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Commerce Commission
Wellington

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Review of Auckland Airport's 2022 – 2027 Price Setting Event 4 (PSE4) – Consultation paper: Air New Zealand (Air NZ) feedback

Thank you for the opportunity to respond to the Commission's consultation paper on the review of Auckland Airport's 2022-2027 Price Setting Event (PSE).

We summarise in this letter the key points of Air New Zealand's (Air NZ) submission.

AIAL has a consistent track record of targeting excess profits

Air NZ welcomes the Commission's draft conclusion that Auckland International Airport Limited (AIAL) is targeting an unreasonably high return on priced assets in PSE4. The Commission has found AIAL has targeted an excess return at each of the last three price setting events: excess revenues of \$72m¹ over PSE2; excess revenues of \$53m over PSE3 and excess revenues of \$193-227m over PSE4. In total AIAL has been found to have targeted excess revenues of \$318-\$352m over PSEs 2, 3 and 4. This consistent and sustained overcharging over three price periods is not consistent with the purpose of Part 4 of the Commerce Act. Furthermore, AIAL's appetite for targeting excess profits appears to be increasing over time.

AIAL's sustained price setting WACC margin provides a powerful incentive to over-invest, which will not be addressed by reducing prices for the remainder of PSE4

AIAL's WACC Margin² is 145 basis points in PSE4 and has averaged 100 basis points over PSE2, 3 and 4. Economic theory suggests that a consistent WACC Margin leads to both static inefficiency (higher prices due to an inflated WACC) and dynamic inefficiency (higher prices due to overinvesting in capex). Air NZ considers this dynamic inefficiency is clearly evident in AIAL's capital plan for PSE4 and PSE5. In particular, the Domestic Processor (DP) is twice

¹ Relative to the revenues required to achieve a return equivalent to the Commission's mid-point WACC estimate

² The WACC Margin is the difference between AIAL's Target WACC and the Commission's mid-point WACC estimate

the size required for an efficient domestic terminal, yet AIAL is proposing to allocate ■■■ of the cost to aeronautical services.

Due to this, Air NZ believes that the Commission has significantly under-estimated the quantum of excess profits that AIAL is targeting, as it only takes into account the static excess profits generated through an excess WACC on a given capital programme. More concerning, AIAL's pattern of overcharging in the earlier stage of a PSE, then only providing a (partial) rebate to customers after the Commission has found AIAL to be targeting excess profits, only addresses the inefficiency caused by static inefficiency. Now that construction has begun, AIAL is committed to its dynamic inefficiency regardless of whether it elects to rebate to customers any of the excessive profits determined by the Commission.

AIAL's capital programme is not reasonable, it is inefficient and AIAL made a deliberate decision not to seek a more efficient path

Air NZ formally withdrew its support for the proposed capital plan after costs escalated and AIAL's indicated pricing increased ■■■ between 2021 and 2022. Airlines have consistently requested for over two years for AIAL to revisit fundamental design assumptions for the DP, to no avail. Air NZ remains firmly of the view that the consultation process was inadequate.

We demonstrate in our submission that the Capital Plan is far too costly for the capacity and service levels AIAL's customers (i.e. airlines) require. Air NZ considers that the demand impact of the resultant tariffs is material, especially in PSE5 once the full impact of the capital plan hits pricing. While we focus on the DP, Air NZ would stress that this does not mean we have no objection to the wider capital plan, rather that the DP is the area we have focused limited resources on once it became apparent that AIAL was committing all airport users to an inefficient capex programme.

The Commission has correctly identified the IATA Level of Service (LoS) as a key metric to determine the appropriate size (and by extension, cost) of a terminal. We provide clear evidence in our submission that:

1. AIAL has applied a high-end LoS more appropriate to an international terminal to the DP; and
2. AIAL has oversized key infrastructure elements by up to double the required functional size than should be expected for NZ domestic services.

AIAL's capital plan represents the first phase of a multi-decade investment plan which spans not only the interlinked capital plan in PSE4 and PSE5, but also a longer-term Master Plan which should eventually include future capacity expansion through a second runway and expansion / upgrades to regional and international services. The fact that the Commission's review process considers only five-year increments renders it incapable of effectively considering the efficiency of a generational capital programme of this nature that spans multiple pricing periods. If AIAL is not adequately incentivised to invest efficiently at the outset

of this programme, this overspending on earlier stages will prejudice the ability for consumers to absorb any further price increases for future capacity-generating infrastructure, as this overspend will be locked into the asset base and therefore flow through to future pricing decisions.

AIAL's behaviour over three price setting events is not consistent with the Part 4 Purpose

The purpose of Part 4 of the Commerce Act is to promote the long-term benefit of consumers of the regulated service by promoting outcomes consistent with what would be produced in a competitive market. Our submission evidences that the current regulatory regime is not incentivising behaviour from AIAL consistent with these outcomes. Notably:

- AIAL has consistently targeted excess profits in each of the past three price setting events, and AIAL's appetite for targeting excess profits appears to be increasing over time;
- AIAL has inadequately consulted with its substantial airline customers by failing to agree the appropriate LoS (and therefore size) of the DP;
- AIAL has made no attempt to meaningfully address the legitimate concerns of its substantial customers regarding the excessive size of the DP and overall cost of the capital plan;
- the resulting over-investment and consistent WACC margin leads to tariff increases which will stifle demand and inhibit future capacity-generating infrastructure; and
- AIAL is not adequately incentivised to innovate and find more efficient ways of providing aeronautical services to its customers.

In a competitive market, suppliers are incentivised to provide the goods and services customers want, in the most efficient manner possible: if a supplier is not efficient or over-specs its offering, it loses business. In the case of AIAL, airlines have been forced to prove that their monopoly supplier is not operating efficiently. This is just one example of many in our submission evidencing why the information disclosure regime is failing to deliver its regulatory objectives.

The credible threat of stronger regulation is required

The Commission has previously observed that information disclosure provides incentives to achieve outcomes consistent with those found in workably competitive markets in two main ways: (i) by providing transparency about how well a supplier is performing relative to other suppliers and over time; and (ii) through the threat of further regulation.

As noted in our cross submission to the Process and Issues paper: the background to the section 56G Commerce Act amendments made clear the critical importance of ensuring this threat is real. The Cabinet Paper noted (emphasis added)³:

The light-handed information disclosure regime is intended to work through providing a **credible threat** of further regulation if the airport's information disclosure does not meet the Commission's expectations. If an airport does not comply with the Part 4 purpose, then further regulation could be applied – either negotiate/arbitrate or price-quality regulation which is provided for in Part 4.

Information disclosure is not effective at constraining AIAL's behaviour because there is no credible threat of further regulation.

Time after time AIAL has imposed charges above what is appropriate. In Air NZ's view, even putting to one side the information disclosure regime's inability to properly constrain the inefficient capital spend, the regime is not meeting its purpose if it permits AIAL to repeatedly charge above appropriate levels, pushing the boundaries of what is credible, but safe in the knowledge that in the worst case they can subsequently pull back their charges by the bare minimum needed to avoid inviting further regulation, albeit still above an appropriate return. Without a change, we are consigning the aviation industry to repeating this process again and again, with consumers the worse for it.

There can be no credible threat of further regulation if no one is testing whether the regime is working. Without this important check, the interests of consumers will continue to be significantly eroded to AIAL's benefit. We therefore encourage the Commission to include that overall assessment in their final report. We are concerned that staying silent on this issue may well be perceived as a tacit endorsement that the current regime is working.

Air NZ is happy to discuss any element of this submission with the Commission.


Yours sincerely,



Richard Thomson

Chief Financial Officer

Air New Zealand



Kiri Hannifin

Chief Sustainability & Corporate Affairs Officer

Air New Zealand

³ Cabinet Paper - Part 4 of the Commerce Act 1986: Strengthening the Regulatory Regime for Major International Airports (mbie.govt.nz), para 10, (emphasis added).

Air NZ's response to the consultation paper and draft conclusions

Section 1: Cost of Capital

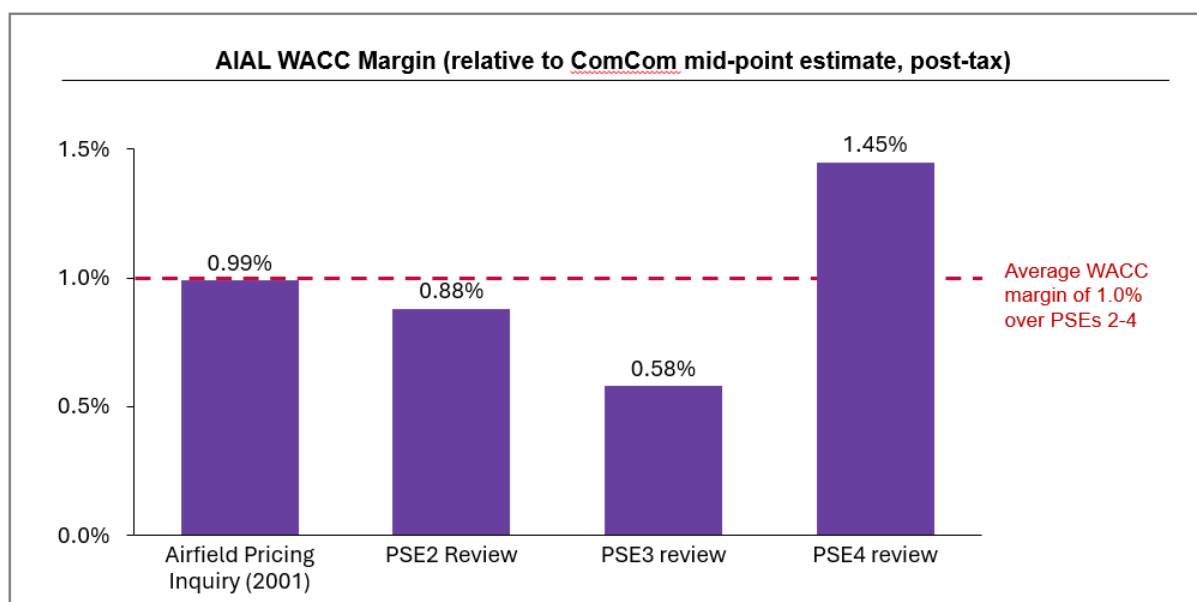
AIAL's Target WACC for PSE4 is too high

- 1.1 The Commission has concluded that AIAL's target cost of capital of 8.73% is excessive, due to the airport departing from the 2016 IMs in respect of:
 - Equity beta of 0.93 rather than 0.74
 - Leverage of 14% rather than 19%
 - TAMRP of 7.5% rather than 7%
- 1.2 The Commission has looked at two scenarios for estimating cost of capital: (1) adopting the 2016 IM parameter values but adjusting the TAMRP to 7.5% as was prevailing in 2022, or (2) adopting the relevant parameter values included in the 2023 IM decision. This results in a target cost of capital of 7.28% under the first scenario or 7.51% under the second scenario. In both cases the resulting cost of capital is higher than the Commission's starting point cost of capital of 6.98% using the 2016 IM values, including a TAMRP of 7%.
- 1.3 Air NZ considers the Commission's first scenario – adopting the 2016 IM parameters – is the appropriate approach to take when assessing AIAL's target cost of capital for PSE4. It is consistent with the approaches taken by Wellington Airport when it set its final prices for PSE4 in March 2021, and Christchurch Airport when it set prices for PSE4 in June 2022. As the Commission notes, such an approach is also “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.”
- 1.4 Air NZ agrees with the Commission's assessment that AIAL's adjustments are unwarranted and result in an excessive target return that is not in the interests of consumers. In particular, use of the equity beta of 0.93 relies heavily on data from the COVID-19 pandemic period, significantly overstating the impact of the pandemic on forward-looking estimates of the equity beta. As was evident from overseas regulators prior to AIAL making its decision, markets were settling and beta dropping as time progressed post the pandemic.
- 1.5 AIAL's PSE4 WACC margin (being the difference between its Target WACC and the Commission's estimate mid-point WACC estimate of 7.28%) is 145 basis points (**bp**).

AIAL has consistently targeted a WACC margin over the past 3 price setting events

1.6 The Commission has determined that AIAL has targeted excess returns (above the appropriate mid-point) at each of the past three price setting events. This WACC margin is shown in the figure below.

Figure 1: AIAL WACC Margin – Historic View



1.7 AIAL's WACC margin in PSE4 is 145 bp.

1.8 By comparison, the average WACC margin that AIAL has targeted over the past 3 price setting events is 100 bp.

A consistent WACC margin creates a strong incentive for AIAL to over-invest

1.9 Economic theory suggests that a consistent WACC margin leads to two market power concerns:

- Static inefficiency: holding RAB fixed, the WACC margin allows AIAL to set higher prices (as the Commission has consistently found); and
- Dynamic inefficiency: AIAL can earn higher profits by proposing greater capex than is necessary, as this increase grows the base from which it earns a WACC margin (the Averch-Johnson effect, or "gold plating").

1.10 This dynamic inefficiency can manifest in different ways:

- Overspending on unit costs for capex;

- Overinvesting in capacity; and
 - Overinvesting in 'quality', either aeronautical or retail (where the aeronautical till is subsidising overinvestment in retail).
- 1.11 Air NZ is of the view that both static and dynamic inefficiency exists in AIAL's pricing and capex programme. We cover static inefficiency in section 2 (Expected Profitability) and the dynamic inefficiency in section 3 (Investment).
- 1.12 In particular, Air NZ submits that AIAL's consistent WACC margin at price setting creates a strong incentive to over-invest. We provide clear evidence of this over-investment in section 3 (Investment).
- 1.13 Air NZ cautions that AIAL's pattern of overcharging at price setting and providing a partial rebate to customers (only after the Commission has found AIAL to be targeting excess profits) only addresses the inefficiency caused by static inefficiency. AIAL will be committed to the dynamic inefficiency inherent in the PSE4/5 capital programme as soon as construction begins. This is a critical point.

