

Review of Auckland Airport's 2022-2027 Price Setting Event

Consultation Paper

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Glossary

Acronym/abbreviation	Definition
AAA	Airport Authorities Act 1966
AIAL	Auckland International Airport Limited
Air NZ	Air New Zealand
Airports IMs	IMs for specified regulated airport services
the Act	Commerce Act 1986
ADT	Alternative Domestic Terminal
BARNZ	Board of Airline Representatives New Zealand, Incorporated
CAPEX	Capital expenditure
CPI	Consumer price index
DJF	Domestic Jet Facility
DTB	Domestic Terminal Building
GAAP	Generally Accepted Accounting Practice
IATA	International Air Transport Association
ID	Information disclosure
IM	Input methodology
IRR	Internal rate of return
OPEX	Operating expenditure
PSE	Price setting event
PSE3	Price setting event for the period 1 July 2017 to 30 June 2022
PSE4	Price setting event for the period 1 July 2022 to 30 June 2027
PSE5	Price setting event for the period 1 July 2027 to 30 June 2032
PV	Present value
Qantas	Qantas group of companies, including Jetstar
RAB	Regulatory asset base
RLB	Rider Levett Bucknall
TAMRP	Tax-Adjusted Market Risk Premium
TIP	Terminal Integration Programme
WACC	Weighted-average cost of capital

Executive summary

Purpose of this consultation paper

- X1 This consultation paper contains our draft conclusions on Auckland International Airport Limited's (**Auckland Airport or the Airport**) pricing decisions for the period 1 July 2022 to 30 June 2027 (**PSE4**). We consider whether Auckland Airport's pricing decisions and expected performance are likely to promote the long-term benefit of consumers. The purpose of our summary and analysis is to promote greater understanding of Auckland Airport's performance.
- X2 We are seeking your feedback on our draft conclusions, which will inform our final report. Submissions are due by 5pm, Tuesday 27 August 2024. You can find details as to how to submit in Chapter 1.

Context of this review

- X3 Auckland Airport is one of three international airports subject to information disclosure (**ID**) regulation under the Commerce Act 1986 (**the Act**).¹ ID regulation is a specific form of regulation that requires airports to publicly disclose information in accordance with requirements we determine. The purpose of ID regulation is to provide transparency on whether regulated businesses are performing in a way that is consistent with the purpose of Part 4 of the Act.² When the purpose of ID regulation is achieved, it helps promote the purpose of Part 4 itself by incentivising regulated businesses to improve their performance. Through ID regulation, we analyse and report on information published by the airports (including their pricing decisions), but we do not cap their prices or revenues or enforce service quality standards.
- X4 The regulation covers specified airport services, such as airfield, aircraft, freight, and passenger terminal activities. Other services, such as retail facilities, car parking and access for taxis, are not regulated and are not part of this review. Within the regulated airport services, there are priced and non-priced activities. 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). Non-priced (ie, other regulated) activities include aircraft and freight facilities, VIP lounges and other dedicated services. Non-priced activities are charged through negotiated leases and licences.
- X5 On 7 June 2023 Auckland Airport set the standard aeronautical prices for airfield activities and specified passenger terminal activities it would charge from 1 July 2022 to 30 June 2027.

¹ Alongside Wellington and Christchurch International Airports.

² Commerce Act 1986, s 53A.

- X6 This price setting event follows the COVID-19 pandemic, which for the aviation industry had an unprecedented impact on demand and certainty. For financial year (FY) 2023 Auckland Airport froze aeronautical prices at FY2022 levels, to provide pricing relief and continue the PSE4 consultation. The decision to freeze prices resulted in Auckland Airport receiving more than \$100 million lower aeronautical revenue in FY2023 than forecast if PSE4 prices were applied from that year. The deferred charges will be recovered over the remainder of the price setting period, to 2027. This arrangement was agreed to by the airlines.
- X7 The global pandemic had a significant adverse financial impact on the aviation industry, including both airports and airlines. Auckland Airport has stated it is not seeking to recover through PSE4 the more than \$500 million revenue shortfalls suffered during the pandemic period.³
- X8 Airlines have raised concerns about the forecast increases in aeronautical charges, and the impact on passenger demand. Auckland Airport considers it shares the interest of its substantial customers to minimise dampening of demand from price increases because passenger numbers are also a key driver of non-aeronautical revenue and shareholder value.

Changes to aeronautical pricing

- X9 Substantial customers of Auckland Airport have raised concerns that aeronautical prices will increase significantly during PSE4 and PSE5. This paper is a review of Auckland Airport's PSE4 decisions, and the focus is on PSE4. PSE5 pricing decisions have not yet been made and any analysis would be speculative. However, we acknowledge that some investment decisions made in PSE4 will affect prices in PSE5.
- X10 Auckland Airport states it has historically had the lowest domestic charges amongst New Zealand airports.⁴ The domestic charges at the three regulated airports for FY2024, which for Auckland Airport covers the period 1 July 2023 to 30 June 2024, are listed below.

Table X1 Comparison of domestic charges

(FY23 \$NZD)	FY24	
	Domestic Jet	Regional
Auckland	\$9.92	\$6.87
Wellington	\$14.68	\$10.81
Christchurch	\$14.10	\$9.67

³ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 13.

⁴ Charges refer to revenue per passenger, which covers landing, parking, terminal and check-in services.

- X11 Auckland Airport's international charge is also low in comparison with other Australasian international airports:

Table X2 Comparison of international charges

(FY23 \$NZD)	FY24
Auckland	\$31.73
Sydney International	\$40.82
Melbourne	\$34.77
Brisbane	\$54.85

- X12 Following Auckland Airport's price setting decisions for PSE4, the aeronautical charges by FY2027 are: \$13.97 (domestic jet), \$9.67 (regional), and \$41.68 (international). We note that while this is a substantial increase in charges from FY2023, the FY2027 domestic and regional prices remain comparable with, or are cheaper than, the FY2024 prices of other regulated New Zealand airports. The international charges by FY2027 also appear comparable with peer Australian international airports' FY2024 prices.

Table X3 Auckland Airport PSE4 price path

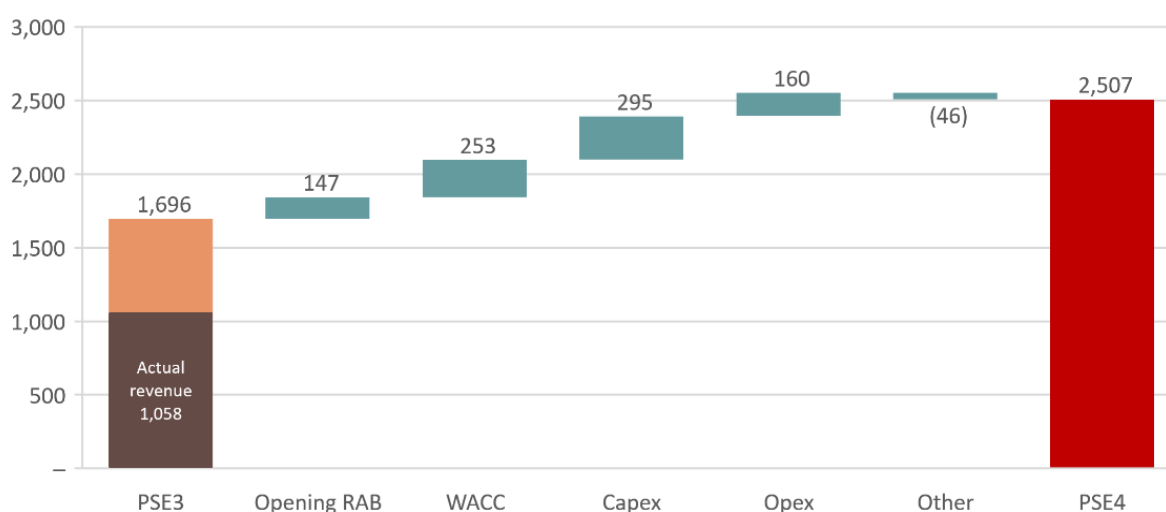
Auckland (FY23 \$NZD)	FY23	FY24	FY25	FY26	FY27
Domestic Jet	\$6.73	\$9.92	\$11.09	\$12.43	\$13.97
Regional	\$4.43	\$6.87	\$7.68	\$8.61	\$9.67
International	\$23.39	\$31.73	\$34.64	\$37.96	\$41.68
Year on year change (FY23 \$NZD)	FY23	FY24	FY25	FY26	FY27
Domestic Jet		\$3.19	\$1.17	\$1.34	\$1.54
Regional		\$2.44	\$0.81	\$0.93	\$1.06
International		\$8.34	\$2.91	\$3.32	\$3.72
Year on year change (percentage)	FY23	FY24	FY25	FY26	FY27
Domestic Jet		47%	12%	12%	12%
Regional		55%	12%	12%	12%
International		36%	9%	10%	10%

X13 We consider these pricing comparisons to be important context in our evaluation of whether Auckland Airport’s pricing decisions for PSE4, including its significant investment programme, are consistent with the purpose of Part 4.

Contributors to the price increase in PSE4

X14 The figure below shows the key reasons for the increase in forecast revenue from priced activities between PSE3 and PSE4 for Auckland Airport. The two most significant increases relate to the return (Weighted Average Cost of Capital or WACC) being targeted by Auckland Airport and PSE4 capital expenditure.⁵

Figure X1 Drivers of change in forecast revenue from priced activities (\$m)



X15 This is a high-level comparison in forecast between PSE3 and PSE4. The actual revenue and expenditure over PSE3 were significantly below forecast due to COVID-19 (shown by the darker segment of the first column in the figure).

Key draft conclusions

X16 Our key draft conclusions are:

X16.1 Auckland Airport’s charges are in excess of what is reasonable for the PSE4 period; it is targeting a return above what we consider a reasonable range.⁶ We estimate the total value of excess profits targeted by Auckland Airport to be between \$193.4 million and \$226.5 million.

⁵ In the chart, the WACC column represents the increase in return on existing assets. The return on capital invested during PSE4 is included in the Capex column. ‘Other’ column covers the voluntary price reduction following our PSE3 review, disposals, and tax adjustments.

⁶ 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.

- X16.2 The forecast capital expenditure, while significant, appears to be reasonable, based on the information we have. We have reviewed the process followed by Auckland Airport to set its capital expenditure plan, including the factors the Airport took into account (such as capacity and quality levels) and the evidence it considered (including the level of independent scrutiny and options considered). We did not find any issues that are inconsistent with the outcomes under Part 4 of the Commerce Act.
- X16.3 We are not convinced that straight-line recovery of depreciation of investment in long-lived assets, such as new terminal infrastructure, best promotes the long-term benefit of consumers. A tilted annuity approach to the recovery of depreciation is likely to be more consistent with outcomes produced in a workably competitive market. This approach increases the value of depreciation recovered as the usage of the asset increases, yielding a flatter pricing profile than straight-line depreciation.

Draft conclusions on the cost of capital

- X17 Auckland Airport's estimate of WACC (8.73%) differs from our mid-point estimate (6.98%). Our mid-point estimate is determined using the 2016 Airport Input Methodologies (IMs).⁷ Our draft conclusion is that Auckland Airport's estimate of WACC is not justified and is inconsistent with the purpose of Part 4 of the Act.
- X18 While Auckland Airport has used inputs of the cost of capital consistent with the IMs for credit rating, debt issuance costs and tax rates, it has varied the inputs for the risk-free rate, average debt premium, equity beta, leverage and tax-adjusted market risk premium (TAMRP).
- X19 We have considered the justification provided by Auckland Airport and conclude that while legitimate reasons are provided for using some different parameter values from our IM-based estimate, these reasons are not consistently applied, and the magnitude of some of these adjustments is not justified.
- X20 We consider it reasonable that Auckland Airport used 1 July 2022 as the date for setting the risk-free rate and average debt premium. This approach was agreed to by Air New Zealand (Air NZ) and BARNZ in Auckland Airport's correspondence with substantial customers as part of the agreement to defer the price setting.
- X21 We consider the magnitude of the asset beta and leverage adjustments to be excessive. The adjustment to the TAMRP is not consistent with the rationale for adjusting the asset beta and leverage.

⁷ The Input Methodologies are the rules, requirements and processes we must determine for services that are regulated under Part 4 of the Act. The Airport IMs contain clear rules for our estimation of the WACC, which we use as a benchmark for assessing profitability.

- X22 Our view is that Auckland Airport has misconstrued the purpose of the equity beta and has implicitly assigned an unreasonably high probability to the likelihood of another COVID-19-type disruption occurring over the PSE4 period. Its estimate of equity beta is unreasonably high.
- X23 We consider Auckland Airport's estimate of leverage is not reasonable for the same reason we consider its estimate of equity beta is not reasonable. Our draft conclusion is that the value of 14% is unreasonably low because it is likely to be inconsistent with the effect the COVID-19 pandemic had on the forward assessment by investors, market analysts and companies of leverage for the PSE4 period.
- X24 The TAMRP of 7.5% used by Auckland Airport was the most recent estimate published by the Commerce Commission when Auckland Airport made its pricing decision. However, Auckland Airport acted inconsistently by not updating the TAMRP (to 7.0%) when it chose to update other WACC parameters. For this reason, we consider Auckland Airport's use of a 7.5% TAMRP is not reasonable in the context of its overall approach.
- X25 Using a similar approach to the one used by Christchurch Airport, which we accepted, an appropriate WACC value is 7.28%. Making consistent adjustments to asset beta, leverage and TAMRP of a size appropriate to reflect more recent economic events (ie COVID-19) we estimate an appropriate WACC is 7.51%.

Draft conclusion on expected profitability

- X26 Auckland Airport has used an estimate of its cost of capital as the target return on its priced services of 8.73%, with a return from the total regulatory asset base of 7.79%.
- X27 Overall, we consider that a value in the range from 7.28% to 7.51% would be a reasonable WACC estimate for the purpose of setting prices for PSE4. The value that Auckland Airport used for PSE4, which was 8.73%, is above this range.
- X28 We have estimated that Auckland Airport is forecast to earn excess profits over the PSE4 period of between \$193.4 million and \$226.5 million, in nominal terms, from the priced activities, as a result of targeting a higher than reasonable return.
- X29 There could be a reduction in aeronautical prices if a reasonable return was to be targeted by Auckland Airport for PSE4.

Draft conclusions on other matters affecting profitability

Operational expenditure

X30 Auckland Airport's operational expenditure forecasts appear reasonable. The Airport's per passenger operating expenditure forecasts are projected to be similar to pre-pandemic levels by the end of the price-setting period. Auckland Airport has used non-tradeable inflation rather than the Consumer Price Index (CPI) as a cost driver. It considers the former likely better reflects its operating cost base, which we accept. We also note that in a 2022 ranking of 50 airports across the globe, with the 1st ranking having the highest operating cost per passenger and the 50th having the lowest operating cost per passenger, Auckland Airport ranked 43rd.⁸

Depreciation

X31 Auckland Airport has adopted a standard straight-line depreciation method for all its assets including new investments. We are not convinced that this approach best promotes the long-term benefit of consumers, when a significant upfront investment is likely to be used by a growing number of consumers over time. Specifically, in our view 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.

X32 This approach reflects the gradually increasing utilisation of the asset meaning that consumers pay a consistent amount toward the cost of the asset over time. The effect is to defer some of the depreciation cost into the future, and thereby reduce price increases in the short term.

X33 We understand that Auckland Airport considered the tilted annuity method for recovering depreciation, which Christchurch Airport applied to its investment in a new terminal.⁹ However, Auckland Airport explained that it did not adopt this approach because it would likely reduce prices in PSE4 but then increase prices in PSE5 and beyond, the pricing periods in which the airlines were concerned the most about increased prices. Based on the information available and in the absence of regulatory asset base (**RAB**) indexation, we are not convinced by this conclusion. 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).

X34 We would welcome a submission from Auckland Airport further explaining why it preferred the straight-line approach, with any analysis and key assumptions supporting its decision.

⁸ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 47.

⁹ Commerce Commission: [Review of Christchurch Airport's 2022-2027 Price Setting Event](#) (PSE4), pp 30-31.

- X35 We find Auckland Airport's use of accelerated depreciation for the investment in the existing Domestic Terminal Building (DTB) is in line with GAAP and not unreasonable, as it is consistent with the Airport's intention to de-commission the DTB when the new domestic terminal becomes operational. Additionally, a non-accelerated approach would have reduced prices in PSE4 but increased prices in PSE5.

Demand forecasts

- X36 There has been extensive consideration, consultation and expert studies on demand from both Auckland Airport and its substantial customers. We understand that expert studies relating to price elasticity of demand show different magnitudes for the potential impact on demand from the increase in Auckland Airport's charges. However, we do not consider that the potential impact of these differences is of sufficient significance in the operating expenditure forecast or the projection of long-term capacity needs. Overall, we consider that Auckland Airport's demand forecast appears reasonable and is unlikely to result in excessive profits for the PSE4 period.

Revenue wash-up mechanism

- X37 Auckland Airport has included a two-way revenue wash-up mechanism in PSE4, to protect both the Airport and airlines from significant revenue variance to PSE4 forecast. Our draft conclusion is that, in principle, this two-way revenue wash-up seems appropriate to address under- or over-recovery of revenue by the Airport in the event of a demand shock, like COVID-19. While some airlines did not agree on the threshold of the wash-up, there was agreement in principle over wash-ups generally and Auckland Airport lowered the threshold after considering airlines' feedback.

Draft conclusions on investment

- X38 Auckland Airport is in the process of implementing an investment program that involves spending around \$5 billion in PSE4, 62% of which relates to the new domestic terminal. For more details, see Table 4.1 in Chapter 4. Fifty-one percent of this investment is forecast to be commissioned in PSE4 and to start being recovered through prices.

Overall draft conclusion

X39 We consider that Auckland Airport followed appropriate processes and applied rigour in costing the investment plan. Auckland Airport considered a wide range of options and had adequate regard to service quality. It has appropriately considered delivery risk mitigation. Based on the information we have, we consider that the forecast capital expenditure, while significant, appears to be reasonable.¹⁰ We have not identified aspects of the planned investment that are inappropriate and therefore produce outcomes inconsistent with the Part 4 purpose.

Draft conclusions on costing and timing

X40 We consider that the process and rigour Auckland Airport applied to planning and costing the investment plan was reasonable. Auckland Airport engaged multiple third-party experts to assist with costing the investment plan and peer reviews. Auckland Airport appears to have appropriately considered the timing of its capital investment projects, with regard to needs for passenger capacity and contingent runway operation in the near future.

Draft conclusions on scope and service quality

X41 We consider that when identifying the needs for investing in a new domestic terminal, Auckland Airport had adequate regard to the current service quality issues, asset maintenance, and capacity requirements in the long run. The service levels that Auckland Airport is targeting for the design of the new domestic terminal do not appear to be excessive, in comparison to the International Air Transport Association (IATA) Optimum Level of Service standards or the average peer airports.

Delivery risk mitigation

X42 Auckland Airport has introduced a capital expenditure wash-up mechanism that aims to reduce the risk of under-delivery in investment. We consider that the introduction of the one-way capex wash-up mechanism shows that Auckland Airport is cognisant of the risk of under-delivery. Without any such mechanism, the underinvestment risk primarily sits with airlines. Auckland Airport is better placed to manage the investment delivery risk. We consider the mechanism provides the right incentives.

