance -- I can't tell you exactly how many line items
3 there are in the CIAL trial balance but, as you would
4 imagine, you would have to split that between around
5 about 7 or 8 different categories and then make some
6 judgments about how you start allocating things like
7 admin and so on if you're going to do it really exactly.
8 What we've attempted to do is to -- and I'll come to
9 this in a little more detail later but I'll touch on it
10 now -- what we've attempted to do is to identify the
11 major items, allocate those to the years in which they
12 have applied, and then, if you like, allocate by
13 percentages the remainder or the leftover amounts. So,
14 they're consistent between a benchmark that we had in
15 1989, being the Travis Morgan report, and the benchmark
16 that we have in the year 2000, being the disclosure
17 financial statements.
18 The reason we've had to do that, of course, is
19 because, when parts of the businesses grow at different
20 rates you can't use a constant percentage all the way
21 through.
22 In 1990 at CIAL airfield revenue made up around
23 about 31% of the total CIAL revenue. It now makes up
24 around 18%. So, it's just slightly over half of what it
25 was a decade ago.
26 Furthermore, the cost structures have changed quite
27 dramatically reflecting the growth because you've had
28 effectively economies of scope. The range of activities
29 that have been undertaken by the airport have also
30 increased, the property portfolio, for example, has grown
31 in size and there are other investments that the airport
32 company's undertaken, which have meant that aeronautical
33 revenue, and airfield revenue in particular, is now a
34 much smaller proportion of the total than it was before.
35 Now, that a constant percentage is not appropriate,
36 has been accepted. In fact, BARNZ, in its submission,
37 did actually accept this for Auckland.
38 To give you some feel for how that looks, this chart
39 just demonstrates what's happened with CIAL revenue over
40 time, and that's on the left-hand axis, and that's
41 thousands of dollars, so we've got a total there, total
42 revenue of around about \$54, \$55 million.
43 Now, airfield revenue is the red or magenta coloured
44 bar and, as you can see, apart from when it was lower in
45 1989 when the new charges came in, the airfield revenue
46 has been relatively constant through time. It hasn't
47 increased dramatically and, as a proportion of the total
48 CIAL revenue, you can see it's dropped quite consistently
49 over time.
50 So, all we're demonstrating here, and the reason

1 that I'm putting this up is just to demonstrate that you
2 can't use a constant percentage, and I think we would
3 accept that. So the alternatives are to go back and try
4 and allocate things directly.

5 So, what we did was, we went back and we tried to
6 build up the three or four major cost line items that the
7 Commission had identified. The depreciation that we've
8 estimated has been based on effectively the company's
9 book values. We took the depreciation schedules in each
10 year and we attempted to build up, if you like, a
11 depreciation schedule from 1989 until 2000.

12 What we then did was, we said, well, that's the
13 depreciation that relates directly to the airfield,
14 there's also a small proportion of depreciation relating
15 to plant and equipment that's utilised by administration
16 services and also the maintenance yard, and that was also
17 a pro -- a proportion of that was also allocated to the
18 airfield depreciation.

19 So, what we did there was, we re-estimated the
20 actual airfield depreciation, and the major item in there
21 is obviously the sealed surfaces, it's comprising around
22 about \$20 million worth of assets originally, so it's
23 quite a significant item. And the depreciation in any
24 particular year has reflected the company's accounting
25 policies, in particular which is -- from the time that it
26 originally started it had slightly different depreciation
27 rates to what it has now, where it actually has used a
28 ranging economic life approach. So there are some
29 differences through time for depreciation.

30 For the other items, payroll and operating expenses
31 were interpolated between two points, as I said before.
32 In 1990 Travis Morgan, I think they're called Travis
33 Morgan Simmons, I think they are, or Simmons Travis
34 Morgan, undertook a pricing analysis for
35 Christchurch Airport, they also took similar analysis I
36 think for the other two airports, and they used
37 information that was built up from the Christchurch City
38 Council's financial records, and also from what they
39 could glean from the company's records at that time, and
40 they built up a charging model for the airfield, and in
41 that charging model for the airfield they had cost
42 allocations.

43 Now, we've used that as a point of departure because
44 we don't have anything else really to go on, and in the
45 year 2000 we've used the percentage allocations for the
46 CIAL pricing model which are actually very close, as you
47 will see from looking at the figures, they're actually
48 very close to the numbers that were used for the airfield
49 financial disclosure. They're close but they're
50 different, and they're different in significant areas.

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1 We acknowledge that this isn't exact, but we think
2 it's actually a better measure than a constant proportion
3 of the total costs, and as I said before, an alternative
4 is to go back to a line-by-line allocation of the annual
5 trial balances, and within the time available we have not
6 been able to do that, but I mean, once again it is a
7 possibility.

8
9 CHAIR: I just wondered, Peter, it might be useful -- the
10 Commission hasn't got a copy of the that Travis Morgan
11 model, how it was worked through. We may have it of
12 course.

13
14 MR SEED: My understanding is the Commission does have a
15 copy of that, although I'm more than happy to provide
16 another electronic copy of the original Travis Morgan
17 model.

18 The Commission has the original documents, and I've
19 cited the numbers in my cross-submission, they were some
20 of the original information that was given back to the
21 Commission back in 1998.

22
23 CHAIR: Okay, that's fine.

24
25 MR SEED: To give you some idea of what this looks like in
26 the cost streams, there's some significant differences
27 mainly in the mid-90s, early to mid-90s as opposed to the
28 earlier years and, in fact, in some instances the
29 Commission has estimated higher amounts than what we've
30 estimated.

31 With depreciation the differences are consistently
32 higher in the earlier years and, once again, that's
33 because the depreciation has been estimated on a constant
34 percentage.

35 I'll just point out that in this particular chart,
36 whereas the other numbers have been adjusted for the
37 12 month period -- or they've been analysed to a 12 month
38 period for all years -- in this particular chart the
39 June 91 year is for 15 months, so the depreciation there
40 is a little higher, it's approximately 25% higher. But
41 all the other remaining numbers have been analysed so
42 they're comparable.

43 So, what we did then was we went back and used the
44 Commission's method to estimate NOPAT after revaluations,
45 tax and the accounting rate of profit, and we came to the
46 conclusion that NOPAT before revaluations had been
47 overstated by around about \$18.6 million and, of course,
48 that would flow through to the rest of the analysis.

49 And, that's the result. Obviously a lot of those
50 numbers are actually driven by the overestimates of

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1 revenue and in the mid-90s the underestimates of costs,
2 as you can see in 1989, the Commerce Commission -- or the
3 Commission has overestimated our NOPAT by around about
4 4 million, and that is really the result of
5 the -- putting all of the terminal revenue into airfield.

6 So, just to summarise: The historic returns that we
7 calculated are significantly different in the early part
8 of the part of the last decade, than what the Commission
9 calculated. The overall result is that, compared to the
10 Commission's average of 2% excess returns, we have come
11 up with a minus 3% average excess return, and that is
12 without addressing any of the asset valuation issues, and
13 it's also using the Commission's assessment of WACC. So,
14 all we've done is just gone back and said, well, if we
15 take perhaps a more realistic approach to the assessment
16 of costs and we also correct the more obvious errors with
17 the assessment of revenue, that is the overall result.

18 Does the Commission have any questions at this
19 point?

20
21 CHAIR: I'll ask one and others may want to. That 99 one
22 is presumably revaluation at that time?

23
24 MR SEED: Correct.

25
26 CHAIR: Were there any revaluations in that period before?

27
28 MR SEED: My understanding is that the Commission's
29 approach is to spread revaluations back but there is an
30 amount of around about \$3 million which is included in
31 that particular year as a revaluation.

32 Now, I do have one issue with that, and I note that
33 in 1999 the Commission has used a land value for CIAL of
34 around about \$12 million, and that seems to be the amount
35 that would apply for the total CIAL airfield land that's
36 reported for financial disclosure purposes. In other
37 words, it's the definition of land for -- under the
38 "identified airfield activities" definition. In other
39 words, it includes land that's held for future
40 development.

41 In the following year, in the year 2000, the
42 Commission has actually used \$9.6 million for the
43 airfield land valuation, which is actually the land
44 valuation or the valuation of land that's used just for
45 pricing purposes, because just recall that CIAL has
46 actually backed out that land that's held for future
47 development, so there's an inconsistency there and the
48 revaluation spike actually arises because of that
49 inconsistency. We have not taken that out here, we are
50 just demonstrating what would happen if the Commission

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1 adjusted the revenue figures and also adopted a more
2 realistic approach to allocating costs back through time.

3

4 CHAIR: Evan Gamby.

5

6 MR GAMBY: Can I just ask you Mr Seed, I think you said you
7 whacked out land held for future development purposes.
8 Can you explain to the Commission why you did that for
9 charging purposes, please?

10

11 MR SEED: Certainly.

12 The reason that we removed, in this case land that
13 was held for future development, was because it is just
14 so far in the future. In this case it would be beyond
15 15, 20 years that that land, which comprises a
16 golf course and also other land that's to the west of the
17 main runway, could potentially be used for a third
18 runway, don't forget CIAL already has two runways. So
19 that was the reason that we actually took that land out.
20 It was a timing and proximity issue more than anything
21 else.

22

23 MR GAMBY: I think the Commission is particularly
24 interested in the timing issue of backing out land. If
25 the period was considerably shorter and there was an
26 identifiable need for, say, another runway but the timing
27 was not quite right, would you leave it in or would you
28 back it out?

29

30 MR SEED: Yes, we would have left it in because, once
31 again, it comes within the time horizon that we'd be
32 using.

33

34 CHAIR: Thanks Mr Gamby.

35

36 MR SEED: Thank you.

37 The second part, or the second leg I guess to the
38 analysis of the Commission's CIAL analysis, was that we
39 looked at the Commission's allocation of future excess
40 returns.

41 Now, these are important because they affect the
42 calculation of allocative efficiency and excess returns,
43 and they're determined as a result of a number of
44 assumptions, in particular the assumptions about airfield
45 revenue, assumptions about the cost of capital,
46 assumptions about operating costs and assumptions about
47 the asset base, and the value of the asset base.

48 Now, all we've done in this analysis of future
49 returns is just to look at the revenue issue, we've just
50 looked solely at the revenue issue in this particular

1 case. In my cross-submission, you may recall in my
2 earlier written material we also made some adjustments to
3 WACC and the asset values to look at the sensitivity of
4 the outcomes through. However, in the cross-submission,
5 and what I will be discussing today I'm just looking at
6 the revenue issue.

7 There are a number of significant errors in the
8 Commission's assessment of future CIAL airfield revenue,
9 and I guess the main one is one that we've picked up and
10 we noted in the earlier submission on the draft report,
11 that was the inclusion of around about 4,600 movements
12 for a Tupolev 154, and that it's an obvious transposition
13 between -- well, it seems to us to be an obvious
14 transposition between a metro-liner, which is a smaller
15 aircraft, weighing about 7 and a half tonne, and a
16 Tupolev 154, which is a larger aircraft, weighing roughly
17 at about 100 tonne. These aircraft are similar to the
18 Boeing 727. They seat about 160 people.

19 So, what will happen there is you take the prices
20 that we calculated, and that aircraft wasn't ever
21 included in the allocation of reference revenue, you're
22 going to end up with an overstatement of reference
23 revenue, you can't help but do that.

24 Just to step back for a second just to describe to
25 the Commission how we actually calculate prices: What
26 we've done is, in the pricing model we've determined the
27 reference revenue for airfield, and then we have
28 allocated that reference revenue between the various
29 aircraft that use the airport.

30 It's important to note that your assumptions about
31 your fleet mix -- what airports refer to as their "fleet
32 mix" -- are critical to the price that's are determined.

33 If you only had one type of aircraft landing at
34 CIAL, obviously you're going to have one price and that's
35 going to apply right across and it won't really matter
36 too much. But if you have a range of different aircraft
37 and they fall into different what we call MCTOW bands,
38 your central assumption about how those bands or how the
39 dynamic between, say, the airline's use of different
40 aircraft in different bands changes through time, can
41 have a significant effect on the out-turn.

42 For example, if airlines start to use aircraft that
43 have -- that what we call lower gauge, smaller aircraft,
44 so they increase their load factors and so on and so
45 forth, you're going to end up with a situation where you
46 will be under-recovering on your reference revenue
47 relevant to what you should be.

48 So, what happened here is we calculated prices based
49 on one set of fleet mix assumptions, the Commission has
50 then used those prices with a completely different set of

1 fleet mix assumptions, and this is one of the major
2 differences, obviously.

3 Second major difference was, they or the Commission
4 in its analysis double-counted the movements growth for
5 the year 2001. The domestic movements were inflated by,
6 I think it was around about 6% from memory, although I'd
7 need to check that figure, and the international
8 movements were also inflated by another number, across
9 the board irrespective of the type of aircraft.

10 Now, that introduces a bias because not all aircraft
11 have increased at the same rate, but also our estimates
12 for 2001 took those increases into account in the first
13 place, so any further percentage adjustment was going to
14 double-count that.

15 The third point is that there was no adjustment for
16 changes in fleet mix. Now, during 2001 there's obviously
17 been some significant changes in fleet mix at
18 Christchurch. There was an initial complete drop in the
19 146 or the whisper-jet usage at Christchurch due to the
20 demise of Qantas New Zealand, subsequently those aircraft
21 have been reinstated and are being used by Air
22 New Zealand and being operated out of what we call
23 Domestic Terminal 2 out of Christchurch, which was the
24 old Ansett terminal.

25 There's also been increased 737-300 usage by Qantas
26 areas, and there's also been a number of other changes,
27 although we haven't necessarily picked those up with the
28 numbers that we put in. For example, Korean Airways have
29 stopped flying the B777-200 series to Christchurch and
30 that has also had a significant impact on the fleet mix
31 there

32 So, for the year 2001 the Commerce Commission said
33 that we -- or rather, for the first year of new prices,
34 and it's a little bit confusing from the Commission's
35 analysis whether they meant for the full financial year
36 ended 30 June 2001 or whether they meant for the full
37 calendar year ended 31 December 2001. We've assumed in
38 this analysis that we're talking about the end of the
39 financial year.

40 For the end of the financial year, 30 June 2001, the
41 actual CIAL revenue for the airfield was \$9.6 million.
42 In the Commission's analysis, the number that's been used
43 is around about \$17.6 million.

44 So, the Commission's assessment was around about
45 \$8 million more than what CIAL's actual out-turn was.

46 And also, due largely to the Tupolev error, the
47 landed MCTOW was around about half a million tonnes less
48 than the Commission's assessment of 2.3 million tonnes of
49 landed MCTOW.

50 Now, these are quite critical because they are all

1 inputs to the assessment of excess returns and allocative
2 efficiency.

3 So, if we can just leave -- this is the first -- or
4 this is the, if you like, it's a transition year, just
5 recall that CIAL's new prices actually came into force on
6 1 January 2001 for the airfield, so we've only had
7 six months of the new prices, the old prices applied from
8 1 July 2000 to the end of December 2000. So we've sort
9 of had a transition year in this particular year.

10 So, if we look at what actually happened in the
11 first full year, the implications are that our airfield
12 revenue is significantly lower still in the first full
13 year if we correct for the fleet mix issues. In fact
14 it's around about \$4,500,000 less than the Commission's
15 assessment. The total landed MCTOW is around about 470,
16 480,000 tonne less than the Commission's assessment.

17 The average landing charge per tonne is about \$7.10,
18 the Commission said about \$7.55 and, as I said before,
19 without changing anything else, without touching any of
20 the other assumptions about WACC or the asset values, the
21 excess returns, instead of being \$3.8 million are around
22 about \$800,000. So, we believe that these are
23 significant differences and obviously we'd like the
24 Commission to take these points into account.

25 Are there any questions at this point, Mr Chairman?
26

27 CHAIR: Yeah, I'll just see, Mr Seed. Susan Brown, do you
28 wish to comment at the moment on those figures?
29

30 MS BROWN: No.
31

32 MR CURTIN: Just one question, Mr Seed, if I could.

33 You showed that the airfield revenues, as you've
34 recalculated them back over time, were relatively
35 constant, say, from 1990 onwards. What was the growth in
36 MCTOW or any other measures of real landings over, say,
37 1990 to 2000? Because I'm wondering, if there was a real
38 growth in activity why the revenues would have stayed
39 relatively stable. I'm not disputing it, I'm just trying
40 to come to an understanding about it.
41

42 MR SEED: I'm sorry, I don't have the data with me and I'd
43 be only guessing off the top of my head, but I can supply
44 that to you.
45

46 MR CURTIN: Mmm, I think it would be interesting. As I
47 say, I'm in no way disputing it, I'm just wondering how
48 did things line up.
49

50 MR BELLEW: I could give you some preliminary comments.

1 There's a reasonable correlation between MCTOW and
2 passenger growth and, on average, passenger growth would
3 have been in the order of about 2.5% for domestic and
4 probably closer to 6% for international. But there's
5 been a change of setting that in terms of more efficient
6 aircraft, in terms of smaller aircraft which works the
7 other way, so those are the factors that basically
8 impact. But there's been real growth in that time
9 definitely measured at the passenger level.

10

11 MR CURTIN: Thank you very much.

12

13 CHAIR: Just to follow that quickly. So the
14 extrapolations, we have entered June 2002, the change in
15 aircraft mix, notwithstanding passenger growth, brings
16 that total landing charge figure down? I think that's
17 what you're saying, Mr Seed, looking at your -- for the
18 year ended 30 June 2002 tonnage is 1.8 as against 2.3.
19 One assumes if passenger growth carried on there's been a
20 change in aircraft mix that, in essence, I presume has
21 more smaller aircraft comparatively than larger ones?

22

23 MR SEED: Mr Chairman, what I have attempted to do in the
24 time available between when we were preparing the
25 cross-submission, was to go back and look at the 2001
26 year out-turn, and given the information -- of course,
27 hindsight's a wonderful thing and we were lucky enough to
28 have the out-turns that the Commission did not, so we
29 were able to use the information for the second half of
30 2001 to infer what the fleet mix would actually look like
31 for 2002, and I have included those as Appendix C1 and
32 Appendix C2 to my cross-submission.

33

34 The main differences there, as I said, were due to
35 the change in B146 movements and also 737 movements, that
36 was how we estimated the fleet mix there.

36

37 CHAIR: Thank you.

38

39 MR SEED: If there are no further questions on that
40 particular part of my presentation, I'd now like to move
41 on to a discussion of optimisation issues. That will
42 then be followed by a discussion of the ODRC and then a
43 discussion of DCF, so we're around about a third of the
44 way through.

45

46 CHAIR: That's fine, because this is another important
47 issue -- principle as well as specificity.

48

49 MR SEED: So, we've been dealing here with issues, there's
50 been some principle issues here but their mainly numbers.

1 We're now going to be talking about some further
2 principles.

3 In terms of my presentation on optimisation, I'd
4 like to address three or four main points, and they are
5 firstly, what is optimisation and does it matter? The
6 second point is, should optimisation include any
7 allowance for hindsight? In other words, should we be
8 able to look back and with the benefit of hindsight make
9 adjustments? I'd like also to touch on CIAL's pricing
10 principles, which were introduced in the pricing
11 proposals that it discussed with airlines and also that
12 we've relayed to the Commission. I'd like to discuss
13 some international trends in this area as well.

14 In terms of what the Commission means by
15 "optimisation", the Commission set out its definition of
16 "optimisation" at paragraph 7.48. I, with respect, think
17 that the Commission's definition of "optimisation" is
18 somewhat incomplete and perhaps a bit misleading.

19 It's paragraph 7.48. The Commission's definition
20 implies that optimisation is only really related to the
21 quantity of assets used to provide the service.

22 Now, I believe that optimisation involves more than
23 making adjustments "just to the quantity of the assets,
24 and thereby reflecting changes in the required deployment
25 of the scale of assets", unquote, as the Commission
26 states. I believe that optimisation is more fundamental
27 and is effected at two levels.

28 Firstly, it's effected at the determination of the
29 replacement cost of the asset, and this is where this
30 notion of the modern equivalent asset comes into play.
31 And secondly, optimisation cuts or bites in terms of
32 determining the quantities of the asset that are to be
33 included. So, there's these two steps.

34 Now, what I'm going to be introducing today is
35 nothing new. As we'll see later, these concepts -- if I
36 was speaking at a Valuers' Conference I'd be looked at
37 long and hard for, "Why are you telling us this?"
38 However, they're perhaps -- as we've already
39 seen -- they're perhaps new or different ways of thinking
40 about the ideas of asset valuation, you know, if you are
41 coming into it cold.

42 The way I view optimisation is that, it involves
43 making adjustments to the asset values to take account of
44 technological obsolescence, redundancy and surplus
45 assets. Now, this term "the modern equivalent asset", if
46 you like, corrects for changes in technology, and also to
47 a large extent obsolescence I guess.

48 What we're looking for is the, if you like, the
49 cheapest way of replicating the utility that's provided
50 by a particular asset; that's what we're aiming to do.

1 We're trying to say, well, if you actually were going to
2 build, say, a hospital today and you were faced with an
3 existing hospital -- sorry, you were faced with a range
4 of choices, how would you go about a building it?

5 Now, that's the question that valuers ask themselves
6 if they have to stump up and actually value a hospital
7 such as -- I'm trying to think of an example -- I'm sure
8 David Clark won't mind -- but if we talk, say, about
9 South Auckland Health as a hospital.

10 That was a hospital that was built back in the
11 1940s. It was built beside the railway station because
12 the troops were going to come through from the wharves,
13 you know, the wounded troops were going to come down from
14 the South Pacific and it had things like tuberculosis
15 wards, it was built out of double brick plastered on the
16 outside, which is a very expensive way of building a
17 hospital.

18 Now, if you were going to build another hospital
19 today, you would do that quite differently, you would
20 probably use tilt slab construction and you would find
21 that the cost of replicating that particular level of
22 utility or replace the asset, not reproducing asset but
23 replacing the asset would be considerably less.

24 Now, the same thing applies with airports, because,
25 for example, when we undertook the valuation of the CIAL
26 terminal, not the -- not that terminals are part of this
27 discussion, but just to use it as an example -- the
28 domestic terminal was valued using the same rate per
29 square metre of replacement cost as the international
30 terminal. The domestic terminal, to rebuild it brick by
31 brick, in exactly the same way that it's actually
32 standing there today, would have been considerably more
33 than the replacement cost.

34 So, do you see what optimisation is trying to do
35 here? It's trying to say, what is the least cost
36 replication of the existing utility?

37 Now, that's the first part. The second part is
38 obviously correcting for the idea of any kind of surplus
39 assets, and we can deal with that later.

40 But, the point I'm trying to get across here is
41 that, optimisation with these two parts, it just doesn't
42 mesh in very well at all with the concept of historic
43 cost, because historic cost is, or could be in CIAL's
44 case, a cost that was based on a construction technology
45 that could have been up to 50, 60 years old.

46 And if we're trying to say, well, what rate of
47 return should an organisation be earning today on the, if
48 you like, the -- its investment today, to me that seems
49 incongruous.

50 So, just touching on these points and just

1 summarising; what does optimisation actually do? Well,
2 if you look at how it actually works in practice -- and I
3 guess I come to this topic as a grimy finger-nailed
4 practitioner, because this is what I largely do for a
5 living, is to look at these types of problems and, just
6 as an aside, these types of optimisation issues aren't
7 just applied to network assets or sewerage assets, or
8 other types of monopoly-owned assets, they are applied to
9 specialised assets in general.

10 Now, specialised assets can be owned by a monopoly
11 or somebody operating in a non-contestable market, they
12 can also be owned by a business operating in a
13 contestable market.

14 I just want to make that point and make sure that's
15 made quite clearly, that ODRC is applied to specialised
16 assets.

17 The test isn't whether those assets are owned by a
18 monopoly or whether they're owned by somebody in a
19 contestable market, they're applied to specialised
20 assets.

21 Now, in association with other professionals in this
22 room, I have been involved in the valuation of assets
23 such as breweries; I've been involved in the valuation of
24 assets such as bottling plants that have been owned by
25 businesses that have shares that are traded on the
26 Stock Exchange and compete -- or rather, the products
27 that they produce compete in contestable markets.

28 So, the assets themselves are specialised; their
29 output doesn't necessarily have to be of a monopoly or
30 non-contestable nature.

31 So, just coming back to this point about
32 optimisation; how do we deal with surplus assets? I'll
33 deal later with how we define what a surplus asset is but
34 once we identify an asset that's surplus, well, it's
35 explicitly optimised, and that has the impact of reducing
36 the value.

37 How do we deal with things like poor asset
38 condition? Going back to our South Auckland Health
39 example. You might argue whether health is supplied in a
40 contestable or a non-contestable market, but that's a
41 good example of valuation of specialised asset there.

42 Say, for example, if you have a run-down hospital,
43 it's poor -- there's an awful lot of remedial work that
44 needs to be done to the building, to the assets, how do
45 you deal with that? Well, those things are explicitly
46 taken account of in the optimisation process; it has the
47 impact of reducing the value.

48 How do you take account of obsolescence? In other
49 words, how do you take account of -- going back to the
50 hospital analogy -- our tuberculosis ward? Well, that's

1 reflected in the modern equivalent asset and it has the
2 impact of reducing the value. In other words, you
3 wouldn't say that you would build or rebuild that
4 particular asset in that particular way. As I used
5 before, the example of Christchurch, you wouldn't rebuild
6 a domestic terminal brick by brick and have all the
7 little rabbit warren corridors going everywhere that you
8 have at the moment; it would be a much more open
9 structure, much more efficient in terms of its heating,
10 ventilation, air conditioning etc and electrical plant
11 and so on and so forth, and you'd find that the
12 replacement cost would be much much lower.

13 The overall impact would be that it would reduce the
14 value, compared -- if I can just make this point -- all
15 of those impacts are reduced value compared to the cost
16 of reproduction.

17 It's just important that we actually make the
18 distinction here between the cost of reproduction of the
19 existing asset, as I said before, brick by brick, and the
20 cost of replacement, which is a replication of the
21 utility that's provided.

22 Lastly, if we're going to look at an asset that, for
23 whatever reason, we know is going to be or have a
24 shortened economic life, for whatever reason; could be
25 that the business is going to be shut down or something
26 like that, how do we take account of that? Or a better
27 example perhaps is that the asset is going to be replaced
28 by another asset at some point in the future. So we know
29 that that asset is only going to continue to provide that
30 utility for a limited period of time.

31 Well, what we do there is, we reduce the remaining
32 economic life of it, and once again, that has the impact
33 of reducing the value.

34 So, it's quite important that we just understand
35 these points because there seems to be, and perhaps I've
36 misconstrued sort of the mood of the views, but there
37 seems to be a view afoot that the ODRC value will always
38 be excessive and open to manipulation.

39 I would put it to the Commission that the ODRC
40 approach is very transparent, and it can be audited and
41 is audited, in fact. And I think that, if you actually
42 have a sensible valuation handbook, for example -- and I
43 think the airports have all produced documents that do
44 that type of thing -- it actually sets out the principle
45 for valuation that valuers can actually follow. For
46 example, giving some indication on how one determines
47 what the surplus assets are, giving some indication on
48 how you determine what the economic lives are, and I will
49 come shortly to describing to the Commission how you can
50 actually determine what a surplus asset is and actually

1 make some assessment about whether it should be included
2 in the asset base or not.

3

4 CHAIR: Can I ask you a question, Mr Seed, at this point,
5 and it may be better addressed to some of the other
6 submitters from other network industries next week, but
7 some of the comments at least on ODV and to a lesser
8 extent ODRC, has tended to surround the frequency and
9 results of revaluations.

10 Now, have you got a view as to whether that's an
11 inherent outcome of the valuation approach, or is it more
12 fundamental in relation to the way those assets have been
13 treated prior to corporatisation, or whatever?

14

15 MR SEED: I think it's a hangover to the past more than
16 anything. If I understand your question correctly.

17

18 CHAIR: My question is, is it based on the historical way
19 in which those assets were valued before corporatisation
20 in the case of airports or power companies or whoever,
21 rather than using ODV or ODRC as a valuation technique?

22

23 I mean some of the discussion -- I'm not taking a
24 view on it at all, particularly surrounding those two
25 methodologies -- tends to be clouded at least by the
26 outcome of revaluations over time.

26

27 So, what I'm trying to get at is, is it the
28 technique of valuation, or is it the timeframe or
29 environment in which the technique was applied?

29

30 MR SEED: I would suggest it's the latter. I don't think
31 it's the technique as such. I think to throw the
32 technique out because there's problems with the
33 environment, is throwing the baby out with the bath
34 water.

35

36 CHAIR: Thank you.

37

38 MR SEED: The next point I'd like to move to is just the
39 issue of how one optimises. My view is that optimisation
40 does rely on hindsight and I disagree, respectfully, with
41 the Commission's proposed application of the optimisation
42 principle insofar as it states -- and it states at
43 paragraph 7.48, that: "So as not to discourage
44 innovation decisions to optimise assets should consider
45 whether the decision to invest was poor at the time it
46 was made and not rely on the benefit of hindsight".

47

48 That's the Commission's view. Now, my view is that
49 that statement is incorrect as it contradicts the sort of
50 fundamental principle of optimisation as it relates to
asset valuation. I think that by its very nature

1 optimisation does rely on the benefit of hindsight, and
2 perhaps if I could just walk the Commission through my
3 reasoning for this now.

4 There are a number of possible reasons why you might
5 want to optimise the assets in terms of identifying
6 surplus assets, and for want of better names I've termed
7 these Type I, Type II and Type III reasons.

8 A Type I reason is where there's been a market event
9 subsequent to the investment that a reasonable person
10 would not have anticipated when the asset was built
11 and/or put in place. So, that's a Type I reason.

12 A Type II reason is -- and I'll give some examples
13 to these reasons to follow -- a Type II reason is where
14 there's an unanticipated technological change and, as we
15 discussed, that could be due to a building technology
16 change or somebody making a new invention, or something
17 like that, and that is going to result in a change in the
18 cost of the technology.

19 A Type III reason, on the other hand, is one that, I
20 suppose my colleague Tom Weston would called "wicked",
21 and that's where a decision was wrong when the asset was
22 built. In other words, it was a wrong decision when the
23 asset was built or put in place, and it was a decision
24 that a rational manager would not have made with the
25 benefit of all the available information. So, you think
26 of Type III decisions as being the "wicked" ones and
27 Type I and Type II decisions as being ones where you
28 couldn't have anticipated reasonably what was actually
29 happening.

