RELEASED WITH THE AUTHORITY OF THE MINISTER OF COMMERCE

RCP03/159

COMMERCIAL-IN-CONFIDENCE

Control of Airports Advice

Purpose

This paper outlines our advice on the control of airfield activities based on the Commerce Commission's report and submissions subsequently received on the report. We recommend that control should not be recommended to the Governor-General.

Date:	9 May 2003	**Priority:**	Medium
Security Level:	In-Confidence	**File Number:**	RCP 2/5/8

Action Sought

	Action Sought	Deadline
Minister of Commerce	Note our view that control should not be recommended for Auckland International Airport; and Agree to submit the attached draft paper to Cabinet.	14 May 2003

Contact for Telephone Discussions

Contact	Position	First Contact	Telephone Work	Telephone After Hours
Rory McLeod	Manager	✓	474 2991	[ ]
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Ministry of Economic Development
Manatū Ōhanga

File: RCP 2/5/8

9 May 2003

Minister of Commerce

Control of Airports Advice

Executive Summary

This paper reports on our analysis of the Commerce Commission's inquiry into airfield activities of the three major international airports and the submissions subsequently received on that report.

We recommend that you should not recommend control on airfield activities for any of the airports under section 53 of the Commerce Act 1986. We consider that you may be satisfied that control may be imposed on airfield activities by Auckland International Airport (AIAL) as recommended by the Commerce Commission. However, we consider that the negative net public benefits of control and the relatively small net benefits to acquirers of control are matters that you should give significant weight in your decision. These matters indicate that control is not appropriate given the level of excess returns forecast to be earned by AIAL.

We have also carried out a simple analysis for Wellington International Airport (WIAL) taking into account the recent increase in airfield charges. We consider that the net benefits to acquirers of control for WIAL are considerably less than for AIAL, and as such, we also recommend that you do not recommend control be imposed.

We outline that the inquiry has identified flaws in the empowering legislation. We recommend that MED officials carry out a review of the provisions in the Commerce Act 1986.

We seek your agreement to submit a paper to Cabinet on this basis. A draft Cabinet paper is attached.

Control of Airports Advice

Purpose of Report

1 This paper outlines our advice on the control of airfield activities based on the Commerce Commission’s report and submissions subsequently received on the report. We recommend that control should not be recommended. This paper seeks your agreement to submit a paper to Cabinet on this basis.

Analysis

BACKGROUND

2 On 16 December 2002, the Ministry provided you with a report on progress on advising you on whether or not you should recommend control on airfield activities at any one of the major international airports. This report outlined the statutory matters that you must consider in making your decision under the Commerce Act 1986 and our view that this required a two-step analysis.

3 We advised that in the first step, as a minimum, you must be satisfied that the criteria in section 52 of the Commerce Act 1986 are met. The Commission’s report primarily deals with these matters. Once satisfied, you have a relatively wide discretion to determine whether or not you should recommend control be declared. In making this assessment, you may have regard to a wider range of relevant matters than those considered by the Commission.

4 The approach taken in our preliminary advice to you was that you should accept the Commission’s analysis in respect of whether the criteria in section 52 of the Commerce Act were met. Based on these criteria, the Commission recommended that the airfield activities supplied by:

a Auckland International Airport should be subject to control;

b Wellington International Airport should not be subject to control, but if the airport imposes a significant increase in charges as a result of its current consultation with the airlines, the Commission would likely be satisfied that control would be in the interests of acquirers; and

c Christchurch International Airport should not be subject to control.

5 In the second step of considering whether you should recommend control, we advised you of a number of matters that we considered to be relevant to your decision. Our preliminary conclusion was that a recommendation of control was not appropriate. We considered that negative net public benefits of control and relatively small net benefits to acquirers of control were matters that you should give significant weight to in your decision.

6 We also indicated that before reaching any final conclusions on how we advise you, we needed to look carefully at the submissions. This report assesses the submissions and outlines the impacts on our preliminary advice and conclusions.

SCOPE OF SUBMISSIONS

7 The previous Minister of Commerce published the Commission's final report on 6 August 2002 and invited comments from interested parties. In the letter to submitters, the Minister stated:

> "In considering the Commission's findings I do not intend to replicate the consultation already undertaken by the Commission. I have, however, decided to invite written comments concerning any new matters raised in the report that were not the subject of submissions to the Commission and on any other relevant matters that are not reflected in the report."

8 The Ministry has received comments from 15 submitters. Submitters included the airport companies, airport company shareholders, local councils, the airlines, property valuers and other interested business groups. A full summary of the submissions is attached as annex one.

9 The submissions have not necessarily confined themselves to focus on "new matters" as requested. However, a few submissions advise that the Commission's final report differs in some fundamental respects from the draft report released for consultation on 3 July 2001. These submissions argue therefore that the submissions relate to new matters, as they had not previously had an opportunity to make submissions to the Commission on them.

10 We consider that identifying what constitutes a "new matter" to which you should have regard is a difficult judgement, particularly given our lack of familiarity with the Commission's consultation processes. Therefore, we have generally assessed the submissions to identify the following:

a Any errors in fact or judgement in the Commission's analysis;

b Any new matters that the Commission did not consider which if it had considered would have changed its recommendations. Given our preliminary conclusion that you should not recommend control, in this report our focus has been on identifying any new matters that would increase the net benefits to acquirers. If these benefits would be substantially increased, then we would look more closely at the arguments that decrease the benefits as well. If the net benefits would not have been substantially larger then the analysis would be complete; and

c Any other relevant matters that you should consider in making your decision.

