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**Air NZ Cross Submission on the Review of Auckland Airport's 2022 – 2027 Price Setting Event 4 (PSE4) – Process and issues paper**

Dear Ana

We welcome the opportunity to provide cross submissions on the submissions provided in response to the Commission's process and issues paper for Auckland Airport's PSE4 review.

The submissions made by AIAL and, to a lesser extent, NZ Airports Association in our view seek to redirect the focus of the Commission's review. They submit, in summary:

- the Commission should not over-index their focus on profitability (though NZ Airports Association recognises the Commission is free to do so);
- it would be unreasonable for the Commission to look at any information that was not available to AIAL at the time it set its prices;
- the Commission should not identify alternative approaches when undertaking its review; and
- the Commission cannot assess whether the information disclosure regime remains fit for purpose.

Air NZ considers that these submissions are revealing, as they highlight the areas of weakness in AIAL's price-setting decisions. Air NZ also submits that certain submissions are wrong as a matter of law, for reasons set out more fully in our response below.

Furthermore, AIAL provides multiple arguments in its attempt to justify targeting an excess rate of return, despite these arguments having been previously found not to hold. Air NZ believes the Commission should use in its PSE4 analysis of Auckland Airport the same mid-point WACC of 6.32% that it used to review Christchurch Airport's PSE4 price setting.

Air NZ notes the unanimity in the substantial users' submissions that AIAL is targeting excessive profitability<sup>1</sup>, the capital plan is too expensive for what it delivers customers<sup>2</sup>, and, ultimately, the light-handed Information Disclosure regulatory regime (**ID regime**) is not fit for

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<sup>1</sup> BARNZ submission p.2; Qantas Group submission p.2; Air NZ submission p.4

<sup>2</sup> BARNZ submission p.2; Qantas Group submission p.3; Air NZ submission p.2

purpose at Auckland Airport<sup>3</sup>. These points should give the Commission sufficient cause for concern and further reinforce Air NZ's position that any earlier conclusions the Commission may have reached as to the effectiveness of the ID regime no longer hold. The airports submit that the Commission cannot assess whether the information disclosure regime remains fit for purpose. We disagree. For the reasons discussed, such an assessment is well within the Commission's discretion.

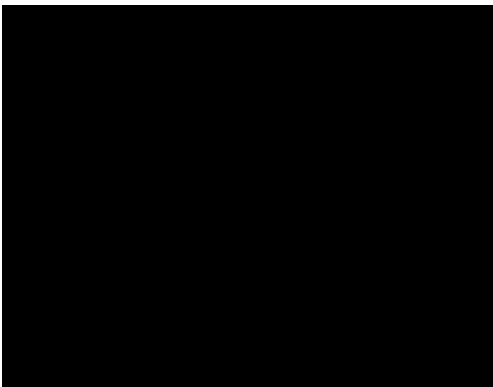
Regardless, Air NZ considers there to be overwhelming evidence that the ID regime is broken as it relates to AIAL, as it is not meeting the Part 4 purposes that regime purports to advance, particularly in the face of vast episodic spending. Air NZ supports the recommendations made by BARNZ and IATA in their submissions for the Commission to commence a s 56 inquiry.

Air NZ is also formally requesting the Minister require the Commission to hold a s 56 inquiry into whether a more balanced alternative type of Part 4 regulation would better meet the purpose of the legislation. Air NZ considers a s 56 inquiry is required urgently given the window to change direction or stop the build on an inefficient and unaffordable build by AIAL is rapidly closing. As highlighted in both Air NZ and Qantas Group's submissions, AIAL is on a 'path dependent' programme which will be increasingly difficult to stop or change the longer it continues.

Furthermore, Air NZ shares Qantas Group's view on the unanswered question around the treatment of sunk costs arising from AIAL's premature commitment to a path dependent construction programme its substantial customers oppose, should AIAL be required to change direction.