Section 2: Expected Profitability

- 2.1 Air NZ agrees with the Commission's interim finding that AIAL is targeting excess profits of \$193m to \$227m in PSE4 via an excessive target WACC.
- 2.2 Air NZ submits that AIAL is in fact targeting additional excess profits in PSE4 well in excess of the Commission's estimate:
 - 2.2.1 Air NZ believes that by failing to pass on tax losses to consumers in PSE4, AIAL is targeting additional excess profits of \$20.4m;
 - 2.2.2 Air NZ further submits that AIAL is allocating an excessive portion of its Group corporate costs to the regulated business, resulting in further excess profits of \$85m to \$110m in PSE4; and
 - 2.2.3 Finally, Air NZ submits that AIAL is also targeting excess profits in relation to excessive investment. This is covered in section 3 (Investment), where we establish that as a result of an excessive footprint and aeronautical allocation for the proposed \$2.1bn (aeronautical) DP and pier, AIAL's regulated asset base on completion will be ~\$720m higher than it would have been had the DP and pier been efficiently constructed and allocated. Once the DP and pier are complete, the additional charges borne by consumers as a result of the inefficient build will be in the order of ~\$120m per annum.

Expected Returns

- 2.3 The Commission's analysis of expected profitability concentrates on priced services as the costs of these services are recovered through aeronautical charges. Air NZ agrees that this is the appropriate approach in the absence of the longer-term analysis of returns on AIAL's non-priced aeronautical assets recommended by the Commission in its review of AIAL's PSE3 price setting. As the Commission notes "*lower return[s] on non-priced assets in PSE4 would likely increase over future price periods when the contractual arrangements [associated with those non-priced assets] are re-negotiated.*" Air NZ concurs with this assessment.
- 2.4 As discussed above, Air NZ agrees with the Commission's assessment that AIAL's target cost of capital is excessive and hence will result in excessive returns. Air NZ considers that the 7.28% cost of capital derived using the 2016 IM parameters is the appropriate target. Maintaining AIAL's approach will result in excess returns of \$226.5m over the PSE4 period.

Tax Losses

- 2.5 Air NZ believes that by failing to pass on tax losses to consumers in PSE4, AIAL is targeting additional excess profits of \$20.4m over PSE4.

- 2.6 If a regulated provider generates a tax loss in a given year, the regulated business will receive the benefit of those tax losses in subsequent years when those losses are offset against taxable profits, lowering the tax expense. The Commission has long held that the benefits of these losses should be passed on to consumers of the regulated entity.
- 2.7 As the Commission stated in its Input Methodologies Discussion Paper from 19 June 2009:

Provided the benefits of these tax losses are passed onto consumers in the year in which they are actually utilised—either by the business or the consolidated group—then the firm’s behaviour will be consistent with it earning normal returns.

2023 Input Methodologies Review

- 2.8 In its submission on the process and issues paper for the 2023 Input Methodologies review, AIAL wrote the following about tax losses:

Under the IMs, annual disclosures require that any current year tax losses must be carried forward to future years when profits are again delivered. The problem with this approach is that when setting aeronautical prices for a five-year pricing period, regulated airports will very rarely (if ever) have the foresight to forecast an as yet unknown upcoming global financial shock (like COVID-19) that will plunge them into a loss-making position for a period of time. Hence airports have little or no ability to compensate for that as yet unknown future shock by setting higher prices that compensate for the losses with higher profits either side of the global shock. In Auckland Airport’s case, COVID-19 delivered several hundred million dollars of un-forecast and therefore unmitigated economic losses.

On the other hand, our tax losses to be carried forward into Price Setting Event 4 (“PSE4”) are known with certainty and must be included in the building blocks aeronautical pricing forecasts. This will reduce our allowable revenues in PSE4 and means that Auckland Airport will gain no direct financial benefit from one small saving grace from the pandemic, i.e. a tax loss that will reduce future cash tax payments. Instead that benefit will be entirely transferred to PSE4 airline customers, some of whom may not even have been operating at Auckland Airport during the pandemic.”

- 2.9 The Commission did not agree with AIAL and made no change to the tax loss IM. Its draft decision, released in June 2023, sets out the reasons:

21.1 Our draft decision in respect of IM decision TX19 is to make no change to how the Airports IM treats tax losses to deal with the impact of COVID-19 on Airports’ revenues. This issue was raised by AIAL in its submission on the Process and Issues paper.

21.2 Airports do not usually forecast making a loss when determining their prices during a price-setting event. As such, the prices will not reflect any tax losses. On the other hand, Airports are required to carry forward any tax losses in their information disclosures and to reflect these via lower future prices.

21.3 Our reason for proposing no change is because the Airports IM already provides sufficient flexibility to deal with this issue. The current IM allows Airports to propose wash-ups for past losses as part of their future price-setting events. We do not consider a change to the Airports tax IM would (a) better promote the s 52A outcomes; or (b) improve regulatory certainty, without detrimentally impacting the s 52A purpose.

AIAL DY 2022 information disclosures

- 2.10 In its DY2022 information disclosures, AIAL disclosed \$72.8 million of tax losses for its regulated business.

AIAL PSE4 Consultation

- 2.11 In its June 2023 PSE4 Reasons Paper AIAL confirmed that *“Auckland Airport is not seeking to recover any of the revenue shortfalls incurred due to the pandemic versus the price setting forecast for PSE3”*. AIAL did however introduce in PSE4 an asymmetric risk sharing washup mechanism.
- 2.12 None of AIAL’s public or private PSE4 consultation documents contain any reference to tax losses.
- 2.13 It is not possible to determine from AIAL’s PSE4 information disclosures whether or not AIAL took the \$72.8m tax losses into account when setting prices for PSE4.
- 2.14 Air NZ assumed however that AIAL had calculated its forecast unlevered tax for PSE4 in a manner consistent with Part 4 of the Input Methodologies Determination (2016 and 2023), which sets out that the calculation of tax needs to take into account any tax losses from the regulated business. If AIAL was proposing to diverge from the Input Methodologies, AIAL should have consulted on this matter. It did not.

Air NZ’s submission on the PSE4 Process & Issues Paper

- 2.15 As part of its analysis to support a response on the PSE4 process and issues paper, Air NZ built a financial model of AIAL’s regulated business, attempting to simulate the analysis the Commission would undertake for its PSE4 review. This analysis suggested to Air NZ that AIAL had not included the \$72.8m of tax losses in its PSE4 price setting.

- 2.16 Air NZ’s submission on the process and issues papers noted the following:

In its DY2022 Information Disclosure, AIAL disclosed \$72.8 million of tax losses for its regulated business. AIAL will use these tax losses to offset tax paid by its regulated business over PSE4. AIAL does not appear to have taken these tax losses into account when setting its target revenues and pricing for PSE4, and as a result AIAL is targeting excess revenue of \$20.3 million over PSE4. Air NZ believes that the Commission should incorporate these tax losses into its ex-ante PSE4 profitability analysis.

AIAL's cross-submission on Air NZ's submission on the PSE4 Process & Issues Paper

- 2.17 AIAL confirmed in its cross-submission that *“when setting prices for PSE4, Auckland Airport did not include the use of tax losses in its pricing forecasts.”*
- 2.18 AIAL suggested that it was entitled to do so because it was still awaiting the Commission's response to its Input Methodologies Review submission on tax losses.
- 2.19 AIAL further pointed out in its cross submission that:

Having considered the Commission's views in the Draft IM Decisions, an alternative approach could have been to include an opening carry-forward adjustment when setting PSE4 prices, to reflect the economic value of tax losses that were carried forward to PSE4. This would have materially had the same effect as the approach that was adopted - that is to not include tax losses in the forecasts when setting PSE4 prices.

- 2.20 AIAL also wrote:

At no time during the consultation on PSE4 prices was this issue raised by Substantial Customers.

- 2.21 If AIAL was proposing to diverge from the Input Methodologies on tax losses or was proposing to include an opening carry-forward adjustment in respect of tax in PSE4, Air NZ submits that it was AIAL's obligation to raise the matter and that AIAL should have consulted on these points in PSE4 consultation. Again, it did not.

- 2.22 Finally, AIAL proposed in cross-submission that:

If the Commission considers that tax losses should be included in its profitability assessment, then we consider it must also include an appropriate opening carry-forward adjustment to reflect the value of tax losses realised and carried forward from PSE3.

- 2.23 Air NZ submits that neither AIAL nor the Commission should include an opening carry forward adjustment in relation to tax losses because it has not been consulted on, as required under Clause 2.5 of the Information Disclosure Determination.

Review of AIAL's PSE4 Price Setting - Consultation Paper

- 2.24 In its report released on 17 July 2024, the Commission did not address the issue of tax losses in AIAL's PSE4 price setting.
- 2.25 The financial model released by the Commission on the same day includes an input line for tax losses utilised in PSE4, but this is blank.

Air NZ's Position

- 2.26 The intent of the current regulations in respect of tax losses is clear – the benefits of tax losses incurred in regulated airports should be passed back to consumers in the year in which they are utilised. Failure to do so would be consistent with AIAL targeting excess returns.
- 2.27 Both the Commission and AIAL have acknowledged the requirement for airports to carry forward any tax losses in their information disclosures and to reflect these via lower future prices at a price setting event. The Commission considered and confirmed the current treatment as appropriate as part of the 2023 Input Methodologies Review.
- 2.28 The fact that AIAL's tax losses were not expected or could not be forecast is not relevant. Tax losses tend to be generated by unexpected events and this would have been understood and anticipated when the regime was established.
- 2.29 AIAL has not included its opening tax loss balance of \$72.8m in its PSE4 price setting.
- 2.30 The forecast unlevered tax in schedule 18 (vi) of AIAL's PSE4 information disclosure schedules (released 17 August 2023) have therefore been calculated in a manner that is inconsistent with Part 4 of the Input Methodologies Determination (2016 and 2023),
- 2.31 If AIAL was proposing in its PSE4 price setting to include an opening carry-forward adjustment in respect of tax in PSE4, it was incumbent on AIAL (under Clause 2.5 of the Information Disclosure Determination) to consult with substantial customers on the matter. AIAL did not do this.
- 2.32 Air NZ's position is unchanged from that expressed in our submission on the process and issues paper. We believe that the Commission should have included AIAL's opening PSE4 tax loss balance of \$72.8m when undertaking its excess profit analysis. If the Commission had done so, its estimate of AIAL's excess profits would have been higher by approximately $\$72.8\text{m} \times 0.28 = \20.4m .

Operational Expenditure

- 2.33 Regulated providers with unregulated business operations will often serve both operations from one corporate office. This generates cost efficiencies (one board, one CEO, one CFO etc.) but leads to complexity and subjectivity in the allocation of those costs between the regulated and unregulated operations. Regulated providers can target excessive profits by allocating a higher than reasonable share of those shared corporate costs to the regulated business.

AIAL appears to be allocating an unreasonable proportion of its corporate overheads to its regulated business

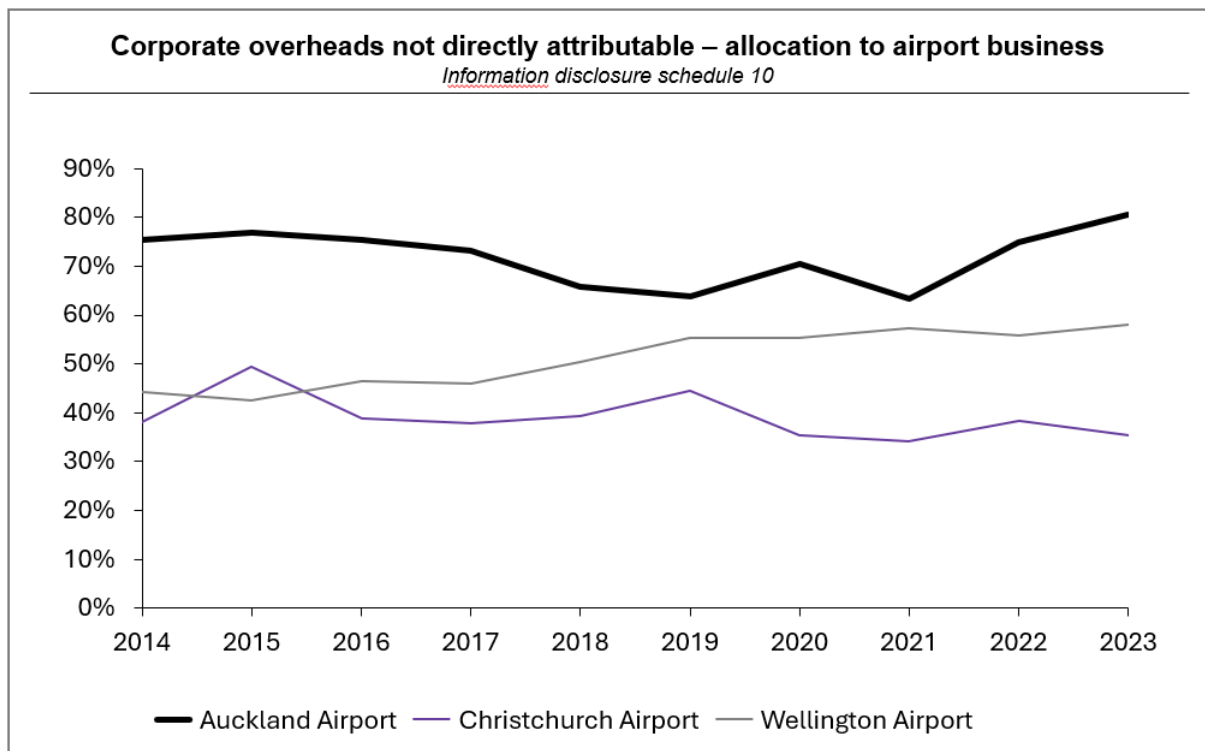
- 2.34 AIAL's DY2023 information disclosures (Schedule 10) showed total corporate overheads of \$44.601m, of which 99% was not directly attributable. AIAL allocated 81% of this not

directly attributable corporate overhead cost (\$35.6m) to the regulated business using proxy allocators.

