



AUCKLAND AIRPORT

**CROSS SUBMISSION TO THE
COMMERCE COMMISSION**

INFORMATION DISCLOSURE

2 November 2009

INTRODUCTION

1. This is Auckland International Airport Limited's ("**Auckland Airport**") cross submission ("**cross submission**") on the Commerce Commission's ("**Commission**") Information Disclosure Discussion Paper issued on 29 July 2009 ("**Discussion Paper**").
2. This cross submission should be read together with the New Zealand Airports Association's ("**NZ Airports**") cross submission ("**NZ Airports submission**"), on the basis that it incorporates and supports the NZ Airports submission. This cross submission addresses issues raised in Air New Zealand Limited's and the Board of Airlines Representatives New Zealand (Inc)'s ("**BARNZ**") (together the "**Airlines**") submissions which specifically relate to Auckland Airport.
3. Auckland Airport's contact for matters regarding this cross submission is:

Simon Robertson
Chief Financial Officer
Auckland Airport
Ph 09 255 9174
simon.robertson@aucklandairport.co.nz

OVERVIEW

4. The Commission has accepted that the information disclosure requirements should only require regulated suppliers to disclose information that is "necessary" to achieve the purpose of information disclosure regulation.¹ Part 4 of the Commerce Act 1986 does not empower the Commission to require disclosure of information that is unnecessary for interested parties to assess whether the purpose of Part 4 is being met.
5. Nevertheless, as discussed in greater detail in the NZ Airports submission, the Airlines continue to advocate for disclosure of detailed information that goes far beyond what interested parties could reasonably require to make an informed assessment. In some instances, going beyond the statutory standard, in the way advocated by the airlines would be to creep into the realm of *de facto* price control. In all instances, it would amount to costly and disproportionate regulation. Each of these is contrary to Parliament's stated intent to impose a light-handed regulatory regime.
6. We set out below our responses on the issues raised in the Airlines' submission of specific relevance to Auckland Airport.

MATTERS RAISED REGARDING AUCKLAND AIRPORT

Q 32 – Merger and acquisition expenses

7. In the Discussion Paper, the Commission expressed its preliminary view that merger and acquisition expenses should be included in Regulatory Profit for the purpose of information disclosure accounts. Auckland Airport supports that approach.
8. In its submission, BARNZ states that it does not have a view on this matter because it is not an issue that has arisen, but then also states that it does not consider that costs

¹ Information Disclosure Discussion Paper, paragraph 758.

relating to takeover activity should be included in the information disclosure accounts on the basis that they do not form part of the operating costs / activities of the regulated business.

9. Clearly BARNZ does have a view, because merger and acquisition activity has occurred. The merger and acquisition expenses incurred by Auckland Airport happen to be sell side takeover costs, and not buy side acquisition costs. Auckland Airport does not see that any distinction should be drawn, as the cost was incurred nonetheless.
10. BARNZ also tries to distinguish these costs as being non-operational and shareholder costs. However BARNZ's logic is inconsistent with respect to non-operational costs. This inconsistency is highlighted by its response to question 19 in the Discussion Paper, which sought feedback on whether the value of vested assets should be recognised as income. Much like takeover costs, vesting of assets is often unexpected and falls outside the standard operating activities of its business. In its response to that question, BARNZ agreed that vested assets should be recognised as income. Yet, following BARNZ' previous logic vested assets should not be included in the information disclosure accounts, as they do not form part of the core operating activities of the regulated business.
11. Much like the characteristics of the vesting of roads (which BARNZ has previously highlighted in submissions), the takeover cost has the following characteristics in that:
 - (a) it is difficult to forecast;
 - (b) it falls outside of normal core operations of the business;
 - (c) Auckland Airport has limited ability to control it; and
 - (d) It is a natural consequence of the publicly listed corporate structure chosen for Auckland Airport at the time of privatisation.
12. Standard accounting practice therefore requires explanatory notes accompanying the accounts to provide interested parties additional information on the nature of these exceptional expenses or income.
13. Auckland Airport believes that transparency in the reporting of these types of events is correct, and the appropriate approach for an information disclosure regime. Just as Auckland Airport transparently reported the vesting of roads in its regulated income in 2003, it has also reported a portion of the takeover costs in the 2008 information disclosure accounts.

