BARNZ RESPONSES TO COMMERCE COMMISSION QUESTIONS RELATING TO WIAL

28 June 2012

OVERARCHING QUESTIONS FOR ALL ASPECTS OF PERFORMANCE:

Has information disclosure had any impact on WIAL's performance and why?

BARNZ has not seen any evidence that the information disclosure requirements or input methodologies determined by the Commerce Commission under Part 4 of the Commerce Act have had any impact at all on WIAL's performance or decisions it has made when setting charges.

WIAL has relied strongly on the statutory right it has under section 4A of the Airport Authorities Act 1966 (AAA) to '*set charges as it from time to time thinks fit'.* It has applied its own approach to all material inputs to the charge setting process. In doing so it has disregarded the input methodologies specified by the Commission under Part 4, instead continuing to:

- Apply its own view of a target cost of capital of 9.51%, as opposed to the Commission's most recent estimated range of a midpoint WACC of 7.06% to a 75th percentile WACC of 8.04%.
- Revalue its land using the MVEU valuation methodology. This adds an extra $1m per ha to WIAL's (already overstated) MVAU land valuation.
- Revalue its specialised assets using ODRC
- Maintain that only forecast revaluations should be treated as income (rather than actual revaluations).

When the Government included Airports within Part 4, it did so with the expectation that Input Methodologies would be relevant to (and even guide) the price setting process. The Explanatory Note to the Commerce Amendment Bill in particular noted that Input Methodologies would '*provide better information to guide consultations between airlines and airports and pricing decisions'* and *'remove much of the contention under the current regime'.* Unfortunately, in the case of Wellington Airport, this has not proven to be the case, with the Airport continuing to utilise its power to set charges as it thinks fit to set prices at levels which contain the expectation of earning significant excess returns.

Has information disclosure had any impact in understanding WIAL's performance, and why?

There has only been one set of historical information disclosure released by WIAL to date under Part 4. At this stage BARNZ itself has not experienced any impact in understanding WIAL's performance as a result of this disclosure.

Going forward it is BARNZ's expectation that the annual information disclosure will assist it in understanding WIAL's performance, particularly through being able to compare WIAL's

price setting disclosures with actual performance following the disclosures at the end of each financial year. However, while this will provide transparency over the accuracy of forecasting, it nonetheless still leaves airlines and the travelling public paying the inflated charges set by Wellington Airport.

Two areas where BARNZ still holds particular concern over the adequacy of the level of information required to be disclosed are:

- *Changes to the asset base resulting from cost allocation*. The disclosures to date have not included sufficient information or detail to understand the causes of changes in cost allocations, whether they are reasonable and whether they are stable or likely to be reversed in the future. For instance, in WIAL's disclosures to date:
    - The Report on the initial RAB (schedule 23) indicates that there were net transfers of $27.9m of assets to the RAB during FY10. These were only vaguely explained in the commentary provided by the Airport. These asset transfers resulted in a further $11.2m of assets being transferred into the RAB due to allocation of shared assets.
    - In the FY11 disclosures Schedule 6 indicates that the RAB reduced by $4.1m due to cost allocations, but no commentary was provided. It is not clear whether or not any asset transfers occurred.

- *The inclusion of leased assets within the schedules assessing the regulatory profit of the Airport*. BARNZ considers that as well as disclosing the performance of each of the segmented activities, there also needs to be disclosure of the financial performance of the pricing asset base – i.e. the set of assets and costs for which the Airport set charges using its price setting powers under section 4A of the AAA. It is this decision, and the profitability of these charges, which provide the primary signal of whether the airport is limited in its ability to extract excessive profits. Currently, there is no transparency over the performance of Airports in relation to the charges which they set using the section 4A AAA power.

Has information disclosure had any impact on the effectiveness and scope of consultation as part of WIAL's second price setting event (PSE), and why?

Information disclosure as such has not had any impact on the effectiveness and scope of WIAL's second PSE.

This is because WIAL's second PSE occurred during the 'vacuum' between the previous AAA information disclosure regime and the new disclosure requirements under the Commerce Act. The last disclosure under the AAA occurred 31 August 2010 for FY10. Disclosure for FY11 under Part 4 did not occur until 31 March 2012. Consultation for the second PSE occurred from April 2011 until the beginning of March 2012 – hence it was concluded prior to the first annual information disclosure being released under Part 4 at the end of March 2012.

In previous consultations BARNZ made considerable use of the AAA Information Disclosure to discern trends over matters such as operating costs and depreciation. The AAA information was also referred to during the second PSE, but was less up to date. BARNZ envisages that the Part 4 Disclosures would similarly be useful in future consultations.

The input methodologies developed by the Commission under Part 4 as part of information disclosure regulation were however available to airlines and WIAL during consultation on WIAL's second PSE. Notwithstanding the availability of these input methodologies, they had minimal (if any) impact on the effectiveness and scope of consultation as they were completely disregarded and dismissed by WIAL. While BARNZ analysis and assessments endeavoured to apply these input methodologies, such analysis was effectively ignored or dismissed by WIAL.

What aspects of performance and behaviour should we focus our efforts on for this review for WIAL?

BARNZ considers that the key aspects of behaviour by WIAL which need to be focused on during the Commission's section 56G review are its pricing decisions, and its use of its ability to use its market power and its right to set charges as it thinks fit under section 4A of the AAA to extract excessive profits. In particular, Wellington Airport decisions around the following matters require particular attention:

- Asset valuation methodologies – where WIAL is continuing to use MVEU to value its land and updated ODRC valuations to value its specialised assets
- The reasonableness of the adopted valuations – in particular the alternative land use underlying the MVAU land valuation where the Airport's valuers have adopted an alternative use with an extraordinarily high level of retail and commercial use
- The treatment of asset revaluations – where WIAL is continuing to maintain that only forecast revaluations should be treated as income with the asset owner retaining the benefit of any revaluations above that level
- The cost of capital – where WIAL has adopted a 9.51% WACC, significantly in excess of the Commerce Commission's range of 6.08% to 8.04%
- The treatment of 'discounts' in the charge setting process – where WIAL increased its required revenue by the amount of its proposed 'discounts'

IS WIAL EARNING EXCESSIVE PROFITS?

The new charges set by Wellington Airport are forecast to cause revenue paid by airlines for specified services to increase by 54% over the pricing period. Overall, BARNZ estimates that using the Commerce Commission mid-point WACC estimate, Wellington Airport will earn $99m in excess returns over the five year pricing period.

The increases to domestic jet and turbo-prop aircraft movements are extraordinary, with charges per passengers on turbo-prop aircraft more than doubling and charges for passengers on domestic jet aircraft increasing by 40%. The percentage increases during the peak and shoulder periods are even higher.

Approximate Charge per Passenger Using Wellington Airport

Passenger type	FY12 charge	Approximate FY 17 off-peak charge	Approximate FY 17 peak charge	Approximate % change FY12 to FY17 off-peak	Approximate % change FY12 to FY17 peak
International	$22.29	$18.55	$20.60	-17%	-8%
Domestic Jet	$10.82	$15.20	$17.10	40%	58%
Domestic large turbo-prop	$6.12	$11.80	$14.60	93%	139%
Domestic small turbo-prop	$6.12	$12.70	$19.20	107%	214%

The analysis by BARNZ is that far from increasing, charges should be decreasing over the new pricing period, with reductions of between 4% and 20% required in year one,[1] with constant charges thereafter, in order to produce an NPV = 0 outcome over the five years.

What is an appropriate level of target return for WIAL, and why is the level appropriate?
- What is an appropriate level to reflect normal performance, and why?
- What is an appropriate level to reflect superior performance, and why?

