

Part B

AIAL's Cross Reference to the Critical Issues Paper

AIAL'S CROSS-REFERENCE TO THE CRITICAL ISSUES PAPER (16 MARCH 2001)

(To be read in conjunction with AIAL's submission dated 27 April 2001)

INTRODUCTION TO PART B

In addressing the Inquiry paragraph 33, page 9 of the CIP notes:

“Although the scope is limited to airfield activities, the integrated nature of airport activities makes it necessary for the Commission to gain an understanding, and consider the impact, of other airport activities.”

It therefore logically follows that numerous questions and queries have been posed within the CIP.

A total of 95 prime questions are asked and within each subset numerous other questions are posed or explanations sought. Well in excess of 300 specific queries are made.

AIAL respectfully advises that it has not separately addressed each and every specific query in detail.

The aim of AIAL's submission however is to answer comprehensively the question of whether it is necessary or desirable to introduce price control of airfield activities. The submission has therefore been structured in a way which takes into account specific factors relating to AIAL.

In this section AIAL has illustrated that the major points in the CIP have indeed been addressed in the submission and accordingly have cross-referenced blocks of CIP questions to the submission.

From within the 300 plus queries that are posed numerous points occur that are related to more than just the airport industry and the charges thereof - and do flow on to the costs of aviation within New Zealand and presumably to the cost of airline tickets.

However, AIAL does extend a very genuine invitation to the Commission to visit AIAL whereat over a day AIAL would be well able to familiarise the Commission with many aspects of the airport industry.

For instance what impact does the fact that New Zealand is “over airported” have on the cost of aviation within New Zealand. Within a 50 mile radius are five airports:- Hamilton, Tauranga, Whakatane, (Rotorua) and Taupo. The latter two are also considering runway extensions to compete for the regional including trans-Tasman markets. Given that Auckland, Wellington, Christchurch, Dunedin, Invercargill, Hamilton, Palmerston North, and Queenstown already promote themselves as international airports - one must wonder how many such airports a population of 3.8 million can sustain.

AIAL has a runway capable of handling 747's. The length of that runway is required regardless of whether AIAL receives one 747 flight per day - or a 100.

Hamilton wishes to extend it's runway to take 767 aircraft as a move up from the current 737 capability. AIAL welcomes the potential competition. However, one again must query how logical it is to have such further facilities duplicated nearby.

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There are also many and various issues raised within the questions posed from the CIP.

The potential elements associated with benchmarking for instance are both varied and complex. What detail should one descend to in looking for fair and equitable measurement? London, Heathrow has security risks that far outweigh those presumed by the sovereign state of New Zealand. Does one calculate such items into benchmarking exercises?

The elements that will initiate a start on the second runway at AIAL are quite different to those that will apply at any other airport in New Zealand. No other New Zealand airport has the incidence of international traffic, both aircraft and passengers.

Safety is a further issue of potential discussion and debate. Along with all other matters noted above the degree of safety that is deemed acceptable, impacts directly on costs. Most airports are land bound and do not require a sea or water rescue component. The degree of water rescue equipment can be affected by whether the water is tidal or not. Accordingly, the costs for rescue services can vary markedly.

New Zealand airports, unlike their United Kingdom counterparts, have no ability to impound aircraft or withdraw services in respect of unpaid charges. How should this be considered in respect of determining comparative methodologies for charges and benchmarking therein? Along with a number of other New Zealand airports AIAL has lost considerable sums over time following the failures of Pacific Express, Kiwi, Cityjet and now Qantas NZ.

AIAL has also seriously considered whether it should be recommending to the Commission that an "industry education" forum be held prior to the hearings scheduled for later this year.

AIAL does however, record its belief that a separate forum could well be provided for by the Commission to better deal with the many externalities identified within the 300 plus queries noted.

Following herein is our reasoned endeavours to address the questions and queries posed.

Definition of Price

Question 1 *How should the definition of price be interpreted in respect of Part IV of the Act? Is price limited to the charges, rents or fees that users or consumers pay to acquire goods or services? Does price (by definition) include other factors, for example, the asset values placed on the assets utilised or employed in supplying goods and services?*

Response The definition of "price" as set out in section 2 of the Commerce Act 1986 ("Act") should apply; "price" is consideration which relates to the supply of a service (here the supply of airfield activities). Other factors, such as asset values are only relevant to the extent that they feed into the methodology of setting price, they are not a component of price and therefore do not need to be included in the definition.

AIAL's "price" for airfield activities is its airfield landing charges.

Question 2 *Given your response to question 1, what prices exist in relation to the airfield activities at Auckland, Wellington and Christchurch International Airports? What prices exist in relation to other airport activities at Auckland, Wellington and Christchurch International Airports?*

Response AIAL's landing charges are detailed at page 60 of the CIP.

Definition of Revenue

Question 3 *How should revenue be defined for the purposes of the Commerce Act? Is it a gross or net (net of expenses incurred) concept? Over what period of time should revenue be measured? Should revenue be a pre-or post-tax concept? Should it be measured in real or nominal terms? Should revenue be determined on a cash basis or an accrual basis?*

Response Paragraph 41 of the CIP states "The Commission must determine what the definition of revenue is for the purposes of the Commerce Act if it is to consider the anticipated amendments and the possibility of controlling revenue." As set out below, AIAL considers that the purpose of the Inquiry is to determine **whether** price control is necessary or desirable and not to consider the **forms** of price control. The definition of revenue is relevant to the question of **forms** but not to the question of **whether**. It is therefore premature to consider its definition.

Question 4 *Given your response to question 3, what revenues exist in relation to the airfield activities at Auckland, Wellington and Christchurch International Airports? What revenues exist in relation to other airport activities at Auckland, Wellington and Christchurch International Airports?*

Response The revenues that AIAL receives from landing charges are set out in AIAL's annual accounts. These accounts have been provided to the Commission and are set out at appendix 1 of the CIP (page 45).