30 Now, an example of a Type I reason might be in an
31 airport's case, an unanticipated reduction in airport
32 landing volumes and, therefore, required capacity, and
33 could be due, for example -- a good example recently is
34 what's happened to Domestic Terminal 2 at
35 Christchurch Airport following the demise of Qantas
36 New Zealand, that was an unanticipated event.

37 Now, a Type II reason, on the other hand, reflects a
38 change in technology, and this is going to affect the
39 cost of building or putting in place those assets, in
40 other words, it's going to dictate the cost of
41 replicating or replacing the utility of those assets,
42 it's probably gonna go down.

43 Now, as I described to you before, the cost of the
44 international terminal built in 1997 is considerably less
45 than the real cost per squaremetre of reproducing or
46 replicating on a brick-by-brick basis the existing
47 domestic terminal, which was built between the 1950s and
48 the 1970s. The later parts, obviously, in the 1980s.

49 So, you've got those two reasons. Now, the Type III
50 reason is the one that really -- I'd just like to

1 concentrate on at the moment.

2 The Type III reason involves airport management and
3 the Board of Directors effectively making a wrong
4 decision, a wrong investment decision -- for whatever
5 reason -- and furthermore knowing that they were making a
6 wrong decision.

7 Now, this could include investments that were made
8 or justified on other than good economic grounds, and I
9 guess there's always situations where, sort of, hindsight
10 plays things back at you. For example, I'm sure you will
11 all recall the Clyde Dam and the kerfuffle, especially in
12 legislation in 81, 82 and so on and so forth.

13 Now, one could say that that was a very bad
14 investment decision and probably up till this year it
15 probably has been. However, for Contact perhaps it's not
16 such a bad decision at the moment. But if we follow the
17 Commission's approach, the optimisation would actually
18 see the dam optimised because it would be without any
19 regard of the benefit of hindsight. In other words, it
20 was only a good decision with the benefit of hindsight as
21 opposed to being a bad decision.

22 So, the accepted interpretation, in valuation field
23 anyway, is that optimisation is -- or the accepted
24 interpretation of optimisation in the valuation field
25 anyway, is to treat all of these reasons for optimisation
26 as being equal or they'll all have equal weight, despite
27 the fact that they imply quite different levels of
28 managerial responsibility.

29 The first two reasons there, you know, "Awfully bad
30 luck chaps but things have changed". The third reason
31 is, "You knew that you were making a bad decision and you
32 went ahead anyway".

33 Now, the important point here is that, if the
34 Commission says that it's not going to rely on the
35 benefit of hindsight to determine if an investment was
36 poor at the time it was made, then the Commission's
37 reasoning -- under Commission's reasoning Type I and
38 Type II events would result in no optimisation.

39 Now, if we look at the third reason for
40 optimisation, for the Commission to apply this, the
41 Commission would actually have to be able to Judge that
42 there were assets that should be excluded because the
43 Commission would actually have to find that the airport,
44 or whoever, made a bad decision at the time that
45 investment was made, and it was knowingly made. In other
46 words, it was a bad decision at the time that was
47 knowingly made.

48

49 MS BATES: Could I just interrupt you at this point please,
50 because what you've said in your handout is, "Our

1 understanding is that the Commission would only optimise
2 for Type III events", and you've referred to
3 paragraph 7.48. If I can read from 7.49, the Commission
4 says:

5 "The Commission's preliminary view is that only used
6 and useful assets should be included in the asset base on
7 which the rate of return is calculated, all other assets
8 should be optimised out."

9 Now, if I can just put a gloss on that. The
10 Commission's purpose for valuing is to -- is for pricing,
11 and so what my friend referred to -- my learned friend,
12 Mr Weston, referred to was "slowing", and you know what
13 they are; whether the asset was used and useful -- and/or
14 useful, and that really links back to not sticking
15 today's consumers for any other than -- any costs other
16 than today's costs. So, that's really the rationale
17 behind the Commission's approach.

18 I think it's not right to say that, "The Commission
19 would only optimise for Type III events", I just wanted
20 to explain to you where the Commission sees itself coming
21 from on this question of optimisation.

22

23 MR SEED: Thank you. Yes, I've taken your point.

24

So, just to summarise, however -- [pause].

25

26 Just to point out, however, we do understand the
27 Commission's position on used and useful. We have some
28 comments later on the application of used and useful, and
29 I guess the discussion that I've got running down here is
30 a logical precursor to that, but I do take your points on
31 board.

31

32 MS BATES: Just excuse me one moment. [Pause]. Thank you.

33

34 MR SEED: Just moving on to the very question now of
35 starting to address the concept of used and useful, and I
36 guess saying, well, you know, how in a practical sense do
37 we determine what a surplus asset actually is?

38

39 Now, our view is that you need to consider a number
40 of questions, and not the least being, for example, when
41 you start asking these questions is the asset, for
42 example, one not being used now but is going to be used
43 in the future and how far away in the future is that? Is
44 it one that's never going to be used at all? And, is the
45 asset that we're talking about one that's temporarily
46 unused say, for example, because of a schedule change but
47 may well be used within the planning horizon of the
48 business?

48

49 Now, in terms of addressing some of these questions,
50 the New Zealand Infrastructural Asset Management Manual,
commonly called "the NAMS manual", N-A-M-S manual, gives

1 some guidance in this area, and suggests that, "Surplus
2 assets reflect the extent..." -- and this is a quote --
3 "...reflect the extent to which some assets are now
4 redundant. An example could be a road bypass or a bridge
5 which is still in place does not serve any purpose". In
6 other words, it's obviously a surplus asset.

7 Furthermore, the NAMs manual emphasises that, "For
8 valuations purposes the existing system configuration
9 should be used and only optimised in part where it is
10 clear that those parts of the system would be
11 reconfigured differently if replaced". That's more of a
12 systematic issue.

13 But I guess what we're trying to get across here is
14 that, optimisation for surplus assets is not an ad hoc
15 approach, it's one that is closely related to the
16 organisation's asset management plan. And I think that's
17 an important issue because there was no discussion of
18 that -- or my understanding is that there was no
19 discussion of that in the Commission's documentation, and
20 I'll introduce later a concept of how these asset
21 management plans can be used to determine what surplus
22 assets are.

23
24 MS BATES: Could I just ask you a further question.

25 Is it your view that the only assets which should be
26 optimised out are surplus assets? And I'll add to that.
27 When you are looking at a valuation for pricing purposes,
28 do you think the only assets that should be optimised out
29 are surplus assets?

30
31 MR SEED: I would just like to step back from that, if I
32 could, and just go back to our definition of
33 "optimisation" that we're talking about. Optimisation
34 occurs at two levels, you optimise for surplus assets and
35 redundant assets, you also correct for obsolescence.

36
37 MS BATES: Yes.

38
39 MR SEED: So there's two levels of optimisation occurring
40 there. So, on one hand, yes, you're identifying surplus
41 assets and taking those out, on the other hand you may
42 also be reducing the value by making adjustments to
43 replacement costs.

44
45 MS BATES: I'm not quite sure whether you have answered my
46 question because what I'm trying to get at is this; I'll
47 try and explain it as clearly as I can.

48 As I said before, we are trying to get an asset
49 value for pricing purposes. Now, given that it's for
50 those purposes, given that we're operating on the basis

1 that you only charge today's consumers for today's costs,
2 would you agree that it would be only surplus assets that
3 you would optimise out, or do you think you would
4 optimise other assets out?
5

6 MR SEED: No, you would optimise surplus assets but I guess
7 what I'm coming to is the definition of what those
8 surplus assets actually are.
9

10 MS BATES: So, would you only optimise out surplus assets
11 in those circumstances that I have described, i.e. it's
12 for pricing and you are operating on the basis that
13 today's consumers will meet today's costs?
14

15 MR SEED: If I understand your question correctly; yes, you
16 would optimise out for surplus assets but, as I said
17 before, you have to be very careful about how you
18 actually define what those surplus assets actually are.
19

20 MS BATES: But, is it only surplus assets that you think
21 you would optimise out for?
22

23 MR SEED: Well, yes. I'm sorry, I don't quite follow that
24 one.
25

26 MS BATES: Well, there may be assets which you wouldn't
27 call surplus assets but they're not used or useful, and
28 they're not assets that you should bring into account for
29 pricing purposes?
30

31 MR SEED: I beg your pardon, I don't make a differentiation
32 between what you are calling "used and useful" and the
33 assets that aren't optimised.
34

35 MS BATES: I'm just trying to understand --
36

37 MR SEED: Perhaps if I can just clarify then, I understand
38 your question. [Pause].
39 I'm sorry.
40

41 MS BATES: That's all right.
42

43 MR SEED: In terms of the used and useful. The used and
44 useful and surplus assets are inextricably related
45 because what I'm saying is that, in terms of how you
46 actually apply your concept of used and useful, and we
47 have some views on that which I'd like to explore with
48 you -- and obviously our view on the application of used
49 and useful is different than the Commission's --
50

1 MS BATES: I think that's probably what it comes down to.
2
3 MR SEED: -- and, therefore, our definition of "surplus
4 assets" is probably different than the Commission's.
5
6 MS REBSTOCK: Can I just put a follow-up question. Given
7 your definition of "surplus assets", why would
8 Christchurch optimise out the value of the land for your
9 expected runway that you're not expecting to do for
10 15 years?
11 I mean, it seems to me that definition would say it
12 shouldn't be optimised out.
13
14 MR SEED: No, I don't believe our definition of "surplus
15 assets" would say that at all.
16
17 MS REBSTOCK: But you have a reasonable prospect that you
18 will be utilising that asset at some point.
19
20 MR SEED: Because we've used a discounted cash flow
21 approach. If you take the present value of the inclusion
22 of that, it's very very low. So, for practical purposes,
23 given that that particular airfield -- sorry, that
24 particular land may not be included for something like
25 20 years, for practical purposes it was left out.
26 May I move on?
27
28 MS BATES: Yes, you may.
29
30 CHAIR: Thanks Mr Seed, please.
31
32 MR SEED: Okay. So, I guess what we're trying to get
33 across here is that, we're trying to set a value which
34 exists somewhere between the risk of systematic
35 over-capitalisation through over-building and including
36 too many assets in the asset base, and systematic
37 under-valuation of the assets through excessive
38 optimisation of the assets that still have some economic
39 value to the firm. So, we're walking a bit of a fine
40 line here and, as a practitioner who's been involved with
41 this, you actually end up having to lean fairly hard on
42 both the master plan of the company and also asset
43 management plans, and that doesn't just apply to
44 airports, it applies to basically any business, that you
45 actually have to make some realistic judgments about what
46 that business and a reasonable operator would be doing
47 there.
48 Now, I've just put in this other definition which is
49 offered by the Institute of Chartered Accountants, and
50 they define surplus assets for accounting reporting

1 purses, as "Assets for which there is no reasonable
2 prospect they will ever be required inutilising an asset
3 in its current form", and that's from FRS-3.
4 Now, all I'm suggesting here is that, Irealise the
5 Commission has a view on used and useful -- and I think
6 we understand where the Commission's coming from there --
7 I'm just asking the Commission to consider some of the,
8 perhaps, modifications to that view which mean that it
9 affects the definition of "useful".
10
11 MS BATES: Could I just say to you -- let me think about
12 how to put this -- but it may be that a valuation for
13 pricing purposes is different from a valuation for
14 reporting purposes; would you accept that?
15
16 MR SEED: No, I wouldn't actually. I believe that, if you
17 are assessing the market value of an asset, you assess
18 the market value of an asset.
19
20 MS BATES: So, you don't see the necessity to use a
21 different approach if you're valuing for pricing?
22
23 MR SEED: There may be some stipulations in, for example,
24 financial reporting standards as to things thatvaluers
25 must take into account, however, overall, if you are
26 asked to determine a fair value or a market value of an
27 asset, ultimately that's going to be the value to all
28 economic agents, not just those people determining
29 prices.
30
31 MR TAYLOR: Could I just follow-up with one there? Just to
32 understand, the value of the surplus land in Christchurch
33 for financial accounting -- reporting purposes, has
34 compared to -- we know what you've done for pricing
35 purposes -- what's it in the accounts at, Peter?
36
37 MR SEED: That's the value of surplus land, is it Peter? I
38 think from memory it's around about \$3 million but I'm
39 only guessing, I can give you the exact number.
40
41 MR TAYLOR: That's roughly?
42
43 MR SEED: It's approximately one-third of the value of the
44 land that's been used for pricing purposes.
45
46 MR CURTIN: Just if I could add one other thing. I think
47 you will be talking about what principles you actually
48 use yourselves in coming to your own view of surplus
49 assets, but looking at ICANZ definition, that's a pretty
50 demanding threshold, and I just wonder about the degree

1 of helpfulness of that definition, accepting
2 extraordinarily unequivocal situations, where a road has
3 been bypassed or something or has been -- your road to
4 nowhere situations it might cover, but virtually
5 everything else it doesn't seem to me to offer a great
6 deal of practical guidance.

7

8 MR SEED: I guess I'm, sort of, offering it as a bound in
9 this case.

10

11 MS REBSTOCK: I just would like to ask you a further
12 question following on from Ms Bates' question.

13 I assume you are taking us through the general
14 approach to valuing assets of the company, and I guess my
15 question is, are we going to get -- are you going to go
16 on and discuss beyond the issue of how they would value
17 whatever assets they have, to the issue of which of those
18 assets that are valued should be included in the asset
19 base that is used for the purposes of price setting in
20 terms of landing charges?

21 Because, it seems to me, there are two different
22 issues, and I wonder if you accept that proposition, that
23 they are two distinct issues, and whether you are going
24 to move on to the issue of how do you -- beyond the issue
25 of how this company values its assets -- how does it
26 decide which of those assets should be included in the
27 asset base for pricing purposes with respect to today's
28 consumers?

29

30 MR SEED: I do -- I deal mainly at the principles level.

31 In terms of including assets, in terms of the
32 discussion of which assets have actually been included --

33

34 MS REBSTOCK: Would you agree, then, that if you don't move
35 beyond the general issue of how a company values its
36 assets, for the purposes we are addressing here -- which
37 is about how these companies price to their
38 customers -- that this only gets us part of the way; that
39 there is a second issue we must address in order to get
40 to the point where we can decide which assets should be
41 included, which value should and which assets should be
42 included for the purposes of pricing?

43

44 MR SEED: Thank you. My discussion is actually critiquing
45 the -- or discussing, really, the Commission's principles
46 and trying to get to that very point, that, how do we
47 determine which assets need to be included in the asset
48 base.

49

50 MS REBSTOCK: But what I hear you critiquing is an approach

CIAL

1 to valuing a company's assets for the purposes of valuing
2 company's assets. What I don't hear is a critique of how
3 the Commission has decided which assets should be
4 included in the asset base for pricing purposes.

5 And so, I just would like to know if you are going
6 to move at some point on to that issue?

7
8 MR SEED: [Pause]. Just a point to note for the
9 Commission: There haven't actually been any assets
10 optimised out at Christchurch so, that's actually not
11 part of the discussion here for a start. But, what I
12 would --

13
14 MS REBSTOCK: I understand that.

15
16 MR SEED: But what I would like to point out is, we are
17 going to be dealing directly with the used and useful and
18 how we actually operationalise that right now in the next
19 slide.

20
21 MS REBSTOCK: Thank you.

22
23 CHAIR: I think, Mr Seed, at the end of the presentation we
24 could probably come back individually to ask more
25 specific questions if it's not covered in the further
26 part of the paper. So I suggest you carry on as you are
27 doing and then, if there are any more questions about the
28 application of the principles once you've been through
29 the use and useful analysis, I suggest we come back to it
30 then.

31
32 MR SEED: Just touching on that very question of pricing
33 principles: CIAL, from its first discussions with the
34 airlines, has always included pricing principles in its
35 discussion. CIAL agrees with the Commission, that
36 principles are required but I guess -- and this is the
37 very point -- the very nub that we're coming to -- is
38 that, from our point of view, the used and used principle
39 is actually undefined.

40 For example, what does it actually mean?
41 Does -- there are a range of possible meanings that we
42 could actually attribute to that, but does it mean, for
43 example, that assets that are going to be used in one,
44 five or 10 years, CIAL's got a five to 10 year planning
45 horizon, should it be including those assets. And I
46 guess one of the things that we touch on is that, there
47 is some potential there for some contradictions in the
48 Commission's definition.

49 Our understanding -- and we use the term "naive", we
50 don't mean it pejoratively, we just mean a crude

1 understanding of what you are talking about -- is that
2 "used and useful" means only assets immediately required
3 are counted in the asset base. In other words, only
4 assets that -- for example, if you could think of an
5 airfield that only needs a certainmetreage of runway,
6 only those assets are actually required; any excess is
7 optimised out.

8 Now, there are a number of potential issues there
9 that I'd just like to raise. One is that, it's one thing
10 to make what amounts to a stroke-of-the-penoptimisation
11 of an asset base. It's another thing to take account of
12 the actual costs of putting in place these types of fixed
13 assets, managing them through time, and dealing with the
14 flexibility and the demand for those, and I guess it's
15 just the same as any other network operator, it's the
16 same sort of principles that face any other network
17 operator.

18 For example, just looking at Christchurch and its
19 operations with airlines; the airport determines its
20 prices looking forward, while bearing in mind that costs
21 are fixed over the pricing period and the airport has
22 little or no control over the demand that's going to be
23 placed on those facilities, it doesn't actually stop
24 aircraft landing there, it doesn't turn people away.

25 Now, one reality is that every six months the
26 airlines basically rejig their timetables. Now, that is
27 also done functionally unilaterally, the timetables
28 change and on international that can have quite marked
29 effects on peak hour pax demand and in the arrivals hall,
30 departure hall and so on.

31 Now, overall then, what we're looking at here is,
32 faced with this kind of volatility going on out there,
33 and also faced with the fact that you've got a facility
34 that you're managing, you've got decisions to make about
35 when you expand, how you operate the facility and so on
36 and so forth, surely the overall goal of the asset
37 manager is to minimise what I've termed here "life cycle
38 costs".

39 In other words, if you build an asset, you are
40 probably going to build an asset that is more than the
41 capacity that you actually currently require. I would
42 suggest to you that it's commercial commonsense that,
43 when, for example, a terminal or another building -- or
44 whatever building that anybody's going to construct is
45 built -- there will always be surplus capacity.

46 It would be very unlikely for somebody to go and
47 build something that, when the building was opened,
48 satisfied that capacity perfectly and then, the day
49 after, was instantly operating in a situation where there
50 was excess capacity.

1 Likewise, it's unrealistic to expect infrastructural
2 asset operators to be able to perfectly match the
3 capacity at each particular point in time with the
4 demand. How else could they do it?

5

6 CHAIR: Can I just ask you a question there.

7 If you're developing a gas field or, say, a pulp
8 mill in a competitive market, if you build another paper
9 machine, say, in a paper mill; then, until you are
10 actually producing paper out of that mill, if there's a
11 glut of world paper in the market at that time, can you
12 logically include costs of that new mill in your pulp
13 price?

14

15 MR SEED: I think you'd have to view it from the point of
16 view of a mark in an equilibrium and I think, if you look
17 through any contestable company, you're never going to
18 find a line item in the trial balance that says, you
19 know, "to holding costs for future development", or
20 anything like that. But what you will find is that, for
21 those businesses to be sustainable and to be able to
22 maintain shareholder wealth, their prices must reflect
23 those holding costs. If the prices did not reflect those
24 holding costs --

25

26 CHAIR: But you mightn't be able to do it initially. Pulp
27 might be a better illustration than gas. I mean, to
28 develop a gas field, ideally you will want somebody who's
29 going to build a gas fired power station. But if you are
30 selling pulp on the world market, on the spot market,
31 where demand goes up, capacity's built above demand and
32 there's an interregnum while prices build up again and
33 your new capacity is used.

34

35 All I'm saying, in that sort of market, if one's
36 investment, even when it's coming on stream officially,
37 pulp prices may still be depressed so you can't recover
38 development costs of that pulp at that point.

38

39 MR SEED: Why would pulp prices be depressed, Mr Chairman?

40

41 CHAIR: Just as an example. As I understand the pulp and
42 paper industry -- I'm not an expert on it -- it does tend
43 to have capacity going in steps, that you build more
44 capacity than you would use, and pulp prices again are
45 notoriously volatile on the spot market. So there, where
46 you've got to compete with other pulp producers, there
47 may be a time where, even though your asset is being
48 built or developed or may be even used, you may not be
49 able initially to recover the costs of that asset in your
50 pulp price.

1 Now here, and it may be the same with other network
2 industries that are in a monopoly position, if in fact
3 you had an airport next door and the same thing was
4 happening as with the paper mill, would you be able to
5 bring those developmental costs of your assets on stream
6 when you wanted to, rather than when the market allowed
7 you to?

8
9 MR SEED: I guess what we're saying here is that we're
10 trying to determine a set of equilibrium prices and in
11 "E" the value of the business is going to be maintained,
12 shareholder wealth won't be destroyed because, under the
13 scenario you've just put, it would imply shareholder
14 wealth would be destroyed.

15
16 CHAIR: Certainly the shareholder is more at risk, I think,
17 in that competitive market situation than perhaps a
18 monopoly situation.

19
20 MR SEED: Yes, but certainly I would agree with you that
21 you would be penalised for over-investment. What we're
22 talking about here is not being penalised for
23 over-investment, but the prices reflecting prudent
24 investment.

25
26 CHAIR: Thank you.

27
28 MS REBSTOCK: I wonder if you could tell us what you would
29 consider a workable definition of "used and useful" for
30 these purposes?

31
32 MR SEED: That's actually on the next slide. If it's not
33 the next one, it's very soon. It will either be just
34 before or just after morning tea

35 Just going back to what we were discussing there,
36 we're saying the ideal is -- well, one way to consider
37 this is to look at the problem from the asset manager's
38 point of view as being one of selecting an investment
39 profile, or a project scenario whereby you're actually
40 minimising your life-cycle costs. And those life-cycle
41 costs of that asset are going to be affected by the scale
42 of the development, the opportunity cost of capital
43 obviously, and also -- I haven't put it up there -- but
44 it's the number of stages in the development.

45 Now, if you incrementally increase your capacity so
46 it's sort of, like every year you're increasing -- I
47 guess a classic one is at an international terminal where
48 you would be increasing the size of the departures area,
49 increasing the size of the arrivals lounge in each year;
50 I think you could imagine the amount of disruption and

1 the extra staging costs that would be involved.

2 So, if we're not going to incrementally increase the
3 size of those facilities in each and every year, what is
4 the optimal scale of the development? How do we tell?
5 Should we build a terminal which is going to do us for
6 20 years? Should we build a terminal which is going to
7 see us through the next two to three years?

8 One way of assessing this is to look at the present
9 value of the life-cycle costs, and effectively choose the
10 one or choose the scenario that actually has the lowest
11 life-cycle costs, because, as the ACCC point out in their
12 draft pricing principles, there are a number of
13 situations where, if you actually over-build, or
14 over-build in the sense that you are building more than
15 is actually required immediately, the present value of
16 those life-cycle costs will be lower because you're
17 building a larger area, so construction costs on average
18 will be lower; you are avoiding a lot of staging costs,
19 they will be reduced.

20 So, I think any idea of used and useful, from a
21 practical point of view, has to actually take account of
22 not just a snapshot in one particular year, but actually
23 should look at minimising the present value of those
24 life-cycle costs.

25 [Pause]. Sorry just before I moved on I realised I
26 hadn't discussed a couple of remaining points on this
27 particular slide.

28 Now, if we were to look at the way that the
29 Commission seems to be operationalising or seems to be
30 planning to operationalise the used and useful
31 concept -- and I just want to pick up on one point here
32 and perhaps it can be clarified.

33 I gather that the Commission's prepared to roll
34 forward holding costs, including or excluding the cost of
35 capital on land? Say, for example, if land is bought
36 today, not that this affects CIAL, but say if land is
37 bought today and it's not going to be used for, say,
38 five years, the Commission makes the point that it's
39 prepared to roll forward costs, holding costs to the
40 point where they don't exceed -- in other words, the cost
41 today plus the holding costs don't exceed the opportunity
42 cost at that particular point in time.

43 Now, the Commission has explicitly excluded any
44 discussion of that from sealed surfaces and airfield
45 improvements, it won't really forward the holding costs
46 there.

47 But, if holding costs are to be rolled forward to
48 future periods, then it just seems to me that there's a
49 potential contradiction there, and I just put it to you
50 just to consider, that if holding costs are rolled

1 forward, does that mean that today's consumers in the
2 year, say 2005, are actually paying yesterday's costs as
3 well, because those holding costs actually relate to
4 previous periods.
5

6 MS REBSTOCK: But they relate, don't they, to an asset
7 that's going to be used in a future period, which is the
8 key issue, isn't it? For pricing purposes, isn't the key
9 issue not when the costs were incurred but when somebody
10 actually gets -- when and who gets the benefit of them?
11 Isn't that the key issue for pricing purposes?
12

13 MR SEED: Oh, I agree entirely but I think you should also
14 be aware that any user of a current facility generates
15 costs that are going to be incurred in the future as well
16 as benefitting from past investments.

17 So, I guess that's one of the difficulties that I
18 have with today's consumers only paying today's costs.

19 It's appealing as a concept, but just
20 operationalising it, I think it's fraught with problems,
21 and I think there are other ways that the Commission can
22 look at this particular problem and achieve ultimately
23 the same result.
24

25 MS REBSTOCK: I understand what you are saying -- I think I
26 understand what you are saying, and I think others have
27 noted in their submissions that -- I'm not sure if this
28 is what you are getting at, but that it is possible that
29 today's consumers help contribute to congestion and,
30 therefore, the need for further investment down the
31 track.
32

33 MR SEED: That's one of the costs.
34

35 MS REBSTOCK: But isn't it possible -- if the Commission
36 were to accept that argument, would it not be possible
37 that that can be taken account of in the "used and
38 useful" definition?
39

40 MR SEED: Well, yes, it is possible. What I am putting
41 forward though -- and I put forward in the
42 cross-submission when we've been talking about the way of
43 calculating the present value of life-cycle costs, is a
44 way of smoothing those costs through time to more
45 realistically take account of the costs that are imposed
46 and the benefits that are received by a consumer at any
47 particular point in time.
48

49 MS REBSTOCK: How -- I mean, I understand what you are
50 saying; how do you deal, then, with some of the issues

1 that, for example BARNZ raises about the need to ensure
2 that the entity -- in this case the airports -- have
3 appropriate incentives to ensure that what they invest
4 in, is invested in at the most appropriate time and in
5 the most appropriate way, and takes full account of any
6 opportunity costs that it ought to? I mean, how do you
7 weigh up those competing concerns?
8

9 MR SEED: Well, this is what I'm discuss -- I'm not
10 discussing right now, but we come to later in a
11 discussion of a point -- it's a wee way on -- but it's
12 really sort of introducing this idea of optimised renewal
13 decision-making. It just means that you look at the
14 benefit cost ratios of the benefits to undertaking a
15 certain scale of investment now, versus the costs, and
16 those are benefits to the acquirers as well as costs to
17 the acquirers, and basically you choose the scale of the
18 development that actually has the highest benefit cost
19 ratio.

20 That's what I'm proposing to the Commission as a
21 working solution to this, because as a practitioner the
22 used and useful slogan, principle, call it what you will,
23 is sufficiently undefined to make it unworkable, and you
24 would have two parties sitting on either side of the
25 table with, basically, no basis for discussion or
26 comparison of the competing points.

27 And all I'm suggesting is that, if we looked at
28 optimised renewal decision-making, which is a tool or a
29 concept that's put forward in the NAMs manual, the
30 Infrastructure Asset Manual for New Zealand, it actually
31 provides a framework that you can use to work these
32 particular issues through, and that's what I'm
33 suggesting.

34 So, I'm sorry, I don't have a two or three sentence
35 reply to you, how would you operationalise that? My
36 reply is, here's the methodology, perhaps we need to
37 investigate it a bit further.
38

39 MS REBSTOCK: Does that methodology deal with the issue
40 that has been raised in some submissions, that -- you
41 know, we do see examples in other jurisdictions where the
42 acquirers agree to pre-finance some of the costs, but in
43 those jurisdictions there is often a regulatory body
44 that, in a sense, enforces the contract so that the
45 acquirer knows that if it makes the investment, that it's
46 going to actually receive the benefit of it, that there
47 is a commitment there that's actually able to be
48 supported.

49 Does the approach that you are suggesting deal with
50 that particular issue, in an environment where -- that's

1 more akin to what we have no New Zealand now than in
2 these other jurisdictions?

3

4 MR SEED: What I'm proposing is a methodology, it's not a
5 contractual arrangement between two parties, and that's
6 more of an issue perhaps that Mr Bellew might like to
7 discuss later on this afternoon when we're talking about
8 the effectiveness of the consultation side.

9

10 MS REBSTOCK: Okay, I mean, I think it would be useful if
11 when we get to that stage, you address the incentive
12 issues around that sort of methodology, because
13 obviously, you know, that's what's leading a lot of the
14 Commission's considerations in this area. Thanks.

15

16 MR SEED: Mr Chairman, I've still got about another 15 odd
17 slides to go through, and I was just wondering whether it
18 might be appropriate to break at this point.

19

20 CHAIR: I think probably we could take a break now and come
21 back say, at around 11 and carry on, Mr Seed. Thank you.

22

23

24 [Adjournment taken from 10.45pm to 11.10am]

25

26

27 CHAIR: Mr Weston, back over to you, please.

28

29 MR WESTON QC: Thank you Chairman. We're running into a
30 slight timing problem with Professor Terry Boyd, who
31 we're going to have to interpose at some point. So it's
32 really an issue of when.

33

34 What we were suggesting is that Mr Seed continue for
35 now. He's going to finish to the end of his optimisation
36 section at least, which will get to the point where he
37 was discussing with Ms Rebstock the solution, how he was
38 going to operationalise this, so that's another
39 half-dozen slides. If he gets through that relatively
40 quickly, he'll try and do the three or so slides he's
41 got to deal with on ODRC and stop at that point. If we
42 take a bit longer, he'll stop before ODRC, leaving ODRC
43 and DFC -- DFC, that was Freudian, wasn't it -- DCF for
44 after Professor Boyd. So, if that's convenient, that was
45 what we had proposed.

46

47 CHAIR: That will fit in with your timing?

48

49 MR WESTON QC: Yes, thank you very much.

50

CHAIR: Over to you.