Draft conclusions on pricing structure

X43 In the PSE3 review we concluded that in general, Auckland Airport's pricing structure did not raise efficiency concerns. Given that there are minimal changes to the pricing structure, we have not revisited this overall conclusion.

¹⁰ We have not undertaken an engineering review of Auckland Airport's capital expenditure plan, as it is not our role to determine the specific investment choices that the Airport should make.

X44 However, in relation to the pricing structure changes that have been made, we do not consider that Auckland Airport has provided sufficient explanation for making the change to the 48-hour parking exemption for domestic freighters. We welcome more information from Auckland Airport on how it considers the change will lead to the more efficient use of airfield parking space.

Draft conclusion on innovation

X45 Auckland Airport appears to be innovating to some degree. However, more evidence of innovative practices would be needed to positively conclude that the Airport is improving its performance through innovation.

Other matters

X46 Auckland Airport's PSE4 information disclosure complies with the requirements we set out in the ID determination. In the submissions to our Process and Issues paper,¹¹ some stakeholders raised issues outside the current scope of the ID requirements, such as unregulated activities and the commercial till of Auckland Airport. The Airport is not required to disclose such information and therefore this paper does not consider this.

X47 We are not party to Auckland Airport's PSE4 consultation with the airlines. We understand the consultation process was confidential and certain information was subject to a non-disclosure agreement amongst the participants. If the parties consider some of the information on regulated activities that was subject to a non-disclosure agreement should be part of the information required to be disclosed by airports, they should inform us and we may look at amending ID requirements in the future.

¹¹ Commerce Commission, "[Review of Auckland Airport's Price Setting Event 4 – Process and issues paper](#)" (30 November 2023) (**Process and Issues paper**).

Chapter 1 Introduction

Purpose of this consultation paper

- 1.1 This consultation paper contains our draft conclusions of Auckland International Airport Limited's (**Auckland Airport or the Airport**) pricing decisions for the period 1 July 2022 to 30 June 2027. This is the fourth event of its kind for Auckland Airport and is referred to as Price Setting Event 4 (**PSE4**).
- 1.2 This paper sets out our draft conclusions from the summary and analysis, which we must publish under section 53B(2)(b) of the Act, on information disclosed by Auckland Airport.¹² The purpose of our summary and analysis is to promote greater understanding of Auckland Airport's performance.
- 1.3 Auckland Airport has been subject to information disclosure (**ID**) regulation under the Act since 2011. ID regulation is a specific form of regulation we use under Part 4 of the Act to regulate certain markets where there is little or no competition (and little prospect of future competition). This form of regulation requires airports (and other regulated suppliers) to publicly disclose information in accordance with requirements we determine.
- 1.4 The purpose of ID regulation is to provide transparency on whether regulated businesses are performing in a way that is consistent with the purpose of Part 4 of the Act.¹³ Through ID regulation, we analyse and report on information published by the airports (including their pricing decisions), but we do not cap their prices or revenues or enforce service quality standards. We consider the decisions and rationale used by airports in setting their revenues and target returns, in the context of the input methodologies (IMs) relevant to regulated airport services. When the purpose of ID regulation is achieved, it helps promote the purpose of Part 4 itself by incentivising regulated businesses to improve their performance.
- 1.5 We seek your feedback on our draft conclusions which will inform our final report. Submissions are due by **5pm, Tuesday 27 August 2024**. You can find details about how to submit at the end of this chapter.

Structure of this paper

- 1.6 This paper is structured as follows:

¹² Auckland Airport is required to publicly disclose information about its price setting event in accordance with the *Airport Services Information Disclosure Determination 2010*. A copy of the current consolidated determination (ie, including subsequent amendment determinations to 18 June 2019) for ease of reference can be accessed via our website. Commerce Commission "[Airport Services Information Disclosure Determination 2010](#)" (18 June 2019).

¹³ Commerce Act 1986, s 53A.

- 1.6.1 **Chapter 1** provides the context and details about how you can provide your views.
- 1.6.2 **Chapter 2** contains our analysis and draft conclusion on Auckland Airport's cost of capital.
- 1.6.3 **Chapter 3** contains our analysis and draft conclusion on Auckland Airport's expected profitability.
- 1.6.4 **Chapter 4** contains our analysis and draft conclusion on Auckland Airport's investment.
- 1.6.5 **Chapter 5** provides our analysis and draft conclusion on Auckland Airport's pricing structure.
- 1.6.6 **Chapter 6** provides our analysis and draft conclusion on Auckland Airport's innovation.

Context for this consultation paper

Auckland Airport has reset its prices

- 1.7 On 7 June 2023 Auckland Airport set the standard aeronautical charges for airfield activities and specified passenger terminal activities it would charge from 1 July 2022 to 30 June 2027.
- 1.8 In addition to the requirements of ID regulation, Auckland Airport must consult (and has consulted) with airlines concerning proposed prices under s4B of the Airport Authorities Act 1966 (**AAA**).¹⁴
- 1.9 Under the current AAA regime, airports are able to set prices they consider appropriate, but must consult with airlines prior to fixing or altering charges and must do so at least once every five years.¹⁵ Consultation on the price setting event also includes the inputs to the prices being set, such as cost of capital, expenditure programmes and demand forecasts.
- 1.10 Section 4C of the AAA requires specified airport companies to consult with substantial customers on any capital expenditure plans that mean the airport will or will likely spend 20% of the value of its identified assets in capital expenditure over the following five years.¹⁶

¹⁴ Airport Authorities Act 1966, s 4B.

¹⁵ The Civil Aviation Act 2023, which will replace the AAA, retains this consultation obligation.

¹⁶ Airport Authorities Act 1966, s 4C.

- 1.11 The substantial customers that Auckland Airport has consulted with during PSE4 are Board of Airline Representatives New Zealand Incorporated (**BARNZ**), Qantas Group (**Qantas**), and Air New Zealand (**Air NZ**). We understand the consultation process was confidential and certain information was subject to a non-disclosure agreement amongst the parties.

How you can provide your views on this consultation paper

- 1.12 We invite submissions and cross-submissions from interested parties on this consultation paper, which will inform our final report that we intend to publish no later than Q1 2025, depending on the extent of submissions.
- 1.13 We have allowed for an extended consultation period of nine weeks. Submissions must be provided no later than 5pm, Tuesday 27 August 2024. We will invite cross-submissions for a period of three weeks after publication of submissions, which will occur soon after they are received. Cross-submissions should only focus on matters raised in submissions. We strongly discourage stakeholders from raising new matters via cross-submissions.
- 1.14 Please email your submissions to infrastructure.regulation@comcom.govt.nz and include “Auckland Airport Price Setting Event 4 Review” in the subject line. We prefer submissions in formats suitable for data analysis and publication on our website, such as Microsoft Word, Excel or a PDF document.

Confidential submissions

- 1.15 We encourage public submissions so that all information can be tested in an open and transparent manner. We recognise that there may be cases where parties wish to provide information in confidence. We offer the following guidance:
- 1.15.1 if it is necessary to include confidential material in a submission or cross-submission, the information should be clearly marked, with reasons why that information is considered to be confidential;
 - 1.15.2 where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information;
 - 1.15.3 both confidential and public versions of the submission or cross-submission should be provided and clearly labelled accordingly; and
 - 1.15.4 the responsibility for ensuring that confidential information is not included in a public version of a submission or cross-submission rests entirely with the party making the submission or cross-submission.

- 1.16 If we consider disclosure of information in the confidential version to be in the public interest, we will consult with the party that has provided the information before any such disclosure is made.
- 1.17 Please note that all submissions and cross-submission we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we do not publish unless good reasons existed under the Official Information Act 1982 to withhold it. We would normally consult with the party that has provided the information before any disclosure is made.

Chapter 2 Cost of Capital

Purpose of this chapter

- 2.1 This chapter contains our analysis and draft conclusions regarding whether Auckland Airport's reported estimate of its cost of capital of 8.73% is sufficiently justified.

Draft conclusion

- 2.2 Auckland Airport's estimate of Weighted Average Cost of Capital (**WACC**) (8.73%) differs from our mid-point estimate (6.98%). Our mid-point estimate is determined using the 2016 Airport Input Methodologies (**IMs**). Our draft conclusion is that Auckland Airport's estimate of WACC is not justified and is inconsistent with the purpose of Part 4 of the Act.
- 2.3 While Auckland Airport has used inputs of the cost of capital consistent with the IMs for credit rating, debt issuance costs and tax rates, it has varied the inputs for the risk-free rate, average debt premium, equity beta, leverage and tax-adjusted market risk premium (**TAMRP**).
- 2.4 We have considered the justification provided by Auckland Airport and conclude that while legitimate reasons are provided for using some different parameter values from our IM-based estimate, these reasons are not consistently applied, and the magnitude of some of these adjustments is not justified.
- 2.5 We consider it reasonable that Auckland Airport used 1 July 2022 as the date for setting the risk-free rate and average debt premium. This approach was agreed to by Air NZ and BARNZ in Auckland Airport's correspondence with substantial customers as part of the agreement to defer the price setting.
- 2.6 We consider the magnitude of the asset beta and leverage adjustments to be excessive. The adjustment to the TAMRP is not consistent with the rationale for adjusting the asset beta and leverage.
- 2.7 Our view is that Auckland Airport has misconstrued the purpose of the equity beta and has implicitly assigned an unreasonably high probability to the likelihood of another COVID-19-type disruption occurring over the PSE4 period. Its estimate of equity beta is unreasonably high.
- 2.8 We consider Auckland Airport's estimate of leverage is not reasonable for the same reason we consider its estimate of equity beta is not reasonable. Our draft conclusion is that the value of 14% is unreasonably low because it is likely to be inconsistent with the effect the COVID-19 pandemic had on the forward assessment by investors, market analysts and companies of leverage for the PSE4 period.

- 2.9 The TAMRP of 7.5% used by Auckland Airport was the most recent estimate published by the Commerce Commission when Auckland Airport made its pricing decision. However, Auckland Airport acted inconsistently by not updating the TAMRP (to 7.0%) when it chose to update other WACC parameters. For this reason, we consider Auckland Airport's use of a 7.5% TAMRP is not reasonable in the context of its overall approach.
- 2.10 Using a similar approach to the one used by Christchurch Airport, which we accepted, an appropriate WACC value is 7.28%. Making consistent adjustments to asset beta, leverage and TAMRP of a size appropriate to reflect more recent economic events (ie, COVID-19) we estimate an appropriate WACC is 7.51%.

Structure of this chapter

- 2.11 This chapter sets out:
- 2.11.1 our framework for assessing Auckland Airport's estimated cost of capital, taking into account the relevant context of the IM Review undertaken in 2016, our reviews undertaken in 2013 and 2014 in accordance with s 56G of the Act (s 56G reports),¹⁷ our 2024 Review of Christchurch Airport's PSE4,¹⁸ and our 2022 Review of Wellington Airport's PSE4;¹⁹ and
 - 2.11.2 our assessment of Auckland Airport's reported estimate of cost of capital, focussing on the reasons and evidence it has provided for adopting a higher equity beta and TAMRP than our benchmark values, a lower leverage than our benchmark value, and a risk-free rate and an average debt premium that differ from the relevant rates that we had published for ID purposes prior to the price setting event.

¹⁷ Section 56G of the Act, as was in effect at the time of the reviews, was a transitional provision requiring the Commission to report to the Ministers of Commerce and Transport on how effectively ID regulation was promoting the Part 4 purpose in respect of specified airport services. The report was to be made 'as soon as practicable' after any new price for airport services was set in or after 2012. We produced the final reports for Wellington, Auckland and Christchurch Airports in February 2013, July 2013 and February 2014 respectively. Section 56G has since been replaced by way of amendment in October 2018. The current s 56G relates to the Commission conducting an inquiry and making a recommendation to the Minister as to whether one of negotiate/arbitrate regulation, default/customised price-quality regulation or individual price-quality regulation should be imposed on the specified airport services in addition to ID, and, if so, how it should apply.

¹⁸ Commerce Commission: [Review of Christchurch Airport's 2022-2027 Price Setting Event](#), Final Report (25 January 2024)

¹⁹ Commerce Commission: [Review of Wellington Airport's 2019-2024 Price Setting Event](#), Final Report (28 September 2022)

Our framework for assessing Auckland Airport's estimated cost of capital

- 2.12 This section outlines our approach to assessing Auckland Airport's estimate of its cost of capital in this review.
- 2.13 We have developed a framework for assessing Auckland Airport's reported estimate of its cost of capital in this review, taking into account the relevant context of the s 56G reports, the changes made during the IM Review in 2016, and lessons from recent PSE reviews.
- 2.14 Our high-level framework for assessing Auckland Airport's reported estimate of its cost of capital, including the key factors we have considered, is set out below. This framework was also used in our most recent reviews of Christchurch Airport's and Wellington Airport's price setting events.²⁰

Departure from mid-point: Is the airport's estimate of its WACC different to our mid-point WACC estimate?

- The mid-point WACC represents our starting point when assessing returns for profitability analysis, but we accept that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate.²¹
- If the airport has departed from our mid-point WACC estimate, what are each of the parameter values used? Has the airport applied an uplift to its mid-point cost of capital (eg, due to asymmetric risks), and if so, what adjustment is made?

Legitimate reasons for departure in relation to each WACC parameter: For each WACC parameter (including any overall WACC uplift), what is the explanation for departing from our IM-based estimate?

- What evidence is provided to support the departure? (For example, is there support from academic articles or other regulatory decisions?). Note: the onus is on airports to provide evidence/sufficient reasoning on any relevant factors.²²
- Has the airport considered consistency with its past pricing decisions (ie, has it applied the same logic consistently over time, or considered the trade-off between short-term fluctuations in parameter values vs predictability)?
- Are we satisfied that the evidence provides legitimate reasons for the departure from our benchmark value, in light of the Part 4 purpose (particularly the s52A(1)(d) requirement to limit the ability of airports to earn excessive profits)?²³

²⁰ Commerce Commission: [Christchurch Airport 2022-2027 Price Setting Event Review](#) (25 January 2024), paragraph 32; Commerce Commission: [Review of Wellington Airport's 2019-2023 Price Setting Event](#) (28 September 2022), paragraph A16.

²¹ Commerce Commission: [Input methodologies review decisions – Topic paper 6: WACC percentile for airports](#) (20 December 2016), paragraph 87.

²² Ibid, paragraph 99.

- If we are not satisfied there are legitimate reasons, then the airport-specific adjustment to that parameter is unjustified.

Legitimate reasons for the size of departure in relation to each WACC parameter: Is the quantum of the adjustment to each parameter (including any overall WACC uplift) justified?

- What evidence is provided to support the quantum? (For example, quantitative analysis demonstrating firm-specific difference from our benchmark value, evidence from academic articles, or other regulatory decisions?). Note: the onus is on airports to provide evidence/sufficient reasoning on any relevant factors.²⁴
- Are there counter-arguments (or other off-setting considerations) which would reduce the size of the adjustment made by the airport? (For example, consider whether arguments made by the other regulated New Zealand airports would work in the opposite direction for the specific airport in question).
- Is the evidence/reasoning sufficient to support the value of the adjustment made to our benchmark value considering the Part 4 purpose (particularly the s 52A(1)(d) requirement to limit the ability of airports to earn excessive profits)?
- If the evidence/reasoning is not sufficient, then we consider the airport-specific adjustment to that parameter is unjustified.

Legitimate reasons for departure in relation to overall WACC: Is the airport's overall estimate of its WACC (combining each of the individual parameter values) reasonable?

- Are there any additional factors relevant to the airport's overall WACC (for example, off-setting considerations regarding other parameters)?
- If each of the individual parameter adjustments are acceptable, and there are no other off-setting considerations, then we consider that airports have legitimate reasons to target above our mid-point WACC estimate.
- However, if there are some adjustments we consider not sufficiently justified (or there are other off-setting considerations), then the airport's cost of capital is unjustified.

Our assessment of Auckland Airport's cost of capital

Is Auckland Airport's estimate of its WACC different to our mid-point WACC estimate?

- 2.15 When considering Auckland Airport's estimate of its cost of capital for this review, the key reference point is our mid-point WACC estimate for airports.

²⁴ Commerce Commission: [Input methodologies review decisions – Topic paper 6: WACC percentile for airports](#) (20 December 2016), paragraph 99.

- 2.16 Previously, in our s 56G reports, we considered a range from the mid-point WACC estimate to the 75th percentile WACC estimate when assessing airport profitability.
- 2.17 However, in the 2016 IM Review, we amended our approach, choosing to use the mid-point WACC to resolve two issues within the framework:²⁵
- 2.17.1 the upper limit of our WACC range had become the de facto benchmark when assessing airport profitability; and
 - 2.17.2 there was limited and weak rationale for using the 75th percentile as the upper limit of the WACC percentile range.
- 2.18 The parameter values used by Auckland Airport for its estimate of the WACC are shown in Table 2.1 below, alongside our mid-point estimate. Our mid-point estimate of the WACC for this analysis is the WACC for suppliers of specified airport services with a June year-end, which was published on 2 August 2022.²⁶
- 2.19 Our draft conclusion, as reflected in Table 3.1, is to use 3.6% for the risk-free rate and 1.17% as the debt premium. This uses 1 July 2022 as the estimation date.
- 2.20 We note the dispute among the parties about the values of the risk-free rate and average debt premium. Had we accepted the BARNZ and Air NZ arguments for estimating as at 1 April 2022, we would have used a risk-free rate of 2.67% and a debt premium of 1.24%.
- 2.21 We discuss our reasons for using 1 July 2022 as the estimation date in the next section.

²⁵ Commerce Commission: [*Input methodologies review decisions – Topic paper 6: WACC percentile for airports*](#) (20 December 2016), paragraph X4.

²⁶ Commerce Commission: [*Cost of capital determination for disclosure year 2023 for information disclosure regulation, For Transpower, gas pipeline businesses and suppliers of specified airport services \(with a June year-end\)*](#), (2 August 2022).

Table 2.1 Parameters used to calculate Auckland Airport’s WACC estimate and the starting point for our analysis

Parameter	Commission (starting point)	Auckland Airport
Risk-free rate (1 July 2022)	3.60%	3.60%
Average debt premium (1 July 2022)	1.17%	1.17%
Leverage	19%	14%
Asset beta	0.60	0.80
Equity beta	0.74	0.93
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	4.97%	4.97%
Cost of equity	7.78%	9.57%
Standard error of midpoint WACC estimate	0.0146	0.0146
Mid-point vanilla WACC	7.24%	8.92%
Mid-point post-tax WACC	6.98%	8.73%

2.22 Auckland Airport estimates that its cost of capital is 8.73% (post-tax) as shown in the third column. In comparison our starting point estimate, which is from our published ID decision on 2 August 2022, is 6.98%.

For each WACC parameter (including any overall WACC uplift), what is the explanation for departing from our IM-based estimate?

2.23 When estimating its cost of capital, Auckland Airport has used inputs consistent with 2016 Airport IM for credit rating, debt issuance costs and tax rates. Auckland Airport has departed from the IMs by using:

2.23.1 an equity beta of 0.93 rather than the 0.74 specified in the IMs;

2.23.2 leverage of 14% rather than the 19% specified in the IMs; and

2.23.3 a TAMRP of 7.5% rather than our benchmark of 7.0% specified in the IMs.

