NZ AIRPORTS ASSOCIATION

REVIEW OF AUCKLAND AIRPORT'S 2022-2027 PRICE SETTING EVENT

SUBMISSION ON CONSULTATION PAPER

3 September 2024

INTRODUCTION

1. This is the New Zealand Airports Association's ("**NZ Airports**") submission on the Commerce Commission's ("**Commission**") consultation paper for the Review of Auckland International Airport Limited's 2022 – 2027 Price Setting Event ("**Consultation Paper**").

2. This submission is accompanied by the following documents (previously provided to the Commission):

   (a) The report titled "Responding to Coding errors made by NZCC" (1 April 2024), prepared jointly by Dr Tom Hird and Samuel Lam from Competition Economists Group, Jeff Balchin from Incenta, and Brendan Quach and Johnathan Wongsosaputro from HoustonKemp ("**Joint Expert Report 2024**").

   (b) NZ Airports' letter to the Commission regarding the coding errors in the Commission's 2023 IM (2 April 2024).

3. The NZ Airports contact for this submission is:

   [redacted]

4. As with our previous submissions on this review, NZ Airports' comments focus on the regulatory framework issues and matters that are relevant to regulated airports in general. Auckland Airport will provide separate submissions specific to its fourth price setting event ("**PSE4**").

5. There is no confidential information in this submission, and it can be published in full on the Commission's website.

EXECUTIVE SUMMARY

6. NZ Airports appreciates the Consultation Paper's constructive approach to a range of performance areas. We acknowledge the Commission has conducted a careful analysis of Auckland Airport's PSE4 decisions while accommodating the unique and challenging context of PSE4 in its summary and analysis, namely:

   (a) the impact of the global pandemic; and

   (b) a significant investment programme by Auckland Airport.

7. While the Commission has made some adverse draft findings on profitability, NZ Airports wishes to emphasise that this is not a case of an airport disregarding the regulatory settings. It is not a sign of regulatory failure. To the contrary, Auckland Airport was seeking to follow the regulatory precedent in place at the time it set prices. The Commission's views on appropriate methods have changed since Auckland Airport set prices, and those views have informed its draft findings, with the benefit of hindsight. Auckland Airport has already publicly indicated that it will respond if the Commission's final report for this review ("**Final Report**") maintains that Auckland Airport's prices are too high. Accordingly, our strong view is that this PSE4 review is an excellent example of the information disclosure regime working as it should for the benefit of consumers. Auckland Airport and its customers were provided with flexibility to seek appropriate solutions in challenging circumstances, and now the outcomes

are being rigorously tested by the Commission with the potential for further adjustments to be made.

8. Key views covered in this submission include the following:

(a) *Overview* – The aviation sector has emerged from the disruptive global impact of the COVID-19 pandemic.

(b) *Capital expenditure and investment plan* – It is encouraging that the Commission has endorsed Auckland Airport's decision-making for a major capital programme that will provide extensive benefits for passengers and the broader aviation community, and resisted calls from airlines to disrupt that programme.

(c) *Cost of capital* – We appreciate that the Commission has used the same assessment framework that has been used since the 2016 IM Review. Consistency in approach is helpful for regulatory certainty. We also appreciate that the Commission has recognised that the 2016 IM should not be used as a rigid benchmark for assessing the reasonableness of Auckland Airport's pricing WACC. We consider that for the Final Report the Commission should:

(i) Remove any summary and analysis based on an unadjusted 2016 IM. The Commission has correctly recognised that this is not an appropriate measure, so it is unhelpful for interested persons to be presented with analysis that uses the 2016 IM as a "starting point" benchmark.

(ii) Further adjust the 2016 IM and 2023 IM so that they are logically consistent and reasonable benchmarks, such that the WACC range is not a product of material (and unanticipated at the outset of PSE4) differences in the IM over time.

(iii) Address the coding errors in the 2023 IM, as identified in the Joint Expert Report 2024 that NZ Airports submitted to the Commission on 2 April 2024. NZ Airports was surprised that the Consultation Paper relied on the 2023 IM without mentioning that those errors had been raised (or that the 2023 IM was subject to a merits review).

(iv) Consider any other reasons that could justify the difference between the scenario mid-points and Auckland Airport's target return for priced assets of 8.73%. Auckland Airport's submission will address these specific points in detail, but as a general point, NZ Airports supports an assessment approach that recognises that the WACC IM does not compensate airports for all asymmetric risks they bear.

(d) *Expected Profitability* – The Consultation Paper focuses almost entirely on "excess returns" for priced services. The Commission should also provide balanced analysis for non-priced activities and regulated activities as a whole, as it indicated it would do in the process and issues paper for this review ("**Issues Paper**") and as was the case for PSE3.

(e) *Depreciation* – The IMs and Information Disclosure Determination provide a choice on what depreciation method to use - standard depreciation or non-standard depreciation.[1] It appears that the Commission is seeking to establish a position that non-standard depreciation is the preferred approach in some cases. NZ Airports requests clear guidance in this respect, which should be consulted on and then made available in advance of future pricing decisions.

(f) *Innovation* – NZ Airports welcomes the Commission's inclusion of innovation (as well as quality and efficiencies) as a metric of performance within this pricing review. It would be helpful for the Commission to consider and provide guidance to airports as to how the impact of innovation should be measured, within the context of an economic regulation regime which has, to date, focussed on investment, expenditure, efficiency and profitability.

OVERVIEW

9. This review is an important part of an effective regulatory regime under Part 4 of the Commerce Act 1986 ("**Act**"). PSE4 is a significant milestone for Auckland Airport following a period of global uncertainty (as were the first pricing setting events for Christchurch and Wellington Airports following the pandemic).