1
2 MR SEED: Thank you. Just picking up on this idea of why a
3 naive application of used and useful will lead to the
4 wrong investment signals. Recall that when I said that
5 it was a naive application of used and useful, it was
6 meaning that only the assets that are actually currently
7 being used by the current users would count into the
8 asset base; this is despite the fact that it may be a
9 rational economic action by an airport operator to build
10 a terminal facility or to build any other facility which
11 is actually larger than that.

12 If I can just skip down to one slide, this helps
13 describe what I'm talking about.

14 I've used the example of a terminal because most
15 people can visualise it a bit more easily than
16 visualising an airfield runway. In this case I've
17 assumed that there is a terminal project on the books,
18 that a terminal needs to be replaced, renewed, it's at
19 the end of its economic life, and the project is being
20 contemplated.

21 Now, assuming that one has undertaken some form of
22 optimised renewal planning procedure and looked at the
23 life-cycle costs and chosen the scale of development
24 which says, okay, well let's look at a 16,000 square
25 metre terminal development, and everybody agrees that
26 that's appropriate, this is how it would actually pan
27 out.

28 The terminal as it stands has an area of
29 16,000 square metres, and that is the dark blue
30 horizontal line. Now, on the left-hand axis we're
31 talking about capacity measured by, not area, but
32 actually by what we call "peak hourpax" or peak hour
33 passenger numbers, it's the maximum number of passengers
34 that actually go through the terminal at the busiest hour
35 of operation of the terminal in any 24-hour period.

36 Now, over time one would expect that the terminal
37 capacity that's demanded will grow at some rate, and that
38 is the light blue shaded area. It's a wide thick band
39 because it's got -- there will be some bounds of error
40 around it.

41 Now, my understanding of a naive application of the
42 used and useful principle is that the area or capacity
43 and, therefore, the area of the terminal that's required
44 in any time up to the year five, would be capped at the
45 black dotted line.

46 So, in other words, the assets that are included in
47 the asset base for pricing purposes would be those
48 following the black dotted line despite the fact that,
49 from an operational perspective, from a building
50 perspective, from a management perspective of the

1 facility, it was rational to actually build the terminal
2 all in one go, as opposed to trying in that first
3 five-year period, from zero to five, to build little
4 increments in each particular year that match the growth
5 in demand.

6 So, once again, this is just my interpretation of a
7 naive used and useful. The only point I'm trying to make
8 is that if you go down the path of naive used and useful
9 what I'm going to describe will be the result.

10 So, just to recap on those details, we've got a
11 simple development of the terminal development, the
12 capital cost is around about \$40 million, peak hourpax
13 growth or rather peak hourpax demand is growing at 6%
14 per year, and after five years we are assuming that
15 demand equals supply, and that the used and useful would
16 mean that charges are based on the lesser of the actual
17 area or the optimised area, being the area that's
18 demanded.

19 So, in other words, it's capped at the actual area,
20 or it could be the optimised area as well. It's
21 important to note that because it is possible for
22 terminals to operate, in other words, to put more
23 passengers through, than what they're actually expecting,
24 than what they're actually built for rather, simply
25 because waiting times rise and the quality of service
26 goes down.

27 Now, as I've said before, developments are always
28 going to have more capacity than immediately required,
29 it's commercial commonsense to do that, and that -- I'm
30 just making the point here that if the holding costs
31 aren't rolled forward, then the airport's never going to
32 recover its cost of capital, and we can prove that
33 arithmetically.

34 I haven't actually put that calculation in with this
35 presentation but I'm happy to supply it by way of
36 spreadsheet to the Commission. We've also discussed this
37 concept in earlier papers during the consultation process
38 with the airlines, and I understand the Commission has
39 copies of that documentation. There is a paper that was
40 produced on optimisation issues, I'm sorry, I don't have
41 the document number but I can find it and supply it.

42
43 CHAIR: That's all right, we can always get it. Thank you.

44
45 MS BATES: I'm sorry to go backwards, but could we turn
46 back to your graph so I understand it perfectly clearly.
47 That black line is where a naive application of used
48 and useful would make the cut?

49
50 MR SEED: The black dotted line, yes.

1
2 MS BATES: Black dotted line, and is this at a point where
3 a 16,000 square metre terminal has been -- actually has
4 been constructed?
5
6 MR SEED: Yes.
7
8 MS BATES: And are you making a point about capacity? Are
9 you saying that that capacity is too small and that the
10 reality is up where terminal capacity demanded is?
11
12 MR SEED: No, I'm saying that in year naught, the capacity
13 that's demanded is below the blue line. In year five the
14 capacity that's demanded is equal to the capacity that's
15 put in place, and in year 10 the capacity that's demanded
16 exceeds the capacity that's put in place.
17 So, by year 10 there are obviously problems with the
18 quality of service that's been provided.
19
20 MS BATES: So, the decision to build at capacity at that
21 time is the airport's right?
22
23 MR SEED: The decision to build is the airport's based on
24 something like optimised renewal decision-making, whereby
25 it was decided that that scale of building was the least
26 cost scale to build, in the sense that the project had
27 the lowest present value of life-cycle costs. When
28 life-cycle costs include all of the costs, such as
29 staging costs associated with multiple developments, the
30 economies of scale that result from building a larger
31 area and so on.
32
33 MS BATES: So, do you think -- is your model based on a
34 wrong decision made by them?
35
36 MR SEED: No, it was the right decision at the time based
37 on ODRM.
38
39 MS BATES: Okay, and you're assuming that the regulator
40 would come in and say, that doesn't come into effect
41 until that terminal's built?
42
43 MR SEED: That's why I have prefaced this by saying, this
44 is a very naive and crude interpretation of how this
45 would be applied, I'm just providing it by way of
46 example.
47
48 MS BATES: It's just by way of example, you're not trying
49 to draw any analogy with what the Commission's done in
50 trying to optimise the asset out?

1
2 MR WESTON QC: Ms Bates, one point, that graph assumes that
3 the building is completed by year zero, i.e. that's the
4 date it starts pricing from, there's no building process
5 over that 10 year period. I wasn't sure whether that --
6
7 MS BATES: No, I understand how it's explained.
8
9 MR WESTON QC: But we do say that that is relevant to used
10 and useful if it's taken in a strict as to take into
11 account only the assets that are useful today in a static
12 sense, because our point is that the triangle above the
13 dotted line up to the point it meets the blue horizontal
14 line is the lost capital, and Mr Seed will come to
15 explain that in just a minute. So, yes, we are using
16 this to deal with the Commission's argument.
17
18 MS BATES: Well, could you say whether or not you think
19 this naive application was made in the Commission's
20 report?
21
22 MR WESTON QC: Well, that's --
23
24 MS BATES: Could I ask the witness that first?
25
26 MR SEED: As I understand it, the Commission is unclear as
27 to whether it would apply in this way or whether there
28 would be some element of price movement, and that's
29 precisely the point I'm going to be making and I'm going
30 to be dealing with it in a couple of slides.
31
32 MS REBSTOCK: Are you aware of any existing assets that
33 were treated in this manner in the report?
34 I mean, is this an issue that actually has
35 arisen -- is this a theoretical concern, or has it
36 practically arisen with respect to Christchurch?
37
38 MR SEED: It will practically arise if used and useful is
39 applied in a naive way. All I'm trying to do is make the
40 point --
41
42 MS REBSTOCK: Let me put it this way. Right now, if I
43 understand it correctly, Christchurch is, what, using
44 about 75% of its capacity? Is that about right, or
45 approximately?
46
47 MR SEED: I'm sorry, I couldn't say.
48
49 MS REBSTOCK: But it's not using its full capacity now.
50

- 1 MR BELLEW: That's right.
2
- 3 MS REBSTOCK: But in the Commission's approach, have we
4 optimised out any of your specialised assets to account
5 for the fact that you are only using 75% of that
6 capacity, in your view? Is that what your concern is,
7 that we have done it or that we might -- I'm just trying
8 to figure out what's behind this. Is your concern that
9 we might decide to do that, or is it that you think we
10 have done it?
11
- 12 MR SEED: All I'm trying to illustrate is that, if there
13 was -- if it was taken to an extreme level, this is what
14 would happen, and I don't believe that that's where the
15 Commission's headed but all I'm trying to say is that, if
16 it was taken to that extreme level, this would be the
17 result and ultimately this points to a point of
18 clarification that I believe that the Commission may need
19 to make.
20
- 21 MS REBSTOCK: Right. Okay, thanks.
22
- 23 MR WESTON QC: Ms Rebstock, if I can add to that. You may
24 recall in opening I said that we're going to deal with
25 issues that actually impacted on airfield, but that some
26 of the principles might flow over into terminal. So,
27 this is something that we see as being a principle that
28 would bite at Christchurch in relation to the terminal
29 side of things in the future.
30 Now, I think Mr Bellew was going to -- did you wish
31 to say anything more?
32
- 33 MR BELLEW: No.
34
- 35 MR WESTON QC: Does that explain the problem?
36
- 37 MS REBSTOCK: It does. It was just a point of
38 clarification.
39
- 40 MR WESTON QC: So, because there has been no optimisation
41 in relation to airfield in relation to Christchurch,
42 there's nothing that immediately applies. Obviously
43 we're all aware that whatever decision is made here will
44 flow over to other areas.
45
- 46 CHAIR: Thanks Mr Weston.
47
- 48 MR SEED: This wasn't a critique of anything that had been
49 done at Christchurch with regard to the airfield.
50

1 CHAIR: No, having said that, if you have any specific
2 criticisms, I'm sure we'll hear about them, so please.

3
4 MR SEED: Okay. Now, just a point to note that, if holding
5 costs are rolled forward, just recall here that we're
6 setting prices so prices will rise -- the required
7 revenue, rather, will rise in each particular year as the
8 area that's regarded as being non-surplus also increases.
9 So, we're in a situation where there will be some holding
10 costs associated with that terminal.

11 If those holding costs were counted it would
12 actually mean potentially that it could result in some
13 kind of price spike.

14 On the other hand, if holding costs are not rolled
15 forward and can't be recovered at some point in the
16 future, then on that particular project the airport would
17 never recover its costs of capital. And, as I've
18 mentioned before, we've undertaken an analysis of this
19 using simple arithmetic model, and we're happy to provide
20 that to the Commission to review.

21 In other words, the point I'm really trying to make
22 there is that there's a potential contradiction between
23 the used and useful concept and the concept of today's
24 consumer bearing only today's costs.

25 Now, I just think that that needs to be clarified
26 and I think one way of doing that is to look at a method
27 such as we've been talking about, which takes account of
28 the fact that we've got an asset that's going to be
29 supplying services over at number of years, and that
30 asset generates costs that don't all accrue in this
31 particular period but may accrue over other periods as
32 well, and optimised renewal, whatever you want to call
33 it, life-cycle costing, will take those into account, and
34 it does provide a framework whereby parties, both the
35 acquirers and the providers can actually sit down and
36 work out what the most optimal form of development is.

37 Whereas the thing I guess I'm personally worried
38 about is that operationalising the used and useful
39 concept is just going to be too hard, there's no
40 framework there for undertaking that analysis.

41
42 MR TAYLOR: I would just like to ask you a question if I
43 could, please.

44 The contradiction that today's -- the point you make
45 about holding costs rolling forward contradicting the
46 slogan, as you put it. Just explain to me why that is
47 so?

48
49 MR SEED: The holding costs effectively relate to the
50 purchase of the asset in previous years. So, I guess

1 what I'm talking about, from a practical point of view,
2 is that prices for these types of assets tend to be
3 smoothed. And, in our reading and our research, the
4 sources that we've referred to suggest that the most
5 practical way of dealing with this is to smooth prices
6 between periods; or over the period in which you are
7 operating.

8
9 MR TAYLOR: I understand what you are saying.

10
11 MR SEED: I'll be dealing with that in more detail later.

12
13 MS REBSTOCK: It's feasible, isn't it, to take account of
14 what you are suggesting in the way you define useful?

15
16 MR SEED: It is.

17
18 MS REBSTOCK: And in that sense, if it's taken account of,
19 perhaps in the manner it has been in the draft, though
20 not explicitly, it addresses that issue?

21
22 MR SEED: I don't think we have any difficulty with the
23 words "used and useful".

24
25 MS REBSTOCK: You need them defined properly?

26
27 MR SEED: It's the definition and, as we've said all the
28 way through, it's the way in which it's operationalised.

29
30 MS REBSTOCK: I understand the point, thanks.

31
32 MR SEED: So, just to show you the scale of the problem,
33 given the parameters that we put up there before.
34 Effectively the net present value, which is the deference
35 between the present value of the costs and the present
36 value of the benefits of this particular project, would
37 be minus \$2.6 million on a \$40 million investment.

38 Now, the upshot of that is that the airports would
39 destroy shareholder value by undertaking any projects if
40 they are optimised using -- and I should just qualify the
41 use of "used and useful" -- using a naive used and
42 useful. I'm not suggesting that that's what you have in
43 mind, I'm just suggesting, if you did adopt a naive used
44 and useful, it would definitely not, I believe, send the
45 right signals.

46 However, I'm going to propose that there are
47 alternatives and one way of looking at this is to take
48 account of the life-cycle costs through time, and try and
49 come up with a scenario that has the least costs to the
50 acquirers and the most benefits.

1
2 MS REBSTOCK: Can I just ask you -- I mean, I know why
3 you're raising it with respect to these hearings -- has
4 this issue been an issue with the airlines in your
5 negotiations?
6
7 MR SEED: Yes, it has.
8
9 MS REBSTOCK: With respect to terminals and other existing
10 assets?
11
12 MR SEED: Yes, it has.
13 Just concluding on this particular topic: So, what
14 guidance do we have?
15 Well, in the Draft Statement of Principles for
16 Regulation of Transmission Revenues, which was put out by
17 the ACCC in May 1999, and the principles -- based on my
18 very brief reading of, and I haven't had time to study
19 them in detail -- based on the brief reading of the
20 Productivity Commission aren't hugely dissimilar.
21 "Over-building may well be a reflection of anticipated
22 growth in demand", which is really what we're talking
23 about. "The extent and the period of over-capacity will
24 depend, among other things, upon the pace and the
25 volatility of growth".
26 So, in general, where you have rapid growth and high
27 volatility in demand, you would expect to have a greater
28 amount of "over-building". When I say "over-building" I
29 don't mean assets that are built just for the sake of
30 building, I mean assets that you do have a view that they
31 will be used.
32 So, one way of taking account of that, as I said
33 before, is to look at the overall life-cycle costs.
34 Therefore, any analysis is going to have to take account
35 of the owner's asset management plan and, just to
36 emphasise here, it can't be as ad hoc as a naive, and
37 just to insert naive there before used and useful, as
38 naive used and useful would imply.
39
40 MS REBSTOCK: Can I just ask you; isn't it correct to say
41 you would look at the company's asset management plan in
42 the context of current demand projections?
43
44 MR SEED: Yes, you would.
45
46 MS REBSTOCK: Not just taking whatever the company's asset
47 management plan happens to be, but its connection -- the
48 weight you would put on what's in that plan depends on
49 the nature of the demand conditions that you're
50 projecting forward.

1
2 MR SEED: Yes, and realistically the company's asset
3 management plan should reflect that expected growth in
4 demand.
5
6 MS BATES: Just one point. Page 14 you continue to use
7 "naive" before application of "used and useful". When we
8 get to page 15, "naive" disappears. We get "used and
9 useful will lead to wrong investment signals". It seems
10 a little contradictory in a way, because when MsRebstock
11 asked you if the definition of "useful" could sort the
12 difficulties out, you agreed that it could.
13
14 MR SEED: I'm sorry, it should be "naive or crude used and
15 useful".
16
17 MS BATES: Where you've used it all the way?
18
19 MR SEED: [Nods]. Just to clarify that point, the
20 useful -- that's actually what we're defining at the
21 moment, in other words, that's really what we're
22 discussing, how do you define "useful"? And what I'm
23 trying to do is provide you with a framework for doing
24 that, and in this presentation I can't possibly go
25 through all the details of how you undertake an optimised
26 renewal decision-making analysis, however the basis of it
27 is fairly clear where you're looking at the costs and
28 benefits of undertaking different scales of development.
29 So, this is really the slide that brings this
30 section to a conclusion, and that's -- we say, how can we
31 identify what a prudent investment is? Well, what we're
32 trying to do is to minimise the life-cycle costs involved
33 in the project, and we do that by determining the
34 least-cost method of supplying that level of service
35 through time, and that may mean that we're going to have
36 some excess capacity here which is going to decline
37 through time as demand grows, as we put on the chart, and
38 one way of working out the path of development, or the
39 optimal path of development, is to use something that
40 takes account of the timing of the demand growth, the
41 timing of the construction, and also all of the other
42 associated costs, because if you have more development
43 stages, for example, you're actually going to have much
44 much higher staging costs. If you're going to have more
45 development stages, you're going to have much much higher
46 construction costs.
47 So, there is a trade-off involved and all I'm
48 suggesting here is that optimised renewal decision-making
49 is a framework that you can use to assess those
50 trade-offs ultimately to determine useful -- in other

1 words, which assets are useful and what scale should be
2 in there.

3 So, under ODRM, or ORDM I beg your pardon, the
4 scenario with the lowest present value of life-cycle cost
5 is the one that's chosen, and that's presumably what a
6 rational investor would want to do.

7
8 MS REBSTOCK: Your heading here, "Prudent Investment" just
9 triggered a thought in my mind, and I'd be interested in
10 your view.

11 I think it's been suggested to the Commission that
12 we might want to consider thinking about an additional
13 criteria which might be asking, is an investment prudent
14 as part of these pricing principles, but it wouldn't be a
15 substitute for used and useful possibly, it would be to
16 supplement it, and I'd be interested in your view on this
17 because it seems to me investment can be prudent for a
18 company but not necessarily useful in terms of meeting
19 the useful test, in terms of whether it should be
20 included in the asset base for pricing purposes at this
21 time.

22 I would just value your comments on that
23 proposition, that this notion of prudent investment is an
24 interesting criteria but perhaps it's an additional one
25 and, you know, it's one of these things that may be
26 necessary but not sufficient in order for it to determine
27 whether an asset should be in the asset base at this
28 particular time, for pricing purposes.

29
30 MR SEED: I guess, I would view the test for prudence as
31 being part of the ORDM exercise. I would see the two
32 things as being rolled into one. And, if the investment
33 is good for the acquirers, it's going to be good for the
34 company, I would have thought, in terms of preserving its
35 shareholder wealth.

36
37 MS REBSTOCK: If I take your point right, if it's used
38 and/or useful, it must also be prudent. So, in a sense
39 it's just subsumed in that definition if it's --

40
41 MR SEED: Yes.

42
43 MS REBSTOCK: Is that --

44
45 MR SEED: That's my understanding at the moment.

46
47 MS BATES: But does the opposite apply, because it's
48 prudent do you think it's used and useful?

49
50 MR SEED: Well, the way that I'm defining "prudent" here is

1 that, it's choosing the investment that has the minimum
2 life-cycle costs, the maximum ratio, if you like, of
3 benefits to costs. So, it would be.

4

5 MS BATES: So the answer would be, "yes"?

6

7 MR SEED: Yes.

8

9 MS BATES: Well, let me put a scenario to you of a prudent
10 investment which like a piece of land for another runway,
11 which everyone agrees is prudent, it's not known when
12 this will come into operation, but it's a safe thing to
13 do because of capacity considerations.

14 Now, assume that there are holding costs that are
15 associated with that piece of land, but -- and assume
16 that the piece of land is also a prudent investment
17 because value rises, so you get revaluation gains.

18 Now, if you decide to put that into your pricing
19 structure and then at a later date, because of
20 circumstances that no one was aware of at the time,
21 becomes a totally stupid decision to actually build the
22 next runway, and the company sells it off, makes a huge
23 capital gain out of it, shareholders benefit, would it be
24 fair do you think in that circumstance to have had your
25 holding costs as part of the pricing structure?

26

27 MR SEED: In the scenario, as you have outlined it, there
28 are a number of quite unusual circumstances.

29 The only example I can think of at the moment where
30 that is actually coming up is -- let's see -- the delay
31 with the Heathrow terminal, prices that were set by the
32 Mergers and Monopolies Commission at the previous
33 quinquennial review, there was an element of price
34 smoothing there based on the investment that was about to
35 take place; that investment has been delayed because of
36 planning problems I gather. I'm sorry, I'd need to
37 consider what the --

38

39 MS BATES: I would have thought it was a reasonably simple
40 scenario; you've got a piece of land, you're holding it
41 in case you need another runway, and everyone thinks you
42 do. But it later transpires, because some other
43 airport's providing the capacity, that it's not a good
44 decision to continue with it. And so, you sell it off
45 for development purposes, make a big capital gain,
46 shareholders are happy, but you've put the holding costs
47 into the pricing structure, and I'm asking you, is that
48 fair?

49

50 MR BELLEW: Let me bring up just a mere practitioner's

1 point of view.

2 I thought we'd been discussing on the basis that we
3 would progressively bring into revenue the appreciations
4 in value, the revaluation. So I think, with respect,
5 this huge capital gain at the end may already be
6 progressively brought through your revenue stream to help
7 offset, and it may even more than offset, the holding
8 costs.

9

10 MS BATES: Yes, I think that's perfectly true.

11

12 MR BELLEW: And, therefore, at the end the net effect of
13 the relation, be it positive or negative, would also be
14 reflected in that account.

15

16 MS BATES: But in that case you'd have to agree, if there
17 was an offset, no need to include that asset as part of
18 your pricing structure, because there's no costs involved
19 because it's offset by the revaluation gains.

20

21 MR BELLEW: Well, no. I think there's another reason as
22 well, apart from pure pricing, and that's the case of
23 getting focused on what is relevant to the business. So,
24 I think that, you know, in this end, there may in actual
25 fact -- I think you've got to bring the wins and the
26 losses through, you can't just bring it in for pricing
27 just because it's a cost.

28

29 MS BATES: No, and that's what I'm saying. If you have no
30 cost because your revaluation which you've brought into
31 the revenue stream wipes it out.

32

33 MR BELLEW: Yep.

34

35 MS BATES: Then you don't put that asset in for the
36 purposes of pricing.

37

38 MR BELLEW: Well, it has no effect in the end except a
39 positive one in terms of the diminution of costs for
40 pricing; you still bring it in though. Conversely, if
41 it's imprudent, in a commercial sense decision, in that,
42 at the end when you realise it, you get a loss, then that
43 has to come through in costs; you can't have it both
44 ways.

45

46 MR SPEED: If I could just point out. When you're looking
47 at projecting your cash flows into the future, of course
48 you've got to be looking at changes in asset values and
49 you've got to be looking at all of the other costs
50 associated. So, in choosing which is the least cost

1 scenario you've already taken into account some of the
2 points Mr Bellew's raised in terms of determining your
3 least cost strategy, or your least cost scenario.
4

5 MS BATES: I'm sorry, I don't quite understand your answer
6 and -- could you just repeat it for me?
7

8 MR SEED: If you were going to put that particular project
9 into the framework that we've been discussing so far,
10 which is this idea of looking at an investment from the
11 point of view of saying, well, which is the least cost
12 way of providing a certain amount of capacity, you would
13 take into account when you are making the decision all of
14 the expected capital gains, all of the expected costs and
15 so on and so forth through time. Now, that's standing
16 here today looking 10 years forward.
17 Now, my understanding is your question was, when you
18 are 10 years down the track, and once again with the
19 benefit of 20/20 hindsight, what would be -- you know, is
20 it fair if -- sorry I've lost the train of my thought.
21

22 MS BATES: Is it fair that the airlines, say, have been
23 charged?
24

25 MR SPEED: Well, it is fair to the extent that charges
26 would have already reflected the capital gains, or
27 included expectations of capital gains which will
28 partially offset the holding costs.
29

30 MS BATES: Where did the airlines get the capital gain
31 from?
32

33 MR SPEED: It's -- well, if revaluations are included in
34 the expectations of cash flows, and that's pretty much --
35

36 MS BATES: So, if revaluations come in, then it wipes out
37 holding costs; and so, there is no cost to put on to the
38 airlines?
39

40 MR SPEED: You've just got to be careful that you're
41 talking about the cash flows here, that you identify the
42 relevant incremental cash flows to that particular
43 investment.
44

45 MS BATES: Just say that last bit again?
46

47 MR SPEED: You have to make sure that you are identifying
48 all of the relevant incremental cash flows, and I
49 wouldn't advocate offsetting one directly across the
50 other. For example, offsetting holding costs with

1 capital gains; I would identify holding costs separately,
2 capital gains separately so you could identify all those.
3 Once again, this is standing here today looking forward.

4 When you undertook or when you undertake an ex-post
5 analysis with the benefit of hindsight, you will be
6 saying, well, we were going to build that runway, we're
7 not going to build it now, but to the extent that it's
8 unfair is to the extent that the capital gains have
9 offset the holding costs; that's actually what the
10 question comes down to.

11 So, I'm sorry, my answer isn't contributing anything
12 further to what Mr Bellew said.

13

14 MR CURTIN: Just on a separate topic, if I could quickly
15 interject --

16

17 MS BATES: Just before we do that, Mr Curtin, I think Mr --

18

19 MR GAMBY: Can I just explore something with you, Mr Seed,
20 for a moment on which the Commission would like to get a
21 clear understanding.

22 In an answer to an earlier question, I think you
23 said you would back out the value of land for the
24 golf course and the third possible runway, because -- I
25 think it wasn't imminent, that was my understanding. And
26 then you indicated, but if it was imminent and
27 identified, subject to a sort of a timing issue I guess,
28 it would come into the asset. That's my understanding of
29 what you said earlier.

30 Now, what I think the Commission's trying to
31 understand here is that, if the revaluation of the land
32 was taking place on, say, a regular basis, is there not
33 the opportunity in that process by increasing the value
34 to then pass on, say, to the airlines in that process an
35 actual cost to them through landing charges? Is that
36 what would happen, and yet, it may still not be something
37 that's actually used?

38

39 MR SEED: There are two effects there, aren't there? One
40 is the increase in the value of the land, and the
41 second -- actually there are three effects, the second
42 one being the -- the second major one really being the
43 increase in the landing charges that would result from
44 that. But, that increase is also offset by the
45 increase -- it's also offset by the capital gains.

46 When you put this into any form of cash flow what
47 you will find is that, where you have positive capital
48 gains through time, the charges are actually reduced
49 because in our discounted cash flow model, which the
50 Commission has a copy of, you can actually see quite

- 1 clearly that where you actually inflate the assets at any
2 positive rate, the charges are actually reduced today.
3
- 4 MR GAMBY: Thank you very much. Does that clarify it?
5
- 6 MS BATES: Yes. Thank you.
7
- 8 MR CURTIN: Just on a slightly different topic if I could.
9 I'm just looking at your last two bullet points. I
10 understand ODRM, it sounds like a kit that a professional
11 asset manager would be using. But looking at those last
12 two points, they seem to me to be two potentially
13 different criteria for selecting between projects. One
14 is a benefit to cost ratio, the other is the lowest
15 present value of just costs on their own.
16 Did you mean to say there are two different criteria
17 there, or were they meant to be alternative explanations
18 of the same one?
19
- 20 MR SEED: They are meant to be alternative explanations of
21 the same point.
22
- 23 MR CURTIN: Just looking at those now, what would actually
24 be your best shot at what the criterion is at the end of
25 the day that an ORDM manager would be using?
26
- 27 MR SEED: In most cases when you're faced with these types
28 of problems you're looking at trying to find the least
29 cost way of providing that particular facility or that
30 particular capacity, so really you are trying to find the
31 one that has the lowest present value of costs.
32
- 33 MR CURTIN: Lowest net present value?
34
- 35 MR SEED: Effectively, yes. No, sorry, the lowest present
36 value of costs, because you're really identifying the
37 cost elements, being in particular the capital costs,
38 staging costs, operating costs, and so on and so forth.
39 Because there's no free lunch if you have more stages in
40 the development, as I said, you're going to increase the
41 whole lot.
42
- 43 MR CURTIN: So, your last point is really the best
44 statement of the criteria?
45
- 46 MR SEED: Yes.
47 Mr Chairman, that brings me to the end.
48
- 49 MR WYDEVELD: Can I just ask a question of you?
50 You suggest that, with any planning of this

1 investment horizon that there is some necessary
2 over-capacity, and I'm just sort of interested in the
3 standard against which you evaluate that.

4 In your graph on page 15 you use a peak hour
5 passenger sort of standard. Is it possible that that
6 standard could maybe exaggerate the over-capacity
7 necessary? And here I'm thinking about things like,
8 would peak pricing, for example, mean that capacity could
9 come on line maybe later than if you attempted that?

10

11 MR SEED: Peak hour pricing -- if I can just start again.
12 The peak hour pax numbers that we have there, it's really
13 a measure of the level of service that's provided by that
14 particular asset, and there are a number of possible ways
15 of measuring that level of service; IATA, the
16 International Air Transportation Association, publish a
17 level of service guidelines, or rather guidelines for
18 assessing the level of service, and they have a scale
19 ranging from A through to about E.

20 In New Zealand we aim for IATA level of Service C,
21 which is somewhere in the middle, and that level of
22 service specifies areas -- it's quite a crude measure,
23 but it does specify areas for passenger queuing, waiting
24 times, and so on and so forth, and there's been quite a
25 lot of discussion in the practitioner literature about
26 the appropriateness of that.

27 So, I'll just caveat my comments by saying that,
28 while the IATA level of service guides provide a useful
29 place to start, it's no substitute for a reasonable and
30 sensible asset management plan for a particular terminal,
31 and there's quite a lot of work that goes into any
32 terminal planning, looking at passenger flows and
33 identifying bottlenecks, and so on and so forth.

34 So, there is actually already bounds around that
35 assessment in the sense that, if you are at an average
36 level of C you are actually operating at probably A in
37 year one, maybe B in year two, you're at level C by year
38 five, and by the time you get out to year 10 you are
39 operating at level E. So there's a dynamic here of
40 service quality. So the service quality is actually
41 changing as you move through time. Level E is actually
42 system breakdown.

43

44 MR WYDEVELD: But service quality is all measured around
45 peak hour?

46

47 MR SEED: Correct. The peak hour pax is the measure for
48 terminal service capacity -- service provision, but
49 George, you might like to comment on that.

50

1 MR BELLEW: Can I make some practical comments on this
2 issue, I was in Sydney last week listening to a very
3 erudite comment on peak hour pricing.

4 I think from Christchurch's point of view, and
5 that's the focus I want to bring as we've got the
6 privilege of presenting at the moment, we are essentially
7 schedule takers. In other words, we take what we get
8 when the airlines want to arrive, and here I'm going to
9 lapse into jargon that might get me into trouble given
10 I'm surrounded by so many erudite Commissioners and
11 others, but essentially the airlines realise that their
12 opportunity costs are of trying to meet our needs, in
13 terms of Christchurch are outweighed by their costs in
14 other areas, such as Narita, or wherever they are leaving
15 from.