Air NZ is happy to discuss any aspect of our cross submission and to provide more information as may be required.

Yours sincerely,



**Air New Zealand**

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<sup>3</sup> BARNZ submission p.1; Qantas Group submission p.10; Air NZ submission p.2 Additionally, IATA submission p.5.

## The Commission can focus on profitability

- The airports submit that the Commission should not focus on profitability (though NZ Airports Association recognises the Commission is free to do so).<sup>4</sup> Air NZ disagrees with the airports.
- The scope of the Commission’s power to review is determined by Part 4 of the Commerce Act and general public law principles.
- Section 52A(1) of the Act sets out the general purpose of Part 4. It provides:

The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
  - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
  - (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
  - (d) are limited in their ability to extract excessive profits.
- As stated in section 52A, the purpose of Part 4 is to promote the long-term benefit of consumers in the relevant market, by promoting outcomes consistent with outcomes that would occur in competitive markets.<sup>5</sup>
  - The four areas of performance listed in section 52A are indicia of a competitive market. The absence of any one of those indicia listed in section 52A would be a clear sign that consumers in the market are not benefitting in the long term, and the purpose of Part 4 is not being met. Put simply, if AIAL is able to extract excessive profits, that is bad for consumers in the long term.
  - It is therefore entirely consistent with the purpose of Part 4 for the Commission to focus on excess profitability (or any one of the other indicia) to determine whether the outcomes in the market are consistent with the outcomes that would be achieved in a competitive market.

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<sup>4</sup> Auckland Airport submission at 9; NZ Airports Association submission at 3.

<sup>5</sup> As the Issues Paper notes, the purpose of information disclosure regulation is set out in section 53A, and links back to this broader purpose. Section 53A provides “the purpose of information disclosure regulation is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of this Part is being met”.

- AIAL says that the Commission must consider all the indicia holistically at the same time and should not focus on profitability. Of course, while the Commission cannot simply ignore one or more indicia, there is no requirement in the Act that the Commission must always examine all indicia at all times (as NZ Airports Association accepts). That is not stated anywhere in the Act, and nor is there any necessary implication in the Act to that effect.
- In any event, AIAL's concerns are overstated. The Commission's focus is not limited to profitability. The Commission's stated focus is "profitability, investment and any related quality considerations", with further comment on "efficiency, pricing and innovation aspects". This expressly incorporates each of the four indicia listed in section 52A. AIAL's apparent oversensitivity to the Commission considering whether AIAL's prices are excessive is revealing.
- Air NZ continues to support the Commission's holistic approach to consider if any of the four indicia are absent in order to assess whether consumers in the market are not benefitting in the long term.

**The Commission is free to, and must, look at relevant information**

- The airports submit that it would be unreasonable for the Commission to look at any information that was not available to AIAL at the time it set its prices.<sup>6</sup> Air NZ disagrees.
- Section 53B(2) sets out what the Commission is required to do when reviewing the PSE4 price-setting information:  
 If a supplier of goods or services is subject to information disclosure regulation, the Commission—
  - (a) may monitor and analyse all information disclosed in accordance with the information disclosure requirements; and
  - (b) must, as soon as practicable after any information is publicly disclosed, publish a summary and analysis of that information for the purpose of promoting greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time.
- AIAL and NZ Airports Association argue that the Commission cannot, when publishing its summary and analysis, look at information that came to light after AIAL made its price setting decision. However, again, there is no such express or implied restriction in this section.
- The question is not, as AIAL asserts, whether AIAL made a reasonable decision on the information available at the time; the Commission's exercise is not to undertake judicial review. The Commission's task is to analyse the information for the purpose of promoting greater understanding of the performance of AIAL, its relative performance, and the changes in its performance over time. There is no reason why that analysis should not take

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<sup>6</sup> Auckland Airport submission at 11; NZ Airports Association submission at 5.

account of information or events after the relevant decision was made. Indeed, it would be odd if the Commission could not, for example, analyse whether particular forecasts or assumptions made by AIAL turned out to be correct or not, if that is relevant to the analysis of AIAL's performance over time. That would be depriving interested persons of information to assess whether the purpose of Part 4 is being met, which is contrary to the purpose of the information disclosure regulation.