Definition of Control

Question 5 *How should price control be interpreted under Part IV of the Commerce Act? How might the definition of control change as a result of the anticipated amendments to s 70? What are the forms of control that may be contemplated? Where do they fit on the spectrum of forms of control, based on the 'degree' or method of control?*

Response The definition of "price control" must be referenced to the definition of "controlled goods or services" at section 52 of the Act. Controlled goods or services are those goods or services for which there is an Order in Council made under section 53, i.e. they are subject to control under the Act. "Price control" means control as per the Act and not any other form of control.

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The proposed amendments to section 70 contemplate that not only “price” but also any component of price, revenue or quality standards may be controlled in accordance with the Act. Therefore, the definition becomes that of “control” which means control in terms of the Act.

Section 70 becomes relevant only once the first threshold (i.e. the imposition of price control) is passed. Section 70 considers what form the imposed price control will take. At this point, consideration of forms of price control is both premature and ultra vires.

However, AIAL’s submission addresses forms of control other than simple price control in its review of international regulation of airports and concludes that control as per the Act should not be introduced for airfield activities.

Key references

- **Section 3:** *Structure of Commerce Commission Inquiry*
- *Beyond terms of reference:* paras 3.6 - 3.9
- **Section 13:** *International Regulation of Airports*

Section 53(2)(a)

Question 6 *Given the requirements of s 53(2)(a), what “conditions, tests or thresholds” would be useful in determining whether competition is “limited or likely to be lessened”? How should the words “limited or is likely to be lessened” be interpreted? To what extent is the Commission’s approach to competition in Parts II and III of the Commerce Act relevant in respect of Part IV? What specific factors need to be considered in respect of any such “conditions, tests or thresholds”? Please explain.*

Response AIAL does not seek to persuade the Commission that airfield activities are not supplied in a market where competition is limited (or is likely to be lessened). It accepts that such an argument would be artificial. Therefore, it does not address fine definitions of “limited or is likely to be lessened”.

However, there is a scale of limitation or lessening and certain factors (or conditions, tests or thresholds) are relevant in determining the extent to which competition is limited or lessened in the market for airfield activities. The degree of limitation or lessening is relevant to the assessment of **whether** or not price control is necessary or desirable, because necessity or desirability in the interests of users, consumers or suppliers requires a balance between any harm caused by the present system and the harm caused by intervention.

Conditions, tests and thresholds which are useful in determining the extent to which competition is limited are the constraining market factors which operate upon AIAL. These include the current regulatory regime and countervailing power of the airlines as well as certain specific market issues which are addressed in the submission. These constraining factors limit both the extent of market power held by AIAL and AIAL's possible exercise of any such power.

Key references

- **Section 5:** *Market Definition*

Section 53(2)(b)

Question 7 *Given the requirements of s 53(2)(b), what "conditions, tests or thresholds" would be useful in determining whether control of goods or services is necessary or desirable? How should the words "necessary or desirable" and "in the interests of" be interpreted? What specific factors need to be considered in respect of any such "conditions, tests or thresholds"? Please explain.*

Response **"necessary or desirable"**: The test in determining whether the imposition of control is necessary should be one of fact, namely, whether airports have exercised any market power in the past. The tests for desirability of control should be made against the perceived objectives of regulation and the assessed costs and benefits.

"in the interests of": The principal objective of goods or services regulation should be the promotion of economic efficiency and not a de facto objective may be to keep airport profits at a moderate level, and to do this by redistributing income from airports to the airlines.

Key references

- **Section 2:** *Executive Summary*
 - *Is price control necessary or desirable?:* *paras 2.4 - 2.5*
 - *Previous or present abuse of market power?:* *paras 2.6 - 2.7*
 - *Aims and objectives of regulation:* *paras 2.12 - 2.14*
 - *Adequacy of current regulatory regime:* *para 2.19*
 - *Practical considerations:* *para 2.23*

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Interests to be Considered

Question 8 *In determining whether the imposition of control is “necessary or desirable”, whose interests is the Commission able to consider? Whose interests should it consider? In considering whether the imposition of control is “necessary or desirable”, whose interests is the Commission acting to safeguard? In terms of the current provisions, how should the terms “users”, “consumers” and “suppliers” be defined and interpreted? With respect to the likely amendments, how should the term “persons acquiring the goods” be interpreted? How does the term “persons acquiring the goods” compare to the terms “users” and “consumers”? How, if at all, do the interests to be considered change given the anticipated amendments? Please explain.*

Response The Act requires that the interests of “users or consumers or suppliers” be considered in determining what is necessary or desirable. Amendments to the Act refer to the interests of persons acquiring goods or services (whether directly or indirectly). For present purposes, there is no effective distinction between these definitions. In either case, it appears acceptable to define the “users” or “consumers” or the “persons acquiring” as both the airlines and the travelling public.

Given the universal nature of the travelling public it is arguable that the overall national interest viewpoint is the correct viewpoint to adopt - as is the case with both the Electricity Inquiry and the Telecoms Inquiry. Therefore, national efficiency implications should be a major consideration in determining whether price control is necessary or desirable. This will encompass the interests of users, consumers, suppliers and all relevant stakeholders without introducing a subjective bias in favour of a particular group.

Moreover, one of the general principles in assessing the economic rationale for price control, and the associated question of the public benefit thereof, is that:

Public benefits must be net gains in economic and/or social terms.
Any transfer or redistribution of wealth from one person or group in
New Zealand to another should be ignored.¹

AIAL submits that the present Inquiry ought not to concern itself with pressures for price control that may be motivated by a possible de facto objective of redistributing the income from the profitable operation of airports in New Zealand to major (international) airline companies. The poor returns of Air NZ in particular, should not influence the findings of the Commission. The airline management’s decisions in relation to, for example, the purchase and operation of Ansett Australia and the maintenance of unprofitable regional routes in New Zealand² are totally unconnected to the subject of this Inquiry.

1 Commerce Commission report, Public Benefits Guidelines.

2 Refer, for example, Sunday Star Times article, 8 April 2001.

It is also relevant that airport charges constitute a minor proportion of airlines operating expenses (about 4%) and that the impact of AIAL's recent price increases are calculated to be only NZ\$0.50 per domestic passenger and NZ\$1.00 per international passenger.