2.35 Air NZ does not believe an allocation of 81% of corporate costs to the regulated business is reasonable. We note the following:

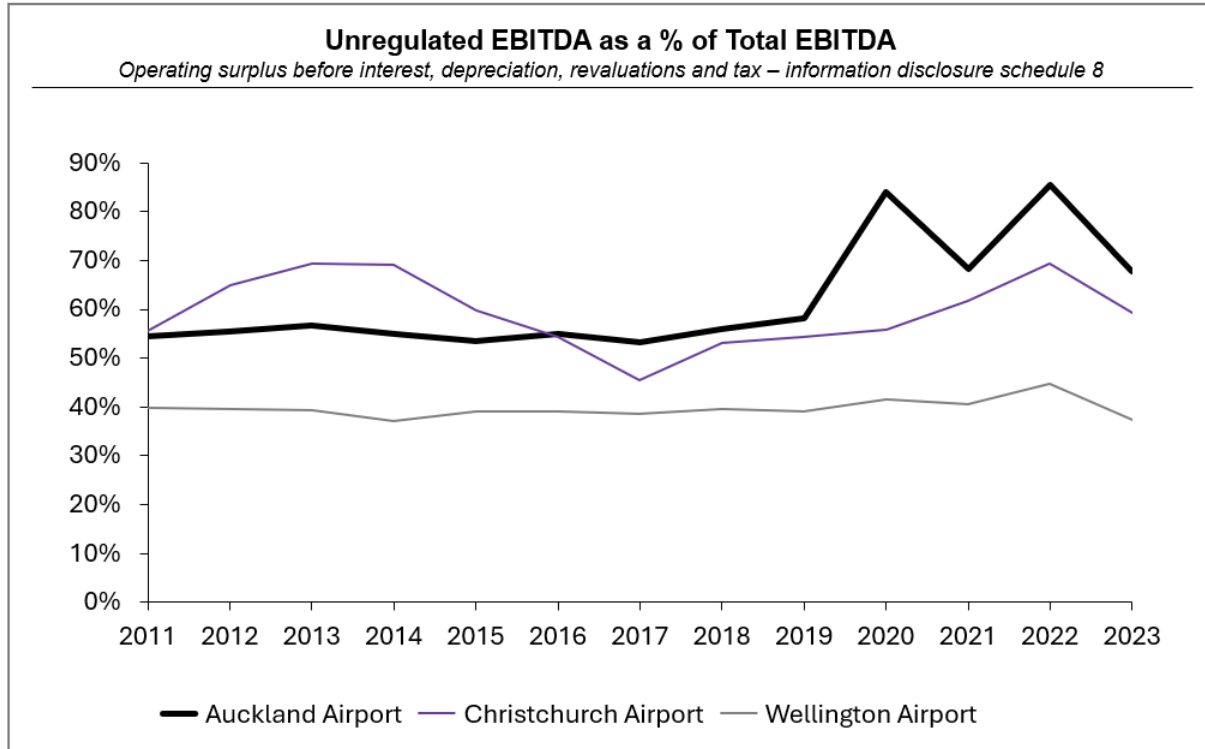
- AIAL has a large and valuable unregulated business. We estimate the regulated business contributes only ~30% of AIAL's total enterprise value⁴; and
- AIAL allocates materially more of its corporate overheads to its regulated business than either Christchurch Airport or Wellington Airport (refer figure 2). This is despite AIAL having an unregulated business that is proportionally much larger than either Wellington or Christchurch (refer figure 3).

Figure 2: Corporate Overheads Not Directly Attributable – Allocation to Airport Business



⁴ AIAL's total enterprise value is ~\$14.0bn (market cap as at August 2024 of \$11.3bn plus Forsyth Barr forecast net interest bearing debt as at 30 June 2024 of \$2.7bn). AIAL in its August 2023 Price Setting Disclosure forecast RAB as at 30 June 2024 to be \$2.2bn. Assuming the regulated business enterprise value is ~2.0x RAB (this was the average valuation of EDB transactions in New Zealand during the Information Disclosure era) AIAL's unregulated business has an enterprise value of \$14.7bn less \$4.4bn = \$9.6bn, which is ~70% of AIAL's total enterprise value.

Figure 3: Unregulated Operations – Contribution to Group EBITDA



Corporate cost allocation in PSE4

2.36 AIAL has allocated the following corporate overheads to the regulated business in PSE4

(\$m)	DY23	DY24	DY25	DY26	DY27
Corporate Overhead Allocation to Regulated Business	42.6	52.7	56.5	57.8	61.9

2.37 Air NZ does not know what portion of AIAL's corporate overheads for PSE4 have been allocated to the regulated business for the purpose of PSE4 price setting. We assume it is a similar amount to the 81% AIAL allocated in DY2023. On this basis Air NZ believes that airport consumers are receiving no benefit from the efficiencies that AIAL must capture by having a combined head office function to service both regulated and unregulated activities. In fact, consumers of AIAL's regulated airport services appear to be subsidising the cost of operating AIAL's highly profitable and valuable non-regulated businesses by paying more than their fair share of the corporate overheads.

- 2.38 Air NZ believe that AIAL should be allocating ~50-70% of its corporate costs to its unregulated business (based on the relative contribution to operating profit of its unregulated business and the behaviour of its peers). On this basis we estimate AIAL's excessive allocation of corporate overheads is inflating its aeronautical revenues by \$14 million to \$22m annually in PSE4.
- 2.39 While we acknowledge that we did not raise this concern with AIAL during PSE4 consultation, our resources and focus in PSE4 consultation were primarily focused on the size, adequacy and efficiency of the capital plan – that does not change the fact that it represents a material level of excess revenue. We also consider this to be one of many examples where the ID regime doesn't strike the right balance in incentivising the desired behaviour from AIAL; airports will look at multiple means to increase revenues until this is challenged by consumers, and this challenge is dependent on the resources and capabilities of consumers to identify and evidence this. This is not consistent with outcomes in a workably competitive market.

Commission to consider whether AIAL is targeting excessive profits through excessive allocation of not directly attributable corporate overheads

- 2.40 Air NZ therefore requests that: (i) the Commission reviews the proxy allocators used by AIAL to allocate not directly attributable corporate overheads for PSE4 price setting to determine whether they are reasonable; and (ii) if they are not reasonable incorporate a more reasonable allocation into the Commission's calculation of excess profits over PSE4.

Commission should not factor AIAL's closing carry forward RAB adjustment into its PSE4 profitability analysis

- 2.41 Schedule 18 (i) of AIAL's PSE4 information disclosure schedules (released 17 August 2023) included an additional carry forward adjustment of \$42.3m at the end of PSE4, taking the closing carry forward adjustment to \$43.7m.
- 2.42 Where AIAL includes a forecast closing carry forward adjustment (as defined), clause 2.5(1)(d) of the Airport Services Information Disclosure Determination 2010 requires that, in addition to publicly disclosing a description of the adjustment and explaining how it has been calculated, AIAL must also publicly disclose "a summary of views expressed by substantial customers ... from the consultation undertaken as part of a price setting event". AIAL confirms it did not consult with substantial customers regarding this carry forward adjustment in its PSE4 Price Setting Disclosure. Air NZ acknowledges that AIAL characterises this as one of several errors and omissions following the announcement

of its PSE4 pricing decision,⁵ but nevertheless believes AIAL should have consulted on it when it became apparent, and then publicly disclosed a summary of views from substantial customers. It did neither. Not only is this a failure to comply with the requirements, it is another example of its failure to properly consult.

- 2.43 Air NZ submits that AIAL should not have included the closing carry forward adjustment of \$42.3m in its PSE4 disclosures or factored this carry forward adjustment into its PSE4 price setting.
- 2.44 Air NZ submits that the Commission should therefore not include the closing carry forward adjustment of \$42.3m in its calculation of AIAL's excess profits over PSE4.

Depreciation

Tilted Annuity Depreciation

- 2.45 Air NZ supports the Commission's draft conclusion (paragraph 3.54 of 17 July 2024 consultation paper) that a standard straight-line depreciation approach does not best promote the long-term benefit of consumers.
- 2.46 Air NZ supports the Commission's draft conclusion (also paragraph 3.54) that the tilted annuity approach to recovering depreciation of long-lived assets such as terminal infrastructure is likely to better promote the objectives of Part 4.
- 2.47 Air NZ agrees with the Commission's observation that *"using a straight-line method to recover depreciation means that in the short term, when there are fewer users, the price is higher for use of the same asset. This is exacerbated by the unindexed value of the asset base which means that in real terms users pay less over time toward depreciation (under a straight-line approach)"*.
- 2.48 CIAL applied tilted annuity depreciation to all aeronautical assets from 1 July 2017. The tilt factor selected by CIAL was based on the expected long term passenger growth rate for the airport.
- 2.49 Air NZ supported the adoption of tilted annuity depreciation by CIAL in RY2018 on the basis that the capital charge would increase over time at approximately the same rate as demand so that prices would be approximately constant in nominal terms over time.
- 2.50 Air NZ submits the tilted annuity depreciation approach adopted by CIAL has worked well for consumers and is consistent with the Part 4 purpose.
- 2.51 Over the course of the consultation process, AIAL did seek the views of airlines regarding the potential for a longer-run price path which could share costs over a longer term. Air

⁵ Commentary, section 3.2.5.3.


NZ indicated it would be interested in exploring potential options for price-smoothing over a longer period.

- 2.52 In the final month of the PSE4 consultation process AIAL shared one slide with substantial customers around the depreciation profile of a hypothetical \$1bn airfield investment assuming a usage-based depreciation rate (based on number of landings). AIAL concluded from this that “alternative depreciation profiles introduced in PSE4 are unlikely to reduce PSE5 aeronautical prices”.
- 2.53 Air NZ is not aware that AIAL considered the application of tilted annuity depreciation for PSE4.
- 2.54 Air NZ expects that were AIAL to apply tilted annuity depreciation (with an appropriate tilt factor aligned with AIAL’s long term passenger growth) to the assets commissioned in PSE4, it would result in better outcomes for consumers relative to straight line depreciation:
- Tilted annuity depreciation reflects the gradually increasing utilisation of the asset over time, meaning that consumers pay a consistent amount toward the cost of the asset over time, resulting in a flatter pricing profile than straight-line depreciation.
 - Tilted annuity depreciation should lower prices in PSE4 and PSE5, which will aid the recovery of post-pandemic passenger volumes
- 2.55 Air NZ notes that the Commission has requested a submission from AIAL further explaining its preference for straight line depreciation. We look forward to reviewing this submission. We strongly encourage AIAL to base the analysis on the actual assets intended to be commissioned in PSE4, rather than hypothetical assets.

Accelerated Depreciation of the DTB

- 2.56 We note the Commission’s finding that *“Auckland Airport’s use of accelerated depreciation for the investment in the existing Domestic Terminal Building (DTB) is ...not unreasonable, as it is consistent with the Airport’s intention to de-commission the DTB when the new domestic terminal becomes operational.”*

2.57 

- 2.58  However, we believe that AIAL’s stated intention to de-commission the DTB at the end of PSE4 was neither reasonable nor realistic at the time it set PSE4 prices. As a result, consumers have been unnecessarily levied with higher prices than was necessary.

Information disclosures

- 2.59 The Commission has indicated in its report that it “may look at amending ID requirements”. Air NZ would suggest that interested parties would benefit from the inclusion in airport information disclosures of more information relating to depreciation, both in annual disclosures and at price setting events.
- 2.60 We note that Schedule 4(vii) of the information disclosure template for electricity distribution businesses provides RAB information by nine asset categories and includes information on weighted average remaining life and weighted average total expected life.
- 2.61 Air NZ believes this information would be a useful addition to the information disclosure requirements for Airports, both annually and in respect of the assets to be commissioned in a price setting period.

Demand forecasts

- 2.62 Air NZ disagrees with the Commission’s draft conclusion (paragraph 3.78.3) that AIAL’s overall demand forecast appears reasonable, for the following reasons.
- The Commission appears to be considering the PSE4 period in isolation when determining AIAL’s incentives for demand forecasting, whereas Air NZ argues that these incentives change when considered over PSE4 and 5 together.
 - The Commission states that there has been extensive consideration of the airlines’ demand study, however AIAL committed to the construction of the DP less than two working days⁶ after receiving the Airlines’ demand study. This cannot be considered as extensive consideration.
 - Air NZ considers that AIAL did not seek a response to airline concerns, rather sought a justification and support of its own position, despite airlines arguably being the experts in understanding how their own customers respond to changes in airfare pricing – a fundamental principle of dynamic pricing practices employed by airlines.
 - Air NZ considers the differences between the expert studies’ impact on demand to be significant.
- 2.63 Air NZ considers that the impact on demand over PSE4 and PSE5 of AIAL’s capital plan is of significant concern. Air NZ submits that AIAL is incentivised to over-state demand across PSE4 and PSE5 ahead of the commencement of construction on the DP, knowing that it has the option to re-assess for PSE5 once construction is well underway and the

⁶ The airlines’ BISOE study was completed and sent to AIAL on the evening of 14 March 2023. AIAL’s Board decision to commit to the Terminal Integration Programme occurred on 16 March 2023.

project is irrevocable. Readjusting to a lower demand profile at PSE5 price setting will result in further price rises based on a capital plan which has not adequately accounted for the demand impact of the price rises required to fund it.

- 2.64 Focusing on PSE4 in isolation ignores the interdependencies between investments made in PSE4 and future PSEs. The path dependence of AIAL's investment program means this approach risks predetermining future pricing decisions.
- 2.65 This is because once the PSE4 capex is sunk, continuing down the same path may be the most efficient thing to do in PSE5 and beyond, even if there was a more efficient total programme that could have been embarked on in PSE4.

Incentives in forecasting demand

- 2.66 The Commission's draft report states that "Airports have some incentive to be conservative in their passenger demand forecasts to set higher prices."
- 2.67 While Air NZ agrees that this statement may be true in the context of a single five-year price setting period, we do not believe it applies in the case where an airport, with a consistent history of targeting a WACC margin, is trying to justify embarking on a generational reinvestment programme spanning several PSEs.
- 2.68 To the extent that demand forecasts are used to justify capital plans, there is an offsetting effect when returns beyond the immediate PSE are considered. Specifically, given that AIAL has historically and is likely to continue to target returns greater than WACC, inflating demand forecasts today helps to justify the increases in the RAB on which excess returns will be earned in future periods. Thus, during a phase of steady state investment this impact on incentives may not be large, however when there is a step change in investment required this effect is likely to be much more important. This is because inflating demand forecasts now can materially inflate the RAB which is locked in for future pricing periods.
- 2.69 Air NZ therefore believes AIAL has a strong incentive to overstate demand projections in PSE4 (i.e. to understate the dampening effect on long-term demand caused by the significantly increased prices required to fund its capex programme), to ensure the capex programme is committed.