2.24 As discussed above, there is also a dispute about the values of the risk-free rate and the debt premium used by Auckland Airport, which we discuss first in this section.

Our assessment of Auckland Airport's risk-free rate and average debt premium

- 2.25 After freezing its standard charges for financial year 2023, Auckland Airport, on 7 June 2023, set charges for the remainder of the PSE4 period.²⁷ These charges were disclosed on 17 August 2023.
- 2.26 According to Auckland Airport, the approach of freezing charges for a year and then recovering the “sub-target returns” in financial year 2023 over the remainder of the PSE4 period was agreed with “the vast majority of Auckland Airport’s airline customers.”²⁸
- 2.27 In its cross-submission to our Process and Issues paper, Auckland Airport stated it had been clear in its consultation that it would use 1 July 2022 as the date for the calculation of the risk-free rate.

A key term from this proposal was that Auckland Airport’s target return for the full five-year PSE4 pricing period will be determined retrospectively, after a second round of consultation with Substantial Customers, as at 1 July 2022 (the commencement of PSE4) by applying the relevant input parameters as at that date (e.g. including the observable interpolated 5 year risk free rate).²⁹

- 2.28 In its 17 March 2022 request to the Commission for an extension of time for complying with the ID requirements, Auckland Airport stated that the WACC would be set retrospectively based on parameters as at 1 July 2022.³⁰ Auckland Airport indicated in that letter that Air NZ and BARNZ supported the proposal to delay price setting and to use 1 July 2022 as the date for setting WACC parameters, and counter-signed the proposal in December 2021, while Qantas did not.
- 2.29 BARNZ in its submission to the Process and Issues paper indicated that it was appropriate to use an updated value of the risk-free rate, but did not specifically indicate it supported using the value as at 1 July 2022 rather than 1 April 2022.

BARNZ agrees it is appropriate for AIAL to use the Commission’s updated estimate of the risk-free rate, which is higher than the rate of 2.6% used in the 2016 IM review.³¹

- 2.30 Air NZ, in its submission to the Process and Issues paper, did not refer to its support for the use of 1 July 2022, but rather provided reasons for why 1 April 2022 should be used.

For the purpose of PSE4, AIAL used an RFR inherent at the beginning of the PSE4 pricing period (the Commissions RFR estimate of 3.6% as at 1 July 2022). AIAL claims that this

²⁷ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), section 1, paragraph 2

²⁸ Ibid, section 1, paragraph 2.

²⁹ Auckland Airport, "Cross-Submission on responses to the Commerce Commission Process and Issues Paper for its review of Auckland Airport’s 2022-2027 price setting event" (21 February 2024) (**Auckland Airport cross-submission**), section 5.2, pg 26.

³⁰ Letter from Auckland Airport to Commerce Commission (17 March 2022).

³¹ BARNZ, “Feedback on proposed review of Auckland Airport’s 2022-2027 Price Setting Event” (31 January 2024) (**BARNZ submission**), paragraph 16.

“represented the latest available information at the start of the PSE4 pricing period.” Air NZ disagrees. The 3.6% estimate was published on 2 August 2022, more than a month after the beginning of the PSE4 period, and approximately two months after the airport’s pricing decision would have expected to be made on previous precedent.³²

- 2.31 After reviewing Air NZ’s submission, BARNZ in its cross-submission agreed with Air NZ.

While BARNZ noted in our earlier submission that there was some basis for the risk free rate of 3.6% as used by AIAL, we agree with Air NZ’s point that – using the logic that AIAL itself presents – the correct risk free rate (RFR) should be that prevailing at the start of the PSE 4 period – i.e., 2.67%.³³

- 2.32 Qantas did not provide a submission on the timing of the risk-free rate.
- 2.33 Auckland Airport’s situation is similar to the situation when Wellington Airport set prices retrospectively for its PSE4. Wellington Airport has a disclosure year of 1 April to 31 March, and its PSE4 period is 1 April 2019 to 31 March 2024. Wellington Airport agreed with its customers to use the value of the risk-free rate calculated at 1 April 2019, which was the start of its PSE4.
- 2.34 Auckland Airport’s retrospective use of 1 July 2022 is consistent with Wellington Airport’s use of 1 April 2019, because both are at the start of their respective PSE4 periods (Auckland Airport’s PSE4 commences on 1 July 2022).
- 2.35 Christchurch Airport is on the same PSE4 period as Auckland Airport and has used 1 April 2022 as the date for the risk-free rate. However, Christchurch Airport’s situation is different to Auckland Airport’s because Christchurch Airport did not defer its price setting, and therefore the 1 July 2022 estimate was not available when it set its prices.
- 2.36 We have considered the submissions by Air NZ and BARNZ that Auckland Airport should base its WACC on the value of the risk-free rate that was available prior to the start of the price setting event. Our draft view is that there is no regulatory reason for why companies subject to ID regulation, when setting prices retrospectively, should use a value from prior to the start of the price setting event rather than at the start of the price setting event. What is more important is that the parties reach an agreement on the method that would be used so that they are not surprised by the outcome.
- 2.37 In this situation most but not all parties agreed to the use of 1 July 2022, and those that did agree have since changed their mind.

³² Air New Zealand, “Review of Auckland Airport’s 2022-2027 Price Setting Event 4 – Process and Issues paper: Air New Zealand feedback” (31 January 2024) (**Air NZ submission**), paragraph 21.

³³ BARNZ, “Cross-submission to process and issues paper: PSE4 Price Review” (21 February 2024) (**BARNZ cross-submission**), paragraph 25.

- 2.38 Our draft conclusion is that it is reasonable for Auckland Airport to use 1 July 2022 as the date for setting the risk-free rate and average debt premium. This approach is consistent with evidence that 1 July 2022 was agreed to by Air NZ and BARNZ in Auckland Airport's correspondence with substantial customers as part of the agreement to defer the price setting. It is also similar to the approach taken for Wellington Airport's PSE4 where prices were set retrospectively.

Our assessment of Auckland Airport's equity beta

- 2.39 The COVID-19 pandemic resulted in a spike in airport equity betas as future airport revenue became uncertain due to government restrictions and self-imposed limitations on air travel. Auckland Airport considered the estimate of equity beta in the IMs was outdated and chose to recalculate this value for PSE4.
- 2.40 Auckland Airport's consultant, Competition Economists Group (CEG), used a similar comparator sample as for the 2016 IMs and updated the calculation for the 10-year period to 30 June 2022. The resulting value of equity beta, 0.93 compares to the value of 0.74 in the IMs (which was calculated using data for the 10-years to 31 March 2016).
- 2.41 Auckland Airport explained that it calculated the equity beta using the 10-year period to 30 June 2022 because it considered this was a fair way of accounting for macroeconomic events over time:

In Dr Hird's opinion, continuing to replicate the Commission's traditional rolling 10-year data analysis period would provide an actuarially fair attribution to all macro-economic events across time. This is because all years will be equally represented in pricing decisions over the long-run.³⁴

Those economic shocks and associated periods of higher systematic risk are not hypothetical. They are indeed experienced by regulated airport companies through the course of time and must be captured in their target returns so as to deliver investors their required risk-adjusted return over the long term.³⁵

- 2.42 Auckland Airport noted CEG's view that the method used by the UK Civil Aviation Authority, which calculated the equity beta using a pre-COVID estimate plus a premium that reflected the likelihood of another pandemic-type event during the pricing period, would over-compensate airports because the adjustment would need to be applied to all future price setting events. In comparison, CEG stated that continuing to estimate the equity beta using the average of data over the past 10 years would result in a temporary increase of a lesser amount.

He [Dr Hird] considered that a full account of the UK precedent in relation to COVID-19 if applied to Auckland Airport would result in a permanent increase in compensation for all future PSEs equivalent to an asset beta uplift of more than four times the increase in asset

³⁴ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), page 54.

³⁵ *Ibid*, page 54.

beta attributable to COVID-19 in the 2016 IM method adopted by Auckland Airport to establish the PSE4 Target Return. Moreover, he noted that Auckland Airport's method only results in a temporary lift from COVID-19.³⁶

- 2.43 Auckland Airport also stated that making adjustments to the use of 10-year historical data would cause other problems:

To get the right result over the long run, airports and the Commissions would need to be able to perfectly forecast the probability of such future economic shocks. Since perfect foresight isn't possible in this context, an approach that attempts to adjust measured asset beta results for economic shocks will deliver the wrong result over time.³⁷

More importantly perhaps, there is the potential for such a change to be perceived as an illustration of asymmetric regulatory risk. That is, where an ad hoc change is introduced in an attempt to dilute a period of realised high systematic risk, whereas a period of realised low systematic risk would be unlikely to elicit a similar response.³⁸

- 2.44 When it calculated the updated equity beta estimate, Auckland Airport disregarded the 0.05 downward adjustment to the asset beta that had been applied in the 2016 IMs. The downward adjustment was based on the conclusion that the average asset beta from the comparator sample was too high because it was affected by non-aeronautical activities, which had a higher asset beta than aeronautical activities.

- 2.45 Auckland Airport stated:

Given both CEG's conceptual conclusions and empirical analysis, Dr Hird found no clear support for Auckland Airport adopting the Commission's 5 basis point downward adjustment to the overall global comparable company average asset beta result for the regulated aeronautical component. In fact, the empirical evidence suggests that there should instead be an upwards adjustment for the aeronautical component. However, Auckland Airport did not make any such upwards adjustment for our PSE4 WACC calculation and target return determination.³⁹

- 2.46 We understand why Auckland Airport has updated the equity beta estimate in the 2016 IMs. The equity beta is normally a relatively stable estimate over time and the estimate made at the IM review would be expected to be applicable for the period of the IMs. However, the COVID-19 pandemic has had a disruptive effect on airports which may have caused the equity beta estimate in the 2016 IMs to be out of date. We therefore accept that Auckland Airport had legitimate reasons for departing from using the 2016 IMs for their calculation of the equity beta.

³⁶ Ibid, page 56.

³⁷ Ibid, page 55.

³⁸ Ibid, page 55.

³⁹ Ibid, page 56.

- 2.47 However, we are concerned that the equity beta used by Auckland Airport will not result in outcomes consistent with ensuring the objectives in s 52A(1)(a) to (d) are balanced and promoted appropriately. Auckland Airport has calculated the equity beta using a conceptual approach that would provide airports with compensation, ex-post, for the effect pandemics and other macroeconomic shocks have on airport equity betas. This is because Auckland Airport is proposing that the equity beta continues to be calculated on a rolling 10-year basis so that returns going forward are adjusted for historical equity beta outcomes.
- 2.48 While the method Auckland Airport has used is the method we previously used to calculate equity beta, the purpose of the equity beta is not to provide compensation for historical events. Instead, the equity beta is a forward-looking estimate of the relative risk from holding an airport company in a diversified portfolio of investments compared to holding the market share index. The equity beta that should be applied to the WACC for PSE4 is the market's view of the equity beta over the PSE4 period, which we discuss further in the next section. We consider that such a calculation would help to ensure the objectives in s 52A(1)(a) to (d) are promoted.
- 2.49 In comparison, Auckland Airport's calculation of the equity beta places considerable weight on the period of the COVID-19 pandemic when equity betas were the highest. In effect, Auckland Airport is assuming investors consider that the prospect of another COVID-19 type event will result in the average equity beta for PSE4 being equal to the average equity beta over the 10-years to 30 June 2022.
- 2.50 While no one can predict when a future pandemic-type event will occur, it is unreasonable to assign this such a high weighting.
- 2.51 While our final decisions and reasons from the 2023 Part 4 IM review were not available at the time Auckland Airport set its prices (just prior to the release of our draft decision in June 2023), the data that the 2023 IMs were based on, which was up to mid-2022, indicated equity betas had declined from their peaks and were reverting to near pre-pandemic levels. This data was also available to Auckland Airport when it made its pricing decision.
- 2.52 We also note that Christchurch Airport, which made its pricing decision for PSE4 in June 2022, used the equity beta in the 2016 IMs.
- 2.53 Our draft conclusion is that Auckland Airport has misconstrued the purpose of the equity beta and has implicitly assigned an unreasonably high probability to the likelihood of another COVID-19-type disruption occurring over the PSE4 period. In doing so, our draft conclusion is that Auckland Airport has calculated an equity beta that is inconsistent with the objectives in s 52A(1)(a) to (d).
- 2.54 Our draft conclusion is that Auckland Airport's equity beta is unreasonably high.

Our assessment of Auckland Airport's leverage

- 2.55 For the same reason that Auckland Airport considered the estimate of equity beta in the IMs was outdated, it also considered the estimate of leverage was outdated.
- 2.56 Auckland Airport's consultant calculated leverage using the same comparator sample and 10-year period that it used to calculate equity beta.
- 2.57 As a result, Auckland Airport used 14% as the value of leverage in its WACC rather than the 19% specified in the IMs. Auckland Airport did not provide any information about its choice of leverage other than it was obtained along with the calculation of the equity beta.
- 2.58 The value of 14% indicates average leverage for the companies in the comparator sample declined for the ten years to 30 June 2022 compared to the 10 years to 31 March 2016.
- 2.59 However, we do not consider Auckland Airport's estimate of leverage is reasonable for the same reason we do not consider its estimate of equity beta is reasonable. That is, we are concerned that the calculation of leverage has placed too much weight on data that was affected by COVID-19.
- 2.60 Our draft conclusion is that the value of 14% is unreasonable because in our view it is likely to be inconsistent with the market's forward assessment of leverage for the PSE4 period.

Our assessment of Auckland Airport's TAMRP

- 2.61 Auckland Airport indicated in its disclosure that it used 7.5% for the TAMRP because:
- This was considered to be the best approach given that it was the most recent estimate of a sector-agnostic parameter, and considered appropriate by our independent advisor, CEG.⁴⁰
- 2.62 Auckland Airport is referring to our values of TAMRP that were estimated for the fibre IM decisions, published in November 2020, and for our amendment to the gas transmission services IMs, published in March 2022.^{41,42} These decisions were the latest estimates available from the Commission when Auckland Airport finalised its prices on 7 June 2023.

⁴⁰ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 57

⁴¹ Commerce Commission: [Fibre input methodologies: Financial loss asset final decision – reasons paper](#) (3 November 2020), paragraph 3.24.3.

⁴² Commerce Commission: [Gas Transmission Services Input Methodologies Amendment Determination \(No.1\) 2022](#) (25 March 2022).

- 2.63 We reviewed our estimate of the TAMRP for our 2023 review of the Part 4 IMs. The estimate of 7.0%, published in the draft decision on 14 June 2023, was effectively unchanged from the previous estimate for specified airport services. This estimate was not available when Auckland Airport set its prices on 7 June 2023.
- 2.64 We accepted the use of 7.5% by Christchurch Airport for its PSE4 on the basis that it was our most recent estimate when it made its pricing decision in mid-2022.
- 2.65 However, Auckland Airport postponed its decision for a year and has adopted an approach that uses market data as at 1 July 2022, but information and methods that were developed or available after 1 July 2022. It is unclear why Auckland Airport chose to recalculate the equity beta and leverage in 2023 but not the TAMRP.
- 2.66 For the purpose of this assessment, we consider Auckland Airport would have been consistent in its approach to calculating the WACC parameters if it had recalculated the TAMRP, just as it recalculated the values of equity beta and leverage.⁴³
- 2.67 Our draft conclusion is that Auckland Airport was inconsistent by not updating the TAMRP when it chose to update other WACC parameters. For this reason, we consider Auckland Airport's use of a 7.5% TAMRP is not reasonable.

Is the size of the adjustment to each parameter (including any overall WACC uplift) justified?

Equity beta and leverage

- 2.68 While we consider the equity beta and leverage combination used by Auckland Airport to be unreasonable, for the purpose of this assessment we need to identify values that are reasonable so that we can determine whether the values used by Auckland Airport are materially different.
- 2.69 Our first scenario follows the approach adopted by Christchurch Airport, which chose not to revise the equity beta and leverage from the values in the 2016 IMs. This is a reasonable option for determining the equity beta and leverage because it was the approach used by a peer airport in New Zealand and applied to the same price period. It is also the option that is 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.

⁴³ For example, if Auckland Airport had recalculated TAMRP prior to setting its prices in June 2023, using the same method as Dr Lally in his 10 April 2023 report and using data up to 1 July 2022, the value would have been 7.0%. However, we acknowledge that this analysis by Dr Lally was undertaken a short time before prices were set for PSE4.

- 2.70 An alternative is to use the outcomes of the 2023 IM review. Even though these outcomes were not available to Auckland Airport when it set its prices, the outcomes are our best estimate of the methods that would be used by investors, market analysts and companies to determine the WACC for airports in the context of the COVID-19 pandemic. As such these are the (benchmark) values that we consider reasonable if the asset beta, leverage (and TAMRP) were estimated at the relevant time.
- 2.71 The 2023 IM review considered the issues around the estimation of the equity beta and leverage in detail and involved multiple rounds of consultation before coming to a final decision. The 2023 IMs were based on a comparator sample that differed from the 2016 sample because we considered the 2016 sample was not reliably capturing the effects that COVID-19 had on the airport equity beta and leverage. Our reasons for adopting a different estimation method in the 2023 IMs compared to the 2016 IMs are explained in detail in the cost of capital topic paper for the IM Review 2023 final decisions.^{44, 45}
- 2.72 We have noted that Auckland Airport has disregarded the 0.05 downward adjustment to the asset beta that was used in the calculation of the equity beta for the 2016 IMs. We do not consider this is inconsistent with the objectives in s 52A(1)(a) to (d) as we decided in the 2023 IM review to not continue to make this adjustment.
- 2.73 For the purpose of this assessment, we have adopted two scenarios for equity beta and leverage that we consider are reasonable. Our starting point scenario uses values from the 2016 IMs, which are 0.60 for equity beta and 19% for leverage. An alternative scenario uses values from the 2023 IMs, which are 0.87 for equity beta and 23% for leverage. These values compare to Auckland Airport's 0.93 for equity beta and 14% for leverage.

TAMRP

- 2.74 As discussed above, we consider Auckland Airport should have recalculated the TAMRP, just as it recalculated equity beta and leverage, and as a result would have used a value of 7.0%. We consider that this is the value that would have been used by investors, market analysts and companies at the time Auckland Airport set its prices.

⁴⁴ Commerce Commission: [Cost of capital topic paper, Part 4 Input Methodologies Review 2023 – Final Decision](#) (13 December 2023), Chapter 4.

⁴⁵ We note that our 2023 IMs are the subject of appeals brought by Auckland International Airport Ltd, Wellington International Airport Ltd and Christchurch International Airport Ltd (joint appeal), New Zealand Airports Association Inc, and First Gas Ltd. These are matters before the Court and no decisions have yet been released.

- 2.75 However, we also consider that Auckland Airport's approach of using the latest published value of the TAMRP that was available when it made its decision, which is 7.5%, would not have been unreasonable if it had also used this alongside the values of equity beta and leverage from the 2016 IMs.
- 2.76 For the purpose of this assessment, we have used values of 7.0% and 7.5% in our scenarios of WACC values for comparison against Auckland Airport's WACC.

Is the airport's overall estimate of its WACC (combining each of the individual parameter values) reasonable?