10. The global pandemic demonstrated the true risks faced by airports and their customers. Border closures and lockdowns caused international air travel out of Auckland to all but cease for over 18 months, with significant disruption to domestic services. The adverse impact for all aviation participants was severe, and Auckland Airport's revenues in PSE3 were $500 million lower than was forecast at the time of that PSE.[2]

11. A key benefit of the airport regulatory regime is that it provided airports and their customers with flexibility to appropriately respond to the disruption and volatility caused by the COVID-19 pandemic. To best assist the entire sector to deal with the uncertainty presented by the pandemic, Auckland Airport froze prices and delayed PSE4 pricing decisions for 12 months, a proposal that was accepted by Air New Zealand and the Board of Airline Representatives New Zealand ("**BARNZ**"). This decision helped to avoid highly uncertain forecasts being adopted to determine aeronautical prices in PSE4 (although the forecast is still highly uncertain by normal standards).

12. As the aviation sector has emerged from the pandemic shut down and is now back on a growth trajectory, it is important for the New Zealand aviation network and the New Zealand economy that Auckland Airport has recommitted to significant investment to accommodate future growth, particularly in domestic operations. While there is unanimous agreement across the sector that the investment is needed, it is natural that different participants have different views on precisely what is needed and how much it should cost.

13. NZ Airports encourages the Commission to maintain its focus in this review, and future reviews, on the long-term benefit of all consumers and to continue to carefully test the views of participants focussed on their short-term interests. In this respect, important context for this review includes the following:

(a) Auckland Airport's domestic prices have, for many years, been low, reflecting aging infrastructure at Auckland Airport. Given the cost of building a new terminal that will provide significant long-term quality and efficiency improvements, it is logical that

[1] Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 (consolidated as at 23 April 2024), Airport Services Information Disclosure Determination 2010 (consolidated as at 18 June 2019).
[2] Auckland Airport *Submission on Commerce Commission Process and Issues Paper for its review of Auckland Airport's 2022 – 2027 price setting event* (31 January 2024), at section 4.1.

aeronautical prices will eventually increase under a building blocks model. As the analysis in the Consultation Paper illustrates, Auckland Airport's FY27 domestic prices will still be below the FY24 prices of its Wellington and Christchurch peers.[3]

(b) Airline customers submitted concerns about PSE5 price increases. NZ Airports agrees with the Consultation Paper's view that any analysis of PSE5 decisions, that have not been made, would be speculative and the focus is on PSE4.[4] Nevertheless, it is clearly the case that airlines have full transparency that Auckland Airport's historically low domestic charges will increase over PSE4 and into PSE5.

(c) NZ Airports struggles with airlines' claims that Auckland Airport's domestic prices increasing to levels on par with its peers presents material challenges for them or their passengers. Airline fares have been rising since 2022 due to shortages in airline capacity relative to demand. Given that aeronautical charges make up only a small portion of the overall airfare paid for by passengers, the impact on consumers from slightly higher airport charges can only account for a fraction of the increases in airfares we see in New Zealand. In this country, the lack of competition in the airline market, combined with the dominant airline's severe aircraft constraints, means domestic airfares are likely to significantly increase regardless of comparatively small increases to airport charges.

(d) Constrained airport capacity would be expected to similarly affect airline fares (reflecting dynamic airline pricing which can increase airfares significantly when demand exceeds supply). That is to say, Auckland Airport's charges will not make travel unaffordable to end consumers. What will make travel unaffordable is constrained capacity that provides airlines with the ability to inflate airfares. This risk was demonstrated following the pandemic where airlines hiked domestic airfares out of Auckland Airport by up to 55% on pre-COVID-19 levels – a $70 increase.[5] In comparison, for this PSE4 period, Auckland Airport's domestic jet charges will increase by an average of $1.76 per year and its regional charges will increase by $1.26 per year.[6] Airlines' professed concern for the affordability of air travel is not evidenced by their pricing history. In contrast, the international consensus on the impact of increase capacity and competition on airfares has been reinforced again by the Australian Consumer and Competition Commission's most recent report on the Australian market, which found that:[7]

> …when Rex entered several intercity routes in 2021, the average airfare paid per passenger across those routes fell by around 25%. Compared to their 2019 levels, average revenue per passenger on routes with increased competition has been lower than the broader domestic network in every month since February 2023.
>
> [footnote omitted]

(e) In addition to opposing much needed investment, in this review there is a demonstrable pattern of airlines opposing decisions that do not suit their short-term

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[3] Commerce Commission *Review of Auckland Airport's 2022 – 2027 Price Setting EventConsultation Paper* (17 July 2024) ("**Consultation Paper**"), at tables X1 and X3, and paragraph [5.31].

[4] Consultation Paper, at paragraph [X9].

[5] See Infare, airfare data for Auckland for 2 months to August 2023 compared to the same period in 2019.

[6] See Auckland Airport's PSE4 price setting disclosure.

[7] Australian Consumer and Competition Commission *Domestic airline competition in Australia* (August 2024), at page 3, available here: https://www.accc.gov.au/system/files/domestic-airline-competition-august-2024-report.pdf.

interests, even when there is evidence on the record that the decisions were supported at the time. Examples of matters where the Consultation Paper has been required to deal with such airlines' views include:

(i) use of 1 July 2022 as the date for setting the risk-free rate and average debt premium;

(ii) concerns about the detail provided on depreciation forecasts and rates that were not raised during price consultation;

(iii) views on demand forecasts, which would result in higher prices for passengers, are the opposite to the general demand forecast incentives of airlines and airports;

(iv) concerns about the symmetric revenue wash-up; and

(v) arguments that the threshold for the capex delivery wash-up, which is in favour of airlines, is too high.

14. NZ Airports is disappointed that the significant benefits that will be delivered by Auckland Airport's investment programme have been clouded by the Consultation Paper's draft findings that Auckland Airport is targeting excess profits on its priced assets. NZ Airports considers that it is important for stakeholders to recognise that Auckland Airport sought to apply and update the 2016 WACC IMs in its price-setting decisions, rather than depart from them. Auckland Airport was not deliberately seeking to target excess returns or otherwise disregard the regulatory settings in its PSE4 decision-making. This is consistent with the approach that all regulated airports adopt in their pricing decisions.

