

## **BARNZ CROSS-SUBMISSION ON WELLINGTON AIRPORT ISSUES PAPER SUBMISSION**

**20 July 2012**

BARNZ has divided its cross-submission to Wellington Airport's Submission on the Commerce Commission Issues Paper into two parts.

The first section responds to points made by Wellington Airport more generally about the regulatory regime for Airports under Part 4 of the Commerce Act, and the relationship between it and the right Airports have to set charges as they think fit under the Airport Authorities Act 1966 (AAA). The key matters of this nature are:

- Whether consultation and information disclosure work well together?
- Whether consultation was a collaborative approach at Wellington Airport resulting in jointly determined outcomes and targets?
- Whether BARNZ is treating the ID Regime as price control?

The second section of this cross-submission responds to some of the points made by Wellington Airport which more specifically relate to the inputs used in, and the outcome of, its price setting determination. The key matters responded to under this group of topics are:

- Whether BARNZ has over-stated the differences between WIAL's inputs and those of the input methodologies determined by the Commerce Commission?
- The level of return forecast to be earned by WIAL over the forthcoming pricing period.
- The nature and extent of any commercial concessions made by WIAL during consultation.

In addition to these three points, there are a number of other areas in WIAL's submission where its portrayal of matters raised by airlines during consultation does not, in BARNZ's view, accurately represent the views of the airlines. These are briefly clarified.

### **PART A – MATTERS CONCERNING THE REGULATORY REGIME**

#### ***Whether consultation and information disclosure work well***

WIAL has repeated its views expressed during the input methodology determination process that the consultation and information disclosure requirements set out in the AAA have worked well for a long period of time, that there has not been any regulatory or performance failure, and that the previous regime was considered effective.<sup>1</sup>

Wellington Airport quoted heavily from various Treasury papers prior to the introduction of the Commerce Amendment Bill which questioned whether appropriate level of analysis had been undertaken with regard to the inclusion of Airports within Part 4 of the Commerce Act. However,

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<sup>1</sup> WIAL Substantive s56G Submission, para 10 and 14 - 20

the Courts have been fairly clear that papers this early in the legislative process are of limited relevance and value when determining the meaning and intent of Parliament with respect to the final words enacted in an Act.

Wellington Airport has omitted to refer to the more relevant and authoritative Parliamentary documents, which are very clear that the previous information disclosure under the AAA was — contrary to Wellington Airport’s assertions — not seen as effective. In particular, the Explanatory Note to the Commerce Amendment Bill described the AAA Information Disclosure Regulations as ineffective with respect to guarding against monopoly pricing and informing consultation, stating:<sup>2</sup>

The current disclosure regime does not specify a sufficient level of detail to determine whether airports are over-recovering or not. Some of the crucial components in assessing whether airport user charges are excessive or not are the input methodologies relating to how the value of the asset base is calculated (including how asset revaluations gains are treated) and how common costs are allocated. The disclosure regulations do not specify any clear requirement in respect of the appropriate methodologies that should be used by airports. The lack of specificity also contributes to contention, for example, about which assets should be included in the asset base for aeronautical pricing purposes.

The Commerce Select Committee agreed, supporting the inclusion of airports in subpart 11 of the Bill, stating:<sup>3</sup>

We consider that the information disclosure regime currently provided for under the Airport Authorities Act is not effective because there are no detailed rules on how disclosed information must be compiled, and there is no monitoring and analysis by a regulator of the disclosed information.

It has to be acknowledged that, from the perspective of the Airports, the previous information disclosure regime, coupled with the right Airports have under section 4A of the Airport Authorities Act (AAA) to set charges as they think fit, did work extremely well. However, from the airlines perspective, the balance between the interests of suppliers and users was far from right. The most recent judicial authority on the right airports have to set charges under the AAA ruled that inclusion of monopoly profits within the charges set is not a ground on which airport charges can be challenged.<sup>4</sup> The AAA therefore literally does give the Airports *carte blanche* to set charges as they think fit, however they think fit, by what-ever mechanism they think fit, at the level they think fit, and the right to then enforce the charges they set as a summary judgment, with airlines having no ability to resist paying other than on extremely limited procedural grounds.