WIAL has set prices using a 9.5% WACC, which is significantly in excess of the Commission's most recent estimated range from a 25th percentile WACC estimate of 6.08% to a 75th percentile WACC estimate of 8.04%, with a midpoint WACC estimate of 7.06%

A comparison of the inputs being used by WIAL and the Commerce Commission in its latest Cost of Capital for airports is set out below:

	WIAL WACC used to set prices	**ComCom Airport WACC Determination as at 1 April 2012**	**BARNZ estimate used during consultation**
Risk-free Rate before Tax	3.90%	3.61%	3.66%
Debt Premium	1.89%	1.94%	1.82%
Debt Issue Costs	0.54%	0.35%	0.35%
Market Risk Premium	8.0%	7.0%	7.0%
Leverage	40.0%	17.0%	17.0%

[1] The range reflects the Commerce Commission range of WACC estimates from 6.08% to 8.04%.

Beta (Asset)	0.75	0.60	0.60
Investor Tax Rate	28%	28%	28%
Cost of Debt			
RFR.BT+DebtP+DebtI	6.33%	5.90%	5.83%
Cost of Equity			
Beta (Equity) = BetaA/(1-Lev)	1.25	0.72	0.72
RFR.BT*(1-Ti)+BetaE*TAMRP	12.8%	7.64%	7.7%
Post Tax Weighted Average Cost of Capital	**9.51%**	**7.06%**	**7.10%**

The core differences between WIAL's approach and the Commerce Commission's are:

- WIAL used a 10 year cost of debt, which is higher than the five year cost of debt
- WIAL used a PTMRP of 8% rather than the 7% identified as reasonable by the Commission for all regulated industries
- WIAL used an asset beta of 0.75 rather than the asset beta of 0.6 identified as reasonable by the Commission for the airport sector

BARNZ sought advice from Futures Consultants Ltd (FCL) during consultation on the differences in WACC inputs between WIAL and the Commerce Commission Determination, and specifically on whether there is any valid reason for departing from the Commerce Commission cost of capital methodology developed for the purposes of information disclosure, when setting charges. The FCL Report is attached as Attachment 1. FCL concluded that '*in every instance, [the] parameter estimate is either the same as the Commission's or such that it will yield a higher estimate of WIAL's WACC'.* Futures Consultants concluded:

> *… there is no justification for WIAL adopting when setting charges parameter estimates different from [those] the Commission has set for WIAL for information disclosure purposes. Should WIAL use Sapere's WACC estimates in order to set charges for its regulated services, without making offsetting adjustments in one or more of the other components it uses for this purpose, it will be seeking very significant excess returns compared with the level the Commission considers to be appropriate.*

BARNZ considers that the Commerce Commission's mid-point estimate of 7.06% is the appropriate level to set charges so as to anticipate a return reflecting a normal performance, noting however that some of the inputs used by the Commission when estimating its WACC range are generous towards suppliers. Below average returns, albeit still within a normal range, could be expected within the range down to the 25th percentile. Superior performance could be expected within the range up to the 75th percentile, which the Commission has estimated at 8.04%, however prices should not be set using a WACC estimate reflecting superior performance. Superior returns should have to be earned through superior performance – not granted through use of a WACC at the upper bounds of an appropriate range. The 9.51% WACC applied by WIAL simply reflects an expectation of excessive returns.

How should we assess profitability, given the airports inter-temporal use of wash-ups, discounts and other discretionary mechanisms?

BARNZ considers that the Commission should undertake two assessments. The first would be on the basis of the returns earned or forecast to be earned in any given year by an Airport, without any adjustment by inter-temporal mechanisms. This would indicate whether there is any systematic bias in forecasts over time.

The Commission should then undertake a second assessment which endeavours to match the revenue earned with the wash-up mechanism. This assessment would enable a judgment of the degree to which wash-up mechanisms have acted to limit excessive pricing in the long run.

How reasonable is WIAL's revenue forecast for the second PSE compared to the first PSE forecasts, and why?

BARNZ considers that the revenue WIAL is forecast to earn under the charges it set in March 2012 is unreasonable, and will result in the Airport substantially over-recovering on its pricing asset base and earning significant excess returns.

WIAL's current level of revenue earned from its common use terminal and airfield assets is $55.7m. Under its building block methodology, WIAL assesses its required revenue as $60.3m in FY13, increasing to $85.9m by FY17. This represents a 54% increase in required revenue over the 5 year pricing period.

The expert advice obtained by BARNZ points to the inputs being used by WIAL in its financial model being materially overstated, such that the required revenue being sought by WIAL is significantly too high and will result in the airport substantially over-recovering.

During consultation BARNZ took the outcome of its analysis and the expert advice it had received, and carried out an alternative revenue calculation of the maximum allowable revenue for Wellington Airport with respect to its common use airfield and terminal facilities and services. BARNZ has updated this analysis for the changes made by WIAL in its Final Pricing Determination. This is attached as Attachment 2.

This exercise shows that far from being able to justify a 54% increase in required revenue over the five year pricing period, there is no need whatsoever to increase charges, and, in fact, a significant decrease to charges is warranted.

If the current charging structure was to continue, with charges remaining at the current levels, then BARNZ analysis indicates that, applying the Commerce Commission mid-point WACC estimate of 7.06%, WIAL would earn excess returns of $99m over the five year pricing period. Charges need to decrease by a one off reduction of 12.5% in the first year of the pricing model, and thereafter remain constant, in order for a NPV = 0 situation to apply at the Commerce Commission's mid-point WACC. The relevant outcomes across the Commerce Commission's full WACC range for Airports is summarised in the table below:

	Required revenue	Over-recovery under WIAL's new charges	Reduction needed to current charges to produce NPV = 0 outcome
25th percentile WACC estimate of 6.08%	$238.4m	$124.1m	20.75%
Mid-point WACC estimate of 7.06%	$263.2m	$99.3m	12.5%
75th percentile WACC estimate of 8.04%	$288.0m	$74.5m	4.25%

The following items are the key changes which BARNZ considers need to be made to WIAL's financial model:

- Land should be valued at its opportunity cost, measured by a MVAU valuation undertaken in accordance with Schedule A of the Commerce Commission Input Methodologies Determination for Specified Airport Services. BARNZ has obtained advice from Property Advisory Ltd that the value of WIAL's land under the Commission's MVAU methodology is $950 000 per ha.
- Civil works and buildings should be valued using the disclosed 2009 valuations, rolled forward for acquisitions, disposals, depreciation and indexed at CPI.
- The buildings asset base needs to be reduced by $3.0m reflecting the food court being incorrectly treated as common space.
- The appropriate WACC is the Commerce Commission range of 6.08% to 8.04%.
- Forecast operating expenses need to be reduced by 10% per passenger in order to represent an efficient forecast.
- The proposed growth rebates, which amount to $11.8m over the pricing period, should not be treated as a cost to be recovered which increases the required revenue targeted by the Airport from aeronautical charges.

The outcome of these changes significantly reduces the required revenue applicable under the building block methodology for Wellington Airport's common use airfield and terminal facilities. Using the Commerce Commission's estimate of the mid-point WACC as an illustration, the annual difference in required revenue is as follows:

Comparison of Required Revenue Under WIAL and BARNZ Building Block Models

	2013	2014	2015	2016	2017	Total
Annual required revenue under WIAL building block model ($000)	60,303	65,686	71,918	78,706	85,850	362,463
Annual required revenue under BARNZ building block model ($000)	49,574	51,061	52,593	54,171	55,796	263,194

The analysis by BARNZ shows that by setting charges at a level so as to earn $362m of revenue over the pricing period, Wellington Airport will be substantially over-recovering and earning significant excess returns.

How reasonable are WIAL's asset valuations, and why?

WIAL revalued its land in 2011 using MVEU (comprising an underlying MVAU valuation plus holding costs during its notional development as an airport) and revalued its civil works and buildings using ODRC during 2011. It has used these revaluations as the opening pricing asset base.

BARNZ considers that WIAL's 2011 valuations are over-stated and unreasonable and the valuation methodologies used by the Airport are inconsistent with the Commerce Commission's input methodologies for asset valuation.

Valuation of land – underlying MVAU valuation over-stated

WIAL assessed its MVAU valuation of land used for aeronautical purposes as being $141m, which equates to $1,366 280 per ha.

