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

2 September 2024

Regulation Branch
Commerce Commission
Wellington

By email: infrastructure.regulation@comcom.govt.nz

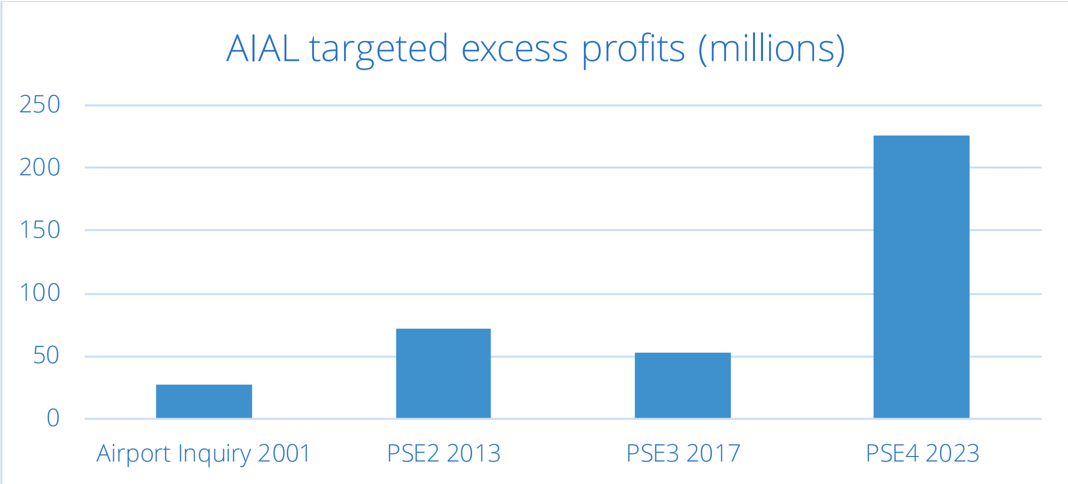
Re: Review of Auckland Airport's 2022-2027 Price Setting Event – Consultation Paper

Thank you for the opportunity to respond to the draft decision of the Commerce Commission with respect to Auckland International Airport Limited's (AIAL's) Price Setting Event 4 (PSE4). The Board of Airline Representatives New Zealand (BARNZ) represents 25 member airlines, all operating services to and from Auckland Airport. On behalf of our member airlines, BARNZ meets the definition of substantial customer. We note that some of our members will make independent submissions to this consultation process.

## AIAL pricing under Information Disclosure

BARNZ was pleased to find that the Commission identified that AIAL is targeting excess profits when it set its cost of capital. BARNZ submitted to this effect during price consultation with AIAL, in two separate written responses. In a scenario where the basis for cost of capital assumptions should be the 2016 Input Methodologies, it was clear to all participants (likely including AIAL) that the target WACC of 8.73% set by AIAL was far too high, set using conflicting and unjustified inputs.

Since the inception of the Information Disclosure regime for monopoly airports, AIAL has consistently applied a target return in excess of what is justified. In fact, the only thing that has changed over the course of the life of the Information Disclosure regime is that AIAL's attempts at excessive profit taking have become more excessive.




Despite the fact this consultation was carried out under non-disclosure agreement (NDA) at AIAL's insistence, the Commission can be assured that BARNZ and others pointed out to AIAL in written submissions supported by independent economic advice that its cost of capital inputs were inconsistent and unjustified.[1] However, as is always the case, the airport remained committed to parameters set to target an excess profit.

It would be more remarkable had AIAL **not** targeted excess profits. Airlines have come to expect that Auckland Airport will target an excess profit when setting prices. The only question is, how much? In undertaking price setting, AIAL has learnt that to extract the highest returns, it should target excess profits. Following a year of consultation and a further year of Commission Review, AIAL can respond as necessary to the Commission's indication of excess range, reducing prices only as much as the airport company believes will satisfy the process. In this way, no possible return is left 'on the table'. Meanwhile, airlines and their customers pay excessive prices without contract for years.

This process leaves BARNZ wondering what AIAL considers the point is of consultation with substantial customers on cost of capital if no meaningful engagement occurs or change is delivered – aside from satisfying the requirement for consultation. It would save significant resource and time if airlines simply accepted the airport will target excess profits and waited for the Commission to indicate the acceptable justified range.

