

Commerce Amendment Bill 2008

9 May 2008



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Section One

Auckland Airport

Submission

Auckland Airport Key Facts

The Airport:

- accommodates more than 12 million travellers each year. About 70 per cent of all international travellers in New Zealand arrive or depart through Auckland Airport
- contributes around \$19 billion annually to the national economy (13.7% of GDP), and \$10.7 billion to the Auckland economy
- sustains directly or indirectly 283,000 jobs nationally
- sustains directly or indirectly 153,900 jobs in Auckland
- caters for 155,000 aircraft movements a year
- processes 105 international and 322 domestic flights every day
- is the country's second-largest cargo port by value
- handles 231,938 tonnes of airfreight each year
- handles \$12.5 billion of international freight, generating \$8.2 billion worth of GDP nationally, a year
- has 53,000 shareholders including tens of thousands of ordinary New Zealanders
- provides a base for more than 10,000 people who work in and around the airport
- is developing a sustainable business by including features such as solar panels, solar water heating and rainwater harvesting
- includes recycling facilities for travellers in the international terminal
- forecasts potential demand in 2025 of
 - 24 million passenger movements
 - 223,500 aircraft movements
- is a platinum sponsor of TRENZ, New Zealand's largest annual international tourism business event

A: Introduction

1. Auckland International Airport Limited (“Auckland Airport”) makes this submission to the Commerce Committee (“Committee”) on the Commerce Amendment Bill (“Bill”).
2. The Bill has significant implications for the ongoing operations and development of Auckland Airport as one of New Zealand’s most important infrastructure assets.
3. Auckland Airport wishes to appear before the Committee to speak to its submission.
4. Auckland Airport’s contact for matters regarding this submission is:
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B: Auckland Airport’s position on the Bill

5. Subpart 11 of the Bill (Airport services) proposes a new information disclosure and monitoring regime for selected airports, to be administered by the Commerce Commission (“Commission”).
6. Auckland Airport’s position is that the current information disclosure and consultation regime under the Airport Authorities Act 1966 (“AAA”) is credible and robust. Auckland Airport does not charge excessive prices. The regime under the AAA should therefore be retained, with enhancements if necessary, making the inclusion of Subpart 11 unnecessary. Subpart 11 should be deleted from the Bill.¹
7. However, a decision may be made to retain Subpart 11. In that case, Auckland Airport will work constructively with the Committee to help ensure that Subpart 11 promotes the objectives of the Bill, and in particular, preserves incentives to invest in essential infrastructure, while preventing excessive prices.
8. This requires some critical amendments to Subpart 11 and certain other provisions relevant to the proposed information disclosure regime, to clearly define and appropriately constrain various powers in the Bill, so that regulated airports are not subjected to ongoing investment uncertainty. Auckland Airport cannot support the proposed information disclosure and monitoring regime for airports in its current form.
9. Auckland Airport generally supports the remainder of the Bill as an improvement on the current regulatory control provisions of the Commerce Act 1986.

¹ If Subpart 11 is deleted, clause 30 of the Bill, which discontinues the application of information disclosure under the AAA, must also be deleted.

C: Executive Summary

10. Auckland Airport supports the Bill's objective, as stated in the explanatory note, to "provide specifically for incentives to invest in infrastructure". It understands that the Bill has been introduced to alleviate investment uncertainty for regulated sectors, such as electricity lines and gas distribution, which are also subject to industry specific regimes under the Bill.
11. Ironically, the Bill will create greater investment uncertainty for Airports by imposing new regulation on them under the Commerce Act 1986. Unlike electricity lines and gas distribution businesses, the airport sector is not currently controlled under the Commerce Act.
12. Subpart 11 creates regulatory uncertainty and imposes significant threats to Auckland Airport's investment plans. The costs of imposing this uncertainty are unlikely to be outweighed by any benefits. Therefore, Subpart 11 (Airport services) should be deleted from the Bill to achieve the Bill's objective. If it is retained in its current form, the certainty and incentives for airports to invest provided by the existing regime under the AAA will be lost, to the detriment of passengers and the airfreight industry.
13. The existing regime works effectively. Auckland Airport does not charge excessive prices to its airline customers to use Auckland Airport's facilities. Analysis by Ernst & Young (attached) shows that Auckland Airport's aeronautical activities did not earn excessive profits over the period 2001 to 2006. In fact, it under recovered by a total of \$80 million over that period.
14. At the same time, the regime has provided incentives for Auckland Airport to invest wisely in infrastructure. Auckland Airport has in place the right facilities to meet the needs of airlines, passengers, and exporters and importers. Unlike many other sectors in New Zealand, airports have no infrastructure deficit, with significant investment to improve capacity and passenger facilities occurring at the present time.
15. Auckland Airport's aeronautical pricing has remained relatively stable over the last 20 years, despite an increasing investment profile and the increasing complexity of airport operations over the period. Airport fees also account for a small proportion of airlines' fares (about 5%). Airlines would not spend time and resources pursuing lower airport charges if any savings would simply be passed on to passengers. It would therefore be highly optimistic to think that Subpart 11 will promote lower prices for passengers.
16. Despite the apparent freedom to set prices "as it sees fit" under the AAA, there are real constraints on aeronautical pricing. Since the Commission's regulatory control inquiry into aeronautical pricing under Part 4 of the Commerce Act, completed in 2002 (*'Commission's airport pricing inquiry'*), the practical application under the AAA has evolved considerably. Essentially, the Commission has provided benchmarks and guidance for pricing methodologies which have informed and influenced subsequent consultations between Auckland Airport and airlines.
17. There will never be a complete meeting of the minds between airports and airlines on investment decisions and pricing under any regulatory regime. Indeed, the existing regulatory regime was expressly designed on the basis that it was inappropriate to expect airports and airlines to agree on prices because the airlines have a short term investment focus compared to the airports' long term focus. Airlines also run a low fixed and high operating cost business compared to a high fixed and low operating cost business for airports.
18. Further, incumbent airlines have incentives to oppose expansion at airports, since this facilitates competition between airlines (which is good for passengers and tourism generally). The interests and objectives of airlines themselves often differ. This creates additional conflicts not easily resolved.

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19. Any regulatory regime must reflect these inherent conflicts, rather than try to impose a “solution” that does not fit. In particular, these considerations provide a powerful argument against imposing a negotiate/arbitrate regime on airports, and Auckland Airport is pleased that the Bill does not impose this form of regulation on airports.
20. A cautious approach to regulatory reform is required.
21. Any perceived deficiencies with the current information disclosure regime can be addressed using powers under the AAA, which includes establishing more robust information disclosure requirements and the setting of input methodologies.
22. Information disclosure itself does not concern Auckland Airport, and nor is it opposed to the principle of providing greater guidance via the setting of input methodologies, provided those input methodologies are appropriate. That already occurs under the existing regime.
23. The real threat to investment in the proposed regime comes from:
- (a) The appropriateness of the input methodologies set by the Commission, which will likely determine whether or not the regime is workable for airports. Even though they will not be binding outside information disclosure, they could unduly influence pricing consultation.
 - (b) The Commission’s analysis of and reporting on the airports’ activities, using the input methodologies.
 - (c) The threat of further regulation, in new forms, under Part 4.
24. The threat of regulation will not be more credible and robust than under the existing regime, but will be more uncertain. This undermines incentives to invest. Auckland Airport has already delayed a decision on whether to accelerate the next stage of expanding its arrivals processing facilities, partly in light of the Bill’s proposals. Auckland Airport has recently completed work to accommodate the arrival of the A380, which was possible under the existing regime, but it remains unclear whether essential development like this would proceed under the proposed regime.
25. If Subpart 11 is retained, then the proposed amendments explained in this submission are required. Key amendments sought by Auckland Airport to preserve investment certainty are:
- (a) The ability to amend “specified airport services” (ie those services that are regulated) by Order in Council must be removed.
 - (b) The Commission should be required, to the extent practicable, to give effect to input methodologies that have already been adopted by suppliers and their customers.
 - (c) Clarification that the Commission’s duty to publish reports on performance under section 53B(2) must be exercised consistently with the purpose of information disclosure. This means that reports should be limited to promoting an understanding of the relative performance of regulated entities in meeting information disclosure requirements. The Commission should also consult with the regulated entity before publishing that report.
 - (d) Section 56G, which requires the Commission to report on whether information disclosure is promoting the purpose of new Part 4, should be deleted. Such a requirement is unique for airports, subverts the processes and tests for regulation established by the Bill, and creates significant uncertainty. It goes beyond and is inconsistent with the purpose of information disclosure regulation. If it is retained, Auckland Airport will be unable to undertake investment with any confidence, as any resulting price adjustments will be reviewed by the Commission, with an uncertain outcome.

D: General Submissions on the Bill

Key Points

26. This section explains the following key points:

- (a) The Bill's objective of promoting investment in key infrastructure would best be served by retaining the current regime under the AAA. The information disclosure and consultation regime under the AAA effectively constrains the airports' ability to set prices "as they see fit" (the words used in the AAA), and preserves incentives to invest. The consultation obligations are taken very seriously by Auckland Airport, which has made very significant concessions to the airlines during the consultation process.
- (b) The most recent prices set following consultation are effectively inflation adjustments only and are fair and reasonable in the context of the investment undertaken and proposed by Auckland Airport (about \$175 million for projects completed over the last 4 years and a further \$175 million for projects due to be completed within the next two years). Ernst & Young's analysis shows that Auckland Airport significantly under-recovered for its aeronautical activities over the 2001-2006 pricing period (by \$80 million).
- (c) No regulatory regime (including negotiate/arbitrate) will ever be able to achieve complete agreement between airports and airlines, given that their investment objectives and incentives naturally conflict. It is also inappropriate to require agreement, given that airlines' interests may also conflict with the interests of passengers.
- (d) Thus, Subpart 11 of the Bill does not provide any benefit, since there is no evidence of excessive pricing by airports, giving new powers to the Commission creates investment uncertainty, and any perceived deficiencies in the existing information disclosure regime can be addressed using powers available under the AAA. Even if the new regime resulted in lower aeronautical charges (which is unlikely), airlines are unlikely to pass on savings to passengers.

Promotion of investment in key infrastructure

27. Auckland Airport supports the Bill's objective to "provide specifically for incentives to invest in infrastructure". It agrees that certainty is "a key pre-requisite for this" (as stated in the Explanatory Note). Auckland Airport also supports the new purpose statement in the Bill, particularly the promotion of incentives to innovate and invest.
28. However, contrary to those objectives, the Bill imposes significant threats to Auckland Airport's investment plans if enacted in its current form. These threats are explained in further detail in the next section, but essentially:

- (a) The Bill would impose new regulation on Auckland Airport, which necessarily produces regulatory uncertainty and additional costs. The Bill's general scheme, particularly the Commission's monitoring and reporting powers, implies that the proposed information disclosure regime is intended to be a stepping stone to the imposition of further regulation in the future; and
- (b) The Commission will gain new powers to regulate airports, and its decision-making will be critical to the workability of the proposed regime. It will have a very broad discretion under the new regime, particularly when setting input methodologies, which provides a further element of regulatory uncertainty.

29. Auckland Airport is currently undertaking an extensive investment programme. It has invested about \$175 million on projects completed within the last four years, and will spend a further \$175 million on projects to be completed within the next two years. It is able to do so with confidence under the existing regime. Its new arrivals area in the international terminal was officially opened on 3 April 2008. The secondary screening area is due for completion in June 2008. As noted by Hon Nanaia Mahuta in the House on 10 April 2008:

The opening of the new arrivals hall is only the first stage of the redevelopment. The next stage will be to revamp the baggage hall, allowing more space for Customs Service and Biosecurity New Zealand staff to clear arriving passengers and their luggage. I am advised that this is due to open in July. The new design and layout will again greatly improve the arrival experience of visitors to Aotearoa New Zealand and improve passenger processing.

30. Stage one of the new Pier B, which will accommodate the A380, is due to be opened in October. Other investment projects include:
 - (a) the new northern runway;
 - (b) the redevelopment of the international departures area, including expansion of the emigration area with improved dining and shopping;
 - (c) the next stage of arrivals processing expansion (Stage 3B), bringing the baggage hall, Customs, MAF Biosecurity secondary screening and arrivals concourse for meeters and greeters up to a newly developed first floor, located between Piers A and B at the centre of the terminal.

31. In short, Auckland Airport is undertaking investment in a timely and responsible manner to meet future growth demands, and to improve current capacity. When making its investment decisions, Auckland Airport takes into account the performance of existing facilities, the airlines' views, regulatory risk, and being able to ensure an appropriate return on investment.
32. Auckland Airport, like any other regulated infrastructure provider, must have certainty and confidence in the regulatory regime to make the investments necessary to ensure long term quality and security of service.
33. Auckland Airport recently deferred a decision on whether to accelerate Stage 3B so that, among other things, it can obtain greater certainty on the overall regulatory environment and the expected return from investing in this project, in light of the Bill's introduction.
34. The delicacy of regulating airports without inhibiting essential investment has recently been recognised in Australia. The Australian Minister for Infrastructure, Transport, Regional Development and Local Government recently released an issues paper "Towards a National Aviation Policy Statement", covering all aspects of the sector. On airport pricing, the issues paper noted that "the challenge for governments is to get the balance right between ensuring airports have regulatory certainty to undertake significant infrastructure investment while also ensuring the prices they charge to users remain fair".
35. Given these considerations, Auckland Airport submits that any reform of the regulatory regime must be approached with caution. In particular, significant reform is unnecessary and undesirable.
- (i) per unit charges for each category of activities, including landing charges;
- (ii) the methodology used to determine the above charges;
- (iii) passenger charges, and the methodology used to determine these;
- (iv) the basis for allocating assets to identified airport activities;
- (v) dates of asset revaluations and reports they are based on, as well as the new asset value;
- (vi) details of operating costs;
- (vii) the weighted average cost of capital ("WACC"), and the methodology and calculations used to determine this; and
- (viii) statistical information on employees, passenger numbers, flights landing, and interruptions to airport services.
- (b) Consultation obligations: Auckland Airport must consult with airlines each time prices are altered and at least every five years. Auckland Airport takes its obligation to consult very seriously. New Zealand courts have determined that the airports' consultation obligation involves:
- (i) a genuine engagement by the airports with an open mind.
- (ii) the airport must inform the airlines of what is proposed and provide sufficient information so that airlines can provide informed views. Airlines must be given a reasonable time and sufficient opportunity to provide their views and/or raise issues.
- (iii) further consultation with airlines if the final decision materially changes from the proposal consulted on.²
- (c) Threat of further regulation: Auckland Airport is subject to the threat of control under Part 4 of the Commerce Act, which provides real constraints on its pricing during the consultation process. Auckland Airport has already been subject to the Commission's airport pricing inquiry, which imposed years of uncertainty and compliance costs, and has no desire to repeat that experience.

The current regulatory regime is credible and robust

36. The existing regulatory regime consists of the following:
- (a) Information disclosure: Auckland Airport must comply with substantial and detailed information disclosure requirements. It must disclose statements of financial position, financial performance and cash flows. It must report separately on activities undertaken to enable the servicing of aircraft and the handling of freight, to enable the landing and take-off of aircraft, and certain activities undertaken in relation to aircraft passengers. The following additional information is required in the disclosure financial statements:

² *Wellington International Airport Limited v Air New Zealand & Ors*[1993] 1 NZLR 671, 675 (per McKay J); *Contact Energy Ltd v Electricity Commission* (HC, Wellington, CIV-2005-485-000624, 29 August 2005, MacKenzie J).

37. As the Ministry of Transport explained when this regime was introduced (“Airport Authorities Amendment Bill: Departmental Report and Recommendations”), 24 April 1996 (“MOT Report”):

*The objective of the Airport Authorities Amendment Bill is to guard against the **potential** for monopoly abuse by continuing to require airport companies to consult over charges, by enhancing this obligation by requiring these companies to consult at least once every five years (all airport companies), and by extending consultation requirements to capital expenditure for airports with annual revenue of over \$10m. In addition, it would bring in a system of rigorous information disclosure for airports with over \$10m of annual revenue. This environment is designed to ensure that the release of information will discourage airports from monopoly pricing and ensure that their charges are contested on at least a five yearly basis. In addition, there would continue to be a threat of further regulation if airport companies abused their monopoly positions.*

Pricing outcomes under existing regime are reasonable

38. The prices set by Auckland Airport under the existing regime are reasonable, and not excessive. There is no suggestion in the Regulatory Impact Statement accompanying Subpart 11 (“RIS”) or the explanatory note that airports are earning excessive returns. Rather, the Bill has been introduced because of the perception that there is **potential** for this to happen.

39. As part of its submission to the Ministry of Economic Development (“MED”) on the Review of Part 4 of the Commerce Act, Air New Zealand provided a report by PriceWaterhouseCoopers (“PwC report”) that sought to establish that Auckland Airport earned excessive returns between 2001 and 2006. Auckland Airport submits that the PwC report is conceptually and factually flawed. Auckland Airport’s views are supported by Ernst & Young, whom Auckland Airport recently engaged to review the PwC report. Ernst & Young’s report is attached to this submission. Ernst & Young found that:

- (a) PwC failed to measure returns cumulatively over the pricing period, which is fundamentally incorrect. If PwC amended its analysis to reflect this, it would find that Auckland Airport under-recovered on its aeronautical activities by about \$42 million between 2001 and 2006;

- (b) PwC used ex post WACC estimates for each year. Returns should be judged on a prospective basis, and not retrospective. Thus, using the appropriate WACC at the time the prices were set, Ernst & Young conclude that it is highly likely that Auckland Airport did not achieve an excess return on its aeronautical activities between 2001 and 2006. Ernst & Young’s midpoint estimate is that Auckland Airport under recovered by \$80 million for that period.

40. The RIS states that the Commission’s airport pricing inquiry undertook extensive analysis and found that Auckland Airport was earning excessive returns. Even if the Commission’s conclusion was correct at the time, Ernst & Young’s analysis shows that the same conclusion cannot be made about the 2001-2006 pricing period.

41. As the chart opposite shows, a simple analysis of the audited annual accounts of Auckland Airport over the twenty years since the company was formed demonstrates that aeronautical revenues per passenger have remained constant at around \$13.00 per passenger in 2007 dollars. Auckland Airport’s profitability is generated from the combination of non-aeronautical revenue growth and efficiency improvements; which is an expected outcome from operating the airport on a commercial basis.