- 2.77 Auckland Airport's overall estimate of its post-tax WACC is 8.73%. In comparison, we have calculated two estimates of the WACC. These estimates are shown in the following table, alongside the WACC that has been used by Auckland Airport.
- 2.78 The first scenario is consistent with the 2016 IMs except that it uses a higher value for the TAMRP. The WACC parameters are the same as those used by Christchurch Airport but with a risk-free rate and debt premium as at 1 July 2022. This alternative estimate of the WACC is 7.28%, based on an equity beta of 0.74, leverage of 19% and a TAMRP of 7.5%. This alternative is higher than our starting point WACC of 6.98%, as presented in Table 3.1, because it is based on a TAMRP of 7.5% rather than 7.0%. This is consistent with the approach we accepted for Christchurch Airport.
- 2.79 The second scenario, which uses parameters that are consistent with the 2023 IMs, results in a WACC of 7.51%. This scenario uses an equity beta of 0.87, leverage of 23% and a TAMRP of 7.0%.

Table 2.2 Parameters used to calculate Auckland Airport's WACC estimate and our WACC estimates

Parameter	Commission (Scenario 1)	Commission (Scenario 2)	Auckland Airport
Risk-free rate	3.60%	3.60%	3.60%
Average debt premium	1.17%	1.17%	1.17%
Leverage	19%	23%	14%
Asset beta	0.60	0.67	0.80
Equity beta	0.74	0.87	0.93
Tax adjusted market risk premium (TAMRP)	7.5%	7.0%	7.5%
Average corporate tax rate	28%	28%	28%
Average investor tax rate	28%	28%	28%
Debt issuance costs	0.20%	0.20%	0.20%
Cost of debt	4.97%	4.97%	4.97%
Cost of equity	8.15%	8.68%	9.57%
Standard error of midpoint WACC estimate	0.0146	0.0146	0.0146
Mid-point vanilla WACC	7.54%	7.83%	8.92%
Mid-point post-tax WACC	7.28%	7.51%	8.73%

2.80 Our draft conclusion is that Auckland Airport's estimate of the post-tax WACC, of 8.73%, is unreasonable because it is materially higher than the estimates of the WACC we consider reasonable, which range from 7.28% to 7.51%.

Chapter 3 Expected profitability

Purpose

- 3.1 This chapter focuses on whether Auckland Airport is limited in its ability to extract excessive profits under s 52A(1)(d) of the Act. This chapter summarises and draws draft conclusions from the following sources: the PSE4 disclosures and schedules published by Auckland Airport, the submissions and cross-submissions by stakeholders to our Process and Issues paper, and additional information provided by Auckland Airport.
- 3.2 This chapter considers whether Auckland Airport's target return on its priced assets, and associated profit, has been sufficiently justified such that it is likely to be in the long-term interest of consumers. This chapter also summarises and analyses key aspects of the profitability analysis: operational expenditure, depreciation, demand forecasts, and the two-way revenue wash-up.
- 3.3 Our draft profitability analysis model has been published alongside this consultation paper. This analysis uses the same methodology in the PSE3 review.⁴⁶

Draft conclusions

Expected returns

- 3.4 Auckland Airport set the target return on its priced services equal to its estimated WACC of 8.73%, with a return on its total regulated activities of 7.79%. This decision will result in additional cost to consumers over the PSE4 period. We have estimated that this represents excess profits of between \$193.4 million and \$226.5 million, in nominal terms, from the priced activities over the price setting period. This range is based on our estimate of two WACC scenarios of 7.28% and 7.51%, respectively, as discussed in Chapter 2.

⁴⁶ For a detailed methodology of our profitability assessment please refer to Attachment C of [“Review of Auckland International Airport’s pricing decisions and expected performance \(July 2017 – June 2022\)”](#)

Operational expenditure

3.5 Auckland Airport's operational expenditure forecasts appear reasonable. The Airport's per passenger operating expenditure forecasts are in line with pre-pandemic levels by the end of PSE4 period. Auckland Airport has used the non-tradeable inflation rather than the CPI as a cost driver. It considers the former likely better reflects its operating cost base, which we accept. We also note that when benchmarked against other international airports in a 2022 Airport Performance Indicator report, Auckland Airport ranked 43rd out of 50 airports on operating costs per passenger.⁴⁷ In this ranking of 50 airports, the airport ranked 1st has the highest operating cost per passenger, whereas the 50th has the lowest operating cost per passenger.

Depreciation

3.6 Auckland Airport has adopted a standard straight-line depreciation method for all its assets including new investments. We are not convinced that this approach best promotes the long-term benefit of consumers, when a significant upfront investment is likely to be used by a growing number of consumers over time. Specifically, in our view 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.

3.7 The tilted annuity approach reflects the gradually increasing utilisation of the asset meaning that consumers pay a consistent amount toward the cost of the asset over time. The effect is to defer some of the depreciation cost into the future, and thereby reduce price increases in the short term.

3.8 We understand that Auckland Airport considered the tilted annuity method for recovering depreciation, which Christchurch Airport applied to its investment in a new terminal. However, Auckland Airport explained that it did not adopt this approach because it would likely reduce prices in PSE4 but then increase prices in PSE5 and beyond, the pricing periods in which the airlines were concerned the most about increased prices. Based on the information available and in the absence of regulatory asset base (**RAB**) indexation, we are not convinced by this conclusion. 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).

3.9 We would welcome a submission from Auckland Airport further explaining why it preferred the straight-line approach to recovering depreciation, with any analysis and key assumptions supporting its decision.

⁴⁷ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pp47.

- 3.10 We find Auckland Airport's use of accelerated depreciation for the investment in DTB is in line with GAAP and not unreasonable, as it is consistent with the Airport's intention to de-commission the DTB when the new domestic terminal becomes operational. Additionally, a non-accelerated approach would have reduced prices in PSE4 but increased prices in PSE5.

Demand forecasts

- 3.11 There has been extensive consideration, consultation and expert studies on demand from both Auckland Airport and substantial customers. We understand that expert studies relating to price elasticity of demand show different magnitudes for the potential impact on demand from the increase in Auckland Airport's charges. However, we do not consider that the potential impact of these differences is of sufficient significance in the operating expenditure forecast or the projection of long-term capacity needs. Overall, we consider that Auckland Airport's overall demand forecast appears reasonable and is unlikely to result in excessive profits for the PSE4 period.

Revenue wash-up mechanism

- 3.12 Auckland Airport has included a two-way revenue wash-up mechanism in PSE4, to protect both the Airport and airlines from significant revenue variance to PSE4 forecast. Our draft conclusion is that, in principle, this two-way revenue wash-up seems appropriate to address under- or over-recovery of revenue by the Airport in the event of a demand shock, like COVID-19. While some airlines did not agree on the thresholds of the wash-up, there was agreement in principle over wash-ups generally and Auckland Airport lowered the threshold after considering airlines' feedback.

Expected returns

Our approach to assessing Auckland Airport's expected returns

Is Auckland Airport targeting excessive profits?

- 3.13 In our approach to assessing Auckland Airport's expected profits, we have used our estimated range of cost of capital discussed in Chapter 2. This range, in the form of two scenarios, is 7.28% to 7.51%, which is lower than Auckland Airport's cost of capital estimate of 8.73%.

- 3.14 Similar to our approach in PSE3, we have assessed Auckland Airport’s expected revenue and expected returns using an Internal rate of return (IRR) calculation.⁴⁸ Using IRR we are able to assess Auckland Airport’s expected revenue and expected returns across the assets used in supplying regulated airport services during the PSE4 period.
- 3.15 We then compared Auckland Airport’s expected revenue and expected return under its estimated cost of capital to the return that would be expected had it used our own cost of capital scenarios. The comparative results are shown in Table 3.1 for returns on Auckland Airport’s priced assets. The analysis in this section concentrates on Auckland Airport’s priced services, as these are activities recovered through aeronautical charges. Non-priced services are recovered through leases from arms-lengths contracts with varying terms, compared to the usual price setting event period of five years.

Auckland Airport’s expected returns on its priced asset base

- 3.16 Auckland Airport’s target return, which is equal to its estimated WACC, on its priced services of 8.73% will result in additional costs to consumers over the PSE4 period. We have estimated in our profitability modelling, and shown in Table 3.1, that this is an excess of between \$193.4 million and \$226.5 million in aeronautical revenue, in nominal terms, over the PSE4 period. The range is based on our estimate of two WACC scenarios discussed in Chapter 2.
- 3.17 In Chapter 2, we assessed Auckland Airport’s WACC of 8.73%. Our draft conclusion is that our two scenarios of 7.28% and 7.51% better reflect the Airport’s cost of capital. We have used these two WACC scenarios in our assessment of whether Auckland Airport is targeting excessive profits.
- 3.18 Auckland Airport’s expected returns on its priced asset base are compared in Table 3.1 below, along with the associated expected revenue over PSE4.

Table 3.1 Summary of Auckland Airport’s expected returns and revenue on its priced assets

	Expected return (post-tax)	Revenue (\$m)
AIAL's expected return on its priced RAB	8.73%	2,507
Scenario 1 of our WACC estimate	7.28%	2,280
Scenario 2 of our WACC estimate	7.51%	2,313
Difference between AIAL’s expected return and our Scenario 1	145 basis points	226.5

⁴⁸ For a detailed methodology of our profitability assessment please refer to Attachment C of [“Review of Auckland International Airport’s pricing decisions and expected performance \(July 2017 – June 2022\)”](#).

	Expected return (post-tax)	Revenue (\$m)
Difference between AIAL's expected return and our Scenario 2	122 basis points	193.4

- 3.19 Our draft conclusion is that Auckland Airport is targeting a return that is higher than is reasonable. Auckland Airport's target return of 8.73% is higher than both our mid-point WACC scenarios of 7.28% and 7.51%. The aeronautical revenue targeted by Auckland Airport is between \$193.4 million and \$226.5 million higher than that in our two WACC scenarios. We consider a target return on the priced regulatory assets within the range between 7.28% and 7.51% is likely to better reflect the long-term interests of consumers.
- 3.20 We have concentrated on the return on priced activities in this paper as aeronautical charges are based on the recovery of priced assets. Auckland Airport's total regulatory asset base (RAB) is made up of both priced and non-priced assets. Priced assets make up approximately 80% of the total RAB. We note that Auckland Airport's expected return on total regulatory assets at 7.79% is lower than its expected return on its priced assets at 8.73%, but still above the range of WACC estimates we consider reasonable. The return on non-priced assets would therefore be significantly lower than 8.73% over the PSE4 period. However, contractual arrangements relating to non-priced assets occur over varying time periods that do not align to the recurring five-year price setting event periods. The lower return on non-priced assets in PSE4 would likely increase over future price periods when the contractual arrangements are re-negotiated.

Our draft conclusion

- 3.21 Auckland Airport's target return, which equals to its estimated WACC, on its priced services of 8.73% will result in additional cost to consumers over the PSE4 period. We have estimated in our analysis that this is an excess profit of between \$193.4 million and \$226.5 million, in nominal terms, from the priced activities over the price setting period. The range is based on our estimate of two WACC scenarios of 7.28% and 7.51% discussed in Chapter 2.

3.22 We do not have significant concerns with Auckland Airport’s forecasts underpinning its expected returns and consider the Airport’s cash flow forecasts are generally suitable for the cash flow forecasts used in our IRR calculation. The exception is the forecasts relating to the straight-line depreciation method used, which we are not convinced are appropriate for new long-lived assets. The remainder of this chapter summarises and analyses the following inputs as described in our Process and Issues paper, namely operational expenditure forecasts, depreciation and demand forecasts. Later in this chapter we also summarise and analyse the revenue wash-up arrangement Auckland Airport proposed.

Operating expenditure forecasts

Does the level and timing of forecast operational expenditure appear reasonable?

3.23 This section considers whether Auckland Airport’s operational expenditure (opex) forecasts for the PSE4 period are reasonable, based on information available at the time prices were set. Table 3.2 below sets out Auckland Airport’s opex forecasts over PSE4 period.⁴⁹

Table 3.2 Auckland Airport’s forecast PSE4 operating expenditure

Opex forecasts (\$m)	FY23	FY24	FY25	FY26	FY27	Total
Priced services	116	145	155	158	170	746
Non-priced services	14	17	18	19	20	87
Total regulated services	130	162	173	177	190	832

3.24 Auckland Airport’s operating expenditure forecasts influence the prices it charges customers and influence our assessment of the Airport’s ability to earn excessive profits.

3.25 Where airports can spend less than what is forecasted, they can earn returns that are greater than their target returns. Airports have incentives to operate efficiently. If airports forecast their operating expenditure over and above expected actual costs, they can earn excessive profits, other things being equal.

How Auckland Airport has forecasted operating expenditure

3.26 For PSE4, Auckland Airport initially used forecast FY23 operating expenditure as the baseline. Projected changes from cost drivers were then applied to the remaining years in PSE4. Cost drivers used were inflation, individual business unit forecasts and passenger volume forecasts. The PSE4 operating expenditure forecast was then aligned to the Airport Board's approved FY24 operating expenditure budget.⁵⁰

⁴⁹ From Auckland International Airport Limited PSE4 schedule 18 (total RAB) & 19 (priced assets).

⁵⁰ Auckland International Airport Limited: Price Setting Disclosure (17 August 2023), pp 45-46.

Cost Drivers

- 3.27 We note that over PSE4, forecast operating expenditure per passenger reduces in both nominal and real terms, returning close to pre-COVID levels by the end of the pricing period.⁵¹
- 3.28 Auckland Airport used non-tradeable forecast inflation and forecast staff headcount to inform the forecast of its operating expenditure over PSE4. Passenger demand was also a key cost driver, which has been considered in a separate section in this chapter.
- 3.29 Auckland Airport used non-tradeable inflation forecasts from the New Zealand Treasury in 2023 Budget to develop its opex forecasts. We note that non-tradeable inflation is a change from PSE3, where Auckland Airport used RBNZ CPI forecasts. As shown in Table 3.3 below, non-tradeable inflation is higher than the CPI over the majority of the PS4 period.⁵² The Airport Input Methodologies do not require that airports use the CPI to forecast their operational expenses over a price setting event period.⁵³

Table 3.3 Comparison of inflation measures

	FY23	FY24	FY25	FY26	FY27
Tradables	6.13	3.28	2.03	1.56	1.33
Non-tradables	6.04	3.31	2.98	2.81	2.73
Total CPI	6.20	3.30	2.60	2.30	2.10

- 3.30 Auckland Airport believes that compared to the CPI, non-tradeable inflation better aligns with its cost base, which is largely domestic service and labour costs.⁵⁴ In its PSE4 disclosure commentary, the Airport also noted that it did not use the Treasury's hourly earnings forecast (ie, wage inflation), even though about one-third of its operating expenditure is personnel costs. Had it used wage inflation, the operating expenditure forecast would have been higher, as the hourly earnings forecast is well above the non-tradeable inflation forecast over the PSE4 period.⁵⁵

⁵¹ Ibid, pg 47.

⁵² Stats NZ.

⁵³ Commerce Commission: [Airport Services Information Disclosure Determination 2010](#) (Consolidating all amendments as of 20 December 2016).

⁵⁴ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 46.

⁵⁵ Ibid, pg 46.

- 3.31 Auckland Airport has estimated a 22% overall increase in Full-time-equivalent (FTE) aeronautical staff from 480 to 585 over the five year PSE4 period, from FY23 to FY27.⁵⁶ This growth in FTE is for increased infrastructure delivery and guest experience improvement.⁵⁷ Auckland Airport noted in its disclosures that airlines challenged whether the growth in FTEs was achievable, given the labour shortage.⁵⁸ The Airport stated that it considered feedback during the consultation process and considered the increases in FTEs were justified.⁵⁹

Benchmarking Auckland Airport's operating expenditure

- 3.32 Auckland Airport included information from Jacobs' Airport Performance Indicators 2022 which compare operating cost per passenger. Out of 50 airports, with the 50th ranking having the lowest operating cost per passenger, Auckland Airport ranked 43rd.⁶⁰
- 3.33 In its submission to our Process and Issues paper, Auckland Airport reiterated the volatility that the COVID-19 pandemic introduced:⁶¹

In the initial pandemic response significant short-term cost savings were implemented to protect financial viability as borders were closed and revenue decreased significantly. As demand ramped up again so did the operational requirements, at a time when broader economic pressures including labour shortages and cost inflation all combined to create a volatile cost environment. Despite this volatility, the return of real operational expenditure per passenger to pre-pandemic levels over the forecast period reflects an efficient outlook for operations as economies of scale return with passenger numbers.

Submitters' views

- 3.34 Air NZ submitted that:

This escalation in [operating] costs does not indicate an efficient or cost-effective approach over the course of PSE4.⁶²

and

AIAL's operating cost forecast for PSE4 indicates a significant increase in costs over the period, with FY27 costs almost 50% higher than FY23. Notwithstanding some need to ramp up operations as the recovery from COVID winds up, the fact that FY24 costs are forecast to be 128% of the FY19 costs, but only 90% of FY19 passenger volumes, is of major concern.

⁵⁶ Ibid, pg 46.

⁵⁷ Ibid, pg 47.

⁵⁸ Ibid, pg 47.

⁵⁹ Ibid, pg 47.

⁶⁰ Ibid, pg 47.

⁶¹ Auckland Airport, "Submission on Commerce Commission Process and Issues paper for its review of Auckland Airport's 2022-2027 Price Setting Event" (31 January 2024) (**Auckland Airport submission**), pg 37-38.

⁶² Air NZ submission, pg 15.

Passenger volumes in FY27 are forecast to be only 7.8% higher than FY19 yet costs are forecast to be 36% higher than FY19.⁶³

3.35 Auckland Airport responded in its cross-submission that it:

considers the issues raised by Air New Zealand have sufficiently been addressed already during the PSE4 consultation, the PSE4 PSD, and the Auckland Airport submission to the Issues Paper.⁶⁴

3.36 Qantas submitted that:

AIAL's opex exceeds multiple Qantas benchmarks by about 200%.⁶⁵

3.37 Auckland Airport responded in its cross-submission:

Qantas provided no evidence in its submissions for this claim, and Auckland Airport considers it to be unfounded.⁶⁶

Our draft conclusion

3.38 Our draft conclusion is that Auckland Airport's operational expenditure forecasts appear reasonable. The Airport's per passenger operating expenditure forecasts are in line with pre-pandemic levels by the end of the price-setting period. Auckland Airport has used the non-tradeable inflation rather than the CPI as a cost driver. It considers the former likely better reflects its operating cost base, which we accept. We also note that when benchmarked against other international airports, Auckland Airport ranked 43rd out of 50 airports on the lowest operating cost per passenger.⁶⁷ In this ranking of 50 airports, the 1st airport in the ranking has the highest operating cost per passenger, and the 50th has the lowest operating cost per passenger.

Depreciation

Is Auckland Airport's approach to forecasting depreciation reasonable?

⁶³ Air NZ submission, pg 15.

⁶⁴ Auckland Airport cross-submission, pg 33.

⁶⁵ Qantas, "Feedback on proposed review of AIAL's 2022-2027 price setting event" (31 January 2024) (**Qantas submission**), pg 3.

⁶⁶ Auckland Airport cross-submission, pg 33.

⁶⁷ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 47.