16 So, from my point of view, and I well understand the
17 theory of peak hour pricing, I don't believe in a real
18 world it will act as an incentive and a way of
19 effectively, much as I would love of, of getting more
20 efficient use of the asset because we're a schedule
21 taker.

22
23 CHAIR: Thanks for that comment because it is raised in our
24 draft report, as you know, this concept in relation to
25 trying to ration peak hour space.

26 I think Professor Boyd is ready?

27
28 MR WESTON QC: Yes, as you can see we've had to change
29 horses. Mr Seed's got ODRC and DCF left to go.

30 Now, obviously there's a degree of overlap because
31 both will be dealing with ODRC so in a sense it probably
32 doesn't matter which of the two goes first.

33 So, we thought that was perhaps a useful point to
34 change the horses, so I'd now like to introduce Professor
35 Terry Boyd, and he's going to make a presentation. I
36 think he's got a few slides that he may be using on the
37 OHP there. Professor Boyd?

38
39 PROF BOYD: Good morning Mr Chairman, good morning
40 Commission. We have a few minutes of the morning left.
41 I am going to restrict my presentation to property
42 valuation methodology. I can hear that the Commission is
43 wrestling with a whole lot of issues related to, I
44 suppose, input variables into this pricing model, and
45 where often in a continuum you're going to draw a line
46 and say, this is the correct figure or input to put into
47 there.

48 I think on some of these practical issues I haven't
49 looked at enough detail to say that is the correct value
50 or that's the correct issue or variable to put in.

1 However, I have looked at some detail as the methodology
2 and approach being used in this and would say on overall
3 I'm very comfortable with the approach in terms of the
4 valuation asset base.

5 With one exception, and that one exception is the
6 use of an historical cost unadjusted to present day value
7 as a basis for determining a current value and,
8 therefore, used to determine a current cost.

9 I have major concerns with this, and so essentially
10 this is the issue which I will be addressing.

11 I'd like to, if you don't mind, take you back a wee
12 bit on this and possibly if we could just put up one
13 slide and say; property is quite distinct from most other
14 types of assets, and particularly when we are evaluating
15 securities we tend to have to use a certain amount of
16 methodology related for fixed property which is quite
17 distinct from other securities.

18 The nature of it is that it is very lumpy, as we
19 refer to it. There are a number of reasons why it does
20 not meet the assumptions for financial pricing modelled,
21 and it's very difficult to get it to fit into that.

22 So, going back now --

23

24 MR WESTON QC: This is part of his evidence already, it's in
25 the materials you have, it's the annexure to his --

26

27 MS BATES: Sorry, I can't see it properly, so I'm just
28 fishing around looking so I can follow your argument
29 better.

30

31 MR WESTON QC: At the back. It came in as part of our
32 reply submissions to the draft report, and it's right at
33 the end of that.

34

35 CHAIR: Sorry Professor Boyd, carry on please.

36

37 PROF BOYD: Thank you.

38 So, approximately 100 years ago the body of
39 knowledge in relation to real property valuation was made
40 a lot more substantial by a work of people -- and I
41 notice one of them quoted Bonbright and others -- and
42 taken on by one of the persons who formulated this
43 further into valuation standards, being (inaudible) cap.

44 This shown on the slide at the moment is a
45 standardised valuation process which is used
46 internationally, in most international literature, to
47 advise on the methodology used for any valuation process.

48 I put it up for that reason, because it shows a
49 logical process no matter what purpose you are valuing
50 the asset for.

1 And I think this is important at this stage to say
2 at the outset, you do not define a different methodology
3 for different purposes for which the valuation is
4 undertaken, but you do in the first step, and the first
5 step as shown on the slide is, define the problem and
6 define the value that is to be achieved.

7 Just following down on those points, you then get to
8 a property analysis, you look at alternative uses, you
9 look at the probable-use selection, followed by a
10 probable-buyer profile, a choice in variation method and
11 you will notice how far down the chain that the
12 methodology comes into play, and then finally come to a
13 value.

14 I would like to turn to the right-hand side of that
15 document and just relate it briefly in terms of the
16 valuation of airfield assets, and I don't want to at this
17 stage break them up into any types, but any major airport
18 you would have to -- well, the valuation in this case,
19 the problem relates to defining fair earnings and,
20 therefore, you're trying to define a value which looks at
21 the current existing use valuation for airport
22 properties.

23 I'll come back to that if you don't mind because I
24 need to a bit later. But it will, therefore, mean that
25 if I am looking at an existing use valuation for
26 airports, I must identify and categorise the property
27 components, which have been done, and I believe done very
28 efficiently in terms of what's been submitted.

29 Then you must look to see if there are any
30 alternative uses. This is to a large extent negated by
31 the definition of "value", this is an existing use
32 valuation. Because it is an existing use valuation, you
33 do not consider the alternative uses for which it is
34 being proposed.

35 But you do come down to say that it has got the most
36 probable uses in airport and that, therefore, if it is
37 going to be as an airport our most probable buyer profile
38 is an airport owner and, therefore, that is the context
39 within which I am looking at it.

40 Then come to the level of saying now, how do you
41 value this land? In terms of the valuation methodology
42 there are three major approaches which are accepted. By
43 far the preferred approach is the market approach, of
44 determining a market or a fair value based in terms of
45 comparable market evidence.

46 If there is no market evidence you have two market
47 alternatives, one being considered as an investment or
48 otherwise termed income approach, where you can look at
49 the potential benefits that are going to come from an
50 asset and determine a value as a residual from that.

1 Or alternatively you can do a cost approach. In
2 this the only appropriate method is the cost approach
3 and, therefore, it's necessary to look at the cost
4 approach, and this is the one being used.

5 In terms of valuation methodology again, the cost
6 approach is normally referred to as the replacement cost
7 approach, and possibly I could just mention that in my
8 submission to you -- on page 5 and I think we could put
9 it up again on the screen -- it's quite clear in terms of
10 how the New Zealand Institute of Valuers instructs their
11 members to determine the cost approach, because they say
12 in this, which is also up on the screen, "All specialised
13 owner/occupied properties and other specialised
14 properties shall be valued on the depreciated replacement
15 cost basis except when market methods can be applied".

16 Clearly this is not preferential to a market-based
17 approach. It is, however, the preferential approach if a
18 cost approach is being used.

19 The reason for this is that the replacement cost
20 approach, duly depreciated and duly optimised where
21 necessary, will arrive at the current cost based on the
22 current value.

23 So, this is the approach that is recommended, and
24 more strongly than that, it is a standard in New Zealand
25 and internationally for the valuation of property assets.
26 And I'd suggest to you the purpose for which it is done
27 is not relevant, the standard still stays.

28 It's essentially for this reason that I have
29 difficulty with the concept of using an historical cost
30 instead of a replacement cost. I am conscious that the
31 replacement cost has some difficulty and I'd like to deal
32 with that a bit later on, but the issue is that the
33 standard being used, after many many years of thought in
34 terms of body of knowledge and in terms of accreditation,
35 if I could say of our educational bodies, if we did not
36 follow this methodology we would not get accreditation by
37 the professional body as the standard approach to be
38 used.

39 Normally the requirement is on a valuer, that if you
40 do not follow the standardised approach you must qualify
41 your valuation to that extent.

42 Now, I'd like to go on, if you don't mind, now, just
43 following the summary that I gave in my report as the
44 executive summary.

45 As I have glossed over a few points that I'd like to
46 come back to in terms of these points and expand on them,
47 and clearly be happy to take any questions, either as we
48 go through it or later at the end.

49 The first one is that clearly I believe here that we
50 are determining the existing use valuation. This is the

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1 only appropriate valuation in this current scenario,
2 therefore that is the primary thing that we are trying to
3 achieve. What is the valuation of this property for an
4 airport purposes?

5 I would suggest under point 2 there that the
6 opportunity cost approach is not appropriate for
7 infrastructure property assets of this nature. The
8 reason being is that it has, as its basis, the
9 consideration of alternative usage. I think it does have
10 a lot of merit because you will notice in the valuation
11 exercise as well, they stress, examine the alternative
12 use. However, when you are going down the route of
13 saying this is the existing use and we are evaluating on
14 the existing use, then the concept of alternative use
15 does not come into play, and this is why I feel that when
16 we look at the infrastructure and specialised assets
17 under an opportunity cost regime, we should be saying
18 they have no value.

19 I don't believe there's any doubt in my mind in
20 that, and we cannot say this for the situation, and the
21 reason being is that we're looking at an existing use
22 scenario rather than an alternative use scenario, and as
23 an existing use scenario they have substantial value, and
24 we cannot ignore that.

25 If you will just take out at the moment the
26 opportunity cost approach and say, in order to determine
27 the current-day cost approach in my estimation it should
28 be the next point, which is point 3, that you're
29 internationally accepted valuation approach -- and I
30 would suggest that you would have difficulty, and I may
31 be a bit bold on this, but that you would have difficulty
32 in getting any professional valuer to recommend another
33 approach other than this approach as a primary method
34 wherever possible, and I must turn that back to the
35 Commission's consultants as well and possibly ask them
36 that issue some time, and I'll ask them to consider it
37 because, to me, that is very clear in terms of the
38 preferred approach. And that is what we call "the
39 depreciated replacement cost approach".

40 I'd like to at this stage just deal with the concept
41 of depreciated replacement cost. The depreciation is
42 meant to take out some of the difficulties with this
43 approach. I don't underestimate the difficulties with
44 such an approach, however I don't believe this should be
45 discarded for that purpose. We can determine a
46 replacement cost with a reasonable degree of certainty.
47 We have people who specialise in this, such as quantity
48 surveyors who are dealing with this type of physical
49 replacement, not reproduction but replacement, we're not
50 really talking about reproducing the identical article

1 but rather replacing a similar and equally functional
2 type of article in today, so that we can find the cost
3 and we can find today's cost for that.

4 But when we are looking at the actual article that
5 is there, we do need to depreciate to its current cost.
6 So depreciation, with all the methods of both what we
7 call economic, functional, obsolescence and the actual
8 physical depreciation allows us to adjust that building
9 or that structure that is there, or the infrastructure
10 that is there to what we would call the current day
11 value, and that is the process to get to the current day
12 value.

13 Using that approach we can then consider
14 optimisation. There are in my mind two stages.
15 Depreciation relates to the structure that is there and
16 bringing it to its current day value. The optimisation
17 looks at usefulness.

18 So, just dealing with the depreciation at the
19 moment, that to me is the most logical process to come to
20 a current cost of those property assets.

21 Dealing with point 4, the historic costs. You will
22 notice, and I can again refer you to my document; in my
23 document on page 6 the valuation standards put out to
24 valuers -- and I would just mention to you that, although
25 they are noted in page 6 as belonging to the Australian
26 Property Institute, the Property Institute is a merger
27 between valuers and other property practitioners, but it
28 still sets specific standards for the valuation practice.

29 And in its practice it has a guidance note 9, and
30 its guidance note 9 deals first of all with regard to,
31 where the concept of what I'd call "the replacement cost
32 approach". And then under guidance note 9, under
33 Section 12.24 it says, "Where the concept of a
34 replacement cost or reproduction cost does" -- sorry, let
35 me just read through it, my apologies, let me get this
36 right.

37 I'm reading now under GN9, 12.24 and it says, "Where
38 GN9, 12.22..." -- which is the one where there is not an
39 identical or an asset with an equivalent service
40 potential -- "...applies, but the current price of the
41 asset or modern equivalent asset cannot be ascertained
42 readily, current cost is determined by application of
43 suitable indexes to historic cost or previously revalued
44 amount calculated to reflect changes in specific prices
45 of the assets provided the amount gives a realistic
46 approximation of current cost".

47 I totally support that statement, and I think it
48 makes about three points. Firstly, it is not
49 preferential to a replacement cost approach. Secondly,
50 you can use either some historic value or a historic

1 cost, but on condition that you index it up to make it
2 equivalent to a current cost.

3 And with respect to the Commission, the basis that
4 is being proposed at the moment, in terms of the
5 valuation of the specialised assets, as I read it, does
6 not do this. And by not doing that, you then have an
7 anomaly because you are using different approaches to try
8 and arrive at a current value base.

9 I believe the land component is being correctly
10 valued. I believe that the improvements on, are not
11 being correctly valued, and the combination of that is
12 not bringing together a current value which would form a
13 substantial and defensible base to determine current
14 costs and, therefore, my proposal would be, in order that
15 valuers can A, understand and B, debate amongst
16 themselves the accuracy of the approach being used, we
17 need to have a uniform approach which is accepted by
18 valuers and fully understood by valuers as the
19 replacement cost approach. And, that's the issue that, I
20 suppose, is the only issue that I take any major concern
21 against.

22 I would like to refer to optimisation, and I don't
23 think that my standpoint differs very differently from
24 what I have heard Mr Peter Seed say. I think
25 optimisation is necessary.

26 I believe the concept of how you're going to define
27 what may be surplus assets which may be assets which have
28 got a potential there that need to be brought to account
29 or not brought to account, needs to be considered and
30 that, if you are using the term "used and useful" then
31 just allow some latitude in terms of what is considered
32 to be used and useful.

33 I might just add to it by saying that I very
34 recently have done a study for a dairy products
35 distributor manufacturer and they have picked up a bit of
36 land which happens to be approximately 20 hectares. In
37 their decision-making process they are looking to develop
38 the building in terms of what they will use over the next
39 five years. They have then decided to build something
40 else that they will lease, and then they have another
41 huge swag, which is more than half the property, not
42 developed.

43 Now, therefore you have almost three concepts of
44 stages of, this is what I believe is going to be what I
45 need to use over the next few years. I will build more
46 and I'm going to lease it out to somebody else for
47 three years because that's surplus to my current
48 requirements, but I will need it, I believe, in the
49 future and it is worthwhile for me to do that at this
50 stage.

1 Now, I don't know whether this helps in terms of
2 what Mr Seed is saying, but this is the process they went
3 through and then they had surplus land which they didn't
4 take account in terms of the current building.

5 So, I don't envy you trying to sort out the one on
6 used and useful, but I do believe there need to be some
7 parameters to say, is this a logical life cycle type of
8 development which is being considered in a most
9 reasonable manner to arrive at a realistic solution.

10
11 CHAIR: Thanks very much.

12
13 MR CURTIN: Thank you very much for that, I think that was
14 quite a robust statement of, yeah, the principles
15 involved and I see where you're coming from.

16 Earlier on in the proceedings we did have a
17 statement from one of the experts for Auckland, from
18 NERA, quite a different approach to yours as I understand
19 it, and I'm not putting this in any kind of inquisitorial
20 way, referring to NERA's statement was that you really
21 had to think about the economic question that was being
22 addressed and, depending on the economic question that
23 might be addressed, it might be compensation for
24 nationalisation or it could be for pricing purposes or
25 measurement of excess returns, you would actually,
26 depending upon the question, you would then reach into
27 the tool box for a valuation method. And they suggested
28 there might be a hierarchy of valuations from scrap value
29 at one end to maybe deprivation value at the other end.

30 As I understand you, I hope I'm not exaggerating or
31 simplifying, but I would suspect you don't have a lot of
32 sympathy for that argument, and you're rather inclined to
33 think that there is a valuation that's probably going to
34 be appropriate for most purposes; I just wonder if you'd
35 like to explain on your view and how I've represented
36 theirs?

37
38 PROF BOYD: Yes, thank you. Now, probably I haven't made
39 myself totally clear on that; if we went back to the
40 original slide, you see, it is important to look at the
41 purpose for which it is being achieved, because the
42 purpose for which it is being achieved will then select
43 between those three approaches, being the market
44 approach, the investment approach and the cost approach.

45 And yes, we do have -- for instance, for insurance
46 purposes you might be saying, look, I need a specific
47 valuation for insurance purposes, and that might differ
48 for that reason. So, yes, there can be differences and
49 that's a reason why you look at the use for which it's
50 going to be used at an early stage and then come down to

1 your methodology.

2 So yes, there are differences in terms of the
3 methodology that can be imported there but they are still
4 within that group that you have got.

5 There was an earlier question from the Commission
6 that I think relates to this and it might also help to
7 clarify. It was, what should be taken in for pricing
8 purposes, is this a correct methodology, and what should
9 be in or not in, in terms of assets that need to be taken
10 into account?

11 Now, I see that as two separate issues. I don't
12 believe the methodology changes if we're trying to say
13 we're trying to determine today's cost. But what
14 elements come in is optional. In other words, you might
15 decide to say that for pricing purposes we're not going
16 to take those elements in, whereas for balance sheet
17 purposes I might take them into account. But I still
18 believe the methodology to arrive at that cost approach
19 would not change, whether you're doing it for
20 balance sheet purposes or whether you are doing it for
21 pricing purposes. So that's where, when you have come
22 down to selecting your methodology, then the methodology
23 is robust and the methodology doesn't change. But it
24 can -- the methodology can be selected according to the
25 purpose for which it is undertaken. Does that help?

26
27 MR CURTIN: Yep. Thank you.

28
29 MR GAMBY: Terry, I've just got one question, I think you
30 highlighted it very well with your example of, I think it
31 was in the dairy industry. In the case of the large
32 substantial piece of land that's put aside at this stage;
33 when somebody was actually buying that piece of land, how
34 would they have treated the land, in terms of valuation,
35 knowing that they wouldn't be using it for a certain
36 period of time? What would they have done to the value
37 at that stage?

38
39 PROF BOYD: In terms of this company, and I'll just speak
40 about this company at the moment, they chose to buy
41 20 hectares on the basis that they would probably use
42 five over the next few years, and yet felt that it was
43 probably worth staying there for 20 years, so their time
44 horizon was about 20 years. So they were willing to
45 pay -- they had to pay -- the concept of saying, if we
46 wish to stay put for 20 years, we need to buy this
47 20 hectares of land even though we can't use it.

48 They will then try and minimise their costs by
49 saying, look, two-thirds of this at the moment we're not
50 going to use, what can we do? Do we build another type

1 of development for somebody else, and they looked at it
2 and said, no, we'll see if we can lease it as a container
3 depot, we're quite happy to harden it. So, although it
4 has been a cost to them, they would like to take that
5 cost out of their ongoing holding costs.

6 And I'm not sure, you can tell me whether I am
7 responding to your question well, but they had the three
8 stages; they felt at the first stage they would buy the
9 land, the large land, they would take their building
10 which was going to be surplus to their current
11 requirements but they would need it within the next
12 five years, and they would be happy to bear that cost of
13 that building. They would bear the cost of the secondary
14 building which was an extension of theirs and lease that
15 to somebody else, so they did, felt that they would not
16 have done the development unless they could have leased
17 that because they anticipate that they will not use that
18 for five years.

19 So that's the way they structured it but that was to
20 them the most efficient means, so that they did buy a
21 huge tract of land and had to value that land in the
22 marketplace, but they tried to minimise the cost to them
23 by then passing on to somebody else to make it revenue,
24 sort of -- get a revenue from it, if they could, into the
25 future. Does that help?

26
27 MR GAMBY: I think that's very helpful. Let's take the
28 situation that they hadn't been able to pass on that cost
29 by building a building and they had a large parcel of
30 land sitting there, that they knew they'd need into the
31 future but they couldn't actually do as you've indicated
32 in that scenario. Would they then pay less at the time
33 they purchased it, or would they have to meet the market,
34 and what would they do if they had to meet a higher
35 price? How would they resolve that seemingly
36 incompatible problem, if they paid a market price? What
37 happens?

38
39 PROF BOYD: I'm not quite sure whether -- let me try this
40 in two forms.

41 In they had to meet the market, quite frankly
42 they've got to buy the land but their decision at that
43 stage would be, do we go for the larger tract because of
44 the additional cost involved, or do we go and find a bit
45 of land half the size, and it's therefore difficult for
46 me to make that decision on their behalf.

47 Would they -- because of the very high holding costs
48 of something for a long-term in the future, would they
49 rather go and shorten their time horizon and buy it for,
50 say, a ten year period, which is quite likely.

1 Or, alternatively, they might well move out to
2 cheaper land on the concept of saying well, I'd rather go
3 for a large tract of cheaper land so that I don't have to
4 move at a later stage. Would be a case of the cost
5 benefit to the individual concerned.
6

7 MR GAMBY: This may have not been such a good example I
8 suspect.

9 What I'm trying to ask you I guess is, if an
10 organisation had to hold land for a long period of time,
11 knowing that effectively if they'd bought it at a certain
12 level, would they expect to pay land at a lower level of
13 value knowing that when it came useful to them it would
14 have a higher level of value in one form or another.
15 Either useful at a higher level to them or useful in the
16 market at a higher level?
17

18 PROF BOYD: I think in response that they would expect to
19 have a higher value in the future. So, it is quite
20 likely when they are investing in an asset such as land,
21 they would expect that growth in value, yes, I think
22 that's a reasonable expectation, and that could well be
23 one of the factors in their decision to go for the larger
24 tract, on the basis that they were doing an investment,
25 if they are willing to look at that sort of type of
26 exercise.
27

28 CHAIR: I just wonder whether it might be worth raising the
29 other point yesterday with Auckland, where they were
30 looking at values of land sold contiguous and not so
31 close to the airport. On this analysis would you fix a
32 price completely independent of that. I wonder whether
33 you'd care to follow that up.
34

35 MR GAMBY: I don't believe you were here when the
36 suggestion was put that there's a certain level of value
37 which has been applied to part of the land, but when it
38 becomes useful in another particular type of use then
39 this moves under the market value existing use basis, or
40 the fair value basis, either one, from one level of value
41 to the other.

42 I don't know whether you have considered that in
43 terms of excess land in relation to specialised assets,
44 but that appears to be what takes place. And the
45 question that the Commission is particularly interested
46 in, is in the process of it moving from one level of
47 value to the other there is both a timing issue at which
48 it may be charged to certain individuals, say the
49 airlines, and also the question of, does the -- when it
50 moves from one level of value to the other, does it not

1 then incorporate all the costs involved of holding that
2 land when it moves from one to the other? Perhaps you'd
3 like to comment. Is that where you --

4
5 CHAIR: The only other point which is probably
6 self-evident, in that model does one tend to chase the
7 other? I mean whether you're building an airport or a
8 port, if you like, or a shoppingcentre, and you are next
9 to a K-Mart and you're a shoe shop, you'd probably sell
10 more shoes than if you are not. So, a large
11 infrastructure like an airport tends to have an immediate
12 impact on contiguous land values, which then can follow
13 each other up in valuing the airport. Do you see what I
14 mean? It's almost a circular argument.

15
16 PROF BOYD: I agree with you, Mr Chairman, in terms of your
17 point that, if in fact you are sitting adjacent to an
18 asset which has a higher value than you, and that there's
19 a potential that you will be assumed into that, that
20 there does have the ability of pushing your value up.

21 The only other issue is now, what is to make the
22 asset -- let's take the airport and let's take airport
23 land next to it. Yes, I would say that land adjacent to
24 the airport would increase in value because of its
25 proximity to the airport provided the airport's basic
26 value is higher than its basic value.

27 However, I'm not sure that there is a continuous
28 growth upwards, because the airport is in fact in that
29 situation the dominant value, and if the dominant value
30 goes up, yes, I suppose the one next door as a proportion
31 of that, or as what we'd call a potential element of it,
32 would go up as well.

33 So, that I agree with. I'm just not sure that, bear
34 in mind the airport value will go up essentially in terms
35 of the productivity and the usefulness of it.

36
37 CHAIR: To be fair, the Auckland model, there are other
38 influences on land values around Auckland Airport that
39 also are reflected in the price of that land, so the
40 airport may not be the major factor but it's certainly an
41 important one. Thank you.

42
43 MR GAMBY: Did you want to try and address the earlier
44 question, as to the -- part of it, which I thought was
45 actually where I thought the Chairman was driving at. My
46 apology.

47
48 CHAIR: That's fine. Please.

49
50 PROF BOYD: Yeah, I feel a bit uncomfortable with that to

1 be honest because I'm not quite sure -- if you would like
2 to summarise it again for me, I'm sorry Evan.

3

4 MR GAMBY: I'll do the best I can, Terry.

5 The situation appears to be that, and this is the
6 way I think I would see it as a valuer, that you come
7 along and look at an asset which may have some value in
8 the future, and it may be five, seven, 10 years away but
9 you don't know quite when that's going to be. And
10 valuers will come along and say, I think it has a value
11 of -- let's take \$100,000 per hectare.

12 My understanding of the evidence which was given,
13 and the way I understood it was given, is that, at the
14 time, when the use becomes perhaps more quantifiable,
15 which might be five, seven, 10 years, then the valuers
16 would come along and value it at, say, \$200,000 a hectare
17 which reflects, as I understood the answer, the resource
18 management issues, the holding costs and any other issues
19 that may result. So it's almost -- it goes up slowly
20 during the revaluation and then it takes this great big
21 quantum jump.

22 Now, I think the question that the Commission is
23 perhaps looking at here is, should landing holding
24 charges be charged against this lower level of value over
25 the period when you're not quite sure, when you know
26 there's going to be a substantial jump at the end of it
27 when it becomes useful.

28 Would that be a fair way of expressing it? So, are
29 you getting a double whammy by charging it during the
30 process and then taking the higher value?

31

32 PROF BOYD: In response I'm going to sidestep the charges
33 issue, because I don't really want to comment on whether
34 the charges should be taken into account.

35

36 CHAIR: I understand that, that's fair enough.

37

38 PROF BOYD: In terms of the value, I can understand the
39 concept if you are saying you're buying land, and land is
40 valued on its current and future benefit. If the future
41 benefit's so far removed then it really just has its
42 current benefit. If, over time, the future benefit comes
43 close -- and you could take the scenario of rural land on
44 the fringe of a city; as the city expands, so that which
45 was originally just rural land now has potential for
46 residential development and, therefore, in time it does
47 increase in value because of factors that are increasing
48 the future benefit that's coming towards it, and to some
49 extent I can see that in relation to land either adjacent
50 to, adjoining or part of but not essentially part of the

1 fabric of something such as an airport.

2 I would refrain from commenting on how the charges
3 in relation to that should be taken into account.

4

5 MR PICKFORD: Can I just ask you one question about the
6 optimisation process and the use of this modern
7 equivalent asset, I know you actually didn't say much
8 about it and maybe Mr Seed will want to comment too.

9 It seems to me that in practise it must be very
10 difficult to actually work out the value of the modern
11 equivalent asset, certainly in the context that Mr Seed
12 raised it when he talked about South Auckland Hospital
13 with a 1940s style of design. You are talking about
14 reproducing that asset in a modern form to provide the
15 same level of functionality.

16 How can that actually be, because, by definition,
17 you are actually sort of upgrading it to a modern
18 standard of asset presentation and design, and so, the
19 two assets can't in any sense be equivalent, I would have
20 thought, but maybe I'm wrong. Perhaps you would like to
21 comment?

22

23 MR SEED: That's actually precisely the point that we're
24 making, that you're replicating the utility that's
25 provided by the existing asset, and you are never in the
26 position of over -- when I say "overoptimising" or
27 "optimising upwards", for example, with an old facility
28 such as that, and I set out in the slides all of the
29 issues -- in fact, not necessarily all of them
30 either -- but a large number of the issues that you would
31 actually take account of, in assessing what the modern
32 equivalent asset replacement cost actually was.

33 It's a very transparent way of doing it, and
34 you -- for example, you can build up construction costs
35 relatively easily, you can observe those. You know what
36 you need to spend on that building to comply with the
37 Building Act, fire regulations, other types of -- and
38 also to meet other types of compliance, you can actually
39 quantify those exactly.

40 You can identify the remaining economic life of the
41 asset, there are plenty of people around, for example
42 Marine and Industrial, who do nothing else other than
43 that, which is identify remaining economic lives of
44 assets.

45 So, I don't think it's quite as difficult as perhaps
46 you might see it. From a practitioner's point of view,
47 that's what we do all the time and I -- does that address
48 your question?

49

50 MR PICKFORD: Well, I was really looking at it in terms of

1 the actual utility or functionality of the building. I
2 mean, you gave the example where the old building doesn't
3 have a high level of functionality, and it seemed that in
4 replicating it with a modern asset you'd actually want to
5 improve its functionality, so you'd end up with a more
6 efficient building than the one you're replacing. So, in
7 a sense you're not comparing like with like at all.

8

9 PROF BOYD: If I could just come in at this stage and say
10 that; I hear your point, but I don't think it is that
11 difficult to use the same concept of functionality. It
12 is necessary to take concepts when you're working with
13 replacement as reproduction cost, but it is -- I think as
14 Mr Seed says -- is being done all the time. We can take
15 the most difficult examples and you will run into some
16 struggles with them, but I still don't think that it is
17 something that is beyond the ability of the valuers and
18 the other asset managers who are looking at these things
19 to say, that is the functionality of that building,
20 whatever your measure of functionality is in terms of
21 beds or whatever you think you're going to raise it, and
22 you'll put it into another building that has that same
23 type of functionality.

24 To me, I must come back to it and say that is still
25 easier to me than trying to find some historical cost and
26 index that historical cost up to the current day value
27 and say, well, yes, that represents the current cost,
28 because that has a great deal of difficulty with it and,
29 if you don't index it up, you don't have a measure of
30 comparison.

31 You definitely cannot use a net present value, which
32 has been suggested here by Dr Carpenter because, with all
33 due respect, I've never seen a five, 10 year-old historic
34 cost in a net present value. Net present value, by the
35 nature of it, is looking forward, present day forward in
36 time. How do you logically incorporate a five or
37 10 year-old historic cost and say it is at today's cost?

38 So, I would still say that, trying to find a
39 reasonable correct cost today is much easier to me than
40 trying to take an historical figure and adjust that
41 historical figure to present day.

42

43 MR STANLEY: Terry, just briefly carry on from that.
44 There's been a suggestion that the ODRC approach, which
45 we accept is a robust valuation method, is subject to the
46 possibility of undue influence or manipulation by the
47 entity involved, in terms of the possibilities of
48 deciding what parameters should apply. Would you like to
49 comment on that?

50

1 PROF BOYD: Yes, Mr Chairman, there's no doubt there's some
2 difficulty, in that you have to have various variables
3 into this, which are uncertain, and have a certain amount
4 of subjective judgment. But I would think that's the
5 reason why you need forums such as this wherevaluers can
6 put up figures and they can be audited and they can be
7 examined to say, has a reasonable stance been taken.
8 It's not the methodology, it's the inputs into the
9 methodology that need to be examined.