The information disclosure regime does not restrain AIAL from targeting, and collecting, excess profits. There is no penalty should an airport target excess profits and continue to do so over

[1] BARNZ has been notified in recent days that the NDA as applies to PSE4 consultation will be temporarily waived, following a request made by the Commerce Commission to AIAL. BARNZ welcomes this development. BARNZ had already requested the NDA between it and AIAL be removed in future periods or be varied to allow information to be shared with government agencies. This request has not been granted by AIAL. BARNZ was recently required to confirm acceptance of its NDA with AIAL to receive information about proposals for development of the current domestic terminal. The ability of regulated airports to bind substantial customers to individual NDAs limits what should be an open discussion with border agencies on design and operation of future facilities. BARNZ considers NDAs as insisted on by AIAL to be unnecessary, and notes consultation with other regulated airports proceeds without concern even in the absence of such agreements.

multiple periods. While the Commission appears to draw comfort from the fact that AIAL may re-set prices to return some of the excess profits targeted on 1 July 2025, BARNZ member airlines are not similarly comforted. BARNZ member airlines have been paying these prices since they were set more than a year ago in July 2023. Any price reduction will not occur until excessive prices have been paid by airlines until July 2025: some two years into the regime. In that time, one BARNZ member airline has become insolvent, and several have reduced their presence in the market – so will not pay landing fees in the measure they may have been paid in the over-recovery period.

There is no other regulated company which is permitted to over-charge its customers so excessively and for so long. The information disclosure regime not only *allows* for this predatory pricing behaviour but *encourages* it. If AIAL does not target excess profits, it is not maximising returns inside the regime. As the regime does not penalise airports who set prices like this, we can only expect other airports to price in a similar manner in future periods.

## Specific comments on Cost of Capital

BARNZ fully agrees with the Commerce Commission's draft conclusion that the WACC of 8.73 percent proposed by Auckland Airport is not justified. The Commission is absolutely correct in its assessment that, to reach such a WACC, Auckland Airport has applied excessive and unjustified changes to some key WACC parameters – notably the asset and equity betas together with leverage. The Airport's rationale for adjusting WACC parameters has not been consistently applied, notably with respect to its choice of the TAMRP.

The Commission sets out two alternative scenarios for estimating the WACC. Both of these are internally consistent and have a much stronger rationale than that proposed by Auckland Airport. The first scenario draws on WACC parameters that were in force at the Airport's self-selected estimation date of 1 July 2022. As a result, this scenario uses the prevailing estimates for the asset and equity betas and leverage from the 2016 IM review, with updates to the risk-free rate, debt premium, and TAMRP consistent with the estimation date. These parameters lead to a mid-point post-tax WACC of 7.28 percent.

The second scenario proposed by the Commission draws on the new beta and leverage estimates that arose from the 2023 IM review, along with the updated TAMRP estimate of 7.0 percent used in that review. This scenario implies a WACC of 7.51 percent. We note that in using these latest beta and leverage estimates, the Commission considered and again rejected many of the arguments that Auckland Airport and its advisors proposed at the time of the IM review and reiterated in its PSE4 submission, notably concerning how the Covid-affected period should be factored into the estimates.

BARNZ views both of the Commission's scenarios as analytically sound and far preferable to the Airport's proposal. Of the two options, however, we think there is a strong case for preferring Scenario 1, with a WACC of 7.28 percent. As the Commission notes, Scenario 1 is "*the option that is consistent with our standard expectation that the equity beta and leverage estimates that were made at an IM review would be applicable for the period of the IMs*" (para 2.69). In other words, Auckland Airport should have been expected to base its estimates on the 2016 IMs.

An “accident of timing” may not be the most appropriate expression, but it was an unusual set of circumstances that led to estimates from the 2023 IM review becoming available during the Airport’s PSE4 review. This unusual timing will not always occur, especially given the normal 7-year cycle of IM reviews and 5-year cycle of PSE reviews. Rather than considering the dual set of parameter estimates that have come available in the course of the current PSE4 review, we feel a more robust approach – one that can be applied consistently through time – would be to stay with the Commission’s “standard expectation” that the then-prevailing IMs from 2016 be used.

BARNZ considers that Christchurch Airport provides an important comparator and precedent in this regard. With a PSE4 period that is the same as Auckland’s, an estimation date (1 April 2022) just a little earlier, and as one of Auckland Airport’s very few domestic peers, Christchurch chose to use the beta and leverage estimates from the 2016 IMs. The Commission accepted Christchurch’s approach and deemed the resulting WACC to be reasonable. For consistency and robustness, Auckland should follow the same approach – implying use of the parameters in Scenario 1 and the WACC of 7.28 percent.

