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Have your say on the review of Auckland Airport's 2022 – 2027 price setting event

Process and Issues paper

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Introduction

1. We are undertaking a review of pricing decisions made by Auckland International Airport Limited (Auckland Airport) under section 53B(2)(b) of the Commerce Act 1986 (the Act). Auckland Airport is subject to information disclosure (ID) regulation, and is required to disclose publicly and to us the price setting information after it has made pricing decisions.[1] On 7 June 2023, Auckland Airport set the prices that its airline and freight customers will pay for using the airport, such as landing and passenger charges, during the period 1 July 2022 to 30 June 2027. We received the price setting information disclosure from Auckland Airport on 17 August 2023.[2]

2. This price setting event features significant investments in aeronautical infrastructure and price increases, which were decided by Auckland Airport in an environment where inflation and interest rates are high and aeronautical demand is recovering post COVID-19. At a high level, the increases in prices are attributed to a range of factors, including the significant investments planned, higher cost of capital and lower total passenger volumes compared to the previous price setting period.

3. Under section 53B(2)(b) of the Act, we must publish a summary and analysis of the price setting information as soon as practicable after that information is disclosed by an airport, regulated under the Act. The purpose of summary and analysis is to promote greater understanding about the performance of each regulated airport, their relative performance, and changes in performance over time.

4. Part 4 of the Act provides for the regulation of the price and quality of goods or services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition. The purpose of Part 4 as set out in section 52A(1) of the Act is to promote the long-term benefit of consumers in regulated markets by promoting outcomes that are consistent with outcomes produced in competitive markets so that suppliers of regulated goods or services:

    4.1 have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

    4.2 have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

    4.3 share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

    4.4 are limited in their ability to extract excessive profits.

5. Information disclosure regulation has its own specific purpose (section 53A of the Act). The purpose of information disclosure regulation is for sufficient information to

[1] This is expanded on at paragraphs 8-13.

[2] Auckland Airport's disclosure information can be found at: https://corporate.aucklandairport.co.nz/investors/regulation

be readily available to interested persons to assess whether the purpose of Part 4 is being met.

Purpose of this paper

6. This paper outlines our proposed approach to and timeline for this review, and explains:

   6.1 that Auckland Airport has reset its prices;

   6.2 our preliminary thoughts on how we might approach this review, including possible focus areas;

   6.3 our proposed timeline for undertaking this review; and

   6.4 how you can have your say on this review.

7. After we consider any submissions on this paper, we will provide an update if there will be any substantive changes to our proposed scope, process or timeline for this review.

Auckland Airport has reset its prices

Airport Authorities Act

8. Under section 4A of the Airport Authorities Act 1966 (AAA), airports can set prices as they see fit from time to time. Section 4B of the AAA requires that airports must carry out consultation with substantial customers including airlines before fixing or altering charges and within at least five years after fixing or altering charges.[3] This means that airports must consult on and set prices at least every five years.

9. In June 2023, Auckland Airport set the prices that will apply during the period 1 July 2022 to 30 June 2027. The prices are payable by its customers for using certain of the airport's facilities and services, such as the aircraft landing charge, airfield parking charge, passenger charge and check-in charges. Key charges are listed in the table below.

Table 1: Key charges from 1 July 2022 to 30 June 2027

		FY23	FY24	FY25	FY26	FY27
MCTOW charges						
<6 tonnes	$/Landing	$60.24	$75.64	$86.98	$100.03	$115.04
6-40 tonnes	$/tonne per landing	$8.73	$12.74	$14.65	$16.85	$19.38
40 tonnes		$14.20	$20.72	$23.83	$27.41	$31.52
Passenger charges						
Domestic Passenger Charge (DPC)	$/pax	$3.10	$5.05	$5.80	$6.67	$7.67

3 Substantial customer has the meaning set out in section 2A of the Airport Authorities Act 1996.

		FY23	FY24	FY25	FY26	FY27
Regional Passenger Charge (RPC)	$/pax	$2.64	$4.53	$5.21	$5.99	$6.88
International Passenger Charge (IPC)	$/pax	$15.49	$21.20	$23.56	$26.20	$29.15
Transit Passenger Charge (TPC)	$/pax	$6.24	$21.20	$23.56	$26.20	$29.15
Runway Land Charge	$/pax	$1.19	$0.00	$0.00	$0.00	$0.00

10. There is a one-year delay in this price setting event because the COVID-19 pandemic materially affected the airport's ability to forecast passenger demand and thereby set prices accurately. Following consultation with its substantial customers, Auckland Airport kept the prices unchanged for the 2022/2023 financial year (price-freeze), allowing the price setting process to continue during the extension period.[4] We received the price setting information disclosure from Auckland Airport on 17 August 2023.