Q 33 - Actual Finance Costs

14. Auckland Airport agrees with the Commission's preliminary view that regulated business units should not be required to disclose financing information due to the difficulty in meaningfully allocating the portion that relates to the regulated business.
15. BARNZ disagrees with the Commission's preliminary view.
16. Auckland Airport believes BARNZ' analysis in this area is misguided for the following reasons:
 - (a) Even if the underlying data used by BARNZ in its analysis was "robust", BARNZ' calculations are flawed; and

- (b) BARNZ does not understand the manner in which the regulated accounts are constructed and the inherent difficulty in meaningfully allocating the portion which relates to the regulated business.

17. Auckland Airport elaborates on these concerns below.

Flaws in BARNZ' calculations

18. BARNZ outlines the actual interest cost reported by Auckland Airport as evidence that, on average over the nine years of information disclosure, the actual cost of debt for Auckland Airport's regulated activities has been 1.4% below that contained in its WACC. The analysis provided by BARNZ contains the following key errors for "actual" interest cost calculations:

- (a) BARNZ calculates interest cost as a fraction of closing debt. In practice this should be based on the weighted average outstanding debt. This is normally proxied by the average of opening and closing debt; and
- (b) BARNZ omits the capitalised interest costs, which are a critical component of total interest costs incurred. To estimate the average "actual" interest rate paid the gross interest cost including capitalised interest should be used.

19. Appendix 1 to this cross submission illustrates a reconciliation of this information. It shows that BARNZ assessed actual interest cost is almost exactly the same as the interest cost excluding capitalised interest. The interest cost analysis by BARNZ contains a 0.8% error on average across the years. Despite correcting an error in their most recent submission, the BARNZ data still contains errors in each year of between 2% and 23%. In FY08 BARNZ concludes interest costs of 6.29%. Correcting this calculation, Auckland Airport estimates a reported average interest cost of 8.14%.

20. Auckland Airport also notes that BARNZ seeks to compare this mis-estimate of finance costs at a consolidated group level against WACC estimates determined for a regulated subset of activities for which there was a particular consultation set for a particular term. As noted in earlier submissions, the WACC estimate in 2000 was initially estimated on an *ex ante* basis to apply for three years, yet through the process of a legal settlement, this resulted in airfield prices being set for seven years.

21. The actual interest costs for the regulated entity requires consideration of the appropriate credit rating and debt to debt to equity ratio for the stand alone regulated business.

22. Auckland Airport not only wishes to demonstrate BARNZ's miscalculations, but also that BARNZ's errors show that even relatively well-informed interested parties are likely to be unable to correctly interpret, and consequently may be misled by, the reporting of "actual" finance costs in information disclosure reports. Auckland Airport therefore disagrees with BARNZ that disclosure of financing costs is necessary to allow an assessment of whether Part 4 is being met. Such disclosure is more likely to confuse interested parties or result in misdiagnosis of problems.

Limitations in allocated finance costs to the regulated business

23. BARNZ demonstrates a lack of understanding of the process of financing an airport with its suggestion that:²

² BARNZ Submission on Information Disclosure Discussion Paper, 11 September 2009, p 18.

Where debt is incurred for a purpose specific to the regulated activity, then that debt should be allocated to the regulated activity. Where borrowings are undertaken on a company wide basis then more pragmatic rules will be need, such as the proportion of asset base, proportion of revenue or proportion of capital expenditure.