The Commission estimates that the higher-than-reasonable returns targeted by Auckland Airport would lead to the Airport earning excess profits of between $193.4 million and $226.5 million. In its press release of 17 July 2024 responding to the Commission’s report, the Airport accepts that it would adjust its pricing if the Commission’s final report continues to say that the WACC is too high. The Airport states that these price adjustments would take place from 1 July 2025 and apply to the final two years of PSE4, with the adjustments balancing out the effects of charges in place over the first three years of PSE4.

BARNZ certainly agrees that this balancing-out process has to occur, and we would also point out that this cannot be just dollar-for-dollar. It has to recognise the time value of money, with each dollar of excess revenues earned in the earlier years of PSE4 worth more than each dollar of reimbursement later in the period. In other words, the net present value of the excess returns and reimbursement has to end up at zero. This is equivalent to the Airport being required to pay interest when it reimburses airlines for its earlier overcharging.

## Depreciation

We agree with the Commission’s questioning of the depreciation method pursued by Auckland Airport. We support the Commission’s view that, in a context of rising customer numbers over the long period in which the Airport’s new investments will be used, the tilted annuity approach provides a better method than straight-line depreciation for spreading these investment costs more equitably over current and future airport consumers. There are also likely to be efficiency gains with the tilted annuity approach, in that depreciation changes will more accurately reflect the time pattern of usage and therefore the costs imposed. As the Commission observes, Christchurch Airport makes use of the tilted annuity approach, and we see this example as again providing a useful precedent and point of comparison.

## Demand

The Commission's draft decision asks whether Auckland Airport's demand forecasts for PSE4 are reasonable. In the context of Auckland Airport's extensive and multi period capital plan, the question the Commission needs to ask on behalf of consumers is whether the demand forecast made by Auckland Airport for PSE4 *and PSE5* is reasonable. If the Information Disclosure regime does not allow the Commission to address this question, in the context of a generational multi-period capital plan, an alternative regulatory regime should be applied which does allow this oversight.

As the Commission notes, demand forecasting and in particular price elasticity of demand was a key area of focus of substantial customers during price consultation. This is because AIAL and its customers were attempting to assess the impact of proposed prices as forecast by AIAL on customer demand for PSE4 and PSE5. To do this, both parties needed to use the forecast price paths to 2032 AIAL created for its customers which spanned PSE4 and PSE5. Given that price paths for PSE5 are not subject to information disclosure, BARNZ does not know whether the Commission has access to the upper and lower bound price paths for PSE5 AIAL shared with its customers in price consultation. If these have not been made available, BARNZ suggests that these are requested by the Commission, and considered.

The Commission correctly notes that substantial customers Air NZ and Qantas Group are concerned about the impact of prices on demand. In the BISOE demand studies commissioned by BARNZ with support of Qantas Group and Air New Zealand, and submitted to AIAL, demand impact is felt significantly by domestic and Tasman air services over PSE4 and PSE5. The effect of price on demand for international services was much weaker.

This effect makes sense. Tasman and domestic services are far more price sensitive than a long-haul fare at a higher price might be. That is not to say there is no impact on demand for long haul services – just that the effect is weaker.

AIAL argues that airlines first do not have to pass all landing charges on to customers, and second that costs are spread across different fare brackets proportionally – so even where costs are passed on, in AIAL's view they are paid by the higher cost ticket – and magically not paid at all by the lower cost sale ticket.

This logic does not hold true. Where costs are directly generated by landing charges, they apply to that fare – the fare is sold at a price which recognizes the costs that contribute to it. An airline will not offer fares at prices which are beneath the costs which contribute to providing that air service. When applying forecast landing charges of PSE4 and PSE5 to the lowest cost sale fares using market data from New Zealand operators – that application of new cost pushed up the price of that sale fare such that it could no longer be offered at that price.

BISOE found that when prices for Tasman and domestic air services were assumed to rise over PSE4 and PSE5 customers would make choices to fly using a lower fare class. As the customer base took a sideways step along the fare class band, there were ultimately a portion of customers who no longer purchased the sale air ticket. As AIAL's landing charges rose on the back of the increasing capital costs magnified by excess returns over time, a greater portion of customers fell out of the customer base. These customers are the demand impact.

BARNZ considers that the demand forecasts created by AIAL are a reasonable assumption of demand patterns post-pandemic absent any effect of prices set for PSE4 and proposed to be set by AIAL in PSE5. However, we do not consider demand for air travel to and from Auckland will be unaffected by prices set in PSE4 and proposed in PSE5 by AIAL.