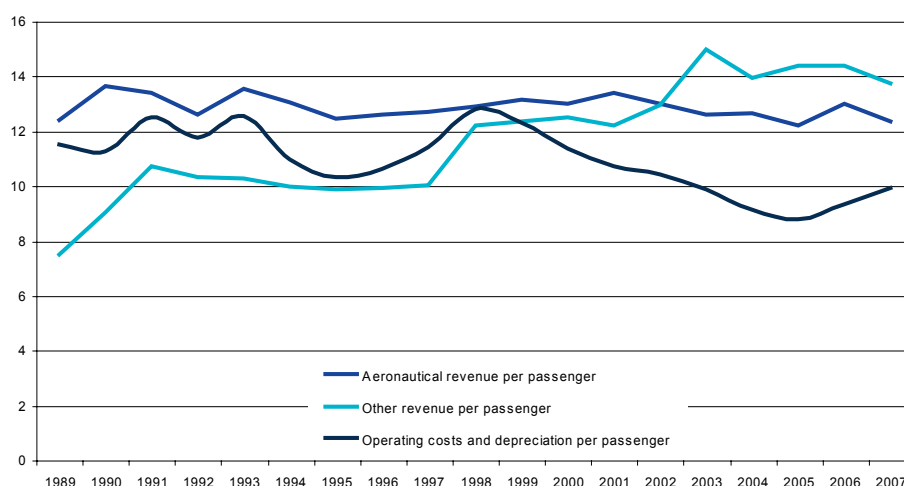
Existing regime prevents Auckland Airport from setting prices “as it sees fit”

42. The existing regulatory regime imposes significant restrictions and discipline on Auckland Airport’s aeronautical prices, despite the apparent freedom to set prices “as it sees fit” under the AAA.

43. The practical application of the regime has evolved considerably in the last six years, since the Commission’s airport pricing inquiry. Contrary to statements in the RIS, Auckland Airport and airlines consult under the AAA using reliable information disclosed to the airlines supported by a financial model to assist the airlines to analyse the data provided. Consultation is informed by available guidance and precedent, which effectively prevents airports from setting excessive prices.

44. The Commission’s findings and methodologies during the airport pricing inquiry, combined with the airlines’ countervailing power, greatly influence Auckland Airport’s approach to information disclosure and consultation with the airlines. For example, during consultation on current airport prices, which took place over a period of almost three years:

Per passenger metrics (indexed to 2007 \$)



Source: Annual reports and Reserve Bank of New Zealand CPI calculator.
Note: 1993 has been normalised to a 12 month financial year.

- (a) Auckland Airport and the Board of Airline Representatives (“BARNZ”) largely agreed on the overall approach to consultation on prices (and were working to consolidate the outcome by settling a process to use as a platform for future consultation, in an effort to make the process more efficient).
- (b) Auckland Airport operated on a fully transparent “open book basis” during consultation. It made significant amounts of commercially sensitive information, which was not required to be released under the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999, available to the airlines to inform the pricing consultation process. Auckland Airport also meets information disclosure requirements on an annual basis.
- (c) Any departure by Auckland Airport from relevant approaches taken by the Commission’s during the airport pricing inquiry required careful assessment.
- (d) If the Commission had not published material directly on a particular point, the discussion of differences in approach between Auckland Airport and BARNZ throughout the consultation process was often focused on the likely approach that the Commission would take on those issues.
- (e) Auckland Airport also took into account relevant approaches adopted by the Australian Competition and Consumer Commission and Productivity Commission when making pricing decisions.
- (f) Auckland Airport and the airlines reached agreement on many aspects of how prices should be set, which resulted in Auckland Airport making significant concessions, including:
 - (i) Adopting a 10 year moratorium (until July 2017) on asset revaluations for aeronautical pricing purposes. This was to address airlines’ concerns.
 - (ii) Closely following the opportunity cost valuation approach for airfield land recommended by the Commission (Market Value Alternative Use). Auckland Airport previously used a Market Value Existing Use approach, which was historically used by airports and was supported by valuation and legal precedent.
 - (iii) Crediting \$99 million to airlines to reflect unanticipated increase in airfield land values over the previous pricing period (representing more than half of increases in land value). Auckland Airport also elected to retain 30 June 2006 values for pricing purposes, as opposed to updating them to current values applicable at the time new prices were finalised.
 - (iv) No longer applying the Avoidable Cost Allocation Methodology approach to allocating common costs, and instead adopting a simpler and more transparent allocation based on terminal space favoured by BARNZ and the airlines.

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45. Essentially, there is now a body of established precedent, rules and guidelines that influence the airport pricing process. This includes legal precedent and guidance from regulatory authorities.
46. The existing regulatory regime enhances the airlines' countervailing power and the accountability of airports during consultation. As further explained in the attached report by Nera Economic Consulting ("NERA"), the outcomes of the consultation process can be influenced by the following factors:
- (a) The airlines have significant resources available to devote to the consultation process, including associated media and lobbying campaigns;
 - (b) Auckland Airport is subject to statutory constraints (ie consultation under the AAA);
 - (c) Auckland Airport is subject to a credible threat of further regulation. The principles and methodologies established by the Commission's airport pricing inquiry have constrained Auckland Airport's subsequent pricing conduct, and continue to provide a base for the airlines to make further complaints to the Commission if necessary; and
 - (d) Auckland Airport is subject to the threat of litigation.
47. This has achieved the objectives of the existing regime, as anticipated in the MOT Report:
... consultation requirements, coupled with the countervailing market power of the airlines, and information disclosure would place real constraints on the ability of airport companies to monopoly price.
48. The outcome is that any concerns raised by the airlines on pricing matters are influential. For example, the recent decision by Auckland Airport to delay making a final decision on Project 3B took into account the airlines' opposition to accelerating that project.

Complete agreement not possible under any regulatory regime

49. However, there is unlikely to be a complete meeting of the minds between Auckland Airport and airlines on investment decisions and pricing, under any regulatory regime. An element of contention is natural and appropriate. Indeed, the existing regulatory regime was expressly designed on the basis that it was inappropriate to expect airports and airlines to agree on prices, and that the airports should be the "circuit-breaker" in pricing consultations.

50. That is because the airlines have a short term investment focus compared with the airports' long term focus, and the airlines' interests do not necessarily align with the interests of all airport users, including passengers, or between themselves. The MOT Report states that requiring airports to agree pricing with airlines would be inappropriate:

*The substitution of "negotiation" for "consultation" would give airlines a right of veto over all airport financial decisions because negotiation would require agreement between the parties. This would be a significant departure from the proposed regime because consultation leaves the final decision rights in the hands of the airport company concerned. **Airlines have a conflict of interest in these decisions because their interests lie in minimising the facilities available at an airport, either to maximise their profits by reducing airport charges or to prevent use of the airport by competitors.** Minimisation of facilities is not necessarily in the interests of all airport users. **Airlines also tend to have short term objectives in contrast to the long term planning horizon of an airport.***

*As well, airlines have incentives to attempt to achieve prices or outcomes which discriminate against competitors. **Invariably then, it would be difficult for an airport company to negotiate agreement with all of the airlines involved in pricing or capital expenditure decisions, making disputes difficult to avoid.***

51. Any new regulatory regime must reflect these inherent conflicts, rather than try to impose a “solution” that does not fit. In particular, these considerations provide a powerful argument against imposing negotiate/arbitrate as a form of regulation. Essentially, requiring airports and airlines to negotiate prices is not only inappropriate given the airlines’ conflict of interest, but will inevitably fail, given the airlines’ differing investment objectives. While airlines may view arbitration as a desirable end game or circuit breaker, it presumes that the costs, uncertainty and threats to investment inherent in such a regime are justified to remedy excessive pricing. As indicated above, the existing regime already prevents excessive pricing, without those costs.

Any problems with information disclosure can be fixed under the existing regime

52. The perceived deficiencies with the existing regime can be addressed using powers available under the AAA.

53. The RIS summarised the problem it seeks to address as follows:

A sound regulatory regime should enable the regulator to identify the extent of monopoly pricing which should encourage airports to price their services in a manner consistent with the outcomes of a workably competitive market. The current regulatory regime for airports fails to do this.

In the context of the review of the regulatory control provisions in the Commerce Act, some members of the aviation sector made a number of submissions on the regulatory regime for airports. MED received 8 submissions. The key problem identified with the current regulatory regime for airports is the lack of a credible information disclosure regime to constrain the exercise of substantial market power by major airports in setting airport charges. This problem has been exacerbated by the lack of guidelines on both the desired outcomes from the regulatory regime, and on appropriate input methodologies (how to value assets, calculate the cost of capital, etc) to provide guidance on desired regulatory outcomes.

54. Section 9A of the AAA provides a very broad power for regulation to prescribe information disclosure requirements, including “prescribing any methodology or methodologies that must be used in completing disclosure financial statements and disclosure financial forecasts”. Regulation 17 of the Airport Authorities (Airport Companies Information Disclosure) Regulations provides that the Secretary of Transport may issue guidelines for information disclosure, including the valuation of assets, allocation of revenue, costs, assets and liabilities, and calculation of the weighted average cost of capital. These powers have not been used.

55. Perhaps more importantly, the RIS focused on finding a solution to a perceived problem of inadequate information transparency and monitoring, without considering how the proposed solution to that narrow problem might impact on regulatory certainty and airports’ incentives to invest. This oversight has occurred because the Bill imposes regulation without the process and tests for imposing regulation contained in the Bill itself having been followed. For example, there is no analysis of the benefits of regulating the services in meeting the purposes of the Bill, particularly the promotion of investment in infrastructure, against the costs of doing so (sections 52F(1)(c) and 52H(4)).

It might be thought that one potential benefit of regulation is lower prices for passengers. That would be highly optimistic. Even if airports were charging excessive prices, airlines are unlikely to be spending the time, effort and money to achieve lower charges so that any savings can be passed on to passengers.

56. In summary, the existing regulatory regime and the threat of further regulatory intervention has greatly influenced Auckland Airport’s approach to pricing. Auckland Airport believes that the outcomes sought by the new purpose statement proposed by the Bill are in fact being achieved under the current regulatory regime. Namely, Auckland Airport:

- (a) Has incentives to innovate and to invest, including in replacement, upgraded and new assets;
- (b) Has incentives to improve efficiency and provide services at a quality that reflects customer demands;
- (c) Shares with customers the benefits of efficiency gains in the supply of regulated services;
- (d) Is limited in its ability to extract excessive profits.

E: How the proposed regime will affect airport pricing

Key points

57. This section explains the following key points:

- (a) The proposed information disclosure regime for airports is not light-handed. It is heavy-handed bordering on de facto price control, due to:
 - (i) The implications of formalising input methodologies, particularly WACC, for consultation on prices;
 - (ii) The ongoing role of the Commission in analysing and reporting on the activities of airports, using the input methodologies; and
 - (iii) The threat of further regulation, in new forms, under Part 4.

- (b) Aspects of the proposed regime are workable in principle, but it will impose some onerous, costly and unjustified new constraints on the airport sector. If the proposed information disclosure and monitoring regime is enacted in its current form, it will generate significant investment uncertainty, which is contrary to the Bill's purpose and objectives.

58. The flow diagram below sets out the regulatory obligations to be imposed on Auckland Airport by the Bill in its current form. It is followed by Auckland Airport's observations on how in practice those obligations, in light of the above points, will produce regulatory uncertainty and deter investment to a greater extent than would be expected from an appropriate information disclosure regime.

Proposed new regulatory regime for airports:

Commencement of amended Commerce Act 1986 (“CA”)

When the Bill is passed, the Airport will be brought under a new monitoring and information disclosure regime under the CA for “specified airport services” (essentially these are the same as “identified airport activities under the Airport Authorities Act 1966 (“AAA”))

The Commission will be required to commence work on developing input methodologies that will underpin the monitoring and information disclosure regime. These must include cost of capital, valuation of assets, allocation of common costs, treatment of tax and pricing principles.

Interim information disclosure

While the new regime under the CA is being designed, the Airport will be required to publish financial statements in accordance with existing information disclosure regulations under the AAA (the Commission will also be administering information disclosure under the AAA at this stage, so the Airport would be required to provide the Commission with copies of the information disclosed.)

Information disclosure under the AAA must continue until the Commission has determined under section 52O how the new information disclosure regime will apply. The Commission must make its determination under section 52O no later than 1 July 2010 (although the process may be extended for a further six months under section 52(T)).

Process for Setting Input Methodologies

When the Commission commences work on input methodologies it must publish a notice of its intention outlining the process that will be followed and proposed timeframes. During the course of its work on developing the input methodologies the Commission must publish draft methodologies and provide reasonable opportunity for parties to give views on them (the Commission may also hold one or more conferences and must have regard to views from interested persons within the timeframes). The Commission must publish final input methodologies in the Gazette.

Persons who gave views during the input methodology process with significant interest may appeal an input methodology determination to the High Court within 20 working days of the date on which it is published. (An appeal of an input methodology cannot stay the application of that methodology while the appeal remains unresolved.) Following publication of input methodologies the Commission is required to make a determination under section 52O as to how the information disclosure regime will apply to the airport sector.

(Note that there is no obligation to consult with interested parties on the section 52O determination).

Information Disclosure under the New Regime

From the date of the completion of the Commission’s determination under section 52O, the Airport will be required to disclose in accordance with that determination (this will require copies of information to be given to MOT, the Commission and to be publically available). Given the deadline for the section 52O determination, the new regime will likely commence for the 2010-2011 financial year when consultation for the 2012 pricing review under the AAA is likely to begin. Information disclosed must apply all input methodologies except for WACC and pricing principles.

Analysis and reporting by the Commission

Each time the Airport discloses information under the new regime, the Commission is required to publish a summary and analysis of the information disclosed under section 53B(2)(b) “for the purpose of promoting greater understanding of the relative performance of individual regulated suppliers, and changes in performance over time”. That reporting could draw conclusions from the information disclosed using the input methodologies set for WACC and pricing principles. Under the CA there is no reason why the Commission could not conclude that it should initiate an inquiry under section 52H in light of its review.

Pricing Consultation

In 2011 - 2012, regulated airports will be required to consult on the 2012 price reset under the AAA. Consultation will be as per the existing obligations under section 4B of the AAA (with attendant disclosure of information to airlines). (Future consultation rounds will also be under section 4B and 4C of the AAA). During consultation airlines could seek to use input methodologies as determined by the NZCC as the relevant building blocks for pricing consultation, if it suits them (there may be instances where the Commission's methodologies favour the Airport, rather than airlines). Airlines could also use the summaries published by the Commission on the Airport's performance to inform consultation. If information disclosure requires publication of information in relation to non- specified services, the airlines could use that information as well.

The Airport would not be technically bound to apply the Commission's input methodologies to its consultation on pricing, but, note the Commission's reporting requirements above and below. The risk is that if the Airport does not apply the input methodologies and is not guided by WACC and pricing principles, the Commission may draw adverse inferences and may recommend or initiate an inquiry.

Further reporting by the NZCC to the Minister

Under section 56G the Commission is required to report to the Minister as soon as practicable after the 2012 price review on how the information disclosure is meeting the requirements of purpose statement of amended Part 4 of the CA .

The Commission could draw conclusions based on the "building blocks" used by the Airport for price setting in terms of how they relate to the input methodologies set by the Commission. The Commission could also draw on previous summaries and analyses it has published and also use the input methodology set for WACC and pricing principles as tools in its assessments.

(Note there is no consultation in terms of the advice the NZCC gives to the Minister.)

If the outcome of reporting is positive

If the outcome of reporting is positive, the information disclosure regime will likely continue until airport charges are amended in the future.

Each time prices are amended the Commission will be required to issue a further report to the Minister under section 56G.

In addition, the Commission will be required to carry out periodic reviews of the input methodologies which underpin the regime (reviews must be undertaken at least every seven years). Consultation is required on material changes to the input methodologies.

If the outcome of reporting is adverse

If the outcome of reporting is adverse the Commission could recommend that the Minister commence an inquiry into the airport sector with a view to imposing a negotiate/arbitrate regime.

At the very least the Commission could propose strengthening the information disclosure regime in some way e.g. requiring more disclosure about non regulated services.

Note

Under section 53D the Commission may require the Airport to disclose information on non-regulated services (e.g. revenues from leases) as part of information disclosure requirements. However the Commission may only require such information "to the extent necessary".

Miscellaneous

At any time the Airport may apply to the Commission under section 53F for an exemption from being required to publically disclose financially sensitive information.

At any time the Commission may exercise its general powers to require production of information under section 98 of the CA. It also has a range of investigative powers under section 53Z, including a power to require suppliers to prepare forward looking plans.

Setting input methodologies

59. If the Bill is passed as currently drafted, the Commission's obligation to set input methodologies will be the most important (and immediate) issue for regulated airports. The appropriateness of the input methodologies will likely determine whether the regime is workable for airports or not, as the Commission will apply those methodologies when monitoring and analysing pricing. As noted by NERA in the attached report:

*Firms in industries characterised by the need to achieve efficient and timely investment in large specific assets will only have proper incentives if the legal and regulatory foundations that support the regulatory pricing regime are sound. **The methodologies and principles that guide the determination of total revenue and the level and structure of prices therefore require particularly careful analysis and scrutiny.***

60. It is critical that input methodologies are set to be forward looking only. As also explained by NERA, backward looking methodologies and/or pricing principles, which seek to ensure that an infrastructure company earns a predetermined target return on capital (ie rate of return regulation) are inappropriate. In particular:
- (a) It does not encourage efficiency, as companies have a guaranteed financial return regardless of efficiency;
 - (b) The risk of investment is borne by customers, again because the regulated company has a guaranteed return;
 - (c) A forward looking approach enables the regulated company to obtain a return on capital commensurate with its operational risks, which is consistent with achieving competitive market outcomes;
 - (d) Although a forward looking approach can result in returns exceeding forecasts, it will depend on the circumstances as to whether it is appropriate to look backward to adjust that return. There is no uniform way of reflecting variations in a regulatory pricing context;
 - (e) By extension, focussing on returns for short periods or single years may reveal little about whether excess returns are being earned. A high profit in one year, in excess of forecast WACC could be due to various factors not associated with the exercise of market power, which are not repeated the next year.

61. The Bill contains no constraints on the Commission's ability to set input methodologies, and there is no limitation on the range of matters that could be included as input methodologies. There is limited constraint on when they can be set. In short, the Bill provides no certainty regarding input methodologies at all. Thus, the Commission's approach to setting and applying input methodologies remains a key area of uncertainty under the Bill.
62. Based on the experience of previous consultations, both the airports and airlines will participate in consultation on input methodologies with significant knowledge, sophisticated views, and with extensive evidence to support their respective positions, including reports from expert economists.
63. In the 2007 pricing consultation round Auckland Airport and airlines made significant progress toward achieving common understanding on some significant matters. It would be desirable for these understandings to form the basis of the relevant input methodologies under the Bill. However, while airlines had some incentive to reach agreement with Auckland Airport on some matters under the current regime so that the consultation could focus on the inputs of greatest contention (such as WACC and revaluations), there is no incentive for airlines to adhere to those agreements once a new regulatory regime is in place, given that the Commission is required to determine each input methodology afresh.
64. Further, adopting input methodologies agreed between the parties is efficient because they resulted from a voluntary exchange taking into account all relevant commercial factors for each party. The parties themselves naturally have a better understanding of the industry than the Commission. Therefore, requiring the Commission to reconsider those methodologies imposes unnecessary costs with no benefit.
65. Auckland Airport proposes an amendment to the Bill (explained in the next section) to require the Commission, to the extent practicable, to give effect to input methodologies agreed between the parties in previous consultations.