STRUCTURE OF REPORT

11 This report has been structured on the basis of the analysis of submissions outlined above. The report outlines the Commission's analysis and the key issues raised in submissions to identify any errors and the impact of correcting those errors. The Commission's analysis is broken down into three parts – limited competition, excess returns and net benefits to acquirers.

12 This is followed by an analysis of any new information raised in submissions that was not taken into account by the Commission in its analysis. The major new information is Wellington International Airport's recently announced increase in charges.

13 In summarising the results of this analysis the report outlines whether you can be satisfied that the criteria in section 52 of the Commerce Act have been met for each of the airports.

14 The report then discusses other relevant matters identified in submissions that you may take into account in deciding whether or not to recommend control for any airport.

15 The report concludes with recommendations for each of the airports and a brief discussion on problems identified with Part IV of the Commerce Act 1986.

LIMITED COMPETITION – COMMISSION'S ANALYSIS

16 Section 52(a) of the Commerce Act requires you to be satisfied that the relevant goods or services were supplied in a market in which competition is limited or likely to be lessened. The goods and services in this case are airfield activities, and the Commission has defined markets relating to the supply of these activities. In general terms, these markets correlate to the matters that are covered by "landing charges" set by the airports.

17 You should be aware the airports also provide a wide range of other goods and services, some of which are contestable and some non-contestable. For example, in 2002 approximately 73% of Auckland International Airport's revenue related to sources other than airfield activities. The Board of Airline Representatives New Zealand (BARNZ) submits concerns relating to Wellington and Christchurch International Airports' setting of terminal charges. However, this activity is outside the scope of this inquiry [
].

18 An assessment of the state of competition in the relevant markets is important, as it is normal to require evidence of market failure before considering any form of intervention. Section 52(a) requires only evidence that "competition is limited" in the market, which is a relatively low standard compared to other key prohibitions in the Commerce Act.

19 A key issue in assessing the state of competition is the extent to which airlines can exercise countervailing power in the market for airfield activities. This analysis requires an assessment of the effectiveness of the obligations under the Airport Authorities Act 1966 relating to information disclosure and consultation requirements.

20 The Commission outlines in its final report that the countervailing power of the airlines cannot be ignored as a feature of the relevant markets. It also states that the current regulatory regime appears to provide some restraint on each of the airports, and that airlines do have some power, but their ability to effectively exercise that power is limited. As such, the Commission concludes competition is limited for each of the airports.

21 BARNZ (supported by Air NZ and Qantas) supports the Commission's conclusions. The airport companies generally argue that the countervailing power of airlines is understated. In terms of new matters, Wellington International Airport Ltd (WIAL) submits that there are changes in competitive circumstances that were not apparent at the time of the Commission's

conference. In particular, if the Air NZ and Qantas alliance proceeds it could significantly increase the countervailing power of airlines. In addition, WIAL refers to the volatile aviation market and how Freedom Air has withdrawn all its domestic schedules from Wellington Airport effective from October 2002.

22 The outcome of the proposed Air NZ and Qantas alliance is too uncertain to be taken into account in this inquiry. Similarly, while not specifically raised in submissions, the fall out from the war with Iraq and the spread of SARS on the aviation market is also uncertain. We consider that the Commission's analysis of the state of competition is reasonable and we recommend that you should be satisfied that competition is limited in the airfield activities markets for each of the airports.

EXCESS RETURNS – COMMISSION'S ANALYSIS

23 Section 52(b) of the Commerce Act requires you to be satisfied that it is necessary or desirable for airfield activities to be controlled in the interests of acquirers. The Commission has adopted a building block approach to make this assessment. The first part of this approach is to assess the existence of excess returns, with a particular focus on the likelihood of future excess returns.

24 The Commission calculates excess returns according to the following formula:

Excess returns ($) = Net earnings – (Appropriate asset base x Weighted Average Cost of Capital)

25 The forecasts are based on the airports' own forecasts and growth estimates, modified as appropriate to be consistent with the Commission's methodology and assumptions.[1] The forecasts relate to the period of the current price agreement for each airport.

Appropriate Asset Base

26 The asset base is an important determinate of prices in markets where competition is limited. As a general rule, the higher the asset value, the higher the revenue needed to generate the required return on assets, and the higher prices need to be.

27 Key issues in assessing the appropriate asset base are:

a The valuation methodology – the value of assets should reflect their market value to encourage efficient resource use. However, if competition in the product market is limited, the assets used in the production of that product may attract rents and be overvalued. The Commission considers that as a general rule non-specialised assets (e.g. land) should be valued at opportunity cost. This is the highest alternative use of the asset in the event that the airports were closed.

b Valuation of specialised assets – Opportunity cost is not an appropriate methodology for valuation of specialised or sunk assets, as these assets would have no alternative use. The Commission considers that

[1] The Commission and airports have used a multi-till approach (based on segment financial reporting) to identify those revenues and costs that are attributable to airfield activities as opposed to other activities carried out by the airports.

specialised assets should be valued at depreciated historical cost[2] in order to maintain incentives for investment and to preserve continuity of supply. The Commission advises that this decision should not be a precedent for other infrastructure industries as it in part takes into account industry specific factors such as any midlife asset valuation switches and investor expectations at the time of asset transfers.

c Optimisation of asset base – a firm operating in a market where competition is limited may be less efficient and, therefore use a greater amount of assets (or assets of a higher quality) than necessary. The Commission considers that airfield assets that are not "used and useful" should be excluded from the asset base for pricing purposes.

d Future capital expenditure – a subset of the "used and useful" principle is the treatment of assets acquired for future development and when the value of the asset can be included in the asset base for pricing purposes. The Commission considers that the timing of capital expenditure is a difficult judgement based on minimising costs, but the value of those assets should only be included in the asset base for pricing purposes from the time of construction. The capitalised holding cost should be included at that time, but treated as a specialised asset to be depreciated over the short term.

