

Jo Perry
Chief Advisor, Compliance and Performance Analysis
Regulation Branch
Commerce Commission
Wellington

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

29 May 2018

Dear Jo,

Air New Zealand welcomes the invitation to respond to the Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022), Draft Report – Summary and analysis under section 53B(2) of the Commerce Act 1986 (Draft Report).

WACC: AIAL is targeting excess returns

We support the Commission's initial view that AIAL are targeting an excess return without sufficient justification. In targeting 7.06% WACC, Auckland Airport will be collecting excessive revenues of \$65 million from customers over PSE3.

Given PSE3 prices are effective from July 2017, this excess revenue is already being recovered. Once the final decision is released by the Commission, Air New Zealand would be happy to enter into discussions with AIAL, or with the Commission on how revenue might be best returned.

The information supplied by AIAL so far in the process does not substantiate their claim for any asset beta uplift. Air New Zealand expects AIAL will provide a significant amount of material to support their claim for asset beta uplift, delivering a WACC above the Commission's mid point of 6.41%. We note that the time period between this submission and following cross submissions is short, and it may be that additional time is required for delivery of cross submissions so that this material can be properly analysed and responded to.

Operating leverage uplift drives asset beta

The Commission observe that Auckland Airport have targeted excess profits by estimating operating leverage much higher than that provided in the Commission's comparator sample. That higher operating leverage has delivered a much higher weighted average cost of capital - 58 basis points beyond the Commerce Commission's midpoint of 6.41%.

The Commission's comparator sample contains 26 companies. As the Commission points out in their assessment of AIAL's asset beta adjustment, EBIT growth divided by revenue growth suggests AIAL is in fact an average of this sample, rather than an outlier.¹

The Commission has requested additional evidence from Auckland Airport to support uplift in the asset beta. The request includes operating leverage comparisons to comparator sample companies, independent review as to whether an increase in operating leverage delivered an increase in regulated or corporate WACC, and evidence from other regulators where asset beta adjustments have been made due to operating leverage of a similar magnitude as AIAL.

We note the Commission's examples of other regulated services including Heathrow Airport, where any uplift to asset beta granted by international competition authorities such as the UK Competition Commission have been of lesser magnitude. Air New Zealand considers that AIAL is not an outlier in provision of a capex programme while delivering aeronautical services.

Air New Zealand notes also the Commission's framework for assessing the target return and in particular, the Commission's recognition that there may well be "additional factors" which off-set any operating leverage impact on the asset beta. For example, Auckland Airport included in its pricing decision provision for additional charges to be imposed to recover the cost of any "Regulatory or Requested Investment" undertaken during the course of PSE3. Air New Zealand considers it essential that the Commission's final report take into account all issues which may impact on Auckland Airport's target return, and not just those circumstances which work in the interests of airport shareholders.

Other regulated services are not commercially negotiated

The Commission considers that returns on other regulated income, estimated by the Commission as 7.9%, are also unjustified. While these returns are based on individual agreements outside of the pricing consultation it is not the case that these agreements are commercially negotiated. AIAL brings significant monopoly power to the negotiations, such that agreements are not negotiated as they would be in a competitive market. The premium AIAL has been able to achieve for provision of what airlines consider essential services is evidence of the imbalance of power in the negotiation process.

Dual till is relevant to WACC assessments

Air New Zealand welcomes the statement from the Commission in the Draft Report that airports dual till nature must be acknowledged when assessing what level of WACC is appropriate. Airports should not require investment incentives as great as those offered to, for example, electricity companies, as they are supported by unregulated revenue streams

¹ Table 2.2, Draft Report, page 30

that generally benefit from any investment in aeronautical assets. For example, as part of its terminal upgrade work, AIAL forecasts improvement in its unregulated retail earnings, and growth in passenger volumes leads directly to increased car parking revenue.

Capex programme

AIAL is planning to invest \$1.8b in aeronautical infrastructure over PSE3. As stated in our submissions to date, Air New Zealand welcomes this investment. However, we reiterate our concerns that this investment:

- Has generally occurred well behind growth, to the benefit of shareholders;
- Does not require investment from shareholders, as AIAL maintains a policy of paying out 100% of NPAT as dividend; and
- Is likely to occur late in PSE3, and that this pattern of spending provides cash flow benefits to the regulated monopoly from its captive customers.

We maintain our position that in paying out \$454m to shareholders in 2014, AIAL ensured shareholders were protected from making reasonable investment into the regulated assets, on the pretext of being assessed as 'cash positive' by credit agencies. A good steward of monopoly infrastructure would have anticipated required investment at that time and invested at least a portion of those excess earnings in infrastructure.

Shareholders in AIAL can instead look forward to secure returns over PSE3, and there is nothing in the current regulatory settings for specified airports to stop further windfall gains being delivered to shareholders in a similar manner.

Peak pricing

The Commission has set out in its draft decision that AIAL should have given further consideration to peak pricing, and in particular to the benefits of lower charges off peak as means of increasing volumes. Both AIAL and airlines consider that peak pricing would not incentivise change in usage patterns, and that this includes any uptake of off-peak use.

Commission's further review

Air New Zealand is pleased that the Commission will commence an ex-post analysis of the performance of specified airport performance, assessing innovation, service quality, and efficiency. We also welcome the Commission's intention to review backward looking information disclosure requirements to align with required forecasts.

However, Air New Zealand considers that information disclosure is not a strong enough regulator of airport services to drive best outcomes for consumers in areas such as service quality and efficiency. This is reflected in current information disclosure performance metrics in which provide limited insight to quality and efficiency issues which matter to consumers such as cost of an airport visit, ease of transit through the airport, and ease of access to aircraft via airbridge.

Second Runway

Air New Zealand agrees with the Commission's assessment that AIAL's excessive WACC would result in an over-capitalisation of the second runway land of ~\$8 million over the course of PSE3. Consumers will carry this burden in perpetuity when the asset is added to the RAB.

Air New Zealand is disappointed that the Commission, in accepting the imposition of the RLC, has given no weight to users' views that this charge is premature. Notwithstanding airline acceptance of the need for the second runway at some point in the future, AIAL's decision to impose this charge from 2020 in no way reflects a commercial market outcome. Air New Zealand reiterates its views as stated in our 28 November 2017 response to the Commission's Process and Issues paper that the RLC is an arbitrary charge that is not NPV-neutral to airlines or their customers, transfers the risk of non-development to customers, and does not meet AIAL's stated aim of "price-smoothing". The RLC is the least best option for achieving AIAL's stated aims.

Air New Zealand is happy to discuss matters raised in this submission, as may assist the Commission in issuing its final report.

Kind regards,



Jeff McDowall
Chief Financial Officer
Air New Zealand