Information disclosure requirements

66. The Commission is required to make a section 52O determination setting out information disclosure requirements (including how the airports will be required to report against the input methodologies) by July 2010, or by the end of 2010 if the Minister grants an extension for the setting of input methodologies.
67. Auckland Airport anticipates that it will be required to make its first disclosure under the new information disclosure regime in mid 2011, for the 2010/11 financial year.
68. The information disclosure requirements do not in themselves cause concern for Auckland Airport, provided commercially sensitive information is properly protected. Auckland Airport is already subject to an information disclosure regime under the AAA.
69. The new uncertainty imposed on Auckland Airport is the Commission's obligation to analyse the information disclosed and publish a summary and analysis under section 53B(2)(b) "for the purpose of promoting greater understanding of the relative performance of individual regulated suppliers, and changes in performance over time".
70. If the Commission's statement indicates that Auckland Airport's information disclosure performance is in some way inadequate, it will put significant pressure on Auckland Airport to improve going forward. If Auckland Airport fails to address concerns raised by the Commission, whether Auckland Airport believes those concerns are legitimate or not, it would risk a full inquiry by the Commission.

71. It appears from the Bill (section 53F(2)) that it is intended that the Commission will apply all input methodologies, including WACC and pricing principles, as part of its analysis. However Auckland Airport does not believe that the intent is to allow the Commission to publish a substantive analysis of Auckland Airport's pricing performance, which would be completely inappropriate under an information disclosure regime. That would amount to de facto price control, which the Bill in fact seeks to avoid by making WACC and pricing principles non-binding.
72. Even non-binding WACC and pricing principles are inappropriate under an information disclosure regime, as it still risks amounting to de facto price control (explained further in the next section). Or put another way, the setting of WACC and pricing principles can serve no relevant purpose under an information disclosure regime.

Pricing consultation

73. In 2012 Auckland Airport will determine aeronautical prices for the period 2012 to 2017.
74. The setting of input methodologies by the Commission will significantly influence pricing consultations. This can best be explained by briefly describing the process by which previous consultations have been conducted:
 - (a) The consultation took place over about three years. Auckland Airport tabled an initial building blocks aeronautical pricing proposal. The negotiated terms sheet that evolved as part of the consultation process was accompanied by comprehensive subsequent proposals explaining the reasons and rationale for the "building blocks" and supporting evidence, including expert economist and other specialist reports.
 - (b) The building blocks include items such as appropriate WACC ranges for airports, approaches for valuing particular specific assets, depreciation, tax and capital expenditure. In essence, Auckland Airport commences consultation by tabling a set of proposed input methodologies.
 - (c) Airlines are given an opportunity to counter the proposed building blocks with their own reasoning and evidence. Auckland Airport responds to the airlines' counterproposals, and so on.

-
- (d) As the consultation progresses, some of the building blocks are agreed and the consultation increasingly focuses on the outstanding issues.
- (e) At the end of the consultation, Auckland Airport makes its final pricing determination using all the building blocks that have been agreed by the parties. Auckland Airport also makes decisions on the “building blocks” for which no agreement has been reached. However, Auckland Airport’s final choice of unresolved building blocks often incorporates some form of concession to the airline’s perspective, and is influenced by any guidance available from relevant regulators.
75. Under the Bill, setting input methodologies specifically designed for airports, even though non-binding, will significantly reduce Auckland Airport’s discretion when proposing a “terms sheet” at the commencement of consultation. Any material departure from the established methodologies for information disclosure would need to be fully justified. The airlines might seek judicial review if a relevant input methodology is not followed by Auckland Airport. Indeed, Auckland Airport understands that a key intent behind imposing information disclosure based on established input methodologies is to remove much of the contention in current consultations. Auckland Airport does not oppose this outcome in principle, but whether the regime is appropriate and workable in practice will depend on the robustness of the methodologies established by the Commission.

Ongoing regulatory uncertainty

76. Previously, Auckland Airport has taken the threat of control under Part 4 of the Act seriously, especially as a result of having been subject to the Commission’s airport pricing inquiry, a watershed experience that it has no wish to repeat. The threat of regulation following excessive pricing is credible under the existing regime.
77. Under the proposed regime, the regulatory threat will be subject to greater uncertainty, but not greater credibility. Essentially, that is because Airports would be continuously subject to scrutiny by the Commission, which is required to report to the Minister (under section 56G) any time a new price is set in or after 2012 on whether the information disclosure regime is meeting the proposed requirements of the new purpose statement.
78. Auckland Airport has no means of anticipating what the Commission will report to the Minister, or what the outcome of the reporting is likely to be. This matter is entirely beyond the control of Auckland Airport, whatever concessions it makes to airlines during pricing consultation. If the report to Ministers is adverse, Auckland Airport considers that the risk of further regulation is high.
79. In particular, Auckland Airport is aware from Treasury advice obtained under the Official Information Act that negotiate/arbitrate was seriously considered for inclusion in Subpart 11. Combined with the imposition of new information disclosure regulation by the Bill, this indicates that Ministers are generally prepared to impose further regulation by legislation without following the inquiry process established by the Bill.
80. This provides a significant deterrent to investment, because any investment that results in a change of airport pricing would trigger a requirement for the Commission to report under section 56G, with the outcome of that report being very uncertain.

F: Proposed Amendments

81. The following sets out Auckland Airport's proposed amendments to the Bill, if Subpart 11 is retained. Auckland Airport submits that if the amendments set out below are accepted, and details of the regime are devised appropriately by the Commission (in particular the most appropriate input methodologies are set), the regime would better preserve the incentives to invest provided by the existing regime under the AAA.

Specified services

82. Under section 56B, only "specified airport services" are regulated. Section 56A defines "specified airport services" as including:

- (a) Aircraft and freight activities;
- (b) Airfield activities;
- (c) Specified passenger terminal activities; and
- (d) Any other services determined by Order in Council made on the recommendation of the Minister to be specified airport services.

83. The terms used in points (a)-(c) have the same meaning as in section 2 of the AAA, which Auckland Airport submits is appropriate. However, it is inappropriate that further services can be included by Order in Council, for the following reasons:

- (a) Only aeronautical services should be subject to regulation. The current distinction between regulated and non-regulated services best preserves Auckland Airport's incentives to invest across all services;
- (b) The definition is comprehensive and captures all relevant aeronautical services without resort to an additional power to include further services by Order in Council;
- (c) Extensive procedural and accounting requirements that are used to separate aeronautical and non-aeronautical assets, revenues and costs. There is significant precedent in this regard that has been used in consultation processes and information disclosure. Any changes to this approach would add considerable cost and uncertainty for Auckland Airport;

(d) Given the significant policy issues involved and potential adverse implications for airports if additional services are included in the regulatory regime, an Act of Parliament, or a full inquiry process under the Bill (which requires the Commission to consider and make a recommendation on how the goods or services should be defined), are the only appropriate mechanisms to expand the range of services that are regulated. In short, the Bill sets out a process to regulate goods and services, and it should be followed if it is proposed to regulate further goods or services;

(e) Section 52N states that an Order in Council imposing regulation (on any supplier or sector) cannot be amended to include a further good or service unless the Commission first holds an inquiry. It is therefore inconsistent and unfair to allow, for regulated airports only, a back door amendment to the range of regulated services;

(f) A flexible definition as currently included in the Bill increases regulatory uncertainty and will undermine investment confidence.

84. As noted in the NERA report, a dual till is appropriate for Auckland Airport's circumstances. Further, the appropriate boundaries of the regulated till depend on a range of complex factors. This supports Auckland Airport's position that any change to the range of regulated services must be fully considered under the inquiry process established by the Bill.

85. Auckland Airport therefore submits that section 56A(1)(d) and section 56A(4) of the Bill must be deleted.

Further review

86. Section 56G states that:

As soon as practicable after any new price for a specified airport service is set in or after 2012 by a supplier of the service, the Commission must -

*(a) review the information that has been disclosed by suppliers of specified airport services under **subpart 4**; and*

*(b) report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in **section 52** in respect of the specified airport services.*

87. Auckland Airport submits that this provision is inappropriate, for the following reasons:

- (a) It only applies to regulated Airports. There is no similar reporting requirement for any other goods or services that are regulated, or may be regulated in the future, under the Bill. There is no justification for singling out regulated Airports in this manner;
- (b) The Bill establishes a process for the Commission's consideration of whether and how goods and services should be regulated, and it should be followed. If the Commission is required to undertake a substantive analysis such as envisaged by section 56G, it should be required to establish the input methodologies that will be applied, and consult on both the input methodologies and its proposed report to the Ministers. In other words, it is inappropriate for the Commission to report on the matters in section 56G, which essentially require an assessment of whether airports are earning excessive returns, outside an inquiry process;
- (c) The uncertainty created by this provision is a strong deterrent to investment. If investment requires an adjustment in prices, this will trigger a review with an uncertain outcome.

88. Auckland Airport therefore submits that section 56G must be deleted.

Input methodologies

89. Auckland Airport supports the requirement for the Commission to establish input methodologies up-front and the availability of merits review of input methodologies. However, the Commission's approach to input methodologies will determine whether the regulatory regime is workable, and thus influence investment decisions. In particular, as noted above, input methodologies must be forward looking.

WACC and Pricing Principles

90. Auckland Airport understands that section 53F(2)(b), which states that Auckland Airport is not required to apply input methodologies on WACC and pricing principles for any purpose related to information disclosure regulation, was included to ensure that information disclosure did not amount to de facto price control.

91. However, if WACC and pricing principles are deemed inappropriate for information disclosure purposes, then it must also be inappropriate for the Commission to use them for monitoring and analysis purposes, as allowed by section 53F(2)(a). That would still amount to de facto price control, as the Commission will judge Auckland Airport's pricing by applying the WACC and other input methodologies it has set. If Auckland Airport fails to apply those methodologies to its aeronautical pricing, an inquiry by the Commission is a real risk.

92. Auckland Airport submits that "pricing principles" are problematic for other reasons, and should therefore be deleted from the Bill as follows:

- (a) Section 52S(1)(a)(v) requires the Commission, to the extent applicable, to establish "methodologies for evaluating or determining [pricing principles] in respect of the supply of the goods or services". There is no further guidance in the Bill as to what "pricing principles" should encompass. This is likely to lead to regulatory uncertainty, dispute and further grounds for merits review.

- (b) The Cabinet Paper Commerce Act Review: Airports provides some guidance on the intention for including pricing principles as input methodologies, as follows (at para. 42):

With regard to pricing principles, we propose that the Commission develops a set of high-level pricing principles. The Australian Government has published some pricing principles for assessing airport performance. The Australian Government gives regard to these principles when monitoring prices, and a consistent failure to produce results consistent with these principles may trigger more detailed scrutiny and potentially more regulation. Along the same lines, we propose that the Commerce Commission monitors airports having regard to the principles it develops and the prices of services supplied in markets where the airports have high degrees of market power.

- (c) However the Australian regulatory regime only monitors the performance of airports against these pricing principles. There is no compulsory information disclosure regime, no binding input methodologies, and no requirement to consult with customers.
- (d) In the New Zealand regulatory context, it is difficult to envisage how pricing principles can or will be any different from the purpose statement or other input methodologies set by the Commission. Pricing principles are therefore superfluous, at least for the regulation of airports, and probably for other sectors also.

93. Auckland Airport therefore submits that section 53F should be amended as follows:

53F Input methodologies on cost of capital and pricing principles

(1) This section applies to input methodologies for evaluating or determining the cost of capital

(a) evaluating or determining the cost of capital; and

(b) pricing principles

(2) Those input methodologies are applicable in respect of information disclosure regulation as follows:

(a) the Commission may apply them for the purposes of monitoring and analysis; but

(b) if information disclosure is the only type of regulation to which the goods or services are subject, the supplier is not required to Commission, despite subsection (a), must not apply them for any purpose related to that regulation, including the purposes of monitoring and analysis.

(3) For the avoidance of doubt, if information disclosure is the only type of regulation to which the goods or services are subject, the supplier is not required to apply those input methodologies for any purpose.

94. If pricing principles are nevertheless retained in the Bill, given their vague nature and potential to cover any aspect of pricing, they should be subject to section 52S(2), namely that they must not unduly deter investment in non-regulated goods or services.

Adoption of agreed methodologies

95. As part of previous consultations, Auckland Airport and airlines have settled some input methodologies.

96. The Commission should be required to give effect to those decisions when determining input methodologies under the Bill. This will help ensure that:

- (a) The most appropriate input methodologies for the relevant sector are set;
- (b) The Commission is not required to spend precious time allowing parties to re-litigate matters than have previously been agreed;
- (c) The most efficient process is used, namely the adoption of voluntarily agreed methodologies;
- (d) The experience and knowledge of the parties in determining appropriate methodologies for commercial application in the airport pricing context, which has taken up significant time and resources, is not lost.
- (e) The Commission can focus on determining contentious input methodologies that the parties have not agreed.

97. Auckland Airport therefore submits that a new section 52U(2)(e) should be included in the Bill as follows:

(2) During the course of its work on an input methodology, the Commission -

...

(e) must, to the extent that it is satisfied the relevant parties have before the commencement of this section used an input methodology in relation to the supply of the goods or services, give effect to that methodology.

Timeframes for methodologies

98. Section 52T requires the Commission to determine input methodologies for regulated airports and electricity and gas lines companies by 30 June 2010, unless the Minister extends the deadline (by up to six months).
99. The RIS records that the Commission has estimated the cost of developing the methodologies to be \$4 million over 3 years, with appeals to the High Court involving additional time delays and costs.
100. Auckland Airport agrees that developing the input methodologies will be an intensive and time-consuming task. Although there may be areas of overlap, it will be important to ensure that the input methodologies are appropriate for each sector. Auckland Airport considers that the proposed 2 year statutory timeframe is ambitious, and risks the establishment of sub-standard methodologies in haste.
101. However Auckland Airport agrees that it is important to impose statutory time constraints on the setting of input methodologies, given that they are the platform of the regulatory regime. On balance, the deadlines for setting input methodologies proposed by the Bill should be retained.

Review of input methodologies

102. Section 52X requires the Commission to review input methodologies at least every seven years. The Commission may also amend them so long as it follows the process established by the Bill. It is not expressly stated in the Bill, but it appears that the relevant section 52O determination must be amended before any new input methodology can apply to the regulated good or service.
103. This process would allow new input methodologies to be set during a regulatory period. In the case of regulated airports, for example, it may mean that new input methodologies are set for information disclosure, but which the Commission can also use for monitoring and analysis purposes, even though the prices being monitored by the Commission were established under the guidance of old methodologies.
104. Auckland Airport is concerned to ensure that input methodologies have no retrospective effect in this way. Principally, this means that the Commission should not be able to use new methodologies to monitor and analyse prices set under the guidance of old methodologies.

105. This can be achieved by adding a provision to section 52V as follows:

(4) The Commission may not apply an input methodology for any purpose in respect of any event, including the setting of prices for the regulated good or service, that took place before the input methodology was published under this section.

Determinations about how regulation applies

106. Section 52O determinations are a fundamental part of the regulatory regime, given that they set out the detailed requirements for how regulation will apply.
107. Auckland Airport is concerned that there is no obligation for the Commission to consult on the section 52O determination that will set out the requirements for information disclosure under Subpart 11.
108. The absence of an obligation to consult on section 52O determinations is understandable for regulation imposed following an inquiry. As part of an inquiry, the Commission must publish for consultation a proposed recommendation to the Minister. That recommendation must, in essence, contain all material matters that would be included in a determination under section 52O. Further, the section 52O determination must not materially depart from the recommendation or advice given to the Minister.
109. However, Subpart 11 imposes information disclosure in the absence of an inquiry, so for airports, this means that aside from consultation on input methodologies, there is no opportunity for consultation on the detailed information disclosure requirements.
110. This is unfair and breaches the principles of natural justice. Auckland Airport therefore submits that the Bill should be amended to include a new section 52O(8) as follows:

(8) In the case of goods or services regulated under any of subparts 9 to 11, the Commission may only make a determination under this section after consulting with interested parties.
111. Such an amendment is also necessary to ensure consistency with section 52P, which requires the Commission to consult before amending a section 52O determination in any material way. It would be illogical to require the Commission to consult before amending a determination under Subpart 11 if it had not been required to consult on the matters included in the original determination.

Information disclosure

Information disclosure requirements

112. Section 53C requires a section 52O determination to set out information disclosure requirements. With the exception of consolidated information as discussed below, Auckland Airport does not oppose any of the matters that must or may be included in the determination.

113. However, Auckland Airport submits that it is important to impose a general constraint on the exercise of power under section 53C, by including a new provision as follows:

(6) The Commission's requirements under the section 52O determination must be reasonable, having regard to the purpose of this Part, the confidentiality of the information in question, and the time required to prepare the information.

114. The importance of such an amendment is self-explanatory, and it is consistent with the constraint imposed on the Commission's analogous power to require Telecom to disclose information under the Telecommunications Act 2001.

Confidentiality of information

115. As indicated above, during consultations under the AAA, Auckland Airport voluntarily provides airlines with a range of commercially sensitive and/or forecast information. Under section 53C, the Commission will have power to require Auckland Airport to publicly disclose such information.

116. Section 53Z empowers the Commission to exempt public disclosure of commercially sensitive information, as follows:

(1) The Commission may, on application, exempt any person or class of persons, in respect of any information or class of information that the Commission considers to be commercially sensitive, from any obligation to make that information publicly available as part of the requirements of information disclosure regulation, negotiate/arbitrate regulation, or customised price-quality regulation.

(2) The Commission may grant the exemption on any terms and conditions that it thinks fit.

(3) The exemption must be granted by notice in the Gazette, and takes effect from the date specified in the exemption (which must not be earlier than the date of the Gazette notice).

(4) The Commission may, in like manner, vary or revoke any exemption.

(5) The Commission must keep a list of all current exemptions made by it under this section available for public inspection free of charge during normal office hours of the Commission at the offices of the Commission.

(6) An exemption under this section is not a regulation within the meaning of the Regulations (Disallowance) Act 1989 or the Acts and Regulations Publication Act 1989.

117. A discretionary power of this nature is inadequate to protect commercially sensitive information from public disclosure. The Bill must include a mandatory provision that prohibits the Commission from requiring the public disclosure of commercially sensitive material, for the following reasons:

(a) The purpose of the information disclosure regime is to ensure that a regulated supplier "publicly discloses reliable and timely information, so that interested persons are informed about matters relating to the supply of the regulated goods or services". This purpose can be met without requiring the disclosure of commercially sensitive information;

(b) Under section 53B(2) the Commission is required to monitor and analyse information and "publish a summary and analysis of that information for the purpose of promoting greater understanding of the relative performance of individual regulated suppliers, and the changes in performance over time". Again, this function does not require the disclosure of commercially sensitive information;

(c) As a publicly listed company with continuous disclosure obligations, it is appropriate for Auckland Airport to determine what information is commercially sensitive;

(d) Provision of commercially sensitive information to airlines and the Commission should be treated separately. In particular:

(i) Auckland Airport can and does disclose commercially sensitive information to airlines as part of its consultation obligations under the AAA, subject to obligations of confidentiality imposed on the airlines;

(ii) The Commission would retain power to require the disclosure of commercially sensitive information to the Commission under section 98 of the Commerce Act or pursuant to its other powers under proposed section 53ZC. Such information would be subject to the Official Information Act, but Auckland Airport (or any other regulated supplier in a similar position) would be given an opportunity to assert that any request for the information should be declined by the Commission on relevant grounds under that Act, or could apply for a confidentiality order under section 100 of the Commerce Act.