28 The impact of these issues on the asset bases of the three airports is outlined in the following table.

$000s	**CIAL**	**WIAL**[3]	**AIAL**
Airport's asset base for pricing purposes	$40,067	$94,936	$308,972[4]
Non-specialised assets revalued at opportunity cost	+$16,483	-$12,816	-$36,931
Specialised assets revalued at historical cost	-$18,463	-$11,943	-$20,703
Optimisation of assets not used or useful		-$2,619	-$24,582
Optimisation of assets not yet in construction			-$36,757
Total impact on asset base	-$1,980	-$27,378	-$118,973
Commission's valuation of asset base	$38,087	$67,558	$189,999

[2] The valuation methodology for specialised assets was subject to a split 3-2 decision by the Commissioners. The minority recommended optimised replacement cost for specialised assets.
[3] The WIAL figures have been amended to exclude the double counting of the seawall error.
[4] Revised to exclude ground handling area land.

29 These issues were hotly contested in submissions and are discussed below.

Opportunity Cost

30 Opportunity cost was contested on the basis of its use in principle and the way it has been applied in practice. BARNZ outlines that the airlines have consistently supported the opportunity cost methodology, as any alternative could allow monopoly rents to be capitalised in land values. The airports and airport shareholders argue that opportunity cost is a novel concept not used by international regulators. They argue the land should be valued on its market value existing use as an airport and refer to High Court and Court of Appeal judgements under the Airport Authorities Act 1966 to support their views.

31 In practice the airport companies and the Commission have used comparable sales or a zonal approach[5] to calculate the base value of the land (although in some cases coming up with different results). Differences arise in the treatment of holdings costs and development costs (such as levelling, seawall construction, and reclamation costs). The Commission has said that these should be treated as specialist assets, except for development costs that have already been counted in the opportunity cost of the land. It is primarily the deduction of holding and levelling costs that reduces AIAL's asset base and the deduction of holding and seawall construction costs that reduces WIAL's asset base.

32 BARNZ submits that the Commission has erred on the side of generosity to the airports by adopting higher values than the airports to determine the base value of the land. In addition, the Commission did not include future revaluation gains to the land in its forecasts. In contrast, the airports argue that the way the Commission has applied the opportunity cost principle is contrary to New Zealand financial reporting standards. WIAL argues absorbing development costs in the opportunity cost of land discourages efficient investment in improvements to the land. AIAL raises a number of technical points about the Commission's valuation of its land.

33 We consider that the use of comparable sales or the zonal approach to valuation should constrain the ability for monopoly rents to be included in the land values, as the market for land should be competitive. However, the treatment of development costs does require careful judgement as it can lead to double counting in the asset base and overvaluation.

34 The submissions did identify a numerical error in the Commission's calculation of WIAL's asset base where the value of the seawall was deducted twice. This has been corrected in the above analysis, such that the net adjustment to WIAL's asset base is amended from -$40 million to -$27.3 million.[6] In addition, we discuss the implications of including revaluation gains in the summary at the end of this section.

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[5] The comparable sales method estimates the value of the land by reference to sales prices of unimproved land in localities around the airport. The zonal approach estimates values by reference to sales of land of equivalent size having similar characteristics but not necessarily adjacent to the airport.

[6] Note this correction of $12.635 million is slightly less than that submitted by WIAL ($16.509 million), as WIAL did not take into account the corresponding amendment for depreciation.

Historical Cost Versus Replacement Cost

35 Valuing specialised assets at historical cost as opposed to replacement value is opposed by all the airports and their shareholders. This matter was also the subject of a 3-2 split decision by the Commissioners, with the minority supporting replacement cost.[7]

36 The Commission concludes, in theoretical terms, that there may not be a lot to choose between the two methodologies, providing that both are implemented correctly and consistently over the lives of the assets.[8] Returns to investment (i.e. interest plus depreciation) from both replacement cost and historical cost valuation can have the same net present value over the life of the asset, assuming revaluation gains are treated as income. However, the returns have a different time profile – both diminishing over the life of the asset, but returns based on historical cost valuation diminishing at a faster rate than replacement cost valuation. The result is that switching from historical cost to replacement cost valuation during the life of an asset can enable excess returns to be earned.

37 The Commission favoured historical cost for airports out of concerns that:

a the airports have switched from historical cost to replacement cost in the middle of the life of the assets and this has had efficiency and distributional implications,

b existing investors would not be unreasonably harmed by the reversion to historical cost, and

c the transaction costs of using and maintaining replacement cost valuations would be high.