- 3.39 Airports recover depreciation on 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.
- 3.40 The projected capital expenditure programme over the PSE4 period increases Auckland Airport's RAB from \$1.7 billion to a projected \$4.2 billion.⁶⁸ To forecast depreciation, the Airport uses a standard straight-line method, which means assets are assumed to depreciate evenly over their useful lives. It has also adopted shorter asset lives for investment in the existing domestic terminal building, which is planned to be decommissioned when the integrated terminal building is operational in 2028/2029.⁶⁹

Submitters' views

Useful lives

- 3.41 In its submission to the Process and Issues paper, Air NZ noted that Auckland Airport provided only high-level depreciation forecasts, but not the specific rates used over PSE4 period.⁷⁰ Air NZ suggested that we review the depreciation rates that Auckland Airport is applying to airfield capital expenditure commissioned in PSE4, and the rates that the Airport is applying to international and integrated terminal investment.⁷¹

- 3.42 Air NZ further noted that the:

Information Disclosure schedules do not enable interested parties to undertake meaningful analysis of airport's approach to regulatory depreciation. Air NZ's ability to analyse AIAL's depreciation forecasts is therefore limited to a high-level review. We recommended the Commission undertake a more detailed review as part of its PSE4 analysis.⁷²

- 3.43 Auckland Airport responded in its cross-submission that it:

...provided extensive information to airlines through consultation on PSE4 prices on all building block parameters used to determine PSE4 prices. Auckland Airport's approach is also consistent with the ID requirements.⁷³

⁶⁸ Refer to Chapter 4 for summary and analysis of Auckland Airport's proposed capital expenditure programme over PSE4.

⁶⁹ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 41.

⁷⁰ Air NZ submission, pg 9.

⁷¹ Ibid, pg 10.

⁷² Ibid, pg 9.

⁷³ Auckland Airport cross-submission, pg 30.

- 3.44 Auckland Airport noted that no substantial customers, including Air NZ, asked the Airport to provide detailed information about asset lives during the Airport's PSE4 consultation.⁷⁴ Auckland Airport pointed out that asset lives at a component level vary. For instance, terminal assets include not only structural component (eg, steel and concrete) but also IT systems that have shorter lives comparatively.⁷⁵

Accelerated depreciation on the domestic terminal building.

- 3.45 In its submission to the Process and Issues paper, Qantas stated that it:

...disagrees with AIAL's position and therefore we disagree with need for accelerated depreciation. We have raised this issue with AIAL but are not aware of any serious consideration of options to re-use the terminal by AIAL. The Qantas Group believes that the existing terminal can be used for some level of Domestic facilitation, which in turn would reduce the size of the Integrated Domestic Terminal.⁷⁶

- 3.46 In its submission to the Process and Issues paper, Air NZ stated that it:

...believe[s] AIAL should continue to depreciate this expenditure [DTB] at normal rates...
and that

...the Commerce Commission should not apply accelerated depreciation rates to this [DTB] expenditure when it undertakes its analysis of AIAL's ex-ante profitability over PSE4.⁷⁷

- 3.47 In its submission to the Process and Issues paper, BARNZ stated that:

AIAL has not addressed the issue of how shortened asset lives might apply to the Domestic Terminal Building (DTB), as spend on the DTB would not be spent evenly across the asset. Nor has it addressed what might happen in the event that planned decommissioning of the DTB was delayed.⁷⁸

- 3.48 However, BARNZ also notes that

If depreciation was not adopted for the DTB capital works, they would instead be decommissioned in PSE5 and remaining book value written off as operating cost. AIAL's extremely high capital costs are likely to bring even higher prices to airlines operating to Auckland in PSE5. Against this Hobson's choice, it would be preferable to consume some of these costs in PSE4. It would be even more preferable to design and build an efficient airport AIAL's customers can afford.⁷⁹

⁷⁴ Ibid.

⁷⁵ Auckland Airport cross-submission, pg 31.

⁷⁶ Qantas submission, pg 4.

⁷⁷ Air NZ submission, pg 10.

⁷⁸ BARNZ submission, pg 6.

⁷⁹ Ibid.

3.49 In its cross-submission to our Process and Issues paper, Auckland Airport noted both Air NZ and Qantas were against the accelerated depreciation of investment in the DTB.⁸⁰ In response to BARNZ's queries about shortened asset lives and contingency if the decommissioning of the DTB were delayed, Auckland Airport stated that these questions had not been raised during its PSE4 consultation. Auckland Airport further noted that BARNZ's query regarding shortened asset lives "...was addressed through the materials we provided during consultation and is also addressed in the detail set out in the PSE4 PSD, and the submission to the Issues Paper."⁸¹ In regards to the query about decommissioning the DTB Auckland Airport stated that:

The answer...is that the IMs would be followed. Under the IMs once an asset is commissioned its asset life would not be adjusted, and the asset would then be depreciated in accordance with that shortened asset life. Importantly, as has been previously stated in the PSE4 PSD this approach is NPV neutral for Auckland Airport.⁸²

Tilted annuity depreciation

3.50 Christchurch Airport has used the tilted annuity method for recovering depreciation of its new terminal assets since its PSE3. This method was agreed on by parties to Christchurch Airport's consultation process.

3.51 Tilted annuity depreciation acts as a price smoothing mechanism, like RAB indexation, but goes further by recovering a lower amount of depreciation at the beginning of the life of an asset, and a higher amount of depreciation towards the end of the asset's life rather than the asset depreciating evenly over its life span. This is based on the expectation that the utilisation of the asset (in this case passenger numbers) would grow over time. The implication is that passengers pay a constant rate for use of the asset over time. Recovery of straight-line depreciation means that users in early years pay relatively more to use the asset. Where the real value of the asset is declining over time (ie, the asset value is not inflation-indexed) this inter-period inequity is exacerbated.

3.52 We understand that Auckland Airport considered the tilted annuity depreciation method during its consultation process but ultimately decided not to adopt it.⁸³ The Airport's reason for not adopting the method was that it would likely reduce prices in PSE4 but then increase prices in PSE5 and beyond, the pricing periods in which the airlines were concerned the most about increased prices.⁸⁴

⁸⁰ Auckland Airport cross-submission, pg 31.

⁸¹ Ibid.

⁸² Ibid.

⁸³ Auckland International Airport Limited: *Price Setting Event 4 Reasons paper (June 2023)*, pg 44.

⁸⁴ Ibid, pg 44.

- 3.53 We are not convinced by this explanation for assets with long lives such as terminal infrastructure. Recovery of depreciation through a tilted annuity method has potential benefits to consumers over the longer term life of these assets. It could be more allocatively efficient to defer the depreciation of the significant investment further out to match the passenger growth and utilisation, and smooth the price increase over a longer term.

Our draft conclusion

- 3.54 Our draft conclusion is that while Auckland Airport has adopted a standard straight-line depreciation method, we are not convinced that this approach best promotes the long-term benefit of consumers when a significant upfront investment is likely to be used by a growing number of consumers in the long run. Specifically, in our view 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. We would welcome a submission from Auckland Airport further explaining why it preferred the straight-line approach, with any analysis and key assumptions supporting its decision.
- 3.55 We find the accelerated depreciation of the DTB is in line with GAAP and not unreasonable, as it is consistent with the Airport's intention to de-commission the DTB when the new domestic terminal becomes operational. Additionally, a non-accelerated approach would have reduced prices in PSE4 but increased prices in PSE5.

Demand forecasts

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

- 3.56 This section considers whether Auckland Airport's demand forecasts for the PSE4 period are reasonable, based on the information available at the time prices were set. Aeronautical prices are set by estimating a volume forecast for each charged service. Demand forecasts are therefore a key driver of the revenue the Airport will earn during the pricing period and influence our assessment of whether the Airport is limited in its ability to extract excessive profits. They also inform the level and timing of investment in infrastructure, which we discuss in Chapter 4.

Incentives in forecasting demand

- 3.57 Airports have some incentive to be conservative in their passenger demand forecasts to set higher prices, given a certain revenue forecast. A higher actual demand will then provide airports with extra revenue. In the current price setting event however, airlines consider Auckland Airport's demand forecast to be too high because it underestimated the potential reduction in demand caused by the increase in airport charges.

- 3.58 The different views on the potential impact of the price increase on passenger forecasts appear to relate to Auckland Airport's planned capital investment. The airlines argue that the investment in such capacity may not be necessary, whereas the Airport insists capacity expansion is required. Both Auckland Airport and the airlines have engaged experts to advise on the potential adverse impact of the price increase on future demand. The parties hold different views.

Regulatory requirements

- 3.59 Airports are required to report on demand forecasts as part of ID regulation. Demand forecasts are a key input into the calculation of operating and capital expenditure forecasts and thereby total revenue requirement over the price setting event period. Airports are required to disclose the following:⁸⁵
- 3.59.1 Annual and busy hour forecasts of international and domestic passenger arrivals and departures;
 - 3.59.2 International transit and transfer passengers (as applicable); and
 - 3.59.3 Aircraft runway movements by busy hour, busy day and financial year, expressed in total certified take-off weight (MCTOW) and number of aircraft.
 - 3.59.4 Airports are also required to provide an additional five years of forecast passenger, aircraft numbers and MCTOW demand.

How Auckland Airport has forecast demand

- 3.60 In PSE4 Auckland Airport took a two-step process in forecasting demand:⁸⁶
- 3.60.1 Auckland Airport engaged an independent aviation forecasting specialist, DKMA, to create an unconstrained forecast;
 - 3.60.2 Then, the Airport produced its own constrained forecast by overlaying adjustments for:
 - 3.60.2.1 transit passengers;
 - 3.60.2.2 unbillable passengers, including those less than two years of age, and;
 - 3.60.2.3 the impact on demand from higher airport charges – the price elasticity of demand.

⁸⁵ Commerce Commission: [Airport Services Information Disclosure Determination 2010](#) (Consolidating all amendments as of 20 December 2016), clause 2.5(1)(a)(iii) & Schedule 20.

⁸⁶ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 86-90.

Unconstrained forecast

- 3.61 During the COVID-19 pandemic Auckland Airport initially forecasted its post-pandemic demand recovery at a high level, in consensus with airlines. Auckland Airport then commissioned DKMA to undertake an objective demand forecast of passenger and air traffic. The Airport consulted with its substantial customers and provided feedback to DKMA. DKMA's view is that long-term aviation demand is driven by economic, demographic and tourism growth.⁸⁷
- 3.62 On average, DKMA has projected New Zealand's GDP to grow on average 1.8% per annum through to 2048. Population wise, New Zealand is expected to grow by 0.7% per annum nationally and 0.9% per annum in the Auckland area. DKMA forecast that the tourism is set to recover to pre-pandemic levels by 2026 and then grow at 3.5% per annum over the period 2026 to 2028.⁸⁸

Constrained forecast

- 3.63 Auckland Airport adjusted DKMA's unconstrained forecast by aligning with its own latest forecast for the 2023 financial year and the 2024 budgets. Non-billable passengers, defined as passengers under two years old, airline positioning crew and departing transit passengers,⁸⁹ were also removed from the forecast.⁹⁰ Substantial customers were consulted throughout the process of forecasting unconstrained demand as well as constrained demand.⁹¹
- 3.64 After excluding non-billable passengers, Auckland Airport further adjusted the demand forecast, informed by the advice from an aviation industry economics expert, InterVISTAS, on the impact that the higher charges could have on demand for travel through the Airport.⁹²
- 3.65 InterVISTAS considered how future demand would be impacted based on Auckland Airport's forecast aeronautical charges in PSE4 and how airlines may pass them on through airfares. When charging their passengers, airlines can choose to pass on the full 100% of aeronautical charges (or 'pass-through costs' from the perspective of airlines) or less. InterVISTAS prepared an analysis using both 60% and 100% pass-through aeronautical charges. In applying InterVISTAS' analysis to its demand forecast, Auckland Airport used the midpoint of 80% pass-through aeronautical costs.⁹³

⁸⁷ Ibid, pg 86.

⁸⁸ Ibid, pg 87.

⁸⁹ Transit passengers are charged on arrival only.

⁹⁰ Ibid, pg 83.

⁹¹ Ibid, pg 90.

⁹² Ibid, pg 89.

⁹³ Ibid, pg 89.

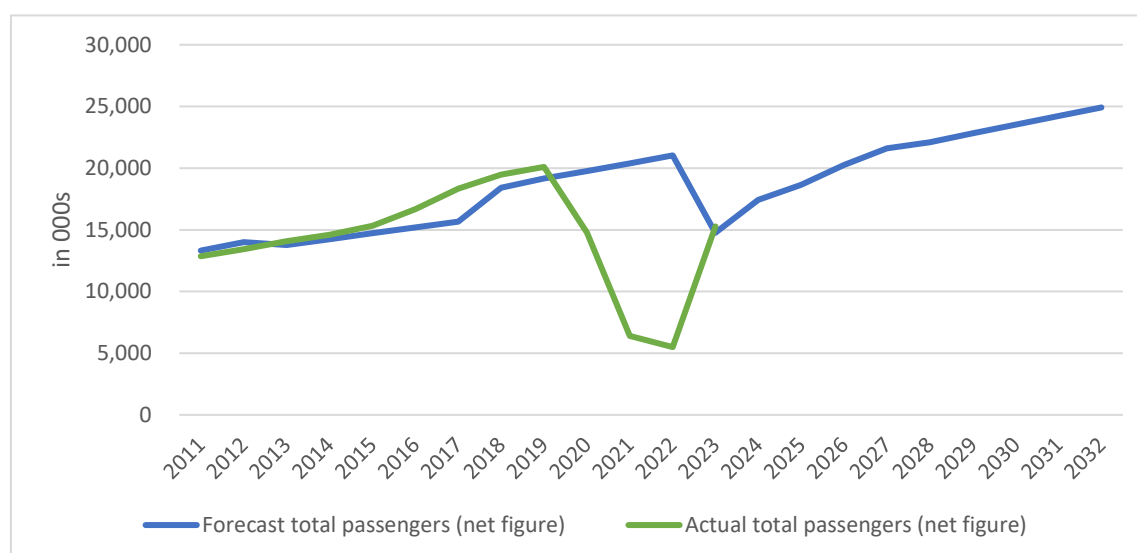
- 3.66 Auckland Airport noted that the airlines disagreed with this assumption on the pass-through percentage of 80% and that they considered pass-through costs should not be less than 100% of airport charge increases.⁹⁴ However, Auckland Airport stated that it considered the feedback by substantial customers, including an alternative elasticity study, but ultimately concluded that:

...key assumptions of the study were inconsistent with real world management practice of airlines (which spread airport costs across different fare brackets proportionately) and that the InterVISTAS study provided a more robust estimate of potential price elasticity of demand impacts.⁹⁵

Forecast and actual passenger numbers

- 3.67 Using Auckland Airport's ID and PSE4 data, we have charted its forecast and actual passenger numbers in Figure 3.1 below.⁹⁶

Figure 3.1 Total passengers (excluding international transit passengers)



- 3.68 As shown in Figure 3.1, actual passenger numbers increased over the period 2011 to 2019, slightly above forecast passenger numbers until 2020 when there was a significant decrease due to COVID-19. The passenger numbers are forecast to recover to the pre-COVID level by around 2026/2027.

Submitters' views

- 3.69 Price elasticity of demand was a contentious area of demand forecasting during Auckland Airport's consultation process with its substantial customers.

⁹⁴ Auckland International Airport Limited: *Price Setting Event 4 Reasons paper* (June 2023), pg 25.

⁹⁵ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 90.

⁹⁶ Actual figures obtained from the dataset of Airport ID data as at December 2023 on our website: <https://comcom.govt.nz/regulated-industries/airports/regulated-airports-performance> and forecast figures are from Auckland Airport PSE4 price setting schedules, s20a.

3.70 Submissions from Auckland Airport’s customers to our Process and Issues paper also focus on the price elasticity of demand. Air NZ states that Auckland Airport’s demand forecast:

materially overstates expectations for future demand, particularly increases occur once the IDT is commissioned and enters the RAB in PSE5, quadrupling the current RAB by DY2032. These increases will disproportionately impact New Zealand’s domestic air traffic network.⁹⁷

3.71 Qantas’ submission stated that it “has serious concerns about the passenger forecast”, that they are “not convinced that there is any immediate need for the capacity based on the [demand] forecast”⁹⁸ and:

while they accept that growth is a possibility, AIAL was trending towards negative growth prior to the COVID 19 pandemic and recovered more slowly than other ports. Given the costs of sunk investment, it would have been prudent to wait before investment.⁹⁹

3.72 Qantas further submitted that:

the constraints of price-elasticity have not been properly considered by AIAL. The implication of the capital plan will have a material impact on NZ aviation through:

- Reducing demand,
- Reducing capacity,
- Possibly reducing the level of competition on routes, days of the week, with a compounding reduction in capacity; and
- Cyclical impacts on other airports BBMs [Building Block Models] at their PSEs and on AIAL’s at the next PSE.¹⁰⁰

3.73 Auckland Airport responded in its cross-submission to our Process and Issues paper that it disagrees with Qantas’ submission as pre-pandemic traffic was growing strongly and “the decline in regional volumes in 2019 was largely due to Jetstar’s exit from the regional market.”¹⁰¹

Auckland Airport’s response to submissions

3.74 Auckland Airport remarked on the differing incentives of airports and airlines in its cross-submission to our Process and Issues paper:

Airlines have strong commercial incentives to keep airport charges as low as possible, because minimising airport charges reduces operational cost for airlines. Airlines may

⁹⁷ Air NZ Submission, pg 11.

⁹⁸ Qantas Submission, pg 5.

⁹⁹ Qantas Submission, pg 5.

¹⁰⁰ Qantas Submission, pg 5.

¹⁰¹ Auckland Airport cross-submission, pg 29.

prefer to have lower operational costs, with lower service quality. However, lower service quality can impact on all airport users, not just airlines. That is why the airport is the party accountable for delivering the right service that consumers demand – quite rightly it is the airport’s social licence at stake if a poor service is provided.¹⁰²

- 3.75 Auckland Airport further submitted that "The commercial incentives for airlines to delay or oppose investment is strong."¹⁰³ Auckland Airport cites a 2019 study from the Australian Productivity Commission into the Economic Regulation of Airports on this point, which notes that "...airfares could be higher if, for example, anticompetitive behaviour successfully delayed necessary airport investment, and this resulted in congestion."¹⁰⁴
- 3.76 Airlines suggested that the forecast demand dampening provided by InterVISTAS was too low and the impact of aeronautical charges on demand should be higher.¹⁰⁵ Auckland Airport submitted that for this to be adopted, then aeronautical charges would be higher, resulting in increased profits overall.¹⁰⁶ In its cross-submission Air NZ responded to this point that:

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.¹⁰⁷

- 3.77 In its disclosures as well as its submission to our Process and Issues paper, Auckland Airport stated that it “carefully considered” findings of the separate study into demand impact, but ultimately found that the “InterVISTAs study was highly robust, and that the study provided by the airlines overstates the likely reduction in demand from airport charges.”¹⁰⁸

Our draft conclusions

- 3.78 Our draft conclusions on the reasonableness of demand forecasts are as follows:

3.78.1 There has been extensive consideration, consultation and expert studies on demand from both Auckland Airports and airlines. Auckland Airport has taken into consideration views of the airlines and expert reports provided by them as well as obtaining its own in response to airline concerns.

¹⁰² Auckland Airport cross-submission, pg 7.

¹⁰³ Ibid, pg 8.

¹⁰⁴ Ibid, pg 8.

¹⁰⁵ Auckland Airport submission, pg 30.

¹⁰⁶ Auckland Airport submission, pg 30.

