

Auckland Airport cross-submission on section 53B review, 19 December 2017

Appendix A: Auckland Airport comments on BARNZ assessment of PSE3 pricing decision against Part 4 criteria: response to primary questions¹

Question	BARNZ overall assessment	Auckland Airport comment																		
1) Is the Airport innovating appropriately?	Broadly yes, although some collaborative structures could be more effective.	<p>Thank you. We agree.</p> <p>There is a good deal of alignment between the airlines and the airport on the nature of transformation that we aspire to, however no party has full control of key influences / levers for that transformation. It is important that stakeholders continue to work together to realise innovation at Auckland Airport. We continue to invest in the Collaborative Operational Groups at various levels of seniority, as well as experimenting with new methods for identifying innovations and seeking commitment.</p>																		
2) Is the Airport delivering services at the quality consumers demand?	Performance is mixed. The Airport has experienced poor service quality issues recently due to growth and current KPIs are not being met. However, the customer survey scores are reasonable and the Airport has said it is willing to work with airlines and agencies to deliver improvements.	<p>Auckland Airport reports regularly to its Board on the service quality metrics embedded within information disclosure, conscious that we are accountable for reporting these publically. Those service quality metrics were established by the Commission following consultation with airlines.</p> <p>Overall the evidence as reported in annual disclosures over PSE2 shows that:</p> <ul style="list-style-type: none"> Service reliability remains high at Auckland Airport, with a high availability of core services (available 99.9% - 100% of the time) and corresponding low number and duration of outages – particularly as the traffic handled at Auckland Airport has grown exponentially over PSE2. Strong passenger satisfaction over PSE2, with scores ranking between “Good” and “Very Good” (as shown in the chart below). Quality experienced by passengers at Auckland Airport in PSE2 is broadly comparable with Wellington Airport, although lower than Christchurch Airport (to be expected given the new terminal infrastructure at Christchurch Airport). <div style="text-align: center;"> <p>Passenger satisfaction indicators (1 = poor, 2 = fair, 3 = good, 4 = very good, 5 = excellent)</p> <table border="1" style="margin: 10px auto;"> <caption>Passenger satisfaction indicators (2013-2017)</caption> <thead> <tr> <th>Year</th> <th>International Service Quality</th> <th>Domestic Service Quality</th> </tr> </thead> <tbody> <tr> <td>2013</td> <td>4.0</td> <td>4.0</td> </tr> <tr> <td>2014</td> <td>4.0</td> <td>4.0</td> </tr> <tr> <td>2015</td> <td>4.0</td> <td>4.0</td> </tr> <tr> <td>2016</td> <td>4.0</td> <td>4.0</td> </tr> <tr> <td>2017</td> <td>4.0</td> <td>4.0</td> </tr> </tbody> </table> </div>	Year	International Service Quality	Domestic Service Quality	2013	4.0	4.0	2014	4.0	4.0	2015	4.0	4.0	2016	4.0	4.0	2017	4.0	4.0
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¹ This Appendix provides a shortened and annotated version of BARNZ’s attachment to its first submission – which discusses quality, innovation and efficiency considerations. Should the Commission decide to broaden the scope of its review, we request an opportunity to respond to BARNZ’s views on these topic areas in more detail.