38 The minority Commissioners favour replacement cost on the basis that:

a international use of historical cost should not be a precedent for New Zealand, as we do not have the same institutional framework here (i.e. a regulatory compact[9] with industry to guarantee a rate of return over the life of the asset and the use of rate of return regulation);

b the transaction costs for maintaining and using historical cost are also high; and

c the use of historical cost for specialised assets and opportunity cost value for non-specialised assets creates an uncomfortable hybrid of past and current values.

[7] Note that all decisions of the Commission are determined by the majority of votes of the Commissioners voting on the issue. The minority Commissioners, therefore, do not reflect the views of the Commission.
[8] Differences can arise due to risk associated with inflation, the pace of technological change, the scarcity of the asset, and optimisation. These factors are not considered to be significant for airports.
[9] In the United States, for example, the regulators guarantee controlled firms a rate of return over the life of particular assets.

39 The Commission has calculated historical cost values using the airports' asset values as a starting point then deducting any revaluation gains since vesting and revising the calculation of depreciation. Inflation is dealt with through the use of a nominal WACC.

40 BARNZ and the airlines outline that the airports are likely to distort revaluation gains if replacement cost valuation is used and therefore they favour historical cost. The airports and their shareholders favour optimised replacement cost, which they argue is a mainstream valuation methodology for infrastructure. The airport companies argue that there has not been midlife switching in asset values to disguise excess returns, although BARNZ disputes this. The airports also disagree with the Commission's view that different valuation methodologies may be appropriate for different industries depending on their circumstances.[10] In terms of historical cost, AIAL raises a number of technical points about the Commission's method for determining historical costs.

41 The difference in valuation methodologies would have a significant impact on the analysis, such that the minority Commissioners do not recommend control for AIAL. BARNZ outlines that the minority Commissioners did not include any future revaluation gains in their forecasts when applying replacement cost valuation and that, if considered, it could have changed their recommendation. In its letter to you of 31 October 2002, the Commission has run the minority scenario with estimated revaluation gains of 1.5% (being the rate of inflation) and it increases the net benefits to acquirers of control of AIAL by $0.881 million per annum from the revised base case. It is not clear if this would have been sufficient to change the minority's recommendation. However, if this alternative approach was adopted it would still result in small net benefits to acquirers and therefore would not affect our preliminary conclusion.

Used and Useful

42 The Commission has deducted land that it considers is not needed for the operation of airfield activities from the asset base. In the case of WIAL, it has deducted airfield land that is leased out to third parties. In the case of AIAL, it has deducted the seabed, Wiroa Island and the Eastern Approaches land as being surplus to the requirements to run the airport. The Commission justifies its approach by stating that the airport is protected from conflicting uses of this land by zoning and planning constraints and ownership is not necessary.

43 AIAL submits that Wiroa Island facilities are used for navigational purposes by the Airways Corporation. However BARNZ submits that this does not require AIAL to own the island, and the Commission points out that the Airways Corporation should bear this cost and not the airlines. AIAL also raises a number of technical points about how the Commission has removed these assets from the asset base, which if accepted would reduce excess returns.

[10] In correspondence to you WIAL has noted the Commission's recommendation that either replacement cost or historical cost valuation methodologies are appropriate in the electricity lines business sector if consistently applied.

Future Capital Investment

44 The Commission has deducted land held by AIAL for development of a second runway from the asset base. The runway is unlikely to be required before 2008 at the earliest and it considers that current consumers should not bear the costs of this future development until at least construction has begun.

45 AIAL argues that removing this land from the asset base imposes irrational incentives on AIAL to now sell the land, which it had prudently acquired, and pay a higher price to purchase it in the future when it is needed. BARNZ submits that the purchase of the land was prudent and they have no quarrel with AIAL's decision, but note that AIAL made the purchase without the agreement of airlines. They note that the Commission has shifted its position to allow airports to earn a return from when construction begins rather than when facilities first come into use, as provided in the draft report. We note that the Commission's recommendations are sensitive to the treatment of the second runway.

Opening Asset Values

46 In calculating excess returns in each year, the Commission has used asset values at the beginning of each year multiplied by the weighted average cost of capital (WACC), rather than a midyear average value as was used in the draft report. This means investment during the year does not earn a return until the beginning of the next period. AIAL says that this understates the asset base by approximately 10% and has a significant impact on the calculation of excess returns.

Weighted Average Cost of Capital

47 The WACC is a normal rate of return required to attract debt and equity investment in airports. The Commission writes that "as well as being compensated for bearing the entity's capital costs, operating and maintenance expenditure, and taxes, capital providers earn a rate of return that reflects what they could be earning by committing their funds to an alternative project of similar risk – their opportunity cost of capital."

48 The appropriate WACC is airport specific. The Commission notes that determination of the elements of WACC is subjective and involves considerable uncertainty. If WACC is too high, airport operators will be able to achieve excess returns, while if it is too low, it may discourage investment. For this reason, the Commission estimates a range of WACC for each airport around a point estimate.