10 And I think there is adequate provision for that.
11 With all due respect you have some very competentvaluers
12 consulting to the Commission at the moment. If they were
13 to look at figures that were produced and put out in
14 terms of ODRC, I believe they could examine those as
15 equally well as they could examine those that are looking
16 at the land values, which are going to look at it on the
17 basis of all alternative use.

18
19 CHAIR: Yes, on that point. I mean, there's been a lot of
20 debate here in recent years about the application ofODV
21 to line networks, and, indeed, in that context guidelines
22 have been published as to howODV principles, or what ODV
23 principle should be applied. Certainly the
24 interpretation of those principles has occasioned a lot
25 of debate, and I think what you are saying is that it's
26 not too different conceptually underODRC, but there will
27 be considerable debate about the application principles
28 and the point that Mr Stanley made, about what assets are
29 actually put in under what conditions.

30 I'm not sure what the short answer to that one is,
31 but...

32 Now, on timing, first of all, what's your preference
33 Mr Weston? First of all, does Professor Boyd got to run
34 off to catch a plane, or what's your timetable?

35
36 MR WESTON QC: I think 1.30 was a witching hour -- 1.30, so
37 I don't know whether you've got more questions for him or
38 not, or --

39
40 CHAIR: Others might. I'd like to break at about 12.45 but
41 Dr Lally might have a couple of points just before that,
42 and if you are willing we could probably start again at
43 1.30 with Mr Seed. There isn't much else to do around
44 this part of town anyway.

45
46 MR WESTON QC: Opportunity costing.

47
48 CHAIR: With respect, yours may be higher than mine, but I
49 won't add on that any more.

50 I might ask Dr Lally perhaps just briefly to get the

1 points, while Professor Boyd is here, then perhaps
2 adjourn at quarter to and come back at 1.30. Okay,
3 Dr Lally.

4
5 DR LALLY: A couple of questions, Professor Boyd. There
6 seems to me to be quite a variation in opinion amongst
7 the experts who are appearing for the airports on a very
8 fundamental question, and that fundamental question has
9 been put a number of times by various Commissioners and
10 experts, and the question is, does the choice of
11 valuation method vary according to the purpose in mind?
12 Mr Houston yesterday, or the day before, pre-empted
13 that question by starting his presentation by saying
14 quite unambiguously, "The answer is yes". As the purpose
15 varies, the valuation method varies.

16 And if I understand you correctly, you are also
17 saying, "Yes"?

18
19 PROF BOYD: Yes, within the types of methodology that are
20 available, yes, you can choose a different methodology
21 according to the purpose. But the purpose will come from
22 what is mentioned early on there, is your problem
23 analysis and the definition of the value that you
24 require. Once you decide what value you require, which
25 can relate to the purpose for which it is required, then
26 you select a methodology.

27
28 DR LALLY: The same question was put to Mr Seed earlier
29 this morning, and if I understood him correctly, his very
30 clear answer was "one size fits all".

31
32 PROF BOYD: No, I don't think in fact, with respect, that
33 was his response that I heard.

34
35 DR LALLY: My intention was that Mr Seed would respond to
36 that question.

37
38 CHAIR: Perhaps, if Professor Boyd and Mr Seed will work it
39 out, which of them or both. So, it's over to you.

40
41 PROF BOYD: As I understood it, what Mr Seed was saying,
42 which was the same thing I was saying, was that if you
43 are valuing and you are looking at an airport of this
44 nature and you are valuing for pricing purposes or trying
45 to determine the same cost value for balance sheet
46 purposes, you would use the same approach. Therefore,
47 your intention here is to arrive at the current value of
48 the property. Once you have decided to arrive at the
49 current or the market value, then the purpose for which
50 that valuation is used does not change.

1 Let me give you the example that if, in fact, I
2 wanted to sell my house and I put a value on it, that
3 valuation should also be able to be given to the banks as
4 security to say, that is the valuation on which you could
5 place security.

6 I'm not going to go to the bank with a different
7 valuation and say, that's a valuation for security
8 purposes whereas this is a valuation for the marketing
9 purposes. Once you have chosen the approach you are
10 using, that should not change.

11

12 CHAIR: Mr Seed, have you got any further comment?

13

14 MR SEED: The discussion reminds me of a cartoon I saw
15 years and years and years ago. You may recall a
16 character called Jock. He was a farmer-type character
17 and he used to appear in a cartoon that was published in
18 the Farmer Magazine, probably not many of you have seen
19 that but anyway, I'll persevere.

20 Jock is standing, leaning on a gate talking to the
21 valuer who's just actually driven up to value his farm,
22 and Jock leans across the fence and says something along
23 the lines of, "Well, listen here mate, what I'd really
24 like is I'd like a high value for the bank and I'd like a
25 low value for the rates. I want a high value when I go
26 to sell it to the neighbour and I want a low value when I
27 have to confront the Tax Department".

28 That is illustrating hopefully we're not doing that
29 kind of thing here. If we're asked to assess the market
30 value of an asset, we assess the market value of the
31 asset.

32 My understanding is that Greg Houston, when he was
33 introducing these different valuation methods, was
34 talking about exit value for example. Now, if you ask
35 Professor Boyd or another valuer to talk about exit value
36 they would talk about net realisable value.

37 So, I think perhaps, Dr Lally, I mightn't have made
38 myself that clear, but if we're talking about market
39 value, there is one way of actually assessing that.

40

41 CHAIR: All right, thanks very much. Well, we're getting
42 to quarter to 1, so I might draw it to a close and just
43 to thank Professor Boyd for taking the time to present
44 his paper and answer questions, and reconvene at 1.30.
45 Thank you.

46

47

48 [Adjournment taken from 12.46pm to 1.30pm]

49

50

1 CHAIR: Okay, we'll reconvene. Mr Weston, please.

2

3 MR WESTON QC: Thank you, Mr Chairman. Mr Seed is going to
4 resume with his presentation. He's going to make a few
5 introductory comments about ODRC but we're largely
6 leaving that with Professor Boyd and he's mainly going to
7 deal with DCF. Thank you.

8

9 MR SEED: Thank you, Mr Chairman. We've spent quite a lot
10 of time this morning talking about the optimisation
11 issues surrounding the optimised depreciated replacement
12 cost approach, and really, I don't think there's anything
13 further that the next two slides that I have here are
14 really going to add. So, if I could just please skip
15 over these and just skip down to touch on the use of ODRC
16 and who actually uses it -- rather, who it's used by or
17 advocated by, and I just want to run through some of
18 these points.

19 ODRC is actually specified in Valuation Standard 2
20 for specialised assets and we note that in the
21 Commission's report that it referenced Valuation
22 Standard 2 and the valuation standard for specialised
23 assets, but it didn't actually then go on to say that
24 ODRC was the recommended approach. So I just want to
25 raise that particular point.

26 It's also recommended by the valuation standards of
27 the International Valuers Standards Committee, the
28 Institute of Chartered Accountants Standards of
29 New Zealand, FRS Standard 3. Now, the NAMS manual,
30 that's the new infrastructure asset manager manual also
31 recommends ODRC, and remember that's the manual we were
32 referring back to when we were talking about
33 optimised -- sorry, I've lost my place -- ODRM.

34

35 CHAIR: We know the one you mention.

36

37 MR SEED: Obviously, the Ministry has its ODV manual,
38 Transpower has its ODV manual, and both of those are -- I
39 think they are mentioned in the relevant legislation, are
40 they not?

41

42 CHAIR: The information disclosure regulations certainly
43 refer to the ODV manual; whether it's mandated or not --
44 Mr Bertram may know, off the top of my head I can't -- he
45 says it's not -- it's mentioned in the manual.

46

47 MR SEED: And ODRC is used in the valuation ports, roads
48 and other specialised assets. I'd just like to pick up
49 the point that I made this morning that we're talking
50 here about, the degree of the specialisation of assets

1 dictating the use of ODRC, not necessarily whether the
2 assets are owned or utilised by an institution or an
3 entity that operates as a monopoly. So what dictates the
4 use of ODRC is the degree of specialisation.
5 And also, ODRC or DORC as they discuss it in
6 Australia, is specified by the ACCC and discussed and
7 also utilised by the ACCC for airports, gas and also
8 lines businesses.
9 So, if I can make those comments and close on ODRC.
10 I'd be happy to come back and answer any questions on it,
11 but I think between Professor Boyd and I we've covered
12 the points I wish to make.
13
14 CHAIR: I'd ask Mr Gamby or --
15
16 MR GAMBY: No, I have no questions.
17
18 CHAIR: Dr Pickford first, please.
19
20 MR PICKFORD: Can I ask you what the situation is in the
21 United States with respect to regulator's utilities,
22 which I understand are regulated on the basis of historic
23 cost. Could you tell us, if you know it, what valuation
24 standards are used there?
25
26 MR SEED: The valuation standards that should apply would
27 be the International Valuers Standards Committee
28 standards.
29
30 MR PICKFORD: Are you certain if that's actually the case
31 for these regulated entities in the United States?
32
33 MR SEED: I'm sorry, I can't answer that question.
34
35 MR GAMBY: It may not be a particularly fair question
36 Mr Seed, but I would have liked to have addressed
37 Professor Boyd because it came up in our discussions.
38 When Professor Boyd mentioned that he had only one
39 concern with the Commission's findings, I think, and it
40 related to historic cost, was he actually addressing the
41 question of the land value at that stage? Were you
42 aware, or was anybody aware; could you tell us that
43 particular?
44
45 MR SEED: No.
46
47 MR GAMBY: You don't know.
48
49 MR WESTON QC: For what it's worth, my understanding was,
50 he was dealing with the sealed assets when he was talking

1 about that. But, if that's important, we can try and get
2 a clarification.

3

4 CHAIR: It might be useful if you could, please.

5

6 MS REBSTOCK: I think it might be clear in the transcript
7 when we get it. I think he clarified what he meant.

8

9 MR SEED: Now, I'd like to move to the last topic of my
10 presentation, which is the use of discounted cash flow
11 techniques for pricing.

12 The Commission mentioned discounted cash flow, or
13 what I'll refer to as DCF, once at paragraph 7.5, and it
14 says that, "There is a circular problem if discounted
15 cash flows are used to set prices".

16 Now, circularity's an issue that's been around for
17 some time and it's by no means new, I guess the first
18 citation of the concept was back in -- I think it was
19 1944 in the Hope -v- Natural Gas case in the US; that's
20 cited in Fred Kahn's book on The Economics of Regulation
21 Principles and Institutions.

22 All the Federal Power Commission then was saying,
23 was that the prices couldn't necessarily depend on the
24 value of the asset, and the value of the asset base
25 couldn't depend on prices or the rates that are charged.
26 Now, I don't think that anybody would dispute that.

27 Now, that just means simply that circularity arises
28 when the initial capital is estimated using DCF and the
29 prices also are estimated using DCF. So, circularity
30 does not arise however when the assets are valued using
31 ODRC, or historic cost for that matter, and that applies
32 to both DCF -- and where I've got "HC" there, that should
33 actually refer to the building block approach. So, it
34 applies in both cases whether you use what we've called a
35 "DCF approach", or whether you use what we call a
36 "building block approach".

37 Now, because CIAL's model -- and this is our
38 contention -- because CIAL's model for the airfield
39 pricing and other terminal pricing does not calculate the
40 initial capital value using a DCF approach, it cannot be
41 circular. The price is determined exogenously from the
42 model and, as we'll discuss later, CIAL's approach is
43 totally consistent with approaches that are used by the
44 ACCC and The World Bank, or recommended by The World
45 Bank.

46 The DCF approach that we have utilised in
47 determining our charges, is widely used in pricing all
48 sorts of securities, for example the DCF approach is used
49 in determining lease payments for different assets and
50 effectively that's what we've done here. If you can

1 think of the DCF as Auckland model that calculates an
2 analysed payment, and that analysed payment being the
3 reference revenue which is then divvied up amongst the
4 different types of aircraft landing at CIAL.

5 And the approach that we've used is virtually
6 identical to that set out in The World Bank publication,
7 resetting price controls for privatised utilities, and I
8 have a copy here with me, [indicates], it's sub-titled "A
9 Manual for Regulators". And, what it goes through is
10 just the approach that one would take, and it actually
11 deals with some of the issues that arise, including the
12 valuation of assets. For example, they recommend a
13 replacement cost approach, and also the treatment of the
14 cash flows and what should be included, and so on and so
15 forth.

16 The ACCC also utilised the DCF approach in that
17 case -- I think there are three cases I've cited in my
18 submission on the draft report, and they were the case of
19 Adelaide, Melbourne and Perth, I think from memory. I'm
20 sorry, Professor Boyd left with my notes, so I'm
21 operating a little bit blind here at the moment.

22 The main point to grasp here is that DCF is simply a
23 more transparent version of what I would call the
24 building block model. Under the building block model a
25 large number of the assumptions that are made explicitly
26 in the DCF model, assumptions about passenger growth,
27 assumptions about efficiencies in expenses, assumptions
28 about quite a wide range of things, like for example
29 capital expenditure, are all actually wrapped up into one
30 number in the building block approach. And, any
31 criticism or virtually all of the criticisms of the DCF
32 approach also largely apply to the building block model.

33 For example, if you criticise that the building
34 block model makes a large number of assumptions, well,
35 you've already implicit made those points, or assumptions
36 with the use of the building block model because the
37 building block model actually relies on a, if you like,
38 amplified case of the DCF approach. And, as I discuss in
39 my evidence, it actually uses a model that we call "a
40 model for a growing perpetuity", and that, if you will,
41 rolls a whole suite of assumptions into basically one
42 number, and that number is used to then calculate the
43 prices.

44 Mr Weston's just given me the three airports. The
45 airports are Adelaide, they were used -- the DCF approach
46 was used by the ACCC. At the Adelaide Airport, to
47 determine the multi-user integrated terminal charges, the
48 determination of the pass-through charges for necessary
49 new investment at Perth Airport, and lastly, the DCF
50 model was used for the determination of pass-through

1 charges for necessary new investment at Brisbane Airport.
2 I just think it's important to note here that
3 those -- rather, during CIAL's consultation round with
4 airline customers, the airline suggested that the
5 comparisons of the CIAL pricing model with the
6 application of DCF at Australian airports wasn't really
7 that appropriate. And the reasoning appeared to be that
8 determining the extra price that should be charged at an
9 Australian airport for a facility was somehow different
10 from determining a charge at Christchurch for the use of
11 the airfield or the use of the terminal.

12 I can't actually see how that is so. Surely what's
13 at question here is the pricing methodology and not the
14 asset to which it's actually been applied to, because
15 it's a methodology, as I said, that we've researched and
16 we believe is credible and we believe there's a fair bit
17 of support for, and, as I said, the publication -- the
18 approach that we've taken is basically set out totally in
19 this document, [indicates], which I'm happy to provide to
20 the Commission.

21 This leads us to the point of addressing the issue
22 of price smoothing, pre-financing, pre-funding, call it
23 what you will.

24 The Commission says in its initial view that
25 pre-funding is inappropriate, and following on from the
26 discussion we had this morning regarding used and useful,
27 I can understand where the Commission's coming from on
28 that angle.

29 By its very nature, discounted cash flow approaches
30 take into account future CAPEX.

31 Now, the test then becomes what's -- in exactly the
32 same way we've been talking about what a relevant asset
33 is, what's a relevant CAPEX. And in exactly the same way
34 that you would determine the ODRM -- sorry, optimised
35 replacement methodology, or you're using that -- sorry,
36 not the ODRM, you would also use the DCF because one is
37 just the analogue of the other.

38 In other words, if you are actually looking at how
39 that investment in that terminal, for example, is going
40 to work, there is an element of capital, if you're using
41 a crude or -- you know, we were talking about the crude
42 or naive used and useful definition this morning, which
43 it's not clear whether -- I don't think that's where the
44 Commission's coming from, but if you were going to use
45 that approach, there's always an element of asset that's
46 going to be added in at some point in the future.

47 Now, what the DCF model does, is it tends to smooth
48 the price path over that time period.

49 So, what you've done is you've determined the least
50 cost way of putting the asset in place, and then with the

1 DCF model you've determined the path of prices, so one,
2 if you like, is related to the other.

3 Now, the point I'd like to make is that, the smooth
4 price path is consistent with our reading of how prices
5 behave in competitive markets. It's also consistent with
6 the views of the ACCC and, for example, The World Bank
7 sponsored studies that we've reviewed -- and, in fact, if
8 I could just read you a reference which I have in my
9 earlier evidence, and I had summarised in my notes but
10 they're not here obviously.

11 This is from Resetting Price Controls for Privatised
12 Utilities, a Manual for Regulators by Richard Green and
13 Martin Pardina, P-A-R-D-I-N-A.

14
15 CHAIR: If we haven't got one already, we'll get a copy of
16 that anyway.

17
18 MR SEED: And from page 57, setting out the principles for
19 translating the revenue requirement into a price control,
20 they state:

21 "First we should aim to avoid fluctuations in
22 prices. If prices are changing rapidly and in a
23 seemingly unpredictable manner, customers will not be
24 able to react to the signals that prices are meant to
25 send. It is better to set a smooth path of prices based
26 on the company's revenue requirements over the whole
27 period than to match revenues and prices in each
28 sub-period at the cost of significant variations in
29 prices".

30 They raise a second point, and they say:

31 "Second: Incentives will be stronger if the price
32 control moves smoothly between the present level of
33 prices and the level desired in final year is shown in
34 the dotted line in figure 5.1".

35 And further to that; if prices are going to be
36 relatively smoothed in a competitive market, it would
37 seem to us that price smoothing is appropriate.
38 Furthermore, price smoothing is consistent with the views
39 expressed by the ACCC, that prices should not vary with
40 the vintage of the asset. And that particular view is
41 set out in the ACCC's Draft Principles for Regulatory
42 Pricing of Transmission Assets -- sorry, can I give you
43 the correct reference later. Sorry, beg your pardon,
44 Statement of Principles for the Regulation of
45 Transmission Revenues of the ACCC.

46 Now, just as a comparison of the DCF and building
47 block approaches; the things to consider here is, what's
48 taken account of explicitly and what's most transparent
49 and what's implicit and, therefore, difficult to winnow
50 out.

1 Now, in comparing both of these methodologies, for
2 example, you ask the first question; uses a cost-based
3 approach for the value of the asset? Yes, both of them
4 do, so there's no circularity involved with either the
5 DCF or the building block approach.

6 Are prices a function of the asset base? Yes, they
7 are in both cases.

8 Are prices a function of the cost of capital? Yes,
9 they are in both cases.

10 Now, the DCF, does it take account of the forecast
11 productive efficiencies, yes, it does explicitly because
12 you can -- or the costs that you actually put into your
13 DCF model can actually have productive efficiencies
14 imposed upon them. You can factor those in explicitly.

15 How, in terms of building block method, it's
16 implied, it has to go in there in the cost estimate that
17 you are putting in, in year one.

18 Does it take account of forecast economies of scale?
19 Yes, because in the DCF model what you are doing is you
20 are explicitly forecasting increases or changes in
21 traffic.

22 Now, increases or changes in traffic levels have the
23 impact of actually reducing the current level of -- well,
24 actually just to rephrase that sorry. Increases in the
25 forecast level of passengers and the forecast level of
26 movements has the impact of reducing the current level of
27 prices.

28 Next question; does the, or does either method take
29 account of the expected volume growth? Yes, it does, or
30 the DCF model does. And lastly, does the model take
31 account of expected capital expenditure? The DCF model
32 does explicitly and the building block model is implied.

33 Just a last point, one I haven't actually put on
34 there, and it relates to the discussion we had this
35 morning; the DCF model also explicitly takes account of
36 forecast capital gains in the determination of prices,
37 and in the case of CIAL those forecast capital gains
38 actually offset the charges that are charged to the
39 airlines.

40
41 CHAIR: That was the point Mr Bellew made, I think earlier
42 on, too.

43
44 MR SEED: Yes.

45 So, just to summarise, and this is the summary for
46 this presentation: I have four questions and the first
47 one is, is there evidence of historic airfield excess
48 returns at CIAL? Well, no. Based on relatively simple
49 corrections to the revenue, and also using an approach
50 which probably more realistically models the cost

CIAL

1 structure for CIAL in the early part of the decade; first
2 is the latter. I don't believe that there are, and those
3 simple corrections completely nullify the excess returns.

4 Is there strong influence support for the use of
5 ODRC to value airfield assets? Yes, there are. Or yes,
6 there is rather. And I believe that ODRC is a good proxy
7 for the market value of the assets that are being
8 employed.

9 Third question: Can DCF be used to set prices?
10 Yes, DCF can be used to set prices and it is not
11 circular.

12 Lastly: Is there support for price smoothing? Yes,
13 I believe there is strong support for price smoothing.
14 And that concludes the presentation, Mr Chairman.

15
16 CHAIR: Thanks, Mr Seed. Any questions, Mr Curtin?

17
18 MR CURTIN: Just one. In paragraph 148 of your submission,
19 you mention concepts behind the DCF model are not new,
20 and you're quite correct, I mean DCF is applied all over
21 the place, but you do mention that there's quite a lot of
22 criticism back from the airlines, and no doubt the
23 airlines will be quite capable of speaking for
24 themselves, but from your understanding what do you think
25 the brunt of the criticism was, where were they coming
26 from and what would be your response?

27
28 MR SEED: The airlines were concerned about the inclusion
29 of capital expenditure in the discounted cash flow
30 forecasts. And, our response is that, because we have
31 included increases, for example, in passenger growth and
32 all of the other factors that would show an increase in
33 traffic, and also because in the -- particularly in the
34 case of the domestic terminal where the redevelopment of
35 the existing terminal, which is currently around about
36 two-thirds too small for the number of passengers going
37 through it, is imminent, our response would be that it's
38 valid to include that capital expenditure in the
39 forecasts, particularly when you are looking at the issue
40 of price smoothing as well.

41 [Pause]. The other criticism that the airlines did
42 have was, the use of DCF was circular.

43
44 MR CURTIN: I was wondering actually where the argument
45 was because, if we look at your worked example in
46 paragraph 139; if you had, say, in year four a large slab
47 of investment going on, which you treat as an
48 expense -- let's say a big one, say \$1 million -- to get
49 the whole thing to come back to NPV of zero over the
50 six year period, the charges are going to have to be

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1 pretty impressive compared with what they would have been
2 otherwise?

3

4 MR SEED: Yes, that's correct, the charges do rise if you
5 put the capital expenditure in there. But I think, at
6 the same time you've also got to look at all the other
7 parameters that are in there.

8 I was trying to demonstrate here with a relatively
9 steady state model, and I've also included capital
10 expenditure, but I've included capital expenditure that
11 is equal to depreciation. So, one is the analogue of the
12 other really.

13

14 MS BATES: Just a point of clarification. Where you have
15 said that the Commission only mentions DCF once, and
16 that's at paragraph 7.5, that's true but it mentions it
17 in the context of asset valuation methodology, and makes
18 it clear that the circularity problem arises when the
19 initial value is fixed by having regard to returns.

20 So, I just wanted to make it clear that, I don't
21 think there's any difference between us on that
22 particular point. Did you think that there was?

23

24 MR SEED: Our understanding was that the Commission was
25 saying that you couldn't use DCF for pricing purposes.

26

27 MS BATES: Well, I'll just read it to you. "In competitive
28 markets prices are set independently of asset values and
29 the current value of a business or an asset is able to be
30 determined from the total present value of the cash flows
31 it can generate, i.e. that's a situation where valuation
32 is based on return. Prices determine the value of
33 assets. However, where markets are not competitive, as
34 with airfield activities, prices depend on the value of
35 assets. There is a circular problem if discounted cash
36 flows are used to set prices".

37

38 MR SEED: Therefore --

39

40 MS BATES: To go on. "Since prices will influence the
41 level of expected cash flow which in turn determines
42 asset value". So, what I'm just saying is that that
43 statement is made in the context of a situation where the
44 asset's valued by means of looking at the returns.

45

46 MR SEED: So, we would take it, then, that the Commission's
47 quite comfortable with the use of DCF where, for example,
48 you're using a cost-based approach to determine the asset
49 value initially?

50

1 MS BATES: I won't answer that. Not being an economist,
2 I'll ask an economist to answer it.

3
4 CHAIR: I think probably the answer -- when we finally
5 bring out our report, you will find the answer there.
6 That will perhaps be the best way of doing it.

7
8 MR WESTON QC: Ms Bates, if I could just respond to that.
9 You are absolutely right by what you say there by
10 reference to 7.5. We took that explicit reference to
11 DCF, together with other references in the report, to
12 saying that pre-funding is inappropriate to be a general
13 -- "condemnation" is too strong a word but is the best I
14 can do at the moment -- of DCF because DCF, in terms of
15 our approach, is the way pre-funding comes into the whole
16 deal. So, it was a mixture of those two things.
17 In giving you those references, it was really just a
18 convenience so you could quickly find the anchor point in
19 the draft report; it wasn't intending to say that that
20 one reference of itself condemned DCF.

21
22 MS BATES: I just wanted to clarify that point.

23
24 CHAIR: I think you are right, the pre-funding issue is
25 obviously a central point in consideration of the whole
26 issue.

27
28 MS REBSTOCK: I just wanted to follow-up on a couple of
29 things and get your view on it.
30 In a submission from BARNZ they make the following
31 comment, and I'd just like you to comment on it. BARNZ
32 also notes there are circularity issues involved in
33 valuing assets in their existing use in a monopoly
34 market, because the cash flows which would be used to
35 support the existing use value are in fact driven off
36 that value". Do you not accept that that's an issue?

37
38 MR SEED: If you are determining the existing use value
39 using a cost-based approach, no, it's not. All they've
40 described there is the circularity problem, so I don't
41 think that's an issue with our use of the DCF model as
42 such.

43
44 MS REBSTOCK: The other bit that I wouldn't mind you
45 commenting on since you referred to Professor Kahn, is
46 another quote from BARNZ' submission where they refer to
47 some evidence given behalf of Sydney Airport by
48 Professor Kahn in which he was talking about measuring
49 opportunity cost by the value of the next best
50 alternative use.

- 1 And the bit of that quote that seems relevant is, he
2 said, "My clients and I maintain that the only possible
3 basis of independent valuation free of circularity --
4 free of the circularity I have described, and in any
5 event its true economic cost was its opportunity cost and
6 its next most valuable alternative use, which the airport
7 estimated at 16 million. I know of no economist who
8 would disagree with that proposition".
9 He's talking about land in this case, but I'd just
10 like to -- I mean, you have referred to Professor Kahn
11 yourself and the merits of his thinking, so I'd just like
12 your views on that statement.
13
- 14 MR SEED: I'm sorry, I've been going now for about
15 four hours, my brain's a little fried. Could you please
16 read that again?
17
- 18 MS REBSTOCK: It's in the cross-submissions on -- there's
19 not a page, but it's?
20
- 21 MR WESTON QC: Is it para 57?
22
- 23 MS REBSTOCK: Para 57, that's it.
24
- 25 MR WESTON QC: Just while Mr Seed's reading that, I have a
26 feeling that at some point Professor Kahn has explained
27 that. Somewhere in this whole massive paper that I have
28 seen, I have seen a subsequent statement by
29 Professor Kahn -- I'm sure I have, I'm not going to put
30 my hand on my heart, because that was an interesting
31 issue and I think he has addressed that.
32
- 33 MS REBSTOCK: Maybe you could bring that back to us when
34 you locate it.
35
- 36 MR WESTON QC: It would be like, Madam Curie trying to find
37 her bit of radium I suspect, but I'll do my best.
38
- 39 CHAIR: It may be in his report that's attached to the
40 Auckland Airport's evidence?
41
- 42 MR WESTON QC: I don't think it's come in formally into
43 this.
44 I may be quite out of line in this, but I've got a
45 feeling that that is the case, and it may be that others
46 in the room would be able to put their finger on it.
47
- 48 MS REBSTOCK: I mean, leaving aside whether he's changed
49 his mind, since he said that he couldn't imagine an
50 economist would disagree with it -- maybe in fact he has

1 -- I'd still be interested in your view on what he had to
2 say.

3
4 MR SEED: I might be wrong, but wasn't this issue actually
5 addressed by Greg Houston the other day?

6
7 MS REBSTOCK: Yeah, I'm asking you for your view.

8
9 MR SEED: I could fall back to my humble practitioner
10 response to this?

11
12 MS REBSTOCK: If you'd like to come back in your closing
13 submission, that's fine.

14
15 MR SEED: I'd prefer to if that's possible.

16
17 CHAIR: Thanks, Mr Seed. All right, well, thank you very
18 much. Mr Weston?

19
20 MR WESTON QC: Thank you, Chairman.

21 Now, that -- we thought that might take a bit
22 longer, but Mr Bellew's going to close. As I said at the
23 outset, he's going to talk about countervailing power but
24 there are other topics he's collected up as we've gone
25 through this and he's going to try and address these from
26 his perspective as the chief executive, not wearing an
27 economist's hat or a lawyer's hat, it's simply his
28 perspective -- well, I shouldn't say "simply his
29 perspective as chief executive", and yes, "the commercial
30 perspective" as Ms Vautier says.

31
32 MR BELLEW: Well, Mr Chairman, Members of the Commission,
33 let me quickly summarise what I'd like to address.

34 I'd like to talk very briefly indeed about some of
35 the shareholder expectations that impact on airfield
36 pricing behaviour at Christchurch.

37 I'd like to give my views in terms of some of the
38 market realities, as I interpret them obviously, and some
39 recent events and how they impact on pricing behaviour.

40 I'd then like to make some further comments about
41 the characteristics of the airport business as I
42 experience it, and how they relate to some of the
43 concepts that have been discussed.

44 Firstly, to deal with the issue of shareholder
45 expectations which are really reflected by way of policy
46 as it comes through the statement of corporate intent. I
47 have to emphasise that, particularly a majority
48 shareholder -- Christchurch City Council which owns 75%
49 of Christchurch International Airport, they have an
50 expectation that we will do everything possible to

1 attract more air services to Christchurch.

2 I emphasise; they require of us that we do
3 everything possible to attract more air services to
4 Christchurch.

5 Now, I think the reason why they would require that
6 is pretty obvious. They see the economic benefits that
7 flow to the Christchurch community, Canterbury and the
8 South Island from increased tourism, and I'll come back
9 to tourism perhaps later.

10 In fact, I can assure you that at every quarterly
11 review we have with our shareholders, this issue is
12 canvassed, this issue.

13 A fact: We are not capacity constrained in terms of
14 our runway and airfield services, and I think that was
15 alluded to by one member of the Commission earlier.