BARNZ commissioned a valuation by Property Advisory Ltd (PAL) of WIAL's operative aeronautical land using the Commerce Commission's land valuation methodology as set out in Schedule A of the Commission's Input Methodologies Determination dated 22 December 2010. The outcome of the PAL valuation is a valuation of $98.0m for the 103.2 ha of operational airport land owned by Wellington Airport (as opposed to $141m in the revised Telfer Young valuation). This translates to a value of $949 645 per ha.

The PAL valuation was informed by advice provided by:

- Market Economics with respect to current and future demand for potential alternative uses of Wellington Airport land holdings
- Zomac Planning Solutions with respect to the likely composition of the alternative land use in the event the airport closed
- Rider Levett Bucknall with respect to the likely costs which would be incurred in undertaking the alternative use subdivision

BARNZ attaches the PAL valuation and all of these reports and subsequent responses to WIAL as Attachment 3.

One of the key differences between the Telfer Young valuation and the PAL valuation commissioned by BARNZ is the amount of commercial and retail land included in the alternative land use plan.

WIAL's valuation is based on a land use plan prepared by Boffa Miskell which includes 31.6 ha of commercial land use (comprising a town centre, large format retail and a business park). BARNZ sought advice from Zomac Planning Solutions. Zomac advised that they

considered the Boffa Miskell alternative land use plan contained significantly too much commercial and retail land and that 7 ha was a more realistic allowance. The amount of commercial and retail land has a significant effect on the underlying valuation, as not only is it able to be sold for a much higher value, but it is also realised earlier in the development timeframe. Given the importance of this issue, BARNZ obtained a comprehensive analysis from Market Economics of the current and future demand for potential alternative uses (including residential, retail, commercial and industrial uses) of the Wellington Airport site in the event the airport was to close. Market Economics concluded that in the absence of the airport, a commercial centre of between 30,000 – 45,000m^2 of additional retail floor space, having the character of something less than a sub-regional role, would develop, which would be unlikely to decrease Kilbirnie's current sub-regional role. Market Economics identified that the Boffa Miskell proposal would lead to the proposed commercial area being one of the largest centres in Wellington, which is unlikely to be feasible in reality as it would have to replace Kilbirnie's sub-regional role.

Another key difference between the Telfer Young $141m valuation of WIAL's aeronautical land and PAL's $98m valuation, is the length of time over which the land development will occur. Telfer Young have assumed that all land sales will be completed within seven years. PAL has allowed eleven years for the land sales to be completed. BARNZ notes that previous valuations by WIAL have consistently been based on a ten year development period. The reduced realisation period significantly increases the resulting valuation.

Overall, BARNZ does not consider that the Boffa Miskell large scale proposed retail precinct is 'appropriately justified, legally permissible, financially feasible' as required by the Commission's land valuation methodology. While it undoubtedly 'results in the highest valuation of the land', not all land developed can be a Sylvia Park or Albany Town Centre. It is not sufficient just to adopt a use which results in the highest valuation of the land. In order to comply with the Commerce Commission's valuation methodology the use must also be one which is physically possible, appropriately justified, legally permissible and financially feasible.

BARNZ strongly considers that the Commerce Commission needs to obtain its own valuation of WIAL's aeronautical land holdings in accordance with Schedule A (or an independent peer review of WIAL's valuation) before the Commission can properly review the effectiveness of Information Disclosure under Part 4 of the Commerce Act and form a sound conclusion of its ability to promote the purposes set out in section 52A. The reasonableness of the valuations adopted form one of the key inputs to determining the reasonableness of the charges set and whether or not excess returns are likely to be earned. An independent assessment of the alternative use valuation adopted by WIAL of its land holdings is a vital foundation to the analysis required to be undertaken as part of the Section 56G Review.

<u>Valuation of Land – appropriate methodology</u>

While WIAL has purportedly undertaken an MVAU valuation applying Schedule A of the Commerce Commission's Input Methodology Determination (albeit that the result is not one that is appropriately justified, legally permissible or financially feasible), it has not used this valuation as the basis for setting charges. Instead, it has converted this (already overstated)

MVAU valuation of $141m to an MVEU valuation by adding land conversion costs which it assesses as $101m, comprising rates of $7.5m, planning approval costs of $8.0m and holding costs of $85.5m, effectively increasing its aeronautical land value by 73% to $242m.

The proposal by WIAL to utilise a market value existing use (MVEU) valuation is fundamentally inconsistent with the approach taken by the Commerce Commission in both the Airport Price Inquiry in 2002 and the determination of input methodologies under Part 4 of the Commerce Act.

For both pricing purposes and information disclosure and monitoring purposes, the Commerce Commission has consistently considered that opportunity cost is the measure by which airport land should be valued.

In the Airport Price Inquiry the Commission rejected MVEU, despite extensive submissions on behalf of WIAL and the other airports, stating:[2]

> … the Commission considers that none of those valuations are appropriate for the purposes of either judging the efficiency of asset allocation between alternative uses, or for pricing. From an economic perspective, the owner of an asset that earns at least as much in its current employment as in its next best alternative use will have no incentive to transfer that asset to that alternative use. Any return over-and-above that minimum amount called the asset's transfer earnings is economically a rent, that is, a return beyond that needed to retain the services of the asset in its current employment. (Emphasis added)

The Commission confirmed its rejection of MVEU in its recent Part 4 Determinations, noting that in a workably competitive market, land values will reflect the opportunity cost of the land in its next best alternative use. Past land conversion costs will either be reflected in the opportunity cost value of the land (such as levelling costs) or will already have been recovered long ago. As such there is no need to allow airports to earn a return on these past costs in order to encourage investment. Allowing airports to add on land conversion costs would simply have the effect of increasing the ability of airports to earn higher profits, without those profits appearing excessive.

WIAL has assessed the costs of converting its land to airport use as $101m, which adds 73% to its MVAU valuation. As noted by the Commission, adding on land conversion costs in this manner has the sole effect of increasing the charges the airport is seeking to set. The assessment of airport land conversion costs is effectively an exercise of creating value through alteration of a figure in a spread sheet. The holding cost rate utilised in WIAL valuations has varied significantly over time, from 9.5% in 2007 to 10% in 2009, 11.8% in the draft 2011 valuation, increasing to as high as 13.4% in Telfer Young's August 2011 valuation, reducing to 12.9% in Telfer Young's Revised Valuation and finally 12.4% in Telfer Young's advice for WIAL's Final pricing Decision. WIAL itself has made what it terms a commercial concession and applied its WACC of 9.51% to calculate holding costs for the purposes of pricing. This further under-scores the subjective and arbitrary nature of this calculation, and its complete lack of grounding in any actual verifiable market value. Simply changing this one figure has a significant impact on the outcome of the valuation, and results in remarkable uplifts to the perceived value, without any further actual investment.

[2] Commerce Commission, Airports Inquiry Final Report, August 2002, para 5.90

By contrast, the opportunity cost of an asset is the amount required to keep it in its current use. In a competitive market, an asset not earning a return on its next best alternative use, will, over time, be transferred to that alternative use. BARNZ therefore considers that for the purposes of setting prices, airport land should be valued at its opportunity cost,[3] determined through a valuation undertaken in accordance with Schedule A of the Commerce Commission Input Methodology Determination. The costs of converting the land to use as an airport today should not be added to the opportunity cost land value, and in doing so, WIAL has adopted a valuation which is not reasonable, and which does not reflect the outcome of a workably competitive market.

Valuation of specialised assets (buildings and civil works)

WIAL has revalued its specialised assets (other than plant and equipment) using ODRC as at 31 March 2011.

This is inconsistent with the Commerce Commission's methodology which was that for the purposes of determining the regulatory asset base, the 2009 disclosed valuation of specialised assets should be treated effectively as a deemed historic cost and should be rolled forward thereafter for CPI, additions, disposals, depreciation and (until 2012) lost and found assets.

The Commission considered that using the indexed 2009 valuations would not fail to provide the airports with the opportunity to earn a normal return on their original investment. The Commission considered that further upwards revaluations to new ODRC values, with prices being reset on those new ODRC values, would be inconsistent with outcomes in a workably competitive market.