		<p>We acknowledge that the speed of growth has created some pressure points and that there is some congestion experienced at peak times of the year. At the beginning of the pricing consultation Auckland Airport sought to understand airlines' service quality priorities, and took steps to resolve issues raised by airlines (for example, BARNZ has noted that we took steps to resolve baggage system reliability issues). We remain committed to working alongside airlines and other key stakeholders over PSE3 to develop a set of service measures that all parties value, and to formalise the process for notification and rectification of service level matters. We want to make sure that we are measuring and sharing meaningful data, that we are responsive to airline concerns about service quality, and that there are key processes for airlines to bring issues to our attention and for us to lead the resolution of those issues.</p> <p>Auckland Airport has an ambitious culture, and we acknowledge our responsibility for taking the necessary leadership to realise continuous improvement in service quality improvements for the benefit of our customers. We welcome feedback from our customers on where our collaborative approach is working and where there is room for improvement. We note that current KPIs that are monitored as part of our collaborative working groups are joint KPIs that rely on performance from several agencies operating at the airport – Auckland Airport alone is not accountable for these.</p> <p>In terms of day-to-day operations, we note that service levels are affected if aircraft do not arrive to schedule. Airlines in COG have agreed an aspirational target of 65% on time arrivals performance.</p> <p>Taking a more long-term perspective, it is important to note there is a key interdependency between service quality and efficiency of infrastructure. The base case capital plan for PSE3 represents a service standard for common use assets, which was informed by airline feedback and industry and IATA planning standards. We remain open to customer requests for different quality standards for individual services or at peak, to the extent those customers value the differential service and are prepared to pay for it.</p>
<p>3) Is the Airport's price structure efficient?</p>	<p>Broadly yes, with the exception of the runway land charge and some aspects of cost allocation and check-in charging.</p>	<p>We are pleased that BARNZ has acknowledged that Auckland Airport's price structure is broadly efficient, that the airport has set prices equal to the costs of each area, and that we try to improve the efficiency of our pricing over time. Changing price structure brings with it a range of challenges and creates forecast risk uncertainty. Time will tell whether the cost-benefit of making the changes we have done to the pricing structure for PSE3 pay off in terms of driving the intended efficiencies and price/quality trade-offs and the extent of revenue risk generated by the change.</p> <p>We note that the structure of check-in charges is intended to promote optimal use of scarce resources. Relatively less space-intensive services are priced lower than more space-hungry service options. Since prices were set, a further two airlines have transitioned to the common use kiosks and we anticipate take-up to increase further ahead of 1 July 2018 when we transition from the traditional counter pricing approach to per passenger pricing.</p> <p>On the efficiency of the Runway Land Charge, we note that:</p> <ul style="list-style-type: none"> • An additional runway is a long-lead time, very expensive investment. It is not in the interests of consumers for it to be too early (bringing forward costs of investment), nor for it to be too late (consumers bear congestion and delay costs). • The collective actions of the industry have the potential to cause a change to the demand or supply programme and theoretically delay the requirement for the second runway. Auckland Airport cannot directly pull these levers, but we can reveal the consequences if these levers are not pulled in a timely fashion by forecasting the schedule, capacity and delay based on what is known today and therefore the necessary investment to maintain reasonable services levels. • Like the introduction of parking charges (which have had an immediate effect discouraging inefficient parking on the airfield), the potential introduction of the Runway Land Charge in FY20 if triggers are met is motivating parties to consider what they can do to

avoid the charge. We have seen that the Runway Land Charge is creating senior level support for an industry-wide drive for airfield efficiency through the Airfield Capacity Enhancement programme – which had previously stalled due to a number of retirements and waning attendance. Auckland Airport is strongly of the view that the price signal is an important motivator for the recent sponsorship of the Airfield Capacity Enhancement programme by senior airline representatives. The planned timing of the second runway in 2028 assumes the same demand forecasts as applied for pricing and the effective delivery of a programme of work to deliver a sustained capacity increase. If the Airfield Capacity Enhancement project can “outperform” the efficiencies targeted, such that construction is not triggered, the introduction of the Runway Land Charge can be deferred.

- We expect the Commission to carefully review and comment on the appropriateness of our approach in its summary and analysis, including the rationale underpinning why we have included revenues associated with land held for future use for PSE3. In designing the Runway Land Charge the level and timing of the charge evolved throughout consultation in direct consideration of feedback received and with regard to known regulatory guidance at the time.

4) Is the Airport targeting excessive profits?

Yes. The Airport's target WACC is too high and may be well in excess of its true WACC.

We discuss this point in detail in our main cross-submission. We are pleased that BARNZ has acknowledged that Auckland Airport provided an extensive explanation of our target return, and that our approach was influenced by the regulatory regime.

We note that BARNZ has quoted a Forsyth Barr report that suggested Auckland Airport's “true WACC” was between 5%-6%. This is not consistent with the available empirical evidence. For example, using the Commission's own model and Auckland Airport specific empirical data – as we have been encouraged to do – generates a WACC range for Auckland Airport of 6.85% - 7.55%. In that context, a target return of 6.99% for Auckland Airport's priced activities and an overall target return of 7.06% for total regulated activities are within the range of normal returns for Auckland Airport and will generate no excessive profits over PSE3.