- Similarly, as Air NZ has already submitted, it is also relevant for the Commission to look ahead to the effects of PSE4 on PSE5 given clear interdependencies between the assets commissioned in PSE4 and PSE5. Capex carried out but not commissioned in PSE4 will essentially lock-in increases to the RAB that will be priced in PSE5. This is also relevant to AIAL's performance.
- Air NZ also requests the Commission consider where the conduct of the consultation process was the main reason that information was not available to AIAL at the time it set its prices. BARNZ, IATA and Qantas Group all make reference in their submissions to a flawed consultation process and Air NZ concurs.
- At the point in the consultation process that it became clear to Air NZ that its feedback, and the feedback of other substantial customers, was not being sufficiently considered before AIAL committed to its capital plan, Air NZ publicly called on AIAL to pause construction plans in order to work collaboratively through a meaningful, efficient and affordable redevelopment alternative.
- Air NZ submits that the very fact it then had to independently commission international airport design and engineering experts to develop an alternative design in order to evidence to AIAL that a more efficient alternative terminal design was indeed possible, is entirely relevant in assessing AIAL's performance – both in terms of the efficiency and affordability of their proposed terminal, and whether the quality of consultation was sufficient to enable innovation and optimal customer outcomes.

**The Commission can consider alternative approaches from those adopted by AIAL**

- AIAL and NZ Airports Association say that the Commission should not provide views on whether a different decision should have been made from the one AIAL made.<sup>7</sup> It is difficult to understand AIAL's concern in this regard. The Commission said in the Issues Paper that it will not determine what decision AIAL should have made but may consider alternative approaches.<sup>8</sup>
- Air NZ submits that is an entirely logical and permissible approach. An analysis of the decisions made by AIAL necessarily requires some comparison against alternatives, and it may have been reasonable to adopt any one of a number of different approaches.

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<sup>7</sup> Auckland Airport submission at 11; NZ Airports Association submission at 6.

<sup>8</sup> Issues Paper at 7.

- In particular, Air NZ agrees with Qantas Group that alternative approaches are an important data point in order to help establish a baseline for efficiency.

**The Commission can consider whether the information disclosure regime remains fit for purpose**

- The airports submit that the Commission cannot assess whether the information disclosure regime remains fit for purpose.<sup>9</sup> We disagree.
- NZ Airports Association appears to suggest that the availability of an inquiry under section 56G of the Act means that the Commission cannot consider whether the information disclosure regime is fit for purpose when reviewing information for the purposes of section 53B. We disagree.
- It is difficult to see how NZ Airports Association can make that submission in the face of section 53B(3) of the Act, which provides that “to avoid doubt, the Commission may, as part of a summary and analysis, include an analysis of how effective the information disclosure requirements imposed on the goods or services are in promoting the purpose of this Part”. *Section 53B(3) expressly provides that the Commission’s analysis can include analysis of whether the disclosure requirements are effective to promote the purpose of Part 4.* In addition, section 56F provides that the Commission can commence an inquiry on its own initiative. It would be natural for the Commission to be able to commence a full inquiry based on its own observations gathered through the section 53B process.
- The link between the information disclosure regime and section 56G is clear from the legislative history. The introduction of the expedited section 56G process in 2018 was in large part to ensure the threat of that greater regulation operated as a constraint on the monopoly airports. 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):<sup>10</sup>

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.

- Accordingly, it is well within the Commission’s discretion to comment on whether the information disclosure regime remains fit for purpose.

<sup>9</sup> Auckland Airport submission at 7; NZ Airports Association submission at 3.