How AIAL has forecast demand

- 2.70 Air NZ refers the Commission to submissions by BARNZ regarding the combined airlines' demand impact study commissioned with BIS Oxford Economics (**BISOE**).
- 2.71 Air NZ remains of the view that AIAL's InterVISTAS study materially understates the passenger demand impact over PSE4+5 of AIAL's actual and indicative charges. By contrast, the Airlines' BISOE study provides a more robust analysis as it:

- Directly estimated the price-elasticity of demand using actual airfare data for the New Zealand market;
- Used route-level elasticities rather than national elasticity;
- Applied an allocation of airport price increases more consistent with real world airline revenue management and strategic decision making; and
- Considered the airline response function to an effective tax.

2.72 A fuller explanation of the above is contained in BISOE's Response to AIAL Comments Regarding Price Setting Decisions PSE4, as submitted by BARNZ.

2.73 As a result of these differences, Air NZ considers that (i) the airlines' demand study is based on a more robust and accurate data set and methodology, and (ii) the differences in demand impact are of material significance. This latter point illustrates a fundamental issue of the impact of inefficient investment: AIAL's proposed capex programme is simply unaffordable, and it will have a significant impact on domestic growth.

AIAL's response to submissions

2.74 Air NZ strongly disagrees with assertions from AIAL in the consultation paper at paragraphs 3.74 and 3.75 that, in effect, the airports are accountable for deciding what service levels customers require, as airlines are commercially incentivised to keep prices/service levels low. This ignores that:

- Airlines sell the 'product' of airport infrastructure to passengers through airfares, and by extension airlines have a direct feedback loop from passengers as to what they require and expect for what cost;
- As the seller of the product, airlines field complaints directly from their customers if service levels are not up to scratch – therefore it is arguably not an airport's "social licence" at stake in isolation. We discuss this in further detail below; and
- While it is true that airlines wish to keep prices low, efficient expenditure is as important a driver as service levels. Infrastructure bottlenecks, particularly at an airline's home or hub airport, is a critical strategic risk to an airline's growth ambitions. AIAL's attempts to characterise airlines as opposing investment at AKL are demonstrably untrue⁷, and distracts from the core argument that investment should be efficient and in line with customer requirements.

⁷ Air NZ's calls for capacity investment to meet air traffic demand is well documented publicly, for example: [Air New Zealand boss Christopher Luxon apologises for 'challenging year' - NZ Herald](#); and Air NZ's PSE3 submissions.

- 2.75 Note that when airports discuss the customer experience in relation to the airlines' passengers they are not exclusively talking about aeronautical activities and will by nature include their Till 2 activities – this will inform design decisions and thus directly impact aeronautical charges.
- 2.76 In regards to a passenger's airport experience, Air NZ's internal data shows it is almost always held responsible by passengers for a poor airport experience. Air NZ's own customer satisfaction data (**CSAT**) supports this - the arrivals experience rates within the top [REDACTED] influential factors driving Air NZ customer satisfaction, while airport experience overall sits in the top [REDACTED]. Therefore, it is particularly important for Air NZ to ensure passengers have a satisfactory airport experience, balanced against many of the other factors that contribute to CSAT.

Revenue wash-up mechanism

- 2.77 The Commission's draft conclusion is that AIAL's proposed revenue wash-up "seems" appropriate but that AIAL could be more transparent about how this would work in practice, to "aid customers' understanding". Air NZ agrees with the Commission that further transparency is required and reiterates its view in our submission on the Process and Issues paper that the revenue wash-up mechanism designed by AIAL is extremely favourable to the airport.
- 2.78 Air NZ considers that the symmetrical nature of the wash-up (+/- 15% of revenue and +/- 0.75% IRR threshold) does not acknowledge the fact that if AIAL is falling short of its targets by that much, then its airline customers would also be facing significant financial losses (as was evident during the COVID-19 pandemic). For airline customers to then have to face increased revenue requirements in future to offset airport losses is not consistent with a competitive market or in the interests of consumers.
- 2.79 In respect of AIAL outperforming its targets, Air NZ considers the +15% threshold before there is any return of revenue is significantly too high in the context of AIAL. With forecast priced revenue of \$2.5 billion over PSE4, AIAL could generate additional revenues of ~\$380 million over the period which would not be taken into account in any carry-forward adjustment.

Section 3: Investment

- 3.1 AIAL is in the process of implementing the first phase of a multi-PSE investment plan which spans not only the identified capital plan to 2032, but also a longer-term Master Plan which should eventually include future capacity expansion through a second runway and expansion / upgrades to regional and international services.
- 3.2 The AIAL Master Plan is now more than 10 years old, contrary to IATA guidance which suggests that airport masterplans should be “reviewed every five years or more regularly as required by market developments” and the requirement for Australian airports to update their master plans every five years. Notwithstanding, Air NZ’s external experts have estimated (based on the existing publicly available, high-level information on AIAL’s 2014 Master Plan) that an order-of-magnitude cost to deliver the full Master Plan is likely to be in the order of \$19bn (in 2023\$).
- 3.3 In this context, Air NZ considers that it is of paramount importance to ensure that AIAL is adequately incentivised to invest efficiently at the outset of this programme, as overspending on earlier stages will crowd out investment in future capacity-generating infrastructure if rises in per passenger aeronautical charges extend beyond the capacity of passengers to absorb them.
- 3.4 Unfortunately, Air NZ is of the view that AIAL is not investing efficiently in aeronautical assets, and its actions demonstrate that it is not incentivised to invest efficiently in aeronautical assets. Our key reasons for this are:
- The DP⁸ is oversized compared to multiple benchmarks, most notably through a unilateral application of the very top end of the IATA Levels of Service (LoS) metrics. As a result the DP is twice the size required for an efficient domestic terminal;
 - One of the main beneficiaries of the over-sizing of the terminal is retail space, and dwell space (which is a key driver of the value of retail space), however AIAL plans to allocate █████ of the cost of the terminal to the aeronautical till;
 - During consultation, when this over-sizing translated into indicative per-passenger pricing █████ higher than airlines had been consulted on, AIAL made little to no effort to revisit design assumptions, instead insisting to airlines that there was “no other option” to reduce the size (and by extension, cost) of the terminal;
 - When airlines were forced to commission their own airport engineering experts to prove that there was in fact plenty of scope to reduce the size of the terminal, while maintaining levels of service well within the correct application of IATA’s LoS,

⁸ The Domestic Processor includes the headhouse, pier and apron, as per AIAL’s PSE4 Price Setting Disclosure – Appendix A

AIAL's response was to staunchly maintain and defend its position that no other option had been available to them; and

- In support of its position, AIAL has provided measurements that incorrectly understate the size of gate lounge infrastructure against the IATA guidelines.

3.5 Air NZ therefore disagrees with the Commission's overall draft conclusion on investment, for the reasons set out in the remainder of this section. We conclude that:

- The process and rigour AIAL applied to planning and costing the investment plan was not reasonable;
- AIAL did not consult customers on the selection of an appropriate LoS, instead unilaterally selecting the highest end of the IATA optimum range. This LoS is more suitable for high end international terminals, and therefore AIAL's regard to service quality issues and capacity requirements is disproportionate to customer needs;
- The forecast capital expenditure to be allocated to aeronautical services is not reasonable, as more efficient options were available to provide the same capacity and operational needs, at a LoS commensurate with customer and passenger requirements; and
- As a result, this planned investment is producing outcomes inconsistent with the Commerce Act 1986 Part 4 purpose, as consumers will be paying more than they should for the service quality they require.

3.6 We note here that in prior assessments the Commission appears to have placed considerable weight on the views of customers when assessing the appropriateness of AIAL's investments. We urge the Commission to continue to do so.

Capital Expenditure Consultation Process

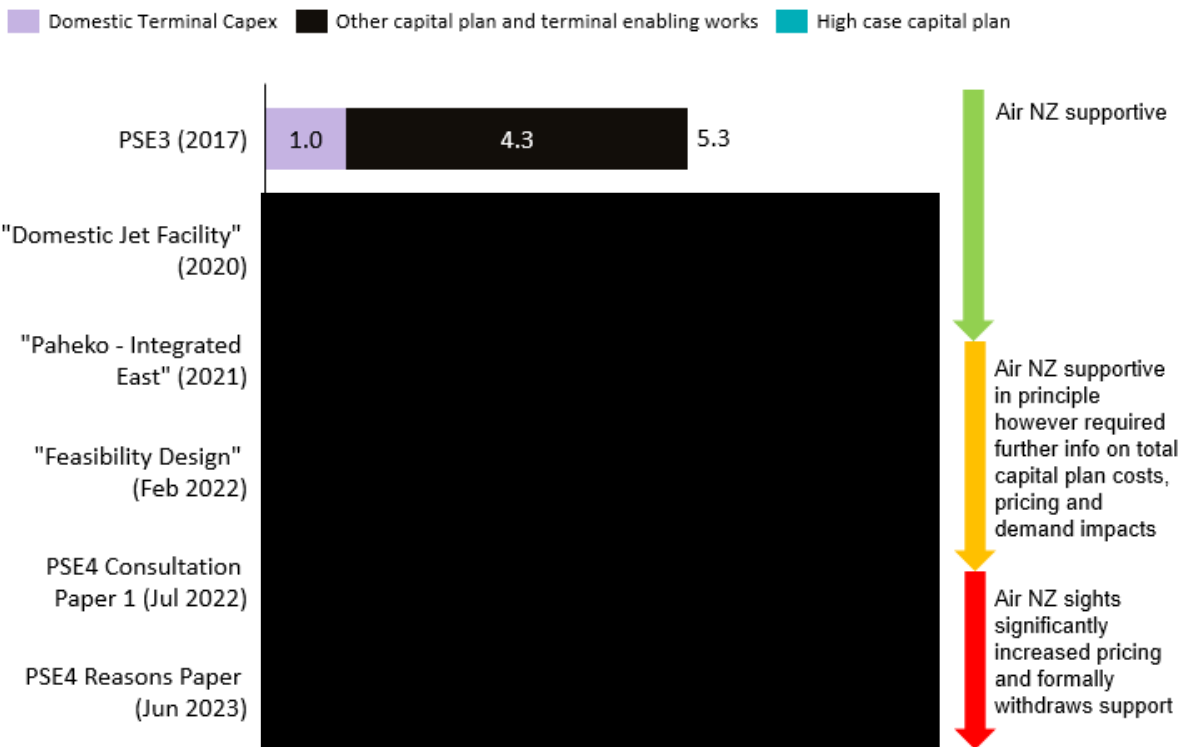
3.7 Air NZ acknowledges that there has been history of discussions on a new Domestic terminal commencing from around 2012. Air NZ had been a proponent of investment in a new terminal, given its ambitions to grow capacity at its hub airport in AKL.

3.8 While the consultation paper provides detail on the history of consultation on what is now referred to as the Terminal Integration Programme (**TIP**) and how the various concepts evolved over time, there is no information provided on how the price/quality equation became so out of balance between 2021 and 2022 that Air NZ was forced to withdraw its support.

3.9 Slide 15 in Air NZ's supporting information document summarises this position, which we set out in more detail below.

Figure 4: Summary of consultation between PSE3 and PSE4

Initially Air NZ supported the design at a substantially lower cost to passengers however became increasingly concerned about cost escalations



Notes:
 This graph provides information as communicated to Air NZ by AIAL. We have attempted where possible to include full costs for the DP (pier, headhouse, apron) as inclusions/exclusions in the programme varied over time.

- 3.10 In 2017, the indicated cost for a new Domestic Jet Terminal as disclosed during the PSE3 review was \$1.0bn within a capital plan totalling \$5.3bn, \$1.7bn of which was for a capacity-enhancing second runway. Air NZ was supportive.
- 3.11 In early 2020, the Domestic Jet Facility was costed at \$1.2bn but ultimately put on hold due to the Covid-19 pandemic. Air NZ remained supportive of this capex and also supported the pause to the commencement of works.

- 3.12 In 2021, Air NZ was consulted on project Paheko, and in April endorsed the Integrated East concept. At the time, AIAL stated costs as “full Dom Processor (Pier A1 and Headhouse) of \$ [REDACTED]”⁹ (please see note 1 in figure 4 above).
- Indicative pricing was given at the time in a graph¹⁰, indicating FY32 per pax price levels of ~\$ [REDACTED] (INT), ~\$ [REDACTED] (DOM), and \$ [REDACTED] (REG)
 - AIAL estimated that [REDACTED] of domestic jet charges by 2032 (to ~\$ [REDACTED]) would lead to a reduction in passenger demand of [REDACTED]% over the period.¹¹
 - Air NZ was supportive of the concept however noted at the time there was a need for additional information in several areas, and that price elasticity impacts were critical.¹²
- 3.13 Subsequent to this, Air NZ remained supportive of ongoing capex to progress the design of the terminal and commencing “no regrets” items which addressed existing capacity, operational and customer service issues. However, Air NZ consistently requested further information on the full costs associated with the developing programme, through various forums including MACPAC and bilateral discussions.
- 3.14 In February 2022, AIAL presented an update on the Integrated Terminal where the floorplate of the various areas of the development and the indicative cost of these specific areas was provided to “confirm that the size and scope of the integrated terminal remains appropriate, and the costs understood for the services being delivered”.¹³ Included in this presentation was:
- Costs by area, with the total cost of the integrated terminal estimated at \$ [REDACTED] bn (aeronautical)¹⁴; and
 - Selective benchmarking of various parts of the terminal to DTB in terms of IATA LoS, described only as “Optimum”, “Sub Optimum/Under Provided” or “Optimum high range”. No detail was provided on which “optimum” had been chosen and whether this was appropriate for a NZ domestic terminal.