¹⁰⁷ Air New Zealand, “[Air NZ Cross Submission on the Review of Auckland Airport’s 2022-2027 Price Setting Event 4 \(PSE4\) – Process and issues paper](#)” (21 February 2024) (**Air NZ cross-submission**), pg 10.

¹⁰⁸ Auckland Airport submission, pg 30.

- 3.78.2 We understand that expert studies relating to price elasticity of demand show different magnitudes for the potential impact on demand from the increase in Auckland Airport's charges. However, we do not consider that the potential impact of these differences is of sufficient significance in the operating expenditure forecast or the projection of long-term capacity needs.
- 3.78.3 Auckland Airport has forecasted higher passenger demand than what the airlines consider is reasonable. This is opposite to the general demand forecast incentives of airports and airlines. For PSE4, higher passenger demand forecast means that the price per passenger is lower than otherwise, which benefits consumers. When facing constraints, capacity expansion by investing in infrastructure enables airline competition, which also benefits consumers. Our draft conclusion is that Auckland Airport's overall demand forecast appears reasonable and is unlikely to result in excessive profits for the PSE4 period.

Revenue wash-up

Is the two-way revenue wash-up reasonable?

- 3.79 Auckland Airport's PSE4 disclosure includes carry-forwards relating to historical adjustments seen in past PSEs, correction of errors and omissions. In addition, Auckland Airport has introduced two new ex post wash-up mechanisms to share risks with its customers: a two-way revenue wash-up, and a capex wash-up.¹⁰⁹ The latter is discussed in Chapter 4.

Allocation of risk

- 3.80 In the context of Part 4 regulation, consistent with how risks tend to be allocated in workably competitive markets, our view is that risks should be allocated to suppliers or consumers depending on which are best placed to manage them.¹¹⁰ If suppliers are not compensated for risks that are outside their control, then this might have a detrimental effect on incentives to invest.¹¹¹
- 3.81 Auckland Airport has included two new risk sharing measures in the form of wash-ups over the PSE4 period:
- 3.81.1 A **two-way revenue wash-up** which aims to partially compensate Auckland Airport or airlines for material differences between actual and forecast aeronautical demand (measured by revenue) over the PSE4 period.

¹⁰⁹ Auckland Airport submission, pg 31-33.

¹¹⁰ Commerce Commission: *Input methodologies review decisions: Framework for the IM review* (20 December 2016), pg 42.

¹¹¹ *Ibid*, pg 42.

- 3.81.2 A one-way **capex wash-up** which aims to compensate airlines if the Airport under-delivers on the forecast commissioned asset. Further detail and analysis are provided in Chapter 4 of this paper.

Two-way revenue wash-up

- 3.82 In its disclosures, Auckland Airport states that this wash-up is intended to partially share with airlines demand risks in the event of a significant shock.¹¹² The mechanism is described as follows.
- 3.83 A revenue wash-up is triggered if the PSE4 aeronautical revenue falls short of (or exceeds) the price setting forecast by more than 15%, and at the same time, the PSE4 IRR for priced activities falls short of (or exceeds) target return by more than 0.75% after tax. Any wash-up will only occur to the extent that it coincides with a 0.75% or more reduction (or increase) in actual PSE4 post-tax IRR versus the target return. 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).¹¹³
- 3.84 The overall effect of this wash-up mechanism is to protect both the Airport and airlines from a significant different-to-forecast demand outcome (both upside and downside) in the form of revenue.

Submissions

- 3.85 In their joint submission, Freightways and NZ Post noted that they are unable to provide feedback on the impact of any risk sharing arrangements, including consideration of the use or lack of any opening or closing carry forward adjustments:

as management have not been provided access to the building block model used to develop pricing by AIAL. We find this disappointing as in all our recent airport charging discussions with Palmerston North and Christchurch their building block models were shared openly, and this assisted with the parties understanding and reaching a resolution around the aeronautical charge.¹¹⁴

- 3.86 BARNZ submitted that following:

the asymmetric risk wash-up attempts to compensate the airport company for risk taken. BARNZ considers that compensation for risk exists in the calculation of the airport's target

¹¹² Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 67.

¹¹³ Commerce Commission: *Process and Issues paper*, pg 13.

¹¹⁴ Freightways & NZ Post, "Auckland Airport's 2022-2027 price setting event" (22 January 2024) (**Freightways & NZ Post submission**), pg 3.

WACC – according to the Commission’s Input Methodology. If the WACC methodology generates a return which already compensates for risk taken, BARNZ asks whether the asymmetric risk wash-up twice-compensates AIAL? ¹¹⁵

3.87 Air NZ submitted that it had:

concerns about asymmetric risk are valid in the context of a business which has the ability to set its own prices when it deems appropriate. In the non-price-regulated world, no business can be guaranteed of achieving a full return on its investment in the event of a material asymmetric event. An event such as COVID-19 does not impact airports in isolation – all parts of the economy were severely impacted. ¹¹⁶

3.88 Air NZ further submitted that it:

considers the revenue wash-up is extremely favourable to AIAL. The airport has the potential to earn more than \$400m incremental to forecast revenues over the PSE4 period before the wash-up would potentially be triggered. (noting that there would also need to be a 0.75% uplift to IRR to trigger the mechanism). This \$400m incremental revenue is retained by the airport and does not form part of any carry forward adjustment into the next pricing period. Even at a 5% threshold, the increased revenue for the airport would be ~\$140m. ¹¹⁷

3.89 Auckland Airport responded to this point in its cross-submission that Air NZ:

focuses on only one side of what is a symmetrically designed wash-up mechanism, which is not favourable to Auckland Airport but rather is fair and balanced. It ignores the fundamental design of this wash-up, in that it equally exposes Auckland Airport to the same upside and downside risk, not just upside which Air New Zealand has focused on in its submission. Air New Zealand has not justified its claims that the wash-up mechanism is favourable to Auckland Airport. ¹¹⁸

3.90 In its response to BARNZ and Qantas, Auckland Airport noted in its cross-submission that:

it has already addressed issues raised by BARNZ that Auckland Airport is being twice compensated in our previous submission and PSE4 PSD, while the comments from Qantas focus on the investment plan, rather than the wash-up mechanism itself. ¹¹⁹

¹¹⁵ BARNZ Submission, pg 6.

¹¹⁶ Air NZ Submission, pg 11.

¹¹⁷ Air NZ Submission, pg 12.

¹¹⁸ Auckland Airport cross-submission, pg 32-33.

¹¹⁹ Auckland Airport cross-submission, pg 33.

Our draft conclusion

- 3.91 Auckland Airport indicates in its submission on our Process and Issues paper that this wash-up is to cover demand shocks due to significant events, like COVID-19.¹²⁰ It does not appear to be intended for normal operations and revenue fluctuation of the Airport. Auckland Airport notes in the disclosure that it incurred 32% revenue losses during PSE3 because of COVID-19. If this wash-up mechanism was in place then, 17% of the 32% revenue losses against the PSE3 revenue forecast would be recovered in PSE4.¹²¹ Auckland Airport is not seeking to recover in PSE4 over \$500 million revenue shortfall against PSE3 forecast.
- 3.92 Wellington Airport introduced a demand wash-up due to COVID-induced uncertainty, as part of its PSE4 decisions in April 2021. In our review of Wellington Airport's PSE4, we noted COVID-19 pandemic was a Type I asymmetric risk that arises through infrequent events that could produce large losses. In workably competitive markets, it is often unfeasible for firms to recover the cost of catastrophic events after the event. We considered regulated providers such as airports should be exposed to at least some of the costs of such risk materialising, to mitigate the risk of under-preparation for this type of risks. This encourages them to spend efficiently ex ante to prepare for such a possibility and not fully rely on ex post relief.¹²²
- 3.93 Our draft conclusion is that in principle, the two-way revenue wash-up seems appropriate to protect both the Airport and airlines from significant revenue variance to forecast and address under- or over-recovery of revenue by the Airport in the event of a demand shock, like COVID-19. The presence of this risk sharing mechanism does not affect our estimate in Chapter 2, of a reasonable WACC for Auckland Airport over PSE4. This is because WACC is an industry-wide measure and unaffected by how Auckland Airport decides to share risks with airlines. While some airlines did not agree on the thresholds of the two-way revenue wash-up, there was agreement in principle over wash-ups generally and Auckland Airport lowered the IRR threshold from 1% to 0.75% after considering airlines' feedback. We consider more transparency from Auckland Airport around inputs and analysis could aid customers' understanding of the effect of the revenue wash-up mechanism.

¹²⁰ Auckland Airport submission, pg 31.

¹²¹ Auckland International Airport Limited: Price Setting Disclosure (17 August 2023), pg 67.

¹²² Commerce Commission: *Review of Wellington Airport's 2019-2024 Price Setting Event Final Report* (28 September 2022), paragraphs 126-127.

Chapter 4 Investment

Purpose

- 4.1 This chapter contains our analysis and draft conclusions on the extent to which Auckland Airport's capital expenditure forecasts raise any significant concerns about whether the airport is likely to invest appropriately, efficiently and at a quality that reflects consumer demands.
- 4.2 This analysis is relevant to the extent to which Auckland Airport has incentives to invest, including in replacement, upgraded, and new assets; and has incentives to improve efficiency and provide services at a quality that reflects consumer demands (in accordance with sections 52A(1)(a) and (b) of the Act).
- 4.3 The timing and value of Auckland Airport's capital expenditure profile affects its expected profitability. Therefore, some of the analysis and conclusions in this chapter directly affect our assessment of the extent to which Auckland Airport's target returns are likely to promote the long-term benefit of consumers.

Table 4.1 Auckland Airport's summary of forecast capital expenditure

Projects (\$m)	PSE4	PSE5	10-year total
Terminal Integration Programme (incl. Enabling & airport resilience, Domestic Processor and Transport Hub)	3,134	764	3,898
Aeronautical Programme	509	229	738
Renewals – airfield pavement and ground lighting	285	299	584
Renewals - other	389	172	561
Cargo Precinct	262	23	285
Roading Programme	164	0	164
Domestic Terminal Building Upgrades	148	0	148
Contingent Runway	88	49	137
Utilities Programme	57	25	82
Total Capital Expenditure	5,036	1,561	6,597

- 4.4 As part of its PSE4 decisions, Auckland Airport has planned for approximately \$6.6 billion in capital expenditure. The projects will be delivered over both PSE4 and PSE5 periods, with the majority of spend planned in PSE4. Auckland Airport has disclosed that its capital expenditure plan has begun as it involves significant milestones that need to be met for Auckland Airport to remain operational throughout the planned works.

- 4.5 Unlike PSE3, the PSE4 submissions on our Process and Issues paper highlighted disagreements in how the investment plan, in particular the Terminal Integration Programme (**TIP**), was viewed between Auckland Airport and its substantial customers. The TIP is estimated to cost approximately \$3.9 billion, the largest programme in the \$6.6 billion investment plan.

Draft conclusions

- 4.6 Our draft conclusions are:

4.6.1 We consider that the process and rigour Auckland Airport applied to planning and costing the investment plan was reasonable. When identifying the needs for investing in a new domestic terminal, Auckland Airport had adequate regard to the current service quality issues, asset maintenance, and capacity requirements in the long run. It considered a wide range of options. Auckland Airport has appropriately introduced a one-way capital expenditure wash-up mechanism to mitigate the risk of under delivery.

4.6.2 Based on the information we have, we consider that the forecast capital expenditure, while significant, appears to be reasonable.¹²³ We have not identified aspects of the planned investment that produce outcomes inconsistent with the Commerce Act 1986 Part 4 purpose.

Our approach to assessing Auckland Airport's capital expenditure forecasts

- 4.7 We assess whether we have any significant concerns that Auckland Airport's capital expenditure forecasts for the PSE4 period do not provide for investment that is appropriate, efficient, and at a quality that reflects consumer demands.
- 4.8 Our analysis focuses on the Terminal Integration Programme because its cost and timing is the key concern of the Airport's substantial customers. We consider factors such as future capacity requirement, targeted levels of service and project scope, which are important in determining the cost and timing.
- 4.9 We therefore assess:
- 4.9.1 The needs identification, options considered and the scope of the new domestic terminal;
- 4.9.2 whether the Airport is expected to provide services at a quality that reflects consumer demand;

¹²³ We have not undertaken an engineering review of Auckland Airport's capital expenditure plan, as it is not our role to determine the specific investment choices that the Airport should make.

- 4.9.3 whether the investment has been costed appropriately;
- 4.9.4 whether planned investment is expected to occur at an appropriate time;
- 4.9.5 whether there are concerns that there is evidence of planned under or over-investment; and
- 4.9.6 whether Auckland Airport has established mechanisms to mitigate risks related to the under-delivery of the programme of this size.

Information used to assess Auckland Airport's capital expenditure forecasts

- 4.10 Our analysis of Auckland Airport's capital expenditure plan relies on:
- 4.10.1 the regulatory disclosures provided by Auckland Airport as part of this pricing event;
 - 4.10.2 submissions and cross-submissions received on our Process and Issues paper;
 - 4.10.3 further confidential information received from Auckland Airport (reasons paper for PSE4, board paper excerpt from 16 March 2023); and
 - 4.10.4 high-level analysis of Auckland Airport's actual capital expenditure against its forecasts over the PSE3 period and commentary in the Airport's annual disclosures.¹²⁴

Capital expenditure plan

- 4.11 Auckland Airport has forecasted its PSE4 capital expenditure. Table 4.1 shows the cash flow view.¹²⁵

Table 4.2 Capital expenditure cash flow by category for PSE4

Capital expenditure by category (\$m)	FY23	FY24	FY25	FY26	FY27	5-year total
Capacity growth	363	750	1,124	1,043	1,083	4,362
Asset replacement and renewal	130	152	143	134	115	674
Total	492	902	1,267	1,177	1,197	5,036

¹²⁴ We note that PSE3 included the years that were most impacted by the COVID-19 pandemic and are unusual in that respect.

¹²⁵ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), schedule 18.

- 4.12 This represents a significant increase compared to the forecast capital expenditure from PSE3 in both growth and renewal categories. In PSE3, a total of \$2.3 billion was forecasted to be invested, whereas the actual investment was about \$895.4 million. This is a less useful comparison, as it involved COVID-related pauses to planned investment (including a new domestic terminal). PSE4 introduced a capital expenditure wash-up mechanism discussed later in this paper to mitigate the risk of under-delivery. PSE3 did not include such a mechanism.
- 4.13 A significant portion of the capital expenditure plan is the TIP, which consists of three key projects including the Enabling and Airport Resilience works, the Domestic Processor and the Transport Hub.

Table 4.3 Terminal Integration Programme

Projects (\$m)	PSE4	PSE5	10-year total
Terminal Integration - Enabling & Airport Resilience	1,513	129	1,641
Terminal Integration - Domestic Processor	1,497	596	2,093
Terminal Integration - Transport Hub	124	39	163
Total	3,134	764	3,898

- 4.14 Following a lengthy period of planning and consultation with airlines, Auckland Airport has decided on building the Domestic Processor to address capacity and service quality issues with the existing domestic terminal and to meet future capacity needs. More context about the Domestic Processor and the alternative options considered are discussed later in this chapter.
- 4.15 The Domestic Processor is forecast to cost about \$2.1 billion in total through to 2030, with a cost of about \$1.5 billion during PSE4 (2022-2027). The Domestic Processor makes up a majority of the Terminal Integration Programme and was a point of contention during and after the PSE4 consultation Auckland Airport undertook with its substantial customers. It is a focus of this summary and analysis.

Capital expenditure consultation process

- 4.16 Section 4C of the Airport Authorities Act 1966 requires specified airport companies to consult with substantial customers on any capital expenditure plans that mean the airport will or will likely spend 20% of the value of its identified assets in capital expenditure over the following five years.¹²⁶ Auckland Airport consulted with Air NZ, Qantas and BARNZ on a confidential basis.¹²⁷

¹²⁶ Airport Authorities Act 1966, s 4C.

¹²⁷ We understand some information was compartmentalised within the same consultation due to commercial sensitivities.

History of the capital expenditure consultation process

History of the Terminal Integration Programme

- 4.17 At the heart of the capital investment plan is the TIP, which aims to integrate domestic and international customers through one terminal. This programme is the result of consultation dating back to 2012, during which it was named differently in the iterative process. In 2014, Auckland Airport released its Master Plan which noted the physical constraints of Auckland Airport and considered four main options to meet future capacity:
- 4.17.1 Domestic terminal north/international terminal south.
 - 4.17.2 Domestic terminal south/international terminal north.
 - 4.17.3 Domestic terminal south and then relocated north, a flip.
 - 4.17.4 Split domestic terminal either side of the international.
- 4.18 The domestic terminal south, and international terminal north was the option most favoured at the time. Key stakeholders and substantial customers were consulted with on the overall Master Plan with feedback being requested from November 2013 to February 2014. This included submissions on the terminal concepts including an early integrated terminal concept.¹²⁸
- 4.19 In 2017, the Terminal Development Plan (TDP) expanded on the 2014 Master Plan and more fully considered integrating the domestic and international terminals.
- 4.20 From 2018 to 2020 further consultation took place as there was broad support for the TDP. Following the decisions about the staging and form of the terminal, the development of the Domestic Jet Facility (DJF) was launched as part of PSE3.
- 4.21 The DJF project was announced in February 2020, with the delivery Alliance team confirmed and works scheduled to start in August 2020. However, it was soon terminated due to the global pandemic in March 2020, with the support of airlines at that time.

¹²⁸ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 30.

2021 Paheko Consultation

- 4.22 In 2021, Auckland Airport considered if there was a rapid and cost-effective way to migrate domestic jets into the international terminal due to the closure of international borders. The Airport consulted with customers about how this might occur. Two options were considered, 'Integrated West' and 'Integrated East', with the East option being consistent with the DJF concept. Integrated East was preferred by airlines which took advantage of the low traffic environment to deliver a more integrated facility at stage 1 of the build, rather than re-visiting it through a second stage like the DJF plan.
- 4.23 Following this consultation, the Integrated East solution was approved by Auckland Airport's board, and was supported by Air NZ and BARNZ. A public announcement was made in August 2021.¹²⁹ Consultation continued following this announcement to refine the design.

Recent consultation

- 4.24 Between June 2021 and May 2023, ahead of its final pricing decision on 7 June 2023, Auckland Airport consulted with substantial customers on investment at least 6 times:
- 4.24.1 Consultation Paper 1: Draft Capital Plan – 6 July 2022-30 August 2022.
 - 4.24.2 Consultation Paper 2: Information Paper – 20 September 2022-4 November 2022.
 - 4.24.3 Draft Capital Plan Review and airline workshops – 17/18 November 2022.
 - 4.24.4 Consultation Paper 3: Draft Pricing Proposal – 8 February 2023-21 February 2023 and 21 March 2023.
 - 4.24.5 Airline meetings and engagement – March-May 2023.
 - 4.24.6 Further consultation and engagement with airlines – May 2023.

Changes made by Auckland Airport following consultation feedback

- 4.25 In July 2022, Auckland Airport released its Draft Capital Plan, which set out the 10-year aeronautical capital investment plan, its key projects and an indicative forecast on the impact to aeronautical prices.
- 4.26 In November 2022 Auckland Airport decided that a review of the Draft Capital Plan was appropriate given the feedback received, and adjusted the timeframes for the PSE4 consultation accordingly.