Nor is this view shared by other analysts. For example, Deutschebank recently published the following analysis of what it considers to be Auckland Airport's WACC across different segments (November 2017):

Figure 39: Segmental WACC

	AIA Group	Regulated	Dual Till	Property
Risk Free Rate	4.4%	4.4%	4.4%	4.4%
Equity Beta	0.86	0.76	0.92	0.70
Equity Market Risk Premium	6.5%	6.5%	6.5%	6.5%
Cost of Equity	10.0%	9.3%	10.4%	9.0%
Debt Premium	1.50%	1.50%	1.50%	1.50%
Cost of Debt	5.9%	5.9%	5.9%	5.9%
WACC	7.98%	7.55%	8.25%	7.30%

Source: Company data, Deutsche Bank

We consider the better approach is to focus on the information put forward in our pricing decision and disclosure in support of our target return.

5) Is the Airport operationally efficient?

No. The evidence indicates a lack of efficiency and the Airport has indicated that it expects to see 'diseconomies of scale' in PSE3.

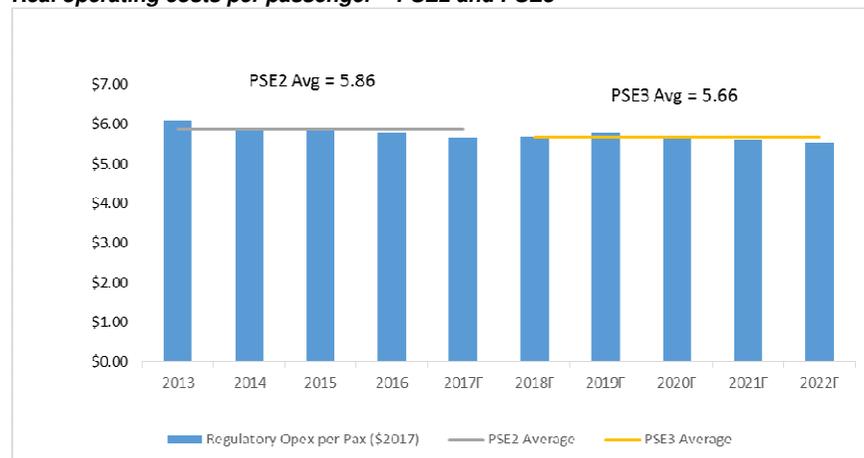
We note that we requested feedback on operating cost efficiency during the pricing consultation process, and the airlines provided one or two direct ideas which were factored into the forecasts for PSE3. We remain open to hearing through the period where the airlines consider operating efficiencies can be achieved based on their observations and will evaluate the merits of these as they arise.

We were unaware that BARNZ could not replicate the real opex forecasts in our pricing disclosure until we received its section 53B submission. We have since reviewed the disclosure information and have found a small error in the operating cost information. This affected the information presented for other regulated activities and the total regulated cost forecast (the aeronautical pricing forecasts were not affected, and are the same between our final pricing decision and the pricing disclosure). Our corrected analysis is shown in the table below, and shows that forecast opex for PSE3 is effectively flat (declining in real terms by 0.4%) on a per passenger basis relative to the FY17 forecast at the time we set prices – which had a forecast average for that year of \$5.66.

<i>Nominal</i>	2018F	2019F	2020F	2021F	2022F
Operating costs - Aeronautical Pricing Activities and Non-Isolatable activities	105.3	112.9	117.3	121.7	126.8
Operating costs - Other regulated activities	8.4	9.5	10.0	10.3	10.6
Total regulated cost forecast per Schedule 18	113.7	122.5	127.3	132.0	137.4
Passengers (m)	19.8	20.6	21.2	21.9	22.6
Nominal regulated cost forecast per Schedule 18	5.74	5.94	5.99	6.03	6.08
Real regulated cost forecast per Schedule 18	5.67	5.77	5.70	5.62	5.55
Average					5.66

Although opex per passenger can vary from year to year, it has been broadly flat in real terms at Auckland Airport in the period since Part 4 was introduced, as shown in the following chart. Average opex per passenger over PSE3 is also decreasing relative to the 5-year period for PSE2.

Real operating costs per passenger – PSE2 and PSE3



We have not stated that we cannot achieve further efficiencies from the footprint, as claimed by BARNZ. What we have tried to explain is that we do not consider it is realistic to expect economies of scale in every area of an airport's operation at all times, and passenger growth will not

always lead to per-unit cost decreases for every operating cost line item. Auckland Airport has had a highly efficient cost base compared with global airport comparators, and now faces a period of intensive and complex brownfields development. This is consistent with feedback from BARNZ’s advisor through the pricing consultation process that operating costs per passenger for Auckland Airport could be producing constant returns to scale but may also be demonstrating temporal diseconomies of scale associated with the temporary costs of expansion. As described elsewhere, congestion encourages further ideas for efficiencies, but those efficiencies are soon captured.