Part 4 of the Commerce Act

11. Auckland Airport is one of the three airports in New Zealand currently subject to information disclosure regulation under subpart 11 of Part 4 of the Act. The regulation covers aeronautical services, such as airfield, aircraft, freight, and passenger terminal activities. Non-aeronautical services, such as retail facilities, car parking and access for taxis, shuttles, and buses, are not regulated.

12. The Airports Information Disclosure Determination requires regulated airports to publicly disclose information about their forecast total revenue requirement following a price setting event.[5] This includes a description of how each of the key components of the forecast total revenue requirement have been determined and an explanation of any differences between the determination of each component for price setting purposes and the approach for historical information disclosures.

13. The information disclosure on the 2023 price setting event is the fourth of its kind for Auckland Airport since information disclosure requirements were set under Part 4. The 2023 price setting event is referred to as PSE4 in this review.

Proposed approach to this review

Background

14. Our obligation under section 53B(2) of the Act is to promote greater understanding about the performance of each airport, their relative performance, and changes in performance over time. The intent is to help interested persons assess whether the purpose of Part 4 is being met.

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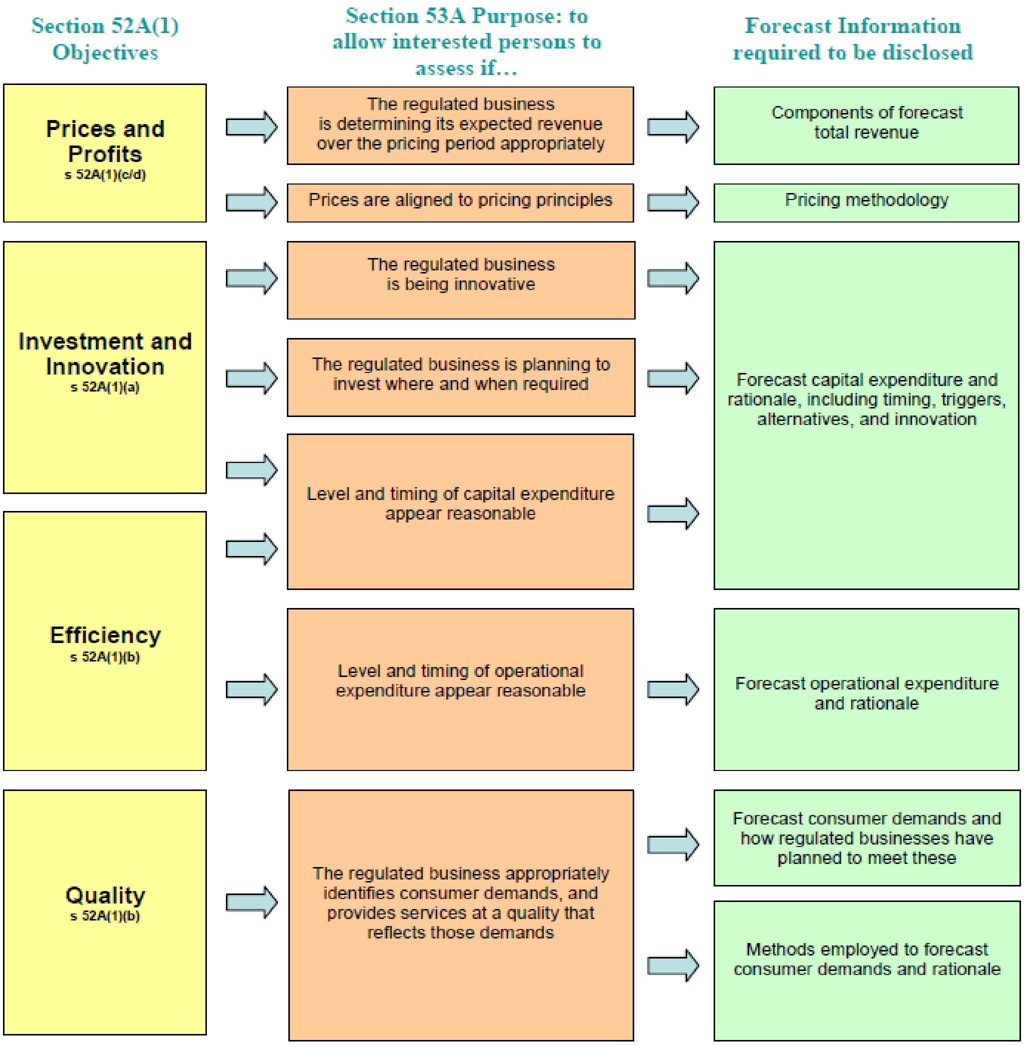
4 With one minor change being the discontinuation of the $2.00/international pax plus Goods and Services Tax Regulatory or Required investment charge (pg 8, 66, 72 of the AIAL disclosure).