Air NZ was supportive of the cost as presented subject to ongoing discussions around growth and demand impact. [REDACTED]
[REDACTED]

⁹ Auckland Airport – MACPAC Monthly Aeronautical Capital Plan Consultation Pre-read – 14 April 2021, p.35

¹⁰ Ibid, p.40

¹¹ Ibid, p.43

¹² Auckland Airport MACPAC Minutes – 13 May 2021

¹³ MACPAC – Monthly Aeronautical Capital Plan Airline Consultation Meeting, 22 February 2022, p.18

¹⁴ FY22 Real dollars, excluding capitalised interest – indicative based on feasibility design

- 3.15 On 1 June 2022, AIAL requested any further feedback on the design of the Integrated Terminal by 30 June 2022, ahead of a recommendation to be made from AIAL management to its full Board of Directors on 17 August 2022.
- 3.16 On 29 June 2022, Air NZ was presented with an update on the Integrated Terminal Concept Design. AIAL stated that they would “*continue to engage further with airlines on this through the bilateral and pricing consultation processes*”.¹⁵ At the time, Air NZ stated that providing complete feedback on capex was challenging without understanding the impact to pricing and preferred if pricing was available as part of capital planning discussions. AIAL responded that indicative price paths would be available in Consultation Paper 1 of the PSE4 pricing review, to be released on 4 July 2022.¹⁶
- 3.17 On 30 June 2022, Air NZ wrote to AIAL, providing feedback on the proposed terminal. Air NZ wrote:

The scale of investment required for the integrated terminal, alongside the broader Masterplan for Auckland, will result in sustained cost increases for our customers and we remain very concerned about the impact this will have on demand and our strategic ambition for Auckland as our hub. We seek confirmation that AIAL will continue to review opportunities to minimise increases in aeronautical charges and rents, reduce regrettable spending and/or phase costs out into later years.

Understanding the 10-year capital plan and aeronautical pricing impacts is critical for us to be able to provide informed feedback on the proposed designs. Therefore, we reserve the right to provide additional feedback on receipt of the draft capital plan in July. As the programme moves forward, we request regular updates on total programme costs and risks.

- 3.18 On 7 July 2022, Air NZ finally received AIAL’s PSE4 Consultation Paper One and Draft Capital Plan. This was Air NZ’s first sight of the entire proposed capital plan including indicative pricing. At this point Air NZ was presented with the following:
- Proposed cost of the Integrated Terminal increased to \$■■■■ bn
 - Proposed full Capital Plan \$■■■■ bn (Second runway **not** included)
 - Proposed indicative prices by FY32 increased by ■■■■% compared to those provided when Paheko East was endorsed, to \$■■■ (INT), \$■■■ (DOM) and \$■■■ (REG)
 - DP capacity meeting “IATA Optimum LoS”.

- 3.19 In Air NZ’s response on 30 August 2022, it formally withdrew support, stating:

Air New Zealand has previously provided support for the direction outlined in the Auckland Airport Masterplan and shared our ambitions for Auckland as our home port

¹⁵ MACPAC – Monthly Aeronautical Capital Plan Airline Consultation Meeting, 29 June 2022, p.24

¹⁶ Auckland Airport MACPAC Minutes – 29 June 2022

and hub. We continue to acknowledge that a level of investment is needed to address existing capacity constraints and challenges with legacy infrastructure. However, the scale of investment forecast over the next ten years exceeds what has been previously indicated by some magnitude. Of significant concern is that pricing forecasts have increased c. ██████%¹⁷ (FY32 forecasts) from what was indicated to us in 2021. We believe this level of price increase would create a material decrease in overall passenger demand relative to what it would be with reasonable price increases. This impact on demand challenges some of the core benefits of the integrated terminal proposition and its ability to strengthen a hub proposition and reduce traffic transiting through Australia. We anticipate that this level of price increase would also create risk for regional New Zealand, tourism spend, air freight capacity and air connectivity more generally. As such, Air New Zealand cannot support the Capital Plan as it has been shared in full.

Air NZ further requested:

- An independent economic study to provide an assessment of the potential impact of this investment on passenger demand and the broader economy; and
- A prioritised view of the capital plan and an assessment of options to descope or defer lower priority elements, as well as a review of design specifications of the Integrated Terminal.

3.20 On 4 November 2022, Air NZ repeated its concerns in its response to Consultation Paper 2, stating:

As we have indicated previously, the scale of investment forecast over the next ten years, we have increasingly significant concern about the scope and affordability of the Masterplan.

We believe this level of price increase would create a material decrease in overall passenger demand relative to what it would be with reasonable price increases. This impact on demand challenges some of the core benefits of the integrated terminal proposition and its ability to strengthen a hub proposition ... We anticipate that this level of price increase would also create risk for regional New Zealand, tourism spend, air freight capacity and air connectivity more generally.

Further, we reserve the right to moderate any of the attached based on the updated elasticity and economic studies underway.

3.21 On 17 and 18 November 2022, Air NZ and other airlines participated in “Value Engineering” workshops run by AIAL. While Air NZ had hoped this would be the forum in which a fundamental review of the significantly escalated costs and design specification of the terminal could be achieved, this did not eventuate. On 12 December 2022 Air NZ wrote to AIAL, stating the following:

¹⁷ Sic – note this calculation is in fact ██████% on a nominal basis.

commit us in advance to significantly higher levels of investment and aeronautical charges in PSE5.

- Strongly believed that the cost and price path of the DP and, by extension, the capital plan, had substantially changed since initial discussions on the DP began, and Air NZ's view that AIAL had not addressed this point in its responses;
- Had views about serious shortcomings in the consultation process, notably: AIAL's apparent pre-determination to proceed to commit to expenditure under the Capital Plan before the PSE4 consultation period had ended; being inflexible in revisiting key premises of its plan in light of new information and changed circumstances; and not providing information in a timely, complete, or adequately detailed manner; and
- Was concerned that AIAL was not adequately taking into account the impact of the expanded scale and scope of the capital plan on customer demand, including the wider value destructive effect this would cause on the NZ economy.

3.25 AIAL had throughout this process repeated its claim that there was “no other option” available to it to fundamentally alter the design of the DP, despite repeated requests from its substantial customers to do so once cost escalations fundamentally changed the cost-benefit profile of the terminal. In a 17 April 2023 letter sent to Air NZ, it stated: [REDACTED]

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED].”

3.26 At this point it became very clear to Air NZ that AIAL was unwilling to meaningfully consider any alternative that would provide the same capacity at an acceptable LoS for a lower cost. It was at this stage, in April 2023, that Air NZ engaged leading global airport engineers Arup, to independently verify this. The result was Air NZ's Alternative Domestic Terminal (**ADT**), details of which were submitted to the Commission in April 2024.

3.27 In a workably competitive market a supplier would be incentivised to offer customers a price/quality mix that best met their needs, whereas Air NZ considers the onus to be flipped here. This is a further example of the limitations of the ID regime in failing to incentivise behaviour consistent with the purpose of Part 4.

3.28 Furthermore, for infrastructure projects of this magnitude, a better-business case methodology requires a comprehensive option development and evaluation to be undertaken and shared to determine the optimum design and staging outcome. AIAL failed to undertake meaningful option testing of the capital delivery plan and staging, indicating to substantial customers that no other options were feasible and there was a need to commence construction immediately.

3.29 Air NZ notes that in section 4.24 of its consultation paper, AIAL makes reference to “*consultation with substantial customers on investment*” between March-May 2023. As

AIAL itself stated at the outset of those meetings, the decisions relating to the Integrated Terminal had already been made by AIAL, and AIAL was simply explaining matters for Air NZ's information. When Air NZ tried to test the logic and assumptions behind some of those decisions, AIAL said [REDACTED]. Air NZ considers that AIAL itself had excluded these meetings as "consultation" and should not now be referring to them as such. Any further "consultation" was restricted to pricing decisions only, not investment.

Does AIAL plan to invest in its assets appropriately?

- 3.30 As set out in the previous section, Air NZ removed its support for AIAL's capital plan in July 2022 once the cost and indicative pricing escalated to the extent that Air NZ no longer believed the capital plan to be affordable for its passengers.
- 3.31 Air NZ believes the fundamental reason for the disconnect between AIAL and its substantial airline customers on this matter stems from an inadequate consultation process. In particular, Air NZ submits that AIAL has failed to substantively consult substantial airline customers around LoS design parameters and instead decided unilaterally what its 'optimum' was.
- 3.32 Airlines have therefore not been meaningfully engaged in the development of the design and are, perhaps unsurprisingly, not supportive of the design and cost outcomes.

AIAL failed to consult genuinely on the design of the DP

- 3.33 IATA provides guidance about best practice capital planning consultation between an airport and its substantial airline customers. IATA suggests that *"the appropriate level of service values should always be established in consultation with the airline community and other stakeholders as appropriate. Consultation from an early stage in the planning process is a fundamental requirement to capture Users' requirements and work towards consensus and informed, joint decision making"*.¹⁸
- 3.34 In summary, LoS provides best practice guidance to inform appropriate space per passenger and waiting times for key processor elements, as part of the overall passenger journey at an airport. This ultimately determines what terminal footprint is required for a given passenger forecast, based on a combination of the operation type (domestic, international etc.) and the customer base of the airlines (low-cost, full service etc.). As footprint size is a key driver of cost, it is important that this is established in early stages of consultation so that quality and cost expectations between an airport and both its customers and other airport users are aligned

¹⁸ <https://www.iata.org/contentassets/d1d4d535bf1c4ba695f43e9beff8294f/iata-level-of-service-paper-best-practice.pdf>

- 3.35 Air NZ submits that AIAL has fallen far short of IATA's recommended best practice for consultation with their airline customers. In particular, AIAL did not consult with airline customers on the appropriate range of levels of service in advance of the design process. Instead AIAL has unilaterally imposed its own, higher than required, LoS, which is the fundamental reason for the disconnect which eventuated between AIAL and its airline customers.
- 3.36 This is a significant failure in consultation. AIAL's failure in consultation on the appropriate LoS values, at an early stage in the planning process, was integral to the broader failure of AIAL's consultation with its substantial airline customers.
- 3.37 Once the true cost and price impact of the DP became apparent to airline customers, AIAL has shown an unwillingness to consider alternative cheaper viable options, or adapt their design to meet airline customer views, despite having had more than two years to do so and despite airlines requesting a temporary pause to work collaboratively on seeking alternative solutions.

AIAL has applied a high-end international LoS to the design of the DP

- 3.38 AIAL services international, domestic and regional passengers. The different types of passengers have different behaviours and therefore different requirements from airport infrastructure. For example:
- 3.38.1 Domestic passengers turn up, on average, 35-40 minutes before departure time¹⁹ compared to international passengers who turn up, on average, 60-90 minutes, before departure time. Typically, domestic passengers have a much lower retail spend owing to the turn-up-and-go nature of their behaviour. Peak period domestic passengers are also more likely to check-in remotely and check-in fewer bags²⁰. This means a lower LoS is typically required to account for lower overall dwell time, less complex needs (e.g. no customs/border processing) and lower propensity to spend on retail.
- 3.38.2 By contrast, international passengers are required to turn up earlier with greater time needed to check-in, drop bags, pass through immigration and security before reaching 'airside-dwell'. International passengers more frequently travel in groups with more checked baggage. International travellers have a higher expectation for retail and food & beverage (F&B) as well as a higher expectation for airline lounges, better quality toilets and additional dwell space and seating. International flights are more frequently serviced with bigger-format wide-body aircraft with higher passenger numbers per departure gate. The implication of the international services and passenger behaviours is a greater demand for space for each of the airport infrastructure elements (check-in,

¹⁹ Source: Airbiz Planning Parameters Report – Aeronautical Master Planning Programme 2011-2030

²⁰ Air NZ passenger data shows that international passengers check in an average of 50% more bags than domestic passengers.

bag drop, immigration, security, dwell space, lounges, retail/F&B, pier width and gate lounges).

3.39 To assist airports and airlines reaching agreement on design requirements for new airport facilities, IATA developed the Airport Development Reference Manual (**ADRM**)²¹ which includes LoS guidance to provide a best practice framework for sizing airport terminals, utilising a range of inputs including passenger type, passenger forecasts, aircraft type, peak passenger hour, peak aircraft movement hour, amongst others.

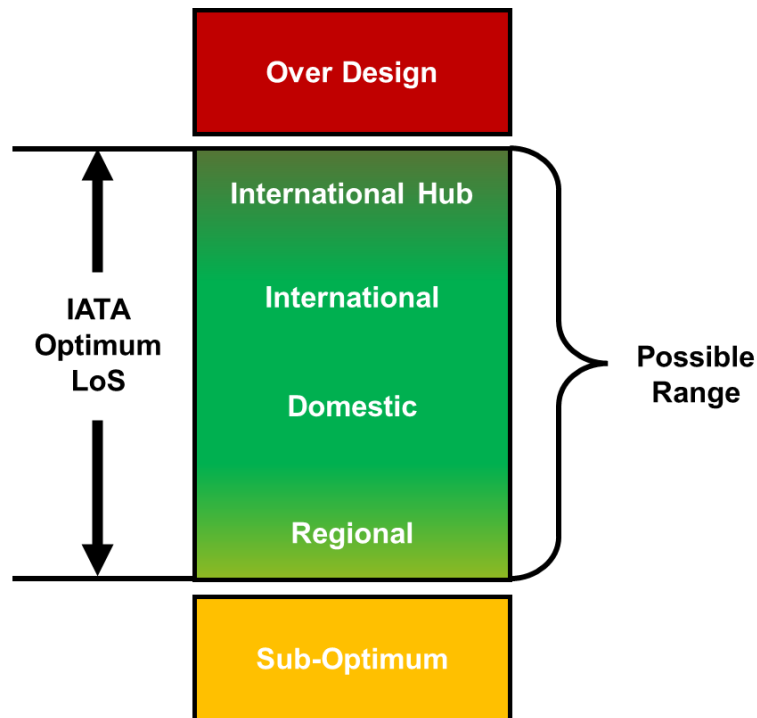
3.40 The purpose of the IATA ADRM is to:

- Provide consistent benchmarked spatial requirements to efficiently operate the various airport functions required within a terminal and supporting airfield.
- Help airports standardise the provision of airport infrastructure to avoid excessive spend or delivering facilities with insufficient capacity.
- Provide a framework for airports to engage with customer airlines to discuss and agree appropriate provision of space when designing new airport infrastructure.
- Provide a range of service levels based on the different customer needs and expectations to be applied to different airport environments.

3.41 A key output of the IATA LoS guidance is an optimum range within which airlines and airports are expected to agree the appropriate LoS depending on passenger type, customer needs and expectations, complexity of airport processing (from simple regional at one end to complex international at the other), and also taking into account the requirements of airline customers based on their own business model (from low cost carriers at one end to full service at the other). More information about the IATA LoS model is set out in slide 2 of the supporting materials and in figure 5 below.