49 The key elements for calculating WACC are:

a The relative proportions of debt and equity in the firm – ideally these weights should not be influenced by annual variations and should reflect some long term or target proportions of the company. The Commission has calculated the actual leverage ratio for AIAL at the time the prices were set and used this for all the three airports. The Commission's advisor, Dr Martin Lally, advises that the leverage ratio exerts little effect on the WACC calculation.

b The risk free rate – this is the interest rate that an investor would earn on a riskless investment and government stock is typically used. The Commission's approach is to use an average yield on government stock over the period in which each of the airport's consulted with the airlines (ending with the point at which the new prices came into effect) and with a maturity matching the point at which prices will again be reviewed.

c Debt premium – this represents the additional premium above the risk free rate that is required by investors to hold debt. It reflects marketability and exposure to the possibility of default. The Commission adopts a debt premium of 1% for the three airports.

d Market risk premium – this represents the additional premium that investors require to hold the market portfolio over and above the return from riskless assets. It is not affected by firm specific factors, but its calculation is the subject of debate. The Commission adopts a tax-adjusted MRP of 8%, being the midpoint in a range of 7 – 9% derived by the alternative methods of calculation.

e The respective asset and equity betas – beta measures systemic risk or the sensitivity of assets returns to market returns. This can differ between companies, as each company may have different sensitivities to changes in the economy due to such factors as customer profile, operating leverage, capital structure, etc. This is the most subjective element of calculating WACC. The Commission has used regulated US utilities as a benchmark to calculate the asset beta.

f Adjustments for tax – The Commission has adjusted the WACC post corporate tax.

50 A comparison of the WACCs for each of the airports, as calculated by that airport and by the Commission, is shown in the following table.

	AIAL	**WIAL**	**CIAL**
Commission	7.21% to 9.81%, point estimate 8.41%	8.07 to 10.67%, point estimate 9.27%	7.68 to 10.28%, point estimate 8.88%
Airport	8.5 to 9.4%	9.5 to 11.5%	10.15%

51 The main contention in submissions is the calculation of the asset beta, using a benchmark of regulated utilities, and the use of AIAL's leverage ratio for the other two airports rather than their actual leverage ratios. The Commission considered these matters, including obtaining expert advice, and we are satisfied that its approach is reasonable.

52 More generally the airports emphasise the uncertainty with calculating WACC and recommend that the Minister focus on the WACC range rather than just the point estimate when assessing the extent of excess returns and net benefits to acquirers. We agree with this view.

Net Earnings

53 The Commission has forecast net earnings over the period of the current price agreements. Forecasts are produced for CIAL and WIAL to 2003 and to 2007 for AIAL. As WIAL was currently in negotiations on price increases at the time the Commission completed the inquiry, the Commission estimated an interim increase of 10% in WIAL's charges. The main points of contention in the submissions relate to projected increases in operating and capital expenditure.

54 The airports generally submit that future operating expenditure should be increased at a greater rate than the 1.5% inflation rate used by the Commission. They outline increases in insurance costs since September 11, fluctuations in airfield operating expenses to carry out required maintenance, and the fact that a large proportion of the costs are wage related and have been escalating recently at an annual rate of [ ].

55 More specifically, AIAL submits that the Commission should have increased operating expenditure by the inflation rate for 2005 to 2007 and some allowance should be made for future capital expenditure. We discuss these issues in more detail in the summary at the end of this section.

56 AIAL also identifies a numerical error in the Commission's analysis whereby the Commission has used international MCTOW figures in its forecasts rather than all traffic figures. The Commission has accepted that it made an error and the corrected data has been incorporated into this report.

Excess Returns

57 Taking into account the two numerical errors identified in the Commission's report, the Commission has estimated excess returns for each of the airports as follows:

Estimated Excess Returns for AIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	1,662 to 5,958	3,975
2002	1,938 to 6,877	4,598
2003	-(211) to 5,459	2,842
2004	-(1,102) to 4,960	2,162
2005	-(1,842) to 4,683	1,671
2006	-(1) to 6,313	3,399
2007	1,875 to 7,977	5,161
Average	331 to 6,033	3,401

Estimated Excess Returns for WIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	-(1,798) to -(5)	-(833)
2002	-(2,596) to -(840)	-(1,650)
2003	-(1,166) to 574	-(229)
Average	-(1,854) to -(90)	-(904)

Estimated Excess Returns for CIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	-(2,421) to -(1,453)	-(1,900)
2002	581 to 1,572	1,115
2003	-(437) to 620	132
Average	-(759) to 246	-(218)

58 Based on this analysis, AIAL is forecast to consistently make excess returns at the WACC point estimate over the period, and generally make excess returns over the majority of the WACC range throughout that period. WIAL is forecast to generally make losses at the WACC point estimate and over the WACC range, while CIAL is approximately breaking even at the WACC point estimate.

NET BENEFITS TO ACQUIRERS – COMMISSION'S ANALYSIS

59 The second part of the Commission's building block approach in determining whether the threshold in section 52(b) is met is to assess whether control would lead to a net improvement in acquirers' economic welfare. Acquirers in this case are the airlines and, indirectly, the passengers of the airlines.

60 The key elements of this analysis are:

a The benefits to acquirers of control – this is calculated as being largely equivalent to the removal of the identified excess returns, and the potential for further price reductions to acquirers as control imposes stronger incentives on the airports to minimise costs and reduce productive and dynamic inefficiencies. The potential for productive and dynamic efficiency gains are assessed on an airport by airport basis;

b The costs of control – there will be direct costs associated with implementing control incurred by the Commission and the controlled airport. In addition, there will be indirect costs arising as a consequence of control being imposed, which relate to an inability for control to achieve all the benefits identified above and the potential for it to create further inefficiencies. The Commission has assumed that all of these costs are incurred by the controlled airport,[11] and in turn are passed on to acquirers in the prices they pay. These costs are additional to the current costs imposed on airports by the consultation and disclosure regime under the Airport Authorities Act.