15. The Consultation Paper acknowledges that it was appropriate for Auckland Airport to update the WACC IM. It is only after Auckland Airport set prices that it has become clear that the Commission has different views on how the pandemic should impact estimation of WACC.

16. Nevertheless, in response to the Commission's draft conclusions on the cost of capital, Auckland Airport has publicly confirmed that if the Commission's final conclusions support a lower WACC, then it will adjust its pricing – just as it did in PSE3.[8] NZ Airports emphasises that this, together with all the positive draft findings, is clear evidence that airports take the Commission's views seriously, and that the regulatory regime for airports is working well to promote the long-term interests of consumers.

CAPITAL EXPENDITURE AND INVESTMENT PLAN

17. NZ Airports endorses the positive draft conclusions in relation to Auckland Airport's capital expenditure and investment plan, including that:

(a) the process and rigour that Auckland Airport applied when costing the capital expenditure plan was reasonable;[9] and

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[8] Auckland Airport Media Release "Auckland Airport to consider reducing charges once it receives final Commerce Commission feedback" (17 July 2024), available here: https://corporate.aucklandairport.co.nz/news/latest-media/news-articles/auckland-airport-to-consider-reducing-charges-once-it-receives-final-commerce-commission-feedback.

[9] Consultation Paper, at paragraph [4.102].

(b) there are operational and financial reasons for Auckland Airport to proceed with the Terminal Integration Programme now and deferring this investment because of cost concerns is unlikely to address those concerns.[10]

18. We support the manner in which the Commission has assessed Auckland Airport's investment. The Commission's approach strikes an appropriate balance between reviewing the robustness of Auckland Airport's decision-making process while not seeking to replace Auckland Airport's decisions with its own judgement. We trust that the same approach will be consistently applied for all pricing reviews.

19. The PSE4 review should provide confidence to all interested parties that the ongoing major investment at Auckland Airport has been extensively tested and found to be reasonable. The Commission has appropriately considered whether Auckland Airport's disclosures show that Auckland Airport is seeking to promote the Part 4 purpose and that good processes and decision-making frameworks are followed. NZ Airports considers that this is within the proper scope of the Commission's role.

20. It is also appropriate that the Commission has not considered the impact of Auckland Airport's capex on future prices, ie in PSE5 (rejecting the airlines submissions).[11] The Commission's clarification that any analysis on PSE5 would be speculative since these prices have not been consulted on and no PSE5 decisions have been made is particularly important. NZ Airports understands that, even though PSE5 decisions are yet to be consulted on, Auckland Airport has had forward-looking conversations with its substantial customers on projections for PSE5, in an effort to provide full transparency on how PSE4 decision-making could have implications for PSE5. NZ Airports considers such conversations between airports and airlines should be encouraged. Clearly, if preliminary or indicative PSE5 discussions that are contingent on further consultation were subject to this PSE4 review, then that would establish a precedent that discourages airports from proactively and willingly engaging with airlines on a broader basis than strictly required by the regulatory regime.

21. In addition to opposing the capex plans, BARNZ and Air New Zealand asserted that the threshold proposed by Auckland Airport as the trigger for the capex wash-up was too high. During consultation with substantial customers Auckland Airport reduced the value of the trigger from 15% to 7.5%.[12] The submissions on the Issues Paper demonstrate the substantial customers' lack of consistency regarding the trigger – where BARNZ submitted the trigger is 15% while Air New Zealand submitted the trigger is around 20% of PSE4 capital expenditure (instead of total asset base).[13] Both have continued to submit that the trigger is too high. NZ Airports is pleased to see that the Commission has not been swayed by the self-interest of the airlines and recognises that Auckland Airport has acted appropriately to manage the risk of under-delivery.[14] We encourage the Commission to stay on this path for all reviews and continue to carefully consider the evidence that airports seek to promote the Part 4 purpose.

[10] Consultation Paper, at paragraph [4.109].

[11] Consultation Paper, at paragraph [X9].

[12] Auckland Airport *Cross-Submission on responses to the Commerce Commission Process and Issues Paper for its review of Auckland Airport's 2022 – 2027 price setting event* (21 February 2024), at page 32.

[13] Consultation Paper, at paragraphs [4.118] and [4.120].

[14] Consultation Paper, at paragraph [4.124].

COST OF CAPITAL

Overview

22. While Auckland Airport's decisions on WACC differ from recent decisions made by Christchurch and Wellington Airports, the Commission's approach to assessing Auckland Airport's WACC is relevant to all three airports. In particular, the proposed use of the 2023 IM, determined after Auckland Airport set prices, would be a significant precedent for future price settings if confirmed in the Final Report. It will no longer be the case that airports can be confident that the IMs in force at the time they set prices provide the best guidance on how their pricing decisions will be assessed by the Commission.

23. The Commission's draft conclusions are as follows:[15]

(a) Auckland Airport's WACC of 8.73% differs from the Commission's starting mid-point estimate of 6.98% (determined using the 2016 IM).

(b) Auckland Airport's WACC is not justified and is inconsistent with the Part 4 purpose.

(c) There are some legitimate reasons for Auckland Airport using some parameters that are different from the 2016 IM, however:

(i) the magnitude of the asset beta and leverage adjustments are not justified; and

(ii) the adjustment to the TAMRP is not consistent with the rationale for adjusting the asset beta and leverage.

(d) Auckland Airport has misconstrued the purpose of asset beta and has implicitly assigned an unreasonably high probability to the likelihood of another pandemic occurring in PSE4.

(e) Appropriate WACC values are 7.28% (using an approach similar to Christchurch Airport) or 7.51% (using the 2023 IM).

24. We appreciate that the Commission has:

(a) used the same assessment framework that has been used since the 2016 IM review – consistency in approach is helpful for regulatory certainty; and

(b) recognised that, in the circumstances, some flexibility in the application of its framework was required – instead of using the 2016 IM as a rigid benchmark, the Commission has used an adjusted 2016 IM benchmark and the 2023 IM as appropriate WACCs.