What is clear, is that it is not solely the primary "users" (in this case the airlines) who should have an overriding interest.

Key references

- **Section 2:** *Executive Summary*
 - *Practical considerations:* *paras 2.2.3(a)*
- **Section 4:** *Historical Background and Understanding: para 4.5*
- **Section 5:** *Market Definition*
 - *Services supplied:* *para 5.2*
 - *Purchasers:* *paras 5.3 - 5.4*

Efficiency

- Question 10 *Should efficiency be considered by the Commission when determining whether control of goods or services is necessary or desirable? Are the considerations in s 73(c) relevant to determining whether control should be imposed? Should the "promotion of efficiency", as stated in s 73(c) be considered in determining whether control should be imposed? Is efficiency one of the "conditions, tests or thresholds" that need to be considered in determining whether control of goods or services is necessary or desirable per a 53(2)(b)? How, if at all, would your answer differ as a result of the anticipated amendments to the Act? Why?*
- Question 11 *If it is appropriate to consider efficiency, how should the term 'efficiency' be defined? Practically, what would need to be considered? How could efficiency be measured?*
- Question 12 *Given your responses to questions 6 -11, what "conditions, tests or thresholds" would be useful in determining whether (i) airfield activities are or will be supplied in a market in which competition is limited or likely to be lessened; and (ii) it is necessary or desirable for the prices of airfield activities to be controlled in accordance with the Commerce Act?*
- Question 13 *What weight should the Commission give to the various "conditions, tests or thresholds"? Why?*
- Questions 14 *What evidence is required to establish that airfield activities supplied or acquired at Auckland, Wellington and Christchurch International Airports meet the "conditions, tests or thresholds" and satisfy the requirements for control?*

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Response The "promotion of improved efficiency" should be the key objective in determining whether price control of airfield activities is necessary or desirable. Other possible objectives for regulation (e.g. promoting further competition in airfield activities, or redistributing income between airports and airlines) are, in AIAL's view, either not relevant or should be considered to be of secondary importance.

Key references

- **Section 6:** *Reasonableness of Current Charges and Efficiency at AIAL*
- **Section 7:** *Operational Efficiency of AIAL*
- **Section 8:** *"Correctness" of AIAL Pricing Methodology*
 - *Principles of economic efficiency:* *paras 8.17- 8.18*
 - *Allocative efficiency:* *paras 8.19 - 8.21*
 - *Productive efficiency:* *para 8.22*
 - *Dynamic efficiency:* *para 8.23*
 - *Loss of efficiency:* *paras 8.24 - 8.27*
 - *Efficiency - authorisations:* *paras 8.28 - 8.34*
 - *Efficiency v fair & reasonable:* *paras 8.35- 8.37*
 - *AIAL's current charges - efficient:* *paras 8.98 - 8.101*
- **Attachment 3:** *Benchmarking of International Airports' Relative Efficiency*

Goods or Services Supplied or Acquired

Question 15 *What goods or services are supplied or acquired at each of Auckland, Wellington and Christchurch International Airports in respect of airfield activities? Please differentiate between the goods and services.*

Response AIAL has reviewed and commented separately on the detailed accuracy of the profile of its services, as set out in Appendix 3 of the CIP (pgs 65-70).

Relevant Markets

- Question 16 *Are the market(s) in which airfield activities are supplied or acquired geographically limited? In other words, are there separate markets for airfield activities at each of Auckland, Wellington and Christchurch International Airports; or are there regional markets; or is there a national market for airfield activities? Do other airports compete with any of Auckland, Wellington and Christchurch International Airports? What relevance (if any) does the distinction between domestic and international services have for market definition?*
- Question 17 *Are airfield activities supplied in a broader market than a market for airfield activities? If yes, in what market are they supplied in? If the relevant market is the one for aviation services (or something similar), is this also the market in which airlines operate and provide services? Please provide reasons.*
- Question 18 *Are the activities undertaken as airfield activities supplied in separate product markets? If yes, which markets are they supplied in? Please explain why.*
- Question 19 *Do other activities or markets have an impact-either currently or potentially-on the market for airfield activities? Please identify and explain what these other markets are.*
- Question 20 *In summary, given your responses to questions 16 - 19, what are the relevant markets with regard to the airfield activities supplied at each of Auckland, Wellington and Christchurch International Airports? Please explain.*

Response Although it is generally acknowledged that airports face limited direct competition, this is not tantamount to the assertion which the airlines frequently make; namely, airfield services are part of a “cluster of services” and are supplied/acquired in a location-specific market.

AIAL submits that airports in fact operate in a regional market, which is defined by the competitive pressure which they face from:

- Other airports (and the ability of airlines to switch flights to other airports; change their operational ‘hubbing’ centres and maintenance bases; or leverage off global alliance/codesharing arrangements);
- Comparative competition (benchmarking against other airports) and against other providers of equivalent on-airport services (e.g. carparking);
- Airlines’ other countervailing powers.

Key references

- **Section 5:** Market Definition

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Competition Analysis

- Question 21 *What are the price elasticities of demand for airfield activities? What, if any, substitutes are available for airfield activities? What are the cross elasticities between any identified substitutes and the airfield activities they could substitute for? In other words, what are the characteristics of (1) the supply of, and (2) the demand for, airfield activities? Please provide reasons.*
- Question 22 *With respect to each of the markets identified in your response to question 20, to what extent does each airport face competition in airfield activities from: (1) other airports, (2) other transport modes, and (3) the potential for other competitors to enter the market? Please provide reasons.*
- Question 23 *What factors give rise to countervailing power if it exists? What is the potential for the users of airfield activities (e.g. airlines) to exercise countervailing power? Does the countervailing power, if any, vary depending on the significance or size of the aircraft operator? Is the countervailing power, if any, stronger when airlines act collectively? Do foreign and domestic airlines have different amounts of countervailing power? Please explain.*
- Question 24 *What goods or services (included within the definition of airfield activities) are supplied or acquired in a market in which competition is limited or is likely to be lessened? In which markets? Please explain.*

Response Airfield activities occur in a market where there is limited direct competition, and where the elasticities of demand are therefore low (given the factors which determine airlines' use of individual airports; and the fact that airport charges constitute a small part of airline operating costs and hence the airline ticket prices charged to consumers).