61 The Commission has assessed the net benefits to acquirers of control as being the difference between the benefits and costs of control. The Commission has assumed that price cap regulation is imposed to estimate the costs of control, but other forms of control are possible. There are also significant difficulties in estimating the indirect costs of control. The method used by the Commission is to assume that 25% of the excess returns are not removed, and potential

[11] The Commission's costs will be recoverable from the controlled airport through a cost recovery levy under section 74 of the Commerce Act 1986.

productive and dynamic inefficiencies of control are a proportion of the assessed productive and dynamic efficiency gains for each airport of between 0 – 2% and 50 – 100% respectively.

62 Incorporating the corrections of the two numerical errors identified in submissions, the Commission has estimated net benefits to acquirers of control for each of the airports as follows:

Net Benefits to Acquirers of Control for AIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	89 to 4,123	2,097 to 2,239
2002	[ ]	[ ]
2003	[ ]	[ ]
2004	[ ]	[ ]
2005	[ ]	[ ]
2006	[ ]	[ ]
2007	[ ]	[ ]
Average	-(1,042) to 4,146	1,656 to 1,784

Net Benefits to Acquirers of Control for WIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	-(3,179) to -(625)	-(1,832)
2002	-(3,981) to -(1,461)	-(2,652)
2003	-(2,543) to -(189)	-(1,227)
Average	-(3,235) to -(758)	-(1,903)

Net Benefits to Acquirers of Control for CIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	-(3,749) to -(1,993)	-(2,883)
2002	-(883) to 636	-(95)
2003	-(1,757) to -(73)	-(830)
Average	-(2,130) to -(476)	-(1,252)

63 The submissions contest the Commission's assessment of net benefits to acquirers of control in principle and in the manner it has been estimated. BARNZ submits that the costs of control should not be taken into account in deciding whether or not to recommend control, as it has the effect of condoning a certain level of excess returns before control could be contemplated. WIAL submits that consideration should be given to the state of competition in assessing whether it is "necessary or desirable to impose control" in accordance with the criteria in section 52(b) of the Commerce Act.

64 The submissions generally contest that the benefits and costs of control have been over or under estimated. AIAL submits that the benefits of control are overstated by including 0 – 2% productive efficiency gains additional to the 14% nominal gains already forecast in the estimate of excess returns. WIAL submits

that the method of estimating costs of control as a proportion of benefits of control is flawed, particularly in respect of productive and dynamic efficiency effects, as it means that the costs can never exceed the benefits.

SUMMARY OF ASSESSMENT OF THE COMMISSION'S ANALYSIS

65 In its letter to you of 31 October 2002, the Commission considered the impact of the submissions and advised that the correction of the two numerical errors in its report did not affect its recommendations. On the basis of its analysis the Commission continues to recommend that the airfield activities supplied by:

a Auckland International Airport should be subject to control; and

b Wellington and Christchurch International Airports should not be subject to control.

66 The Commission has also identified four other matters raised in submissions that are not errors but are issues of judgement that could be reconsidered. These four matters relate to treatment of inflation on operating expenditure, future capital expenditure, cost of capital, and future land revaluation gains for particular airports.

67 The Commission states in its letter to you that, in light of it having considered these four matters in its final report, it is not advocating that you incorporate them into your decision on whether to recommend control. The judgements made at the time the Commission prepared its final report took into account a range of factors, including the absence of available information and the difficulty of making forecasts. With the benefit of these further submissions, the Commission considers that there may have been a case for incorporating the impact of these matters, although its notes that all forecasts have a degree of uncertainty.

68 If all the points were accepted, the net benefits to acquirers of control for AIAL and WIAL would be as follows:

Net Benefits to Acquirers of Control for AIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	768 to 4,805	2,778 to 2,920
2002	[ ]	[ ]
2003	[ ]	[ ]
2004	[ ]	[ ]
2005	[ ]	[ ]
2006	[ ]	[ ]
2007	[ ]	[ ]
Average	-(705) to 4,527	1,997 to 2,126

Net Benefits to Acquirers of Control for WIAL ($000s)		
	Over WACC Range	**At Point Estimate**
2001	-(2,651) to -(229)	-(1,305)
2002	-(4,038) to -(1,503)	-(2,700)
2003	-(1,611) to 532	-(460)
Average	-(2,767) to -(400)	-(1,488)

69 The result is the net benefits to acquirers of control for:

a WIAL would be marginally increased but still remain negative; and

b AIAL would be within a range of $1.9 - $2.1 million per annum at the WACC point estimate (up from $1.6 – $1.8 million in the corrected analysis). Coincidentally this is a similar amount to that in the Commission's final report before the error correction.

70 This result does not have an impact on our preliminary conclusions. We note, however, that in revising the analysis we have assumed revaluation gains of 1.5% (being the inflation rate) similar to that used for specialised assets when revising the minority Commissioners' analysis. The analysis is very sensitive to the level of revaluation gains, such that if 3% had been used, the net benefits to acquirers are almost doubled. Given the uncertainty with calculating revaluation gains, we consider that you note that the Commission's analysis is sensitive to these matters. However, we recommend that you continue to focus primarily on the corrected report analysis and do not incorporate these new calculations into your decision.