The question before the Commission now, however, is not whether the previous regime worked well or not, or whether Airports were appropriately included within Part 4. Rather, the question is whether information disclosure under Part 4 is effectively promoting the purpose in section 52A in respect of the regulated airports. As such, WIAL’s submission on whether or not there was any previous regulatory failure or need to bring Airports within Part 4 is not relevant to the Commission’s task under section 56G.

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<sup>2</sup> Explanatory Note to Commerce Amendment Bill, pages 34 - 35

<sup>3</sup> Report of Commerce Select Committee on Commerce Amendment Bill, page 13

<sup>4</sup> *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98

### ***Was consultation a collaborative approach resulting in jointly determined outcomes and targets?***

The language used in Wellington Airport's submission paints a picture of consultation as having led to jointly determined outcomes, and of targets or inputs to charge setting as being a product of a collaborative consultation process. Wellington Airport has variously described:

- Challenging targets for efficiency and traffic being 'set through consultation' (para 95)
- The revenue requirement being 'determined during the consultation process' (para 105)
- WIAL establishing 'a company specific WACC in consultation' (para 114)
- Asset valuations being 'prepared as part of consultation' (para 123)

From BARNZ's experience as a key participant in that consultation process, the various inputs and decisions used in WIAL's price setting were not the product of the consultation process. Rather they were simply the result of Wellington Airport using its power under section 4A of the AAA to set charges as it thinks fit. There was not a collaborative constructive process involving commercial engagement with an open mind. Wellington Airport did not engage with users to determine these inputs. Rather, in all material respects, Wellington Airport appeared to have determined the level of revenue it required prior to the consultation process starting, and made its pricing decisions unilaterally using its statutory right to set charges as it thinks fit.

### ***BARNZ regards the ID regime as a price control environment***

WIAL has alleged that BARNZ has simply 'emphasised the differences to the Commission's input methodologies' and has 'appeared to regard the ID Regime as a price control environment' which 'diminished the benefits of the AAA process working side by side with the ID Regime'.<sup>5</sup>

BARNZ does not accept this criticism. BARNZ is fully aware that the Airports are not subject to price control and continue to retain the right to set prices as they think fit under the AAA. In BARNZ's view this is one of the significant short-comings of the current regulatory regime for Airports as it gives Airports the ability to set what-ever charges they please. As noted above, the Court of Appeal has ruled that the inclusion of monopoly profits within the charges set by Airports under the AAA power is not a ground on which airport charges can be challenged.<sup>6</sup> BARNZ is therefore very clear that the ID Regime, and the input methodologies determined by the Commission, are not binding upon the Airports and do not represent price control.

That said, BARNZ does see the input methodologies and other determinations by the Commission as representing the most recent statement in New Zealand of the best practice for outcomes designed to promote the long term interests of consumers and balance the interests of suppliers and acquirers in an appropriate manner so as to lead to the long term benefit of consumers. As such, the input methodologies are seen by BARNZ as being highly relevant to the setting of charges by airports and consultation between Airports and their substantial customers.

It is apparent that Parliament sees the input methodologies and ID Regime working in the same way as BARNZ does in relation to the airport sector. The Explanatory Note accompanying the Commerce

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<sup>5</sup> WIAL Substantive s56G Submission, para 85

<sup>6</sup> *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98

Amendment Bill described the advantages of providing for the development of input methodologies by the Commerce Commission as follows:<sup>7</sup>

The advantage of this option is that it significantly improves the value and relevance of the information disclosed. Providing for specification of input methodologies provides better information to guide consultations between airlines and airports and pricing decisions. (Emphasis added)

## **PART B – MATTERS CONCERNING WIAL’S CONSULTATION AND PRICE SETTING DECISION**

### ***Is BARNZ overstating the differences in WIAL’s approach from the input methodologies?***

WIAL submit that BARNZ (and Air NZ) have over-stated the differences in view with WIAL, and that the only material differences were land value and cost of capital.<sup>8</sup>

BARNZ does not believe it has over-stated the differences it has with the inputs used by WIAL to set charges. BARNZ agrees that the most material differences are land valuation issues and the cost of capital, but BARNZ also notes that these differences are extremely significant. It is simplistic to portray there as only being two differences, as WIAL has done. Together these two factors account for more than 90% of the difference in monetary terms, representing more than \$90m of the \$99m of over-charging estimated by BARNZ as likely to result from WIAL’s charges over the five year pricing period at a 7.06% WACC.