25. However, for the reasons discussed below, we consider that for the Final Report the Commission should do the following:

(a) Remove any summary and analysis based on an unadjusted 2016 IM. The Commission has correctly recognised that it is not an appropriate measure, so it is unhelpful for interested persons to be presented with analysis that uses the 2016 IM as a benchmark.

[15] Consultation Paper, at paragraphs [2.2] - [2.10].

(b) Further adjust the 2016 IM and 2023 IM so that they are logically consistent benchmarks (such that the WACC does not change depending on the differences in the IM over time).

(c) Address the coding errors in the 2023 IM, as identified in the Joint Expert Report 2024 that NZ Airports submitted to the Commission on 2 April 2024, and acknowledge that there is a merits review of the 2023 IM in progress that could result in changes to the 2023 IM.

(d) Consider other reasons why a pricing WACC above the Commission's mid-point estimate is justified (or put another way, reasons why there should be a further uplift to the Commission's mid-point estimate).

Headline conclusion on WACC does not assist interested persons

26. The Commission's lead draft conclusion is that Auckland Airport's WACC differs from the Commission's mid-point estimate of 6.98% determined using the 2016 IM.[16] It describes the mid-point WACC estimate as "the key reference point" for its assessment.[17]

27. We suspect that the Commission considers it is necessary to provide this comparison under step 1 of its assessment framework. However, we consider that such a comparison is unhelpful (and potentially misleading), and the assessment framework should be applied more flexibly to remove this comparison. That is because:

(a) The Consultation Paper subsequently provides a range of WACC values that the Commission considers reasonable, with the lower bound being 7.28% and the upper bound being 7.51%.[18] The lower bound uses an adjusted 2016 IM value. Establishing a range that does not use the 2016 IM is an implicit (if not express) acceptance that the 2016 IM value of 6.98% is out of date and is not a helpful benchmark for comparison.

(b) If this lead conclusion is retained, it risks interested persons continuing to misinterpret the Commission's views on an appropriate WACC. NZ Airports understands that after the publication of the Consultation Paper, at least one media article referenced the Commission's lead conclusion of 6.98% as the appropriate WACC, requiring Auckland Airport to request amendments to the article to ensure that readers were not misled.

(c) By removing the comparison, the Commission will ensure that it is not read out of the proper context of its reasoning and analysis that follows.

Updating the 2016 IM equity beta was appropriate regardless of COVID-19

28. NZ Airports endorses the view that Auckland Airport had legitimate reasons to not use the 2016 IM equity beta as it stood.[19]

29. We consider it is important to clarify that Auckland Airport sought to use the 2016 IM approach, but with (what it considered to be) appropriate comparator data updates for asset beta and leverage. While it is true that this resulted in a departure from the 2016 IM equity

[16] Consultation Paper, at paragraph [2.2].
[17] Consultation Paper, at paragraph [2.15].
[18] Consultation Paper, at paragraphs [2.78] and [2.79].
[19] Consultation Paper, at paragraph [2.46].

beta estimate, it would be helpful for interested parties to understand that Auckland Airport did not depart from the method. Instead, the position is more accurately described as follows:

(a) Auckland Airport's equity beta is higher than the 2016 IM value because it updated the comparator sample data in accordance with the Commission's established precedent;[20] and

(b) Auckland Airport's equity beta is higher than the 2023 IM value because the 2023 IM includes material changes to the comparator sample and adjustments for pandemic risk, which occurred after prices were set for PSE4 (as discussed below).

30. This is an important point of principle for NZ Airports. All regulated airports are committed to the regulatory regime, and take the guidance provided by the IMs very seriously. They seek to follow the IMs unless there is good reason not to in light of the specific circumstances of the airport (which the Commission accepts is a legitimate approach). We are concerned about any potential findings that could be misinterpreted by stakeholders as suggesting that an airport was disregarding or not following the established regulatory guidance. That was clearly not the case for Auckland Airport's price setting.

31. NZ Airports submits that it was appropriate for Auckland Airport to update the 2016 IM equity beta and, putting COVID-19 aside, it was reasonable to expect that the Commission would accept that approach because of the following:

(a) Equity beta is a forward-looking parameter to cover the PSE4 period. It is therefore reasonable that any estimates are based on updated data as at the time of setting prices for PSE4.

(b) This is evident in the approach followed by the Commission in the 2016 IM review, where it reviewed equity beta parameter estimates in light of updated information and new data, while following largely the same approach as it did in 2010.[21] This included updating the comparator sample for electricity distribution businesses, gas pipeline businesses, and airports to "obtain a more accurate estimate of asset beta".[22]

(c) The 2016 IM uses the two most recent five-year periods when calculating asset beta, as this provides an appropriate balance between the number of historic observations for statistical reliability and the best reflection of future beta.[23]

(d) The Commission recognised in the 2016 IM Review that going back further in time poses a risk that the asset beta does not represent forward-looking risk.[24] Auckland Airport followed this approach and appropriately updated the data at the time it set prices.

[20] Consultation Paper, at paragraph [2.48].

[21] Commerce Commission *Input methodologies review draft decisions – Topic paper 4 Cost of capital issues* (16 June 2016), at paragraph [68].

[22] Commerce Commission *Input methodologies review draft decisions – Topic paper 4 Cost of capital issues* (16 June 2016), at paragraph [68], at table X1.

[23] Commerce Commission *Input methodologies review decisions -Topic-paper 4 Cost of capital issues* (20 December 2016), at paragraph [300].

[24] Commerce Commission *Input methodologies review decisions -Topic-paper 4 Cost of capital issues* (20 December 2016), at paragraphs [299] – [300].

(e) The 2016 IM equity beta was 6 years old at the start of PSE4 and would have been obsolete for four out of five years of PSE4. It was therefore reasonable to use updated data to provide a forward-looking estimate for PSE4.