NEW INFORMATION SINCE COMMISSION REPORT

71 The major new information since the Commerce Commission's report is the recent increase of landing charges by 77.7% announced by WIAL to take effect from 1 July 2002 (equivalent to $4 per passenger). The majority of this increase relates to the development of the new Wellington terminal at a cost of $116 million, which is outside the scope of this inquiry. However, 27.6% of the increase relates to airfield activities, and this includes the 10% interim increase already taken into account by the Commission. [ ] we are able to advise you on this issue without referral to the Commerce Commission.

72 We have analysed the points of disagreement that arose in the consultation process between WIAL and BARNZ in setting the new prices. [

].

73 We have been provided (in confidence) copies of proposals and submissions provided to WIAL as part of the consultation process. [

].

July 2002 WACC for WIAL	
Commission methodology	7.34 to 9.94%, point estimate 8.54%
WIAL Airport	10.0%

74 A full reconsideration of the impacts of this 27.6% increase on the criteria under section 52 of the Commerce Act would require recalculation of WACC and forecast returns over the revised price period. This would be a relatively involved process. We have undertaken a simple analysis increasing prices from April 2002[12] by 27.6% using a revised WACC as at 1 July 2002 (being 8.54% at the point estimate). The results are as follows:

27% price increase for 2002/03 for WIAL ($000s)		
	Over WACC Range	**At Point Estimate**
Excess returns	975 to 2,675	1,891
Net benefits to acquirers	-(684) to 1,383	399

75 Net benefits to acquirers of $0.399 million per annum at the point estimate are considerably less than those estimated for AIAL of $1.6 – $1.8 million per annum. Given our view that these net benefits for AIAL are not sufficient to recommend control, we have not considered it necessary to make an assessment of whether WIAL would meet the criteria under section 52 of the Commerce Act and, as such, whether control may be imposed for WIAL.

RELEVANT MATTERS FOR MINISTER'S CONSIDERATION

76 In our preliminary advise to you of 16 December, we outlined relevant matters that you could consider in determining whether you should recommend control for AIAL. These relevant matters were:

a The level of prospective net benefits to acquirers from control as a proportion of total landing charges paid to AIAL, and as a proportion of AIAL's net profit from airfield activities. We outlined that these proportions for AIAL were 3.1% and 7.9% respectively;

[12] The price increase came into effect on 1 July 2002. We have backdated the increase to April to allow consideration of the increase in charges over a 12 month period. This provides a better assessment of the impact of the increase in charges going forward.

b The sensitivity of the Commission's analysis to other less costly forms of control – our preliminary conclusion was that other less costly forms of control may also result in less benefits if they are less effective in reducing excess returns and encouraging efficiency gains, and therefore the Commission's final analysis may not be sensitive to alternative less costly forms of control;

c The net public benefits of control – we outlined the importance of net public benefits of control from a public policy perspective when considering interventions. A net public benefit analysis differs from net benefits to acquirers, as it is neutral as to income transfers between acquirers and suppliers and focuses on the net impact for New Zealand. A net public benefits analysis is consistent with the purpose of the Commerce Act 1986;

d Market interventions other than control, such as enhanced information disclosure, alternative dispute resolution, or enhanced consultation processes were available if Ministers requested these be explored, and

e The precedent and signalling effect of your decision on market behaviour by airport companies and across the economy generally.

77 We outlined that negative net public benefits of control and, in our view, not significant net benefits to acquirers of control were a matter that you should give weight in your decision.

Net public benefits of control at AIAL (000s)		
	Over WACC Range	**At Point Estimate**
2001	-(1,087) to -(117)	-(724) to -(582)
2002	[ ]	[ ]
2003	[ ]	[ ]
2004	[ ]	[ ]
2005	[ ]	[ ]
2006	[ ]	[ ]
2007	[ ]	[ ]
Average	-(1,164) to -(146)	-(757) to -(629)

78 Net public benefits at the WACC point estimate will be between -$0.757 and -$0.629 million on average based on the corrected report analysis. Net benefits to acquirers are only $1.7 million per annum on average and are negative at the upper range of the WACC estimate.[13] We estimate that if the airlines passed on the full reduction in charges to passengers, it would result in approximately a 35 cents reduction in the average price for a one-way trip.[14] We consider that passengers are unlikely to be demand sensitive to this level of price change.

[13] If the revised judgements relating to capex, opex, and land revaulation (1.5%) are also taken into account, the net public benefits continue to be negative and the net benefits to acquirers are approximately $1.9 to 2.1 million on average, but still negative at the upper range of the WACC estimate.
[14] Based on figures provided by WIAL in the Dominion Post (1 March 2003).

79 The submissions have also commented on these matters. In respect to other market interventions, BARNZ and the airlines outline their strong support for the Commission's pricing principles (applying the building block approach) developed in the report and note that these principles would be a significant enhancement to the current consultation process. The adoption of the Commission's pricing principles in the Airport Authorities Act 1966 would be effectively a form of price control with oversight by the Courts rather than the Commission. Adoption of this approach would require an assessment by Ministers that airports should charge efficient prices rather than what is within the bounds of reasonableness for a commercial undertaking.

80 The Ministry of Transport has put on hold an operational review of the information disclosure regulations and consultation requirements pending the outcome of your decision on control. The priority, scope and timing of this review will be reconsidered in light of your decision and other government priorities.

81 Our view is that a decision on whether or not to recommend control should be made on its merits and any further work on other policy options should proceed independently.

82 The submissions have also identified additional matters that you may consider, including:

a International obligations; and

b Incentives on investment.