However, as indicated previously, airports are subject to strong competitive pressures via:

- Indirect (comparative) competition with other airports;
- Changes in aircraft and passenger demand as a result of airline decisions to change their aircraft fleet, maintenance bases, operational hubs, codesharing arrangements, etc;
- Other airline countervailing powers (including the risks of regulation).

In New Zealand the airlines have considerable power due their collective approach to AIAL through BARNZ. In addition, Air NZ, due to its significant market position (which with the recent demise of Qantas NZ looks set to increase) is able to exercise considerable countervailing power over AIAL.

Key references

- **Section 5:** *Market Definition*
- **Section 11:** *Existence of Contestability and Countervailing Power*
- **Attachment 1:** *Memorandum of Understanding between AIAL and AUA*
- **Attachment 6:** *Supplementary details of AIAL Consultation*
- **Attachment 9:** *Breakdown of Airline Alliances*

Charging Principles

- Question 25 *What broad principles should govern the pricing of airfield activities? Are the principles any different to those that should apply in respect of any other airport activities? Are they any different to those that should apply in other industries?*
- Question 26 *Should charges for airfield activities be derived directly from a specific pricing model; or should they be derived from commercial negotiations with users? What are the positives and negatives of each approach?*
- Question 27 *If in response to question 26 you consider that charges for airfield activities should be derived directly from a specific pricing model, what are your views of the methodologies or models utilised by Auckland, Wellington and Christchurch International Airports? If you disagree with the model they use, what alternative model do you think they should use? Please explain.*
- Question 28 *Which costs should airports attempt to recoup from users and consumers of airfield activities? Should both operating and capital costs be recovered? Should both direct and common (overhead, joint, or indirect) costs be recovered? Should the cost of any land held for future development be recouped? Should the cost of any runway area not used by any aircraft operating at an airport (either because the runway has been extended beyond the needs of aircraft currently using the airport or because the airlines now operate smaller aircraft at the airport) be recouped?*
- Question 29 *Should charges for airfield activities recover only costs, or should they include profit margins necessary to achieve a rate of return? Does your answer differ in respect of any other airport activities?*
- Question 30 *How should costs be allocated between airport activities? Should airline users obtain any benefit-by way of, for example, reduced charges for airfield activities-from other revenue the airport company derives? For example, should the revenue from passenger departure charges be deducted from the pool of costs allocated to airlines, since the airlines provide the passengers who pay the charges? Similarly, should airlines receive a benefit from revenue derived from concessionaires and public car parking? Should airlines receive a benefit from other commercial revenues, for example, rents for buildings and land at the airport and utilities charges? Is a single-till or twin-till approach appropriate? Please provide reasons.*

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Question 31 *How does the means by which costs are recovered impact on the charges for airfield activities? How does it impact on users and consumers? Should some costs be recovered from airline companies-through, for example, charges for airfield activities - and others direct from their passengers? Please identify the costs and provide reasons.*

Question 32 *In summary, given your responses to questions 25-31, how should charges for airfield activities be structured and determined? Please explain why.*

Question 33 *Do you have any other comments about the specific charging principles adopted by Auckland, Wellington and Christchurch International Airports in respect of airfield activities? How do the principles adopted by the airports compare to the principles that you consider that they should utilise.*

Response AIAL is required to earn a satisfactory level of return from its operation to fund the continuing development of Auckland Airport (and thereby cover not only the costs of its current operations and service its existing equity and debt capital, but also any new capital investment).

AIAL's charges reflect the user pay principle that users shall bear their full and fair share of the cost of providing an airport, including appropriate amounts for cost of capital and depreciation of assets and also the pre-funding of agreed projects. Any proposed changes to the charges for its airfield activities and other "identified airport activities" are the subject of lengthy and detailed consultation.

Questions 25 - 33 and their relevance in the context of AIAL's pricing methodology are considered in detail in Section 8 of AIAL's submission.

Key references

- **Section 8:** *"Correctness" of AIAL Pricing Methodology*
- **Section 9:** *Valuation of Assets*
- **Section 10:** *Airfield Returns and WACC*
- **Attachment 5:** *Determination of Cost and Equity and WACC in respect of AIAL's Identified Airport Activities*

Cost Allocation Methodologies

Question 34 *What are the costs of airfield activities? Which are direct costs (able to be directly attributed to individual users and consumers)? Which are joint (common) costs? What drives or determines these costs? Why?*

Question 35 *Where cost allocations are used to arrive at charges for airfield activities, on what basis should costs be allocated between users? To what extent should individual components of costs be allocated separately based on individual cost drivers? Should capital costs and operating costs be recovered separately? In other words, which users should be expected to meet the various costs identified? Why?*

Question 36 *Do you have any other comments about the specific cost allocation methodologies adopted by Auckland, Wellington and Christchurch International Airports in respect of airfield activities?*

Response AIAL uses an Avoidable Cost Allocation Methodology (ACAM) - which is an extension of activity based costing and allocates to each of its activities (and the users thereof) the direct costs of those activities and a share of any joint (common) costs according to the principles of cost causality and the underlying cost drivers.

Key references

- **Section 8:** *“Correctness” of AIAL Pricing Methodology*
- **Avoidable cost allocation methodology:** *paras 8.73 - 8.78*

Airport Use and Congestion

Question 37 *Should airports with high runway use have lower charges for airfield activities than airports with less use or vice versa? Why? What factors should be used in deciding whether an airport is congested?*

Question 38 *How should growth translate into changes in charges for airfield activities over time? Should charges be adjusted when the number of aircraft movements, passenger numbers, or the size of aircraft operated changes significantly? If so, what would constitute a significant enough change?*

Question 39 *Is there any evidence of runway congestion currently at Auckland, Wellington or Christchurch International Airports? What are the implications of the use of pricing to control airport congestion? What issues should be considered when trying to fit such pricing within any price control mechanism? Why?*

Response Airport congestion is usually evidenced by visible capacity problems (queuing, etc.). Supporting data can be examined such as movements per hour (runway capacity), flight times, arrival delays, departure delays, airport user 'comments cards', etc.