5 *Airport Services Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.5.

15. Our forecast information disclosure framework for airports links the performance areas in the purpose of Part 4 to the required forecast information and assessment of it.[6] Given that price setting event disclosure contains predominantly forecast information, we consider this framework to be a useful guide for our review.

Figure 1 Disclosures informing ex-ante assessments



16. We have flexibility under section 53B of the Act to determine which areas of performance we focus on and we are not required to consider all aspects of performance at one time. Price setting event disclosure generally contains forward-looking information and provides the most detail about expected profitability, prices and forecast expenditure, whereas historical information disclosure, which is not the subject of this review, tends to provide better insight into performance areas such as service quality, level of innovation, actual expenditure and return. Using the information in the PSE4 disclosure, we intend to mainly focus on profitability,

[6] Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" (22 December 2010), page 131.

investment and any related quality considerations, and comment on efficiency, pricing and innovation aspects.

17. The purpose of our analysis is to assess whether the expected outcomes of Auckland Airport's pricing decisions are consistent with the purpose of Part 4 of the Act. This analysis does not determine the specific choices that Auckland Airport ought to have made in its pricing decisions, nor what we would have done in its place. In this sense, we are not required to identify alternative approaches unless we choose to do so. To the extent that we find the outcomes of the airport's pricing decisions are consistent with the purpose of Part 4 of the Act, we will describe those decisions as being reasonable or appropriate.

Possible key focus areas

18. We propose to focus on particular areas of Auckland Airport's performance in this review, based on:

    18.1 where we expect to gain the greatest insights from the PSE4 information disclosed by Auckland Airport; and

    18.2 our preliminary views on what the key areas of interest are likely to be for persons interested in the performance of Auckland Airport in PSE4.

19. Firstly, we will consider whether the airport has been limited in its ability to extract excessive profits, including:

    19.1 the reasonableness of its cost of capital and target returns, as this is a key contributor to the airport' ability to extract excessive profits;

    19.2 the reasonableness of other inputs into its pricing model, such as demand forecasts, and the depreciation profile given the significant growth in the regulatory asset base planned over the PSE4 period; and

    19.3 the impact of any risk sharing arrangements, including consideration of the use or lack of any opening or closing carry forward adjustments.

20. Furthermore, we propose to consider whether the airport is investing in its assets appropriately and in a way that meets the quality consumers demand. We intend to rely principally on the investment plan information in the PSE4 disclosure to draw conclusions in our summary and analysis, but may gather limited additional information where necessary.

21. Finally, we intend to assess how efficient the capital (capex) and operational expenditure (opex) estimates are for PSE4, and comment on pricing structure and innovation aspects.

Our proposed timeframes for this review

22. The table below sets out proposed timeframes for undertaking this review. These timeframes may change following finalisation of the scope of this review.

Milestone	Indicative dates
Process and Issues paper published	30 November 2023
Submissions due	31 January 2024
Cross-submissions due	14 February 2024
Update on process and scope, if required	March 2024
Draft review report published	Late May 2024
Submissions on draft review report due	Late June 2024
Cross-submissions due	Mid-July 2024
Final PSE4 review report published	September 2024

How you can have your say on the review of Auckland Airport's price setting event

23. We are interested in your views about the proposed scope (paragraphs 19-21) and timeframes for this review.

    23.1 Do you agree with the performance areas we propose to focus on, including the specific questions set out later in this paper, which we ask ourselves as part of this review?

        23.1.1 Are we asking the right questions? Are there any questions that are irrelevant or omitted?

        23.1.2 Is our proposed analytical approach reasonable?

    23.2 Do you have any concerns about the timeframes set out in the table above?

How to provide feedback

24. Please provide your submissions on this Process and Issues paper by 31 January 2024. Cross-submissions are due no later than 14 February 2024.

25. We intend to publish all submissions and cross-submissions on our website.

26. Submissions should be addressed to: infrastructure.regulation@comcom.govt.nz.

27. Please include "Feedback on proposed review of Auckland Airport's 2022-2027 price setting event" in the subject line of your email.