²¹ <https://www.iata.org/en/publications/manuals/airport-development-reference-manual/>

Figure 5: Indicative illustration of the application of IATA's LoS range²²



3.42 The Commission has referenced in its consultation paper (para 4.83) that “*Auckland Airport considered the IATA Optimum Level of Service when planning the domestic processor*”, however, there is no single ‘optimum’ but instead an optimum range.

3.43 Applying the IATA LoS to the DP generates an “optimum” spatial range of between 25,000 to 70,000 sqm. AIAL’s design is right at the top end of this very wide range, at [REDACTED]

3.44 In the New Zealand domestic context, the domestic travel market trends more towards a low-cost carrier model (within a global context) given domestic airlines do not offer business class seats or tickets. On this basis the lower end of the LoS might be expected, with some exceptions made in consultation with airlines (e.g. Air NZ’s business model requires lounge space on its domestic and regional network).

3.45 However, AIAL has applied a high-end LoS, more appropriate for an international-terminal, to the DP – i.e the DP has been sized to accommodate the demands of an international terminal serving international passengers even though it will only serve domestic services via the pier.

3.46 This issue could have been remedied, at an early stage, had AIAL consulted with airlines on the application of LoS guidance. As a result, there has been a fundamental failure in

²² Prepared for Air NZ by Arup

design. The DP is significantly larger than is required, with dwell space, gate lounges and retail provision substantially larger than is typical for domestic passenger requirements.

Elements of the design reported to meet IATA guidance have been incorrectly measured and are in fact clearly over-sized

- 3.47 AIAL reported²³ that the proposed Domestic Pier gate lounge provision was 1.1 m² per passenger, which is less than the IATA guidance²⁴ that states an average range between 1.2 m² and 1.55 m² per passenger.
- 3.48 Air NZ engaged the services of Arup to review AIAL's space calculations against designs provided to Air NZ by AIAL. Arup's review has shown that AIAL's gate lounge provision estimate of 1.1m² per passenger is incorrect. Counter to IATA guidance, AIAL has not included the boarding counter and queuing space in its calculations. When these spaces are included, the actual gate lounge provision of AIAL's design is 1.8 m² per passenger, which is 60% higher than the IATA guidance (as provided above).
- 3.49 Furthermore, Arup has pointed out that the new domestic pier includes a considerable amount of additional seating and dwelling spaces adjacent to the gates which has not been included in AIAL's gate lounge assessment but would likely be used by passengers waiting next to their gate. When these spaces are also accounted for as gate lounge space, the AIAL design increases to 2.75 m² per passenger – suggesting that the amount of lounge space provision is in fact 83-129% higher than IATA guidance.
- 3.50 More information about AIAL's incorrect spatial calculations, including a diagrammatic representation of the omitted space, is set out in slides 9-14 of the supporting information presentation.

The \$2.1bn DP is twice the size of an efficient domestic terminal

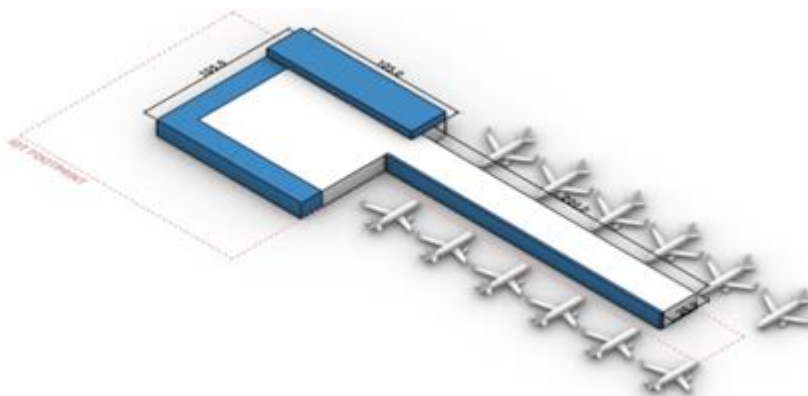
- 3.51 The Commission has referenced in its consultation paper (para 4.84) that "*benchmarking found that except for airside dwell, check-in and plant space, all other design provisions for the Domestic Processor were in line with or below IATA guidelines and comparable peer airports*". While these three elements (airside dwell, check-in and plant space) make up half the measured elements, Air NZ will further demonstrate that through inaccuracies, oversizing key elements and additional unaccounted spaces, that when combined and considered together, lead to a facility that is substantially oversized for the New Zealand domestic market.

²³ Paragraph 4.84, Review of Auckland Airport's 2022 – 2027 Price Setting Event Consultation Paper, 17 July 2024

²⁴ IATA ADRM 12

- 3.52 Air NZ engaged Arup to test AIAL's claims with respect to the IATA LoS and sizing of the DP. Specifically, Air NZ requested that Arup utilise the IATA LoS Model to determine an efficient size for the DP and pier, using the same inputs as AIAL, but applying a lower LoS more appropriate for an New Zealand domestic service. The analysis considered space allocation and functions dedicated to the DP and does not consider the shared 'landside' functions of transport, parking pickup/drop-off, landside services, landside-dwell or landside retail space.
- 3.53 Arup determined that an appropriately designed domestic facility, designed to an IATA LoS appropriate for the NZ domestic context, would require a footprint of 35,000 m². This would provide sufficient space to accommodate increased security screening capacity, VIP lounge space, retail, dwell space, seating and facilities for domestic customers along with high-end baggage system and back-of-house space. Contrary to AIAL's assertions²⁵, Arup's proposed sizes have always included sufficient space to accommodate all back-of-house, bussing and docking space. This domestic baseline is represented in the conceptual figure below and summarised in more detail in slide 4 of the supporting materials presentation.

Figure 6 – IATA Optimum Range Domestic Facility (35,000 m²)



- 3.54 Arup determined that, were the DP to be designed to a higher IATA LoS more typically seen at *international* terminals, it would have a footprint of 47,000 m². The additional space would accommodate border agencies, increased security provision, more VIP lounges, greater dwell spaces and additional retail facilities. Air NZ submits that none of these are required for domestic passengers in the DP. This international-level baseline is represented in the figure below with more detail provided in slide 5 of the supporting materials presentation.
- 3.55 However, the actual footprint of the DP has been calculated by Arup at [REDACTED] m². This is [REDACTED]% above the efficient sizing Air NZ believes is appropriate for domestic services

²⁵ Analysis of Feasibility Study – AKL Domestic Terminal Options, Auckland Airport, 19th December 2023

within the IATA optimum LoS range. That is, the DP as proposed by AIAL is twice the size required for an efficient domestic terminal. This is represented in the figure below with more detail provided in slide 6 of the supporting materials presentation.

Figure 7: AIAL’s Domestic Processor (Pier and Headhouse) Design 

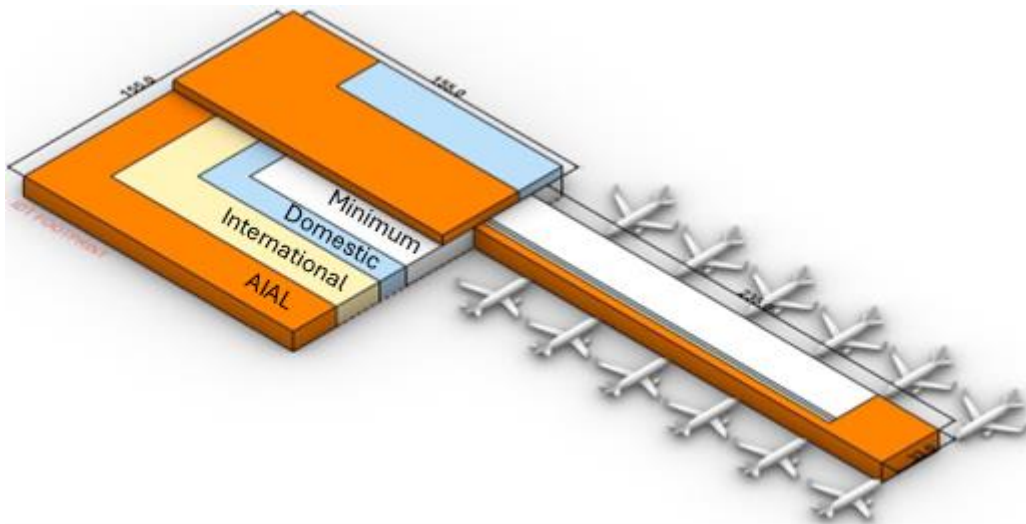






Figure 8: Terminal Size and Scenario Summaries

Design Scenario Summaries	
Minimum:	25,000m ² (-28% under Domestic)
Domestic:	35,000m ² (-%)
International:	47,000m ² (+34% over Domestic)
AIAL’s Design:	

3.56 Domestic headhouse

3.56.1 The headhouse includes provision for required security screening, dwell space and seating, circulation space, passenger services including toilets, back of house operations and supporting retail/F&B.

3.56.2 The AIAL design provides for m² of space to accommodate these functions, whereas the IATA LoS more suitable for domestic customers suggests that around 25,000 sqm is required to accommodate these functions. An example of this in practice would be Perth Airport Domestic T1. Consequently, Air NZ considers the headhouse is oversized by m², or, %.

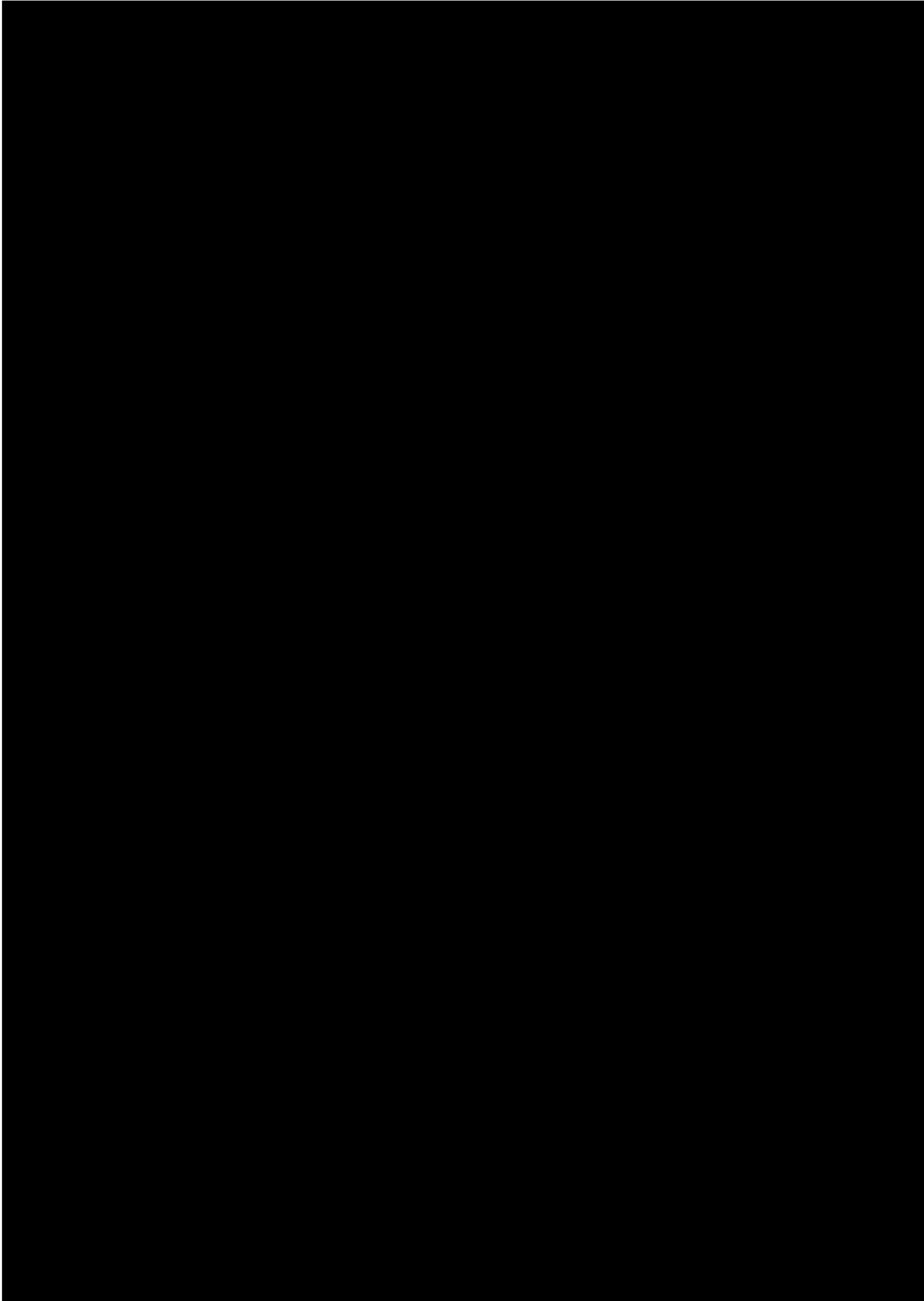
3.57 Domestic pier

- 3.57.1 The Domestic Pier includes provision for required circulation space to reach the gates, gate lounges (seating, dwell space, queuing space and counters), passenger services including toilets, back of house operations and any supporting retail/food and beverage.
- 3.57.2 The AIAL design provides for [REDACTED] m² of space to accommodate these functions, whereas IATA LoS more suitable for domestic customers suggests that 10,000 m² is required to accommodate these functions. Consequently, Air NZ considers the Domestic Pier is oversized by [REDACTED] m², or [REDACTED]%, which has been predominantly provisioned as seating, circulation space and retail.
- 3.57.3 The overall dimensions of the pier are excessive. There is opportunity to reduce both the length and width of the pier while maintaining gate and passenger capacity. For example, it is common design practice (such as Perth Airport Domestic T1, Melbourne Airport Domestic T1) to use jet-bridges at the end of a pier to access two or three aircraft stands rather than build the equivalent longer pier. It is also common practice for a domestic pier supporting Code C aircraft to be 24 metres-wide rather than the AIAL designed 33 metre width – which is more commonly experienced for larger format international piers.

There is an over provision of retail and F&B across the DP

- 3.58 Once Air NZ and Arup had established that AIAL's DP was twice the size of an efficient domestic terminal, Air NZ requested Arup to undertake a more detailed review of space allocation in the DP to determine how the additional space was being provisioned. The result is summarised in the figure below, with more detail provided in slide 7 of the supporting materials presentation.