24. In practice, Auckland Airport's financial structure, like other corporate organisations, is determined at a corporate level. Financing at the corporate level reflects the business operations as a whole and it is therefore difficult to allocate finance costs more specifically. In determining the appropriate capital/debt structure Auckland Airport's objectives are to ensure:
- (a) That Auckland Airport has a credit rating at a level that allows Auckland Airport to acquire competitive pricing on future funding;
 - (b) That Auckland Airport can access required debt funding on market competitive terms or better on a sustainable basis;
 - (c) Maintenance of adequate and prudential liquidity levels to meet known and also unforeseen financial and funding obligations;
 - (d) A balanced approach is taken to debt maturities to manage liquidity risks within the overall balance sheet structure;
 - (e) Financial risks can be managed within pre-determined prudential limits; and
 - (f) Prudent financial resource allocation given forecasts of cashflow, capital plans, dividend policy and risk outlook.
25. This information is reviewed in detail prior to significant debt maturities, capital developments and significant price negotiations. Any one of the pragmatic rules proposed by BARNZ will introduce further noise and misinformation into the process. It may also undermine the treasury risk management processes conducted by Auckland Airport, which seek to manage the risks for the whole company to most effectively protect each business within the company.
26. Auckland Airport is required under the current Airport Information Disclosure Regulations 1999 to report interest costs. Auckland Airport has therefore had to develop a standard accounting process for determining these interest costs by segment, which meets its auditors' requirements. The steps are as follows:
- (a) Allocate all revenue, expense and balance sheet items excluding borrowings based on the applicable allocation rule;
 - (b) Allocate borrowing to balance the statement of financial position;
 - (c) Apply the ratio of borrowing between identified airport activities and non-identified activities to the interest cost; and
 - (d) Re-balance the statement of financial position through borrowings. This involves a process of iteration to check that the split of borrowings is in line with the initial proportions.
27. This process is internally consistent, yet does not provide sound insight into the allocation of debt, nor interest costs to the regulated assets.

28. Auckland Airport believes that the Commission ought to take the opportunity when determining the new information disclosure requirements to remove the reporting of “actual” interest costs, as interest costs is an example of poor quality data. While it is perceived to be developed with accuracy, this is simply not possible. Therefore, rather than informing interested parties, it is more likely to serve to confuse the picture.

Q 48 – Regulatory Asset Base Information

29. Auckland Airport is concerned that BARNZ is encouraging the Commission to change its preliminary view that for information disclosure, the Regulated Asset Base (“**RAB**”) should not be updated for ‘adjustments due to capital expenditure reviews’. BARNZ submits that such adjustments should occur in the same manner as for price controlled entities. In this context, BARNZ has referred to construction expenditure for the Northern Runway. As Auckland Airport has previously submitted, the Airlines are seeking to use the design and development of the Information Disclosure regime to override consultation requirements under the Airports Authorities Act 1966 (“**AAA**”). Such advocacy by the Airlines is inconsistent with their stated position that *de facto* price control is not their desired outcome.
30. Auckland Airport agrees with the conclusion articulated by the Commission in paragraph 302 of the Discussion Paper, as follows:

In summary, where information disclosure is the only regulatory instrument, a regulator does not generally make any direct adjustments in respect of capital expenditure efficiency and prudence.

31. The reason for this conclusion is that “an important characteristic of information disclosure is that it does not involve direct intervention by the regulator in setting prices or enforcing performance standards”.³ Instead, the Commission’s monitoring and analysis can provide indirect incentives by commenting on capital expenditure decisions made by the regulated entity.
32. Auckland Airport therefore submits that any change in the Commission’s position will risk cutting across existing statutory obligations under the AAA, which Parliament intended to retain, and would be inconsistent with the purpose of information disclosure.

33. Q 54 – Quality of Supply

34. Auckland Airport understands the importance of quality of supply to its customers and agrees with BARNZ that airlines and passengers view supply interruptions very seriously.
35. Auckland Airport has supported, with NZ Airports and BARNZ, the collation of a number of metrics on quality of supply in the information disclosure accounts and continues to do so.
36. We would however like to highlight to the Commission the important role the Commission plays in interpreting information. The commentary by BARNZ is an example of an interested party focussing on particular areas and seeking to infer poor quality of supply, when the overall picture may be very different. It will be important for the Commission to ensure that it is in a position to draw the correct interpretations of metrics when it reports in or after 2012.

³ Input Methodologies Discussion Paper, paragraph 6.225.