28. We prefer to receive your feedback in a format that is easy for us to analyse, such as Microsoft Word, Excel or PDF file formats.

29. We recognise that there may be cases where parties wish to provide confidential information to us. If it is necessary to do so, the information should be clearly marked, with reasons why that information is confidential.

30. If submissions contain confidential information, an additional document labelled "public version" should be provided. The responsibility for ensuring that confidential information is not included in the public version of a submission rests entirely on the party making the submission.

Specific considerations

31. In this section, we set out specific questions in boxes that reflect our focus areas. We would like to hear from you if we are asking the right questions at this stage of the review. You will have the opportunity to share your views on the PSE4 outcomes when we publish our draft consultation paper.

How we expect to approach assessing whether Auckland Airport is targeting excessive profits

General approach to assessing profitability

32. Airports are required to disclose their target return for the price setting period and to identify proposed risk allocation adjustments.[7] For clarity, as Auckland Airport's price setting occurred on 7 June 2023, the input methodologies (IM) that apply to this review are the IMs that were in force at that time.[8]

33. For this review, we intend to estimate Auckland Airport's expected return for PSE4 based on our understanding of the airport's forecasts and compare this to the airport's disclosed target return.

34. In establishing our estimate of the airport's expected return, we intend to review the reasons if and when the airport has used different parameters or approaches from those set out in the information disclosure requirements and IMs. We intend to consider the impact of different views on forecasts and projections and may perform a scenario analysis.

35. We intend to consider the impact of risk allocation decisions and the influence they may have on the assessment of expected returns. This is because the use of risk allocation adjustments allows airports to change which stakeholders bear the risk of actual outcomes being different to forecast.

Cost of capital

36. The mid-point weighted average cost of capital (WACC) represents our starting point when assessing the appropriate level of returns targeted by an airport.[9] However, we consider that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate.[10] We require airports to provide evidence to explain any differences or departures through information disclosure.

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7 Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 163.

8 Commerce Commission "Airport Services Input Methodologies Determination 2010" (Consolidated 20 December 2016).

9 Commerce Commission "Input methodologies review decisions – Topic Paper 6 – Airport profitability assessment" (20 December 2016), paragraph 80.3.

10 Commerce Commission "Input methodologies review decisions – Topic Paper 6 – WACC percentile for airports" (20 December 2016), paragraph 170.

We intend to consider the returns for both priced and all regulated activities when assessing cost of capital and profitability.[11]

37. Auckland Airport is targeting a return of 8.73% for priced activities and 7.79% for all regulated activities over PSE4. In comparison, our mid-point WACC estimate of 1 July 2022 is 6.98%. The difference in target return appears to result from a different tax-adjusted market risk premium (TAMRP), asset beta, and leverage to those specified in the IMs in force at the time pricing decisions were made.

38. Auckland Airport has adjusted the WACC parameters that were decided at the 2016 IM review. The variations are to the asset beta (from 0.60 to 0.80), leverage (from 0.19 to 0.14) and TAMRP (from 7.0 to 7.5), all of which increased its WACC. Auckland Airport has also not applied the 0.05 downward adjustment to the asset beta that was implemented in the 2016 IM review to account for our concern that the asset beta calculated using the comparator sample overstated the risks associated with the New Zealand airports' share of aeronautical revenue compared to non-aeronautical revenue.

39. The variations to asset beta and leverage are based on new estimates, using a similar set of international comparators as firms we used for the 2023 IM review draft decisions, but with data up to June 2022. Auckland Airport has decided to have the higher asset beta estimates for the COVID-19 period flow through, without adjustment, into the values it has used for its WACC. For the TAMRP, Auckland Airport has applied an updated estimate we adopted for the Fibre and Gas IMs after we reviewed the IMs in 2016.

Is Auckland Airport targeting excessive profits?

Depreciation

40. Airports recover depreciation of their regulatory assets (return of capital) from the revenue for regulated services, so forecast depreciation and its profile will have an impact on the prices and trend over time, given the longevity of infrastructure assets.