There are indeed other differences. They include (as listed on page 3 of BARNZ’s submission on the Issues Paper) the treatment of the cost of the ‘rebates’ for new services (which comes to \$11m over the five year pricing period) and the treatment of unforecast revaluation gains. The magnitude of the difference attributable to the treatment of unforecast revaluations necessarily depends upon the underlying valuation adopted and the amount of revaluation. Under the approach taken by BARNZ, where land is valued at its opportunity cost of \$0.95m per ha, there are not any unforecast revaluations which now need to be treated as income. However, this is not the case if WIAL’s MVEU land valuation of \$2.4m per ha is adopted.

A fuller list of the issues BARNZ identified with the inputs used by WIAL to set charges may be found on page 7 of BARNZ’s Substantive Submission on the Issues Paper, which includes other items such as forecast operating costs and asset allocation.

### ***What is WIAL’s return on investment?***

Wellington Airport has portrayed its return on investment as being below its cost of capital, and even below the Commerce Commission’s estimates of an appropriate WACC level. In particular, it has claimed that:<sup>9</sup>

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<sup>7</sup> Explanatory Note to Commerce Amendment Bill, pages 34 - 35

<sup>8</sup> WIAL Substantive s56G Submission, para 121

- Its actual return on investment under its FY11 Disclosure statements was 6%
- Its actual return on investment under its FY12 Disclosure statements is likely to be 7%
- Going forward the likely return on investment is forecast to be 8% over the next pricing period at WIAL's inputs, or 8.9% at Commerce Commission inputs

The calculation of the level of return on investment is materially affected by both the level of profit earned and the asset base used as the denominator. The valuation of the asset base is the most influential factor affecting how the level of return is portrayed. In particular, how the assets were valued? What the level of valuation is? Which assets were included within the asset base? In addition, the level of profit will be affected by the allocation of costs if multiple activities are undertaken, as is the case with Airports.

In the case of Wellington Airport:

- It reclassified the allocation of some \$40m of assets to the regulated asset base in 2010 as disclosed in its Schedule 23 Report on the Initial Regulatory Asset Base Value
- It adopted an MVAU valuation of land of approximately \$1.4m per ha, as opposed to the \$0.95m per ha value considered appropriate by BARNZ's valuation advisors, Property Advisory Ltd.
- It revalued its specialised assets upwards by \$31m in 2009

All of which will tend to portray its historical returns as being under-stated.

Looking forward, BARNZ calculates that applying the BARNZ inputs<sup>10</sup> to the level of charges WIAL has set, then the return on investment will be in the vicinity of 11.5% over the pricing period, with Wellington Airport likely to earn \$99m more in revenue than is justified. This is significantly in excess of the Commerce Commission WACC range of 6.08% to 8.04%.

### ***Were significant commercial concessions made by WIAL during consultation?***

WIAL has made a number of references to it having made what it terms 'commercial concessions' to airlines during the consultation process. WIAL submits that this shows the countervailing power of the airlines.

Wellington Airport claims that these 'commercial concessions' amount to \$93m over the pricing period made up of:<sup>11</sup>

- A reduction in the Airport's WACC from its initial 11.27% to 9.51%, and a reduction in the WACC applied in the MVEU calculation from an airport developer WACC of up to 13.4% to

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<sup>9</sup> WIAL Substantive s56G Submission, para 97 – 98 and 114

<sup>10</sup> Refer BARNZ Alternative Revenue Calculation Spread-sheet dated 20 June 2012, provided to the Commerce Commission as Attachment 2 to the BARNZ Submission on the Section 56G Issues Paper

<sup>11</sup> Refer WIAL Substantive s56G Submission, para 118 and WIAL Final Pricing Document, 1 March 2012, page 9

WIAL's own WACC of 9.51%, which together represent a \$49.1m reduction in required revenue

- A capex wash-up of \$11.4m for The Rock being completed later than forecast in the previous pricing period (which when grossed up for tax and increased to reflect the opportunity cost of capital is stated to represent a \$20.9m reduction in required revenue in WIAL's financial model)
- A revaluation wash-up of \$14.5m for revaluations in the previous pricing period (which when grossed up for tax and increased to reflect the opportunity cost of capital is stated to represent a \$26.7m reduction in required revenue in WIAL's financial model)
- The smoothed pricing path, which had an overall net outcome of increasing the required revenue over the five year pricing period by \$3.6m.