118. Auckland Airport therefore submits that a new section 53C(5) should be included in the Bill as follows:

*(5) The **section 52O** determination may not require a supplier to publicly disclose commercially sensitive information.*

119. If the Committee accepts such an amendment, section 53ZF could be deleted.

Provision of consolidated information

120. Section 53D provides that a section 52O determination may require the following information to be disclosed:

- (a) Information for all businesses including those related to the supply of unregulated goods or services;
- (b) Information for the supply of all unregulated goods or services in aggregate;
- (c) Reconciliation between information provided above with information disclosed in accordance with information disclosure requirements applying to regulated goods or services.

121. This is of direct relevance to Auckland Airport, which operates a mix of regulated (aeronautical) and unregulated (non-aeronautical) services.

122. Section 53D limits the Commission's power to require such information by stating that the Commission may only require disclosure of such information to the extent required to enable the Commission to monitor compliance with information disclosure regulation applying to regulated goods or services.

123. It appears that the only time this could be reasonably necessary is to ensure compliance with any relevant allocation of common costs or common assets methodology. Auckland Airport therefore submits that the power in section 53D should be further limited as follows:

(1) The purpose of this section is to enable the Commission to monitor compliance with any applicable input methodology under section 52S(1)(a)(iii) under information disclosure regulation applying to regulated goods or services.

124. Auckland Airport supports the requirement under section 52S that any allocation of common costs or common assets input methodology "must not unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services".

Monitoring and analysis

125. Section 53B(2) empowers the Commission to "monitor and analyse" all information disclosed in accordance with information disclosure requirements and requires it to "publish a summary and analysis of that information for the purpose of promoting greater understanding of the relative performance of individual regulated suppliers, and the changes in performance over time".

126. Auckland Airport submits that this section must be amended to provide greater clarity on the "performance" that the Commission is required to publish its analysis on. Consistent with the purpose of information disclosure regulation as set out in section 53A (ie to disclose reliable and timely information), Auckland Airport interprets section 53B(2) as only requiring the Commission to report on the regulated suppliers' performance in complying with information disclosure requirements. It would be outside the purpose of information disclosure regulation to require the Commission to publish analysis on the regulated supplier's price performance, for example.

127. If, however, it is intended that the Commission will report on substantive pricing performance, then this is inappropriate under an information disclosure regime. It would amount to de facto price control.

128. Given that the Commission's duty under section 53B(2) necessarily involves the interpretation of information received, and the Commission's summary and analysis could adversely affect the regulated entity's interests, it would be consistent with the principles of natural justice to require the Commission to consult with the regulated entity prior to publishing its analysis.

129. Auckland Airport therefore submits that section 53B(2)(b) should be amended as follows:

(2) If a supplier of goods or services is subject to information disclosure regulation, the Commission -

...

(b) must as soon as practicable after any information is disclosed in accordance with information disclosure requirements, and after consulting with the supplier of goods or services, publish a summary and analysis of that information, for the purpose of promoting greater understanding of the relative performance of individual regulated suppliers in meeting the applicable information disclosure requirements, and the changes in that performance over time.

Further amendments required

130. Auckland Airport submits that the Bill must be amended to ensure that regulated airports receive the same protection and due process as suppliers who are regulated following an inquiry by the Commission. In particular:

- (a) Orders in Council imposing regulation must have an expiry date of no greater than 20 years (section 52M). There is no expiry date for the information disclosure regime imposed by the Bill.
- (b) There is no process for the Commission and/or Minister to amend or revoke the information disclosure regime imposed by the Bill, unlike for regulation imposed by Order in Council (section 52N).

Merits Review

131. Auckland Airport supports the availability of merits review under the Bill. However it disagrees with merits review only being available for determinations on input methodologies. It submits that merits review should be available for the substantive part of the decision making process as to whether and how to regulate.

132. That is because no credible distinction can be made between the importance of the input methodologies themselves, and the way those input methodologies are applied by the Commission.

133. Auckland Airport submits that to improve accountability in the regime, it is sensible to allow merits review:

- (a) on the final recommendation of the Commission following an inquiry (but not on any subsequent decision by the Minister); and
- (b) on section 52O determinations and any amendments to section 52O determinations.

Negotiate/arbitrate

134. Auckland Airport is aware from papers it obtained from Treasury under the Official Information Act that Ministers and officials seriously contemplated imposing negotiate/arbitrate on airports under Subpart 11. It is pleased that this was not the final decision, and that negotiate/arbitrate is not included in Subpart 11.

135. Negotiate/arbitrate can never be an effective or efficient form of regulation for airports. The airlines have an inherent conflict in that their interests do not align with other airport customers, and in some cases do not align amongst themselves. The risk is that any negotiation or arbitration of outcomes in the airlines' favour may be against the interests of other customers. At the very least, there is no guarantee that airlines will share gains with their customers. The current regime expressly excluded any requirement for airports and airlines to agree, for that very reason.

136. Negotiate/arbitrate could feasibly be an effective regime for other sectors, so on balance Auckland Airport does not oppose this form of regulation being included as an option in the Bill.

Appendix A: List of proposed amendments

137. The following lists Auckland Airport's recommended amendments to the Bill, as explained in the submission above.

Subpart 11

138. Subpart 11 and clause 30 should be deleted from the Bill. Alternatively, Subpart 11 must be amended as follows:

- (a) Delete section 56A(1)(d) and section 56A(4) (power to recommend that an Order in Council be made to amend the definition of "specified airport services").
- (b) Amendments to ensure that regulated airports receive the same protection and due process as suppliers who are regulated following an inquiry by the Commission. In particular:
 - (i) An expiry date for the information disclosure regime imposed by the Bill.
 - (ii) A process for the Commission and/or Minister to amend or revoke the information disclosure regime imposed by the Bill.
- (c) Delete section 56G.

Further amendments required

- (d) Include a new section 52O(8) as follows:

(8) In the case of goods or services regulated under any of subparts 9 to 11, the Commission may only make a determination under this section after consulting with interested parties.
- (e) The term "pricing principles" should be deleted from the Bill wherever it appears.
- (f) A new section 52U(2)(e) as follows:

(2) During the course of its work on an input methodology, the Commission -

...

(e) Must, to the extent that it is satisfied the relevant parties have before the commencement of this section used an input methodology in relation to the supply of the goods or services, give effect to that methodology.
- (g) Include a new section 52V(4) as follows:

(4) The Commission may not apply any input methodology for any purpose in respect of any event, including the setting of prices for the regulated good or service, that took place before the input methodology was published under this section.

(h) Amend section 53B(2)(b) as follows:

(2) If a supplier of goods or services is subject to information disclosure regulation, the Commission -

...

(b) must as soon as practicable after any information is disclosed in accordance with information disclosure requirements, and after consulting with the supplier of goods or services, publish a summary and analysis of that information, for the purpose of promoting greater understanding of the relative performance of individual regulated suppliers in meeting the applicable information disclosure requirements, and the changes in that performance over time.

(i) A new section 53C(5) as follows:

(5) The section 52O determination may not require a supplier to publicly disclose commercially sensitive information.

Section 53ZF could then be deleted

(j) A new section 53C(6) as follows:

(5) The Commission's requirements under the section 52O determination must be reasonable, having regard to the purpose of this Part, the confidentiality of the information in question, and the time required to prepare the information.

(k) Amend section 53D as follows:

(1) The purpose of this section is to enable the Commission to monitor compliance with any applicable input methodology under section 52S(1)(a)(iii) under information disclosure regulation applying to regulated goods or services.

(l) Amend section 53F as follows:

53F Input methodologies on cost of capital and pricing principles

(1) This section applies to input methodologies for evaluating or determining the cost of capital

~~(a) evaluating or determining the cost of capital; and~~

~~(b) pricing principles~~

(2) Those input methodologies are applicable in respect of information disclosure regulation as follows:

(a) the Commission may apply them for the purposes of monitoring and analysis; but

(b) if information disclosure is the only type of regulation to which the goods or services are subject, the supplier is not required to Commission, despite subsection (a), must not apply them for any purpose related to that regulation, including the purposes of monitoring and analysis

(3) For the avoidance of doubt, if information disclosure is the only type of regulation to which the goods or services are subject, the supplier is not required to apply those input methodologies for any purpose.

(m) Merits review should not be confined to decisions on input methodologies.

Section Two

Ernst & Young

Report

Auckland International Airport Limited: Review of Excess / (Deficient) Returns

6 May 2008

Reliance Restricted

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Reliance Restricted

6 May 2008

Mr Tony Gollin
General Manager Aeronautical
Auckland International Airport Limited
PO Box 73020
Auckland Airport
Manukau 2150
New Zealand

Dear Tony

Report prepared by Ernst & Young Transaction Advisory Services Limited (“EYTAS”) in connection with Auckland International Airport Limited’s (“AIAL”) submission on the Commerce Amendment Bill.

Further to your recent instructions and our engagement letter dated 21 February 2008, we have undertaken a review of the report prepared by PriceWaterhouseCoopers (“PwC”) on the returns of AIAL.

This report has been prepared on the specific instructions of AIAL solely for the purpose stated above and should not be relied upon for any other purpose or by anyone other than AIAL. We understand that AIAL’s submission, which will include this report, will be provided to the Commerce Select Committee. This report is not to be used by AIAL or any other party for any other purpose or in any other context without our prior written approval.

The analysis in this report is based on information obtained publicly and from AIAL. Ernst & Young could not and has not verified or audited this information.

Thank you for your instructions on this matter. Should you wish to discuss any of our findings further, please do not hesitate to contact us.

Yours Faithfully
ERNST & YOUNG TRANSACTION ADVISORY SERVICES LTD

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Abbreviations

AIAL	Auckland International Airport Limited
CE	Capital Employed
EBIT	Earnings before interest and tax
EBITDA	Earnings before interest, tax, depreciation and amortisation
FY01	Fiscal Year Ending 30 June 2001
Nera	Nera Economic Consulting
NOPAT	Net Operating Profit After Tax
PP&E	Property Plant & Equipment
PwC	PricewaterhouseCoopers Limited
ROCE	Return on Capital Employed
WACC	Weighted Average Cost of Capital

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Summary of Key Findings

Summary of Key Findings

Overview

In April 2007, the Ministry of Economic Development (“MED”) issued a discussion document entitled ‘Review of Regulatory Control Provisions under the Commerce Act 1986’.

- ▶ The MED invited submissions on the issues covered by the discussion document, including the purpose of economic regulation, methods of regulation and possible changes to the existing approaches available.
- ▶ Air New Zealand provided a submission to the MED covering both ‘generic’ regulatory issues and more specifically focusing on the regulation of airports. Air New Zealand’s submission included a report prepared by PricewaterhouseCoopers (“PwC”) estimating the excess returns generated by AIAL between FY01 and FY06.
- ▶ Auckland International Airport Limited (“AIAL”) has asked EYTAS to review the PwC report and to provide comment on the analysis undertaken, for the purpose of AIAL’s submission on the Commerce Amendment Bill, to be made to the Commerce Select Committee. A summary of our key findings is presented below.

Subject	Findings	Page
The PwC analysis fails to identify deficient returns across the period under review, focusing on only those years with excess returns. When negative return years are included PwC’s own analysis suggests the aeronautical activities of AIAL incurred a \$42 million cumulative loss or deficient return over the period FY01 to FY06.	<ul style="list-style-type: none">▶ Based on PwC’s own calculation of Capital Employed, Net Operating Profit after Tax (“NOPAT”) and the appropriate Weighted Average Cost of Capital (“WACC”), the aeronautical activities of AIAL generated a cumulative deficient return over the six year period between FY01 and FY06 of \$42 million. The only relevant measure of excess / (deficient) returns is the cumulative measure over the entire period. PwC fail to identify this which, in our view, is fundamentally incorrect.	20
PwC have used ex post WACC estimates for each period. An ex ante WACC estimate should be used, based on parameters known or reasonably expected at the time prices were set.	<ul style="list-style-type: none">▶ PwC has used independent WACC estimates for each year during the period of review. In our view, these ex-post estimates are inappropriate when attempting to identify excess returns. In this case, what is relevant is the cost of capital at the time prices were set. We provide an ex-ante WACC estimate based on data available at the time.	17
Our analysis suggests we can be 85% certain the aeronautical activities of AIAL did not generate an excess return from FY01-FY06. Our midpoint estimate is an \$80m cumulative deficient return.	<ul style="list-style-type: none">▶ Using PwC’s estimates of Capital Employed and NOPAT we have simulated an excess / (deficient) return distribution, recognising that there is some uncertainty in the parameters used to derive WACC. Based on this simulation, we are 85% certain that AIAL did not achieve an excess return on its aeronautical activities between FY01 - FY06. Our midpoint WACC estimate suggests an \$80 million deficient return.	22

Introduction

Introduction

Engagement Overview

Proposed Regulatory Changes for Airports (Commerce Amendment Bill)

In April 2007 the Ministry of Economic Development (“MED”) issued a discussion document entitled ‘Review of Regulatory Control Provisions under the Commerce Act 1986’.

- ▶ The MED invited submissions on the issues covered by the discussion document, including the purpose of economic regulation, methods of regulation and possible changes to the existing approaches available.
- ▶ Air New Zealand provided a submission to the MED covering both ‘generic’ regulatory issues and more specifically focusing on the regulation of airports. Air New Zealand’s submission included a report prepared by PwC estimating the excess returns generated by AIAL between FY01 and FY06.
- ▶ Auckland International Airport Limited (“AIAL”) has asked EYTAS to review the PwC report and to provide comment on the analysis undertaken for the purpose of AIAL’s submission on the Commerce Amendment Bill, to be made to the Commerce Select Committee.

Scope of the PwC Report

After brief discussion on the various economic arguments for and against certain approaches to measuring returns and setting prices in a monopoly environment, PwC essentially calculate an estimate of the ‘excess / (deficient)’ return achieved by AIAL between FY01 and FY06. The three core components of this calculation are as follows:

- ▶ Net Operating Profit After Tax (“NOPAT”)
- ▶ The Weighted Average Cost of Capital (“WACC”).
- ▶ Capital employed (“CE”).

The Return on Capital Employed (“ROCE”) is then calculated and compared with WACC to determine an estimate of the excess / (deficient) return.

Information Sources & Qualifications

We have obtained information from AIAL management, AIAL annual reports and disclosure statements and public documents related to the review of the Commerce Act and associated submissions, including the submission made by Air New Zealand (with assistance from PwC). We have not, nor have we been required to:

- ▶ Determine the accuracy of the information provided to us or obtained from public sources.
- ▶ Audit the information used.

Introduction

Structure of the Report

Source: EYTAS

Step One	Cross Check PwC NOPAT (Net Operating Profit after Tax) estimates	Section One
Step Two	Cross Check PwC Capital Employed estimates	Section Two
Step Three	Calculate Return on Capital Employed (ROCE) = NOPAT / Capital Employed	Section Two
Step Four	Calculate WACC estimate at time prices were set	Section Three
Step Five	Calculate Excess / (Deficient) Return = [(ROCE – WACC) * Capital Employed] / [1-tax]	Section Four

NZX Returns July 2000 to June 2006

	FY01	FY02	FY03	FY04	FY05	FY06	CAGR
NZX ALL	10.7%	8.4%	13.1%	23.3%	20.7%	7.5%	13.8%
NZX50	na	3.2%	10.5%	21.9%	20.4%	10.5%	13.1%
NZX Property	18.3%	14.9%	15.0%	11.9%	21.7%	20.4%	17.0%

Source: IRG database
Ref: Presentation Tables

Structure of Report

Essentially, we estimate excess / (deficient) returns on the aeronautical activities of AIAL over the period FY01-FY06. The report is structured as follows (and illustrated in the graphic to the left):

- ▶ Section one presents the aeronautical NOPAT estimates provided by PwC, which we cross check at a high level.
- ▶ Section two presents the aeronautical capital employed estimates provided by PwC and calculates the return on this capital employed (again, we undertake a high level cross check on these estimates).
- ▶ In section three we calculate an estimate of the Weighted Average Cost of Capital (WACC) of AIAL's aeronautical activities based on data available at the time prices were set, with reference to expert evidence provided in the 2001 Commerce Commission Inquiry into Airfield Activities (at Auckland, Wellington and Christchurch), Lally (2001).
- ▶ In section four we provide an estimate of the excess / (deficient) return on aeronautical activities, by comparing actual Return on Capital Employed (as determined in section two) with the estimate of WACC (per section three), using simulation analysis.

Returns to Non-Aeronautical Activities

We note that, in their report, PwC also carried out an analysis of excess / (deficient) returns to the non-aeronautical and consolidated activities of AIAL. We do not repeat the analysis for 'non aeronautical' activities (and hence consolidated activities). While it is not part of our scope to form a view on the use of a dual or single till, the concept of an 'excess' return would seem inappropriate when considering 'non-aeronautical' activities (and so by implication consolidated activities). In this regard we note that a dual till approach is consistent with the Commerce Amendment Bill, which only applies to "specified airport services". We refer to the comments of Nera in Section Four of their report, supporting the dual till approach.

Indeed, the aim in competitive markets is precisely to achieve a return in excess of one's cost of capital. While this might not be expected to happen indefinitely, it is not unreasonable or unusual to observe returns in excess of WACC for sustained periods (of five years or more).

The table to the left presents the annual and cumulative return achieved on the NZX, NZX50 and NZX Property index over the six year period under review. These returns clearly illustrate that those investors with an over exposure to real estate (as is the case with AIAL), are likely to have earned returns in excess of their cost of capital. Furthermore, these cumulative average returns reflect both good and bad performers and hence it can safely be assumed that some firms will have significantly exceeded these average returns over the six year period in question (as the non-aeronautical and hence consolidated activities of AIAL have done).

Introduction

Looked at ex-ante (i.e. as at 2001), such returns can properly be regarded as unforeseen and as such;

- ▶ Should properly accrue to the party carrying the risks of ownership in the ensuing period, and
- ▶ Are not evidence of the abuse of a market power.

Data Sources

We note that the EBITDA and EBIT data from which PwC has derived the NOPAT estimates (Estimates One and Two described in the next section) are as reported in the disclosure statements prepared by AIAL. These disclosure statements are provided in accordance with the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999. These disclosure statements are audited by Deloitte, who in their audit report, have confirmed that:

- ▶ The statements **give a true and fair view of the financial position of the Company's Identified Airport Activities** as at *[the relevant date each year]* and the results of its operation and cash flows for the year ended on that date, and of the matters disclosed in accordance with the Schedule to the regulations.
- ▶ The statements comply with the regulations.
- ▶ Subject to these regulations, comply with New Zealand generally accepted accounting practice.