41. Auckland Airport's total regulatory asset base is projected to grow from around $1.7 billion to approximately $4.2 billion over the PSE4 period. This is driven mainly by the significant increase in assets to be commissioned from the capital expenditure programme. Auckland Airport used a standard straight-line depreciation method to forecast depreciation. Shorter asset lives were adopted for the capital expenditure to

11 Priced activities include facilities and services for airfield landing and parking, passenger terminal (except VIP lounges) and check-in. Generally, priced activities are charged based on usage (eg, per passenger, per hour). All regulated activities consist of priced activities plus other regulated (non-priced) activities, which include aircraft and freight facilities for maintenance and services of aircraft and handling of freight, VIP lounges and other dedicated services. Non-priced activities are charged through negotiated leases and licenses.

upgrade the existing domestic terminal building, which is planned to be decommissioned when the integrated terminal is operational.

Is Auckland Airport's approach to forecasting depreciation reasonable?

Demand forecasts

42. Demand forecasts are a key driver of the actual revenue an airport will earn during a pricing period. When airports can outperform demand forecasts, they are able to earn returns greater than the target.

43. We recognise that actual outturns will be different from forecasts as an element of uncertainty will always be present, especially after an economic shock such as COVID-19. In general, there may be an incentive for any airport to be conservative in projecting demand for services, whereas airlines may be more optimistic about demand which would lead to lower prices.

44. Given the significant increases in prices for PSE4, we are interested in how Auckland Airport has considered the price elasticity of demand in forecasting passenger numbers and setting prices.

45. We propose to consider whether the demand forecasts used by Auckland Airport to set its prices were a reasonably objective projection based on the information available at the time prices were set.

To what extent does the demand forecast provided by Auckland Airport in its PSE4 disclosure, reasonably reflect expectations for future demand and why?

Carry forward mechanism

46. A carry forward mechanism can be used by an airport to adjust the opening and/or closing values of their regulatory asset base for a pricing period, to account for historical adjustments, corrections, and omissions. It could also be used to adjust for over/under charges associated with passenger demand or capex delivery from one pricing period to another, which reflects risk-sharing between airports and its customers.

47. As discussed in the 2016 IM Review,[12] risks should in principle be allocated to suppliers or consumers depending on who is best placed to manage the risk. We use the term 'risk' as a way to describe the fact that actual outturns can be different from forecast.[13] Where an airport has not identified any alternative risk allocations,

[12] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 170.

[13] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 374.

the risk that actual outturns are different from forecast is assumed wholly by the airport.

48. Auckland Airport's PSE4 disclosure includes carry forwards relating mainly to historical adjustments seen in the past PSEs, correction of errors and omissions. In addition, Auckland Airport has introduced two new wash-up mechanisms to share risks with its customers, an asymmetric risk sharing (revenue) wash-up and a capex wash-up. The latter is discussed in the efficiency section.

49. The two-way revenue wash-up has been introduced to partially compensate Auckland Airport or airlines for material differences between actual and forecast aeronautical demand over PSE4 period. It is triggered if the PSE4 priced revenue falls short of (or exceeds) the price setting forecast by more than 15% and at the same time the PSE4 internal rate of return (IRR) for priced activities falls short of (or exceeds) target return by more than 0.75% after tax. If triggered, the wash-up would recover (or refund) the lesser of the revenue shortfall (or surplus) over and above the 15% threshold, and the priced IRR shortfall (or surplus) over and above the 0.75% threshold. This would be implemented as a positive or negative carry forward adjustment to the opening pricing asset base value to increase or reduce the revenue requirement for the next pricing period (PSE5).

Is the two-way revenue wash-up reasonable?

How we expect to approach assessing whether Auckland Airport is investing in its assets appropriately

Investment rationale

50. Auckland Airport's PSE4 pricing decisions include significant capital expenditure during the current and following pricing periods, with a forecast of $2.6 billion in commissioned assets for priced activities during PSE4 compared to $1.4 billion forecast for PSE3. A total of $6.7 billion in regulatory capital expenditure is planned for the next 10 years, out to 2032. Investment in infrastructure often includes multi-year programmes and projects. The ID regulation requires airports to disclose a 10-year capital expenditure forecast, with the initial five years fed into price setting for the period in question.

51. The largest capital expenditure relates to the terminal integration programme at a forecast of $3.9 billion over 10 years, which is to integrate the domestic terminal and jet operations into the existing international terminal. Approximately $1.6 billion of assets within the terminal integration programme is forecast to be commissioned over the PSE4 period. Other key projects include renewals (eg, airfield pavement and ground lighting), upgrades to international terminal and airfield facilities, and the cargo precinct.

52. We plan to assess whether Auckland Airport is planning to invest when and where required. We propose to consider the investment rationale, such as needs identification, project sequencing, options considered, customer engagement,

constraint and contingency factors. In undertaking our summary and analysis pursuant to s 53B(2) of the Act, we intend to rely principally on the investment information in the PSE4 disclosure to draw conclusions, but may gather limited additional information where necessary.