(f) One of the Commission's early steps in the 2023 IM Review was to ask CEPA to update the comparator data in a manner consistent with the 2016 IM Review approach.[25]

32. Accordingly, at the time that Auckland Airport set its prices, it was clear that the impact of COVID-19 supported the (already existing) need to update the 2016 IM. But it is incorrect to imply that the 2016 IM equity beta estimate should not have been updated if COVID-19 had not occurred. COVID-19 was therefore an additional and new element to consider as part of an updating exercise that was appropriate to undertake in any event.

The purpose of equity beta has not been misconstrued

33. The Consultation Paper acknowledges that Auckland Airport used the 2016 IM approach to estimate asset beta.[26]

34. However, it then goes on to say that Auckland Airport has:[27]

(a) used a conceptual approach that would provide ex-post compensation for the effect of pandemics and other macroeconomic shocks; and

(b) misconstrued the purpose of equity beta and applied an unreasonably high probability to the likelihood of another pandemic occurring in PSE4.

35. It must be emphasised that these cannot be criticisms of Auckland Airport or its approach. They are, in fact, criticisms of the 2016 IM, which Auckland Airport applied. It is unnecessarily inflammatory to turn implicit criticisms of the 2016 IM into explicit criticisms of Auckland Airport. Returning to NZ Airports' important point of principle above, stakeholders should not be given the impression that a regulated airport has disregarded the regulatory settings. Auckland Airport has already publicly stated that it will reconsider its PSE4 pricing if the Commission remains of the view that its target returns are too high (despite its view that its targeted return is reasonable). Therefore, NZ Airports recommends that the Final Report focusses on encouraging this constructive approach by recognising that, if the 2023 IM is used as a benchmark in the Final Report, then Auckland Airport's price setting has been assessed using regulatory settings that were materially changed after it set prices.

36. NZ Airports acknowledges that:

(a) there is a debate about whether COVID-19 has had a disproportionate impact on the historic data so that it might not provide the best forward looking estimate; and

(b) the Commission has changed the 2016 IM approach to estimating asset beta in the 2023 IM to, among other things, reduce the weight placed on COVID-19 impacted data.

[25] Commerce Commission *CEPA report on aspects of the cost of capital Input Methodologies for the 2023 review* (8 December 2022).
[26] Consultation Paper, at paragraph [2.48].
[27] Consultation Paper, at paragraph [2.48].

37. However, both are contested matters. The 2023 IM approach to equity beta is subject to a merits review.

38. Therefore, it is inappropriate to imply that Auckland Airport was opportunistically seeking ex-post compensation when it has been acknowledged that it was using the 2016 IM. All airports continually seek to apply established principles for cost recovery and risk sharing, which generally preclude ex-post recovery.

39. The nature of the estimation method for asset beta relies on how historical events have impacted the comparator firms being measured. The fact that these historical observations have been determined by the IMs to be the best method to establish a forward-looking estimate does not mean that a regulated entity is being ex-post compensated for those events. Indeed, part of the debate about the 2023 IM is that it only sought to mitigate the impact of COVID-19 on the historical data and not other major shock events, such as the global financial crisis ("**GFC**"). It does not follow, and it has never before suggested, that this means airports have historically been ex-post under or over compensated for matters, such as the impact of the GFC and pandemic risk.

40. In summary, NZ Airports understands that the 2023 IM reflects the Commission's view, which is different to NZ Airports' view, on how the impact of COVID-19 should be accommodated in estimates of asset beta. The Commission will understandably not depart from its 2023 IM position for the purposes of this review. However, we consider it is possible for the Commission to objectively state this position in the Final Report without needing to make negative observations on Auckland Airport's motives or conceptual approach, which simply used the method of the 2016 IM in force at the time it set prices.

TAMRP should be 7.5% for both scenarios

41. Auckland Airport used a TAMRP of 7.5%, which was the Commission's most recent economy-wide estimate (published in 2020 and confirmed in March 2022) at the time it set prices (7 June 2023) and as at the start of PSE4 (1 July 2022).

42. NZ Airports considers that it is appropriate for airports to use the most recent estimate of TAMRP published by the Commission at the time of setting prices. It was therefore appropriate for the Commission to accept that 7.5% was reasonable for Christchurch Airport to use when it set prices in mid-2022 (which is why 7.5% is included in Scenario 1).[28]

43. The Commission updated TAMRP to 7.0% as part of the 2023 IM Review, but it acknowledges this estimate was not available at the time Auckland Airport set prices.[29]

44. Despite the foregoing, the Commission's draft finding is that Auckland Airport's TAMRP of 7.5% was unreasonable because it should have updated the TAMRP to 7.0% to be consistent with its updating of asset beta and leverage.[30] There are two responses to this:

(a) the Commission has not accepted Auckland Airport's updates to asset beta and leverage, so it is inconsistent to require a TAMRP update; and

(b) it is not clear why an update as at 1 July 2022 would have resulted in a TAMRP of 7.0%.

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[28] Consultation Paper, at paragraph [2.64].
[29] Consultation Paper, at paragraph [2.63].
[30] Consultation Paper, at paragraph [2.67].

45. The Commission's logic appears to be that Auckland Airport should have used the same method as Dr Lally in his 10 April 2023 report, and used data up to 1 July 2022, which would have generated 7.0%.[31] The report from Dr Lally is not in itself evidence of the correct TAMRP as it was not calculated as at 30 June 2022 (it used data into 2023).[32] If the Commission has independently conducted the calculations and produced that result, then that could have been made clearer in the Consultation Paper.

46. Putting aside that Dr Lally's report was provided a short time before Auckland Airport set prices, NZ Airports disagrees with the Commission's apparent reliance on such evidence and conceptual approach.

47. The IMs provide the clear benchmark that airports expect their decisions and performance to be measured against.

48. Auckland Airport was setting its prices as at mid-2022. The clear evidence is that 7.5% was acceptable as the pan-industry IM TAMRP at that date (as applied by Christchurch Airport). That is the best and most reliable estimate for airports to use.