AIAL Aeronautical Earnings

AIAL Aeronautical Earnings

Aeronautical Earnings FY01 – FY06

The table below presents two Net Operating Profit After Tax (“NOPAT”) estimates for the aeronautical activities of AIAL, **each derived by PwC**.

Aeronautical NOPAT FY01 - FY06

Currency: \$m	FY01	FY02	FY03	FY04	FY05	FY06
Estimate One: PwC estimate (adjusted depreciation / tax)	29.9	34.0	42.4	48.4	53.7	63.2
Estimate Two: AIAL reported (PwC assessed tax on EBIT)	28.0	34.2	42.9	47.6	50.9	58.2

Source: PwC Review of Returns of Auckland International Airport Limited, EYTAS analysis
Ref: Report Tables

We comment on each of these estimates below:

Estimate One: ‘PwC estimate (adjusted depreciation / tax)’

The first estimate referred to as the ‘PwC estimate’, is based on the exclusion of revaluation gains (post June 2000) from capital employed, in addition to earnings. Essentially, PwC derive a NOPAT estimate based on the following:

- ▶ PwC start with Aeronautical EBITDA.
- ▶ PwC has then deducted its own estimate of depreciation (as opposed to reported aeronautical depreciation which includes the impact of revaluations). This estimate is based on applying the effective depreciation rate for the AIAL Group, to the aeronautical fixed assets (excluding land), net of revaluations (post June 2000). Capital expenditure is added to fixed assets each year based on information disclosed in the cash flow statement.
- ▶ PwC then apply tax on this derived EBIT at a rate of between 30% and 33%. We assume any difference from 33% reflects timing differences associated with tax and accounting depreciation.

We have undertaken a similar exercise (EYTAS ‘cross check’) to that described above, using the effective depreciation rate on aeronautical activities (as opposed to the group), sourced from the Disclosure Statements, and obtained similar (although not identical) EBIT estimates to those established by PwC (and presented above). We have not attempted to replicate or reconcile the PwC tax estimates. However we note that, to the extent PwC have overestimated the benefit of timing differences (i.e. the effective tax rate is closer to 33% than PwC suggest), the deficient return determined in Section Four below would increase (become more negative).

In the interests of transparency and ease of comparison we use PwC’s NOPAT estimates to calculate ROCE (rather than the estimates we derived in the process of cross checking PwC’s analysis).

AIAL Aeronautical Earnings

Estimate Two: 'AIAL Reported (PwC assessed tax on EBIT)'

The second estimate, referred to as 'AIAL reported (PwC assessed tax on EBIT)' is based on AIAL reported EBIT (as provided in the disclosure statements). PwC has then deducted tax on EBIT at a rate of between 30% and 33%.

Thus, this estimate differs from the 'PwC estimate' as a result of differing depreciation. The depreciation reflected here is that which is reported by AIAL, which is based on reported fixed assets, including revaluations.

AIAL Return on Capital Employed

AIAL Return on Capital Employed

Aeronautical Capital Employed FY00 – FY06

The table below presents the capital employed in the aeronautical activities of AIAL, based on PwC's own estimates excluding revaluation gains (Estimate One), and reported disclosure statements (Estimate Two). These are both as presented by PwC in their report.

Aeronautical Capital Employed FY00 - FY06

<i>Currency: \$m</i>	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Estimate One: PwC estimate (excluding revaluations)	532.5	582.6	586.4	579.8	606.9	684.5	697.1
Estimate Two: AIAL reported	532.5	582.9	646.7	645.0	671.9	755.9	1,197.9

Source: PwC Review of Returns of Auckland International Airport Limited
Ref: Report Tables

We make the following comments with respect to the table above:

- ▶ The 'PwC estimate' (Estimate One) is based on the closing FY00 asset base, with cumulative capital expenditure (drawn from the cash flow statement) added, and accumulated depreciation (consistent with NOPAT Estimate One), deducted.
 - We have undertaken a high level cross check of this estimate and obtained similar (although not identical) results.
 - In the interests of transparency and comparability we present (and use) the PwC estimate in our calculations in Section Four when estimating excess / (deficient) returns.
- ▶ The 'AIAL reported' estimate (Estimate Two) is drawn directly from the Disclosure statements, and includes reported revaluations.

AIAL Return on Capital Employed

Historic Capital Returns on Property 1992 - 2007

Nominal Capital Return	pa
New Zealand retail	4.8%
Auckland industrial	3.1%
Auckland non CBD office	1.8%
New Zealand composite property	2.4%

Source: Property council investment performance index

Ref: Cumulative annual returns - Section PL - Profit and Loss Analysis

Estimated Return on Capital Employed

The table below presents the return on capital employed achieved by AIAL over the six year period, based on the NOPAT and Capital Employed estimates detailed above. ROCE is calculated using the following formula:

$$ROCE = \frac{NOPAT}{CapitalEmployed}$$

Aeronautical Return on Capital Employed FY01 - FY06

Currency: \$m	FY01	FY02	FY03	FY04	FY05	FY06
Estimate One: PwC estimate (excluding revaluations for both NOPAT and CE)	5.4%	5.8%	7.3%	8.2%	8.3%	9.1%
Estimate Two: AIAL reported (including revaluations in CE only)	5.0%	5.6%	6.6%	7.2%	7.1%	6.0%

Source: PwC Review of Returns of Auckland International Airport Limited, EYTAS analysis

Ref: Report Tables

These ROCE estimates are the same as those presented in the PwC Report. We note that we have not presented the third ROCE estimate provided by PwC in its report, which includes revaluation gains in both NOPAT and Capital Employed. In our view, this estimate is not appropriate for measuring excess / (deficient) returns during the time period in question, for the following reasons:

- ▶ AIAL included forecast real revaluation gains of 1.5% per annum, when setting its prices in 2001. When average inflation levels are taken into account, these forecasts are relatively consistent with, or ahead of long term real property price growth on commercial property (as shown in the table to the left).¹ Hence, such an estimate was likely to have been a reasonable expectation of future revaluations at the time prices were set. To the extent that any realised growth in return on capital employed (or excess return) reflects unforeseen events, then the inference that any excess returns 'identified' by PwC are attributable to the abuse of monopolistic power, becomes highly debatable. Put another way, if reasonable or defensible (or for that matter, agreed) expectations proved ultimately incorrect, then any excess or deficit should arguably be retained by the monopoly business (as is the case in a competitive environment where actual returns differ from expected returns). In this respect we again refer to Nera's comments (in Section Three of their report) where they comment that:

".....our view is that the pricing approach adopted by AIAL is preferable to the principles articulated by Dr Tretheway. As a matter of economic principle, there is no basis for favouring a pricing framework that seeks to ensure that AIAL earns predetermined target return on capital through the imposition of respective adjustments. Rather, the appropriate basis on which to set prices that are designed to reflect those applying in competitive markets is the forward-looking cost of providing the relevant service."

1. The data in the table to the left has been obtained from the New Zealand Property Council which started monitoring returns to commercial property in 1992/1993.

AIAL Return on Capital Employed

- ▶ Asset revaluations are likely to be cyclical and, to the extent that excess returns are 'tested' post a sustained and unexpected real estate 'boom', there is some inevitability to their identification. With this in mind we note that CBRE estimate industrial land value growth in the greater Auckland and Airport Oaks regions to have been approximately 23.5% and 24.8% p.a. respectively compounding over the five year period ended 30 June 2006. Thus, the identification of excess returns in this case, does not necessarily imply the extraction of monopoly profits or inappropriate pricing ex ante (indeed, there may equally be revaluation losses when property prices are falling, but this does not suggest under pricing). In our view, the relevant question is what could reasonably have been expected or forecast ex-ante (not simply whether excess returns occurred). Were this not the case then, at the extreme, we could potentially see the situation where AIAL would have to 'pay' airlines to land, in order to offset cyclical but unforecast revaluation gains.

In any event, we note that PwC has finally also chosen to focus on return on capital employed excluding revaluations from both NOPAT and Capital Employed (Estimate One), which may suggest they are also conscious of these issues.

Estimating the Aeronautical WACC

Estimating the Aeronautical WACC

The WACC Parameters

We now turn to a review of the primary parameters used to estimate WACC, with reference to expert opinion from the review undertaken as part of the 'Inquiry into the Airfield Activities at Auckland, Wellington and Christchurch' (subsequently referred to as Lally (2001)). That is, we consider the WACC relevant to the aeronautical activities of AIAL at the time prices were set, based on information available at that time.

The WACC parameters that we consider in detail are the risk free rate, the market risk premium and the asset beta. These are generally considered the most significant because:

- there is generally less consensus with respect to these parameters (in the case of airports), and /or;
- variation in them has relatively more impact on the WACC derived than is the case for the remaining variables.

The choice between a point estimate and a range

Before proceeding with our review of the parameter estimates, the philosophical question of whether to use a range or point estimate, needs to be answered.

In our view, point estimates of WACC are not appropriate when attempting to estimate 'excess' returns in a regulatory environment (or in many other settings), because:

- ▶ It is widely accepted that significant uncertainty exists with respect to the various parameters and in this regard we refer to a comment in a recent report prepared for the Commerce Commission (on the WACC for Gas pipeline businesses):

"The WACC estimate reflects seven parameter estimates over which there is significant uncertainty." Pg 76, (Lally 2007)

- ▶ It is widely accepted that the consequence of falsely identifying excess returns is more severe than failing to identify them where they do exist. This is because of the serious implications under investment has, for all stakeholders. These views are mirrored in the recent report prepared by Lally (2007) as follows:

"Given that there is some uncertainty as to the correct parameter estimates, and that the consequences of judging excess profits to exist when they do not are more severe than the contrary error, my view is that one should choose a WACC value from the higher end of the distribution on WACC." Pg 4 Lally (2007).

Hence, a range for the WACC, when estimating excess returns in Section Four, would seem appropriate.

Estimating the Aeronautical WACC

The risk free rate

PwC do not identify the methodology used to determine the risk free rates adopted in their analysis. In determining what rate to adopt here, we draw on comments from Lally (2001) and the recommendations made in the Commerce Commission inquiry into airfield activities:

"I favour an average on government bond yields over the period in which consultation occurred, ending with the point at which the new prices came into effect, and with maturity on the bonds matching the point at which the new prices will be reviewed." Pg 472, Lally (2001).

On this basis, the Commerce Commission in their report dated 1 August 2002, preferred the average five year government stock rate over the period April to September 2001 which they calculated at 6.33%.

The Post Tax Market Risk Premium (PTMRP)

The estimate of the PTMRP to be used has a significant impact on the final WACC estimate.

Again, we have reviewed Lally (2001), including the contrary views of submitting experts. Lally (2001) settled on a range of 7.0% - 9.0% with a midpoint estimate of 8.0%.

We also note that PwC's estimate of the PTMRP, until September 2002, was 8.0% (based on PwC's own published cost of capital and market risk premium reports at the time), rather than the 7.5% they have applied in their analysis.

The Asset Beta

The most relevant research available in relation to airfield asset betas at the time prices were set, was the paper prepared by Lally (2001), and the submissions on which this report draws (i.e. the various experts representing airports and airlines).

Submitting experts for the airports suggested estimates in the range of 0.40 to 0.70, and airlines favoured an estimate of 0.3. As such, the total range of expert evidence, suggested an asset beta of between 0.3 and 0.7. This range clearly illustrates the uncertainty (and difficulty) associated with estimating the appropriate asset beta.

After significant debate, which we do not review here, Lally adopts a range of 0.4 to 0.6 (for New Zealand's three international airports), based on the evidence of UK and US Electricity Utilities. However, there were various arguments made against the range adopted and those which, in our view, Lally (2001) fails to entirely / successfully discredit, are briefly summarised as follows:

- ▶ Electric Utility customers have less countervailing power than the customers of airfields, suggesting a higher asset beta for airports, all else equal.

Estimating the Aeronautical WACC

EYTAS Adopted WACC (midpoint estimates)

WACC parameters	PwC 2001 Estimate	
Corporate tax rate	33.0%	33.0%
Marginal Investor Tax	28.0%	33.0%
Risk-free Rate before Tax	5.69%-6.38%	6.3%
Debt Premium	1.0%	1.0%
Market Risk Premium	7.5%	8.0%
Debt/(Debt+ Equity)	30-40%	25.0%
Beta (Asset)	0.45	0.5
WACC (after tax)	7.6-8.1%	8.4%

Source: EYTAS, PwC
Ref: Report Tables

- ▶ US Regulated Utilities are poor comparators because there is less likelihood of political influence as the regulation is enshrined in case law (and hence UK Utilities are a better comparator). This would suggest a higher asset beta, all else equal.
- ▶ The current environment (consultation) does not provide much scope for recouping the effects of past adverse shocks as proposed by Lally (2001). This would suggest a higher asset beta, all else equal.
- ▶ The income elasticity of demand for airports services is higher than for electric utilities, suggesting a higher asset beta, all else equal.

We also note that:

- ▶ Lally (2001) commented that, in the case of airfields, a longer price setting period is likely to lead to a higher asset beta, all else equal. The range adopted by Lally (2001) of 0.4 to 0.6 reflected an expectation of a three year price setting period. However, AIAL in fact chose to set its prices for five years.
- ▶ The review completed in 2001 related to airfield activities (and landing charges based on maximum chartered take-off weight), not aeronautical terminal activities. AIAL's terminal charges, which are primarily based on passenger volumes, are more volatile than landed weight and hence a higher asset beta would likely apply to terminal activities (and so aeronautical activities in general) relative to airfield activities, all else equal.

Other WACC Parameter Estimates

We do not comment in detail on the remaining parameters used to estimate WACC (including leverage, the debt premium and the tax rate) as there is relatively less debate with respect to these parameters (particularly when their impact on the final WACC estimate is considered).

WACC Estimate Adopted

The table to the left presents the mid point estimate of the aeronautical WACC for AIAL based on information available at the time prices were set (and compares it with the PwC point estimates used). In the next section we provide high and low estimates of the PTMRP and the asset beta for the purposes of simulating an excess / (deficient) return distribution.

The most obvious difference between the WACC estimates used by PwC and that we have provided in the table to the left is that PwC have chosen to use a different WACC estimate for each period between FY01 and FY06 (hence the range observed). The most appropriate measure of risk (and hence WACC) is that which reflects the view held when prices were set *ex ante* (not what actually occurred *ex post*). We also refer to the comments of Nera (page 10, paragraph 2) in this regard.

We note that AIAL undertook a comprehensive review of its WACC as part of the recent aeronautical pricing consultation process. However, it is the *ex ante* estimate of the cost of capital that is relevant when

Estimating the Aeronautical WACC

establishing whether excess / (deficient) returns were earned. As such, we do not consider this more recent evidence (i.e. we focus on the information available to all parties at the time prices were set).

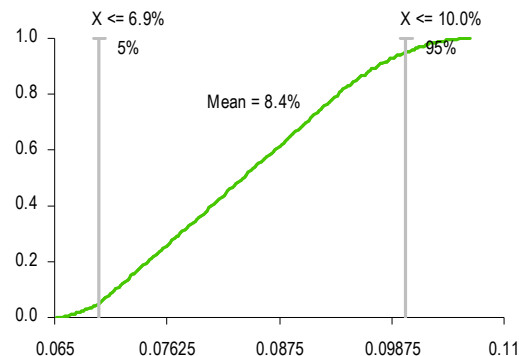
We now move to estimating excess returns based on the ROCE and WACC estimates established.

Estimate of Deficient Return on Aeronautical Activities

Estimate of Deficient Return on Aeronautical Activities

Simulated WACC Distribution

Source: EYTAS



Estimate of Excess / (Deficient) Return on Aeronautical Assets FY01 - FY06

The table below and chart to the left presents the WACC distribution we use to estimate the cumulative excess / (deficient) return on aeronautical activities over the six year period (FY01 to FY06) based on 10,000 simulations (using @Risk software).

WACC Simulation Assumptions / Results

WACC distribution	Min	Mean	Max	5%	95%
Market Risk Premium	7.0%	8.0%	9.0%	7.1%	8.9%
Beta (Asset)	0.30	0.50	0.70	0.32	0.68
WACC (after tax)	6.5%	8.4%	10.7%	6.9%	10.0%

Source: EYTAS

Ref. Report Tables

We have chosen to set ranges (as shown in the table), with a uniform distribution, for the two most debatable / significant WACC parameters as follows:

- ▶ We have put a range on the market risk premium of 7.0% to 9.0%, based on the research reviewed in Lally (2001).
- ▶ We have put a range of 0.3 to 0.7 on the asset beta, based on the complete set of evidence provided in Lally (2001) from both airlines and airports (and the submitting experts). The asset beta is the most significant parameter under consideration and while Lally (2001) adopted a range of 0.4 to 0.6, there were contrary views (as described above), which might support an estimate from the higher end of the 0.3 to 0.7 range. Furthermore, we are setting a maximum and minimum range (as our distribution is uniform) and hence a larger range, with the same midpoint, seems both appropriate and reasonable.

We have adopted a uniform distribution in the absence of data available to calculate the standard deviation of the relevant parameter estimates. Relative to a normal distribution, the mean is the same but the confidence intervals may differ.

Estimated Cumulative Excess (Deficient) Return using PwC estimates

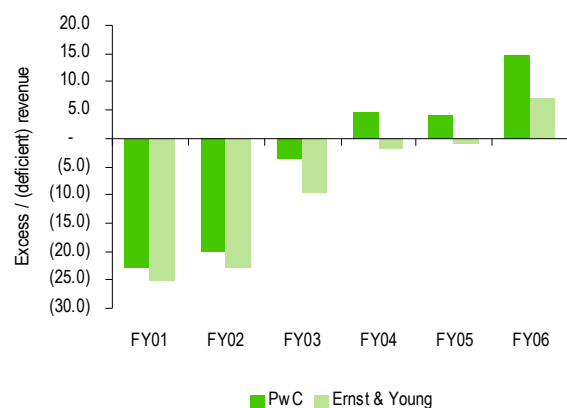
Before discussing our estimate of the excess / (deficient) pre tax return (or revenue) using the WACC estimates from Section 3, we briefly consider the PwC analysis.

Specifically, we note that PwC on page 21 of their report ignore those years in which the return on aeronautical assets failed to generate a WACC return. They then refer to the improving trend in 'excess / (deficient)' return, and focus on the 1.4% excess return in FY06. Unsurprisingly, by simply ignoring all years in which negative returns are observed, an 'excess' return is identified.

Estimate of Deficient Return on Aeronautical Activities

Excess / (deficient) revenue (or pre tax return)

Source: PwC Review of Returns of Auckland International Airport Limited, EYTAS analysis



However, what is relevant is not the excess / (deficient) return in one period but that observed over the long run (ideally the life of the assets for which a return is sought and at a minimum it would seem, over at least the length of a pricing period e.g. five years).

This view is expressed in Lally (2002), a report prepared for the Commerce Commission on measuring, or detecting the presence of excess returns, *ex post*.