¹²⁹ Media Release, [Auckland Airport resets precinct-wide infrastructure plan](#), August 2021.

- 4.27 The November 2022 review explored opportunities to reduce cost and assess the scope and timing of key parts of the project. The savings opportunities were presented to substantial customers. Feedback was provided by substantial customers following the November consultation, which Auckland Airport considered ahead of releasing the Revised Capital Plan in February 2023.
- 4.28 In February 2023, the Revised Capital Plan adopted savings identified during the previous consultation. The net impact of the changes reduced the value of commissioned priced investment over PSE4 by around \$430 million, however the overall cost over the 10-year investment programme increased as the savings had been offset by growing construction costs escalation and other adjustments to the forecast.
- 4.29 In March 2023 Auckland Airport re-affirmed the TIP, as decided in May 2021 (Paheko consultation), as it considered it to be the best decision for the long-term interests of passengers and the New Zealand economy.

Does Auckland Airport plan to invest in its assets appropriately?

- 4.30 This section uses the information we have available to consider the capital investment decisions and the rationale behind the decisions Auckland Airport has made.

Background

- 4.31 Auckland Airports notes that the existing domestic terminal building (DTB) is 57 years old and beyond its design life. While it has had refurbishments over the years, the Airport believes it will be facing more significant capacity constraints if it continues to provide terminal services for domestic flights. The capacity constraints are observed in baggage, airside dwelling, security screening, land transport and airfield.
- 4.32 While substantial customers disagree with the Airport (and amongst themselves potentially) on the size, the cost and timing of a new integrated domestic terminal, there is general consensus that investment of some kind is required for Auckland Airport to address issues associated with DTB assets nearing the end of life.
- 4.33 Auckland Airport is a single runway operation. The Airport states that the runway that is currently in use requires significant renewals, with pavement renewed and operable by the end of the decade, approximately five years from now. This requires the runway to be completely closed for months. With the main runway unusable during this time, a contingent runway (Alpha) and a taxiway (Bravo) will be required. The existing DTB footprint encroaches on taxiway Bravo, constraining capacity for take-off and landing, while the contingent runway Alpha is in operation.

Needs identification

4.34 In its disclosure Auckland Airport outlined its process for determining the need for capital investment in accordance with clause 2.5(1)(m)(i) of the Airport Services ID Determination.¹³⁰ Its disclosure notes that Auckland Airport is responsible for the long-term master planning and airport system resilience, and it must consider the short, medium and long-term implications of any airport infrastructure decisions.

4.35 Auckland Airport notes:¹³¹

Aviation is an industry that has historically been subject to material and ongoing changes in demand, supply and operational dynamics. This has recently been demonstrated by the significant impacts due to the COVID-19 pandemic, resulting in significant short-term volatility in demand.

4.36 In determining the need for investment, Auckland Airport follows its development principles outlined in its disclosure, and the design objectives outlined in the 2014 Master Plan.¹³²

4.37 Auckland Airport in its capital expenditure plan seeks to:¹³³

- 4.37.1 ensure the long-term operational, safety and commercial aviation requirements of the Airport continue to be met. This includes the delivery of additional capacity that will enable economic growth and that is informed by long-term thinking;
- 4.37.2 deliver an overall airport system with the capacity and ability to adapt to changing environmental, social, technological and economic conditions and pressures;
- 4.37.3 meet the needs of modern airport users, including airlines and passengers;
- 4.37.4 provide a high-quality connection for passengers transferring between domestic and international services;
- 4.37.5 provide access to and from the Airport for the maximum range of transport modes, including facilitating public transport access and protecting for future connectivity (including rail) in a clear, efficient and effective manner;

¹³⁰ Commerce Commission, [Airport Services Information Disclosure Determination 2010](#)(consolidated June 2019).

¹³¹ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 29.

¹³² *Ibid*, pg 29.

¹³³ *Ibid*, pg 29.

- 4.37.6 design and deliver infrastructure in a manner that enables Auckland Airport's role as an international, national and regional gateway for airlines, commuters, tourists, visitors and workers; and
 - 4.37.7 reflect the distinctive character of Auckland Airport, including promoting and enhancing New Zealand's unique culture and heritage.
- 4.38 Auckland Airport states that the need for a new integrated domestic terminal is driven by a number of factors.¹³⁴
- 4.38.1 The DTB is beyond its design life and increasingly uneconomic to maintain.
 - 4.38.2 The DTB was consistently operating over capacity resulting in poor customer experience pre-COVID and is forecast to do so again from 2024 onwards, as passenger numbers recover and grow post-COVID.
 - 4.38.3 The position of the DTB provides poor connection experience for transferring passengers.
 - 4.38.4 The DTB encroaches on Taxiway Bravo, causing inefficient contingent runway operations (eg, delays in landing and take-off) when the main runway pavement is replaced by the end of this decade.
 - 4.38.5 The location of the DTB is planned to be developed into airfield for long-term growth according to the Airport's Master Plan.
- 4.39 We consider that when identifying the needs for investing in a new domestic terminal, Auckland Airport had adequate regard to the current service quality issues, asset maintenance, and capacity requirements in the long run. We note the majority of Auckland Airport's customers appear to agree that there is a need for investment of some kind to meet some of the needs identified, but they have different views on the type, size and timing of the solutions.

Options considered

- 4.40 We outlined earlier the history of the consultation process, referring to various options that were considered since 2012, to address the infrastructure needs of Auckland Airport and the re-development of the current domestic terminal. This section outlines the options that were considered in the most recent iteration of the consultation leading up to the Airport's decisions on the investment and pricing for PSE4.

¹³⁴ Auckland International Airport Limited: *Price Setting Disclosure – Appendix A* (17 August 2023) pg 7-14.

Customer feedback

- 4.41 Auckland Airport identified the main points of feedback from its substantial customers were:¹³⁵
- 4.41.1 a lower cost alternative development pathway should be pursued;
 - 4.41.2 domestic operations should remain in the DTB for longer;
 - 4.41.3 given the cost there will be significant impacts on passenger demand; and
 - 4.41.4 the costs have changed significantly since the Paheko consultation.

How Auckland Airport considered alternative options

- 4.42 Auckland Airport elaborated on how it considered different options during the consultation and decision-making process. We set out below Auckland Airport's explanation on why it decided on its final plan.
- 4.43 Auckland Airport states the proposed plan is the best option to deliver capacity, resilience, and future growth capacity. It says that many projects in the TIP address resilience which would need to be completed regardless and including them in the TIP is the most efficient way of delivering this infrastructure.¹³⁶
- 4.44 Auckland Airport is of the view that no viable alternatives that meet all necessary requirements and that would be materially lower in cost have been proposed by customers or identified by Auckland Airport.

Alternative design

- 4.45 Auckland Airport stated acceptable alternative designs would not deliver materially reduced cost. In particular, it said alternative designs were unlikely to reduce terminal floorplate, the main driver of cost.
- 4.46 Auckland Airport considered other options:
- 4.46.1 operating the Integrated Terminal without a pier – this option would require a bus lounge or a form of canopy to a new domestic apron. The Airport considered this would be a step-down in service quality without providing a substantial uplift in capacity.
 - 4.46.2 construction of a single-level walk-out pier – the potential cost savings of this approach were considered marginal by the Airport in comparison to the poor passenger experience it would provide. Auckland Airport did not consider the pier would handle off-schedule arrivals and departures well.

¹³⁵ Auckland International Airport Limited: *Extract of Board Paper* (16 March 2023), pg 18.

¹³⁶ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023) pg 34.

Alternative locations

- 4.47 Auckland Airport reconsidered alternative locations at the end of 2022, similar to the considerations throughout the overall consultation process that began in 2012.
- 4.48 Auckland Airport reconsidered previous work on potential lower cost alternative locations for the domestic terminal including a northern precinct for domestic use that is not integrated. The Airport stated that a domestic terminal to the north would not be materially lower in cost because:
- 4.48.1 Terminal studies confirm that floor area requirements remain between 6,000 and 7,000 m² per million annual passengers. A non-integrated north terminal would not be materially different in cost as the size would need to remain the same. The cost is largely influenced by the size of the build;
 - 4.48.2 Costs would be added to add infrastructure to service a northern terminal. These added costs would more than offset any savings; and
 - 4.48.3 A terminal in the northern precinct would mean duplicate infrastructure would need to be built, resulting in additional cost. Facilities like passenger pick-up and drop-off, baggage systems, and security screening areas would need to be built.
- 4.49 In addition, Auckland Airport states that having a domestic terminal to the north would create inefficiency in the long run, as flight paths make it more efficient for the emphasis of domestic operations to be on the southern runway.

Delaying Terminal Integration and operating the existing Domestic Terminal for longer

- 4.50 Auckland Airport consider that delaying terminal integration, and remaining in the DTB for longer, would result in undesirable outcomes. In particular, the Airport explained that it would:
- 4.50.1 add cost through construction cost escalation;
 - 4.50.2 constrain domestic capacity;
 - 4.50.3 reduce climate change resilience;
 - 4.50.4 reduce the efficiency of contingent runway operations;
 - 4.50.5 impact customer experience; and
 - 4.50.6 not avoid the need for new domestic terminal capacity in an alternative location.

Using the International Terminal as overflow

- 4.51 Auckland Airport considered using the international terminal as overflow originally in 2021. This option, named 'Integrated West' at the time, identified the risk that when international demand recovered, additional capacity would need to be made to meet demand displaced by domestic operations in the international terminal.
- 4.52 Auckland Airport states the rapid post-COVID recovery of international services means that the International Terminal is back to operating at near 2019 levels of demand, and even if harmonised screening and dwell space is achieved, the use would be limited due to a lack of stand capacity at the terminal, especially in peak hours.
- 4.53 Auckland Airport decided that the Integrated Terminal Programme remains the best option for replacing the existing domestic terminal to build resilience in the airport system and deliver the required capacity and customer experience. The ability to build an efficient contingent runway to address the issue of closing the main runway for renewal by 2028/2029 was another factor in this decision.
- 4.54 It appears that Auckland Airport has considered reasonably practicable dimensions (eg, design/scope, location, timing) when identifying the options. We note that the options considered by Auckland Airport cover those indicated by the airlines as their preferred approach, including a smaller scope and delaying and staying in DTB for longer. We refer to these two approaches next when we consider the scope, service levels and timing.

Scope of investment

- 4.55 In submissions and cross-submissions on our Process and Issues paper, substantial customers remain of the view that the scope and cost of the capital investment plan is too large.

Scope of investment and other options proposed by stakeholders

- 4.56 On capital expenditure, Qantas submitted that:¹³⁷

The Qantas Group appreciates the need for significant investment in AIAL and supports the efficient development of necessary infrastructure. However, the Qantas Group has significant concerns about PSE4 and its impacts on future PSEs including:

- *A terminal footprint around twice what is required;*
- *Construction costs around 40 per cent higher than what is efficient;*
- *Unnecessary non-terminal work;*
- *The role of PSE4 expenditure in driving future expenditure*
- *The quantum of existing expenditure;*

¹³⁷ Qantas submission, pg 1 (non-capital expenditure points omitted from reference).

- *The risk that the passage of time and the construction of preliminary stages will restrict the ability to change direction.*

4.57 In its submission, Qantas did not refer to any alternative proposal it might have.

4.58 Air NZ, in its main submission, stated:

Over PSE4 and PSE5, AIAL is proposing a significantly larger and even less achievable capital investment plan than in PSE3. AIAL's PSE4 and PSE5 capital programme totals \$5.7 - \$6.7 billion (for priced assets), which will quadruple its regulated asset base (RAB) by 2032, while delivering very little additional capacity.¹³⁸

4.59 Air NZ appointed consultant Arup to design an alternative domestic terminal (ADT) and requested Auckland Airport to consider it. Air NZ states it would cost about \$1 billion less than Auckland Airport's current plan and would retain the use of the existing domestic terminal in the medium term. It provided the conclusions to Arup's work as:¹³⁹

- *The IDT is 25-50% oversized compared to areas generated by Arup's Programme of Requirements (PoR) modelling and when considering the New Zealand domestic context.*
- *An alternative terminal design is possible that would meet Air NZ's requirements, in the same location as AIAL's IDT. This would remove nearly \$1bn from the total cost of the terminal, involve a simpler and right-sized pier, solve the operational constraints identified, and leverage the capacity freed up in the existing Domestic Terminal Building to reduce the need for immediate significant further capex contributing to further price shocks.*

4.60 Auckland Airport responded in its cross-submission on our Process and Issues paper that:

This proposal is a theoretical design which fails to consider the realities of an operating airport and the quality of experience required by all users of the airport system, including government agencies. Limited consideration has been given to the operational model for this alternative, and a proposal to split domestic jet operations across two terminals will challenge the airport system and travellers.¹⁴⁰

4.61 In its main submission on our Process and Issues paper BARNZ provided:

Capital investments of significant scale are underway, and as AIAL has disclosed, will result more than \$6 billion dollars of aeronautical spending over PSE4 and PSE5. This extremely expensive capital plan does not actually deliver improvements to capacity of the airport. The international check in space remains much the same, as do the number of international gates. By 2032, more and more investment will be necessary to ensure the airport is fit for purpose. This approach suits AIAL and its investors. It does not serve New Zealanders.¹⁴¹

¹³⁸ Air NZ submission, pg 2.

¹³⁹ Air NZ submission, pg 13-14.

¹⁴⁰ Auckland Airport cross-submission, pg 5.

¹⁴¹ BARNZ submission, pg 2.

- 4.62 Auckland Airport further responded to these submissions about the scope of its capital investment plan and about whether there were any viable alternatives. It reiterated that the disclosure outlined the 21 different designs that had been considered over more than 10 years of consultation.¹⁴² Regarding the plan by Arup put forward by Air NZ:¹⁴³

It was only after a decade of consultation had come to an end, and a decision to re-affirm Auckland Airport's commitment to the Terminal Integration Programme had been made in March 2023, that seven months later Air New Zealand provided Auckland Airport with an alternative proposal, developed by Arup that Air New Zealand refers to in its submission. Auckland Airport has carefully examined the proposal to consider whether it would identify a better pathway and give cause to change the decision to proceed with the Terminal Integration Programme. This examination revealed that it was incomplete, did not provide a better solution, or did not materially lower cost.

- 4.63 Auckland Airport elaborated that:

The key features of the Arup design provides for a new pier for domestic jet operations to be constructed in broadly the same location as the Domestic Processor Pier A1. However, this design does not integrate domestic and international operations, maintaining a separate baggage system and check-in, with integration not occurring until 2043 at the earliest. The option relies on continued jet operations out of the western end of the DTB which does not align with the Auckland Master Plan by retaining the DTB at high operational levels until at least 2043 and proposing a terminal operation with 4-front-doors.¹⁴⁴

- 4.64 We received further information from Air NZ and Auckland Airport about Arup's ADT and how Auckland Airport has considered its viability. We have published a redacted version of the information, alongside this consultation paper.

- 4.65 At a high level, the key differences between the Air NZ's ADT plan and Auckland Airport's Domestic Processor are as follows.¹⁴⁵

4.65.1 The levels of service assumptions - Air NZ's proposal targets lower levels of service within the range of International Air Transport Association (IATA) service standards than Auckland Airport's, which is assumed to offer mid-range service levels within the same IATA standards.

4.65.2 The level of integration between the new domestic and international terminals - Air NZ's proposal is an adjacent design with less integration.

¹⁴² Auckland Airport cross-submission, pg 20.

¹⁴³ Ibid, pg 20.

¹⁴⁴ Ibid, pg 22.

¹⁴⁵ Auckland Airport: *Analysis of Feasibility Study – AKL Domestic Terminal Options* (19 December 2023), pg 13, Air NZ/Arup, *Affordable Domestic Terminal Pathway* (April 2024), pg 15.

4.65.3 Estimated cost – Air NZ claims, and Auckland Airport disagrees, that the alternative proposal would cost approximately \$1 billion less, given lower levels of service assumptions and less integration. Air NZ notes that its design removes the immediate benefits but also complexity and cost of a fully integrated solution. Air NZ considers that the alternative proposal allows for integration to occur at a future time and minimises pricing shocks.

4.66 Auckland Airport engaged with the viability of the Arup design based on the information Air NZ provided at the time. This is reflected by its willingness to receive and consider the alternative that Air NZ presented after the capital investment plan consultation had closed. Auckland Airport then presented its feedback on the Arup design back to Air NZ. Auckland Airport has advised us that Air NZ did not provide it with the full Arup design reports for consideration at the time.¹⁴⁶ The full reports with appropriate redactions are now published alongside this consultation paper.

Auckland Airport's December 2023 response to Air NZ proposal

4.67 Auckland Airport stated that the Arup design was incomplete, did not meet the requirements to be a fully functional terminal, would result in poor customer experience, lacked an operational model, and offered a low level of integration.¹⁴⁷

The design is incomplete, with key operating areas like bus lounges and functional back of house space either not being provided for or not being adequate;

The design does not meet the requirements of a fully functional terminal. This includes no provision for the operation of non-passenger screening facilities which are an ICAO regulatory requirement, and an unworkable truck dock which is required to move goods and waste in and out of the terminal;

Continued use of the DTB for a portion of the domestic jet operations would mean high levels of activity at a terminal that is already delivering a sub-optimal customer experience with limited capacity. It also adds complexity into the system by dividing domestic jet operations across two terminals;

There has been no operational model put forward, and our consideration of possible models to operate jet services from two terminals shows a poor customer experience, particularly with confusion around location of arrivals and departures, and complications for international to domestic connections. There is the further issue of how aviation security and other government services would be staffed across two terminals; and

The design offers a low level of integration, which is something substantial customers have been critical of in the past. Instead, they favoured a more seamless integrated experience during consultation on the development of the terminal design.

¹⁴⁶ Letter from Auckland Airport to Commerce Commission (14 May 2024).

¹⁴⁷ Auckland Airport cross-submission, pg 22.

- 4.68 On the cost of the alternative plan, Auckland Airport stated the following costs were understated and the initial analysis reduces the cost gap between the two solutions by 90%, from \$1 billion to \$100 million.¹⁴⁸
- 4.68.1 construction cost escalation - \$92 million;
 - 4.68.2 financing costs (capitalised interest) - \$62 million;
 - 4.68.3 2 years of delay costs - \$92 million (a conservative estimate);
 - 4.68.4 functions missing that are required to operate a terminal - \$246 million;
 - 4.68.5 additional international baggage facilities were not included which are being delivered through the Domestic Processor project - \$196 million (a conservative estimate); and
 - 4.68.6 costs to close out existing commitments to the TIP - \$30 million.

Consideration on the scope for the new domestic terminal

- 4.69 Submitters argue that the costs of the planned investment are too high, and not necessary to meet the future needs of the Airport. Some submitters further argue that the large expenditure plan only serves to inflate the return gained by Auckland Airport rather than it being in the best interest of consumers.
- 4.70 On the scope of the proposed Domestic Processor, Auckland Airport's disclosure explains:
- 4.70.1 The cost of the terminal largely lies with its floor size, which needs to be between 6000-7000m²per million passengers according to studies commissioned by Auckland Airport.
 - 4.70.2 An improvement in capacity is needed as the current domestic terminal is over capacity.
 - 4.70.3 Compared to the current domestic terminal which only has 10 Code C stands, and 6 that can facilitate A321 operations, the Domestic Processor will double the A321 capacity to 12, as well as the ability to fly Code E aircraft in peak times if airlines desire.