16 But can I, at risk of a trivial but personal aspect,
17 bring out another emphasis in terms of the shareholders'
18 strong view as reflected in terms of the Board's
19 relationship with myself. My price, in part, is
20 determined by my success in attracting additional airport
21 services to Christchurch. In other words, my
22 remuneration is, in part, determined on an annual basis,
23 the at-risk component, by an annual measure of how many
24 additional services we attract.

25 Now, I think the reality of this incremental
26 increase is that, when pricing, we continually focus on
27 and have an emphasis on behaviour at the margin.
28 Because, after all, if you are looking at increases or
29 decreases, you often are focusing at the margin.

30 Let me move on now to my views in terms of market
31 realities. I am adamantly of the opinion that we must
32 compete at Christchurch to attract new services, but also
33 to retain existing. In fact, life in this regard for
34 us -- and I'll give some historic examples -- is not
35 always onward and upward despite the fact that on average
36 the outlook for air travel is positive.

37 We do in fact, and have in fact, experienced market
38 shocks, and some of those have been alluded to already,
39 and I'd like to cover those in some detail and there will
40 be some recent ones only.

41 Firstly, there is the muchpublicised recent demise
42 of the former Ansett New Zealand, or Qantas New Zealand
43 franchise. The market shock that we experienced there
44 was very real and very tangible. We have publicly stated
45 that the cost to us was in the order of \$840,000
46 excluding GST, and let me say that those costs are still
47 accruing in certain ways.

48 Another example which was alluded to I think by
49 Mr Seed, was the cessation late last year of services to
50 Christchurch by Korean Air. The annual revenue loss as a

1 consequence of that, based on previous prices, was
2 \$780,000, quite a material sum when put in the context of
3 our aeronautical revenue.

4 The irony, however, is that Korean Air persisted
5 with a decision to withdraw services despite the fact
6 that they were aware that our new pricing, which took
7 effect from 1 January this year, would have resulted for
8 them in a saving of \$230,000 on an annualised basis.

9 In other words, there were other market factors
10 prevailing in addition to airport pricing which
11 influenced that behaviour.

12 Let me move on in terms of other market
13 characteristics. The Air New Zealand Group, as measured
14 by the proportion of aeronautical revenue which they
15 contribute for the month of August, represents 66% of
16 that category. I have, from time to time, particularly
17 yesterday when listening to the arguments about regulated
18 electricity suppliers in the US market, wishfully thought
19 that perhaps I would like to be in that industry when one
20 reflects the daily crisis as it grows in immensity as
21 portrayed now through the daily newspapers.

22 We have a customer who is obviously going through an
23 enormous crisis, who is in a perilous state financially,
24 and they represent 66% of my aeronautical revenue, as
25 measured last month. Surely this indicates that we are
26 not risk free as with respect my airline customers tell
27 me when we are in pricing discussions.

28 In fact, we live in an increasingly turbulent world
29 and are not insulated from market shocks.

30 Our prices are set for three years. They are based
31 on agreed (negotiated aircraft movements) as part of the
32 consultation process. And furthermore, they are
33 forward-looking, obviously implicit in forecasts, but
34 they infer a mix of aircraft types.

35 We have no resource in terms of yesterday being
36 yesterday, and in that regard we have no right to recoup
37 or even adjust or an ability to quickly adjust prices.

38 Let me move on. Another market reality, as I see
39 it, for Christchurch: Much as I am challenged by my
40 shareholders to grow business, our offering -- in other
41 words, the travel market -- as perceived by the airlines
42 who would look at Christchurch as a destination -- may
43 not always be attractive. Let me elaborate, and this
44 will answer a question that was, I think, appropriately
45 raised yesterday.

46 88% of our international passengers through
47 Christchurch Airport are travelling for leisure or
48 holiday purposes. Now, a corollary of that is the fact
49 that, in general, leisure travel is lower yield for
50 airlines compared to, in particular business travel. In

1 other words, airlines attempt to optimise their yield and
2 ideally, whilst they want a full aircraft, they want a
3 mix of high yield and low yield, and the greater the
4 leverage towards the high yield, the more attractive the
5 destination.

6 My point is that, the market that we are servicing,
7 and the market that we price through our charges, is
8 skewed towards lower yield.

9 It would be remiss of me if I didn't deal with what
10 is a vexed and controversial issue, namely the pricing
11 process or consultation. Much as the process causes
12 considerable angst for me, I think it's from time to time
13 been demonised.

14 Let me go on. As the Commission are aware, we are
15 required when setting prices to consult with our
16 substantial airline customers. This process, from my
17 perspective as chief executive, is very influential on
18 the resulting prices in that it demands a certain
19 behaviour of us. In fact, as the Commission will be
20 aware, if the process, with all its purity, is not
21 appropriately followed, then it's already been
22 demonstrated that the airports are at risk of being taken
23 to the court and legal challenge. And this of itself is
24 a substantial threat.

25 Moving on, and still referring to the consultation
26 process. My customers are, in fact -- and I'm talking my
27 airline customers -- are represented by specialist
28 buyers. They have individually extensive experience, and
29 furthermore, they practice pricing discussions
30 frequently. They are truly specialist buyers. In
31 addition, in such discussions they are supported by their
32 local trade group, BARNZ, and in return behind that, and
33 even at a small airport like Christchurch you will, when
34 appropriate, get the appearance of the international
35 trade group of airlines, IATA. So, there is the whole
36 focus of, without being grandiose, the world scene and
37 the world policies.

38 In addition to that, there's a battery of advisors,
39 advocates, and furthermore, if I can comment on
40 bahaviourism, they are a very very cohesive group.

41 Let me say that I think the Commission already has
42 on record evidence of that. That if one member of that
43 group feels somehow disadvantaged as part of the pricing
44 process, the group will behave very cohesively. So,
45 there is an enormously concentrated and specialist
46 professional buying power.

47 Let me go on. As part of the consultation process
48 there is in fact substantial disclosure of relevant
49 information. In fact, I believe it can lead to informed
50 decisions by reasonable people.

1 One aspect of consultation which continually bemuses
2 me, is that there is enormous emphasis during the
3 consultation process on a location or airport specific
4 approach. In other words, the total focus is not on
5 airport charges across a geographic market, but rather on
6 the built-up approach as it applies to Christchurch.

7 As the Commission will be aware, the process is
8 invariably lengthy, often 12 months to 18 months. And to
9 close, I'd like to say that, in my opinion, stressful and
10 demanding though it is, consultation is a robust process
11 and I think that the resulting pricing reflects this.

12 Some more realities of the airport business from a
13 chief executive's perspective --

14
15 MS REBSTOCK: Could I just ask you a question on that
16 point. You make the point that, although it's
17 time-consuming and frustrating, the consultation process
18 is useful. Do you think that process would be improved
19 in terms of its effectiveness, from your vantage point
20 and the airline's, if it was supported by generally
21 accepted pricing principles.

22
23 MR BELLEW: As some of my colleagues have said before, and
24 I subscribe to this view, I think if we could get some
25 agreement as to principles, I think it would be help
26 catalyse or improve the process, I really believe. I
27 think there is a lot of gaming tactics whereby people
28 invariably, for various perceived advantageous reasons,
29 talk past each other and take somewhat disparity
30 attitudes. In other words, a lot of advocacy.

31
32 MS REBSTOCK: Just a follow-up question. Leaving aside
33 what methodology is appropriate, in your experience in
34 negotiating with the airlines, is it conceivable to you
35 that it would also be practical and possible for there to
36 be agreement on -- agreement to be reached on a
37 methodology for valuing assets which would provide the
38 required amount of transparency to bring confidentiality
39 to the negotiation process?

40
41 MR BELLEW: I am by nature optimistic and I would
42 hope -- much as there's obviously great debate and
43 disparity -- that there can be a closing of that gap.

44
45 MS REBSTOCK: I appreciate you being candid, because there
46 seems to be -- we seem to be hearing that from a number
47 of directions, or all the directions you want to hear it
48 from, and so, it does leave me wondering, you know, what
49 is it about the current environment that doesn't allow
50 that middle ground to be found? Because both sides are

1 basically indicating a willingness to find it, and
2 acknowledging the benefits of doing so, yet we're not
3 getting there.

4 In your view, what is it that's getting in the way
5 of that?
6

7 MR BELLEW: Well, you use the word "candid"; if I can be
8 quite candid. It's something that continually bemuses me
9 as well.

10 By way of background, I compare it. I used to be a
11 supplier in a heavy engineering industry to oil companies
12 who are really quite influential buyers, and yet I can
13 say, in my experience, that it was easier in a sense to
14 be able to arrive at outcomes there than it has been in
15 my 13 odd years on pricing in our industry. And yet, we
16 are fundamentally interdependent; "we", airports and
17 airlines.

18 I think that there has been excessive gaming, and
19 I'm being very candid here, and I don't think that's led
20 to always appropriate behaviour.
21

22 MS REBSTOCK: Thank you for that. Just one further
23 question: Would you think that there's enough to be
24 gained from finding the middle ground -- it hasn't been
25 possible so far -- but, would what each of you had to
26 give up be less if you reached -- you got there, do you
27 think that would have greater advantages to you than
28 possibly enduring the full direct and indirect costs of
29 price control, if that's the alternative?

30 I'm not presuming price control is the alternative,
31 I'm just saying "if it was", would that be enough to
32 perhaps give you the incentive to find the common ground?
33

34 MR BELLEW: I must confess in terms of answering this
35 question some bias. My inclination is towards, as I'm
36 private sector by background, laissez faire, minimum
37 intervention, so that biases me, if I can make that point
38 for a start.

39 I think, in the interests of efficiency of process
40 we have to arrive at a better outcome than what we've got
41 now by way of even the process.
42

43 MS REBSTOCK: Thank you.
44

45 MR BELLEW: If there's no more questions, Mr Chairman, can
46 I move on?
47

48 CHAIR: Yes, please.
49

50 MR BELLEW: Thank you.

1 Just some other realities of the airport business
2 and some of these have been covered already. We are
3 certainly capital intensive, in fact very capital
4 intensive business. The ratios are quite unusual. For
5 example, at Christchurch we have approximately \$4
6 invested for each \$1 of turnover, quite an unusual ratio
7 indeed. Furthermore, it's been alluded to by other
8 speakers, we have a very lumpy investment profile and, as
9 a consequence, one of the most challenging business
10 decisions facing myself as chief executive, but also our
11 Board, is the timing and quantum of capital spending, and
12 I note that this is an issue that's been exercising the
13 Commission's questioning.

14 Furthermore, and I think this is international
15 practice I'd like to refer to now, lead times are often
16 very very long, and I think this is something I would ask
17 the Commission please bear in mind. Here I'm going to
18 use empirical evidence, I'm going to quote from the US
19 market which has been referred to in another context
20 earlier, and that is the experience in the US at the
21 moment is that it takes on average 12.4 years to bring to
22 production a new runway.

23 Now, the construction time is relatively short,
24 probably a couple of years at most, but all the rest is
25 all the preparatory work etc that goes in, and including
26 the approvals, the agreement with users, the agreement
27 with the community etc. So, it is not a spot market
28 circumstance at all, it's a very long lead time
29 circumstance.

30
31 CHAIR: Thank you, we've been grappling with this, as you
32 rightly point to I think, so -- yeah.

33
34 MR BELLEW: And perhaps, and I think this has come through
35 in terms of the category of land ownership. Airports are
36 spatially extravagant; in fact, one of the things we must
37 have is an appropriate footprint.

38 Now, I think, depending on one's tactics, you can
39 come up with some quite diverse interpretations in this
40 regard as to, in the context of an airfield, what are the
41 must haves? And at the risk of making the Commission's
42 task even more daunting, I want to bring in a dimension
43 which I don't think has had sufficient emphasise to date.

44 On a minimalist footprint approach, obviously an
45 airfield could be represented by way of the analogy with
46 an aircraft carrier. On the other hand, increasingly
47 airports throughout the world are being capacity
48 constrained by environmental aspects, and in particular
49 airport noise.

50 We're all aware that our communities, and they tend

1 to have a great liking seemingly for airports and tend to
2 move towards us, much as we would prefer they stay away
3 in terms of residential, they have a heightened
4 expectation of what they will and will not accept. In
5 fact, I think the younger people in our community now
6 have a much greater environmental conscience and,
7 therefore, a lower tolerance of intrusion, such as noise,
8 than some years ago.

9 An issue which we have to continually grapple with
10 is, what costs will we incur today by way of buying the
11 spatial barriers or protection to allow us to operate
12 under-curfewed in the future?

13 And indeed, at Christchurch we have a policy of
14 wanting to retain our most competitive position, which is
15 24 hours a day under-curfewed operations.

16 One of the dilemmas, as a consequence, we face is,
17 to what extent should we buy land at the periphery which
18 will give us that certainty of future operation, and is
19 it fair, then, to ask that today's users pay some
20 insurance policy, if you like, to allow unfettered
21 operation into the future?

22 If I interpret my airline customers' expectations
23 correctly, as much as I acknowledge they're excessively
24 frugal when it comes to agreeing to prices, I think
25 conversely they believe that supply from us should be
26 elastic. In other words, they expect that we will always
27 be able to meet their expectations at a point in time.

28 In this regard I think, therefore, the Commission
29 has got a very difficult task as at defines, or indeed
30 refines the used and useful test in the context of our
31 operating environment.

32 To summarise: I have deliberately not used the word
33 "countervailing power", and let me explain why. I think
34 that the word "countervailing power" has sometimes got
35 too lofty and too pure a test relative to the market in
36 which we operate where there is enormous concentration of
37 buying power and very limited option on the supply side
38 as well, but there are other externalities which impact,
39 hence my example about my shareholder expectations, and
40 indeed the way they choose to reward and not reward me
41 which impact in terms of our behaviour in terms of us
42 moving towards efficient pricing. Thank you very much
43 indeed.

44
45 CHAIR: Thank you Mr Bellew, thank you.

46
47 MR CURTIN: Thank you very much for that, I'm always aware
48 of people who say they're not economists and avoid
49 phrases like "countervailing power" but seem to be quite
50 comfortable with the concept of "externalities", so I

1 suspect there's a little bit more economic reasoning up
2 your sleeve than you are prepared to concede.

3 Let's have a look at the bargaining strength of
4 countervailing power. One of the things that has cropped
5 up in a number of the submissions is the issue of the
6 regular scheduling meetings that IATA hold, and also the
7 global alliances, the One World and Star Alliances, and
8 it has been suggested that they are factors, one way or
9 another, in the relative bargaining strengths of airlines
10 and airports.

11 I was wondering if you'd just care to give us your
12 views on those two issues; the IATA scheduling meetings
13 and the global grand alliances?

14

15 MR BELLEW: Well, I think firstly the IATA scheduling
16 meetings; I think the IATA scheduling meetings is an
17 issue I can deal with fairly simply. They are really
18 only relevant when you've got a scarcity of supply and,
19 as we haven't got a scarcity of supply, we don't figure
20 in those scheduling meetings in any significant way at
21 all.

22 As I interpret it, they are mainly there to trade
23 among themselves as to who's going to compromise as an
24 airline vis-a-vis their schedules when they are looking
25 at a scarce resource where there's not enough capacity.
26 So, somebody has to give, somebody has to win, and I
27 think a lot of that goes on when you are facing an
28 airport that just hasn't got sufficient supply.

29 Could you give me the other question now, I'm sorry?

30

31 MR CURTIN: The other question was, in a number of
32 submissions there are references to the different groups
33 of alliances joining up -- different groups of airlines
34 joining the different alliances, like One World and
35 Star Alliance, and it's suggested that that could be a
36 factor in the relative bearing (inaudible) of airports
37 and airlines; I was just wondering if you had a
38 perspective on that?

39

40 MR BELLEW: Frankly, it's not clear-cut.

41 Let me give you a vision first, and I think that the
42 world of alliances, we've seen only the beginning of
43 that.

44 Furthermore, I think that we're going to see some
45 aggregation and disaggregation in terms of, it's going to
46 be rather fluid, in terms of people joining, defaulting
47 leaving etc, and it's quite a dynamic. Which of itself
48 for some airports, and not Christchurch, can have an
49 impact on costs, because invariably the economies are for
50 alliances if they can group their facilities together.

1 So, if people suddenly default and want to join
2 another team or family, this can mean costs. It doesn't
3 apply in Christchurch as we have but one terminal and not
4 multi terminals.

5 Another aspect that I want to bring through though
6 is, that it does mean that there is a concentration of
7 buying power. To illustrate:

8 In a negative sense at Christchurch we are already
9 incurring a cost in this sense. When we built the new
10 terminal we expected that we would be able to persuade
11 Singapore Airlines, and I'm being quite specific, to in
12 actual fact have their own lounge, the reason being that
13 they've got a very high commitment to the most impeccable
14 service standards, they want to differentiate their
15 product etc. But, as a consequence of the subsequent
16 advent of the Star Alliance, of which they are members,
17 they now share a common facility with Air New Zealand.
18 So we are bearing the costs, if you like, of space that
19 we built in anticipation, took the risk of lounge space
20 in that lounge which we won't have a customer for.

21 But it's not all negative and I'm being exceedingly
22 candid indeed. If one looks at the influence of the
23 alliances in terms of their market power in the travel
24 market, there has been a benefit for Christchurch in that
25 the combined market reach with the Star Alliance has
26 resulted in us now being able to have daily services,
27 Singapore/Christchurch/Singapore which we wouldn't have
28 been able to have before, and that's because in
29 Star Alliance, as you probably know, you've got the
30 combined leverage in the marketplace for travel of
31 Air New Zealand, Singapore Airlines and Lufthansa. So
32 that leverage, if you like, thickens up that route and
33 has given us a benefit.

34 So, there are pros and cons.

35
36 MR CURTIN: Thank you very much, that's very practical.

37
38 MS BATES: I have a question for you, and that is; are you
39 able to give the Commission any indication of the costs
40 involved in the negotiating and consultation process.

41
42 MR BELLEW: I haven't got those figures here, I will get
43 those figures and bring them back to you.

44 I assume that you want the direct disbursements,
45 that would leave aside opportunity costs and we don't
46 bring in wear and tear on chief executives either.

47
48 MS BATES: No. I think you've got it right. Yes, we'd be
49 most grateful for that, thank you.

50

1 CHAIR: Just to add to that, I think it was mentioned by
2 Ms Rebstock yesterday, and it follows on from the
3 question about pricing principles. The question was
4 asked of Auckland and I think it was mentioned again to
5 Mr Weston, just a view on whether principles plus the
6 threat of direct regulation might be one way of looking
7 at an outcome to the price control issue.

8 But in saying that, the Commission hasn't taken a
9 view on whether price control should be introduced or
10 not; it's a draft report but it comes from the
11 Productivity Commission in Australia's view for the
12 regulatory environment there for the next five years.
13 So, I think it's on the record somewhere, Mr Weston, but
14 if you could give some consideration to that?

15
16 MR WESTON QC: Chairman, just on that, a very provisional
17 view, because we're all grappling with this as a new
18 item, is that -- and we haven't a final view, but it may
19 help if I get some feedback on this; our provisional view
20 on that is, whatever benchmark you take for setting costs
21 to do your cost-benefit analysis, it's all fairly rough
22 and ready at a certain point, and it's hard to be too
23 precise and we don't have a lot of the information as to
24 what will be costs by a regulatory body under regulation
25 type A as compared to regulation type B.

26 So, our response may well be, at a conceptual level,
27 saying that, you have allocated certain costs and they
28 appear to us to be within a ballpark for price cap
29 regulation. We're not sure that, in terms of the margins
30 of error, that those figures are that far distant from
31 what they'd be from the Productivity Commission's type of
32 proposed regulation, but it's hard for an airport company
33 in Christchurch to get its mind around direct regulatory
34 body costs when we don't have a lot of experience of that
35 and we're unlikely to have the time to go to people who
36 might to give you something more sensible.

37
38 CHAIR: I think a view on the principle of a threat of
39 price control, together with some principles for
40 negotiation between the parties as an approach, which I
41 think is where the Productivity Commission have ended up
42 in Australia -- it's less than introducing price cap or
43 rate of return regulation. But again, as Ms Bates said,
44 if you have any factual information on the costs, of what
45 it might be, you will do your best; I think that's all we
46 can expect.

47 Well look, thanks very much for your presentations
48 and for the time you took, and we'll see you again next
49 week. Thanks indeed.

50 Now, I think for Wellington we might start at

1 3 o'clock. That will give you time, Jim, to get your
2 troops in order. Thank you.
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5 [Adjournment taken from 2.45pm to 3.00pm]
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1 PRESENTATION BY
2 WELLINGTON INTERNATIONAL AIRPORT LIMITED
3
4

5 CHAIR: All right, I just welcome Wellington Airport.
6 Mr Stevenson, before we start, just perhaps a wee bit on
7 timing.

8 I'd like to finish tonight, if it suits you, at 5 to
9 5 sharp. Three of the Commissioners are from Auckland,
10 so need to catch airplanes. Then again, if it fits your
11 timetable, start at 9 am on Monday and basically carry on
12 through Monday as you want to, and if we have to go past
13 5 o'clock, ask you to think about that. And if we run
14 out of time, obviously we'll make another time to make
15 sure there's every chance for Wellington's submission and
16 for questions etc to be considered. So I'd just like to
17 know if you agree to finish at 5 to 5 and then start at
18 9 am on Monday?
19

20 MR STEVENSON: Yes, certainly Mr Chairman. We've got a
21 provisional timetable in our submissions which I was
22 going to take you through first, and it's not meant to be
23 presumptuous but rather to provide you with an indication
24 of the time that we've estimated should be allocated to
25 the various parts of our submissions and evidence.

26 You've all received, I hope, one of these folders?
27

28 CHAIR: Yep.
29

30 MR STEVENSON: What we intend to do throughout the
31 Conference proceedings is add sort of copies of slide
32 material as we go along in advance of each session, and
33 it also already has in it two appendices, and one of them
34 relates to a provisional timetable and order of speakers
35 on behalf of Wellington Airport.

36 There's a second document attached there which
37 simply details the functions of our various speakers and
38 in some cases adds some biographical detail so that the
39 Commission can appreciate who is speaking to them.

40 So, if I could speak first very briefly,
41 Mr Chairman, to our provisional timetable.

42 As you say, we are seeking to end at 5 o'clock, and
43 certainly I believe we can end before then. We are
44 entirely in your hands, and obviously wish to meet your
45 wishes.
46

47 CHAIR: Well, I mean, if you still haven't finished the
48 competition analysis, obviously pick it up again on
49 Monday morning.
50

1 MR STEVENSON: Yes, that's right. Mr Horsley at this stage
2 would start at 9 o'clock on the Monday.
3 So, without going through the detail of this
4 particular timetable, I would like to introduce the
5 speakers really for our first session.
6 Initially I will do, fairly quickly, the base line
7 primary submissions of Wellington Airport, that will just
8 take really a few minutes, and we've invited the Mayor of
9 Wellington, Mark Blumsky, to say a few words from a
10 Wellington perspective, and secondly in the initial
11 session some remarks from an investor perspective from
12 Lloyd Morrison, CEO of Infratil.
13 So, we will be proceeding with that in fairly short
14 order and, with your permission, Mr Chair, we would have
15 a few minutes break to enable them to leave and go back
16 to their various responsibilities.
17 Following that, I would speak to legal and
18 jurisdictional issues, and competition analysis will
19 follow that.
20
21 CHAIR: That's fine. Well, please commence.
22
23 MR STEVENSON: Thank you. So we'll go to our primary
24 submissions, and I'm simply going to outline these, I'm
25 not going to elaborate on them, you will hear throughout
26 the Conference proceedings of our very detailed points
27 under each of these headings.
28 The first submission obviously is that we agree with
29 your preliminary view, that price controls should not be
30 introduced at Wellington Airport. We seek that view to
31 be confirmed in the final report. We note that no other
32 party is seeking the introduction of price control in
33 respect of Wellington Airport.
34 We agree with a number of the Commission's
35 particular preliminary use on jurisdictional and
36 substantive issues, but there are other preliminary views
37 obviously where we have differences, and we've already
38 provided quite extensive written submissions on those. I
39 make the point here, of course, that our presentation
40 over the next day or so really just compliments what is
41 quite detailed written work and expert reports.
42 We also have differences with BARNZ, Air New Zealand
43 and one or two of their supporting parties on a number of
44 issues.
45 So, together, taking account of what you said on the
46 first day, that you wish parties to be quite clear about
47 where the differences are and, you know, what their
48 reasons are for those differences, we've tried to order
49 our presentation in that way so that it can be fairly
50 understood in a fairly straightforward manner, which is

1 not easy in this very novel and highly complex price
2 control inquiry.

3 So, very briefly, the differences arise in these
4 following areas, the legal and jurisdictional area, some
5 aspects of competition analysis, obviously in the area of
6 countervailing power mainly. Land value and value of
7 improvements are obvious areas you've heard a great deal
8 about, and you will hear a bit more from Wellington's
9 point of view.

10 I think there are differentiation -- well, there are
11 different factors between different airports and we've
12 tried to also identify those for you.

13 Weighted average cost of capital, historic
14 performance is something that we wish to go through with
15 you, even though it doesn't really affect your ultimate
16 analysis.

17 And, the other area we wish to go through with you
18 is economic efficiency analysis, where we agree with the
19 Commission's principles and approach, but the
20 implementation aspects we've got a few things to say
21 about that, that might -- hopefully would assist.

22 Finally, we would then go through a summary of our
23 differences and what we suggest are remedies.

24 So, that moves me on, Mr Chairman, to inviting
25 His Worship, the Mayor, Mark Blumsky to talk to us about
26 a Wellington perspective. Thank you.

27

28 MR BLUMSKY: Mr Chair and Commissioners. Can I thank you
29 for this opportunity, it's certainly a first for me to
30 appear in front of the Commerce Commission and certainly
31 one I will certainly put on the CV maybe. There is no
32 electioneering going on I can assure you now.

33 My remarks are made on behalf of the city of
34 Wellington, which does retain a significant community
35 shareholding in the Wellington Airport and, as you may
36 note, I am a director on behalf of the city on the
37 airport.

38 I have been invited by the company to speak to you
39 about significance of our unique inner-city airport, to
40 our council-led initiatives that are promoting the
41 economic development of Wellington, and the need for that
42 company to operate commercially and effectively without
43 unnecessary further restrictions.

44 I certainly will not be speaking directly to the
45 Commission's draft report because that is for the
46 Company's team and the representatives to do that.

47 Those of you that are Wellingtonians will be fully
48 aware that our council has undertaken a concerted drive
49 over the last few years to boost economic development,
50 generally by fostering the growth of industries suitable

1 to Wellington. And I suppose, if you go back sort of
2 six years ago, Wellington as a city was focusing very
3 much on a quality-of-life environment, we thought that
4 was a point of difference. We felt if we made Wellington
5 a really nice place to live in, that that would actually
6 ensure a successful growth. But on talking to those
7 Kiwis that have been leaving Wellington on the bigOE --
8 that turned to a sort of, if you like, a CV trip rather
9 than just an OE trip -- on talking to them and asking
10 them why on earth they didn't come back home, we learnt
11 very quickly that it was actually a job that made the
12 difference to whether they actually stayed in Wellington
13 versus moving. There are a lot of nice places to live in
14 the world.

15 So, we decided to focus then on creating quality
16 jobs in the city and we worked on various industries,
17 tourism, education that were creating the wealth and the
18 jobs for Wellington, and their growth and our other
19 initiatives in the IT area, in particular, have helped
20 raise Wellington's profile both nationally and
21 internationally beyond that of the capital city that was.

22 I suppose an eye-opener to me was when I was lucky
23 enough to be invited to Washington and go to a World Bank
24 Conference on competitive cities two years ago, and it
25 was there that the President of the World Bank made it
26 quite clear that it was, in his eyes, the future that
27 cities were going to drive a nation's economy and that
28 cities were actually going to be the forerunners, the
29 leaders in a nation's drive. It was there that I
30 realised that -- they used a figure, there are 365 cities
31 in the world that are over 1 million people -- it's
32 probably 388 now because that was a couple of years
33 ago -- and when you put Wellington up against that you
34 realise just how small we are as a city. I call -- it's
35 a dot really. But how important it is therefore that we
36 lift our game if we are to be competitive and if we are
37 to get our -- or more than our fair share.

38 Most of our council's achievements impact directly
39 or indirectly on the tourism, travel and hospitality
40 industry, and my council has made a commitment to that
41 industry over the last few years and, in fact, we have
42 directly funded our tourism spend now from, about
43 \$100,000 it was four or five years ago, to closer to
44 \$4 million.

45 One of the significant successes has been a campaign
46 by our tourism organisation called Totally Wellington,
47 called "Send Yourself to Wellington", and that was a
48 fantastic success insofar as people did send themselves
49 to Wellington and did come here and spend a weekend.

50 I think the beauty of that campaign was the

1 partnership with Air New Zealand in particular, that we
2 entered into to drive the advertising and the deals, if
3 you like, that encouraged people to come here, and
4 organisations like Air New Zealand in partnership put in
5 many hundreds of thousands of dollars to leverage the
6 money that we were spending, so that was a very
7 successful campaign.

8 Recently, just published was the Wellington Regional
9 Council's half-yearly economic report card that confirmed
10 that tourism is now our region's biggest export earner.
11 Visits from foreign tourist groups have increased by 70%
12 in the year to May, with the total visit numbers up 11%.

13 We have seen Wellington overtake Rotorua as a
14 visitor destination and that's something the city is very
15 proud of. I think a few years ago people would have
16 laughed if you had thrown that suggestion around that we
17 would be able to do that.

18 But I would suggest to you now that exceptional
19 growth has now pushed Wellington ahead of Queenstown in
20 regard to visitor guest night, and we are now the third
21 most visitor guest night destination in New Zealand
22 having surpassed Rotorua and Queenstown about a month
23 ago, again a figure that has taken -- a fact that has
24 taken many by surprise.

25 Figures for guest nights just in June alone were up
26 20% compared to national growth of 9%.

27 So, the point we're making there is the
28 sustainability and the growth are very very relevant and
29 necessary.

30 And a big part of the drive with tourism has been
31 the Council's commitment to hosting international big
32 events. We've understood the impact that will have on
33 our city, like the World Rugby Sevens, the Edinburgh
34 Military Tattoo, Pinot Noir 2000 -- if you missed it,
35 make sure you get to the Pinot Noir 2003 because it was
36 probably one of the most successful wine events, I think,
37 of all time -- what I can remember of it, anyway, I can
38 assure you.