53. Given the link between service quality and investment, we intend to review the extent to which service quality was considered when Auckland Airport decided on capital projects and programmes.

Is Auckland Airport investing in its assets appropriately and at a quality standard that reflects consumer demands?

How we propose to assess if the forecast expenditure of Auckland Airport is efficient

54. Forecast operating and capital expenditure are significant parameters for the determination of the expected return for airports. While we understand that actual outturns are likely to be different from forecast, we propose to consider whether the expenditure forecasts used by Auckland Airport to set prices are a reasonably objective projection.

55. Where airports can spend less than what is forecasted, they can earn returns that are greater than the target return. This provides incentives to airports to make efficiency gains and outperform their forecast of expenditure. However, there may be an incentive for airports to be more aggressive in projecting expenditure such that, all else being equal, there is a higher likelihood of expenditure being less than forecast than greater than forecast.

56. In this section, we intend to consider the cost-effectiveness of both capex and opex forecasts of Auckland Airport over PSE4. In the case of capex, while the previous section on investment is focused on whether the project decisions and sequencing are reasonable from a strategic perspective, the emphasis of this section is whether AIAL has taken a robust approach to costing projects and considering their deliverability and timing.

Capex delivery risk sharing

57. We have indicated in the past that in general, airports are best placed to manage risks associated with capex projects.[14] In PSE3, Auckland Airport did not use any risk allocation adjustments to share capex delivery risks with its customers.

For PSE4, Auckland Airport has introduced a capex wash-up mechanism to partially compensate airlines if the airport under-delivers on the commissioned asset forecast. This is triggered if the total assets commissioned are 7.5% or more below the price setting forecast and the PSE4 IRR for priced activities exceeds target return by 0.75% or more after tax. If triggered, the airport would carry forward to the next

[14] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 443.

pricing period (PSE5) a downward adjustment to the opening asset value that equates to the lesser of the capex shortfall over and above the 7.5% capex threshold, and the priced IRR surplus over and above the 7.5% threshold, which would reduce the revenue requirement for PSE5. The capex wash-up mechanism is one-way only, which would partially compensate airlines in the event of capex under-delivery but does not benefit the airport in the event of capex over-delivery in PSE4. This mechanism provides some comfort towards assessing the costing and deliverability of projects.

Do the level and timing of forecast capital and operational expenditure for PSE4 appear reasonable? Is the capex wash-up mechanism reasonable?

We intend to consider pricing efficiency and innovation

Pricing efficiency

58. As outlined earlier, in consultation with its substantial customers Auckland Airport kept prices unchanged in the first year of the PSE4 period as the price setting was delayed. The PSE4 prices are set such that Auckland Airport can recover the revenue shortfall in the first year over the remaining four years of the PSE4 period.

59. Auckland Airport retained the existing pricing structure from PSE3, with some minor changes. These include an increase to the transit passenger charge to the same as international passenger charge, and a reduced aircraft parking exemption for domestic freighters from 48 hours to 12 hours from financial year 2024/2025.

60. In PSE3, Auckland Airport introduced a runway land charge (RLC) at $1.19+GST per passenger, subject to conditions. It was to recover some of the land holding costs for the proposed second runway as they were incurred, rather than carrying them into the final asset value of the asset, which was envisaged to be commissioned in 2028. The RLC would not be introduced earlier than July 2020 and only after Auckland Airport had spent more than $50 million on the development of the second runway and decided to proceed with the construction.

61. The conditions for the RLC were not met during PSE3 and so the RLC was never levied. Auckland Airport now expects a delay in timing of the second runway from the late 2020s to the late 2030s or beyond. For the PSE4 period, it retained the RLC in the price schedule but set it to $0.00.

Are there any concerns that the prices set by Auckland Airport are not efficient?

Innovation

62. One of the desirable outcomes in competitive markets as described under the purpose of Part 4 of the Act is that suppliers have incentives to innovate. While forward-looking information in PSE disclosures may indicate any intentions or commitments of regulated businesses to be innovative, historical disclosures containing actual performance information may provide better insights on the level of innovation amongst other dimensions.

63. Nonetheless, we consider airports are free to elaborate in PSE disclosures on how innovative they are or aim to be at both principle and practical levels, and show examples of how innovation is reflected in investment and operational decisions. We would like to understand the innovation aspect in Auckland Airport's PSE4 disclosure.

Is Auckland Airport being innovative?