“Excess earnings are [a] better [measure of performance] because they can be aggregated to form a performance measure for the entire period of study (the aggregation is to compound the numbers forward to the end of the evaluation period).” Pg 515, Lally (2001).

On this basis, PwC’s own analysis (including their WACC estimates) suggests a cumulative excess / (deficient) return (excluding revaluations from both NOPAT and Capital Employed) on aeronautical assets of approximately \$(42) million. Put another way, if you simply add up the excess / (deficient) return PwC themselves calculate for each year between FY01 and FY06 and convert these to present value (at June 2006) using their WACC estimates, the result is a \$42 million deficit. This is shown in the table below which is built from the table in the PwC report on page 21. The chart on the left illustrates the pre tax excess revenue (or return) by year based on the PwC and EY TAS calculations.

PwC Estimation of Excess Returns Excluding Revaluations – Aeronautical

Currency: \$m	FY01	FY02	FY03	FY04	FY05	FY06	Cumulative FV
Return on capital employed	5.4%	5.8%	7.3%	8.1%	8.3%	9.1%	
WACC estimate	8.1%	8.1%	7.7%	7.6%	7.9%	7.7%	
Excess / (deficient) return over WACC%	-2.7%	-2.3%	-0.4%	0.5%	0.4%	1.4%	
Average capital employed	558.1	585.2	583.8	594.0	646.4	691.5	
Excess / (deficient) return	(15.3)	(13.4)	(2.4)	3.2	2.7	9.7	
Excess revenue (or pre tax return)	(22.8)	(20.0)	(3.6)	4.7	4.0	14.5	
FV factors using PwC WACC estimates (based on mid-period cashflows)	1.52	1.40	1.30	1.20	1.12	1.04	
Fv of excess revenue (or pre tax return)	(34.6)	(28.1)	(4.6)	5.7	4.5	15.0	(42.1)

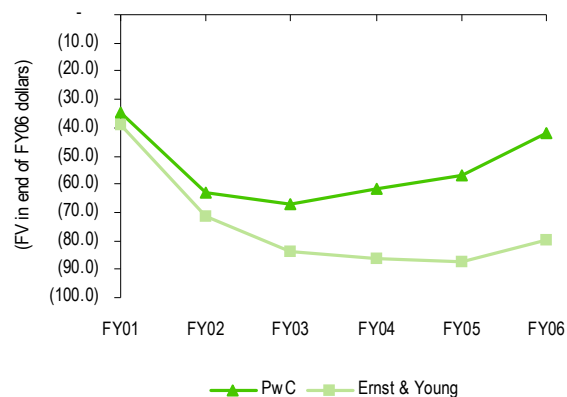
Source: PwC Review of Returns of Auckland International Airport Limited, EYTAS analysis

Ref: Report Tables

Estimate of Deficient Return on Aeronautical Activities

FV of cumulative excess / (deficient) revenue (or pre tax return)

Source: PwC Review of returns of AIAL, EYTAS Analysis



Estimated Cumulative Excess (Deficient) Return

The top left chart and table below present the estimated cumulative excess / (deficient) pre tax return (or revenue) on aeronautical activities, based on the WACC parameters estimated in the previous section. We note that:

- ▶ The calculated post tax excess / (deficient) return is converted to a pre tax return (or revenue) using a tax rate of 33%.
- ▶ The discount rates used to establish the cumulative return (i.e. convert the total cumulative return into a future value) are based on the WACC parameters used above, with the exception of the risk free rate, which is based on the average assessed five year government stock rate, for each of the relevant years.

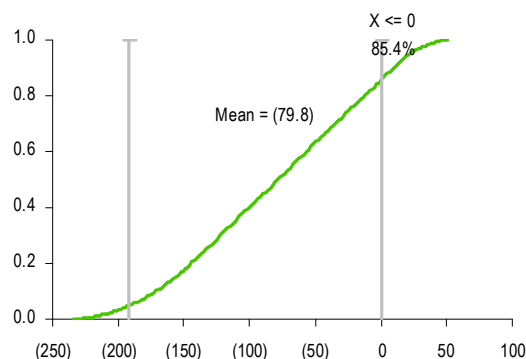
Aeronautical excess/ (deficient) returns pre tax FY01 - FY06 (FV in end of FY06 dollars)

Currency: \$m	FY01A	FY02A	FY03A	FY04A	FY05A	FY06A	Cumulative FV
Estimate One: PwC ROCE estimate excluding revaluations							
Excess / (deficient) return pre tax	(25.1)	(22.8)	(9.7)	(1.8)	(1.0)	7.1	
FV in end of FY06 dollars	(38.7)	(32.4)	(12.7)	(2.2)	(1.2)	7.4	(79.8)
Estimate Two: AIAL reported (including revaluations in asset base only)							
Excess / (deficient) return pre tax	(28.4)	(25.8)	(17.4)	(11.9)	(13.9)	(35.1)	
FV in end of FY06 dollars	(43.8)	(36.7)	(22.9)	(14.4)	(15.7)	(36.5)	(170.0)

Source: PwC Review of Returns of Auckland International Airport Limited, EYTAS analysis
Ref: Report Tables

Cumulative pre tax return (excluding revaluations)

Source: EYTAS



We make the following comments with respect to the table above and second chart to the left:

- ▶ Based on the midpoint estimate of WACC (and adopting PwC's 'Estimate One' of the Return on Capital Employed), the cumulative excess / (deficient) return is estimated at approximately \$(80) million for the period FY01 to FY06, excluding revaluations (post June 2000).²
- ▶ However, as discussed above, the consequence of falsely identifying excess profits, is more severe than failing to identify them where they do exist (because of the serious implication under investment has for all stakeholders). Again, we note that this view is also expressed in Lally (2007).

"Given that there is some uncertainty as to the correct parameter estimates, and that the consequences of judging excess profits to exist when they do not are more severe than the contrary error, my view is that one should choose a WACC value from the higher end of the distribution on WACC." Pg 4 Lally (2007).

With this in mind, we can be 85% sure that AIAL did not earn an excess return from aeronautical activities over the FY01 and FY06 period, based on PwC's Estimate One of ROCE and the simulation of the appropriate Aeronautical WACC (based on information available at the time), as illustrated in the chart to the left.

2. If revaluations are included in capital employed (Estimate Two) this increases to a \$(170) million deficit.

Appendices

1. Disclaimers
2. References

Disclaimers

Disclaimers

The terms on which EYTAS provide this report and opinion were agreed between us on 21 February 2008.

As agreed in our engagement letter, we accept no responsibility whatsoever for reliance on this report other than for the purpose for which it was intended. Further, no responsibility whatsoever is accepted for persons other than those to whom the report is addressed, and those we have agreed in writing will be provided with the opinion.

In Section 1 (“Introduction”) we set out the key sources of information used and relied upon in preparing this report.

Independence and Impartiality

EYTAS has no financial interest in AIAL. This report has not been prepared on a contingent or success fee basis.

Limitation of Liability

EYTAS’s total civil liability (including interest and costs) to you, concerning the subject matter in this report shall be limited to the amount agreed on 21 February 2008.

Indemnification

AIAL has agreed to indemnify EYTAS in respect of any liability arising from any third party claim, in accordance with our Engagement Letter dated 21 February 2008 and The Master Services Agreement.

Reliance on Information

We have relied on the external information set out in Section 1 (“Engagement Overview”). Our duties, while involving an assessment of the information provided and commenting as necessary, do not extend to verifying the accuracy of the information, and we have assumed its authenticity and completeness. We have not audited or reviewed the information provided, nor have we been required to do so.

This report assumes the client has no information or knowledge of any facts or material information not specifically noted in our report which would reasonably be expected to affect its conclusions.

Review of opinion

EYTAS reserves the right, but is under no obligation, to review all calculations included or referred to in this report and, if we consider it necessary, to revise our report in light of any information, inaccuracies, or alterations to the information relevant to this report, which was in existence on the report date and becomes known to us after the date of this report.

Disclaimers

Advance drafts

Advance drafts of this opinion were provided to AIAL in order to check the factual accuracy and completeness of information provided to us.

Third party information

Where it is stated in the report that information has been supplied to us by another party, this information is believed to be reliable at the time of receipt but we will accept no responsibility should it be subsequently proven to be inaccurate.

References

References

Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports.

- | | |
|--------------|---|
| Lally (2001) | Lally, Martin. 2001. The Cost of Capital for the Airfield Activities of New Zealand's International Airports. |
| Lally (2002) | Lally, Martin. 2002. Measuring Excess Earnings on Airfields. |
| Lally (2007) | Lally, Martin. 2007. The Weighted Average Cost of Capital for Gas Pipeline Businesses. |

Section Three

NERA

Report

5 May 2008

Potential Changes to the Regulatory Control Provisions of the Commerce Act 1986

A Report for Auckland International Airport Limited

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1. Introduction

This report has been prepared at the request of Auckland International Airport Limited (AIAL). Its purpose is to evaluate the proposals outlined in the paper prepared by Dr Michael Tretheway on behalf of Air New Zealand, and submitted to the Ministry of Economic Development (MED) in the context of its review of the regulatory control provisions of the *Commerce Act 1986* (the Act).¹ Dr Tretheway proposes a number of wide-ranging changes to the existing regulatory regime for New Zealand airports. By way of summary, Dr Tretheway concludes that:

- § New Zealand's major airports should be regulated because:
 - they face limited competition; and
 - airlines possess limited countervailing power;
- § the existing form of regulation by consultation should be replaced because:
 - airlines do not have countervailing power; and
 - there is no legal compulsion for airports to incorporate the results of consultations into the price-setting process;
- § the Act should include a set of principles to guide the determination of aeronautical prices;
- § a 'periodic single till' should be introduced whereby the economic profits from certain non-aeronautical services should be used periodically to offset aeronautical costs; and
- § historical cost, or historical cost indexed by the CPI should be used to value airport land and any associated specialised assets, due to the problems associated with establishing the opportunity cost of such assets.

Since the lodgement of Dr Tretheway's report the government has released the *Commerce Amendment Bill 2008* (the Bill). If enacted, the Bill would bring the regulatory regime applicable to airports within the auspices of the Act. The Bill contemplates a number of changes to the current regulatory regime that are the subject of Dr Tretheway's report, including:

- § the introduction of more extensive information disclosure requirements at Auckland, Wellington and Christchurch International Airports from 1 July 2010;
- § the creation of a more explicit role for the Commerce Commission (the Commission) in monitoring and reporting the prices levied by airports, together with a threat of further regulation if prices are shown to be excessive. Specifically, it would be required to:
 - develop input methodologies that the airports would be required to use in preparing information for disclosure; and
 - develop additional input methodologies on pricing principles and cost of capital for use in monitoring and reporting on the information disclosed.

¹ Tretheway, M, *Report of Dr. Michael W. Tretheway: On the issue of potential regulatory changes to the Regulatory Control Provisions under the Commerce Act 1986*, 6 July 2007 (hereafter: 'Tretheway').

Throughout this report we evaluate the analysis underpinning Dr Tretheway's conclusions and their applicability to the particular circumstances found at AIAL. Our analysis focuses primarily on the robustness of Dr Tretheway's conclusions as they relate to the *existing* regulatory regime. However, where appropriate we also evaluate his conclusions in light of the changes subsequently proposed in the Bill.

The remainder of our report is structured as follows:

- § section two assesses the extent to which AIAL's airline customers could be considered to possess countervailing market power;
- § section three evaluates the principles proposed by Dr Tretheway for establishing prices for aeronautical services;
- § section four examines the 'periodic single till' proposed by Dr Tretheway, including the potential efficiency consequences from its introduction at AIAL;
- § section five assesses the practicability of employing historical cost valuation principles for AIAL airport lands and specialised assets; and
- § section six concludes.

2. Countervailing Power

Dr Trethewey's conclusions in relation to the existing regulatory regime are predicated on a number of assumptions that remain largely unexplored in his paper. The analysis underpinning his assertions that AIAL faces little constraint in its pricing conduct and that its airline customers do not possess countervailing power is perfunctory and appears not to take account of a number of checks and balances that apply to the consultation process between AIAL and the airlines.

Although airports presently have an ostensibly wide ranging power to set such prices as they 'see fit' and would continue also to have a degree of pricing freedom under the arrangements proposed in the Bill, this is tempered by a number of legal and practical realities that affect the dynamics between AIAL and its customer airlines. Airlines that make significant use of Auckland airport are well-resourced corporations that have a significant proportion of their input costs at stake during consultations with AIAL on the determination of aeronautical prices. Although it is true that such airlines are unlikely to be able to avoid landing at Auckland airport this fact alone does not render them powerless or the price setting process as being without meaning. Rather, the airlines have a number of measures that can be brought to bear in their dealings with AIAL.

First, the resources the parties have to devote to the consultation process may influence the outcome. By way of illustration, Air New Zealand's group earnings before interest and tax (EBIT) for the year ended 30 June 2007 was \$283m² and Qantas' EBIT for the same period was A\$1047m.³ By contrast, AIAL's EBIT for the year ended 30 June 2007 was \$199m.⁴ The financial strength of the airlines allows them to devote considerable resources to persuade the general public and the government to support any point of view they may develop in any dealings with airports. The Air New Zealand media campaign⁵ directed at airport companies at the conclusion of the most recent pricing consultations and throughout the review into the regulatory control provisions of the Act is a pertinent example.⁶

Second, it is not correct to suggest that there is presently 'no legal compulsion' for airports to incorporate the results of consultations into the price-setting process. In assessing the consultation process entered into by Wellington International Airport (WIAL) and its airline customers that followed its corporatisation in 1990 the Court of Appeal explained that

² Air New Zealand Financial Report 2007, p2.

³ Qantas Annual Report 2007, p74.

⁴ Auckland Airport Annual Report 2007, p2.

⁵ See for example: Air New Zealand Media Release, *Air New Zealand rejects unjustified airport price hike*, 2 July 2007; Air New Zealand Media Release, *Change regulatory regime to protect New Zealand consumers – Air New Zealand*, 10 July 2007; Air New Zealand Media Release, *Air New Zealand asks court to review Wellington airport charges*, 14 August 2007; Air New Zealand Media Release, *Government decision on airports a win for consumers – Air New Zealand*, 22 November 2007; Air New Zealand, *That's Not Fare! Airport Companies are Making Travel Expensive*.

⁶ Virgin Blue engaged in a similar campaign in 2002 directed at Sydney International Airport and parties associated with its controlling shareholder in the course of a dispute concerning the use of Sydney airport's Terminal 2. See: The Australian, *Virgin loses it – You bankers are all the same*, 16 August 2002.

although the duty to consult does not require that there be an *agreement* as to the charges, and cannot be equated with *negotiation*.⁷

- § it requires more than mere prior notification;
- § it is never to be treated perfunctorily or as a mere formality or charade; and
- § it means the airlines must know what is proposed and have sufficient information before they can be expected to give their views, and must be given a reasonable time and sufficient opportunity to express its views or point to problems.⁸

The Court also opined on the way in which the statutory duty to consult can provide some protection to the airlines and to the public against the misuse of monopoly power. Specifically, the Court noted that (these factors apply equally to AIAL):⁹

- § WIAL is significantly dependent on the major airlines for a great part of its revenue;
- § WIAL is a public utility whose charges are eventually passed on to the public;
- § WIAL must be expected to fix its charges at a level enabling it to recover its efficient costs, including a reasonable return on its capital; and
- § If WIAL were to act irresponsibly it would be open to the government to impose price control under the Act.

Third, as noted by the Court of Appeal, airports are subject to the ongoing threat of further regulation. The extent to which this factor is capable of influencing pricing outcomes depends crucially on the *credibility* of the threat. The basis on which further regulation would come about and the form it would likely entail have been articulated clearly in New Zealand, even in the absence of the Bill.¹⁰ The process by which regulation would be introduced is clearly specified in the Act. Part 4 of the Act provides the Governor General with the authority to impose price or any other kind of control, on the recommendation of the Minister of Commerce.

⁷ *Wellington International Airport Limited and others v Air New Zealand* [1993] 1 NZLR 671.

⁸ The Court of Appeal has held that the requirement for consultation is met if a decision-maker held meetings with the parties with whom it was required to consult, entered into those meetings with an open mind and took due notice of what was said, provided those parties with relevant information and with such information as they requested and waited until those parties had expressed their view before making its decision.

⁹ *Wellington International Airport Limited and others v Air New Zealand* [1993] 1 NZLR 671.

¹⁰ NERA has observed elsewhere, in a submission to the Productivity Commission's inquiry into price regulation of Australian airport services, that in the absence of clarity regarding the basis for and processes by which further regulation may come about, the threat of price control will lack credibility, and therefore effectiveness. See: NERA, 2006, *Effectiveness of the Regulation of Airport Services*, Report for Qantas, p36:

‘In the case of current price monitoring arrangements for airport charges, although there have been some statements regarding the threat of re-regulation, in practice the threat has lacked credibility. This is because the line between acceptable and unacceptable changes in charges is not known, and the process of implementing re-regulation is not clear, open and transparent.’ [internal footnote omitted]

In contrast to the Australian experience of airport regulation at the time we made this observation, as we noted above, the basis on which further regulation would come about, and the form it would likely entail have been articulated clearly in New Zealand, even in the absence of the Bill, thereby strengthening the threat.

Moreover, the likely *form* of such regulation has also been explicitly considered. In 1998, the Commission commenced a wide-ranging inquiry under Part 4 of the Act into the potential regulation of New Zealand airport services.¹¹ The principles articulated by the Commission in that inquiry have come to represent an important reference point in the ongoing relationship between AIAL and its airline customers. Its impact on the manner in which negotiations are carried out under the *Airport Authorities Act 1966* (AA Act) was outlined by AIAL in its original submission to the Ministry of Economic Development:

- § ‘While the Inquiry process was being undertaken, AIAL (and other airport companies) endured several years of uncertainty and compliance costs and at the conclusion of the Inquiry AIAL faced the real possibility of full regulatory control being imposed. AIAL has no desire to repeat that experience;
- § The Inquiry resulted in a complete shift in philosophy and approach insofar as AIAL's Board, management and investors were concerned. The focus moved to finding a better way of engaging with airlines to negotiate “acceptable” outcomes that would be unlikely to provoke any further investigation by the Commission (and hence avoid the attendant costs, distractions and uncertainty of such a process);
- § The Inquiry also set out the Commission's position on a range of “key inputs” and methodologies. Negotiations are now carried out with reference the Commission's position on matters. By way of example, the papers drafted by Dr Lally are considered to be an important reference point on WACC issues.’

AIAL has indicated that the principles set out and the important methodological decisions made by the Commission during the inquiry serve as a key reference point for pricing negotiations, since these can generally be assumed to be the positions it would take again were further regulation to be imposed. This clarifies the line between acceptable and unacceptable charging. We understand that it has also become AIAL's practice to seek independent expert advice before departing from one of the Commission's positions, or when exploring issues that remained unresolved following the inquiry. For example, during the most recent pricing consultation AIAL commissioned a number of expert reports on (among other things):

- § land valuation;
- § the treatment of revaluations when setting regulatory prices; and
- § the weighted average cost of capital (WACC).