Figure 9: AIAL's Proposed Domestic Headhouse and Pier



3.59 In this design, AIAL has allocated [REDACTED] m² of airside retail and F&B (orange) across the headhouse and pier. [REDACTED] m². The DP has been designed to accommodate [REDACTED]% more retail space than AIAL's existing international terminal, even though it will accommodate much lower passenger numbers who will have significantly lower dwell times and need for retail than international passengers. In fact, Air NZ estimates that the proposed DP has a retail space provision of [REDACTED] passengers per hour per sqm compared to [REDACTED] passengers per hour per sqm in the existing international terminal. Air NZ submits this a substantial over-provision of retail space.

AIAL is proposing to allocate ~[REDACTED]% of the cost of the DP to the aeronautical till

3.60 AIAL's headhouse and pier has a footprint of [REDACTED] m². Air NZ and Arup have shown, based on IATA benchmarks, an efficient footprint for the domestic headhouse and pier would be 35,000m² ([REDACTED]% of AIAL's design). Air NZ would therefore expect AIAL to allocate ~[REDACTED]% of the cost of the headhouse and pier to the aeronautical till, meaning ~[REDACTED]% of the DP overall (i.e. including apron). AIAL is however proposing to allocate [REDACTED]% of the DP to aeronautical services.²⁶

3.61 AIAL is forecasting the aeronautical capital cost of the DP at \$2.1bn. As a result of the excessive allocation to the aeronautical till, Air NZ estimates that once the DP is complete:

3.61.1 the aeronautical RAB will be ~\$740m higher than if the DP was efficiently sized and allocated.

3.61.2 The additional charges borne by consumers as a result of the inefficient build will be in the order of ~\$120m pa.

Benchmarks provided by AIAL to compare to other airports are inappropriate

3.62 Benchmarks are generally used to acknowledge how similar airports in other locations have designed and delivered comparable infrastructure and consider how much that infrastructure cost to deliver. The benchmarks provided by AIAL (consultation paper paragraph 4.98), to compare to other airports are inappropriate and their selection suggests that AIAL is not seeking to provide a meaningful comparison point.

3.62.1 The JFK Terminal 6 example is an entirely inappropriate comparison. The T6 project is considered to be one of the most expensive terminal construction projects in the world. The fact that AIAL are using JFK-T6 as a comparable benchmark is indicative

²⁶ AIAL PSE4 Consultation Paper 2, Table 7, September 2022

of how expensive the AKL design is given its consideration of using this global cost outlier as a benchmark. Factors influencing the high cost of JFK T6 include:

- the multi-level construction of a major international terminal in an existing complex 55M passenger multi-terminal precinct;
- multiple new elevated roadways and transport provision;
- integration of two metro stations;
- a very high-end premium international customer target customer base; and
- the elevated construction costs associated with building in one of the most expensive cities in the world.²⁷

3.62.2 Manchester Airport Terminal 2 Expansion is an international-capable processor and pier project which includes much higher spatial requirements for immigration, enhanced baggage systems, greater dwell times and increased customer needs and requirements. The pier will accommodate 13 gates for a variety of aircraft including Code F A380s as opposed to the proposed 12 Code C planes in the Auckland Domestic Pier. Given it is scoped as an international pier, the Manchester pier will also operate and be sized for bigger planes with greater numbers of passengers requiring more space. Air NZ does not support using this project example as a benchmark given its different scale and function.

3.63 By comparison, Air NZ has previously indicated a more appropriate comparator would be Perth Airport's New Domestic Terminal (T2) which has a gross floor area of 21,500 m², aircraft parking for 36 aircraft and was completed for AU\$121m in 2013.

Capex delivery wash up

3.64 As noted in Air NZ's response to the Process and Issues paper, a capex wash-up mechanism is supported in theory. Air NZ remains concerned however that the threshold for triggering this mechanism remains too high, particularly given the scale of the capex forecast for PSE4. Forecast commissioned capex of \$3.1bn means that AIAL would need to under-spend by more than \$230m before the wash-up would be triggered (assuming the IRR leg of the mechanism is also triggered), with consumers facing a ~\$28m cost for those assets not delivered.

3.65 As with the revenue wash-up Air NZ believes AIAL should provide greater transparency around how this mechanism would work in practice.

²⁷ Arcadis International Construction Cost Index 2023 – New York ranks 3rd in the world, by comparison Auckland ranks 32nd

Other matters relating to capital expenditureThe \$6.7bn capital plan is not delivering a meaningful increase in airfield capacity

- 3.66 Table 4.2 of the Commission’s consultation paper contains information from AIAL’s Price Setting Disclosure (17 August 2023) which shows AIAL’s expenditure cash flow by category for PSE4, indicating that 87% of capex is for capacity growth and 13% for asset replacement and renewal. Conversely, in an extensive Appendix attached to the PSE4 Reasons Paper, the Primary Driver listed for nearly all projects was “Replacement of end-of-life-assets”, with “Growth/Capacity” listed only as a secondary driver.
- 3.67 Air NZ considers that the categorisation of such a significant amount of capex as “capacity growth” is incorrect, when AIAL’s own information indicates the primary driver is renewal and replacement. The integrated terminal is a clear example of this. For \$2.1bn, AIAL will be replacing an existing 11 Code C contact stands and four remote stands (15 in total), with 12 Code C contact stands and three remote stands (still 15 in total), i.e. there is no increase in the total number of stands – the sole gain being one additional contact stand, at the expense of a remote stand.
- 3.68 The number of stands are key to meaningfully increasing airport capacity, as the availability of more stands (particularly contact stands) during peak periods is the critical throttle to capacity growth for both existing and new entrants.

Air NZ has concerns over the timing of capacity generating infrastructure

- 3.69 Air NZ believes investment in domestic capacity is not only required, but overdue. However, Air NZ is concerned that AIAL is investing a significant amount but not actually delivering a material increase in capacity, especially if AIAL proceeds with demolishing capacity in the existing (old) domestic terminal as soon as the replacement gates are built in the new domestic terminal. Key examples of capacity concerns are:
- 3.69.1 *Second runway:* In 2017, there were plans for a second runway provisionally due to be commissioned in the late 2020’s.²⁸ Air NZ now faces a capital plan costing up to \$6.7bn which includes no concrete plan for a second runway. Instead AIAL is now investing short term for resilience purposes in a contingent runway which will cause significant operational disruption. Air NZ considers this a significant failure of long-term planning, which we discuss in more detail below. Given the 10-year lead times on a second runway, Air NZ considers there needs to be clear visibility on timing and funding, as this eventually becomes a key bottleneck to capacity growth and therefore a key strategic risk for Air NZ.

²⁸ AIAL PSE3 Price Setting Disclosure, p.55.

3.69.2 *International and regional growth*: The current capital plan has minimal investment in regional and international capacity growth, and indeed investment in regional facilities was materially reduced by AIAL during the course of the PSE4 consultation, in favour of preserving the escalating spend on the new DP.

Air NZ has concerns over AIAL's long term infrastructure planning process

- 3.70 An airport master plan is a critical tool to facilitate efficient long-term planning and investment as well as to communicate an aligned path for growth to its customers. As IATA points out in its guidance on airport master planning: "All airports should develop a master plan to guide future infrastructure development programs in a logical, sustainable and efficient manner. Airports that lack a master plan or vision of the future risk developing capacity enhancements that are incompatible, misconceived, incorrectly sized and poorly located, resulting in wasteful capex or restrictions in overall capacity".²⁹
- 3.71 IATA suggests that airport masterplans should be "reviewed every 5 years or more regularly as required by market developments. Australian airports are required to update their master plans every five years.
- 3.72 The AIAL Master Plan is now more than 10 years old and consequently most likely well out of date. It includes a range of significant projects, including the Northern Runway. The lack of a contemporary airport master plan creates a lack of transparency around which elements are within the plan, when elements have been changed or deleted and significantly increases the risk of wasteful capex. As an example, it is currently unclear if and when AIAL are planning to deliver the second runway making it very difficult for airlines to factor future capacity, growth and major future capital expenditure into their strategic decision making.
- 3.73 While the 2014 Master Plan is dated, it remains the best information airlines have available to them to assess AIAL's medium to longer term investment plans. AIAL's proposed spend of \$5.7-6.7bn of aeronautical capital expenditure over PSE4 and PSE5 is the first phase of the Master Plan to accommodate a doubling of capacity by ~2050 (through a second runway and expansion / upgrades to regional and international services) at an order of magnitude total cost of \$19 billion (in 2023 dollars).
- 3.74 The fact that the Commission's review process considers only five-year increments renders it incapable of effectively considering the efficiency of a generational capital programme of this nature that spans multiple pricing periods. Stakeholders in some international jurisdictions deal with this issue by comparing the efficiency of an incumbent airport's major expansion proposal against a counterfactual of adding the new capacity

²⁹ <https://www.iata.org/contentassets/d1d4d535bf1c4ba695f43e9beff8294f/airport-master-planning.pdf>

at another airport or constructing a new full-service hub airport. Such considerations are not a feature of the New Zealand regime.

- 3.75 Given the scale of the capex proposed in PSE4 and the clear interdependencies between the assets commissioned in PSE4 and PSE5 as part of the Integrated Terminal Programme, it would be an incomplete analysis to look only at the impacts of PSE4 capex. It is not possible to consider the efficiency of the PSE4 capital plan in isolation from PSE5, given that capex commissioned but not priced in PSE4 will essentially lock-in capex that will be priced in PSE5. To achieve the review's purpose, this is critical information for the Commission to consider.

Section 4: Innovation

- 4.1 As a general competition law principle, the importance of innovation as a driver of competitive outcomes for the long-term benefit of consumers cannot be overstated. Indeed, dynamic efficiency (or inefficiency, as the case may be) forms a core part of the Commission's net benefit assessment of authorisation applications.
- 4.2 Consistent with this, the Part 4 purpose statement identifies that an incentive to innovate and drive better outcomes for consumers is a core element of a workably competitive market.
- 4.3 Air NZ agrees with the Commission's finding that AIAL has not demonstrated significant innovative practices. Moreover, under the information disclosure regime AIAL has no meaningful incentive to innovate, because in our view there is no adequate review process. As the Commission points out in its consultation paper, the PSE review process is forward-looking, providing little focus on the appropriateness of an airport's level of innovation.
- 4.4 In response to the Commission's conclusion that AIAL has not provided sufficient evidence of innovation in its PSE4 disclosure, Air NZ spoke to its own Auckland airport-based staff and Air NZ's design team regarding whether and to what extent AIAL had *actually* implemented innovation in the provision of airport services, and/or supported Air NZ in implementing innovation. From these discussions, it was clear that:
- AIAL has shown little inclination to engage with Air NZ and innovate around improving the efficiency of airport services. Air NZ believes that early and comprehensive consultation is the key to unlocking targeted, cost-effective innovation. Consistent with our submission on the process and issues paper, AIAL's primary focus to increase capacity has been on excessive capital investment, rather than improving its existing services through innovation;
 - Any improvements that are made to airport services are based on a need to replace failing services, substandard improvements, ensuring services conform to standard operation procedures or adopting practices that had become commonplace in other airports, as opposed to genuine innovation; and
 - Air NZ has a good relationship with airport staff at an operational level. However, despite AIAL's claims around its Collaborative Operating Group, this rarely results in action by AIAL on suggested airport improvements or a willingness to consider innovative solutions to problems. This suggests there is a systemic issue with AIAL's lack of investment. This can be compared to other New Zealand airports who have worked collaboratively with Air NZ on innovative solutions to airport problems (see examples at 4.9 below).
- 4.5 AIAL's own submission suggests that it relies largely on airlines and other service providers at the airport to drive innovation. The examples provided by AIAL in response to the process and issues paper simply reinforce the points summarised above. Air NZ's observations on these examples are set out below.

- 4.6 AIAL claims credit for reduced queue times and the establishment of a taskforce to work on improving the customer experience.³⁰ Passenger flow is an extremely important issue for Air NZ. As well as impacting the customer experience, congestion issues have a significant financial impact on Air NZ through missed international to domestic connections, and/or Air NZ having to increase minimum connection times (MCTs).³¹ AIAL has been consistently slow to tackle issues around passenger congestion, and reluctant to implement initiatives suggested by Air NZ that would reduce queues and passenger congestion in the terminal. This has ranged from taking months to action simple requests regarding layout changes, signage and way finding around the Air NZ check in area, to major issues regarding congestion for international arrivals at AKL.
- 4.7 In its submission on the Process and Issues paper (p.41), AIAL also claims credit for “injecting new technology into the baggage system”, largely related to the Eastern Baggage Hall. This is not an example of innovation. The new operating system, and new services such as the early bag store, being adopted for the Eastern Baggage Hall, are already common at overseas airports. In Air NZ’s view, the Eastern Baggage Hall represents an opportunity to future proof and significantly improve the efficiency of the baggage infrastructure at the airport. Air NZ has been frustrated at the lack of willingness by AIAL to undertake early and comprehensive engagement on this issue, with the approach from AIAL largely being to ‘inform’ Air NZ about design rather than ‘consult’ (consistent with our experience in other areas around consultation).
- 4.8 Specific examples include:
- AIAL adopting a new baggage system in the Eastern Baggage Hall but maintaining the existing baggage system for other areas at the airport, meaning AIAL is operating two different systems across the airport, and the benefit of the new system not being fully realised across the airport;
 - Providing a new batch loading system, but not ensuring there are sufficient staging areas within the new baggage hall and precinct to enable airlines to fully realise the automation benefits across the wider baggage handling ecosystem. Without ensuring the efficiency translates across the whole end-to-end baggage make-up process, airline benefit will largely be lost. AIAL has also ignored other suggestions regarding the design of the Eastern Baggage Hall, such that in Air NZ’s view it will be a step backwards from an operational perspective; and
 - AIAL resisting emerging technology, such as automated guided vehicles and robotics within the baggage hall to increase efficiency and improve safety. Until very recently, there has been no material engagement with AIAL on this issue,

³⁰ AIAL, Submission on Commerce Commission Process and Issues Paper for its review of Auckland Airport’s 2022 – 2027 price setting event, 31 January 2024, page 40.

³¹ Minimum connection times (MCTs) is the shortest allowable time required for a passenger and baggage to make a connecting flight at an airport. Increasing MCTs limits the number of travel options available to connecting passengers.

despite repeated requests. Instead, Air NZ has commissioned its own review of overseas airports to understand how this might work at New Zealand airports. In contrast to AIAL's reluctance in this area, Air NZ is working collaboratively with other airports such as Wellington and Queenstown Airports, on this same issue.