49. In the Process and Issues Paper for the IM Review 2023, the Commission itself contemplated updating the TAMRP for airports to reflect the Commission's most recent published estimate of 7.5% (as at 2020 and confirmed by the Commission in March 2022).[33] In the end, the Commission decided not to update the TAMRP for specific airport services to reflect its most recent published estimate of TAMRP – a (draft) decision not made until after Auckland Airport set prices. Put another way – if there was no price freeze for the first year of Auckland Airport's PSE4 period, then the Commission would not be questioning whether 7.5% was the reasonable TAMRP for Auckland Airport to use for PSE4.

50. Finally, there is no inconsistency with Auckland Airport's approach to asset beta and leverage. It appears to NZ Airports that Auckland Airport has followed a consistent approach to all three parameters – namely, what value would have been used if Auckland Airport set prices at June 2022?

51. Accordingly, the TAMRP should be 7.5% for both scenarios.

Scenario 1 is reasonable as a lower bound estimate of WACC if it is applied more flexibly

52. The Commission calculated two estimates of the WACC in order to determine whether Auckland Airport's WACC is materially different. Scenario 1 follows the approach adopted by Christchurch Airport of using the 2016 IM asset beta and leverage values, but with a higher TAMRP of 7.5%. NZ Airports agrees that on its face this is a reasonable lower bound option given Christchurch Airport is a peer airport in New Zealand, but it is still important to consider whether Auckland Airport's specific circumstances were different such that a different WACC was appropriate. We expect Auckland Airport's submission will provide further explanation.

53. NZ Airports makes the following comments on how Scenario 1 should be adjusted on a principled basis.

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[31] Consultation Paper, at footnote 43.

[32] See Dr Martin Lally's report titled "Estimation of the TAMRP" (10 April 2023).

[33] Commerce Commission *Part 4 Input Methodologies Review 2023 Process and Issues Paper* (20 May 2022), at paragraph [6.51].

Scenario 1 should not incorporate a 0.05 downward adjustment

54. For Scenario 1, the Commission has used the 2016 IM asset beta of 0.60.[34] This incorporates a now discredited downward adjustment of 0.05.

55. In setting its PSE4 prices, Auckland Airport did not include the 0.05 downward adjustment. The Commission has accepted this as being consistent with Part 4, given that the Commission discontinued the adjustment in the 2023 IM.[35]

56. Airports should therefore not be measured against a benchmark that includes the downward adjustment. The asset beta for Scenario 1 should be at least 0.65.

Scenario 1 does not incorporate pandemic risk

57. There is common ground between NZ Airports and the Consultation Paper that the 2016 IM asset beta does not incorporate pandemic risk. As discussed above, the Consultation Paper has accepted that this provided a legitimate reason for Auckland Airport to update the 2016 IM asset beta. There are differences in views regarding how pandemic risk should be appropriately estimated.

58. The usefulness of Scenario 1 as a measure of forward-looking risk must therefore be qualified by the fact that it does not include a forward-looking estimate of pandemic risk.

59. At a minimum, it should be increased by the same pandemic uplift (0.04) as provided for in the 2023 IM. Combined with removal of the downward adjustment, this results in an asset beta of 0.69 (and not 0.60).

60. If the coding error is addressed (discussed below in relation to Scenario 2), then the uplift should be at least 0.10, resulting in an asset beta of 0.75.[36]

61. NZ Airports emphasises that it does not accept that 0.04 or 0.10 is a correct pandemic uplift. Our point is that:

    (a) it is the uplift that the Commission has determined to be a correct forward-looking estimate for pandemic risk and / or is the estimate that the Commission should have used if coding errors were not made;

    (b) the 2016 IM does not include this uplift;

    (c) a consistent approach requires the Commission to apply its own uplift method to the 2016 IM so that it incorporates a forward-looking estimate for pandemic risk.

Using the 2023 IM for Scenario 2 is understandable, but it should be applied more flexibly

62. NZ Airports understands why the Consultation Paper proposed using the 2023 IM outcome as a reasonable benchmark for Scenario 2 (the "upper bound"). Unlike the 2016 IM used for Scenario 1, the 2023 IM asset beta purports to incorporate pandemic risk.

[34] Consultation Paper, at table 2.2.

[35] Consultation Paper, at paragraph [2.72].

[36] This is based on the corrected range of 0.07 to 0.15 as calculated by the economic experts in the Joint Expert Report that we provided to the Commission on 2 April 2024. See discussion further below in relation to Scenario 2.

63. The use of the 2023 IM reflects a change in the Commission's position in the Issues Paper, where it stated that the IMs that apply to this review are the IMs that were in force at the time that Auckland Airport made its pricing decision on 7 June 2023.[37] NZ Airports has always understood that pricing decisions would be assessed against the IMs in force at the time the pricing decision was made, given that the IMs are intended to guide pricing decisions.

64. The key challenge is that the Commission has a timing problem when seeking to use the IMs to assess Auckland Airport's WACC:

(a) the 2016 IM is out of date and does not incorporate pandemic risk (see paragraphs 28-32 above); and

(b) while the 2023 IM incorporates the Commission's view of pandemic risk, it was established after Auckland Airport set prices and includes material changes to the comparator sample, so it is difficult to assess the reasonableness of Auckland Airport's decisions against methods that did not exist at the time it set prices.

65. While NZ Airports has some sympathy for the challenge faced by the Commission, ultimately it is a product of the rigid profitability assessment framework the Commission has adopted. Unfortunately, if the Final Report adopts the approach of using the 2023 IM to assess Auckland Airport's price setting for PSE4, it will establish a precedent for all airports where they cannot be confident that their pricing decisions will always be assessed against the IMs that were in force at the time they set prices and / or that the IMs provide the best regulatory guidance for their decisions.

66. In this case, the 2023 IM includes material unanticipated changes to the selection of the comparator sample used to estimate asset beta. In using the 2023 IM for Scenario 2, the Consultation Paper reiterates the Commission's 2023 IM Review position that the 2016 IM comparator sample needed to be changed because it was "not reliably capturing the effects that COVID-19 had on the airport equity beta and leverage".[38]

67. The Commission's 2023 IM decision-making and rationale for changing the comparator sample approach is subject to a merits review before the High Court, so we do not address the Commission's position in any detail here. For present purposes, the short point is that the 2023 IM sample period to determine the baseline or "non-COVID-19" asset beta excluded COVID-19 impacted data, so COVID-19 impact concerns do not provide a logical reason for reducing the size of the comparator sample.