<sup>10</sup> [Cabinet Paper - Part 4 of the Commerce Act 1986: Strengthening the Regulatory Regime for Major International Airports \(mbie.govt.nz\)](https://www.mbie.govt.nz/cabinet-papers/cabinet-paper-part-4-of-the-commerce-act-1986-strengthening-the-regulatory-regime-for-major-international-airports) Cabinet Paper, para 10.

**AIAL continues to target excessive profitability**

- AIAL goes to some lengths to justify its excessive cost of capital, relying on essentially the same arguments it made during the 2023 IM Review process, which ignored international precedent on how to treat the COVID-19 period when assessing the appropriate equity beta. Airlines made extensive submissions on this issue as part of that 2023 Review process. Air NZ notes that the Commission’s final decision as part of the 2023 Review rightly did not accept the approach adopted by AIAL.
- In PSE3 AIAL argued for a WACC uplift as a result of an expected increase in its operating leverage. The Commission, rightly, was not convinced.
- In PSE4 AIAL is arguing for a WACC uplift due to the asymmetric cost of underinvestment. In its submission on the Commission’s issues paper AIAL argued there are asymmetric consequences of risk related to the Commission’s profitability assessment. However, this is simply a rehash of AIAL’s WACC uplift arguments and should therefore be rejected:
  - AIAL’s target WACC for PSE4 (during which it is intending to commission \$2.6b of priced assets) is based on a mid-point WACC. This suggests that AIAL is clearly incentivised to invest at the mid-point WACC.
  - If AIAL really believed that a mid-point WACC provides insufficient incentive to invest, it would be contemplating a much-reduced capital programme in PSE4 and PSE5 or pausing that programme pending the outcome of its appeal on the cost of capital Input Methodology. Air NZ continues to urge AIAL to stop its inefficient build programme and commit to a fundamental and affordable redesign of the Integrated Domestic Terminal. Indeed, Air NZ is concerned that AIAL is overinvesting under current settings, an issue which would be exacerbated by a WACC uplift.
  - Neither AIAL nor NZ Airports have provided any evidence for their assertion that the cost of setting the WACC too low for airports would exceed that of the energy sector (where underinvestment result can result in outages, which have serious economic consequences). This issue has been well traversed in prior reviews of the Input Methodologies.
  - Moreover, Air NZ refutes the assertion by AIAL that its charges will continue to make up a small portion of the airfare paid by passengers. Air NZ estimates that AIAL’s average charge per domestic/regional passenger will increase from \$6.06 per passenger in DY2019 to ~\$46 per passenger in DY2032. This represents ~28% of the current average Air NZ domestic/regional fare and represents a multiple of the margin Air NZ makes on each domestic fare net of the other costs of carriage. Indeed, globally airlines’ net profit per passenger was US\$5.44 for 2023<sup>11</sup> and the long-term average for this figure excluding

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<sup>11</sup> <https://www.iata.org/en/pressroom/2023-releases/2023-12-06-01/>

covid is below US\$3<sup>12</sup>. If the increased airport charges are only able to be recovered in part, then while AIAL may make light of it, this has serious economic implications for Air NZ and, we expect, other domestic carriers. Further, the relevant consideration when considering the asymmetry of regulatory error is the cumulative dollar cost, not the dollars per passenger.