AIAL's broad adherence to the methodologies set out by the Commission operates as an important constraint on its pricing conduct under the current arrangements. The development under the arrangements proposed in the Bill of more explicit guidance on those methodologies that continue to be in dispute, such as asset valuation, would further inform the consultation process. Ultimately, if AIAL's position is perceived as unreasonable by the airlines they are able to complain to the Commission. We note that the Board of Airline Representatives of New Zealand (BARNZ) exercised this option following its most recent consultations with WIAL.

¹¹ Specifically, the Minister requested that the Commission report on whether control should be introduced for airfield activities at Auckland, Wellington and Christchurch International Airports.

Fourth, AIAL is subject to the ever-present *threat of litigation*, whether in relation to in the provision of aeronautical services, or some area of activity common to airports and airlines. The substantial costs associated with legal proceedings means that AIAL will likely want to avoid this scenario if possible, and so this acts as a further discipline on its pricing conduct. Nonetheless, since the corporatisation (and subsequent privatisation) of New Zealand's major airports, various judicial and arbitral tribunals have played a significant role in resolving disputes between the airports and their airline customers. Importantly, this includes the 1993 decision of the Court of Appeal that clarified that nature of the obligation on airports to consult with their airline customers on charging matters.¹²

Dr Tretheway does not acknowledge the significant and effective use that airlines have made of their lobbying power and their capacity to cite the methodological decisions made by the Commission during its inquiry into airport services (and in other contexts) to increase the accountability of AIAL during the charge setting process. Such measures offer a form of empowerment to airlines and, in our view, cannot be overlooked when assessing the extent of airlines' countervailing power. In omitting any acknowledgement of these checks and balances, Dr Tretheway overstates the costs associated with the existing regulatory framework.

Summary:	Dr Tretheway underestimates the countervailing power of AIAL's airline customers. In particular, Dr Tretheway does not acknowledge:
§	the effective use the airlines have made of their lobbying power;
§	the statutory constraints on AIAL's pricing conduct;
§	the airlines' capacity to cite the methodological decisions made by the Commission during its inquiry into airport services (and in other contexts) and the associated threat of further regulation; and
§	the ever-present threat of litigation.
	These factors increase the accountability of AIAL during the charge setting process.

¹² *Wellington International Airport Limited and others v Air New Zealand* [1993] 1 NZLR 671.

3. Proposed Pricing Principles

All forms of regulation need to provide firms with proper incentives in order for them to aspire to the objectives of meeting long-term customer needs through efficient investment and operations. Firms in industries characterised by the need to achieve efficient and timely investment in large specific assets will only have proper incentives if the legal and regulatory foundations that support the regulatory pricing regime are sound. The methodologies and principles that guide the determination of total revenue and the level and structure of prices therefore require particularly careful analysis and scrutiny.

The guiding principles that Dr Tretheway suggests should be applied at New Zealand airports do not represent a sound basis from which to determine aeronautical prices. In particular, their application would be unlikely to provide airports with appropriate incentives to achieve efficiencies in their operations and investment performance, and so their adoption would not be in the long-term interests of New Zealand consumers. Dr Tretheway's principles also appear to be inconsistent in a number of respects with other aspects of his analysis. They include that:¹³

- § the primary guiding principle should be achievement of the 'maximum level' of economic efficiency to allow the infrastructure provider to cover its costs, including a reasonable rate of return on invested capital;
- § the infrastructure operator is entitled only to a reasonable return on capital invested to provide essential infrastructure services;
- § the appropriate return should be computed as a WACC based on the infrastructure provider's actual capital structure, its actual rate of debt interest, and an equity return which adds to the government risk free rate of return the 'minimum' premium appropriate for the level of business risk in the regulated services which enables the firm to attract equity capital;
- § the achievement of an overall corporate rate of return, including non-regulated services, is not to be a factor in determining the appropriate rates to charge; and
- § in choosing between price offers, the arbitrator should be guided by the possibility that other users of similar services may seek to avail themselves of the chosen rate. In other words, the rate for the user should not depend on other users of identical services paying a higher rate in order to allow the operator to cover its costs.

As a general observation *all* of the proposed principles are expressed in *backward looking* terms, with particular emphasis on *ex-post* rates of return on capital. It follows that they entail a strong emphasis on rate of return (ROR) regulation. Dr Tretheway observes that ROR regulation entails a regulator authorising prices to be charged by an infrastructure company which result in the company only achieving a 'fair' rate of return on its invested capital.¹⁴ It therefore involves a pricing framework that seeks to ensure that an infrastructure

¹³ Tretheway, p38.

¹⁴ Tretheway, p21.

company earns a predetermined target return on capital, and often involves *backward looking* assessments of outturn returns against those benchmarks.

Dr Tretheway's articulation of the return appropriate for New Zealand airports is much the same, and implies that airports should be required at all times to earn a return that is no more than (and presumably no less than) their WACC.¹⁵ Dr Tretheway's emphasis on restraining *ex post* rates of return is surprising in light of his (in our view correct) conclusion that ROR regulation itself is *inappropriate* for New Zealand airports. As Dr Tretheway observes, this form of regulation has widely been criticised for entailing poor incentive properties that often give rise to dynamically inefficient outcomes over the longer term:¹⁶

'ROR Regulation almost amounts to a guarantee of a financial return, regardless of whether the company is efficient. ROR regulation is viewed by many economists as resulting in dynamically inefficient industries over time ...

... ROR has also been criticised because the risk of any investment is borne largely by the consumer, as the regulated firm is effectively guaranteed a rate of return, regardless of changes in cost or other market conditions. Furthermore, the ROR regulation provides no incentive for the firm to improve productivity or control costs since any cost increases can be passed on to the consumer.'

In other words, Dr Tretheway's *own analysis* suggests that his proposed pricing principles potentially would result in dynamic inefficiencies over time, and would be 'cumbersome and expensive'.¹⁷ We agree that ROR regulation is an inappropriate form of regulation for New Zealand and, by extension, so too are pricing principles *based upon ROR regulation principles*, including those proposed by Dr Tretheway.

The imposition of backward-looking pricing principles would also be inconsistent with the philosophy and approach adopted by AIAL. Rather than dwelling upon historical factors when establishing its aeronautical prices, or seeking to ensure a predetermined rate of return is achieved, AIAL instead seeks to recover its costs as measured in *forward looking* terms and to obtain a return on capital commensurate with its operational risks.¹⁸ This approach is consistent with that which would be adopted by a hypothetically competitive airport, and so an effectively competitive market outcome.

Of course, *ex post* returns will almost always vary from forward-looking expectations. Such variances between outcomes and expectations arise for a number of reasons, including inaccurate forecasts of demand and budgeted capital expenditure, or greater than expected

¹⁵ Specifically, Dr Tretheway states that the appropriate return should be computed as a WACC based on the infrastructure provider's actual capital structure, its actual rate of debt interest, and an equity return which adds to the government risk free rate of return the minimum premium appropriate for the level of business risk in the regulated services which enables the firm to attract equity capital.

¹⁶ Tretheway, p22.

¹⁷ Tretheway, p23.

¹⁸ Specifically, AIAL seeks to avoid excessive or deficient returns by setting its forward-looking prices so that the net present value of *forward-looking* returns when discounted at the appropriately determined WACC is equal to zero.

efficiency gains. The Commission recently recognised as much in its Draft Authorisation Decisions for gas distribution services:¹⁹

‘...a hypothetical ex post assessment of returns ... would likely find that the NPV of revenues over the period was actually positive. This could be because the businesses are able to make efficiency gains during the regulatory period over and above those assumed when the price path of the Authorisation was set.’

There is no uniform way of reflecting these divergences in current accounts, or in *forward-looking prices* in a regulatory pricing context.²⁰ In particular, an adjustment to asset values and depreciation charges (and thus regulatory prices) is not necessarily required simply because current information differs from that forecast.²¹ Rather, whether or not a backward-looking adjustment is warranted depends upon the circumstances. For example, whether the valuation of capital assets should properly involve a reconciliation or ‘wash-up’ with the asset values that were used to determine prices at the commencement of the *previous* price setting period depends crucially upon:

- § the nature of the regulatory price setting process, including decisions about the way risks should be shared between businesses and their customers; and
- § the nature and extent of any commitments to make such adjustments when prices are set.

Some regulatory processes operate on the basis of a backward-looking ‘wash-up’ of outturns against forecasts, and some do not. Those regulatory regimes that *do* allow for a ‘wash-up’ process have clearly specified regulatory or contractual commitments in place to manage that process.²² Absent a wash-up mechanism, the upside and downside risk of outturn variations from forward-looking expectations is part and parcel of the risk a business undertakes when committing to a forward-looking price path. Outturn windfall gains and losses are observed frequently in competitive markets.²³ Indeed, only in markets when competition is limited is it possible to impose a retrospective adjustment.

¹⁹ Commerce Commission, *Authorisation for the Supply of Natural Gas Distribution Services by Powerco and Vector: Valuation of the Opening Regulatory Asset Base, Valuation Methodology*, 15 February 2007, p58.

²⁰ See for example: Byatt, I.C.R. (1986), ‘Accounting for economic costs and prices: A report to HM Treasury by an advisory group’, London, 1986, Volume II, p43.

²¹ Op cit, p44.

²² Mechanisms for dealing with windfall gains and losses in the context of Australian energy regulation are specified beforehand, in either the National Electricity Rules, the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code), or in regulatory precedent. By contrast, other pricing approaches such as the total service long-run incremental cost (TSLRIC) based pricing principle commonly employed in the regulation of Australian and New Zealand telecommunications markets deliberately omit such mechanisms and so do not explicitly provide for ‘time consistency’ of capital-related costs when determining prices

²³ Consider a residential leasehold agreement under which a tenant agrees to pay a fixed \$100/week price for a property throughout a year based on current and projected rental market conditions. During the year the rental market booms, increasing the equivalent market rental to near \$200/week. Whilst the tenant clearly benefits at the expense of the landlord in these circumstances, there is no suggestion that this has stemmed from the exercise of any market power. Moreover, when the lease is renegotiated, the landlord is unlikely to be in a position to ‘claw back’ the losses he has made during the lease term by loading the short-fall into the new rental price (eg, attempting to charge \$300/week), since the tenant will relocate. Likewise, if fortunes were reversed and the market rental were to fall, the tenant could not expect the landlord to reduce his price to ‘make good’ his past over-payments when the property can be leased at a market rental rate that does not involve compensating a tenant for such losses.

By extension, focusing upon returns over short periods or in individual years may reveal little about whether a business is earning monopoly profits. While some projects or activities will only earn normal or less than normal returns (ie, only cover their cost of capital or perhaps even fall short of this) some will earn higher profits. This inevitably leads to fluctuations in outturn rates of return from year-to-year, including potentially above the forecast WACC. As outlined above, this may occur for a number of reasons unrelated to the exercise of market power, including the achievement of greater than expected efficiency gains.

In light of these factors, our view is that the pricing approach adopted by AIAL is preferable to the principles articulated by Dr Tretheway. As a matter of economic principle, there is no basis for favouring a pricing framework that seeks to ensure that AIAL earns a predetermined target return on capital through the imposition of retrospective adjustments. Rather, the appropriate basis upon which to set prices that are designed to reflect those applying in competitive markets is the *forward-looking* cost of providing the relevant service.²⁴ This principle is also consistent with productive, allocative *and* dynamic efficiency. In contrast, Dr Tretheway's *backward-looking* principles may hinder dynamic efficiency.²⁵

A number of problems potentially arise also from Dr Tretheway's 'primary guiding principle', which requires the achievement of the 'maximum level of economic efficiency'. It is unclear what is meant by the term 'maximum level', which is problematic in itself. Moreover, if the term is intended to reflect the level of efficiency that a firm would be expected to achieve in a *perfectly competitive market* – 'hypothetical perfect efficiency' – this would be an inappropriate benchmark. As Professor Alfred Kahn explains, regulation is generally intended to replicate, as closely as possible, the outcome of an *effectively* competitive market²⁶ – not the textbook ideal of *perfect* competition.²⁷

'...the single most widely accepted rule for the governance of the regulated industries is to regulate them in such a way as to produce the same results as would be produced by **effective competition**, if that were feasible.' (emphasis added)

There are a number of reasons to eschew a benchmark based upon hypothetical perfect efficiency in setting regulated prices. By definition, 'perfect' efficiency is a moving target attainable by few – companies' abilities to transform inputs into outputs efficiently will vary over time and will be constrained by their specific operating environments. No firm can be expected to achieve hypothetical, perfect efficiency in every facet of its operations in perpetuity. The likely consequences of employing such a benchmark would include:

²⁴ We recognise that businesses can and do enter into arrangements to undertake adjustments to forward-looking prices to account for historic events, such as greater than expected capital gains. However, there is no *economic rationale* for retrospective adjustments to future prices based on such factors *unless clearly understood provisions have been made beforehand to share this business risk*. NERA understands that AIAL has not sought such arrangements with its airline customers and does not propose to. Rather, AIAL seeks to earn a normal return on the current value of deployed assets and to bear the risk of outturns that differ from forecasts, in a manner consistent with competitive market outcomes.

²⁵ See: Tretheway, p22.

²⁶ Kahn, A., 1988, *The Economics of Regulation, Principles and Institutions, Volume 1 – Economic Principles*, Massachusetts Institute of Technology, p17. See section 1 above.

²⁷ Kahn, A., 1988, *The Economics of Regulation, Principles and Institutions, Volume 1 – Economic Principles*, Massachusetts Institute of Technology, p17.

- § the derivation of prices that were lower than the lowest sustainable cost of delivering the relevant services; and
- § the undermining of incentives for airports to undertake efficient investment due to the uncertainties surrounding whether they will be able to recover their capital costs.

It is for these reasons that cost benchmarks that underpin regulated prices are typically set by reference to a measure of *average* cost efficiency rather than the ‘maximum level of efficiency’ or ‘hypothetical perfect efficiency’ (if that is what is intended by Dr Tretheway). As the New Zealand Ministry of Economic Development recently acknowledged, benchmarking in this fashion allows for pressure to be put on a sector to improve its *average* efficiency over time.²⁸

Finally, there is an apparent inconsistency in Dr Tretheway’s articulation of the services by reference to which the regulated rate of return should be calculated. Specifically, one of his pricing principles states that the achievement of an ‘overall corporate rate of return including non-regulated services’ is ‘not to be a factor’ in determining the appropriate rates to charge. However, this seems to conflict with Dr Tretheway’s proposed ‘periodic single till’ approach to setting aeronautical and non-aeronautical prices, which is outlined in the following section.

Under a ‘periodic single till’ arrangement, aeronautical prices would be set so as to recover the residual of the total costs of the airport after deducting the net revenues from non-aeronautical activities. In other words, the fundamental premise of Dr Tretheway’s periodic single till based approach is to regulate the *overall corporate rate of return* that may be earned by an airport. This appears to be inconsistent with a pricing principle which states that the overall corporate rate of return should not be a relevant consideration when setting regulated prices.

<p>Summary: The pricing principles proposed by Dr Tretheway are not appropriate for the determination of aeronautical prices since:</p> <ul style="list-style-type: none">§ they appear to be rooted in ROR regulation principles – a form of regulation that Dr Tretheway himself concludes is inappropriate;§ they potentially involve an unrealistic efficiency benchmark.; and§ their application would be unlikely to provide airports with proper incentives to achieve efficiencies in their operations and investment performance. <p>The adoption of Dr Tretheway’s pricing principles would not be in the long-term interests of New Zealand consumers. The pricing philosophy of AIAL, which seeks to recover its efficient costs as measured in <i>forward looking</i> terms, is more appropriate.</p>

²⁸ Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007, p49.

4. Boundaries of the Regulated Till

Dr Tretheway proposes a fundamental change to the way in which the boundaries of the regulated and unregulated tills – and thus those services that are regulated – are defined at New Zealand airports. Specifically, he proposes that those boundaries be defined by reference to three categories of services:²⁹

- § **Category A**, which comprises services essential to airline operation and that have inelastic demands, eg, services provided for landing, take-off and parking of aircraft;
- § **Category B**, which comprises services that are own-price elastic and have cross price demand complements with regulated services, eg, car parking, terminal food and retail outlets and hire car counters; and
- § **Category C**, which comprises services that are own-price elastic but have near zero cross price demand complements with regulated services, eg, income from rental of land for maintenance terminals.

Dr Tretheway proposes in the first instance that the regulated till comprise Category A services, with airports being permitted to retain any economic profits associated with Category B and C services. However, he suggests that after a ‘reasonable initial period’ has elapsed following the ‘growth or development’ of Category B services the economic profits associated with those services should be used to offset Category A costs.³⁰ Dr Tretheway indicates that a four to five year period is ‘reasonable’ in this regard. He refers to this arrangement as a ‘periodic single till’.

The manner in which Dr Tretheway’s proposal is presented suggests that it is a ‘hybrid model’ that contains desirable elements of both a single *and* a dual till. In practice, that is unlikely to be the case. After the initial five year period few Category B services would be expected to remain in the ‘growth and development’ stage, hence the majority of such services will be ‘folded in’ to the regulated till, where they will remain. In other words, Dr Tretheway is, in effect, proposing a *single till* – albeit predicated by a short transition period. This is the basis upon which his proposal should be assessed.

The remainder of this section briefly outlines the principal differences between a single till and a dual till and then examines the relative advantages and disadvantages of each approach.

4.1 Single Till versus Dual Till

Under a *single till* approach to pricing, aeronautical prices are set to recover the residual of the total costs of the airport after deducting the net revenues from non-aeronautical activities (which would encompass Category B services, but not Category C³¹), the charges for which

²⁹ Tretheway, p43

³⁰ Tretheway, p43.

³¹ We are not aware of any regulatory regime that would use economic profits from what Dr Tretheway terms ‘Category C’ services to offset aeronautical costs. Accordingly, when reference is made in the balance of this section to ‘non-aeronautical services’ this encompasses Category B services only.

are set so as to maximise profits. The single till approach to setting aeronautical charges has certain features that account for its widespread use internationally, including:

- § it ensures that an airport operator earns a reasonable return on total assets, while preventing it from exploiting any monopoly power it may possess;
- § it is administratively straightforward and practical to apply, since an airport operator is free to recover costs through any charging structure it deems suitable; and
- § it avoids the complex task of allocating costs that are common to both aeronautical and non-aeronautical activities between those two activities.

A *dual till* approach to pricing separates the aeronautical from the non-aeronautical functions of an airport. It identifies the costs involved in the provision of aeronautical services and uses them as a basis for setting aeronautical charges. For aeronautical services, the dual till approach requires that revenues cover the directly attributable costs of providing these services, including an appropriate return on assets that are used solely for these services, as well as a contribution to costs that are common to both aeronautical and non-aeronautical services. Although it involves a degree of additional complexity to administer, many airports around the world employ a *dual till* in the belief that it will increase the efficiency of their operations and investment decisions, especially during periods of congestion.