As part of the pricing consultation process, we benchmarked ourselves against a number of international airports in order to test the relative efficiency of Auckland Airport’s opening operating cost base. We acknowledge that benchmarking can be challenging and needs to take into account the different passenger mix at each airport. For example, although our operating cost per passenger is marginally higher than Sydney, Brisbane and Melbourne, our passenger mix is considerably different. As with the New Zealand market, we process a significantly higher proportion of international passengers than these comparator airports. Our operating costs are also lower per passenger than Perth Airport, despite the fact that our proportion of international passengers is almost 20% higher. Overall we remain of the view that our operating costs are efficient and benchmark well by international standards.

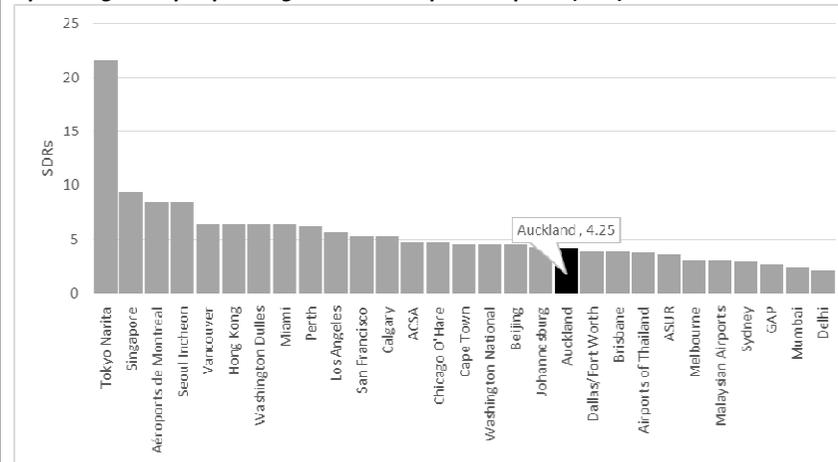
Using analysis set out in Leigh Fisher’s Airport Performance Indicators 2016 Report, we benchmarked our operating costs per passenger, total costs per air traffic movement and total costs per passenger. When costs are ranked from high to low, Auckland Airport ranks:

- 40th out of Leigh Fisher’s total global sample group of 50 airports for operating cost per passenger (so 10th lowest);
- 40th out of 50 airports in terms of total costs per air transport movement (again, 10th lowest); and
- 37th out of 50 airports (or 13th lowest) for total cost per passenger.

Among non-European airports (which typically have lower total cost metrics than European airports), Auckland Airport also benchmarks well. Again when costs are ranked from high to low, Auckland Airport ranks:

- 11th lowest in terms of operating cost per passenger (out of a sample of 29 airports), as shown in the following chart:

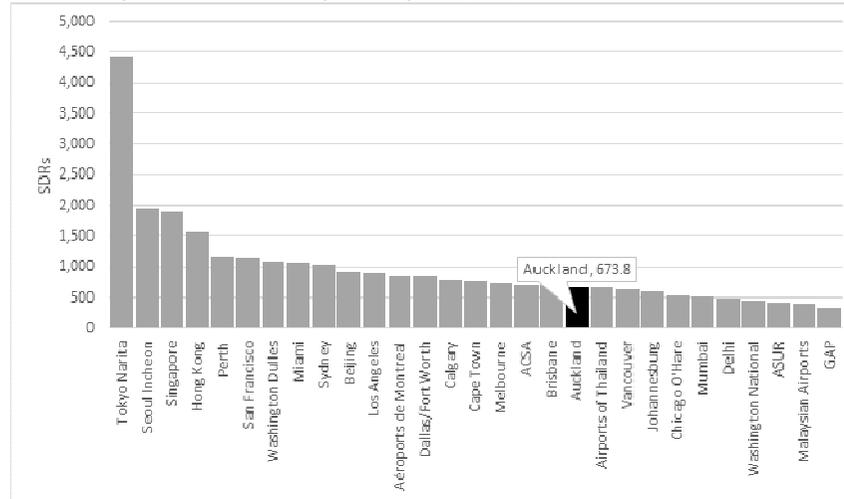
Operating costs per passenger – Non-European Airports (SDR)²



² To allow comparisons between the airports, Leigh Fisher converts the local currency data into a common unit of currency, called the Special Drawing Right (“SDR”). This is based on the trade-weighted values of a group of major currencies from the G8 nations. This unit is intended to allow comparisons to be made over extended periods of time which smooth out some of the larger fluctuations in currency values that can occur using a single currency such as the US Dollar.