Despite significant recent investment in expanded apron and terminal facilities, AIAL is facing renewed congestion problems. These have been highlighted in industry forums (Traffic Capacity Forum) and the recent hearings of the Transport and Industrial Relations Select Committee and will require AIAL to invest in additional terminal facilities and a second runway.

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In order to ensure that this growth in demand and associated expansion of AIAL's airport facilities is 'efficient', the associated costs are included in the charges as a signal to users.

Key references

- **Section 8:** "Correctness" of AIAL Pricing Methodology
 - AIAL's pricing objectives: paras 8.1- 8.4
 - Outline of AIAL pricing methodology: paras 8.5 - 8.11
 - International guidelines: paras 8.12 - 8.16
 - AIAL's current charges - efficient: paras 8.98 - 8.101

Capital Investment

- Question 40 *What factors should be considered by airports in making decisions on timing of investments in respect of airfield activities? When should airports invest in new facilities for airfield activities? Should airports invest only when demand exceeds capacity, or should airports invest in time to meet anticipated future demand? Does the appropriate timing for investment differ between the airports? Please explain why.*
- Question 41 *How should capital expenditure in respect of airfield activities be funded? What alternatives are available? Should an airport development charge (international passenger departure charge) be used to pay for new capital expenditure, or should landing charges and/or terminal charges be increased to fund any new investment? Should there be a limit on the fraction of development costs that can be raised from users and consumers? Should the costs funded by users and consumers be limited to the costs of financing development (for example, interest costs)? Please explain why.*
- Question 42 *When should the costs of new investments in respect of airfield activities be included in the costs allocated to airport users and consumers? Should airport users and consumers commence paying for any capital expenditure before the airport commences the investment, once the investment is commenced (and in progress), or once it is completed and available for use? Should current users and consumers expect a guarantee of future access rights if they pay for investment before it is completed? Please explain why.*
- Question 43 *Under what circumstances would an airport under- or over-invest in facilities in respect of airfield activities? How should recent investments by the airports in respect of airfield activities be interpreted? Is there any evidence of over- or under-investment? For what reasons were such investments most likely made? Are the investment decisions in any way related to corporatisation or the threat of price control?*

Response AIAL plans for its future development on the basis of anticipated future demands (as projected by the airlines); and invests accordingly to meet those demands. Decisions regarding the timing, scale and design of all developments are overseen by various airport committees which include airline representatives.

New investments are taken into account in setting airfield charges when the expenditure is incurred, thereby reflecting the marginal costs of capacity utilisation (and the industry convention that incumbent airlines can 'grandfather' into the future their existing landing rights/slots).

Key references

- **Section 8:** *"Correctness" of AIAL Pricing Methodology*
 - *AIAL's pricing approach:* *paras 8.83 - 8.87*
 - *Substantial customers' criticisms - WACC:* *paras 8.88 - 8.96*
- **Section 10:** *Airfield Returns and WACC*
- **Attachment 5:** *Determination of Cost of Equity and WACC in respect of AIAL's Identified Airfield Activities*

Cross-subsidisation

Question 44 *Is prevention of cross-subsidisation desirable? If so, how could it actually be prevented? Why?*

Question 45 *Is there any evidence of cross-subsidisation in respect of airfield activities at any of Auckland, Wellington or Christchurch International Airports? Between which other airport activities does this occur? Why?*

Response AIAL's pricing policy is to charge users for the costs of the services which they utilise, consistent with the principles of allocative efficiency and ICAO's policies on airport charges. 'Cross-subsidisation' only occurs to the extent that common costs are allocated having regard to demand elasticities and the capacity of users to pay (Ramsey pricing), once "all costs have been fully assessed and distributed on an objective basis" (ICAO policy).

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Key references

- **Section 8:** *“Correctness” of AIAL Pricing Methodology*
- *Single till v dual till approach:* paras 8.38 - 8.43
- *Arguments against dual till:* para 8.44
- *Modified dual till:* paras 8.45 - 8.51
- *Arguments against single till:* paras 8.52 - 8.56
- *Other arguments:* paras 8.57 - 8.58
- *Benefits of dual till:* para 8.59 - 8.66
- *Single till v dual till - summary:* paras 8.67 - 8.71

Asset Valuation Methodology

- Question 46 *How should airfield assets be valued for the purposes of arriving at (1) charges for airfield activities, (2) a rate of return on airfield assets, and (3) price control regulations? In each instance, please include comment on the relative merits of the various asset valuation methods. What principles should be used to assess the merits of different methods?*
- Question 47 *Should airports be required to adopt a standard asset valuation methodology for the purposes of arriving at (1) charges for airfield activities, (2) a rate of return on airfield assets, and (3) price control regulations? What would be the advantages and disadvantages of a standardised approach? Why?*
- Question 48 *When airfield assets are revalued, how should revaluation gains (or losses) be treated? Should they be recorded as income?*

Asset Valuation of Auckland, Wellington and Christchurch International Airports

- Question 49 *Regardless of your views on asset valuation methodology, have Auckland, Wellington and Christchurch International Airports applied their chosen methodology correctly? For example, have airfield assets been optimised appropriately? If not, please explain.*
- Question 50 *Is there any evidence that the asset valuations adopted in respect of airfield activities by any of Auckland, Wellington or Christchurch International Airports are excessive or unreasonable? If so, please provide details.*

Response AIAL has used the same optimised replacement cost (ODRC) methodology for valuing its specialised operational assets used for airfield activities for:

- Statutory reporting purposes (in its annual accounts);
- Setting airfield charges (and consulting thereon - AIAL Consultation);
- Regulatory requirements (in the AIAL Disclosure Statements).