BARNZ strongly disagrees with the characterisation of these adjustments as 'commercial concessions'. Taking each in turn:

- The reduction in WACC from 11.27% to 9.51% begs the question as to whether the starting point was appropriate in the first place. BARNZ considers an 11.27% WACC (and even a 9.51% WACC) to be significantly over-inflated and not representative of an appropriate cost of capital in a workably competitive market. There is no 'concession' in moving from a highly exaggerated and unsustainable position to one that is merely 'over-stated'.
- Likewise the reduction in the cost of capital applied when calculating the holding costs of land in the MVEU valuation from 13.4% to 9.51% is not able to be characterised as a 'concession' given the implausibility of the starting point (putting completely aside the inappropriateness of including land conversion and holding costs within the land valuation which BARNZ does not accept)
- The capex wash-up represents money paid prematurely by airlines as a result of WIAL's practice of front-end loading its capital expenditure, which meant the Rock was included in the asset base on which charges were set some 19 months before it was actually completed. This adjustment is merely a refund to airlines of monies they have already paid and thus is also not able to be characterised as a 'commercial concession'. Moreover, the portrayal of it as \$20.9m artificially over-inflates the adjustment and makes it look larger than it is.
- The revaluation wash-up is necessary due to WIAL using a nominal WACC as well as revaluing the assets on which it sets charges. Without revaluations to the asset base on which charges are set being treated as income the NPV = 0 principle will be breached. In any event, BARNZ notes that this adjustment is still only a partial adjustment and does not result in all revaluations from the previous pricing period being treated as income. Again, this cannot be characterised as a 'commercial concession' as it is an underlying economic requirement which applies when a nominal WACC is used to set charges on a revalued asset base.

- The smoothing of the pricing path is actually shown to cost airlines extra in charges when looked at over the five year pricing period. It is therefore a 'concession' that is in fact a 'penalty' against the airlines.

In summary, BARNZ does not accept that WIAL has made any 'commercial concessions' in its exercise of the right to set prices as it thinks fit under section 4A of the AAA. The more accurate characterisation of the scenario is that Wellington Airport strategically chose to commence consultation from a highly unrealistic starting position so as to deliberately create a situation where it could endeavour to artificially paint itself as having made concessions and having acted with an 'open mind'.

### ***Were there differences during consultation with WIAL's Expenditure Forecasts***

WIAL has stated at para 181 that it considers the AAA price consultations over expenditure forecasts involved 'few material differences'.

While this is a fair statement in relation to the pricing consultations in 2002 – 2003 and 2006 – 2007, it is not accurate with respect to the most recent price reset by WIAL during 2011 – 2012.

As set out at pages 14 to 16 of BARNZ Submission on the Issues Paper, BARNZ does not consider that WIAL's forecast opex costs for the second price setting event are reasonable, given that the forecasts represent average operating costs per passenger which are 34% higher than the operating costs per passenger forecast in the first price setting event.

BARNZ considered that an appropriate and reasonable cost allowance would be achieved if the actual \$2.29 cost per passenger in 2007 was indexed forward for inflation, thus maintaining operating expenses per passenger at real levels from FY07. This produces an average operating cost allowance of \$2.82 per passenger which is 10% lower than the costs which WIAL has forecast, and represents a decrease to the operating expenses forecast by WIAL of \$1.8m on average each year during the new pricing period.

### ***Were service quality levels and trade-offs raised during consultation?***

WIAL has stated at para 208 of its Submission that the airlines did not indicate any level where reductions in service quality levels should be considered. While service quality was not a large component of the consultation process, this statement by WIAL is not entirely accurate as Airlines did express concern over the cost involved with the design of The Rock and submitted that that needed to be optimised out of the asset base.<sup>12</sup>

WIAL also stated at para 238 that substantial customers did not propose any price-quality trade-offs in respect of services during consultation.