68. NZ Airports has also identified coding errors in the 2023 IM and raised these errors with the Commission.[39] Given the nature of the errors (which we believe are unintentional and unambiguous coding errors) and the materiality of their impact on asset beta, we believe the Commission must address them as a matter of priority if it continues to use the 2023 IM as a benchmark for Auckland Airport's PSE4 pricing decisions. Applying the 2023 IM without addressing these errors would understate the correct asset beta under the 2023 IM. In summary, the coding errors are as follows:

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[37] Commerce Commission *Have your say on the review of Auckland Airport's 2022 – 2027 price setting event – Process and Issues paper* (30 November 2023), at paragraph [32].

[38] Consultation Paper, at paragraph [2.71].

[39] We provided the Commission with a Joint Expert Report on 2 April 2024, prepared by Competition Economics Group, Incenta and HoustonKemp which set out the errors in detail. We are re-submitting this report as these errors are relevant to the application of the 2023 IM.

(a) Not using an average of weekly and monthly observations as intended. Correcting this error raises the non-COVID-19 asset beta from 0.63 to 0.65.

(b) Not implementing a weighted least squares regression in accordance with the Flint method (and ordinary least squares regression was applied). Addressing this error changes the uplift range, from 0.02 – 0.08 to 0.07 – 0.15.

69. Fixing both errors would increase the 2023 IM asset beta from 0.67 to at least 0.75.[40]

70. NZ Airports urges the Commission to address the coding errors as a matter of urgency, and in any event prior to the Final Report for this review. It is unclear what the Commission's position would be if the 2023 IM was applied (as it stands) in the Final Report, but there are subsequent changes to the 2023 IM due to the errors being addressed and / or as a result of the merits review. NZ Airports considers that such an outcome would be uncertain, inefficient and costly to all involved, including the Commission. This further illustrates the difficulty in using the 2023 IM for this review.

71. Finally, we understand that Auckland Airport's submission will explain why there are reasons for the Final Report to accept a pricing WACC for Auckland Airport that is higher than the Commission's mid-point scenarios. A key reason is to ensure airports are compensated for asymmetric risks that are otherwise not incorporated in the benchmark WACC. NZ Airports supports an assessment approach that ensures airports receive fair compensation for all asymmetric risks.

72. In summary, NZ Airports submits that adjusting the 2023 IM in the following manner is the best way to ensure Auckland Airport is measured against a reasonable benchmark:

(a) Use the large comparator sample set as per the 2016 IM. The Commission materially reduced the comparator sample in the 2023 IMs, after Auckland Airport set prices in reliance on the 2016 IM.

(b) Address the coding errors that NZ Airports has raised.

(c) Consider other reasons why it is reasonable for Auckland Airport's pricing WACC to be higher than the Commission's scenarios.

73. It should also be acknowledged in the Final Report that there is a merits review of the 2023 IM in progress that could result in changes to the 2023 IM.

EXPECTED PROFITABILITY

74. The Commission's draft findings are that:[41]

(a) the target return on priced services was equal to Auckland Airport's WACC of 8.73%;

(b) the target return on total regulated activities was 7.79%; and

[40] If the mid-point (0.11) of the corrected pandemic uplift range (0.07 to 0.15) was used, the asset beta would be 0.76. For the 2023 IM the Commission did not use the mid-point of the range (0.04 instead of 0.05), so following a consistent approach we have stated that the asset beta should be "at least" 0.75 by using an uplift of 0.1, which is below the mid-point of the corrected range of 0.11. For the avoidance of doubt, we note that NZ Airports' position is that the mid-point should be adopted.

[41] Consultation Paper, at paragraph at [3.4].

(c) this results in excess profits of between $193.4 million and $226.5 million from the priced activities over the price setting period.

75. NZ Airports notes that the headline dollar amounts for "excess returns" apply to priced services only. The Commission appears to defend this approach on the basis that aeronautical charges are based on the recovery of priced assets.[42] It also states that contractual periods relating to non-priced assets occur over varying time periods that do not align with 5-year pricing periods and the lower return on non-priced assets will likely increase in the future.[43]

76. We do not challenge the Commission's views in this respect. However, they do not give a good reason to not provide a complete and fair summary of expected returns for regulated activities.

77. Consistent with the approach to PSE3 for Auckland Airport,[44] and the Commission's indications in the Issues Paper,[45] the Commission should also provide balanced analysis for non-priced activities and regulated activities as a whole. That is, it should also estimate the under-recovery for non-priced activities, and the net position for regulated activities as a whole.

78. NZ Airports is not suggesting that the Commission should be comfortable with the returns for priced activities on the basis that non-priced returns are lower and / or that the net position for regulated activities is only a small amount over its benchmark scenarios. Rather, NZ Airports considers it is important for the Commission to provide the full picture for all regulated services, otherwise there is a perception that it is selectively producing numbers that do not tell the full story for all regulated services.

DEPRECIATION

79. We appreciate the Commission's invitation to allow Auckland Airport to provide further information to explain its use of standard straight-line depreciation.[46] Our comments are from a broader industry guidance perspective.

80. The IMs and Information Disclosure Determinations provide a choice on what depreciation method to use – standard depreciation or non-standard deprecation.[47] The non-standard depreciation methods are not explicitly defined in the IMs and Information Disclosure Determination – the definition merely states that non-standard depreciation methodology is one that is different from standard depreciation methodology.[48] If non-standard depreciation is used, then the airport must explain why it is consistent with the Part 4 purpose (among other things).[49]

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[42] Consultation Paper, at paragraph [3.20].

[43] Consultation Paper, at paragraph [3.20].