In light of prices set in PSE4 and proposed in PSE5, BARNZ expects to see demand for travel reduce – and in particular to reduce for Tasman and domestic sale fare classes as prices for sale fares rise. After PSE4 prices had been set by AIAL, BARNZ received a Reasons Paper from AIAL, which explained its response to the second round of submissions on proposed (and by then, set) prices. BARNZ asked BISOE to review AIAL's arguments on demand in that Reasons Paper and has submitted this opinion to the Commission's PSE4 Review.[2]

BARNZ worked with Qantas Group and Air New Zealand to understand this demand impact during price consultation, commissioning independent advice and creating an environment where real airline data could be provided to third parties in confidence for assessment. This work was not easy to achieve. It is extremely commercially sensitive, such that even today, neither airline has seen the total domestic demand studies as they must be protected from seeing any information from their competitor in this market.

BARNZ has provided the BISOE studies to the Commission in completeness, in confidence. However, given that the domestic demand study relies on data supplied directly from competitor airlines Qantas/Jetstar and Air New Zealand, we are prevented by competition law from making the domestic demand studies wholly public in the submission process. BARNZ is happy to make these studies and any updates based on prices now set available to the Airports Association and to AIAL (noting AIAL received the original studies at time of first issuance) on the basis that their contents remain wholly confidential, including that they must be confidential to both contributing airlines in perpetuity.

Finally, in its draft decision, the Commerce Commission is missing the point of the discussion on demand at paragraph 3.78.3. The Commission notes that higher forecast demand will generate lower prices for consumers. That is true, if it occurs in a vacuum. In reality, lower demand arising from rising prices will bring us to a place where forecasts used for price setting in PSE5 may be lower than those which were forecast for PSE4. Capex committed to by AIAL in PSE4 will be commissioned in PSE5, and will unavoidably be brought to bear on prices in PSE5 – where there are likely to be fewer passengers remaining in the market to pay. This will cause prices for consumers to be higher again – both because the existing forecast has not accounted for demand destruction, and also because of the capex itself – which is so very high it causes prices to rise.

The capex itself is the real challenge of this PSE. It is a contributing factor to the $226.5 million dollars of excess profits, the cause of impact to demand as prices rise over PSE4 and PSE5. It is of such quantum and without significant additional capacity, carriers with greatest exposure to it are

[2] *Response to Airport Comments: Report Produced for BARNZ*, BISOE, 12 September 2023

baulking at the cost on their businesses. It will generate prices which will drive airlines to avoid it where they can – generating system inefficiency and reducing the economic wellbeing of New Zealanders where it causes carriers to avoid New Zealand in total.

## Capital cost

Auckland Airport is undertaking a generational investment in its infrastructure. The need for this has arisen following decades of inaction, further interrupted by the pandemic. The delay in investing in infrastructure has caused prices for capital cost to rise over time. While consultation has been underway under different plan titles since perhaps 2012, prices for that capex have shifted substantially through the years of delay. From the time that the integrated terminal was generally agreed in 2021, prices proposed by AIAL have risen almost at every consultative point.

Consultation Paper One issued in July 2022 proposed capex over PSE4 and PSE5 of more than $7 billion – causing BARNZ and other airline customers to immediately raise concerns about the huge shift in costs. Chief concerns raised related to the huge uplift in proposed costs against limited additional capacity gained for key infrastructure such international gates and check-in space. Submissions from BARNZ also raised concerns about the excessive target returns proposed – and we make similar arguments today. Through the (extensive) consultation process no substantial changes were made, resulting finally in a capital plan including approximately $6.6 billion dollars of capital cost.

Following initial concern raised by airlines on costs, AIAL ran a process to create a Revised Capital Plan. Airlines were hopeful this would include proposals to strip cost out of the programme at scale. However, the small plan changes proposed netted only some $400 million dollars in savings – and at the same time AIAL identified $600 million in additional costs – with the end result being that the Revised Capital Plan cost more than it had at the beginning of the process.

AIAL considers that there is no alternative to the capital plan it has proposed. BARNZ observes that through the consultation process, AIAL never appeared to genuinely seek out a more affordable alternative. Airlines consistently heard the message that this plan is the only possible solution. BARNZ observes than in building anything, there are always ways to reduce cost or change design – AIAL never demonstrated appetite for either during the consultation process.