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<sup>12</sup> BARNZ Assessment of WIAL Initial Pricing Proposal, 10 October 2011, page 33

Again, this is not entirely accurate. BARNZ submitted that the air-bridge charge should be continued as this provided airlines with the ability to select a lower service level if they so desired.<sup>13</sup> The air-bridge charge had been part of WIAL's charging structure since the terminal was opened and BARNZ did not support its cessation, as WIAL proposed to do (and did in fact do).

In addition, BARNZ also proposed that a baggage system charge be introduced on a per bag basis so that airlines would be charged per bag using the baggage sortation system, rather than the overall cost of the baggage sortation system and associated space being levied on airlines on a per passenger basis, regardless of whether or not passengers checked in a bag (or bags). A number of carriers have introduced fare options without bags in order to provide the travelling public with this cost signal and the ability to make decisions over this price-quality trade-off and BARNZ considered that this was also a price-quality trade-off that could be reflected in airport charges.

### ***Are WIAL's charges set so that all activities cover their costs?***

Wellington Airport has noted that it is confident that cross-subsidies are not occurring and that charges for all activities cover their marginal costs.<sup>14</sup> As outlined on pages 25 to 27 in BARNZ's submission, BARNZ doubted whether this is the case, particularly with respect to international terminal facilities where \$33m of terminal facilities directly relate to international passenger processing.<sup>15</sup>

BARNZ questions the appropriateness of an analysis that focusses on short-run *marginal or incremental costs*. The Rock development cost more than \$40m and is less than two years old. Without international activities the vast bulk of The Rock development would not have been required. It is artificial to dismiss the additional investment required for international activities just after it has been incurred, and only take into account the 'skimpy' forward looking marginal or incremental costs when setting international terminal charges, which is what Wellington Airport appears to be doing.

### ***Are the activity rebates discounts?***

Wellington Airport has established a rebate programme within its charging structure for new domestic and international services which meet certain criteria. Charges will be rebated to airlines for between one to three years, at varying percentages, depending upon the nature and frequency of the new service.

At para 250 of its submission WIAL has characterised these rebates as being 'discounts' and noted that it would receive 'no revenue from charges' in the first one to three years of new international services.

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<sup>13</sup> BARNZ Assessment of WIAL Initial Pricing Proposal, 10 October 2011, page 34

<sup>14</sup> WIAL Substantive s56G Submission, para 230

<sup>15</sup> Appendix 8, WIAL Initial Pricing Proposal



BARNZ is highly sceptical about these rebates being characterised as ‘discounts’ and considers such a description misleading. As can be seen below in the extract from WIAL’s Pricing Structure Model, the financial model on which Wellington Airport set charges increased the amount of required revenue payable by the forecast amount of the ‘rebates’, which amounted to \$11m over the five year pricing period. There is no ‘discount’ – the standard charges set by Wellington Airport incorporate the costs of these ‘discounts’ or ‘rebates’. Wellington Airport will be recouping the full airport charges of the new services from existing carriers – whether or not the new services eventuate.

<b>FPD</b>		<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>Total</b>
<b>Airfield</b>	ATM/MCTOW	7,977	12,007	17,229	22,722	28,018	87,953
	Pax	23,351	24,554	26,141	27,731	29,159	130,937
	Parking	1,109	1,081	1,052	1,019	980	5,240
	Incentive	(177)	(429)	(1,589)	(2,482)	(2,585)	(7,262)
	<b>Airfield Total</b>	<b>32,261</b>	<b>37,212</b>	<b>42,833</b>	<b>48,990</b>	<b>55,571</b>	<b>216,868</b>
<b>Terminal</b>	International Pax	3,639	3,729	3,999	4,238	4,277	19,883
	Domestic Pax	23,536	24,070	24,822	25,505	26,043	123,976
	Checkin	1,062	1,054	1,063	1,076	1,088	5,343
	Incentive	(194)	(381)	(800)	(1,103)	(1,129)	(3,607)
	<b>Terminal Total</b>	<b>28,042</b>	<b>28,473</b>	<b>29,085</b>	<b>29,716</b>	<b>30,279</b>	<b>145,595</b>
<b>Total</b>		<b>60,303</b>	<b>65,686</b>	<b>71,918</b>	<b>78,706</b>	<b>85,850</b>	<b>362,463</b>