International Obligations

83 [

]. These obligations are a relevant matter for your decision.

Incentives on Investment

84 The airports and the shareholders of the airports outline that a recommendation of control would deter investment in airports and infrastructure generally in New Zealand. The concern is that a recommendation of control would be an endorsement of the Commission's methodology, in particular the opportunity cost principle and the use of historical cost methodology for specialised assets. They argue that the opportunity cost principle is novel, not used by any other international regulatory competition authority, and its implementation imposes considerable uncertainty as it is not based on understood guidelines.

85 WIAL and its shareholders in particular outline that, if adopted, the Commission's approach would result in a significant expropriation of returns to existing investment. In 1998, the Crown tendered its 66% stake in WIAL, and in 1999, Infratil bought out its co-investors so that WIAL is now jointly owned 66% by Infratil and 34% by Wellington City Council. Infratil advises that its investment cost $116.8 million and to date has provided modest returns of approximately 8% pa. before tax. In purchasing shares Infratil assumed that WIAL's assets would be valued conventionally and in accordance with the Airport Authorities Act as then recently interpreted by the High Court (and Court of Appeal) and supported

by the Crown as majority shareholder of WIAL at the time. They argue it would be inequitable for the Crown to receive payment for shares in WIAL based on a replacement cost valuation and then regulate a different methodology that expropriates those new shareholders' returns.

86 We consider that the imposition of control should not of itself deter investment if it is based on sound principles and gives predictability to future investment decisions. As this is the first control inquiry under the Commerce Act 1986, it is understandable that it has created some uncertainty and the Commission's methodology may not have been anticipated by incumbent investors. We further consider that forms of control such as price cap regulation have a high risk of regulatory error, which can cause distortionary incentives on investment. Therefore when taking into account incentives on investment we consider that control should only be imposed when the problem identified is significant and other means to address the problem are not effective.

CONCLUSION

87 Having regard to matters raised in submissions, we consider that you should accept the Commission's advice (as corrected) and be satisfied that the criteria in section 52 of the Commerce Act are met such that you may impose control on airfield activities for Auckland International Airport. In addition, there is no basis for imposing control on airfield activities for Christchurch International Airport.

88 We consider, however, that in deciding whether you should recommend control for AIAL, you should have particular regard to:

a the negative net public benefits of control (i.e. -$0.7 million per annum); and

b the fact that the net benefits to acquirers of control for AIAL are not significant (i.e. approximately $1.7 million per annum) and have negative values at the upper end of the WACC range.

89 We recommend that you should not recommend control for AIAL.

90 In terms of WIAL, we have reviewed the Commission's analysis given new information relating to the recent increase in landing charges of 27.6%. Doing a very simple analysis, we have calculated that the net benefits to acquirers of control for WIAL will be in the order of $0.399 million per annum. This is considerably less in both absolute and proportional terms than for AIAL and as such we consider that you should not recommend control for WIAL.

91 We recommend that you inform your Cabinet colleagues of your intention to make a decision on this basis. A draft Cabinet paper is attached for your consideration.

Review of Part IV of Commerce Act

92 As discussed in our paper of 16 December 2002, we also think that this inquiry has identified some problems with applying the provisions of Part IV of the Commerce Act. The criteria for when control may be declared are poorly targeted. Our preliminary view is that the test of "limited competition" is too low,

as this could apply to many markets in New Zealand.[15] The relationship between the net benefits to acquirers and net public benefits could also be considered.

93 In addition, the inability of the Commerce Commission to consider what form of control it may impose constrains its analysis and means that if control were declared a further inquiry of potentially similar size would need to be undertaken to implement control. This seems inefficient. We recommend that MED officials carry out a review of these provisions. This review would need to be sensitive to the regulatory control inquiry into the gas pipeline sector currently underway.

Risks

Legal

94 A decision whether or not to recommend control is subject to judicial review under Part IV of the Commerce Act 1986.

Conflict of Interest

95 We note that the Minister of Finance, Dr Cullen, has a conflict of interest in respect of your decision on control of airfield activities, due to his ownership interest in Air New Zealand. We recommend that you do not discuss this matter with him or copy him any relevant papers.

Communications

96 The communication of your decision will need to take into account that Auckland International Airport is publicly listed on the New Zealand and Australian stock exchanges. We anticipate that there will be significant interest in your decision. We suggest that you release copies of this advice paper and the subsequent Cabinet paper with your decision (with any deletions due to commercially sensitive information and legal client privilege).

Recommended Action

We recommend you:

1 **Note** our view that you should not recommend control on airfield activities for Auckland, Wellington or Christchurch International Airports;

2 **Agree to** submit a paper to Cabinet on this basis (a draft is attached);

agree/disagree

3 **Agree** that MED officials should scope out a review of the provisions of Part IV of the Commerce Act to ensure that it is appropriately targetted; and

agree/disagree

[15] This threshold of "competition is limited or is likely to be lessened" also appears in the Telecommunications Act 2001 in respect of the threshold for declaring designated access services provided by Telecom. The telecommunications industry will have an interest in any review of this threshold in the Commerce Act and any implications this may have for the Telecommunications Act.

4 **Agree** to the release of this paper and the final Cabinet paper as part of your media release (with any deletions due to commercially sensitive or legally privileged information).

agree/disagree

Rory McLeod
Manager
Regulatory and Competition Policy Branch

Hon Lianne Dalziel
Minister of Commerce