- Air NZ continues to assert that AIAL is generously incentivised to invest due to the benefits it derives from an unregulated second till, which more than offsets any risk of underinvestment that exist due to a mid-point regulatory WACC. Broker multiple estimates of ~2.0x RAB for AIAL’s regulated business suggest the market has a similar view.
  - Furthermore, the suggestion that the Commission should assess profitability differently for airports that are capacity constrained and those that aren’t is logically incoherent – once an airport invests it will no longer be capacity constrained. AIAL’s suggestion therefore appears to be a cyclical approach whereby there is a relaxed approach to profitability assessment prior to investments occurring and then a strict approach after they have been made (and capacity is no longer constrained). It is unclear how this would improve investment incentives at capacity constrained airports.
- The Commission should continue to assess AIAL’s profitability by using its estimate of AIAL’s mid-point WACC calculated in accordance with the 2016 Input Methodologies and information that would have been available to AIAL had prices been set in the normal course of business (i.e. April 2022).
  - Air NZ disagrees with AIAL’s representation that “*The input parameters for determining the cost of capital were set based on the available information as at 30 June 2022.*” This statement is misleading. AIAL’s target WACC for PSE4 is based on a risk-free estimate rate of 3.60%, which was not published by the Commission until 2 August 2022.
  - Air NZ believes that the Commission should assess AIAL’s PSE4 profitability using the same mid-point WACC of 6.32% it utilised in its recent PSE4 review of Christchurch Airport, and as shown in the table below.

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<sup>12</sup> <https://www.iata.org/en/iata-repository/publications/economic-reports/airlines-to-show-a-profit-in-2023---a-first-since-covid/>



**Table 2.1 Parameters used to calculate Christchurch Airport's WACC estimate**

| Parameter                                 | Commission | Christchurch Airport |
|---|------------|----------------------|
| Risk-free rate (as of 1 April 2022)       | 2.67%      | 2.67%                |
| Average debt premium (as of 1 April 2022) | 1.24%      | 1.43%                |
| Leverage                                  | 19%        | 19%                  |
| Asset beta                                | 0.60       | 0.60                 |
| Equity beta                               | 0.74       | 0.74                 |
| Tax adjusted market risk premium (TAMRP)  | 7.0%       | 7.5%                 |
| Average corporate tax rate                | 28%        | 28%                  |
| Average investor tax rate                 | 28%        | 28%                  |
| Debt issuance costs                       | 0.20%      | 0.20%                |
| Cost of debt                              | 4.11%      | 4.30%                |
| Cost of equity                            | 7.11%      | 7.48%                |
| Standard error of midpoint WACC estimate  | 0.0146     | 0.0146               |
| Mid-point vanilla WACC                    | 6.54%      | 6.87%                |
| Mid-point post-tax WACC                   | 6.32%      | 6.65%                |

- AIAL argues that it is extremely challenging to achieve a full commercial return from many of its non-priced regulated activities. It is difficult to understand AIAL's concern here. Air NZ's understanding is that non-priced activities are generally negotiated at commercial / market rates for a given contract length.
- AIAL submits that its accelerated depreciation is NPV neutral, with the implication being that airlines have no cause for concern. Whilst this may be true for AIAL, it is certainly not for their customers given airlines have considerably higher discount rates than airports. Air NZ submits that, since accelerated depreciation is NPV neutral for AIAL, the airport should favour the treatment that is better for customers/consumers, who would much rather have standard depreciation. Air NZ would also point out that AIAL is not required to determine now at what future date the DTB will be decommissioned. Air NZ points out that AIAL has only just commenced consultation on the regional pathway. The timing of any demolition of the DTB will be contingent, amongst other factors, on the outcome of this consultation and the ability of AIAL to deliver against the wider project milestones. Air NZ believes this matter is evidence that AIAL is significantly more focused on revenue maximisation than it is on customer needs.
- AIAL considers that if the demand elasticity impacts were increased in line with the feedback from airlines, then relative to the PSE4 pricing decision this would have had the

effect of reducing the demand forecasts further and increasing aeronautical prices, resulting in higher profitability for Auckland Airport. AIAL appears to misunderstand its customers' main concerns that the demand impacts it is basing its Capital Plan on will be most acutely felt in PSE5, by which time the capex underpinning PSE5 prices will be largely locked in. AIAL's statement also avoids the fact that higher prices caused by AIAL targeting excess profitability is the key contributor to the demand impacts, therefore the argument becomes somewhat circular.