Any revaluation gains (losses) are consistently treated as movements in AIAL's shareholders' funds (fixed asset revaluation reserve).

AIAL considers that its valuation as it currently stands, is:

- a) Fair and balanced, protecting the interests of airport users while recognising the importance of ensuring that AIAL receives a fair return on assets employed; and
- b) Justified on the basis of market information and advice from independent experts.

AIAL submits that the use of the selected ODRC valuation methodology does not suffer from the main drawbacks of the alternative historic cost and realistic market value approaches and that it best replicates a competitive market.

Key references

- **Section 9:** *Valuation of Assets*

Cost of Capital

Question 51 *Should WACC be computed on a nominal or real basis? Please explain why.*

Response It does not matter whether real or nominal WACC is used providing it is compared against the correctly corresponding cashflows. In determining prices, estimates of future cashflows are generally made in current dollars and therefore it would be appropriate to use a real WACC as opposed to nominal. However, when considering actual returns - ex post, the actual numbers are nominal not real and therefore must, by definition, be compared against a nominal WACC. The alternative would be to recalculate actual numbers into real cashflows. The difficulties this creates and the subjectivity necessary surrounding the timing of cashflows makes it logical to compare:

Ex anti - real WACC
Ex post- nominal WACC

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- Question 52 *Should WACC be computed on a pre- or post - tax basis? Please explain why.*
- Response Ideally it should be computed on post tax cashflows (exclusive of interest tax shield) simply because this fully reflects the cost to the business of the true cost of capital - inclusive of all taxation costs.
- Question 53 *What effective tax rate should be used to determine WACC? Please explain why.*
- Question 54 *How should the cost of debt be determined? What benchmarks should be used to calculate the cost of short and long term debt respectively? Why?*
- Question 55 *What should be the cost of debt for each of Auckland, Wellington and Christchurch International Airports? Why?*
- Question 56 *Should the CAPM be used to determine the cost of equity, or should another model or approach be used? Why?*
- Question 57 *If the CAPM were to be used, what should beta be for each of Auckland, Wellington and Christchurch International Airports? Should an asset or equity beta be used? Why? What firms or industries in New Zealand or overseas have similar risk profiles and can therefore be used as benchmarks for determining beta?*
- Question 58 *What risk-free rate should be used to determine the cost of equity? Why?*
- Question 59 *What market risk premium should be used to determine the cost of equity? Why?*
- Question 60 *What should the cost of equity be for each of Auckland, Wellington and Christchurch International Airports? Why?*
- Question 61 *Regardless of how the airport companies actually finance their assets, what weights for debt and equity should be used in determining WACC for each of Auckland, Wellington and Christchurch International Airports? What factors lead to different debt and equity ratios? What are the implications of them for WACC? Should the focus be long-term or short-term? Please explain.*
- Question 62 *Given you responses to questions 51 to 61, what is the appropriate WACC for the entire business of each of Auckland, Wellington and Christchurch International Airports? Why?*
- Question 63 *Considering questions 51 to 61 again, what is the appropriate WACC for airfield activities of each of Auckland, Wellington and Christchurch International Airports? How does your answer differ in respect of aircraft and freight activities, specified passenger terminal activities, and other airport activities? Please provide reasons.*
- Question 64 *How do your views on WACC (as indicated in your responses to questions 51 to 63) compare to the WACC estimates adopted by each of Auckland, Wellington and Christchurch International Airports?*

Response The cost of capital has been determined by AIAL, using the Brennan-Lally modified version of the capital asset pricing model (CAPM), that has been endorsed in the past by the Commission, Treasury and generally by academics and market analysts in New Zealand. Consistent conversions of the estimated WACC have been made to transform it from a nominal to real basis, and pre- to post-tax basis.

The risk profiles of airports are greater than energy (electricity and gas) utilities; and differ between individual airports according to their traffic mix, pricing policies, etc.

In so far as questions 53 - 64 are relevant to AIAL, they are addressed comprehensively in Section 10 and Attachment 5 of AIAL's submission.

Key references

- **Section 10:** *Airfield Returns & WACC*
- **Attachment 5:** *Determination of Cost of Equity and WACC in respect of AIAL's Identified Airfield Activities*

Rate of Return Earned

Question 65 *What measures of return should be used when examining the rates of return earned by the airport companies for the purposes of this inquiry? Why? What are the merits of using one measure over another?*

Question 66 *What measures of return should be used when examining the rates of return earned by the airport companies for the purposes of this inquiry? Why? What are the merits of using one measure over another?*

Question 67 *What rate of return measure should be used when comparing or benchmarking returns to WACC? Please explain why.*

Question 67 *What is a reasonable rate of return for airport companies to earn on airfield activities given the cost of capital in respect of airfield activities? Does your answer differ in respect of any other airport activities or for the airport company as a whole? Why?*

Response It is AIAL's view that the rate of return for airfield activities should be linked to the prevailing cost of capital at the time that the charges are being reset. When determining the cost of capital it is necessary to consider the prevailing long term cost of debt and also the inherent risks assessed in the business at the time. A specified regulatory rate should not be used in AIAL's view as the volatility of the capital markets differs over time and also the risks faced by each airport will always be different and it is therefore unlikely that a mandated rate would be able to reflect the underlying cost of all airports at that time.

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The costs of capital in each of the specified airfield activities could be argued as being different since there are different risk profiles for each activity. It is appropriate the investors be rewarded based on the risks that they face and a return based on the prevailing cost of capital for each activity would be appropriate.