BARNZ applied the Commission's approach of drawing a line in the sand at 2009 valuations for specialised assets, and indexing those values thereafter for CPI, for the purposes of determining the reasonableness of the charges proposed by WIAL. This is despite the fact that BARNZ considers that the Commission's approach is extremely generous to the airports because of the very large revaluations which were not treated properly as income for the purposes of setting charges from corporatisation through to 2009.

BARNZ estimated that the resulting value of the specialised assets from rolling forward the 2009 disclosed values (which in the case of WIAL were fresh ODRC revaluations) is as follows:

- For civil works, the pricing asset base based on the 2009 disclosed valuations of $116.1m would become $127.4m at the beginning of the pricing period in FY12.

- For buildings, the pricing asset base based on the 2009 disclosed valuations of $87.5m would become $117.6m at the beginning of the pricing period in FY12.

[3] Provided that all revaluations have been, and continue to be, treated as income for the purposes of setting charges. If any airport is not prepared to treat all revaluations (whether forecast or unexpected) as income in the charge setting process, then an indexed asset base should be applied with only revaluations that have been treated as income being included in the asset base used to set charges.

In both cases, BARNZ has adjusted the values for capital expenditure, depreciation and asset transfers and disposals as advised by WIAL. In addition, actual CPI for FY10 and FY11 and forecast CPI for FY12 has been used by BARNZ to index the asset base forward.

Compared with WIAL's ODRC valuation of specialised assets, the indexed forward civil works value is $4.1m less than WIAL's pricing asset base for civil works of $131.5m, while the indexed forward specialised building value is $5.3m higher than WIAL's pricing asset base for buildings of $112.3m as at 31 March 2011.

Although the combined difference is only $1.2m at this stage, it is highly likely to widen going forward, and the continued practice of undertaking new ODRC valuations is of great concern to BARNZ members. The Airports have all recently revised the economic life of their terminal structures downwards, which has caused one-off reductions in their terminal building valuations.

What role has ID played in discussions in the industry about the target return on investment when setting prices?

Information Disclosure, and in particular the Commission's Cost of Capital Determination, has (from BARNZ's perspective) played a very one-sided role in industry discussions about the target return on investment when setting charges.

WIAL effectively dismissed and disregarded the Commerce Commission's cost of capital input methodology determination. As noted above under the target level of return question WIAL has adopted inputs higher than the Commission for risk free rate, debt issuance costs, leverage, market risk premium and asset beta. This has resulted in the Airport applying a WACC of 9.51% that is 35% greater than the Commerce Commission estimate of an appropriate mid-point WACC of 7.06% for Specified Airports.

BARNZ treated the Commission's Determinations on Airport Cost of Capital (updated for the risk free rate and debt premium) as the starting point and sought independent expert advice from Futures Consultants Ltd (FCL) on whether there was any reason to depart from the Commerce Commission industry wide information disclosure WACC when determining a WACC for WIAL to use to determine charges. The FCL Report is attached as Attachment 1. FCL concluded:

> *… there is no justification for WIAL adopting when setting charges parameter estimates different from [those] the Commission has set for WIAL for information disclosure purposes.*

In short, the Government's expressed hope that input methodologies would *'remove much of the contention under the current regime'* has not proven to be the case with respect to Cost of Capital.

IS WIAL OPERATING AND INVESTING IN THEIR ASSETS EFFICIENTLY AND EFFECTIVELY?

Where and when do any capacity constraints occur at WIAL, and is additional investment necessary to address these constraints?

The land area at Wellington Airport is the smallest of the three regulated airports, and Wellington Airport is thus necessarily more constrained than the other airports. This requires innovative operational solutions in order to ensure that maximum utilisation is made of the available land area and physical facilities.

As a general observation, BARNZ has not experienced Wellington Airport being tardy to invest. BARNZ is not aware of any evidence of the Airport ignoring capacity constraints and seeking to defer investment later than it should.

Rather, the concern BARNZ has is over Wellington Airport investing ahead of time, or at a level which is not required for the current market. In particular, WIAL is specifying works at levels above that required for Code C aircraft, which are the largest scheduled aircraft currently using and likely to use Wellington Airport. WIAL then seeks to earn a return on and of this capital, despite the fact it is not required by current users.

Turning now to consider the specific facilities at Wellington Airport:

- **The runway at Wellington Airport** is close to capacity at certain peak times. Realistically, it cannot be economically extended. This creates a need for industry to engage in a runway enhancement programme involving Wellington Airport, airlines, pilots, Airways and other airports to maximise efficiency and utilisation of the current runway. This can only occur through a whole of industry approach covering not only investment, but also operational practices and regulatory requirements. BARNZ' view is that the appropriate working groups and relationships are in place to manage enhancing runway utilisation and investment is occurring as it is identified as appropriate.

- **Taxiway clearances at Wellington Airport** are below ICAO required levels for Code D and E aircraft. However this does not cause any capacity constraint as Wellington Airport has obtained dispensation from the CAA to manage the reduced clearance between the taxiway and runway via operational protocols (ie if a Code D or E aircraft is on the runway, then no other aircraft may use the taxiway). BARNZ considers that this is a very cost effective solution given the current very low volumes of Code D and E aircraft.[4] It has been 12 years since there were regular scheduled Code D aircraft operations at Wellington Airport. Despite this, WIAL is proposing to spend $28m on compliance works over the next ten years to widen the taxiway and improve clearances. In BARNZ's view this is not justified on a cost/benefit analysis given the very low volumes of Code D and E aircraft. The

[4] The Part 4 Information Disclosure indicates that in FY11 there were only seven Code D or E aircraft movements at Wellington Airport, although the previous four calendar years had approximately 40 Code D or E movements pa.

current dispensation to manage the issue by operational protocols is the appropriate solution and should be continued.

- **The space for push-back around some aprons** is congested as a result of the 'horse shoe' design of the terminal which prevents domestic and international aircraft (on the southern international gates) from being able to push-back at the same time, which can create on-time performance issues. WIAL is moving to have its airport operations team under-take gate allocation and responsibility for apron control from FY13 which has been welcomed by some BARNZ members as it may mitigate potential conflict around aircraft push-back.

- **The domestic gate lounges and baggage make up area in the terminal** are both constrained. WIAL has forecast capital expenditure to expand these areas in the current pricing period which is supported by the airlines.

- **International gate facilities** are not constrained as the construction of The Rock resulted in additional international contact gates.

- **Domestic contact gate facilities** are often fully utilised however the use of walk-on gates has alleviated any capacity constraints, enabled the speed of embarkation and disembarkation of passengers from the aircraft to be improved and is seen as an efficient cost effective solution.

What factors outside WIAL's control have contributed to the capex and opex forecast for the second PSE and to changes in expenditure since the first PSE?

Increased insurance and regulatory costs are factors not wholly within WIAL's control which will have added to its cost base. However, BARNZ also observes that WIAL does have some influence over these costs, particularly its regulatory costs which are significantly influenced by the degree to which WIAL chooses to engage external consultants and advisors and the decisions it takes on whether to initiate judicial review and merits review proceedings.

BARNZ does not consider that it is appropriate that WIAL has included the costs of its optional merit review and judicial review proceedings within the cost base on which it has set its charges. The recovery of such costs should follow the event as ordered by the relevant Court, not be met wholly by users — which is the outcome WIAL has delivered for itself.

How reasonable are WIAL's opex forecasts for the second PSE, and how do these compare to the forecasts from the first PSE?

BARNZ does not consider that WIAL's forecast opex costs for the second PSE are reasonable. WIAL has previously exercised commendable control over its costs post its privatisation,

managing its operating costs relating to the AAA pricing activities at a constant level of $2.31 per passenger in nominal terms from FY00 to FY06.