37. By way of example, BARNZ emphasises the negative results associated with the introduction of a new baggage handling system in 2005. The statistic BARNZ quotes is 900 mishandled Air New Zealand bags within the first six weeks of operation. Auckland Airport is very conscious of the implications of this for airlines and for passenger satisfaction and undertook significant planning with Air New Zealand, BARNZ, its other airline customers and the involved government agencies to ensure the minimisation of disruption from the project. It is important to remember that it is not at all unusual in competitive markets, for such teething problems to occur, contingency plans to be developed and for resource to be dedicated to working through those problems, in order to deliver long term gains. Due to the number of parties involved and their collective responsibility for the performance of the system a senior management steering group now exists to drive continuous improvement from baggage handling systems.
38. It is also very important to understand the context within which this very important project was delivered. Following the terrorism attacks of 9/11 a number of additional manual screening checks were required to be added to the front of house baggage screening process in the period up until 2006. The project BARNZ criticises was the implementation of an automated in line hold stow baggage system to replace the front of house process. The new process was required to ensure regulatory compliance and was essential for a modern functional airport of Auckland Airport's size. The project itself clearly highlights innovation where the benefits are passed on to consumers through the delivery of improved services.
39. Introduction of the new hold stow baggage screening system delivered the following benefits to airlines and passengers at Auckland Airport:
- (a) Improved passenger service:
 - (i) Reduced check-in area congestion; and
 - (ii) Reduced overall anxiety for passengers by taking an invasive screening process back of house, rather than keeping it front of mind for passengers.
 - (b) Improved productivity through development of an automated system with processing speed approximately five times that of the manual process, and the associated reduction in the risk of on time performance delays; and
 - (c) Improved labour efficiency for security staff.
40. Designing and installing baggage handling systems for airports is vastly more complicated than it might appear to those not involved in the industry. The complexity of baggage handling system deployment has been illustrated in Hong Kong, Denver and Heathrow. By comparison Auckland Airport's installation problems were relatively minor. BARNZ has not provided any comparative data for bags lost through other airports by its carriers, to assess the Air New Zealand's 900 mishandled bags at that time. It is a small fraction of the annual throughput of the system which exceeds 3.6 million bags per annum and appears relatively small to the one million bags lost by British Airways in 2007.
41. To improve the quality of information disclosure to interested parties, Auckland Airport supports the provision of commentary with the quality statistics to provide context to assist in the interpretation of data collected. We also encourage the Commission to take a medium to long term view in forming its judgements. If the Commission adopts BARNZ' approach of focussing on isolated instances of service interruption, rather than

looking at the high level results, it risks regulatory failure. This could occur, in the sense that the best way to avoid such service interruptions highlighted by BARNZ would be to shy away from innovation, as change inevitably brings with it some “teething problems”.

42. As highlighted in the NZ Airports submission, Auckland Airport is also concerned about the design risk in taking a very wide and detailed approach to information disclosure data. It is not difficult to find one poor data point amongst many and attempt to draw the conclusion that the system is failing. It will be important for the Commission to consider how it will prioritise data in order to deliver a report containing meaningful information.

APPENDIX 1 – Interest cost reconciliation

	2000	2001	2002	2003	2004	2005	2006	2007	2008	Average
Net Interest Cost per P&L	10,273	12,737	10,369	10,386	11,304	15,452	23,208	23,270	27,322	
Capitalised interest	61	364	418	563	478	800	1,167	1,049	4,961	
Annual interest cost	10,334	13,101	10,787	10,949	11,782	16,252	24,375	24,319	32,283	
Closing debt	164,453	204,397	197,708	183,794	194,841	270,904	317,925	360,870	432,178	
Annual interest / average debt		7.10%	5.37%	5.74%	6.22%	6.98%	8.28%	7.17%	8.14%	6.87%
Interest excluding capitalised interest / closing debt	6.25%	6.23%	5.24%	5.65%	5.80%	5.70%	7.30%	6.45%	6.32%	
BARNZ assessed actual interest cost	6.23%	6.22%	5.24%	5.65%	5.79%	5.69%	7.30%	6.45%	6.29%	6.08%
Error in BARNZ estimated interest cost		0.88%	0.13%	0.09%	0.43%	1.29%	0.98%	0.72%	1.85%	0.80%
Relative variation		12%	2%	2%	7%	18%	12%	10%	23%	