- 11th lowest in terms of total costs per air transport movement, as shown in the following chart:

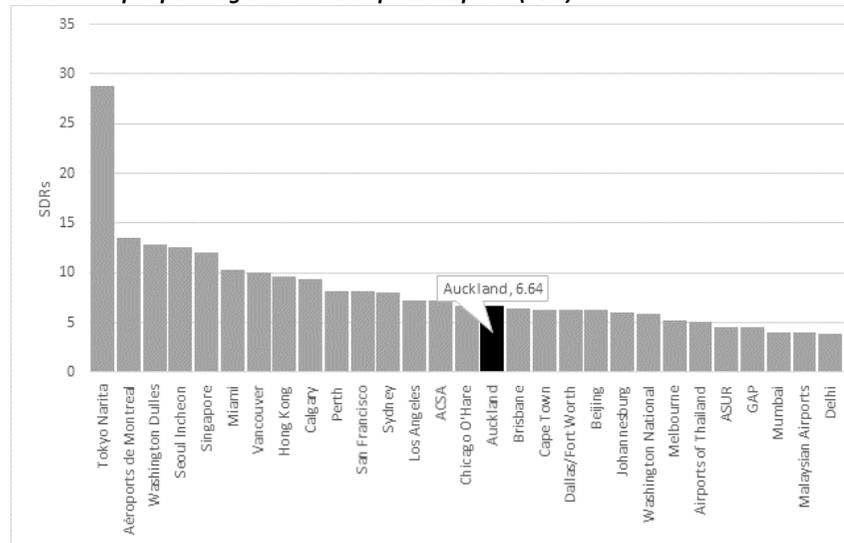
Total costs per ATM – Non-European Airports (SDR)



Source: Leigh Fisher, Airport Performance Indicators 2016 Report.

- 16th lowest for total cost per passenger, as shown in the following chart:

Total costs per passenger – Non-European Airports (SDR)



Source: Leigh Fisher, Airport Performance Indicators 2016 Report.

<p>6) Is the Airport investing efficiently?</p>	<p>The Airport appears to be investing in the right projects but some of this investment is too late. We are not confident that the capital cost estimates are as efficient as they could be.</p>	<p>Ultimately, Auckland Airport seeks to provide timely investment that is demand-led – but we acknowledge that it is not always possible to deliver investment perfectly on time given the long-lead times involved in designing and constructing airport infrastructure. If conditions change rapidly, this can create periods where congestion is experienced before new capacity comes on-stream.</p> <p>Auckland Airport was responsive to airline requirements and changing market conditions through PSE2. Consultation commenced around pier development options in June 2015 and continued steadily, and we worked alongside our airlines to accelerate the capital programme – ultimately spending 80% more than forecast at the time prices were set. All major changes to the capital plan set out in pricing for PSE2 were consulted on with our major airline customers and BARNZ, and we understand that airlines supported the repurposed programme.</p> <p>We consider there is a high level of alignment between Auckland Airport and airlines on the capital plan for PSE2. Through the extensive process of developing the central base case the cost estimates were rigorously tested internally and informed by airline feedback throughout. Some airlines involved a Quantity Surveyor. Auckland Airport also had the cost estimates of BECA for the Terminal Development plan peer reviewed by AECOM.</p>
<p>7) Does the Airport share efficiency gains with consumers?</p>	<p>No. If the airport achieved efficiencies these would eventually find their way into prices. However, the Airport is not delivering opex efficiencies.</p>	<p>We think this represents a narrow view of how Auckland Airport creates and shares efficiency gains with consumers. Auckland Airport’s prices for PSE3 are falling in FY17 for all passenger segments, and are broadly flat overall over PSE3 at the same time as we are spending \$15 per passenger per year on capital investment that will deliver considerable consumer benefits. We think this demonstrates clear sharing of growth efficiencies with consumers. In addition, Auckland Airport creates and shares efficiency gains with consumers in a range of ways as we have explained in our annual disclosures over PSE2. For example, as BARNZ has acknowledged in its submission, Auckland Airport introduces innovations / initiatives that help improve airline efficiency (such as ground power units) to the benefit of consumers.</p>