Board of Airline Representatives NZ
6 Leonard Isitt Drive, Auckland Airport
Auckland 2022

9 August 2023

To: Vhari McWha
Commissioner
Commerce Commission
PO Box 2351
Wellington 6140

By email: IM.Review@comcom.govt.nz

Kia ora,

Board of Airline Representatives (BARNZ) represents 26 member airlines, as well as ground handlers, catering companies, waste management companies, and baggage system suppliers. Our members supply New Zealand with air services, delivering these at airports around New Zealand. We are pleased to provide this cross submission to the IM Review. Accompanying our submission is an independent report from TDB Advisory.

The Input Methodologies (IM) Review is a very important process. Airports set prices including a return informed by the IMs. Under Information Disclosure Regulation, regulated airports are able to target a return which departs from the IMs, and from the Commission's published airport WACC, as long as they justify that departure. To date, the departure airports make has always been higher. AIAL has just set prices for 2.5 billion dollars of capex including an 8.73% return. There is a lot at stake.

The Purpose of Part Four must be met

In conducting the IM Review, the Commission is tasked to ensure it is meeting the purpose of the IM Review under the purpose of Part 4 – that is ensuring:

"*the long-term benefit of consumers …by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—*

(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
(d) are limited in their ability to extract excessive profits."

All these purposes are important. BARNZ agrees that airports should be appropriately incentivised to invest in their assets in a sustainable manner over time. That investment should be efficient – it should not be incentivised to be excessive, gold-plated or otherwise inefficient. Those efficiency gains should be shared with consumers and excess profit taking should be limited.

This purpose is at the heart of the IM Review. The work of the Commission on the IMs to date has been pragmatic, reasonable, and fair. It has reviewed both their result and their construction, to ensure the purpose of Part Four is being met.

Monopoly airports have submitted to protect excess profits

Airports have submitted substantially against the Draft Decision on the Cost of Capital. Some 660 pages of submissions have been put forward, covering a range of concerns. BARNZ and TDB will respond to many of these points. However, at heart, BARNZ would commend the work of the Commission to date, and ask that it hold its ground in the face of this strong reaction from monopoly airports, who are seeking to expand their asset base and retain (and grow) an excess profit margin, to the benefit of their management and shareholders.

Demand risk will arise from extreme capex and target returns

BARNZ noted with interest the template submissions made by airports beyond regulated airports. We would caution against too much weight being applied to these submissions. It is questionable the extent to which these airports and Councils understand the impact that might be felt by them in the event that regulated airports are able to lock in excess profits.

Should AIAL achieve and retain an 8.73% WACC on capex of 2.5 billion dollars to 2027, and similar returns for 3.1 billion dollars in PSE5, prices set as a result of the extremely high capex and heavy margin will affect demand for other airports in New Zealand, reducing domestic air services in particular. Reduction of demand will mean other airports have a reduced ability to invest in their own infrastructure, risking airport infrastructure development beyond Auckland.

RAB multiples show us something is wrong

BARNZ submits that the Commission maintain its focus on total system settings and outcomes. CEG and other submitters have focussed extensively on adjustments to the comparator companies, and on the Commission's treatment of the Covid-19 pandemic. However, there is little discussion of the proposed WACC and the reasonableness checks that surround this. There has been no discussion of the RAB multiples currently achieved by airports. BARNZ notes that recent Forsyth Barr advice indicates AIAL has a share-price based enterprise value materially higher than its asset base, estimating a RAB multiple of 2, indicating the airport is generating returns in excess of what is intended in a well-regulated market.

The Commission has argued persuasively that its proposed WACC is appropriately located within the spectrum of market returns available in NZ. CEG and others provide no counterarguments to this. As BARNZ and TDB have argued in earlier submissions, the RAB multiples provide compelling evidence that investors in AIAL have been more than adequately compensated for putting their capital at risk.

It is notable that, despite the multiple investor concerns cited by AIAL since the draft IMs were issued in mid-June, AIAL's share price – which should be the most useful indicator of overall market sentiment toward this company – has not reacted with any substantial or persistent change. Investors do not assess that there is a risk to their returns. They are buoyed by the regime in place, which AIAL has advised them will protect their returns.

Covid-19 warrants special treatment

Treatment of Covid-19 is an issue well canvassed in submissions. CEG continues to argue that Covid should be treated like any other shock – such as the GFC and euro-area debt crisis – and included in the five-year beta averages without further adjustment.

BARNZ submits that Covid-19 was an extraordinary event, and particularly extraordinary for the aviation and travel sector. It spanned the globe, impacted states and businesses, halted travel, and resulted in the deaths of millions of people. It was an event of scale that has rarely, if ever, been seen in world history outside of world war events.

The Covid-19 pandemic more than warrants the special treatment it has received in the Commission's draft IMs and the departure from past practice in estimating the betas. The proposed treatment is reasonable. Not to adjust for this event would set the regime off balance for at least as long a period as the regime has been in place.

It is not appropriate to 'set and forget' the Input Methodologies

Submissions for the airport companies make much of the need for regulatory certainty. BARNZ submits that the overall Input Methodologies approach (and the Information Disclosure regime that applies to regulated airports) is in fact a relatively new regime. This is only the second full review of the Input Methodologies. The Commission would do New Zealanders a disservice if it was to 'set and forget' these rules, especially in the face of high RAB multiples for regulated monopolies, or when grappling with the right response to a pandemic event, the like of which we have never seen in modern times.

To apply the previous IM approach without question would lead to poorer regulatory outcomes. Making adjustments, with an eye to the total system settings and outcomes, is appropriate to ensure the IMs are relevant and fit for purpose – delivering outcomes which are in the long term best interest of consumers.

Airline pricing arguments are incorrect, and irrelevant

Submissions from NZAA, AIAL and others dwell at some length on airline pricing behaviour, suggesting inter alia that the Commission's draft decision would amount to an unjustified and undesirable transfer of profits from airports to airlines. BARNZ submits that such arguments are first incorrect, and second are largely irrelevant to the issue at hand.

The IM review addresses the regulation of airports and other monopoly or quasi-monopoly suppliers, including determining an appropriate cost of capital for these entities. Airline pricing, or airline regulation more broadly, does not fall within the scope of the IM review. In contrast with airports, airlines operate in a competitive environment. Reflecting this, fluctuations in profits above/below 'normal' market levels are expected to, and do, lead to entry/exit in particular market segments and other changes in supplier behaviour.

A clear example of such response comes in the growing number of international carriers now coming into Auckland, and the sharp fall in international airline pricing observed in New Zealand's June CPI data[1] following a peak of pricing arising from constrained capacity and unmet demand.

Speculation by airports and their advisers on how changes in airport regulation will impact airline pricing is not material to the current IM review. In a workably competitive market, competition can and does impact prices for consumers. For regulated monopolies, this is not the case without a well-designed and executed regulatory regime.

BARNZ thanks the Commission for their work to date. We remain available should the Commission have questions, both now and into the future.

Ngā mihi -

[redacted]

Cath O'Brien
Executive Director
Board of Airline Representatives New Zealand

[1] https://www.stats.govt.nz/information-releases/consumers-price-index-june-2023-quarter/