WIAL Actual Operating Costs 2000 to 2007

2007 Consultation Pricing Model	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**[5]
Actual Operating Expenses	8,430	9,157	8,643	9,651	10,994	9,321	9,219	10,621
Actual pax	**3,613**	**3,669**	**3,704**	**3,900**	**4,321**	**4,603**	**4,572**	**4,634**
Actual expenses per pax	$ 2.33	$ 2.50	$ 2.33	$ 2.47	$ 2.54	$ 2.03	$ 2.02	$ 2.29

When WIAL set charges in 2007 to apply for FY08 to FY12 (the first PSE) it forecast average operating costs at that same level – namely $2.31 per passenger on average over the five years. This equated to a real reduction in operating costs per passenger. Passenger growth over the period meant that total operating costs were nevertheless forecast to increase, in both real and nominal terms. BARNZ views operating costs per passenger as the most appropriate measure to assess the efficiency of operating costs. BARNZ therefore concluded that the forecast operating costs in the first PSE were reasonable.

WIAL Forecast Operating Costs 2008 to 2012

2007 Consultation Pricing Model	2008	2009	2010	2011	2012
Forecast Operating Expenses	10,412	10,537	10,638	11,832	13,011
Forecast pax	4,648	4,744	4,842	5,000	5,163
Forecast expenses per pax	$ 2.24	$ 2.22	$ 2.20	$ 2.37	$ 2.52

In the second PSE WIAL has forecast average operating costs per passenger of $3.10, a 34% increase on operating costs per passenger forecast in the first PSE:

WIAL Forecast Operating Costs

2012 Consultation Pricing Model	**2013**	**2014**	**2015**	**2016**	**2017**
Forecast Operating Expenses	16,638	16,068	17,721	18,103	18,415
Forecast pax	5,293	5,425	5,595	5,775	5,949
Forecast expenses per pax	$ 3.14	$ 2.96	$ 3.17	$ 3.13	$ 3.10

The magnitude of the increase is not justified. BARNZ considers that there is a significant risk that WIAL is forecasting operating expenses at an inflated rate in order to enable the airport to profit from any savings made against the inflated forecast.

If the same efficiency that occurred in the past of maintaining constant nominal costs per passenger was maintained, then WIAL's forecast operating costs per passenger should lower by 35%.

BARNZ considers that an appropriate and reasonable cost allowance is for the actual $2.29 cost per passenger in 2007 to be indexed forward for inflation. This allows expenses per passenger to be maintained at real levels from FY07 costs per passenger. This produces an average operating cost allowance of $2.82 per passenger which is 10% lower than the costs

[5] Figures extracted from WIAL's 2007 final pricing model. Note the 2007 expenses were budget figures.

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.

In its alternative revenue calculations undertaken during consultation BARNZ applied this adjustment.

BARNZ also notes that WIAL has altered its methodology for treating space within its main retail hall, as had been foreshadowed by the Airport during the Airport's Workshop on 18 February 2010. It is now treating the food-court as common space, rather than its previous allocation to commercial/retail activities, which had been the classified for the previous fifteen years, since the terminal was constructed. This is despite Commissioner Duignan having expressly noted that WIAL's intimation that it would be modifying its allocation methodology did not 'work … for the Commission' which wanted to rely on the process as having produced a 'settled outcome' in order to 'avoid having to specify things'.[6]

How reasonable are WIAL's capex forecasts for the second PSE, and how do these compare to the forecasts from the first PSE?

BARNZ has three key concerns with respect to WIAL's forecast capital expenditure, namely:

- The practice of front-end loading the forecast capital expenditure
- Undertaking unnecessary capital expenditure in order to maintain the Airport at a higher category than demanded by the market.
- Designing terminal extensions as an art-form rather than an efficient design that represents value for money.

<u>Front end loading of forecast CAPEX</u>

Asset owners, such as Wellington Airport, which use the building block methodology to set charges, have an incentive to forecast capital expenditure earlier in the pricing period than it would be likely to be incurred. This is because if expenditure is in fact deferred until later in the pricing period, then the asset owner will receive a windfall through the charges being based on expenditure which has not yet incurred or on an asset which is not yet in use. Effectively users will (for the deferred period) be paying for an asset which is yet to be constructed, and from which they do not yet receive any benefit.

The forecast capital expenditure in the second PSE is significantly front end loaded, with 78% of the capital expenditure contained within the five year pricing period being incurred within the first three years of the pricing period. Wellington Airport also significantly front end loaded its forecast capex profile when it set charges in 2007 in the first PSE, with 77% of capex being forecast to occur within the first two years of the previous FY08 to FY12 pricing period.

[6] Transcript – Input Methodologies Airport Workshop, 18 February 2010, per Commission Duignan at page 32, lines 12 to 20.

Due to concerns expressed by airlines in the first PSE Wellington Airport applied a wash-up to the effect that, if the international terminal expansion project was delayed by more than 12 months, the airport would carry forward any moneys paid prior to its completion (ie the return on and of capital and associated tax on the forecast capex) as a credit into the next pricing period. In the event, the international terminal expansion was not completed until some 19 months after forecast and a wash-up, amounting to $9m (compounded to $12m for opportunity cost of money) was treated as a credit in this pricing period.

BARNZ expressed the same concern in relation to the main key projects forecast in the second PSE (namely stage 1 of the Main Terminal Building (MTB) project, stage 2 of the MTB project and the South West Pier Redevelopment) and WIAL has applied the same wash-up concept.[7]

While the wash-up concept ameliorates the risk to users of the Airport biasing the time of projects in order to increase its revenue, it has not completely removed this risk. This is for two reasons.

First, the wash-up only applies to key projects and not to other less material capex. For instance, for three pricing consultations now WIAL has forecast the replacement of rescue fire vehicles in the first year or two of a pricing period, which replacement has, in actual fact in two pricing periods been deferred[8], either through the considerably cheaper refurbishment of the vehicles or through the replacement simply not occurring. This is despite BARNZ having specifically asked during consultation whether replacement was necessary and being assured it was. BARNZ now has a significant degree of cynicism over WIAL's forecast capital expenditure in relation to rescue fire vehicles. The forecasting of costs relating to the acquisition of houses as part of the noise management programme provides a further example of WIAL's general approach of front-end loading capex where-ever possible. At the beginning of March 2012 WIAL set the noise charge on the basis of it compulsorily acquiring 22 houses within the 75dba area at an average cost of $406 000 each in the FY13 year (despite BARNZ's objections to the use of compulsory acquisition under the Public Works Act). Yet when WIAL presented its noise management plan to the Air Noise Committee at the beginning of June some three months later, it was on the basis of offers to purchase being made. Quite clearly, the actual costs of acquiring houses under offers to purchase will be spread over a significantly greater time period than the compulsory process in 2012 – 2013 used by WIAL in forecasting its costs.

Additional Capex relating to Code D and E Aircraft

There has been a significant reduction in the volume of Code D and E aircraft using Wellington Airport over the last decade with a marked down-gauging of aircraft in the market-place occurring around 1998. Prior to 1998, there were approximately 1000 Code D

[7] Note that the Airport does not consider the wash-up should apply if charges are not set by it under the AAA (that is, if there is a regulatory change). BARNZ considers the wash-up should apply regardless of the statute charges are being set under, so long as there is consistency in the treatment of required revenue and the wash-up.

[8] The third pricing period is the present one just commenced, where it remains to be seen as t whether or not the forecast rescue fire appliances will be purchased

and E aircraft movements per annum through Wellington Airport. This dramatically reduced during 1998 and 1999 to double digit Code D and E aircraft movements per annum. In the last four years Code D and E aircraft movements have averaged around 40 movements through Wellington Airport each year – which is less than one per week, and the most recent information disclosure for FY11 discloses only seven Code D and E aircraft movements that year.