The resulting capital plan remains extremely high cost. As we have noted above, this impacts prices and in turn impacts demand. During price consultation for PSE4, airlines submitted on these concerns. Before concluding price consultation, AIAL announced to the market that its board had taken decisions on substantial capital costs – proving that it would not be entertaining serious change to the Revised Capital Plan. This decision was taken just days after airline demand studies had been shared in the consultation process. The only step airlines could have taken at this point was to judicially review the decision to commit to capex, or to judicially review prices once set. Ultimately, this kind of step was beyond the financial and practical resource for BARNZ, bringing with it risk of losses which were not tenable.

BARNZ overwhelmingly considers that AIAL's consultation on capital costs was a façade.

## The Commission as verifier?

The Commission has stated in its Draft Decision that it considers the airport's capital planning is reasonable. BARNZ welcomes any attempt to examine the capital plans of the airport independently and considers this should be a core outcome of good governance over spend which is higher than almost anything else New Zealand is committing to as a country. However, BARNZ respectfully notes that the Commission is not appropriately qualified to interpret the planning assumptions of AIAL, its proposed footprint and whether these align with international standards as set by the International Air Transport Association (IATA).

The Information Disclosure regime does not require independent analysis of the capital plans proposed. This is an option under other forms of regulation available in the Commerce Act, and if the Commission considers that Information Disclosure is insufficient to regulate AIAL, the option of an Individual Price Path, with an independent verifier appointed to review capital plans to ensure they are both sufficient, efficient and reasonable would be an excellent option.

BARNZ member airlines overwhelmingly understand the need to invest in New Zealand's major gateway. A regime which allowed for verification of capital plans would be ideal, particularly where those capital plans exceed prior period PSE commitments by a stated parameter.

## Innovation

The Commission notes that there is insufficient evidence of innovation provided by AIAL. Other regulated airports have demonstrable innovation, such as the sustainability commitments of CIAL in the Kowhai Park development, which have been worked through in conjunction with airlines and with the CAA. Wellington Airport's capital plans include innovative inclusion of assets in future sites such that capital developments are efficient – this in itself is innovative though the development of aeronautical assets is business as usual.

Innovation is also possible in the setting of prices. If AIAL was motivated to be innovative, it might consider alternative pricing approaches, such as depreciation treatments to lower price burden on airline customers. During consultation BARNZ proposed longer run price paths as one method of softening demand impacts. BARNZ proposed that the early years of a smoothed long run path be supported by a contribution from AIAL's unregulated commercial till to its regulated business; to allow customers to step into a longer run price path which would otherwise see steeper increases in prices in early years. AIAL did not entertain such a contribution, noting to BARNZ that it's aeronautical till and commercial till are 'two separate businesses'. BARNZ notes that these two tills are not in fact two separate businesses and that such support would be possible and would also be innovative.

BARNZ has considered what evidence it has of innovation in AIAL's practice but has not been able to identify any.

## Changes to Information Disclosure

The Commission has asked interested persons to comment on what could be changed about Information Disclosure such that the regime might be improved. BARNZ suggests the following:

- The requirement for disclosed service level agreements with airlines, setting out minimum quality standards for ground operations including aircraft turn times and measured passenger processing efficiency;
- The requirement for price setting disclosure of future price paths, in particular where work in progress in one price period will impact prices for the next. BARNZ suggests these be set out as high and low paths. Should this be considered commercially sensitive information, BARNZ suggests these simply be submitted in confidence to the Commission. Should the airport consider these would be outdated too quickly to be of use, BARNZ suggests these be updated in confidence in annual information disclosures; and
- The requirement for an independent verifier for capital plan efficiency where unit price increases exceed 20% on prior price period.

Ultimately, BARNZ considers that Information Disclosure is no longer working to restrain AIAL from targeting excess profits, if it ever did. BARNZ would welcome comment from the Commission in its final decision on whether it considers Information Disclosure is sufficient regulation for AIAL, and how that question might be further examined in a s56 Inquiry process.

Regards,

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

## Summary of attachments:

- *Response to Airport Comments, Report Produced for BARNZ, BISOE 12 September 2023*
- *Domestic Demand Study March 2023 –* ***Confidential and not for publication***
- *Domestic Demand Study March 2023 -* ***Redacted for publication***
- *Domestic Demand Study May 2024, updated for PSE4 prices as set -* ***Confidential and not for publication***
- *Domestic Demand Study, May 2024, updated for PSE4 prices as set -* ***Redacted for publication***