39 We have well and truly confirmed our position as
40 New Zealand's arts capital, and of course we host the
41 national cultural centre of Te Papa.

42 There has been substantial new investment and
43 infrastructure through the city that has, without a
44 doubt, spun off to our restaurant trade and talk amongst
45 others about the stadium and obviously as a venue for
46 significant events. But to show you the power of the
47 stadium, businesses now do -- bars I suppose, they are
48 businesses, now do one month's turnover on one night that
49 the stadium is full. So it's a significant economic
50 driver for us.

1 Clearly, the airport is of immense significance to
2 the region as a gateway, but also as a centre of
3 transport infrastructure for other parts of New Zealand
4 and the South Pacific, and you probably wouldn't find a
5 truer hub in Australasia.

6 It is no secret that the opening in 1999 of the
7 multi-use terminal has made Wellington the envy of other
8 regional centres, and I thoroughly enjoy hosting local
9 Government mayoral conferences in Wellington, I can
10 suggest to you, and meeting my colleagues at the airport;
11 it's a nice environment to meet them in.

12 I believe that this was built, the airport terminal,
13 was built through commercial co-operation through the
14 Airport Company and our major airlines. It is obviously
15 important to council initiatives for the airport to
16 operate on the least cost and the most efficient basis
17 possible. I am aware from my role in the Airport Company
18 Board that this is very much a major driver for the
19 Airport Company.

20 We are looking at -- I mean, it's a fascinating
21 Board to be on, we have being very innovative. One of
22 the things we are doing now, we have set up, just for
23 example, a marketing committee, and it is a committee
24 comprising of us two [indicates Mr Morrison]. We are the
25 marketing committee, and what we are doing literally is
26 looking at ways that we can make the airport terminal, if
27 you like, a part of Wellington, a piece of Wellington, it
28 has a sense of place, it's more than just a terminal
29 where people go through, it actually will tell the story
30 of Wellington, whether it be a single story around an
31 event or a story of the region or whatever, that it will
32 be a changing place. So we're trying very hard to make
33 it more than just a bit of glass and a bit of fancy
34 woodwork; we're trying, as I said, trying to make it a
35 true sense of place, a real point of difference.

36 To this effect the city is pleased to be in
37 partnership with an experienced and specialist
38 infrastructure investor. A fully commercial and
39 profitable airport company is consistent with our
40 council's aims for the continuing development of city
41 infrastructure and the airport's ability to promote the
42 local economy.

43 As part of our partnership, we actively seek to
44 promote the provision of existing and new airline
45 services at the airport -- might have noticed in the
46 paper last night, I have in fact written to
47 Richard Branson and suggested he may visit Wellington and
48 visit the delights of Wellington to get clear in mind why
49 he should be sending his planes to our airport.

50 My message is that the airport and airlines have

1 worked well in Wellington for a number of years. The
2 passenger terminal being the most visible example of a
3 tremendous example of joint co-operation.

4 My understanding is that the Wellington Airport has
5 under-performed financially over a number of years, and
6 is being addressed in the future.

7 However, I know that processes are already in place
8 for consultation with the airlines over the next year.
9 From our point of view, in Wellington Airport's case,
10 commercial approaches have worked well to date and we, as
11 a council, would fully expect them to do so in the
12 future.

13 Again, I thank you for the opportunity just to, if
14 you like, put a Wellington perspective at the front end
15 of our submission.

16

17 CHAIR: Thank you very much.

18

19 MS REBSTOCK: I wondered, Mayor, if I can just ask you a
20 question as a major shareholder in the airport.

21 When Wellington City thinks about its view on
22 changes in charges, could you give us some feel for your
23 approach to, on the one hand wanting to earn a good
24 return from this investment, but also your interest in
25 promoting Wellington for a number of other purposes. Can
26 you comment on how those two interests factor into your
27 own approach as a director of the company into charging
28 issues?

29

30 MR BLUMSKY: Without a doubt, Wellington City, as the 33%
31 shareholder, is very keen for a number of reasons to see
32 a lot more planes landing at our airport. We obviously
33 are very keen to see those planes landing for tourism
34 reasons, for the passengers that they drop off, but also
35 then from a -- as an owner of the airport, from an
36 economic perspective as to the bottom line of the
37 airport.

38 And from our point of view it's a matter I suppose
39 of the negotiation of the commercial operation to find
40 that line where you do find, I suppose, the win/win for
41 both parties, whereby they are -- the airlines feel very
42 encouraged to bring their planes here, but we have
43 actually found the point whereby we make a reasonable
44 return on that plane landing.

45

46 CHAIR: Thank you very much.

47

48 MR STEVENSON: Thank you Mr Chairman, I'd now like to
49 introduce Lloyd Morrison, chief executive of Infratil, to
50 make a few remarks on the investor perspective.

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MR MORRISON: Mr Chairman and Commissioners. I am pleased to have an opportunity to talk at this Conference. As the majority private investor in Wellington Airport, I believe the perspective of Infratil on aspects of the airfield price control study will be relevant and helpful to the Commission.

Like Mark Blumsky, I am not here to represent the company regarding the submission's very detailed report. That's for John Sheridan and his team. However, I wish to comment on four matters.

Firstly, some background to our investment into Wellington Airport. Secondly, how we've gone about managing Wellington Airport since our investment. Thirdly, the key challenge we now perceive for Wellington Airport. And finally, the importance of regulatory certainty for long-term investors such as Infratil and infrastructure assets.

Morrison & Co founded and manages Infratil which is New Zealand's only specialist utilities and infrastructure investor.

Infratil is a Wellington-based organisation, with over 15,000 New Zealand share and bondholders.

Morrison and Co have substantial experience in the airport sector. The firm has been involved in over 20 airport investment transactions, here and internationally, and has experience in airport management in New Zealand, Australia, the United Kingdom and Continental Europe.

We managed the purchase of Wellington Airport from the Crown in a competitive process in 1998, and we continue to advise Wellington Airport.

Infratil's success as a purchaser of the Crown's shares in Wellington Airport reflected our ability to understand and manage the risks identified in the business. We also focused on our ability to implement better operating practices and financial structure, together with enhanced growth over the longer term.

Since acquisition, our focus has been on three areas; operations, finance and airline services. I believe we can say without risk of challenge that Wellington Airport is one of the most efficient airports of its size in the world, in both operational and financial terms.

We believe that on a comparative world basis we are a far more efficient operator compared with our peers than either of our major users when compared to theirs.

Since 1997 passenger numbers at Wellington Airport

1 have increased from 3.3 million to 3.7 million, a
2 10% increase.

3 Over that same period, excluding the write-off of
4 costs associated with Qantas New Zealand's failure and
5 Wellington Airport's participation in the
6 Commerce Commission hearings, costs have fallen by 9%.
7 In other words, traffic's gone up by 10%, costs have come
8 down by 9%. But these figures do not adequately reflect
9 the materiality of savings which have been made in the
10 more controllable areas of costs, although John Sheridan
11 will talk in a lot more detail about these matters.

12 However, the overhead here on the right, which John
13 will talk to later in detail, graphically illustrates
14 these savings. When you look at the cost decreases on a
15 per passenger basis, you should note that these successes
16 have been achieved during a period of low and disrupted
17 passenger growth.

18 On financial structure: Wellington Airport
19 undertook a wide survey of funding options before
20 implementing its current debt arrangements. While we are
21 comfortable with our current funding and level of debt,
22 we are continually looking to lower its cost.

23 The key remaining area of encouraging airline
24 services has been, and remains, our greatest and most
25 difficult challenge.

26 We have seen Ansett get into trouble after their
27 pilot strike, we have seen Qantas New Zealand fail. We
28 have seen Air New Zealand offer a discount TransTasman
29 service out of Palmerston North taking passengers away
30 from Wellington while strategically not scheduling
31 Freedom Air to operate TransTasman out of Wellington.
32 We are waiting on the Government's decisions on ownership
33 of Air New Zealand and whether Virgin Blue is allowed to
34 offer services. We remain actively engaged in
35 encouraging both our existing airline customers and
36 potential new entrants to offer an additional services
37 out of Wellington.

38 In this respect, our interests as owners of
39 Wellington Airport are closely aligned with those of the
40 travelling public, and with the Wellington region. For
41 example, entry of Virgin Blue to the domestic and
42 Trans-Tasman markets would see increased flights and
43 dramatic decreases in airfares into and out of
44 Wellington. Air New Zealand and Qantas would have to
45 discount many more seats to compete.

46 The savings enjoyed by the travelling public would
47 dwarf the entire landing charge component in an
48 Air New Zealand and Qantas TransTasman or domestic
49 airfare.

50 Wellington Airport, as Mark has pointed out

1 strongly, has a real interest in growing traffic out of
2 Wellington, and it is growth that will drive greater
3 efficiencies, even greater efficiencies, and reduce the
4 average landing charges per passenger.

5 Finally, this draws me to the issue of the
6 regulatory regime. Investors are looking for regulatory
7 certainty and regulatory environments conducive to
8 investment, as distinct from heavy-handed Government or
9 regulatory oversight.

10 The costs of Commerce Commission processes are
11 material for a small airport such as Wellington and, as
12 investors, would be a big negative issue for us.

13 Despite considerable cost and personal effort, the
14 detail and quality of our first submission seemed to
15 elicit limited response from the Commission. On several
16 major issues the approach of the Commerce Commission to
17 these regulatory matters was not, in my view,
18 appropriately signalled if companies such as
19 Wellington Airport were to adequately enter debate on
20 potential changes. Valuation stands out in this respect.

21 As an international investor in utility assets, we
22 closely monitor regulatory trends in many different
23 countries. As an adviser we have been involved in
24 aspects of utility regulation in New Zealand, Australia
25 and the United Kingdom. In almost all cases regulatory
26 change has been considered or has resulted when there has
27 been a clear and obviously poor economic performance by
28 specific infrastructure asset classes or industries.

29 What has dumbfounded me personally in this case is
30 the complete surprise of the mooted changes when all our
31 benchmarking experience suggests that the major
32 New Zealand airports are operating at international
33 levels of efficiency with no evidence of aeronautical
34 charges being out of line with acceptable international
35 practice.

36 I cannot stress enough that investors do not like
37 uncertainty. We know the rules, we do not expect to have
38 them changed when they're not failing. It is a complete
39 oddity for Wellington Airport to be the subject of a
40 major regulatory inquiry given its small size and history
41 of a decade of performance well below competitive pricing
42 levels.

43 Wellington Airport's real challenge ahead in
44 providing a positive contribution to the local and
45 national economy is in promoting existing and new airline
46 services to use Wellington Airport. As I have said, this
47 has been a particular focus of Infratil in
48 Wellington Airport. Obviously our preference and those
49 of users at Wellington Airport services, is to focus
50 management efforts on these productive tasks to our

1 mutual benefit, rather than on the inefficiency and cost
2 of any additional unnecessary regulatory oversight.

3 Thank you Chair, thank you very much. I'd just make
4 a couple of comments if I might, linked I think to your
5 last two points.

6 I think in the first place, the Commission's
7 involvement in this exercise, of course, is a consequence
8 of a request by the Government and the previous Minister.
9 So, it wasn't something that we thought about on a Friday
10 and decided to get on with a couple of weeks later, so
11 we're very conscious that we are responding to a request
12 under Section 54(2) I think it is, from the Government
13 and, of course, propose to report back on that reference,
14 that's what the inquiry's all about.

15 I think the second point in relation to the way the
16 reference has been addressed, and Mr Stevenson may well
17 want to comment on this in his subsequent submission, we
18 do of course have to establish a number of thresholds.
19 Whether, for example, competition is limited is a first
20 threshold. And then, one of the subsequent thresholds in
21 that context, should price control be recommended or not?
22 So, it's not quite like sort of the intervention of, I
23 think other regulatory regimes where decisions are being
24 made, as I understand it, to price control utilities full
25 stop and to get on with it.

26 So, while I accept that this inquiry has certainly
27 caused a lot of work and time for the parties and for the
28 Commission, the process is designed as the Act requires,
29 to enable A, those thresholds to be addressed and B, of
30 course people like yourselves and others to make a full
31 input into the final consideration.

32 Thirdly, and I guess just for the record, because
33 you are well aware of it, our report, of course, is a
34 draft one, and when it was published a month or so back,
35 of course it was seen by some commentators as a final
36 report; in fact, I think one or two of the commentators
37 said the Commission is introducing price control. Well,
38 I mean, you are as well aware as we are that it's a draft
39 report and the intent of the Conference is to get full
40 submissions and, of course, to enable your views on our
41 draft report to be fully explored.

42 So, in that context we are going through the
43 Conference with those objectives in mind, and certainly
44 the Act, as I'm sure Mr Stevenson may want to comment
45 later on, provides a number of thresholds working through
46 this process, and then, of course, the Commission is
47 required to make a report to the Minister, who has the
48 final decision.

49 So, it's not by any means a finalised position and
50 indeed the final decision, whatever we recommend, is the

1 Government's.

2 So, I just thought I'd respond on those two or three
3 issues.

4 Just before I close I'd ask -- MsRebstock had
5 another question I think for Mr Morrison?
6

7 MS REBSTOCK: Mr Morrison, I'm interested in asking your
8 views on some of the information that we put in the draft
9 report on our calculations on Wellington -- and I'll just
10 mention, it's table 40 on page 141 that I'm looking at,
11 where the Commission has estimated the actual returns for
12 Wellington since corporatisation to be 6.54% compared to
13 a target return of 8.15. And just leaving aside
14 everything else in terms of what you might expect for an
15 airport industry, one might find the outcome surprising
16 for the case of Wellington, not that I would expect to
17 see it above the target return, but our estimate was well
18 below.

19 I'd be interested in whether you find that result
20 consistent with your own estimates or not, and if it is
21 I'd be interested in how you see that result in terms of
22 what lies behind it, what factors would lead to a result
23 that, at least on the way we calculated it, it appears to
24 be a result that is well below a target return for your
25 company. I'm asking that because it impacts on the way
26 we think about the market within which you are operating.
27

28 MR STEVENSON: Mr Chairman, I think Mr Morrison is
29 obviously at a disadvantage of not having the detailed
30 table in front of him. I'm sure he wants to respond in a
31 detailed way but those sort of detailed tables and
32 financial analysis, of course, is going to be the subject
33 of a lot of detailed evidence later on, but I'm sure he'd
34 want to make a general comment.
35

36 MR MORRISON: Yeah, I want to make a general comment. I
37 mean, we -- I think we're pretty good on the detail and
38 by the end of the submission I hope you'll be happy with
39 the way we've approached it. Clearly, as an investor, in
40 terms of the return on aeronautical assets, they're
41 inadequate, but we did provide the airport with a
42 regulatory framework that the previous owner had worked
43 under, and we've worked under that for a period of time,
44 and we're comfortable to continue to work under that, but
45 the way one gets a return is a combination -- as both
46 Mark and I have been stressing -- of different factors
47 than the ones that we have focused on; very much on
48 efficiency, and we're definite leaders here and I guess
49 we're both trying to get across that what we're
50 interested in doing is controlling our destiny as much as

1 we can.

2 And the second one is growth. The best thing that
3 could happen for Wellington Airport is growth. We don't
4 have the ability to control growth, we can influence it,
5 we could our best, we put a lot of effort, statistical
6 effort into trying to encourage people in terms of demand
7 factors, to look at business opportunities out of
8 Wellington. But I guess the point that I illustrated in
9 the speech, we faced a lot of risk factors that we
10 haven't been able to control, and we do try and control
11 the areas that we can do.

12
13 MS BATES: I guess, building the new terminal and raising
14 finance for that must have had some impact on the bottom
15 line, in terms of the result, is it -- would it be --
16 fair --

17
18 MR MORRISON: I guess what we're saying is, you know, the
19 inquiry is based on airfield, but if you look at building
20 the terminal, yes, I think the term is a combination of
21 trying to encourage growth and provide facilities, and I
22 think it's actually a very good mix.

23 I know there was criticism from some sources about
24 the building of the terminal and whether the terminal is
25 going to be good enough. I doubt that anybody could
26 stand up today, hand on heart, and say they could do a
27 better job. And I think, in terms of optimisation and
28 use of assets, we've been extremely good, and our costs
29 -- and John will go into this -- if anybody knows how to
30 improve them, we'd like to hear from them. I guess what
31 I'm trying to say is, we're very motivated in that
32 respect.

33
34 MS BATES: Thank you.

35
36 MR CURTIN: Thanks very much. Just a couple of quick
37 things. You mentioned a number of times the benchmarking
38 work that you've done, and I'm not totally aware of
39 whether you've shared that with the Commission staff but
40 if there is material available, that would be great.

41 You mentioned also in your speech that you had had
42 some experience with regulatory trends in other
43 countries, Australia and elsewhere, and that's a topic
44 that's been brought to our attention over the last couple
45 of days too, and I wonder if you had any perspective on
46 trends in regulation of airfield activities in Australia
47 that you might want to put on the table?

48
49 MR SHERIDAN: Well, can I say that we've had experience of
50 the cost structures of Australia, the UK and Europe, and

1 of course as a New Zealander I find them astounding, and
2 in terms of regulatory process, it's equally astounding
3 and I don't find they deliver results any better than the
4 current system that we've got here.

5 I guess I think that the better example is probably
6 what's happening in Europe. I'm not sure whether you are
7 aware that we own an airport in Scotland, and we have
8 involvement, our main user there is a discount or low
9 cost airline called Ryan Air, which is an incredibly
10 efficient airline, an outstanding operation, and very
11 profitable despite being the lowest cost operator there,
12 and the airport business is changing. Passengers are not
13 so keen on going to big airports, they are interested in
14 efficiency, but most of all they're interested in
15 pricing, and the elasticity of demand, and it's actually
16 affecting the way airports are operating there.

17 Now, in a regulatory sense, there isn't much focus
18 on anything other than the very largest airports, and I
19 think that's because in air transport a lot more
20 competition between airports and provision of airport
21 services than there might have been historically, and
22 that's an issue that affects us very much.

23 I guess I'm talking about the regulatory model. I
24 can see the regulation of airports moving backwards in
25 Europe because of these sort of trends. In Australia
26 it's yet to be shaken down. If Virgin Blue becomes part
27 of one or two airlines, I don't think we'll see the same
28 changes over there. We would very much like competition
29 to remain in Australasia, not to dissipate.

30
31 CHAIR: Well, thank you very much. I guess just for the
32 record, probably the answer to more tourist numbers,
33 Mr Mayor, is to fix that rugby team, and I speak on
34 behalf of my colleague on my left and, if you can do that
35 before you leave office, you will have solved quite a few
36 problems.

37 Well, thank you very much for your time and for your
38 submissions.

39
40 MR STEVENSON: Thank you Mr Chairman, copies of their
41 statements will be handed up to the Commission and to the
42 staff, and I wonder if we could have just a minute's
43 break to allow the two gentlemen to leave.

44
45 CHAIR: Thank you. [Pause]. Mr Stevenson.

46
47 MR STEVENSON: Yes, thank you very much Mr Chairman. In
48 this part of the session, leading up to the end of the
49 day, we're going to deal with legal and jurisdictional
50 issues and competition analysis. My colleague,

1 Tony Dellow was to be here but he's tied up at a Select
2 Committee now, so I'll proceed without him.

3 The Commission will be aware that there is quite a
4 large volume of legal submissions have been made in the
5 three submissions made to the Commission to date; that's
6 the initial submission in April, and the 14 August
7 comment on the draft report, and then finally the counter
8 submission. So, all what I'd call our, sort of, legal
9 and jurisdictional arguments or discussions are set out
10 in great detail in those documents.

11 But, I think it is necessary to revisit some of
12 these basic areas of the scope of the inquiry. I have
13 noticed, although I haven't been personally here -- I've
14 certainly been following a number of the issues that have
15 come up in the course of the inquiry, and particularly
16 this whole issue of looking at alternative forms of
17 regulation, and I really feel that something needs to be
18 clarified in that area. It's very timely to do so at the
19 beginning of our submissions which, of course, lead on
20 eventually to the airline submissions who have been
21 advocating, effectively, changes in the regulatory
22 regime.

23 So, the first point that I wish to address briefly
24 here is that, we agree with what the Commission has done
25 in terms of seeking to confine the scope of the inquiry
26 to airfield activities, and that has been in the face of
27 requests by BARNZ to widen that inquiry and indeed to
28 have a parallel inquiry into terminal activities.

29 I note that in their submissions on the draft
30 report, that they have raised this invitation again, i.e.
31 that you look into the pricing of terminal activities.
32 Now, that's confined in Auckland and Christchurch but of
33 course, as far as Wellington is concerned, we're
34 obviously in this group of specified airports. We simply
35 reiterate that this is not an inquiry to come up with
36 recommendations or views about terminal activity services
37 and charges.

38 Secondly, the BARNZ submission starts discussing the
39 Airport Authorities Act and the ways in which that might
40 be altered. In the first place they are seeking to
41 perhaps get this inquiry to recommend changes in
42 definitions -- for some reason I'm not quite sure
43 about -- but it seems to line up the Commission's market
44 definitions with what's currently in the Act.

45 Again, this is clearly beyond the scope of the
46 inquiry. They only express the hope that you do it but
47 it's not a matter that you really have any powers to deal
48 with. That is, in terms of having a policy finding on
49 the aspects of the Act.

50 A second aspect of the sort of changes they would

1 wish to see relates to really, the scope of the whole
2 specified airport regime under the Airport Authorities
3 Act. And, in particular, a discussion towards a
4 compulsory -- what I have referred to as compulsory
5 negotiation regime backed up by an arbitrator, and I wish
6 to address this particular issue in some detail later
7 because there's really two strands to this argument.

8 One is the one coming from the Commission's draft
9 report that, within the Commerce Act, within Section 72,
10 one can create, in effect, a compulsory negotiation
11 regime, with the Commission as arbitrator. BARNZ, on the
12 other hand, and as well as the Commission gets into this
13 area, there is a discussion of what I'd call the other
14 alternative form of that, which is strengthen the Airport
15 Authorities Act for compulsory negotiation with an
16 independent arbitrator. The idea of specifying pricing
17 principles is thrown in with each of these options, and
18 I'd like to talk about both those things a little bit
19 later.

20 Dealing here with BARNZ' other submission, pressed
21 for several submissions now, they would wish the
22 Commission to re-enter the single-till/multi-till debate.
23 It's now put up in the form of modified multi-till, but
24 essentially it is a request of the Commission to find
25 some costs allocation mechanisms which will amount to an
26 endorsement by the Commission of a single-till approach
27 to all airport activities.

28 Now, we've already said, and we believe the
29 Commission has agreed, that effectively, because of the
30 limited scope of the inquiry to airfield activities, that
31 really it can only get into that issue insofar as it
32 affected costs allocations that would help you work out
33 the returns that had been obtained for airfield
34 activities. We agree with that limited approach, we
35 agree with your position, that it is beyond the terms of
36 reference, but we're very happy also to agree,
37 Mr Chairman, to your endorsement of multi-till which is
38 becoming quite a worldwide trend, and I hesitate to
39 mention the Australian Productivity Commission report,
40 but obviously it's ticked in that regard as well.

41 The second point on this slide is to do with
42 thresholds, and again we agree with your primary view on
43 this, that as you know, of course, the terms of reference
44 originally and subsequently -- particularly with the new
45 Act providing some legislative endorsement with the
46 ability to set thresholds -- you've taken a view that you
47 should be cautious on that; it's a very static approach,
48 we're dealing with market evolution and changing
49 companies, changing circumstances, and thresholds really
50 is a specifically difficult concept in relation to trying

1 to have thresholds for market definition, i.e.
2 competition analysis, but it's also particularly
3 difficult, we believe, in applying to ongoing, say, price
4 supervision.

5 Our concern with specificity of thresholds is, they
6 become de facto price control, so without even a formal
7 price control endorsement of such things, in effect can
8 send signals and constraints that for all practical
9 purposes mean that you are fully under some price control
10 regime.

11 They're not dynamic, and they shouldn't be followed.
12 You have indicated in your report that caution is
13 appropriate, but then you've gone on to say, and this is
14 what we have some concern about, that the sort of -- and
15 I think you are referring to the pricing principles that
16 you've developed, valuation, WACC etc -- you say, don't
17 like them because they're static, we're not going to
18 follow this terms of reference, we're not going to report
19 to the Minister it seems, but then you say, nevertheless
20 we have some sorts of principles.

21 Now, in our view, you have to really reach a clear
22 conclusion on this, and if there is any suggestion of
23 thresholds being based on the sort of principles that
24 have been espoused in the draft report, well obviously
25 Wellington would strongly object to a number of those, as
26 you will ascertain later on.

27 We don't believe that the advisory role of the
28 Commerce Commission is such that it should attempt to get
29 into high levels of specificity about particular
30 components of prices or things that go to make up prices.
31 If the Government at the end of the day wishes to impose
32 price control through Order in Council, then of course
33 the real work starts for the Commission and we feel
34 there's perhaps been a slight confusion of roles here
35 between being a price authorisation body, such as the
36 Sydney Airport decision being an example of that, the
37 high level of specificity there, and an advisory type
38 jurisdiction where it's a once-only picture, there's no
39 price control of anybody, there are differentiations
40 between companies and we don't feel really that there are
41 grounds to advance along those lines.

42
43 CHAIR: Can I just ask you a question, Mr Stevenson. You
44 are saying, in essence, that if a decision was made to
45 recommend price control as per the statute, then the
46 nature of that price control and what constituted -- for
47 example, made a price level base for the person
48 implementing that decision? Is that what you are saying,
49 rather than this Commission at the moment?
50

1 MR STEVENSON: Yes, what I'm saying is that, once price
2 control is imposed a whole lot of procedures come into
3 play, including your efficiency criteria and competition
4 criteria, and there, of course, you're seeking -- and
5 you've got a range of techniques now, CPI-X whatever, and
6 in that environment, as in the Sydney decision, you are
7 actually identifying specific ways in which prices should
8 be controlled, and you are having to apply a high level
9 of detailed principle and whatever to those, and you are
10 very familiar with that yourself, Mr Chairman, going
11 backwards.

12 But, I feel there's a slight merging of the roles
13 here between price authorisation and the high level of
14 specificity required for that, and the advisory role, and
15 we have clearly distinguished here the general test of
16 efficiency for Section 52 now. We agree with the
17 Commission's principled approach to that, but you have to
18 deal with it at that level. We don't see the grounds for
19 getting into a high level of detail on individual
20 components of prices.

21 One has to stand back in making a quasi policy
22 judgment about whether a company should be under control
23 and the Minister, at the end of the day as BARNZ has
24 pointed out, has a discretion to recommend, and you've
25 got to ask yourself, what does the Minister want
26 to -- what information is held to that person in making a
27 decision?

28 We've said in our earlier submissions that, there
29 needs to be a reality check on this; I think Mr Morrison
30 made this very clear, that a case like Wellington, where
31 10 years of under-performance -- or under-competitive
32 levels, you have your answer there. BARNZ themselves,
33 for instance, say you should look at the imposition of
34 price control in relation to a period of years.

35 So, we feel you can't have a sort of highly specific
36 framework that you seek to apply and whatever, you've got
37 to look at each individual case, and there are various
38 sort of factual matters that you have to take into
39 account.

40
41 MS REBSTOCK: Can I just ask you a question on that? I
42 don't think -- I mean, I think the Commission has
43 expressed its view on this issue of whether it should
44 advise on thresholds, and I don't think it's changed its
45 position from what we put in the draft. But if I
46 understand you correctly, you are concerned about us
47 specifying the principles on which we make our judgments
48 about the various bits of analysis we have to go through
49 in order to form a view.

50 Would it not concern you if those judgments weren't

1 made transparent to you, as a part of this process?

2

3 MR STEVENSON: Well, the particular provisions in relation
4 to thresholds now, and are set out in the legislation, is
5 really to provide specific thresholds to the Minister for
6 the making of a price control decision.

7 You have already found in a preliminary way that
8 that is a very static approach, because those principles,
9 theoretically carry on until either you are requested to
10 do another report or you decide to have an inquiry of
11 your own motion. So, they have the danger of, sort of
12 sitting there at a point in time, and let's take the
13 obvious example of WACC.

14 You've heard a lot of evidence about changes in WACC
15 over time. So, when you talk about principle, some of
16 the principle has actually been converted into what I'd
17 regard as a price authorisation requirement or, you know,
18 some component that makes up your final authorised price.
19 WACC would be an example of that.

20 As you will hear later on, why have a specific
21 mid-point? It's -- I just don't think -- well, I think
22 you are right in saying in your draft report that that is
23 a static approach, and I don't myself think that the
24 provision relating to thresholds is going to be very
25 helpful to anybody. But I agree there's a difference
26 between --

27

28 MS REBSTOCK: The Commission has no intention of providing
29 thresholds advice to the Minister, as we put in the
30 draft. But can I just ask you; I understand the notion,
31 that we have to look at the particular fact circumstances
32 of each airport and make an assessment, but do you accept
33 that those fact circumstances have to be put in the
34 context of -- have to be looked at using some form of
35 analysis that are consistent with the provisions of the
36 Act, and there is -- there are a number of assumptions
37 that need to flow from that -- I mean that need to be
38 made in order to do that. Do you have a concern about us
39 making those assumptions that we had to make as
40 transparent as we did?

41

42 MR STEVENSON: Well, I mean, my sort of only answer to that
43 is that you've got to follow the statute --

44

45 MS REBSTOCK: Yes.

46

47 MR STEVENSON: Is it necessary or desirable? In our view
48 we believe that you've got to weigh into that the reality
49 of the competitive situation. We'll be arguing that in
50 fact there's substantial countervailing power.

1 So, those are the only words in the statute,
2 "necessary" or "desirable" -- we accept that you have to
3 move forward to interpret that, and we agree -- I think
4 we are on all fours with the Commission on the efficiency
5 interpretation -- pretty familiar to you from your
6 earlier work in mergers and takeovers and trade practices
7 areas, is appropriate. We don't have a doubt about that,
8 but I don't see in there authority for explicit
9 specificity -- or whatever you'd like to call it -- of
10 ingredients making up prices. That's actually the next
11 job, hopefully never a job in relation to
12 Wellington Airport, but once the Government has made that
13 policy decision to have control, you've got to go in
14 there.

15 Now, we do say that, when looking at necessary and
16 desirable in relation to the efficiency test, which
17 obviously has some application to prices, efficiency of
18 costs, rates of return, valuation; obviously those things
19 have to be considered and weighed up.