Despite the market reality that airlines are only scheduling aircraft up to Code C to Wellington, WIAL is continuing to scope its capital expenditure work up to the level required for Code D and E aircraft, and charge airlines for this investment, despite it not being required by current operators. This led the Airport to spend an extra $5m on its RESA requirements during 2010 and 2011 order to meet Code D and E aircraft requirements. These ambitions for Code D and E aircraft movements are also responsible for WIAL forecasting runway compliance works of more than $20m over the next ten years primarily relevant to Code D and E aircraft. WIAL currently has a dispensation permitting Code D and E aircraft to use the runway and taxiways with operational procedural restrictions, despite the taxiway width not meeting ICAO Code D and E aircraft requirements. WIAL itself has acknowledged that it can continue to operate under the approved dispensations and procedural restrictions. There is no need for WIAL to undertake work up to the requirements for Code D and E aircraft, given the extremely low numbers of Code D and E aircraft moving through the airport, and the fact that the Ohakea Air-force Base is available as an alternate should Auckland and Christchurch Airports be unavailable. In a workably competitive market this additional expenditure would not occur in the absence of airlines operating Code D and E aircraft at Wellington.

Undertaking terminal extensions using a 'grand design'

The original terminal construction at Wellington Airport was of a well designed building using economical construction materials. The design was modular, so as to enable incremental extensions to occur in a logical and cost effective manner.

The Rock extension, comprising copper sheathed boulder shaped sections is neither modular, cost effective nor enabling of future extensions. The consultation with airlines of the copper sheathing 'rock' design was non-existent.[9] Airlines learned of this through the media.

The Rock was an extraordinarily complex and expensive project. BECA, WIAL's Project Engineers, issued a media release describing it as an 'enormously complex' engineering design which 'stretched the ingenuity of BECA's structural team to the full'.[10]

As noted above, the remainder of the terminal is constructed on clean geometric lines, which were specifically adopted so as to reduce construction costs and allow incremental extension of the building at low cost as required. The Rock's design has dramatically departed from this concept.

[9] As distinct from internal flow and function where WIAL did consult with airlines individually
[10] BECA Media Release 'The Rock Officially Opens', 27 October 2010

BECAs note 'the easiest structure to engineer is a simple box. By contrast, The Rock's design is about as far from a straight-sided cube as it is possible to get'. A media release by Classic Metal, the firm responsible for the copper panels, disclose that the project comprised 3600 copper panels, every panel being tapered and 'individually measured and manufactured'. The Classic Metal team stated that 'the complexity of the project, where there was not a single straight or square panel on the entire job, was the greatest challenge'.[11]

Optimisation of the cost of The Rock (as compared to the cost of an extension in the same design as the main terminal) therefore needs to be addressed. The Rock is undoubtedly celebrated architecturally internationally having won 12 awards. However, airlines should not be charged for the aspirations of Airport shareholders to construct award winning, architecturally challenging, highly complex, terminal buildings which purport to make a statement of Regional Pride and identity. Such costs should be borne by shareholders.

To what extent does the demand forecast presented by WIAL as part of the second PSE, accurately reflect expectations of future demand, and why?

BARNZ considered that the demand forecasts applied by WIAL to set charges for FY13 to FY17 were reasonable.

WIAL applied forecast international passenger growth of 4.3% pa. This is slightly higher than the historical average of 3.9%. At the time of consultation the Air NZ/Virgin trans-Tasman alliance was forecast to increase total trans-Tasman capacity into and out of Wellington by 3.5 per cent. Capacity growth from other current airlines (namely Qantas and Jetstar) also needs to be allowed for. Overall BARNZ considered that the forecast international growth of 4.3% was reasonable, albeit slightly on the optimistic side.

WIAL forecast domestic passenger growth of 2.7%. This is nearly a whole percent lower than the historical average of 3.6%. The reduction of domestic carriers from three down to the historical norm of two domestic carriers is highly relevant to potential domestic growth. The entry of Pacific Blue into the domestic market (coupled with the competitive responses from Air NZ and Qantas) resulted in a substantial stimulus to domestic travel, with growth of nearly 9% in 2008. With the GFC, and the withdrawal of Pacific Blue from the domestic market, passenger volumes softened. Against this, events such as the Cricket World Cup in 2012 and the FIFA U20 Soccer World Cup in 2015 will act as stimulants. Taking all these factors into consideration, BARNZ considered that a forecast of 2.7% domestic growth was within a reasonable range, albeit slightly on the conservative side.

How reasonable is WIAL's demand forecast for the second PSE compared to the forecast from the first PSE?

BARNZ did not consider that the demand forecasts for domestic passengers used by WIAL in the first PSE were reasonable. WIAL had forecast virtually no domestic passenger growth in

[11] Wellington Airport 'Rocks' Win 12 Awards, 13 December 2011, http://www.scoop.co.nz/stories/BU1112/S00474/wellington-airport-rocks-win-12-awards.htm

the initial years, which was criticised by BARNZ during consultation in 2006-2007. In actual fact, domestic passenger volumes increased by 8.8% in FY08 and 5.1% in FY09. Actual domestic passenger volumes disclosed in information disclosure exceeded WIAL's consultation forecast volumes by 8% in FY08, 12% in FY09, 6% in FY10 and 3% in FY11.

What role did information disclosure regulation play in negotiations concerning WIAL's expenditure forecasts?

During consultation[12] BARNZ made reference to historical trends of operational expenditure and costs per passenger disclosed under the previous AAA Information Disclosure Statements to highlight and express concern over the degree to which WIAL's operating costs were increasing, both in absolute terms and on a per passenger basis. Information disclosure under Part 4 was not available to assist in these comparisons at the time consultation occurred.

The cost allocation input methodologies are at such a high level that, in BARNZ's view, they provide little meaningful guidance in the event of differences of view over the allocation of costs.

IS WIAL INNOVATING APPROPRIATELY?

What research and development (R&D) or innovation activities have been undertaken or are forecast to be undertaken by WIAL and what was the outcome these activities (if they have been undertaken), or the expected outcome?

In the next pricing period WIAL is installing a new FIDS system, which will be linked with gate and aircraft stand allocation, enabling the allocation of gates to occur automatically taking into account the scheduled and actual arrivals times of other aircraft. The FIDS system will be web-based, which should make access by users more convenient.

How does the level of R&D and innovation activities compare now to activities prior to the introduction of ID in January 2011?

No comment at this stage

[12] As an aside, BARNZ notes that the AAA requires consultation with airlines over new charges rather than negotiation. Legal precedent has emphasised that consultation does not equate to negotiation, with the consulter having the ability to unilaterally make the final determination in consultation, as opposed to negotiation which rests on a consensus occurring.

What innovation has occurred in other airports in New Zealand or overseas in recent years?

In BARNZ's experience over recent years, the majority of innovation around passenger facilitation through airports has been undertaken by the users of airports, rather than the airports themselves. In general terms, the Airports provide the infrastructure or shell within which airlines and other service providers operate and undertake innovation in the manner in which they provide services to the travelling public. For instance:

- Check-in has been made considerably more efficient by airlines through the use of electronic means of check-in such as kiosks (either on-site or off site), smart-phones, RF tags and internet check-in options
- Customs has also become considerably more efficient with the advent of Smart-gates
- MAF has a project underway to make use of computer images of incoming baggage so that it may be checked prior to its arrival in New Zealand
- The airlines have installed computerised wireless baggage reconciliation systems to use in the bag hall (rather than the previous manual cross-checking processes) in order to comply with international requirements that bags be authorised and accounted for prior to being loaded onto aircraft

However, Auckland Airport has put considerable effort into encouraging airport users and service providers to adopt more efficient processes, and into facilitating a 'whole of airport' processing approach aimed at making passenger facilitation through the international terminal more efficient, particularly through its Lean 6 Sigma initiative.

In addition, Auckland Airport worked jointly with airlines on the introduction of electrical ground power units at the international gates at Auckland Airport which has resulted in a considerable reduction in the amount of fuel burnt while aircraft are at international gates. Auckland Airport, BARNZ and Genesis were the joint recipients of the CILT[13] Award for Public Transport Innovation in relation to this project in 2007.

Auckland Airport is also undertaking a project in this next price setting period to investigate introducing a common-use means of electronic or technology based self-service check-in which would supplement the dedicated kiosks of some carriers. What solution is appropriate will depend upon the costs and likely uptake of the solution and no firm decisions have been reached.

There is currently a joint project between NZ Airports and BARNZ to select a new schedule co-ordinator for international flights to New Zealand. A key outcome of this move will be a step up to web-based coordination which will enable airlines to log and request schedule changes over the internet.