Overall Rate of Return

Question 68 *Given your response to question 67, is there any evidence of excessive or unreasonable rates of return being earned overall by any of Auckland, Wellington or Christchurch International Airports? If so, please provide details. What benchmark(s) should rates be measured against to determine this?*

Segment Rates of Return

Question 69 *Is there any evidence of excessive or unreasonable rates of return being earned on airfield activities by any of Auckland, Wellington or Christchurch International Airports? If so, please provide details. How do the rates of return earned on airfield activities compare to that earned for other airport activities and that for the airport companies as a whole? Please explain.*

Response Consideration of whether there have been excessive rates of return earned on the entire AIAL operation needs to take into account the overall risks faced by AIAL. This calculation needs to be done via a process of deaggregating the entire operations of the company and assessing the individual risks and returns of each area of activity. The returns set out in the June 2000 audited regulatory accounts published in November 2000 illustrate that there are not excessive returns in any of the specified airport activities.

In the calculation of the accounting rate of profit (page 33 of the accounts) it is clear that the revaluation gain on assets values as at June 1999 has for this measure been treated as income. This revaluation is a change in the basis of measurement of the asset values. The change in measurement value has occurred since the original date that these assets were incorporated in the accounts - generally 1988. It is unreasonable to attribute an unrealised gain from a change in basis of measurement as income or revenue.

The returns for the whole AIAL business are higher than those for the airfield alone. The risks inherent in other activities are significantly different from those of the airfield and should not be aggregated.

Overall Rate of Return Adjusted for Asset Revaluation

Question 70 *Taking into account asset valuations, is there any evidence of excessive or unreasonable rates of return being earned overall by any of Auckland, Wellington or Christchurch International Airports? If so, please provide details.*

Response The rates of return earned by AIAL on its various (segmented) activities have been reported in the recent AIAL Disclosure Statements, as well as in the CIP.

AIAL submits that there are obvious difficulties in using measures of profitability that contain variations in revenue and/or the value of assets employed as a result of asset revaluation adjustments.

AIAL believes that the rates of return it has earned to date are not excessive, having regard to the assessed cost of capital of its airfield activities (and other airport activities, and AIAL overall). The removal by the Commission of the revaluation of assets effectively is now measuring nominal year 2000 income against asset values measured in 1988 dollars and, in AIAL's view, is therefore an incorrect comparison.

Key references

- **Section 9:** *Valuation of Assets*
- **Section 10:** *Airfield Returns and WACC*
- **Attachment 5:** *Determination of Cost of Equity and WACC in respect of AIAL's Identified Airfield Activities*

Operational Efficiency

Question 71 *What would be appropriate measures to use in benchmarking New Zealand airports? What issues should be considered in comparing New Zealand airports to each other, to overseas airports, and against themselves across time? Why?*

Question 72 *How should growth in demand (e.g. passenger numbers, aircraft movements, MCTOW landed, tonnes of freight etc) be treated when evaluating the efficiency of operations across time? Why?*

Question 73 *What entities could or should Auckland, Wellington and Christchurch International Airports be benchmarked against? Why? How comparable are these entities? What adjustments may be necessary to make them comparable? Why?*

Question 74 *Relative to other airports and other businesses with similar risk profiles, is there any evidence of excessive or unreasonable costs, prices charged, revenues earned in respect of airfield activities? In other words, are they efficient or inefficient? To what extent does your answer depend on the allocation of assets, revenues and costs between airport activities? Why?*

PART B

Response Given the ownership, regulatory environment and operational differences between individual airports, there are inherent difficulties in benchmarking individual airports against one another, whether domestically or internationally.

However, various industry reports (and independent benchmarking studies commissioned by AIAL) all indicate that AIAL is an efficient airport operation and compares favourably against other 'top-performing' international airports around the world.

Key references

- **Section 7:** *Operational Efficiency of AIAL*
- **Attachment 2:** *Comparison of Charges at Selected International Airports*
- **Attachment 3:** *Benchmarking of International Airports' Relative Efficiency*

Current Regulatory Environment

Question 75 *Historically, has the requirement to consult users constrained the behaviour of any of Auckland, Wellington or Christchurch International Airports, or have they been able to exercise market power? What is your experience of consultation? How effective is it? What are its limitations? How does the existence of countervailing power (if any) affect consultation?*

Question 76 *Historically, has the threat of price control under the Commerce Act constrained the behaviour of any of Auckland, Wellington or Christchurch International Airports? Have the general competition provisions of the Commerce Act such as s 36 constrained the behaviour of any of Auckland, Wellington or Christchurch International Airports? Please provide examples.*

Question 77 *Further to your response to question 75, has the recent consultation changed your views in respect of consultation? Is it any more effective? Do the amended requirements to consult further constrain the behaviour of any of Auckland, Wellington or Christchurch International Airports? Have they caused a change in behaviour? What is your experience of the recent consultation? How effective was it? What were its limitations?*

Question 78 *Are the information disclosure regulations likely to change the behaviour of any of Auckland, Wellington or Christchurch International Airports in the future? What is the impact of greater information disclosure? In particular, how is greater disclosure likely to affect the countervailing power, if any, of users? Is it likely to prove useful in consultation in the future?*

Response The current regulatory environment is new and the associated requirements for consultation and information disclosure have only been used for the first time in the context of the recent review/increase of AIAL's aeronautical charges and the publication of the Financial Disclosure Statements for the year ended 30 June 2000. A commercial agreement with all airlines was almost reached (Air NZ holding out) but agreement was reached with three airlines.

AIAL believes that the effectiveness of the current regulatory environment will become more evident in future, as a result of:

- The experience/understanding gained by both AIAL and its substantial (air-line) customers from using the current regulations for the first time;
- The removal of the incentives for 'obstructing the process of consultation' which stemmed from the existence of the Inquiry; and
- Subsequent releases of annual Financial Disclosure Statements and emerging trends in returns illustrated therein.