20 Obviously you've got to know what Wellington's
21 valuations have been perhaps. But there are general
22 factors that surely, on a reality basis, on a practical
23 basis, you must look at. And if you see in the case of
24 Wellington that this 10 years of under-performance, even
25 with the extraction of your harsh valuation principles,
26 well then obviously you know there's some pretty obvious
27 conclusions one can draw from those sorts of factors.

28
29 MS REBSTOCK: But could we have come to those estimates of
30 performance without making -- using the principles that I
31 think you have difficulty with?

32
33 MR STEVENSON: I think, most certainly you could. In the
34 case of Wellington, it's patently obvious. Identifying
35 an explicit valuation, for instance, methodology is a
36 function of an ACCC under current -- you know, once the
37 price notification is sent to them and they want to look
38 into, say, an airport, they have to have specific pricing
39 principles.

40 And, as you know, the ACCC has got these sort of
41 three efficiency things that they have gleaned from about
42 three pages of directors and statutory provisions. You
43 know, they've got enormous detailed guidance on things
44 like investments and all sorts of things, so they make
45 decisions on those things.

46 But this is not the point to put undue weight on
47 specific ideas of WACC, or specific ideas of valuation,
48 which immensely depart from what the airports can do, and
49 have done in Wellington's case, for 10 years since
50 investing at least. So, that's my answer to you anyway.

1
2 MS REBSTOCK: So, would that have meant that the Commission
3 would have used the estimates provided by the airports to
4 do this assessment at this stage?
5

6 MR STEVENSON: No. I mean, the Commission has got very
7 wide powers to consider what it thinks is relevant now
8 under this new section. It is perfectly entitled to do
9 all the investigations that it has done, perfectly
10 entitled to look at what might have happened under an
11 historic cost valuation, but you've got to move beyond
12 that, in my view, to -- you know, the sort of information
13 that the Minister's trying to get as to -- and I think
14 Mr Morrison made this point -- in a pretty exceptionally
15 poorly-performing company, that warrants price control
16 given that there are no companies under price control
17 under this part in the whole country.
18

19 CHAIR: I guess too, Mr Stevenson, and so you will come
20 back to more detailed explanation of that issue I think
21 as part of the wider submissions. Okay, thank you.
22

23 MR STEVENSON: Right, I'll just move on to my next slide
24 because I'm conscious of your time as well.
25 We've partly discussed this area, Mr Chairman, on
26 forms of control. As far as forms of control is
27 concerned, we agree with what the Commission did in a
28 jurisdictional sense, and that is said that, strictly
29 speaking we shouldn't be looking at forms of control even
30 though the Minister has set out a request in its terms of
31 reference for comment on that area. It's cart before the
32 horse.

33 What it did go on to say is that, we would like to
34 look at one or two -- we would look to look at forms of
35 control purely for the purpose of making some
36 cost-benefit analysis of forms of price control; that
37 would enable us to compare the cost benefits to price
38 control versus some other alternative.

39 And, in some ways that sounds a legitimate way
40 forward. But when you read the draft report you find
41 that that's not followed through.

42 In fact, there isn't a taking of the four or five
43 types of price control in that chapter 11, I think it is,
44 and then identifying sort of particular pricing costs of
45 each one of them. I happen to think that exercise is
46 hopelessly impossible anyway, for a whole lot of mainly
47 institutional reasons.

48 The Commission didn't actually carry out what it
49 said it might do. Now, the unfortunate consequence of
50 that is that other submitters don't understand, or

1 perhaps do not wish to understand, that you've gone into
2 forms of price control purely for a cost-benefit analysis
3 purpose.

4 BARNZ has now come up, in their submissions on the
5 draft report, very keen on the -- in fact, I should say
6 "very keen", they use the word, they are "comfortable"
7 with one of the Commission's forms of approach, and the
8 form of approach, of course, they are comfortable with is
9 this concept of compulsory negotiation with the
10 Commission for what BARNZ calls as the back-up with
11 pricing principles.

12 So, really the concern, as has been expressed in
13 other submissions of Wellington Airport to date, is that
14 -- it wasn't used as a pretext -- I'm not saying
15 that -- but it's moved into provide a basis for
16 discussion of different alternative regulatory models,
17 and BARNZ -- the fact that that is correct analysis of
18 the draft report, is supported by the very fact that
19 BARNZ has endorsed what it thinks is a Commission
20 recommendation favouring compulsory negotiation, with the
21 Commission as back-up.

22
23 CHAIR: Yes, I see what you are saying. I mean, no doubt
24 BARNZ will expand on their particular view on that next
25 week.

26 I just make one point. As you say, there are
27 arguments there about the various forms of price control.
28 One of the things that we've asked the other two airport
29 companies, and would be interested very much in
30 Wellington's views, trying to get an assessment of, as
31 you said earlier, the costs and benefits of various
32 approaches to price control, taken in isolation from the
33 decision as to whether or not to recommend control, is an
34 important part of what we'd have to look at at the end of
35 the day.

36 So I just flag it, that any way you are able to help
37 us with some of those cost and benefit estimates, purely
38 from that perspective -- not prejudging what our
39 recommendation might be -- would be of assistance because
40 you would have seen Auckland's fairly extensive views on
41 indirect and direct costs of price control, as put up by
42 NERA, I think on Tuesday afternoon. So I just flag that
43 for the moment.

44
45 MR STEVENSON: Yeah, I'd like to comment, Mr Chairman,
46 quite briefly on those general issues, and I was
47 interested in the questions raised by Ms Rebstock the
48 other day, and I've read that transcript on this area.

49 I'd like to say a few simple things. This is an
50 airfield price control study, it's a very naturally

1 focused study.

2 The second point is that, it's under the
3 Commerce Act, which has got its own confines as to what
4 the jurisdiction is, it's advisory. And you are asked
5 whether price control is necessary for airfield
6 activities.

7 You've actually got to go through that,
8 unfortunately laborious task. Forms of control and other
9 types of regulatory alternatives is just complete
10 digression, it's outside the terms of reference, it's
11 outside the Act.

12 I think the discussion about, or entertainment of
13 different alternatives is completely jumping the gun, and
14 it's looking -- it's finding solutions for a problem that
15 has not been identified, and this is certainly very stark
16 in the case of Wellington.

17 What was suggested I think in this passage in the
18 transcript, is that, let's put in place something
19 supported by pricing principles -- yeah, there's a
20 reference to the Productivity Commission but --

21

22 MS REBSTOCK: Can I just ask you a question. This issue
23 has come up because, as you know, when we do cost-benefit
24 analysis we have to compare it against something, and in
25 the draft report we used a price cap form of control as
26 the comparator because there are different costs and
27 benefits associated with different forms of control, so
28 you can't do the analysis without using something; that
29 was the view we took in the draft.

30 What I thought we were hearing from the other
31 parties was that we perhaps should not look at the form
32 of control we did as the comparison, because no one here
33 seemed to see it as the likely form of -- as a likely
34 form of control that would be -- that might be relevant
35 to this industry in this country, and that seemed to be
36 coming from the parties.

37 Now, what I would be interested in hearing from you
38 is, in terms of this issue about how we approach the
39 analysis in the final report, when we come to do the
40 cost-benefit analysis, how do you think we should
41 approach this issue of which counterfactual we compare
42 the status quo to? How does Wellington think we should
43 approach that issue? Do you believe we need to pick
44 something concrete in order to pin down the numbers?

45

46 MR STEVENSON: No, I don't think you should go down that
47 pathway. You will hear quite specific evidence from us
48 about how you undertake a net economic efficiency
49 analysis. We've gone into some detail about -- and it's
50 a highly novel thing and I think we've got to commend the

1 Commission, you know, for making the efforts to get to
2 grips with what is quite -- certainly for the first time
3 this has had to be faced, but in doing it there are
4 certain flaws, from Wellington's perception. So, we'll
5 be going through each of those elements of that analysis,
6 including this issue about -- against what do you make
7 the assessment.

8 And my personal point of view is that, there are an
9 enormous number of institutional improbables about
10 picking between different types of control techniques and
11 making an analysis against any single one of them and
12 saying well, this is \$400,000 more than this one, and
13 this is another \$200,000. There's a very good reason for
14 that in that, once you are controlled, the Commission's
15 got discretion to have a range of techniques, it can
16 change it from application to application. It could be
17 that type of control this week, it could be CPI-X, it
18 could be a bit of revenue control next year, and
19 whatever.

20 And, there are certain other aspects of people who
21 are experienced in dealing with courts and commissions
22 and institutions, and you would have to make assumptions
23 about -- let's take the new version of the price control
24 part of the Commerce Act. They've tried to cut down the
25 right of appeal on a price authorisation to points of law
26 to the High Court, but they have left open the fact that
27 there will be an appeal, and everybody knows that lawyers
28 will turn that into fact appeals.

29 There is provision for leave of appeal to the Court
30 of Appeal. So, there are those unknown institutional
31 aspects as well.

32 So, when you talk about forms of control, you've
33 really got to understand the very difficult basis on
34 which you can have a high degree of precision in that
35 area.

36
37 MS BATES: Do you accept that you should in fact refer to
38 the costs of control at all, if you are carrying out a
39 net benefits test?

40
41 MR STEVENSON: Well, our evidence will show you how we've
42 had our best go at it, and nobody's saying that there's
43 going to be some perfect solution.

44 As I said, we commend the Commission for undertaking
45 the analysis and taking it to a certain level. But I
46 think it's got to be regarded as perhaps a less, or far
47 less important issue to -- I try and identify that CPI-X
48 control, you know, would have a specific type of impact
49 different from price control generally. You will see,
50 from our evidence, that just the mere fact of being in a

1 price control environment has all sorts of complications
2 and implications. That, in itself, has to be considered
3 pretty thoroughly.

4

5 MS BATES: Do you consider that you are operating in a
6 controlled environment at the moment, vis-a-vis
7 negotiating in consultation?

8

9 MR STEVENSON: The airport regime is, I believe it's unique
10 in relation to any other industry, bearing in mind, no
11 industry is under price control, the electricity lines
12 regime's in place, Telecom have some sort of intervention
13 regime looming, but we have a high level of regulation
14 than virtually all other industries already.

15

16 MS BATES: Yes, because you have obligations
17 to -- disclosure obligations and other things like that
18 as part of the consultation process, do you not?

19

20 MR STEVENSON: Yes, well, as you know there are statutory
21 consultation requirements every five years, sort of
22 thing, for specified airports, and there are other
23 aspects, I'm going to talk about that a bit later.

24

25 MS BATES: One thing that we've asked some of the others,
26 and I'll ask you, we're quite interested if you are able
27 to give us any information as to the costs involved in
28 the consultation and disclosure process that you are
29 going through at the moment.

30

31 MR STEVENSON: You see, I would have a real concern about
32 that question, because that, as Ms Rebstock was saying
33 before that, there may be some appropriateness in
34 comparing different forms of price control under the
35 Commerce Act for the purposes of identifying cost-benefit
36 analysis, but what you are speaking of there is to
37 compare this with different forms -- well, different
38 types of, sort of, consultation requirements that exist
39 under the Airport Authorities Act.

40

41 MS REBSTOCK: No, it would be to compare the status quo,
42 right, which is what we do in cost-benefit analysis.
43 It's comparing what the costs are now and benefits of
44 letting this happen, as opposed to some form of control
45 which -- I wonder how we can come to a recommendation on
46 whether control is warranted if we don't compare, in a
47 cost-benefit analysis, to discrete situations?

48

49 MR STEVENSON: I could be wrong here but I don't think that
50 was a question asked in the critical issues papers, the

1 first one or the second one. There were certainly
2 requests for general comment on cost-benefit analysis and
3 this sort of thing, but if there had been a request for
4 detailed information of that kind, obviously that could
5 have been addressed, but --

6
7 CHAIR: We've asked the other two airports that question
8 and it's really over to you whether you feel A, it should
9 be asked, which is your first point; and then B, in that
10 context whether you can give us some estimate of what the
11 costs might be. And, as I said at the outset, I want to
12 emphasise, we haven't made our minds up as to whether we
13 should decide price control is necessary or desirable, we
14 are trying to find our way through being able to make a
15 comparative cost benefit judgment which, in my view, is
16 probably going to be part of the overall judgment we've
17 got to make, but no doubt you want to expand these points
18 anyway.

19
20 MR STEVENSON: Yes, it's just that, you know, when I was
21 reading through Ms Rebstock's transcript here, the
22 context of the ideas of comparison was not cost benefit
23 in relation to this particular thing, it appeared to
24 really be inviting a comment on the -- well, the sort of,
25 the merits of alternative forms of regulation.

26 One of the points we've made in our submission is
27 that the particular compulsory negotiation, with the
28 Commission as back-up, or the alternative version of
29 BARNZ, which is compulsory negotiation with an arbitrator
30 under the Airport Authorities Act.

31 We believe both those obviously amount to complete
32 replacement of the consultation regime, they would have
33 effect so as to completely override that regime.

34 In the case of the BARNZ concept, it would require
35 sort of statutory amendment. This is the danger,
36 Mr Chairman, that some of this sort of analysis said to
37 be for working out a cost-benefit analysis, has actually
38 unfortunately drifted into, let's jump over the question
39 of whether price control is warranted at
40 Wellington Airport with its 10 years of low prices, to
41 let's have for all specified airports an alternative
42 regulatory regime.

43 Now, I think we're just pointing out that there are
44 dangers that area.

45
46 CHAIR: I can see where you're coming from so, you know,
47 that's part of Wellington's point of view, so obviously
48 will note that as we move through it.

49
50 MR STEVENSON: I think, Mr Chairman, we've pretty much

1 covered that area, and we've talked about that at length
2 in our submissions as well. I suppose the only
3 additional brief comment I would make here is that the
4 Ministry of Transport decided themselves and have advised
5 you, that well after the Commission's report has been put
6 into Government, that they will be -- after some initial
7 ground work, they'll be looking into the lengthening or
8 otherwise of the Airport Authorities Act.

9 I can tell you, the answer from Wellington Airport
10 will be a pretty obvious one, that the enhanced
11 provisions have been in place since 1998.

12 Wellington Airport has got at least nine months of
13 consultation to go through from this point on, also got
14 an arbitration to be looking at, so we're going to be
15 saying of course that's rather premature.

16
17 CHAIR: I think it's said in your cross-submission pretty
18 strongly too.

19
20 MR STEVENSON: So that's why we're particularly concerned
21 that, perhaps as a slight deviation from the terms of
22 reference into alternative regimes.

23 The only quick points here, Mr Chairman, we're
24 seeking to make, and you heard it perhaps in more stark
25 terms from Mr Morrison, and that is, we were concerned to
26 find that although the Commission had clearly looked at
27 jurisdictional submissions -- and we are grateful for
28 your consideration of those -- and obviously you have
29 done an enormous amount of work, that the report didn't
30 really address some very concrete areas of evidence which
31 are clearly directly relevant.

32 One of the strong points we are trying to make here,
33 and it's all to do with the test that you are going to
34 apply; we want the Commission to look at concrete things.

35 If you sit in a back room and think of ways of
36 analysing things, there's a tendency for the obvious to
37 escape you. And what we're saying in the case of
38 Wellington Airport is, it's an historical form of
39 analysis, you will hear more about that, you really do
40 need to understand better the constraints and
41 countervailing power in a Wellington Airport situation,
42 and we'll talk about that, and the productive efficiency
43 or the notional factor of 1%.

44 These things, in our minds, seem to ignore the fact
45 that a lot of work had gone into presenting. First of
46 all, the staff have asked for an enormous amount of
47 information and that's fair enough, but having given all
48 that, having made submissions, it didn't address
49 Wellington Airport particularly. And we're very selfish
50 in that regard and believe that there should be -- in

1 effect we're running three separate inquiries here.

2 In the case of Wellington, we simply ask that our
3 direct evidence be taken into account and that, in our
4 view, is the best evidence. If you have the concrete
5 evidence in front of you, no amount of analysis and
6 theory should displace that, and certainly once it gets
7 up to the Minister, he wants to know why on earth
8 Wellington Airport should be even subject to some sort of
9 control.

10 We've pretty much covered this topic, Mr Chairman.
11 We do agree with the efficiency interpretation.

12 In our initial submissions we spent several pages on
13 analysing Commerce Commission decisions, the new statute
14 that was about to be, and the Select Committee comments
15 on what the intentions were behind the new price control
16 regime, and we agree that you are on the right track, but
17 you will hear a bit more about its implementation.

18 Secondly, BARNZ have put up in their latest set of
19 submissions on the draft report -- I think there's
20 something like at least 12, what they call factors or
21 criteria.

22 They have a problem with the Commission's efficiency
23 interpretation that we support. They are concerned the
24 way it operates, so they have devised some, what I would
25 regard as diversions for you, a whole lot of subjective
26 criteria that particularly obviously suit their
27 particular point of view.

28 We've been through those factors, we've put in our
29 counter-submissions, what our views are on each one
30 because we didn't want them left untouched as though we
31 agreed with them or something. They are sort of like a
32 grab bag of things. We believe you have to stick to the
33 efficiency interpretation. A lot of what they've got
34 there deals with the first limb of Section 52,
35 competition-related items, other things we regard as
36 quite extraneous really.

37 But one thing they do emphasise, as I mentioned
38 before, is that price control should be considered only
39 where you've got quite a length of time of abuse of
40 market power, and we certainly commend that one to you in
41 the case of Wellington, so I don't wish to repeat those
42 in some detail.

43

44 MS BATES: Could I ask you a question please, I'm not
45 wishing to belabour a matter that you have some
46 sensitivity about, this is a question of an alternative
47 way of regulating, but simply to ask you whether, if you
48 didn't have a disagreement with it on a jurisdictional
49 basis, except it was clear that the Commission did have
50 the jurisdiction to do this, would you have objections to

1 it on an efficiency basis, i.e. do you think that the
2 system that is in place now would be less costly and more
3 efficient than any kind of negotiated solution with an
4 arbitration at the end?
5

6 MR STEVENSON: I think it needs to be clearly understood
7 that the airport regulatory regime has a number of
8 components to it, and we've talked about the Airport
9 Authorities Act, and disclosure and consultation, but it
10 also has price control as the ultimate sanction under the
11 Commerce Act.

12 Now, other industries may not have regarded that
13 last-resort weapon or approach as politically acceptable
14 for a number of years. But, in the case of airports, it
15 has emerged from the previous amendments and the
16 inquiry's been ongoing for some time.

17 So, clearly an inquiry is a credible threat, and so,
18 I just have to make this point; we're not comparing that
19 with this. We already have this, which is consultation,
20 and of course there's judicial review, but at the end of
21 the day if there's a view that, you know, the price
22 control is warranted, well, that can be exercised, and
23 we're doing that very thing now.

24 And you've then got to say, well, what's the actual
25 finding in relation to price control? Not whether the
26 consultation regime has worked or not, you're
27 actually -- regardless of that, what's the story with
28 price control and that's what you are doing now.

29 I don't see why there's a desire to somehow or other
30 break down the consultation regime or say it hasn't been
31 working.

32 In our case, you will hear on countervailing power
33 that there's been 10 years of consultation regime, it's
34 actually quite an elaborated regime.
35

36 MS BATES: Yeah, I know that.
37

38 MR STEVENSON: And it's actually got a number of aspects to
39 it.

40 And, of course, in Wellington's case they actually
41 reached a commercial agreement as well, in 1997, which is
42 still in place until the middle of next year, and is
43 actually governing the scope of the consultation process
44 that is going on right now and has provided in it, in
45 addition to the consultation process arbitration for
46 asset valuation methodologies.

47 So, when we get to that part --
48

49 MS BATES: You say you have worked out your own solution to
50 some extent?

1
2 MR STEVENSON: I think Wellington is in a situation where
3 very few major airlines -- you will hear this from
4 John -- we sincerely believe that the power of the
5 airlines -- and Mr Morrison and Mark Blumsky talked about
6 the constant search for other airlines -- it has forced a
7 particular result.

8 So, when you come to look at the peculiar individual
9 circumstances of Wellington Airport, you are going to be
10 left with no other conclusion about that, regardless of,
11 you know, high level concepts of countervailing power and
12 elasticities, or whatever. On the ground reality is that
13 commercial results have occurred, and have to occur
14 because of the huge exposure of the airport to very few
15 airlines. In fact, one of them has a very very large
16 market share.

17
18 MS BATES: So, are you comfortable with the way the present
19 regulatory regime works?

20
21 MR STEVENSON: I can't answer that question. All I'm
22 saying to you is that, we're here for a price control
23 investigation, and you want to -- you're interested in
24 what the effects have been out of the consultation
25 process, but at the end of the day you are looking at the
26 actual figures, returns and costs and the way the
27 companies conduct themselves. You are looking for any
28 examples of bad behaviour through the consultation
29 process perhaps, that might give you an indication that
30 there's been, you know, abuse of market power, or
31 something like that, which helps you to consider whether
32 price control ought to be recommended. To the extent
33 you're looking for that, you won't find it at
34 Wellington Airport.

35
36 CHAIR: Okay, thanks Mr Stevenson.

37
38 MR STEVENSON: Right, so we'll make a start on the next
39 presentation. I haven't introduced John Sheridan before,
40 and that's sort of a grievous mistake on my part from the
41 outset, and David Gordon, who's planning development
42 advisor or special advisor to the airport, and we really
43 want to address really the three points at the bottom.
44 We're not going to talk about the Commission's low
45 threshold for the limited test; I think it is a fairly
46 limited test, put it that way.

47 But, we want to urge you that you've got to have
48 concrete ideas or concrete facts about the Wellington
49 environment, and also what these judicial decisions have
50 actually said. So, I'll invite John initially to just

1 talk about some of the relationship -- or the information
2 on airlines.

3

4 CHAIR: I just want to, without being pedantic, say, I'd
5 like to finish at five to, and if you've got to come back
6 on Monday, Mr Sheridan, to repeat some of the things,
7 please feel free to do so, not to upset the logic and the
8 train of thought.

9

10 MR SHERIDAN: What I would like to do -- and good afternoon
11 -- is just outline some of the points made up here in
12 bullet points, and this will only take 10 minutes or so.

13 My comments are to highlight factual information in
14 WIAL's submissions on the countervailing power of the
15 airlines in relation to Wellington International Airport.

16 In its preliminary view on the extent of the
17 countervailing power of airlines, the Commission's stated
18 in paragraph 5.108 of its draft report that, "The three
19 large airports are unlikely to be dependent on a few
20 airlines to such a degree as regional airports".

21 This statement is simply not correct in relation to
22 Wellington Airport, and ignores WIAL's initial
23 submissions. Based on March 2001 statistics, WIAL's two
24 major customer, the Air New Zealand Group and
25 Qantas Airways, now make up around 94%, 94% of WIAL's
26 aircraft movement related revenue.

27 Air New Zealand and Qantas Airways transport 93% of
28 WIAL's domestic customers. For international services at
29 WIAL, the same airlines carry 97% of all passengers who
30 fly -- of all international passengers who fly in and out
31 of Wellington Airport.

32 The reality is, we have only got two customers of
33 the size of Wellington.

34 It is also evident that the Air New Zealand Group
35 has a dominant position with respect to market share
36 through Wellington, and this group obviously increased
37 its overall share of aircraft movements at Wellington as
38 an immediate consequence of the demise of Tasman Pacific
39 Limited, TPL, or Qantas New Zealand, as it was trading
40 as.

41 Qantas Airways, Origin Pacific, are not providing
42 replacement services to the level previously provided by
43 Tasman Pacific.

44 Air New Zealand's large share of aircraft movements
45 at Wellington Airport is likely to continue leaving WIAL
46 exposed to a powerful single customer for a significant
47 period ahead.

48 In my view, and based on forward airline schedules
49 known to WIAL, no other individual customer, other than
50 Air New Zealand and Qantas Airways, are likely to exceed

1 5% of WIAL's revenues in the year to March 2002.

2 In terms of significant new airlines entering the
3 market -- and we heard from Mark and Lloyd the fact that
4 we have so much focus on this area -- but in terms of
5 potential new entrants, Virgin Blue is the only airline
6 currently indicating an interest in doing so.

7 WIAL and its directors, such as Mark writing off to
8 Richard Branson just last week, or this week, WIAL is
9 actively encouraging the advent of new airlines.
10 However, Virgin Blue's potential entry is likely to be at
11 least six months away as the airline requires the
12 approval of both the New Zealand and Australian
13 Governments to provide services on the Tasman.

14 Also importantly, Virgin Blue's decision on whether
15 it should fly to Wellington rather than another
16 New Zealand city will be affected by a number of
17 comparative factors and, with respect to ourselves as an
18 airport, those factors would include landing charges,
19 property lease charges that they would incur at the
20 airport, as well as the availability of terminal and
21 operational facilities.

22 So therefore, for an airline such as Virgin Blue,
23 especially at the start-up, they will be seriously and
24 closely looking at those costs.

25 Wellington Airport, we face competition for the
26 Trans-Tasman traveller, and in particular the leisure
27 traveller from Palmerston North Airport. There's no
28 discount carrier such as Freedom Air or Virgin Blue
29 currently operates out of Wellington Airport.

30 Numbers published by Statistics New Zealand reveal
31 that close to 5%, 5% of Wellington residents, all
32 Wellington residents who are travelling to Australia now
33 fly out of Palmerston North on Freedom Air. Why do they
34 do that? It's because, if there's mum, dad and couple of
35 kids and you save \$100 per person on the fare, then many
36 are turning left and going up the coast and flying out of
37 Palmerston North on Freedom Air. We don't have such a
38 carrier out of Wellington.

39 As has been clearly shown in many countries in the
40 world today, price is the key decision driver for many
41 travellers, and Lloyd highlighted this in his commentary.

42 The Air New Zealand Group and Qantas Airways are
43 well informed and sophisticated. They form part of very
44 powerful international airline alliances. They join
45 forces through BARNZ when dealing with issues of landing
46 charges, making themselves a strong and effective group
47 in consultation. This is, from our perspective, a really
48 important point.

49 Airports are not dealing with a disorganised or
50 unsupported group. Rather, the airlines bring skill,

1 experience and strong backing to the table in
2 consultation.

3 While Wellington Airport faces commercial risks
4 should any of its customers fail through competitive
5 pressure, it has relatively long life sunk assets, and
6 costs in most part are fixed. There have been several
7 recent dramatic examples of the risks that WIAL faces
8 with the collapse of Tasman Pacific and with the
9 temporary cut-back of services a couple of years ago with
10 the Ansett pilot's dispute.

11 With respect to the TPL collapse, overnight
12 Wellington Airport annual revenue stream's reduced by
13 \$5 million. However, because of the fixed cost nature of
14 the airport business, it was not possible to reduce our
15 costs by a single dollar on the demise of TPL.

16 Most of TPL's revenue streams have subsequently
17 fortunately been replaced with services from Qantas
18 Airlines, Freedom Air and Origin Pacific, as well as
19 additional services from Air New Zealand. However, we
20 certainly suffered from the collapse of TPL.

21 Conversely, the airlines have the flexibility to
22 alter their use of the airport and charging structure to
23 their benefit. They may, for example, change fleet mix
24 and down gauge aircraft types, or they may alter their
25 flight schedules to provide direct point-to-point
26 services rather than hub services through Wellington. An
27 example of this may be, for example, flying
28 Nelson/Auckland direct rather than providing as many
29 services through Wellington.

30 Our results over the past two years have been
31 materially impacted by the airline's decisions to replace
32 Boeing 767 aircraft with Boeing 737s on the Tasman, and
33 the replacement of jets with turbo prop aircraft on the
34 Wellington/Christchurch sector.

35 We have actually seen a reduction in tonnage being
36 landed at Wellington Airport over the last two years.
37 Notwithstanding that, we have seen growth in passenger
38 numbers.

39 WIAL depends heavily on the patronage of its major
40 airline operators, so we have an interest in ensuring
41 that airlines continue to use and increase the use of our
42 facilities. Conversely, the airline's main assets, their
43 aircraft, can be easily switched to alternative routes or
44 swapped with alternative smaller equipment.

45 At WIAL, we recognise, however, that rather than
46 there being a one-sided airport monopoly, there is, in
47 fact, interdependence between Wellington International
48 Airport and its major airline customers. Interdependence
49 creates strong incentives for the parties to co-operate
50 and gives rise to a need of both sides to avoid

1 opportunistic behaviour by either party. The 1997 Deed
2 reflects this interdependence and the willingness of WIAL
3 to co-operate with customers.

4 WIAL believes it has a good working relationship
5 with the airlines.

6 WIAL's financial results for over a decade have been
7 significantly under competitive levels, and we will
8 detail this in a later presentation on our historic
9 performance.

10 Self-evidently, the airline's countervailing power,
11 and its exercise, has been an important factor behind
12 WIAL under-achieving on the financial front over this
13 period.

14 Thank you.

15

16 MR STEVENSON: That's it, Mr Chairman, in terms of the
17 presentations today.

18

19 CHAIR: All right, well thank you very much. Any brief
20 questions?

21

22 MS REBSTOCK: I had wondered whether we would be able to
23 get more information about some additional facts about
24 what's happening at Wellington Airport. So, for
25 instance, I think we have the split between international
26 and domestic travellers, we also wanted to know how many
27 of your -- within the domestic travellers, do you have a
28 breakdown of the purpose of their travel? Can you give
29 us an idea on the freight side?

30

31 I'm interested in that information because of the
32 initial question about, you know, the extent of market
33 power at Wellington Airport and those factors all would
34 help us to look at Wellington's particular circumstances,
35 and I've asked the other airports, they've indicated on
36 some of the factors that we probably need to ask the
37 airlines for that information, and we'll do that, but
38 we'd welcome any additional information on those things
39 you could give us.

39

40 MR SHERIDAN: We can certainly provide that, we can either
41 do that by responding, because a lot of those numbers
42 both Dave and myself know off the top of our head, or
43 alternatively we may have previously-provided data, and
44 if we don't have that we can provide it. So we can
45 respond to any specific question.

46

47 MS REBSTOCK: The other information I was interested in, in
48 Wellington's case, was the number of travellers who
49 arrive in Wellington by different modes of transport, and
50 I don't know if you have that sort of information but I

1 think it would be useful.

2

3 MR SHERIDAN: No, we wouldn't have that information, sorry.

4

5 MS REBSTOCK: That's fine, thanks.

6

7 CHAIR: Just a brief comment, any additional details you
8 can give us as part of Monday's discussion so that it is
9 discussed amongst the parties, would be very useful,
10 depending of course whether it's confidential or not.
11 Okay, look, thanks very much indeed, we'll reconvene
12 at 9 o'clock sharp on Monday morning. Thank you.

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[Hearing adjourned at 4.53pm]

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