Airways, as providers of Air Navigation Services in New Zealand, have worked collaboratively with airlines on a number of initiatives designed to improve the efficiency and use of air space in New Zealand, including approaches to airports. Key areas in which innovation by Airways and the airlines has occurred include:

[13] Chartered Institute of Logistics and Transport in New Zealand

- The introduction of CAT III at Auckland Airport[14] to enable the landing of aircraft in reduced visibility conditions (i.e. fog)
- The introduction of the Collaborative Arrivals Management System (CAM) which enables airlines and Airways to work collaboratively together on the day to schedule arrivals and departures of aircraft to avoid congestion
- The introduction of Required Navigation Performance (RNP) which provides greater accuracy about the path flown by an aircraft, thereby enabling improved flight times, reduced fuel and overall efficiency improvements.

IS WIAL PROVIDING SERVICES AT A QUALITY THAT REFLECTS CONSUMER DEMANDS?

What changes in quality have occurred since ID was introduced?

There has not been any noticeable change in quality.

What, if any, aspects of quality do you think should or could be improved (or potentially lowered) at WIAL?

BARNZ has not received any feedback from airlines identifying any particular aspect of quality that requires improvement at Wellington Airport.

As previously outlined, BARNZ considers that the design of The Rock was particularly 'grandious' and overly complex. Not only did it considerably increase the complexity of the build, and therefore the cost, it has effectively removed the ability to add onto that area of the terminal in a cost effective and incremental manner. The original design of the Passenger Terminal at Wellington Airport was as a low cost, simple, but well-built terminal, able to be added onto in a modular incremental manner. That was the concept consulted on with, and supported by, airlines when the Terminal was originally designed in 1996 – 1997. The Rock has departed significantly from that concept and involved a construction process where 'there was not a single straight or square panel on the entire job'. It is not appropriate for airlines to have to meet the additional cost incurred as a result of the Airport's shareholders commissioning a design to offer 'a memorable visitor experience through a unique, edgy aesthetic … [embodying] a strong sense of place'.[15]

What consultation was undertaken on aspects of service quality during WIAL's second PSE? How does this differ from consultation on quality at the first PSE?

There was not any particular focus on service quality observed by BARNZ during the consultation process. Quality issues have usually been addressed in one on one meetings

[14] Auckland Airport was also a participant in this project
[15] http://www.campbellyule.com/2012/04/the-rock-wellington-airport/

with the Airport by airlines in the past. Going forward, WIAL is initiating on-going operational review meetings with airline operators. These commenced in April 2012, after the completion of consultation over charges.

What role did information disclosure play in negotiations concerning service quality during WIAL's second PSE?

Information disclosure had not occurred at the time consultation occurred, therefore it was not able to influence considerations of service quality. That said, as noted above, there was not any significant emphasis given to quality of service during consultation with Wellington Airport.

Do the current ID requirements capture the right measures of quality?

This will be seen over time, but BARNZ considers current requirements represent an appropriate starting point.

DO THE PRICES SET BY WIAL REFLECT EFFICIENCY GAINS AND COMPLY, TO THE EXTENT FEASIBLE, WITH EFFICIENT PRICING PRINCIPLES?

How do the prices set by WIAL reflect previous and future expectations of efficiency gains?

BARNZ has not seen any evidence of efficiency gains reflected in the prices set by WIAL in the second PSE. Overall, revenue forecast to be earned by WIAL will increase by 54% from FY12 to FY17.

The expected efficiency gains in operating costs forecast in the first PSE, with operating costs forecast per passenger to remain constant in nominal terms (hence reducing in real terms), did not eventuate. WIAL's previously strong management of the efficiency of its operating costs appears to have completely disappeared, with average operating costs per passenger being forecast at a level which is 34% greater than was forecast in the first PSE.

To what extent do changes in the pricing structure at WIAL at the second PSE better reflect efficient pricing principles (for example, are prices cost reflective, subsidy-free, do they have regard to service capacity, are they responsive to consumer demands?)

WIAL has fundamentally reorganised its charging structure, the most significant changes being:

- a move away from per passenger based charges to a combination of MCTOW and passenger based charges

- the introduction of peak charges
- a move away from individual charges for services based on the costs of each service, to charges based on WIAL's perception of an appropriate price for each service in order to earn its overall revenue target
- all passengers being charged equally for terminal facilities
- the introduction of an incentive scheme for growth and additional services

The outcome of this proposed reorganisation of the charging structure affects airlines differently, depending upon the nature of the services operated by each airline. In its simplest terms, over the five year pricing period, the proposed pricing structure will:[16]

- Grant overall price reductions to international operations of approximately 8% per passenger at peak times and 17% per passenger at off-peak times
- Impose significant overall price increases on domestic jet operations of approximately 58% at peak times and 40% per passenger at off-peak times
- Impose extremely significant overall price increases on regional domestic operations of up to 107% per passenger at off-peak times and up to 214% per passenger at peak times

In BARNZ's view, the degree to which the recent changes in WIAL's pricing structure reflect efficient pricing principles is mixed. Some changes represent a move towards more efficient pricing principles, while others move away from what one would expect of an efficient pricing structure.

Responding to the matters raised by the Commission –

Are Prices Cost Reflective?

In BARNZ's view the prices set are generally less cost reflective. As outlined earlier, WIAL has inappropriately increased its underlying asset valuations, as well as adopting a significantly overstated WACC.

WIAL's cost allocation approach is also less cost reflective. In particular:

- WIAL has moved away from its previous approach of treating the food court seating area as a commercial activity and has now treated this as common space, allocating to aeronautical activities 75% of the costs of the café and bar seating space.
- WIAL has ceased to apply its air-bridge charge, which had existed since the terminal opened in 1997.
- WIAL has ceased to allocate terminal costs to domestic and international activities, despite the fact that the Southern Pier is not able to be used by international

[16] FY17 charges calculated assuming an 80% paying passenger load factor and 15 minutes of paid aircraft parking per aircraft turn-around

operations, and there are large amounts of the International Terminal Rock development which will not be used by domestic operations – even if some gates are occasionally operated as swing gates.

Are Prices Subsidy Free?

BARNZ considers that prices are not subsidy-free. These are three particular areas of concern where BARNZ considers that charges are set outside the bounds of incremental and stand-alone costs. These are:

- The setting of MCTOW rates above 100 tonnes at 10% of the MCTOW rate below 100 tonnes
- The setting of one common terminal charge for domestic and international passengers, which does not reflect the significant dedicated international space and the high costs of The Rock
- The setting of different airfield charges for domestic and international passengers

MCTOW Charges above 100 tonnes

WIAL has moved to only having two weight breaks. It has set a significantly lower MCTOW rate for aircraft weight above 100 tonnes of approximately $1 per tonne (as opposed to the charge in the lower band which is nearly $10 per tonne by FY17). The MCTOW charge above 100 tonnes is effectively set at 10% of the MCTOW charge below 100 tonnes.

It is axiomatic that larger aircraft require increased facilities and services, such as greater runway, apron and taxiway width, length and depth and increased rescue fire costs. Requirements for Code D and E aircraft significantly exceed those for Code C operations. The MCTOW charge for larger aircraft (Code D and E) is clearly set well below the incremental cost of those larger aircraft, should they start operating regular scheduled services to Wellington Airport.

International Passenger Terminal Charge

WIAL has adopted a terminal charge of $5.28 per arriving and departing passenger, increasing annually by approximately 1% pa to $5.40 in FY17. No differentiation is drawn between international and domestic passengers, or between different types of domestic passengers. This is a fundamental change from WIAL's previous approach, which differentiated between turbo-prop passengers, domestic jet passengers and international passengers with respect to terminal charges.

There are over six times more domestic passengers than international passengers. Domestic passengers are much more straightforward and cheaper to process, not having the same border control or security requirements as international passengers and having a much shorter dwell time in the terminal. Significantly less space is required to process domestic passengers, with a much larger number of domestic passengers being able to be processed through an equivalent amount of space. Moreover, the recent construction of The Rock was highly complex, and at a significantly greater cost than other areas in the terminal building. The result of WIAL's approach of setting an equal passenger charge for

terminal facilities is that domestic passengers are cross-subsidising the cost of providing international terminal facilities at Wellington Airport.