Key references

- **Section 11:** *Existence of Contestability and Countervailing Powers*
- **Section 12:** *Adequacy of Regulatory Regime*
- **Attachment 6:** *Supplementary Details of AIAL Consultation, September 1999 - August 2000*
- **Attachment 9:** *Breakdown of Airline Alliances*

Charges Imposed by Auckland, Wellington and Christchurch International Airports

Question 79 *Given your responses to questions 25-78, is there any evidence of excessive or unreasonable charging for airfield activities currently at any of Auckland, Wellington or Christchurch International Airports? Is there any evidence of exercise of market power? To what extent does your answer depend on the allocation of assets, revenues and costs between airport activities? Please provide reasons?*

Question 80 *Do your concerns-indicated in response to question 79-in respect of charges for airfield activities (if any) relate to (1) the overall level of charges, (2) the relativity between them, (3) the types of charges, or (4) the methodology by which the charges are determined? Do you have any additional concerns in respect of charges for airfield activities? Why?*

Question 81 *Should any of Auckland, Wellington or Christchurch International Airport change the way that they charge for airfield activities? If so, how? What are the relative merits of the alternative methods?*

PART B

Response AIAL believes that its airfield charges are reasonable, having regard to the comparative charges of other international airports, its use of appropriate methodologies for valuing its assets (allocation of assets, revenues and costs); and the setting charges to produce a fair return on the capital invested by AIAL.

Key references

- **Section 6:** *Reasonableness of Current AIAL Charges and Efficiency at AIAL*
- **Section 8:** *"Correctness" of AIAL Pricing Methodology*
- **Attachment 2:** *Comparison of Charges at Selected International Airports*
- **Attachment 3:** *Benchmarking of International Airport's Relative Efficiency*

Regulation of Airports Internationally

- Question 82 *What lessons can be learned from overseas regulation of airports? Please explain.*
- Question 83 *Given the "conditions, tests or thresholds" identified for recommending that goods or services be controlled under Part IV of the Commerce Act 1986, and based on your responses to questions 25-82, is control of airfield activities necessary or desirable in the interests of users, consumers or suppliers? For which of Auckland, Wellington or Christchurch Airports, if any, is it necessary or desirable? Please explain why.*
- Question 84 *How should an assessment of the costs and benefits of control be conducted? What are the factors that need to be considered? What weight should be given to the various factors? Please explain.*
- Question 85 *What would be the costs and benefits of the various price control approaches in general? How do these compare to the costs and benefits of other forms of regulation in general?*
- Question 86 *What would be the costs and benefits of invoking controls over airfield activities at each of Auckland, Wellington and Christchurch International Airports? How does this compare to the costs and benefits of the current regulatory regime?*
- Question 87 *How effective would control be if it were just limited to airfield activities? Could the control of airfield activities leave incentives for airports to charge monopoly prices, or offer a lower quality of service, for non-airfield activities? In other words, would it allow controls to be evaded? How could such problems, if any, be prevented? Are any of the concerns identified more or less important at any of the three airports? Please explain.*

Question 88 *Given your responses to questions 83, 86 and 87; are market conditions such that the Commission should recommend the introduction of controls on airfield activities? Please explain why.*

Question 89 *If your response to question 88 is yes, to which of Auckland, Wellington or Christchurch Airports? Specifically, to which (i) regions, areas or localities in New Zealand; (ii) quantities, qualities, grades or classes; and (iii) different persons or classes of persons should controls be applied? Please explain why.*

Question 90 *If the control of airfield activities were to be recommended, what form should it take? What methods or formulae, if any should be used? What conditions should be imposed and how might they differ depending on the circumstances of suppliers or the nature of markets? Please explain.*

Question 91 *On what time and/or under what conditions might any controls end?*

Response AIAL submits that the purpose of the Inquiry is to consider whether price control of airfield activities is necessary or desirable. Accordingly, this submission does not address in detail the question of 'what form of price control'.

Notwithstanding this, AIAL's submission contains a brief review of overseas experience with regulation of airports and concludes that there are significant risks and costs associated with heavy regulation and there therefore appears to be an emerging preference overseas for moving towards lighter regulatory frameworks similar to the type of regime currently in place in New Zealand.

Regulatory regimes frequently specify a range of objectives - including, for example:

- To maintain and/or promote further effective competition;
- To introduce incentives for improved economic efficiency;
- To increase overall welfare (ie operational surpluses, and gains to consumers through lower prices);
- To encourage future investment, including ensuring adequate financing; and
- To protect consumer interests, including improving safety standards.

Overseas experience indicates that these objectives are generally not met with price regulation at airports³. The pursuit of multiple objectives, using blunt instruments like price control, have been found to be inefficient and costly and that "distributional" concerns [about relative levels of productivity] may dominate in terms of the underlying motivation for, and conduct of, economic regulation.⁴

3 Cf. "Reforming UK Airport Regulation", Journal of Transport Economics and Policy (March 2001); "Airport Price Regulation: Rationales, Issues and Directions for Reform", Submissions to the Australian Productivity Commission Inquiry (March 2001).

4 "Economic Regulation of Network Industries", NERA Report for NZ Treasury (May 1999).

PART B

Key references

- **Section 13:** *International Regulation of Airports*
- **Section 14:** *Conclusion*
- **Attachment 7:** *Airport Regulation and its Practical Implications*

Service Quality Standards

Question 92 *Should service quality standards be imposed in addition to controls on prices or revenues? What types of service quality standards could be imposed when goods or services are controlled? How would these differ between activities? Please explain why.*

Investment

Question 93 *Where controls are imposed, how should any historic over-investment or “gold-plating” be taken into account? Please explain.*

Question 94 *Where controls are imposed, how would it impact on any existing investment intentions? Please explain.*

Question 95 *Where controls are imposed, should any limitation be imposed on new investment? If so, what sort of limitations? Please explain why.*

Response AIAL reiterates that the purpose of the Inquiry is to consider whether and not what form.

AIAL submits that there is already sufficient representation by the airlines on its various operational, planning and development committees to ensure their input into investment decisions and service requirements.

The importance of Auckland Airport’s capacity to accommodate future growth in airline traffic (and thus tourism and export growth) and the undesirability of hampering that capacity through the imposition of control should be taken into account.

Key references

- **Section 3:** *Structure of Commerce Commission Inquiry*
 - *Beyond terms of reference:* paras 3.6-3.9
- **Section 4:** *Historical Background and Understanding*
- **Section 11:** *Existence of Contestability and Countervailing Power*
 - *Airline representation on airport committees:* para 11.19