The relative advantages of a single versus a dual till have been well traversed. Notwithstanding Dr Trethewey's endorsement of a *single till* at New Zealand airports, international regulatory precedent suggests that the benefits obtainable from tilling arrangements depend crucially on an *airport's circumstances*. Accordingly, in the following sections we examine the relative benefits of each arrangement in light of the circumstances at AIAL. We note that incorporating Category B services into a single till would widen the scope of the existing regulatory framework. There should therefore be a presumption *against* the introduction of a single till, except where there are compelling arguments *for it*.³²

4.2 Market Power in Non-aeronautical Services

One of the fundamental issues surrounding the relative advantages and disadvantages of a single till vis-à-vis a dual till is *whether airports have market power* in the provision of some non-aeronautical services that would justify their inclusion in the regulated till. To the extent that airports *do* have market power in relation to such services, the single till approach ensures that any greater than normal accounting profits in relation to those activities are applied in the form of a corresponding adjustment to the prices set for aeronautical services.

One fundamental problem with this approach is that it presupposes that the existence of high *accounting* profits from non-aeronautical activities is necessarily the result of the exercise of *market power*. However, in practice there are many reasons why this may not be the case. High accounting profits can equally result from the fact that space at or close to an airport is in short supply but highly valued and in strong demand. Scarcity rents (or 'true economic rents') are a result of this imbalance, which are no different to economic rents achievable at

³² See: Civil Aviation Authority, *The 'Single Till' and the 'Dual Till' Approach to the Price Regulation of Airports: Consultation Paper*, December 2000, p7.

other highly valued locations. Such a phenomenon is reflected in the fact that many airports compare their retail prices with those observable in CBD locations. The same principle applies for car parking, airport offices, and many other non-aeronautical activities.

It follows that it is incorrect to infer that ‘high’ non-aeronautical prices observed at AIAL are evidence of allocative inefficiencies just because these services yield high accounting returns relative to the historic cost of the assets used to provide them. A return calculation based upon a current market-based valuation of those assets may well reveal that returns are ‘normal’. Put slightly differently, if the *scarcity value* of an asset is reflected in prices this should result in a normal return. If high accounting returns reflect true economic rents this *does not introduce inefficiencies* in the provision of aeronautical and non-aeronautical services that may otherwise justify the introduction of a single till. As Professor Kahn explained in a report on behalf of Sydney Airport in 2001:³³

‘The net supernormal profits from the retail services at airports are not, strictly speaking, monopoly profits, but true economic rents, reflecting the value of locating those services at the airport ... Removing them from holding down regulated aviation charges, by moving from a single to dual-till – and in the case of congested airports, as I have demonstrated, from airlines to airport owners – in no way introduces inefficiencies in those markets, where present charges are inefficiently low.’

Moreover, even if an airport *was* found to possess a degree of market power over non-aeronautical activities that enabled it to earn an above normal economic return based on current market-based asset values, this is not sufficient in itself to justify the introduction of a single till, although the case would be strengthened. As the UK Civil Aviation Authority explains, market power is observable in many scenarios throughout the economy where economic regulation has not been introduced:³⁴

‘Some degree of market power exists in many markets to a greater or lesser degree but economic regulation has not been introduced. For example, economic regulation is not applied to motorway service stations, out of town shopping centres and supermarkets, or landlords with properties on Oxford Street.’

It also should be emphasised that the single till itself does not necessarily prevent an airport from setting high prices or demanding high rents for non-aeronautical activities *even if it does have market power*. The effect of the single till is simply to reduce prices for aeronautical services, which does not necessarily imply an improvement in allocative efficiency. If an airport is nearing full capacity – as is the case at AIAL – aeronautical prices are more likely to be below the marginal cost of service. Reducing aeronautical prices in such circumstances is likely to *compound* allocative inefficiencies. As Professor Kahn stated in his 1991 evidence for the US/UK arbitration concerning Heathrow user charges:³⁵

³³ Kahn A, *Evidence of Alfred E. Kahn on Behalf of Sydney Airports Corporation*, 17 January 2001, p21.

³⁴ Civil Aviation Authority, *The ‘Single Till’ and the ‘Dual Till’ Approach to the Price Regulation of Airports: Consultation Paper*, December 2000, p9.

³⁵ Kahn A, *Evidence on Behalf of the Government of the United Kingdom of Great Britain and Northern Ireland, US/UK Arbitration Concerning Heathrow Charges*, May 1991, p20.

‘It is no more consistent with economic efficiency or fairness if prices for restaurant meals, duty-free-sales, car parking or other commercial services at airports are set at excessive levels, than if airlines were subjected to excessive charges for aviation services. Moreover the inefficiency resulting from the former monopolistic prices would not be mitigated, but compounded if the excess revenues were used to hold other airport charges below the level of marginal cost.’

In sum, whether an airport can be said to possess a substantial degree of market power in relation to non-aeronautical activities that might support their incorporation in a single till is a complex empirical issue. Moreover, even if it were established that such market power existed, employing a single till would not necessarily circumvent the exercise of that market power, or improve allocative efficiency. Rather, as Professor Kahn outlines above, the single till would simply transfer the associated profits to lower aeronautical charges, which in light of the congestion at AIAL would risk *creating* allocative inefficiencies.

For these reasons, contentions that a single till should be introduced at AIAL that are predicated on the possession of market power in relation to non-aeronautical services are unlikely to be convincing. A second common line of reasoning for single till arrangements relates to the demand complementarities between aeronautical and non-aeronautical services and the resultant potential for cross-subsidisation to improve economic efficiency. We examine this below.

4.3 Efficient Pricing of Common Products

Efficient pricing generally requires that to the extent goods or services have separate or separable costs, they should have correspondingly separate prices based on those costs. Dual till pricing can better achieve this. By contrast, under a single till the prices for aeronautical *vis-à-vis* non-aeronautical services may *not* reflect their costs, potentially giving rise to *cross-subsidies* between the two services. However, as Dr Tretheway recognises, in some circumstances pricing one service below its incremental cost increases the demand for the other to the extent that the additional profit more than offsets the loss in the under-priced service, thereby improving economic efficiency. The practice of charging customers below incremental cost for razors in order to promote sales of disposable razor blades is apposite.

A single till approach may similarly enhance economic efficiency if it has the effect of holding down the price of aeronautical services and so significantly increasing the demand for complementary non-aeronautical services. However, in order for a single till to have such an effect at AIAL, two conditions would need to hold:

- § the cross-price elasticities of demand must be such that it is profitable for AIAL to set the price of aeronautical services below their incremental cost to stimulate demand for non-aeronautical services; and
- § AIAL would not undertake such cross-subsidisation unless a single till arrangement were in place.

Whether the relevant cross-price elasticities of demand will be strong enough to warrant pricing aeronautical services below their incremental costs depends upon the circumstances at

AIAL – it is a question not of theory but of fact.³⁶ It is certainly not self-evident that this condition would be met. Rather, there are a number of reasons to believe it would not, including:

- § AIAL is close to full capacity, implying that lower aeronautical charges may *not* lead to an increase in the demand for non-aeronautical services since capacity constraints will mean it cannot appreciably increase its use for aeronautical purposes; and
- § the aeronautical price component makes up a very small proportion of the price of most passengers' air tickets, dampening any cross-price elasticity effects.

In addition, it is not obvious that a commercial entity like AIAL would need to be subjected to a single till arrangement for demand interdependencies to be taken into account in its pricing decisions. If cross-subsidisation was profitable – and so efficiency enhancing – it presumably would engage in the practice regardless of whether it is mandated. As Professor Kahn observed in his testimony on behalf of Sydney Airports Corporation:³⁷

‘...if the respective cross-elasticities were such as to make the kind of pricing that [BARA] recommends economically efficient, it would also be profitable for a privatised Sydney Airports Corporation. Even, that is to say, if the regulator were to permit it to price its aeronautical services at their full incremental costs, it could increase its profits by reducing them below that level in order to increase its sales of non-aeronautical services and, in the process, its total profits ... [I]t would not be necessary for a regulator to order it.’

For these reasons, in light of the circumstances at AIAL outlined above, arguments for a single till arrangement that focus upon the potential efficiencies of cross-subsidisation have little application.

One of the arguments regularly cited to support a *dual till* is that such an arrangement can improve the efficiency of their operations and investment decisions, especially during periods of congestion. We address this matter below.

4.4 Signals for Investment

Incentives to invest are likely to differ between a single and a dual till, as well as the division of investment between aeronautical and non-aeronautical activities. Under a single till, if AIAL was earning near or at its maximum rate of return, incremental non-aeronautical revenue from, say, a lucrative lease to a fast food franchise will automatically translate into lower aeronautical charges. In the extreme, the single till can amount to the imposition of a tax on non-aeronautical services to fund aeronautical services.

A single till regime therefore carries a risk that AIAL may either be discouraged from undertaking efficient investments in these profitable activities or that it will undertake its investments in a sub-optimal way. By way of illustration, we understand that AIAL recently explored the possibility of selling advertising space on its aero bridges. However, the airlines

³⁶ Kahn A, *Evidence of Alfred E. Kahn on Behalf of Sydney Airports Corporation*, 17 January 2001, p17.

³⁷ Kahn A, *Evidence of Alfred E. Kahn on Behalf of Sydney Airports Corporation*, 17 January 2001, p19.

argued that the proceeds from this activity would constitute *aeronautical* revenue that could then be used to reduce aeronautical charges. Since AIAL stood to reap little, if any, financial benefit, it chose not to pursue the initiative.

Although the above example concerns a dispute about the boundaries of a dual till, it nonetheless illustrates the type of distortions that can arise frequently in a single till environment where there *is no distinction* between aeronautical and non-aeronautical revenue. Absent a market mechanism, it will instead fall to the regulator – presumably the Commission – to assess the optimal level of investment in competitive non-aeronautical services. This would be a difficult task. Consequently, as the former Network Economics Consulting Group once observed, a dual till approach may result in a:³⁸

‘Substantial lessening of regulatory risk, and therefore is likely to result in a greater level of dynamic efficiency in the provision of these services compared to the single till approach.’

These potential dynamic inefficiencies are compounded where capacity constraints exist, such as the case presently at AIAL. Ordinarily, when capacity limitations arise in effectively competitive markets, prices increase to alleviate the shortage. However, this may not be a viable option for AIAL if it was earning at or near its maximum permitted rate of return under a single till arrangement. Any attempt by AIAL to increase aeronautical charges to free up capacity in these circumstances may serve only to increase revenue further – particularly when demand is inelastic. This may push returns above the permitted maximum and result in aeronautical prices that are artificially depressed. This may encourage artificially high demand for aeronautical services and undermine incentives to invest in aeronautical related services.

It was primarily for this reason that the congestion prone Sydney International Airport switched to dual till pricing in 2001. The single till regime limited the airport company’s ability to reflect capacity constraints in its aeronautical charges. Shifting to a dual till regime enabled it significantly to increase the price for aeronautical services by removing the cross subsidy from more profitable non-aeronautical charges.³⁹ Indeed, there is broad agreement that a dual till is more consistent with the promotion of dynamic efficiency in congested conditions since a single till may have the effect of aggravating the imbalance of supply and demand and therefore the misuse of capacity. As Dr Tretheway notes:⁴⁰

‘Another major limitation of the single-till approach is that prices are not set according to economic principles under congested conditions. This can lead to costly congestion at an airport that is nearing capacity. Since aeronautical fees are reduced by net non-aeronautical revenues, the prices charged to airline users for landing and the use of the terminal are lower than their economic and social costs. The dual-till price cap preserves incentives to develop commercial activities at the airport, and is more consistent with economic principles in congested conditions.’

³⁸ See: ACCC, *Sydney Airports Corporation Aeronautical Pricing Proposal*, May 2001, p77.

³⁹ NERA advised Sydney Airports Corporation throughout this process.

⁴⁰ Tretheway, p41.

Consequently, although the dual till arrangement in place at AIAL is more complex to administer than a single till, it likely serves to improve the efficiency of its operations and investment decisions, especially during periods of congestion. It is worth re-emphasising that Dr Trethewey's proposed 'periodic single till' does not entail similar properties because following the initial five-year period, AIAL effectively would be operating under a single till arrangement, together with its associated dynamic inefficiencies.

Summary:	Dr Trethewey is effectively proposing that a <i>single till</i> arrangement be mandated at New Zealand airports – albeit predicated by a short transition period. This would be inappropriate since:
§	the benefits obtainable from different till arrangements depend crucially on airports' individual circumstances, which will differ from airport to airport;
§	although the existing dual till arrangements at AIAL involve a degree of additional complexity to administer than would a single till, it likely serves to improve the efficiency of AIAL's operations and investment decisions, especially during periods of congestion; and
§	it is unnecessary to mandate a single till in order for interdependencies in demand to be taken into account by airports in their pricing decisions – when cross-subsidisation is profitable (and so efficiency enhancing) airports can be expected to engage in the practice voluntarily.

5. Land Valuation

The relative advantages and disadvantages of different approaches to valuing airport lands and the specialised assets upon them are well recognised in international regulatory proceedings. As Dr Trethewey recognises, in valuing any asset, the preferred economic technique is to measure its opportunity cost, ie, the value of the asset in its next best alternative use.⁴¹ However, as he also highlights, there are a number of practical difficulties associated with estimating the opportunity cost of airport lands and the specialised assets upon them, including environmental remediation.⁴²

There is no question that there are practical challenges associated with estimating the value of such assets in an alternative use. Nonetheless, it is incorrect to suggest, as Dr Trethewey does, that the use of historical cost or indexed historical cost valuation principles should be preferred on the basis that they can better reflect the replacement value of those assets. First, a historical cost valuation rewards shareholders for their financial investment in the asset without taking into account its value in other potential uses. Accordingly, the use of such principles may create perverse incentives, such as selling existing land to replace it with new or leased land, or sub-optimally locating services.

Second, the challenges associated with sourcing reliable historical cost data may be similar, if not greater than those associated with establishing opportunity cost. Indeed, constructing a sensible *historical cost* (or 'original cost') valuation for AIAL is unlikely to be practicable. Put simply, there is very little – if any – data on the sum originally paid for the airport assets from which to construct an historical cost estimate for AIAL. To our knowledge, the earliest available valuation for AIAL is the *vesting* value of the airport as at 1988.⁴³ However, this valuation was based upon the 'open market value for the airport assets in their existing use'.⁴⁴ In other words, it represented a current market valuation, which need not have borne any relation to the historical cost of the airport assets.^{45, 46}

⁴¹ Trethewey, p45.

⁴² Trethewey, p48.

⁴³ The assets and liabilities vested in Auckland International Airport in 1988 were valued at \$350m and \$33.73m, respectively at this time. See; Darroch Valuations, *Auckland International Airport*, 7 March 1988.

⁴⁴ Op Cit, p7. The same basis was also adopted in valuing the additional land which was surplus to operational requirements at that time

⁴⁵ It is also worth noting that the vesting value itself had strictly limited significance. The figure was arrived at largely for practical purposes – namely the need to incorporate a figure into the airport's financial accounts – and had very little bearing on forward-looking prices at that time.

⁴⁶ Even if a robust estimate of shareholders' initial financial investment were available, that alone would be insufficient to construct a robust historical cost valuation. As outlined above, a historical cost valuation represents the *opportunity cost* of the initial investment in an asset. A component of that opportunity cost is any *shortfalls in returns* that arise during the early years of an asset's life. This phenomenon is commonplace in the return profiles of large sunk assets. For example, during its early years it is conceivable that Auckland Airport may have been utilised at well below its capacity and so did not deliver its target return to investors. If that were the case, the quantum of those shortfalls would need to be *added* to the asset value to 'make whole' the original investors. In other words, to construct a robust historical cost estimate, data would also be needed on outturn achieved rates of return relative to the target rate of return over the life of the asset.

Although Dr Tretheway makes a number of salient points regarding the challenges implicit in estimating the opportunity cost of airport assets, his proposed alternative does not necessarily address those problems. Insofar as AIAL is concerned, it is not possible to value its airport lands and specialised assets at their historical cost because the information necessary to undertake such a valuation is simply not available.

In any event, during the most recent round of pricing negotiations one aspect of the building block methodology upon which both AIAL and the airlines appeared to agree was that land should be valued based on a 'market value alternative use' (MVAU) or opportunity cost approach. Although some disagreements with regard to quantum and the specifics of the methodology can be expected, we understand that AIAL did not consider these difficulties to be as profound as suggested by Dr Tretheway in his report. Moreover, the scope for disagreement may narrow over time as AIAL and the airlines become increasingly familiar with the MVAU methodology.

<p>Summary: There are undoubtedly practical challenges associated with estimating the value of airport land and specialised assets in an alternative use. However, the difficulties associated with historical cost based valuation principles may be comparable or greater. It would simply not be possible to value AIAL's airport lands and specialised assets at their historical cost because, to the best of our knowledge, the information required is not available.</p>

6. Conclusion

The preceding sections highlight a number of serious shortcomings in the various regulatory proposals put forward by Dr Tretheway on behalf of Air New Zealand. Dr Tretheway's analysis is pitched at a very high level and he makes little attempt to relate his analysis in any meaningful way to the particular circumstances at New Zealand airports – including at AIAL. In our view, a more careful evaluation of the particular circumstances presented by AIAL suggests that many of Dr Tretheway's conclusions cannot be supported. By way of brief summary:

- § Dr Tretheway significantly underestimates the countervailing power of AIAL's airline customers, which undermines the basis for the extensive changes he contemplates;
- § The pricing principles proposed by Dr Tretheway are not appropriate for the determination of aeronautical prices since:
 - they appear to be rooted in ROR regulation principles – a form of regulation that Dr Tretheway himself concludes is inappropriate;
 - they involve an unrealistic efficiency benchmark;
 - their application would be unlikely to provide airports with proper incentives to achieve efficiencies in their operations and investment performance and so they would not be in the long-term interests of New Zealand consumers; and
 - the pricing philosophy adopted by AIAL, which seeks to recover its efficient costs as measured in forward looking terms, is more appropriate
- § Dr Tretheway's proposal that a single till be mandated at New Zealand airports – albeit predicated by a short transition period – is inappropriate since:
 - the benefits obtainable from different possible till arrangements depend crucially on airports' individual circumstances;
 - although the existing dual till arrangements at AIAL involves a degree of additional complexity to administer than a single till, moving to a single till would potentially:
 - ú distort investment decisions; and
 - ú aggravate the current imbalance of supply and demand (and therefore the misuse of capacity); and
 - it is unnecessary to mandate a single till in order for interdependencies in demand to be taken into account by airports in their pricing decisions – when cross-subsidisation is profitable (and so efficiency enhancing) airports can be expected to engage in the practice voluntarily.
- § Dr Tretheway's proposal that historical cost valuations be used for airport lands and specialised assets is impracticable because the information required would be very difficult to obtain, or would simply not be available.

Put simply, Dr Tretheway's analysis is insufficient for there to be any confidence that his various proposals would represent a material improvement in the existing regulatory arrangements for New Zealand airports.

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