4.9 AIAL's lack of desire to collaborate on innovative solutions is in sharp contrast to other ports in NZ and internationally. In addition to those referenced above, other examples include:

- Working with Wellington airport on decarbonisation through the use of sustainable technologies, including hosting a hydrogen trial and Air NZ's electric demonstrator service from 2025;
- Working with the Southern Airports Alliance (Queenstown, Invercargill and Dunedin Airports), together with the eight southern Regional Tourism Organisations, to encourage visitors to use Air NZ's multi-stop booking tool to fly into one of the three airports, explore the region, and then fly out of another airport. As well as promoting regional tourism, the initiative promotes longer-stay, lower-impact itineraries;
- Increases to charging capacity as part of its electrification strategy. This strategy seeks to convert ground support equipment (GSEs) such as loaders and tugs from diesel to electric-GSEs (e-GSEs). Air NZ has worked with both Wellington and Queenstown Airports to install additional charging capacity and installed its own charging infrastructure at regional airports. Christchurch Airport will be installing additional charging by the end of the year. However, charging capacity at Auckland airport continues to be insufficient, despite repeated efforts by Air NZ to persuade AIAL to either build additional charging capacity or allow Air NZ to install its own equipment at its own cost. Charging infrastructure is so poor at the current Pier A that Air NZ is required at times to tow e-GSE down to Pier B and back for recharge, at significant time and expense, negatively impacting battery life. Air NZ has had to convert several e-GSEs to hybrid systems, given the limited access to charging infrastructure, and has delayed the purchase of additional e-GSEs, instead extending the life of aged diesel GSEs or necessitating the lease of diesel GSEs, increasing costs and CO2 emissions.

Section 5: Assessment of the regulatory regime

- 5.1 As we have demonstrated in this submission, AIAL's behaviour over several price setting events is not consistent with the purpose of Part 4.
- 5.2 Having consistently been found to have targeted excessive profits (following findings by the Commission in 2001, 2013, 2017 and in the Commission's recent draft conclusions report) AIAL's appetite for targeting excess profits and its disregard of the views of its substantial customers appears to us to be increasing over time, and at odds with what would be expected in a workably competitive market.
- 5.3 In our view, Information Disclosure is failing to constrain AIAL's behaviour, and therefore to promote the purpose of Part 4, because there is currently no credible threat of further regulation. The credibility of this threat is central to the effectiveness of the light-handed ID regime.
- 5.4 The Commission's draft report does not make a clear finding on (i) whether AIAL is behaving in a way that is consistent with the Part 4 purpose; and (ii) how effectively the Information Disclosure regime is operating to ensure that AIAL does behave in a way that is consistent with the Part 4 purpose. Unless the final report addresses these critical questions, the Commission's PSE4 review process will effectively reduce the threat of stronger regulation on which the information disclosure regime relies.

AIAL's behaviour is not consistent with the Part 4 Purpose

- 5.5 The purpose of Part 4 is to promote outcomes that are consistent with those produced in competitive markets, such that suppliers have incentives to innovate and invest, to improve efficiency and provide services at a quality that reflects consumer demands, to share the benefits of efficiency gains with consumers, including through lower prices, and are limited in their ability to extract excessive profits." A "workably competitive" market has been described as "...a market in which prices reflect efficient costs (including costs of capital and accordingly, a reasonable level of profit)"³².

³² Major Gas Users' Group Inc v Commerce Commission, "A workably competitive market is one that provides outcomes that are reasonably close to those found in strongly competitive markets; a market in which prices reflect efficient costs (including costs of capital and accordingly, a reasonable level or profit)."

AIAL is not limited in its ability to target excessive profits

- 5.6 As we have shown throughout this submission, AIAL's behaviour over multiple pricing periods is not consistent with what would be expected in a competitive market. We provide further detail to support this finding below.
- 5.7 Air NZ welcomes the Commission's finding that AIAL's charges "are in excess of what is reasonable for the PSE4 period" and that AIAL is targeting excess profits of \$193-227m over PSE4.
- 5.8 As set out in Section 2 of this submission, Air NZ believes the Commission has in fact significantly under-estimated the level of excessive profits targeted by AIAL in PSE4.
- 5.9 The Commission made similar excess profits findings against AIAL in 2001, 2013 and 2017. This demonstrates a pattern of behaviour by AIAL that is not consistent with a simple calculation error or misapplication of the Input Methodologies. The Commission's assessment of excess profits in PSE4 is around three times the size of the Commission's largest previous excess profit assessment, suggesting that AIAL is becoming emboldened over time. We would expect the opposite to be true if ID was effective, given that ID is supposed to 'shine a light' on a regulated firm's conduct.
- 5.10 While AIAL has on one occasion rebated a proportion of the excess profits identified by the Commission, it has taken a significant effort from not only the regulator but also AIAL's key stakeholders to challenge and attempt to hold AIAL to account. No penalty has been levied against AIAL for this behaviour.

AIAL is not providing services at a quality that its customers demand

- 5.11 While in 2013 the Commission may have found that the "quality of service provided by AIAL generally reflected the demands of the airlines and passengers"³³, this is certainly not the case in PSE4 and PSE5.
- 5.12 AIAL's substantial customers do not support the airport's capital plan for PSE4 and PSE5. The fundamental reason for the disconnect between the airport and its substantial airline customers on this matter stems from an inadequate consultation process.
- 5.13 In particular, the airport has failed to consult substantial airline customers around level of service design parameters. Instead AIAL unilaterally imposed its own level of service parameters. As a result, the \$2.1bn DP and pier have been sized as a high-end

³³ X5.2, Commerce Commission's Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport dated 31 July 2013

international facility and are at least twice the size required for an efficient domestic terminal facility.

- 5.14 Despite persistent requests from substantial customers, AIAL has been unwilling to meaningfully consider any alternative that would provide the same capacity at an acceptable level of service for a lower cost. Firms operating in competitive markets have to right-size their investments to the level needed to efficiently service their customers. AIAL has not.

AIAL is not operating and investing in its assets efficiently

- 5.15 Section 3 of our submission clearly illustrates that AIAL is not operating and investing in its assets efficiently:
- It is commissioning \$5.7-6.7bn of aeronautical capital expenditure over PSE4 and PSE5 on a capital plan that does not deliver any meaningful increase in aeronautical capacity;
 - Its DP is significantly over-sized due to an over-provision of retail space, with the excess cost disproportionately allocated to the RAB. As a result, the aeronautical RAB will be ~\$740m higher than if the DP was efficiently sized and allocated. The additional charges borne by consumers as a result of the inefficient build will be in the order of ~\$120m pa. Now that construction has begun, AIAL is committed to this dynamic inefficiency, regardless of whether AIAL elects to rebate a portion of the excess profits determined by the Commission in PSE4; and
 - The lack of a contemporary airport master plan creates a lack of transparency around the future development path for the airport, making it very difficult for airlines to meaningfully participate in consultation with AIAL in the face of a generational capital plan over PSE4 and PSE5.
- 5.16 Air NZ submits that this excessive and inefficient investment is a consequence of AIAL's ability, over an extended period of time, to consistently sustain a WACC margin, which creates a significant incentive for AIAL to over invest. This in turn creates an incentive for AIAL to understate the long-term demand impacts caused by the significantly increased prices required to fund its capex programme, to ensure the programme is committed.

AIAL is neither innovating nor seeking more efficient ways of providing aeronautical services to its customers.

- 5.17 Air NZ agrees with the Commission's finding that AIAL has not demonstrated significant innovative practices. As detailed in section 4, AIAL has shown little inclination to collaborate with airlines on innovation, particularly when compared with Air NZ's experience with other airports. Nor has it developed innovative solutions to improve the efficiency of airport services.

This investment will lead to higher prices for consumers and will stifle demand

- 5.18 The scale of AIAL's planned investment over PSE4 and PSE5 will unnecessarily hit consumers in the pocket through significant increased passenger charges (particularly for domestic and regional consumers). As the airlines' demand study has shown, this will have a direct impact on consumers' demand responsiveness, indicating that consumers will not be willing to pay for the LoS that AIAL has provisioned for in its investment.
- 5.19 As a result of the demand impact, airlines anticipate that AIAL will lower its volume forecasts for PSE5 price setting, resulting in PSE5 prices significantly higher than AIAL is currently forecasting.
- 5.20 There is a significant risk that the overspending on the DP and the wider capital plan will prejudice subsequent investment in future capacity-generating infrastructure if rises in per passenger aeronautical charges extend beyond the capacity of passengers to absorb them.

AIAL is not constrained by the threat of stronger regulation

- 5.21 In order to be effective, information disclosure requires a credible threat of stronger regulation. It is clear from AIAL's behaviour that it does not perceive this threat to exist.
- 5.22 Despite signalling its intention in the Process and Issues paper to include an overall assessment, in our view the consultation paper does not adequately tackle this critical issue, and hence does not properly address whether AIAL is behaving in a way which is consistent with the Part 4 purpose. This omission sends a message to airports that further incentivises the pattern of consumer-detrimental behaviour Air NZ has outlined throughout its submission. If the final report does not address the overall adequacy question, it will further reduce the already weak threat of stronger regulation. As we have said previously, the threat of further regulation is critical to the efficacy of the information disclosure regime. Further undermining that threat necessarily further undermines the regime as a whole.

Three Essential Elements to Light-Handed Regime

- 5.23 New Zealand's regulatory regime for airports under the Commerce Act consists of three key design elements:
- i. Information disclosure;
 - ii. Analysis and reporting;
 - iii. The threat of stronger regulation.

- 5.24 It is an accepted policy principle that light-handed regimes depend on the existence of all three elements in order to be effective.³⁴ In its 2013 Section 56G report for AIAL, the Commerce Commission stated that “the threat of further regulation incentivises suppliers to ensure their performance is consistent with desired outcomes from workably competitive markets.”³⁵
- 5.25 In our view, AIAL’s behaviour over an extended period of time reveals that it does not perceive this threat to be credible. We are therefore concerned that the absence of a more fulsome analysis on the effectiveness of the ID regime risks the process failing to achieve its objective of incentivising airports to behave consistently with the Part 4 purpose. The conduct of AIAL over time can only reinforce this point.

Information disclosure design

- 5.26 The question of whether a credible threat of stronger regulation exists for airports has been considered at length in both a New Zealand and Australian policy context. Common characteristics identified as contributing to the credibility of that threat are:³⁶
- Information disclosure allows interested parties to identify inefficient airport performance;
 - Assessment process to determine whether stronger measures are required is independent of political influence;
 - Stronger regulatory measures exist which could be invoked without new legislation;
 - Timeframe required for implementing stronger regulation and availability of regulatory expertise.
- 5.27 During the most recent review of the effectiveness of the regulatory regime for airports, the Government concluded that these characteristics were not being met in terms of the ability to make change without new legislation and the timeframe required. The specific changes made in this regard were to:³⁷
- Strengthen the Commission’s power to analyse the effectiveness of the regime in its price-setting reports;

³⁴ Arbaster, Margaret. The design of light-handed regulation of airports: lessons from experience in Australia and New Zealand (J Air Transp Manag. 2014 June, 38).

³⁵ NZCC, 2013a, p16.

³⁶ Arbaster, p13.

³⁷ Cabinet Paper: Part 4 of the Commerce Act 1986: Strengthening the Regulatory Regime for Major International Airports (2016).

- Remove unnecessary steps in the inquiry process for investigating the need for changing the type of regulation that applies to airports; and
- Clarify that changes to the type of regulation can be made through an Order in Council rather than legislative amendments.

A threat of stronger regulation requires that, at a minimum, the Commission considers how effectively information disclosure is promoting the Part 4 purpose

- 5.28 The Commission’s draft report is silent on how effectively the purpose of Part 4 is being promoted by information disclosure. This is a critical aspect of the Commission’s reporting function. In the 2016 Cabinet paper on the need for improvements to the regime, there is a clear finding that “analysis and conclusions as to whether the regime was effective at achieving the Part 4 purpose for each airport” was an important feature in ensuring the regime remained effective. Further, the availability of this analysis was an important incentive for airports to continue to meet the purpose of Part 4.
- 5.29 If the final report omits this important step, the Commission risks reducing the threat of further regulation on which the light-handed information disclosure regime relies. It sends the message to airports that they can behave in a way which does not align with the Part 4 purpose (e.g., repeatedly targeting excess profits and undertaking inefficient investment) without consequence.

A section 56 inquiry is the right mechanism to consider whether a move to a more balanced form of regulation for airports is required

- 5.30 The overall assessment of regime efficacy is also a first step to determining whether an inquiry process should be triggered. Cabinet acknowledged that an inquiry would likely follow a summary and analysis report that highlights issues with an airport’s conduct in light of the Part 4 purpose³⁸.
- 5.31 It is acknowledged that the assessment process to determine whether stronger measures are required should be independent of political influence to the extent possible.³⁹ Based on economic theory, if a political process is either not involved, or is involved to a minimal degree or with strong accountability safeguards – the credibility of a threat of stronger regulation is likely to be greater. When the Australian Competition Tribunal (**ACT**) considered an appeal under Australia’s third-party access legislation, it

³⁸ Part 4 of the Commerce Act 1986: Strengthening the Regulatory Regime for Major International Airports, 2016 Cabinet Paper, Paragraph 36

³⁹ Arbaster, p 12.

concluded that the threat of regulation was “limited” given that no conduct on the part of Sydney Airport had to-date “stimulated any further Government action or interest.”

- 5.32 We are concerned the same could be said if the Commission omits to consider the regime efficacy through this current process. We refer to AIAL’s conduct as evidenced at each of the previous price setting events, which we believe demonstrates AIAL is operating on the expectation that, if they offer to refund part of the excess profit amount, the Commission will see this as evidence of the regime being effective. Not only is this pattern of behaviour time consuming, expensive and inefficient for all parties, we believe the regime as currently operating is simply incentivising AIAL to set the WACC above the range as a negotiating tactic.
- 5.33 We therefore encourage the Commission to include an overall assessment of regime adequacy in its final report in order to strengthen the regulatory threat and form the baseline for an inquiry to see whether a different regime would be in the best interests of consumers.