Information provided with WIAL's Initial Pricing Proposal[17] disclosed that the Airport calculated that directly allocating assets to the domestic and international activities resulted in the following allocation of terminal asset value:

- Domestic (TDP) $18.2m
- International (TIP) $32.7m
- Joint international and domestic (TIP/TDP) $29.4m

A simple back of the envelope calculation allowing for required revenue at 20% of the asset's value (reflecting the Airport WACC, tax, depreciation, revaluations at CPI and an allowance for operating expenditure) indicates that a terminal charge in the vicinity of $10.00 per international passenger is currently required in order for international passenger charges simply to meet the incremental costs of international terminal activities. Even then a $10.00 charge would not make any contribution towards meeting the cost of the common terminal space.

The 'Rock' was a predominantly international project, designed to enlarge the international processing capacity of Wellington Airport. It is recognised as such in Infratil's 2011 Annual report which describes The Rock development as an international terminal. The vast majority of the space within the rock development is international space, and is neither used nor required by domestic passengers. During consultation the Airport has sought to reclassify The Rock as a mixed use terminal, and has spread its costs across all passengers. This was patently not the basis on which it was developed. While BARNZ acknowledges that gates 25 to 29 are capable of being used for domestic operations, this only occurs on extremely rare occasions and international operations have priority. The appropriate approach for pricing is to estimate the likely domestic use of certain gates (say 10%), and then allocate that proportion of the value of those gate lounges and airbridges to the domestic cost centre.

WIAL's approach to setting terminal charges is significantly different from the approach it has consistently used in previous price setting since the construction of the terminal building in 1997, and in BARNZ' view, inappropriately results in domestic passenger terminal charges cross-subsidising the cost of international operations.

International Passenger Airfield Charge

Ironically, the opposite situation occurs with respect to airfield charges, where WIAL has adopted an airfield pricing structure which differentiates between international and domestic passengers. Under the new pricing structure a domestic jet passenger will be charged around $5.00 (increasing annually with inflation) while an international jet passenger will be charged $13.00 in FY13, reducing to $8.52 in FY17.

[17] Refer Appendix 8, WIAL Initial Pricing Proposal

Given that the airfield facilities required for a domestic A320 are largely the same as those required for an international A320, this distinction seems extremely odd. While the difference between the domestic passenger charge and the international passenger charge reduces over the pricing period, the difference defies logic.

Taken together, the undercharging of the international terminal passenger charge and the overcharging of the international airfield passenger charge may well off-set each other. However, the pricing structure is extraordinary, and in BARNZ' view, difficult to substantiate.

Do Prices Have Regard to Service Capacity?

The removal of the separate air-bridge charge (which had applied since the construction of the terminal in 1997) means that terminal charges now have less regard to the level of service provided. The choice over whether or not to use an air-bridge was one of the few means previously open to an airline to select a lower level of airport service and have this reflected in a small way in airport charges paid.

On the other hand, the introduction of peak pricing charges should provide improved signals to airlines over runway capacity and scarcity of airport resources at peak times.

Likewise the move to setting counter charges and aircraft parking (beyond an efficient allowance for the unavoidable time necessary to achieve the turn-around of an aircraft) on a time basis should also improve pricing signals to airlines over the time that they occupy these limited resources.

To what extent have airlines and other consumers of WIAL's services been able to make price-quality trade-offs that best meet their needs?

BARNZ will defer to individual airline responses in relation to this question.

How do airlines and other consumers of WIAL's services expect their demand to change in response to the prices set by WIAL in the second PSE, including the introduction of peak pricing?

BARNZ will defer to individual airline responses in relation to this question.

What impact will WIAL's proposed prices, pricing structure and associated incentives have on demand and revenues?

BARNZ will defer to individual airline responses to specifically answer this question.

However, approaching the matter from a general perspective, it is a fundamental truth that in order to survive in the long-term, businesses must cover their efficient operating costs. WIAL has increased its revenue requirements by 60% over the next five years. Airlines will need to recover these increased costs, either by absorbing them within current fare levels or by increasing fares. Increased costs inevitably impact negatively on demand, therefore the significant cost increases imposed by WIAL on airlines are highly likely to reduce demand for air travel through Wellington Airport.

COMPARATOR AIRPORTS

What airports provide a useful benchmark for assessing the performance of WIAL, and why? Please provide any relevant benchmarking data if possible.

BARNZ considers that benchmarking of airports is very much secondary to consideration of the actual assets and costs of the airport in question and its financial performance in relation to such costs, both in the year in question, and also over time.

That said, from time to time BARNZ has endeavoured to compare New Zealand Airports against other Airports in Australia. Australian Airports are considered most appropriate for any benchmarking exercise as Australia has the closest similarities to New Zealand in terms of its labour market, regulation and laws. That said, even benchmarking with Australian Airports is fraught with difficulty, and adjustments have to be made in order to make comparisons on a like for like basis.

BARNZ is updating its benchmarking work comparing the three main New Zealand Airports with relevant Australian Airports and will provide this information to the Commission in due course.

WHAT ARE THE STRENGTHS AND WEAKNESSES OF THE CURRENT ID REQUIREMENTS?

One of the long-standing weaknesses of information disclosure regulation is that it does not provide any redress to users where an airport has abused its power under the AAA to set prices as it thinks fit. Despite Airports now being subject to information disclosure regulation under Part 4 of the Commerce Act, they continue to have the power to set prices as they think fit under the AAA. The Court of Appeal has held that the AAA even permits airports to set charges at a level which includes monopoly returns, with Airports having no obligation to price as if they were operating in a competitive market.[18]

While information disclosure may (to a greater or lesser extent) result in airlines being in the possession of information enabling them to assess whether or not they are being over-charged and whether airports are earning excessive returns, there is little which airlines or passengers can do to resist such over-charging because Airports are able to enforce payment of the charges they have set by means of summary judgment of a debt.

[18] *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98

Information disclosure alone is therefore inherently weak and limited in its ability to ensure the purposes set out in section 52A are achieved.

What are the additional costs to WIAL of complying with information disclosure?

BARNZ does not have the information to answer this question.

How much of the information disclosed during the recent price setting round would have been publicly disclosed, or disclosed to airlines, in the absence of information disclosure regulation?

In the case of Wellington Airport, in the consultation just concluded it elected to make all consultation information publicly available on its web site, which BARNZ welcomes. It has been a long journey to reach this level of transparency – previously BARNZ and airlines have had to sign Confidentiality Agreements with Wellington Airport which placed considerable constraints on the airlines' ability to use and disclose information provided during consultation. In the first consultations in the early 1990's, valuation reports and financial models were not even made available to the airlines.

Therefore while WIAL has elected to make more information available than is required by the Commission's Information Disclosure Determination, and to make such information available in advance of when it is required to be under Part 4, BARNZ nevertheless views the presence of information disclosure requirements as being a key underlying factor to the current willingness of WIAL to disclose information.

What are the benefits to WIAL, airlines and other consumers of WIAL's services of using the information disclosed?

As the first sets of information have only just been released, the full extent of the benefits have not yet been experienced. However, it is BARNZ's expectation that over time the information will prove beneficial, particularly as data series are built up, and as actual performance is able to be measured against forecast performance from price setting events.

What additional information (not captured in responses to the questions above) could be added to the current ID requirements that would better help you assess whether the purpose of Part 4 is being met?

BARNZ considers that there needs to be a better disclosure of the costs, assets and revenues associated with the price setting event. By only having disclosures presented across specified services as a whole, without the price setting event costs, assets and revenues

shown separately, then readers cannot clearly ascertain the profitability of the services where the Airport used its AAA power to set the charges. The costs, revenues and performance of the services that charges are set for is camouflaged by the costs, revenues and performance of other services (such as leased activities or negotiated charges) having also been included.