[44] Commerce Commission *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022) – Final report – summary and analysis under section 53B(2) of the Commerce Act 1986* (1 November 2018), at paragraph [X12].

[45] Commerce Commission *Have your say on the review of Auckland Airport's 2022 – 2027 price setting event – Process and Issues paper* (30 November 2023), at paragraph [36].

[46] Consultation Paper, at paragraph [3.54].

[47] Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 (consolidated as at 23 April 2024), Airport Services Information Disclosure Determination 2010 (consolidated as at 18 June 2019).

[48] Airport Services Information Disclosure Determination 2010 (consolidated as of 18 June 2019), clause 1.4.

[49] Airport Services Information Disclosure Determination 2010 (consolidated as of 18 June 2019), clause 2.5(1)(p).

81. Accordingly, to date the broad approach has been that standard depreciation is the "default" position, and airports need to justify the use of non-standard approaches. This includes Christchurch Airport's use of non-standard depreciation for its terminal.[50]

82. It now appears that the Commission is seeking to establish a position that non-standard depreciation is the preferred approach in some cases.

83. NZ Airports requests clear guidance in this respect. We ask the Commission to consider whether it is possible to provide more specific guidance or principles on when non-standard depreciation should be considered – ie the only present guidance is that it should probably be considered for new terminals. Further, if the Commission has views on what tilted annuity depreciation involves as an appropriate method, then it should consider whether it is appropriate for this to be defined in the IMs.

84. Such guidance or inclusion in the IMs should first be consulted on so that interested parties have an opportunity to provide their views. Any final IMs or guidance would then be available in advance of pricing decisions being made. In that context, NZ Airports does not consider it would be appropriate for any negative conclusions to be drawn on Auckland Airport's chosen method for depreciation for PSE4 when there was no clear guidance at the time that it set its prices.

INNOVATION

85. As NZ Airports has submitted previously, we welcome the Commission's inclusion of innovation (as well as quality and efficiencies) as a metric of performance within this pricing review. We consider that each of the four limbs of the Part 4 purpose are relevant when assessing airports' performance. Including innovation in the Commission's analysis of PSE4 will help to provide a full and balanced picture of Auckland Airport's performance over time.

86. The assessment of innovation by airports is complex. The Commission has not given any clear indication on what they will look at when considering innovation. The Consultation Paper seems to imply that innovation must result in reductions in opex and does not seem to consider any other outcome that might result from innovation.[51] We suggest that innovation could also, or alternatively, result in increased capacity, improved service quality, reduced capex or other even less quantifiable results such as goodwill.

87. In the context of Auckland Airport undertaking a large-scale development (the Terminal Integration Programme) of a kind not previously seen in New Zealand, it is difficult to reconcile the Commission's draft conclusion that Auckland Airport has "not demonstrated" significant innovative practices.[52] This is not a build that involves simply augmenting existing infrastructure, but the major reconfiguration of assets, involving innovative planning and construction.

88. We endorse the examples of innovation that Auckland Airport has provided to the Commission. NZ Airports has been present in discussions between Auckland Airport and airports from other jurisdictions which highlighted the international interest in Auckland Airport's approach to spatial modelling, consumer data, artificial intelligence and stormwater management.

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[50] Commerce Commission *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch Airport – Section 56G of the Commerce Act 1986* (13 February 2014), at paragraphs [F32] – [F41].

[51] Consultation Paper, at paragraph [6.11].

[52] Consultation Paper, at paragraph [6.3].

89. We note that there may be risk and higher costs associated with innovation, in contrast to the known costs of using an established solution. In our view, innovation should not be seen as the goal itself, but more as an important element to consider when looking to improve service quality, reduce opex or delay / reduce capex.

90. Additionally, NZ Airports considers it is not always appropriate or necessary for airports to work independently on innovation. Many cost reductions and efficiencies can be achieved by effectively implementing international best practice.

91. Moreover, airports are statutorily required to follow civil aviation rules, particularly on the airfield. This is for the safety and efficiency of operations. Therefore, to implement any "innovative" solution, the airport may need to ensure the Civil Aviation Authority has appropriate rules and advice, including alignment with the International Civil Aviation Organisation. This can mean innovation opportunities more readily arise in customer-facing and landside construction and operations.

92. Airports' role in an aviation ecosystem means that they are required to serve as a platform for innovation. This can involve creating collaborative spaces across stakeholders, including airlines and government agencies, to resolve problems and create efficiencies using innovative solutions. Auckland Airport's work on addressing screening queues is a good example of this which has served as a model to the rest of the airport network. It is unhelpful to focus on attributing innovation to one stakeholder or another on the airport precinct - rather we encourage a broader view on the innovation culture of an airport and the outcomes they are able to facilitate.

93. NZ Airports considers a key priority for innovation is airports' role in facilitating the decarbonisation transition for aviation. This involves making strategic decisions about investments that will support scope 1 and 2 carbon emissions reductions, and scope 3 reductions over time, without full information on future airline requirements for low carbon and zero carbon aircraft. Some of this work can be undertaken with reference to international best practice, which is appropriate for building an aligned international aviation network. However, there is no playbook - the application of these initiatives to the New Zealand context must be managed responsibly over time both for airline customers and the public. Auckland Airport is demonstrating its work in this space through the provision of ground handling charging functionality, and the largest scale transition of gas boilers to heat pumps in New Zealand, among other sustainability projects.

94. Lastly, we consider there is wider discussion to be had within the Commission regarding the chilling effect that any economic regulation regime might have on innovation in regulated industries. We suggest that the regulatory settings of a price / quality path can have a dampening effect on innovative thinking in a regulated industry because, for example, an innovative new approach may incur (potentially significant) up-front costs to implement and the benefit or savings to consumers may not arise until down the track.

95. We encourage the Commission to continue to include innovation within its reviews of airports' performance. However, the Commission's approach to that metric should be placed within the context of the Commission's historic and general emphasis on investment, expenditure, and profits. It would be helpful for the Commission to provide guidance to airports on this point.