¹⁴⁸ Auckland Airport cross-submission, pg 21-22.

- 4.71 The current DTB has a capacity of 1,250 domestic passengers per hour, whereas the new domestic terminal is planned to handle 1,800 departing domestic jet passengers at peak hour. The busy hour passenger numbers in Schedule 20a of the PSE4 disclosure shows the outbound domestic passenger is forecast to be 1,236 in 2023, increasing to 1,802 by 2032. The size and scope of the planned new domestic terminal are in alignment with the forecast busy hour passenger numbers.
- 4.72 We recognise airlines have a different view on the dampening effect on demand that higher airport charges would have. However, there is consensus that the existing DTB is facing increasing capacity constraint. The peak forecasts suggest that a slower increase in utilisation does not negate the need to invest in greater capacity for growth.

Will Auckland Airport be able to provide service quality in line with consumer demand?

- 4.73 Airports may have some incentive to under-forecast the demand used to derive its prices, in order to earn higher profits. The reasonableness of Auckland Airport's demand forecasts as they relate to profitability is assessed in Chapter 3 of this paper.
- 4.74 This section considers how Auckland Airport has considered demand and service quality when planning its capital expenditure programme.

Capacity needs

- 4.75 Auckland Airport states that the ageing domestic terminal was operating significantly over capacity during 2019 and is expected to be over capacity again in 2024.¹⁴⁹ The current domestic capacity of the domestic terminal is 1,250 domestic passengers per hour. During 2019, there were 12 days where that capacity was exceeded. Auckland Airport expects that if no further capacity investment is made, by 2026 the number of days over capacity would increase to 58 days per year, and by 2033 it would be near continuous at 296 days per year.¹⁵⁰
- 4.76 Capacity would be further strained during the period where the main runway would need to be renewed if an efficient contingent runway is not in place by then.
- 4.77 Auckland Airport engaged DKMA to assist in preparing demand forecasts for the PSE4 period. Regarding how demand forecasts influence plans for capital expenditure, Auckland Airport provides:¹⁵¹

Given the disruption caused by the pandemic, initial capital planning was based with reference to pre-pandemic peak period demand forecasts, which were then updated reflecting the anticipated rate of post-pandemic recovery. These forecasts were then

¹⁴⁹ Auckland International Airport Limited: *Price Setting Disclosure – Appendix A* (17 August 2023), pg A-18.

¹⁵⁰ Auckland International Airport Limited: *Extract of Board Paper* (16 March 2023), pg 32.

¹⁵¹ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 84.

updated with the more detailed DKMA post-pandemic forecasts, with adjustments made to planning assumptions where required.

- 4.78 Submitters are concerned that the increase in aeronautical prices may influence demand. Air NZ stated:¹⁵²

AIAL's price increases over PSE4 and PSE5 will have significant demand impacts. This will be felt most acutely by customers using Air NZ's domestic and regional services... This reduction in volume is significantly higher than AIAL's forecasts and will ultimately lead, at the next pricing reset, to much higher prices than are currently being signalled by AIAL for PSE5. AIAL's high case capex scenario will lead to an even more significant suppression of demand and even higher prices from PSE5 onwards.

- 4.79 Auckland Airport states that aeronautical charges make up a small fraction of an airfare (less than 5%), and that decisions on any PSE5 prices have not been made and would only occur after further consultation with its substantial customers.¹⁵³ Investment in the infrastructure to provide increases in service quality and capacity would also promote competition. The Airport elaborates that:¹⁵⁴

This is in contrast to Air New Zealand increasing domestic and regional airfares by an average of \$70 (or 56%) post the pandemic in the absence of any material increase to airport charges and with little impact on demand.

- 4.80 We note that Auckland Airport recognised the current capacity issues of the DTB and had regard to the potential size of the passenger base that it would need to serve in the future.
- 4.81 Airlines broadly agree that there are capacity issues with the existing DTB as well. We consider that in general, additional capacity enables new airlines to enter markets and promotes competition, which benefits consumers. As was the case in PSE3, route incentive payments remain in place to promote new routes through the Airport. It is also relevant as to how soon the new domestic terminal with the increased capacity would be required, as passenger numbers are projected to grow over time. We discuss the timing of the investment later in this chapter.

¹⁵² Air NZ submission, pg 4.

¹⁵³ Auckland Airport cross-submission, pg 4.

¹⁵⁴ Ibid, pg 4.

Service level

- 4.82 In its submission IATA states that Auckland Airport’s sole use of the Airport Council International (ACI) Airport Service Quality (ASQ) survey alone is not a sufficient measure of service level due to the subjectiveness of the responses, and a more objective measure would be more appropriate.¹⁵⁵ IATA states that “Leading airports and regulators globally utilize the IATA Level of Service (LoS) as best practice guidance to inform capacity and demand studies...to identify the “Optimum” level of service”.¹⁵⁶
- 4.83 Auckland Airport considered the IATA Optimum level of service when planning the Domestic Processor. In May 2022, a benchmark summary for planned level of service by Auckland Airport showed:¹⁵⁷

Table 4.4 Service level benchmarks

Function	Domestic Processor	Average Peer Airports	IATA Optimum
Check-in wait time (mins)	3	6	2-5
Security wait time (mins)	2	2	5-10
Airside dwell (m2/pax)	2.3	1.7	1.8-2.2
Gate lounges (m2/pax)	1.1	1.2	1.5-1.7
Reclaim (belt length/pax)	0.3	0.3	0.3-0.5
Plant (% of total area)	23%	15-20%	N/A

- 4.84 The 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 to peer airports.

¹⁵⁵ International Air Transport Association: “IATA Feedback on Proposed Review of Auckland Airport’s 2022-2027 Price Setting Event” (31 January 2024) (**IATA submission**), pg 4.

¹⁵⁶ Ibid, pg 4.

¹⁵⁷ Auckland International Airport Limited: *Extract of Board Paper* (16 March 2023), pg 20.

- 4.85 Auckland Airport considered proposals to reduce dwell space via floorplate reductions as part of the review of the Draft Capital Plan, through value engineering. Plant and check-in space have also been reduced through subsequent design phases.¹⁵⁸ The Plantroom structure changes reduced the estimated build cost by around \$20 million.¹⁵⁹ Air NZ and Arup claimed that the airside dwell space was too high at 2.3m²/pax (with the IATA optimum range being 1.8-2.2m²/pax). Auckland Airport noted that this dwell space was not reduced during value engineering as it needed to compensate for the smaller gate lounges which fall below the lower end of the IATA optimum level of service and peer airports (1.1m²/pax compared to 1.5-1.7m²/pax).¹⁶⁰
- 4.86 When it comes to the in-airport experience of passengers, airlines may not always have a strong interest to keep service level high (excluding VIP lounges which are not priced, but leased). It is important for Auckland Airport to consider what service levels passengers want. Auckland Airport considered direct passenger feedback when deciding on the scope and design of the Domestic Processor and TIP.¹⁶¹
- 4.87 Overall, our draft conclusion is that the service levels that Auckland Airport is targeting for the design of the new domestic terminal do not appear to be excessive, in comparison to the IATA Optimum Level of Service standards or the average peer airports.

Are Auckland Airport's plans costed appropriately?

- 4.88 The PSE4 disclosure does not contain detailed information on how projects are costed. Auckland Airport provided some clarification in its submission on our Process and Issues paper.
- 4.89 Auckland Airport has commissioned external cost estimators in preparing its expenditure forecasts:¹⁶²

Project cost estimates for specific infrastructure projects are informed by advice from external cost estimators based on the scope and requirements supplied to them by Auckland Airport. Cost estimates reflect the holistic cost of designing, constructing and commissioning assets into operational use and include all ancillary costs such as consenting, project management, construction monitoring and holding costs.

¹⁵⁸ Auckland International Airport Limited: *Extract of Board Paper* (16 March 2023), pg 19-20.

¹⁵⁹ Auckland Airport, Response to Commerce Commission request for information (24 April 2024), pg 6.

¹⁶⁰ Ibid, pg 5.

¹⁶¹ Auckland International Airport Limited: Price Setting Disclosure (17 August 2023), pg 27.

¹⁶² Auckland Airport submission, pg 37.

- 4.90 There are varying levels of cost certainty based on how near completion each project is. Projects that are near completion have the highest level of cost certainty. Auckland Airport has assessed the overall cost certainty of its capital expenditure plan as 'P50' meaning the likelihood of the final cost either exceeding or being less than forecast is 50/50, or evenly balanced.
- 4.91 The costing process determined the real/current day costs of delivering projects, nominal project costs were prepared by construction cost escalation forecasts. Cost manager Rider Levett Bucknall (RLB) derived a construction cost escalation forecast for types of building activity relevant to Auckland Airport's projects, which were used in forecasts of the capital plan.¹⁶³

Cost increase drivers

- 4.92 Compared to the pre-COVID version of the new domestic terminal, project costs have increased significantly. The increases tend to be for a wide range of factors. This section aims to highlight the main drivers for the cost increases, and how Auckland Airport responded to the escalation.
- 4.93 Auckland Airport states that the main drivers of cost increase are scope and market feedback on cost, methodology and programme, and increases to construction costs. A comparison of proposals since terminal integration was proposed is below:¹⁶⁴

Table 4.5 Cost escalation of domestic terminal plans

Estimate Date	Project Reference	Cost Estimate (including Capitalised Interest escalation \$m)	Scope notes
Pre-COVID, 2019	Domestic Jet Hub, Separable Portion 1 and Separable Portion 1x	\$1,203	3x reclaim carousels; Early Bag Store and Power Centre 11 works excluded ¹⁶⁵
Post-COVID, 2020	Paheko East	\$1,540	Feasibility design; 2x reclaim carousels, Early Bag Store and Power Centre 11 infill included

¹⁶³ Auckland Airport submission, pg 37.

¹⁶⁴ With permission from Auckland Airport, the table is reproduced from Auckland International Airport Limited: *Extract of Board Paper* (16 March 2023), pg 27. Auckland Airport also provided additional clarification on the scope notes. The estimates represent the total cost for the Domestic Processor, including both the regulated and unregulated elements.

¹⁶⁵ We understand this reflects a concept design.

Estimate Date	Project Reference	Cost Estimate (including Capitalised Interest escalation \$m)	Scope notes
February 2022	Domestic Processor Feasibility Design	\$1,860	As Feasibility design with adjustment to base rates from Early Contractor Involvement environment ¹⁶⁶
July 2022 ¹⁶⁷	Domestic Processor Concept Design	\$2,210	As Feasibility design with floor area changes (add level 3 plant, level 1 departures, level 2 lounges and Baggage Handling System); further changes to costs and Preliminary & General from Early Contractor Involvement; adjustments to professional fees
October 2022 ¹⁶⁸	Domestic Processor Preliminary Design	\$2,380	As Feasibility design with floor area changes – omit small section of level 3 plant [REDACTED], add increased non-passenger screening [REDACTED] and reclaim hall [REDACTED]; further changes to Baggage Handling System integrator costs [REDACTED]; Preliminary & General [REDACTED] Capitalised Interest / escalation relative to Gross Floor Area increase and schedule push out [REDACTED]; adjustments to professional fees, contingencies and third party costs [REDACTED]

4.94 The Domestic Processor is estimated to cost \$2.1 billion for the regulated elements in the PSE4 disclosure. It is not uncommon for the cost estimate of complex infrastructure assets to increase, as the design is developed and refined through stages. This is because the more detailed the design becomes, the more complete the costing can be.

4.95 We note that given the level of concerns raised by airlines on the scale and cost of the proposed investment, Auckland Airport held workshops with airlines to consider opportunities to reduce cost, assess certainty of the timing and scope of key projects, and consider scope optimisation, value engineering opportunities and trade-offs. However, some customers consider this had little impact.

¹⁶⁶ We understand this means early construction contractor feedback on costs.

¹⁶⁷ We understand the cost estimate report was underway in July but was finalised in August.

¹⁶⁸ We understand the cost estimate for the preliminary design was under review in October but was confirmed in November.

- 4.96 Auckland Airport states that Air NZ and BARNZ both supported the previous 'Paheko East' iteration of the capital expenditure for the priced activities in 2021 which costed, over the 10-year period of PSE4 and PSE5, only 5.4% less than the current proposal considering the increases to construction costs.¹⁶⁹ The Airport elaborates that:

The Paheko consultation was based on a total value of priced aeronautical capital investment from FY23-32 of \$5,389 million to be commissioned into the asset base. The forecast for PSE4 priced base case capital investment plan has increased 5.4% or \$293 million over 10 years at \$5,682 million, compared to the Paheko capital plan supported by Air New Zealand and BARNZ in 2021.

- 4.97 Auckland Airport considers that an increase of \$293 million for the project over 10 years is a regrettable but modest increase considering the large and complex nature of the capital investment plan.¹⁷⁰

Benchmarking

- 4.98 Auckland Airport benchmarked the cost estimate for the new domestic terminal against overseas airports on a cost-per-gate basis.¹⁷¹ The proposed terminal appears to be broadly in line with projects in developed countries. A recent comparable development from Manchester Airport had a project cost estimate of \$1.9 billion NZD, or \$177 million per gate, whereas the proposed Domestic Processor's real cost per gate sits at around \$145 million (\$180 million in nominal terms). A project due to be delivered around the same time as the Domestic Processor from JFK Terminal 6 costs \$681 million per gate, or \$6.8 billion to provide 10 gates.

Our draft conclusion

- 4.99 In our review of the PSE3 of Auckland Airport, we concluded that the Airport's capital cost estimates did not appear to have been costed inappropriately.¹⁷² We noted that the Airport had its Terminal Development Plan (its single largest capital project in the PSE3 period) independently costed and then independently peer reviewed, which indicated that the Airport has applied a high level of rigour in the costing of its forecast capital expenditure plan. In PSE4, Auckland Airport has taken a similar approach when costing the capital expenditure plan.

¹⁶⁹ Auckland Airport cross-submission, pg 19.

¹⁷⁰ Auckland Airport cross-submission, pg 19.

¹⁷¹ Auckland International Airport Limited: *Extract of Board Paper* (16 March 2023), pg 16-17.

¹⁷² Commerce Commission, [Review of Auckland International Airport's Pricing Decisions and Expected Performance \(July 2017 – June 2022\)](#) (1 November 2018), paragraph 183.

- 4.100 For PSE4, we have requested and received additional clarification about independent verification of capital expenditure undertaken to date by Auckland Airport. The Airport showed that independent reviews on either the whole capital plan, or specific aspects of the plan, was sought on 12 occasions. The most recent review of the entire capital plan occurred before COVID-19 in 2019 by McKinsey and Company. Since then, Auckland Airport sought advice on 11 occasions to update the 2019 estimate. Areas of review were informed by issues raised by substantial customers during consultation and Auckland Airport sought external advice in response.¹⁷³
- 4.101 RLB is the cost estimator for the Domestic Processor Project, and Beca is the estimator for the Terminal Integration Enabling Projects. Each estimator has been responsible for reviewing the other's work.¹⁷⁴
- 4.102 We have information on how the capital expenditure forecast was costed and the level of rigour applied to the forecast. We have benchmarking information from Auckland Airport, which provides a high-level comparison. We received further information from Auckland Airport following our inquiries discussed above. Considering the information available to us, the process and rigour Auckland Airport applied when costing the capital expenditure plan was reasonable.

Investment timing

- 4.103 Some submitters to our Process and Issues paper stated a preference to delay the investment in the new domestic terminal and to stay in the current DTB for longer with some upgrade to address the current service quality issues. Auckland Airport considered this option, and its response is set out in paragraph 4.50 above.

Contingent runway operation

- 4.104 Other than the consideration of when the forecast demand would trigger the need for capacity, the timing of the required contingent runway operation also affects the sequencing of a number of interdependent projects in our view.
- 4.105 The centre sections of the main runway are due to be renewed by the end of this decade. As a single runway operation, Auckland Airport must appropriately manage the disruptions that this renewal work will create.
- 4.105.1 A contingent runway (Alpha) needs to be set up to maintain landing and take-off operations during the period when the main runway is closed for periods in the order of months.

¹⁷³ Auckland Airport, Response to Commerce Commission request for information, (24 April 2024), pg 1.

¹⁷⁴ Auckland Airport, Response to Commerce Commission request for information, (2 May 2024).

- 4.105.2 A taxiway (Bravo) is required to support the contingent runway operation.
- 4.105.3 The DTB footprint encroaches on the taxiway (Bravo), limiting the capacity of aircraft movements, when the contingent runway (Alpha) is in operation.
- 4.105.4 The decommissioning and removal of DTB would enable an efficient operation of the contingent runway (Alpha), through a re-aligned taxiway (Bravo).
- 4.105.5 A new domestic terminal would need to start to be built now, in time for transitioning domestic terminal operation from DTB to the new domestic terminal. The DTB can then be de-commissioned, which will make space for the taxiway (Bravo) realignment and support an efficient operation of the contingent runway (Alpha). This allows Auckland Airport to maintain operations when the main runway is closed for pavement renewals.

Cost of delay

- 4.106 Auckland Airport notes that delaying the TIP would likely come at additional cost due to the cost escalation through passage of time. Inflation in the construction sector means costs generally rise over time. Even when inflation trends down, the cost still goes up albeit at a slower pace.
- 4.107 Auckland Airport modelled scenarios where the TIP is delayed by 5 years, assuming projects well underway would continue and future allowance are made for the sunk costs associated with some of the design and enabling costs to date. At an annual escalation between 2% to 5% from 2030 onwards, the Airport estimated that the delay would cost an additional \$424 million to \$685 million for the overall programme, and \$353 million to \$569 million for the priced capex component of the programme.¹⁷⁵
- 4.108 Delaying projects can have benefits, if for example, more information and technological advancement could become available in the future, which could inform the investment decisions. As the project cost is escalated through inflation over time, so is the associated revenue in the form of airport charges in this case. Until the investment for growth is made, there is an opportunity cost associated with the capacity constraint, which is present at the DTB currently.

¹⁷⁵ Auckland International Airport Limited: *Extract of Board paper* (16 March 2023), pg 29.

Our draft conclusion

4.109 Our draft conclusion is that there appear to be operational and financial reasons for Auckland Airport to proceed with the TIP now. The enablement of an efficient contingent runway operation would not only benefit the main runway pavement renewals, but also improve the resilience of the runway operations in general. If the investment is deferred because the cost to build and associated increases in airport charges are considered too high, postponing the same investment into the future is unlikely to address this concern.

Investment delivery

4.110 The submissions highlight a tension between Auckland Airport and its substantial customers regarding the levels of capital delivery. Substantial customers suggest that the Airport has underinvested historically,¹⁷⁶ and is only now, with construction costs high, spending in a 'catch up' manner to increase its margins.¹⁷⁷ Auckland Airport claims that historically, substantial customers oppose investment, and then once investment occurs, criticise the Airport of underinvesting.¹⁷⁸

4.111 To consider the claims made by both Auckland Airport and its substantial customers, we reviewed historical actual capital expenditure, to see what Auckland Airport has spent over PSE2 and PSE3 periods.

Table 4.6 Actual capital investment delivery PSE2-PSE3

(Figures in \$m)	PSE2 (2013-2017)	PSE3 pre-COVID (2018-2019)	PSE3 COVID (2020-2022)
Forecast total	290	762	1,584
Actual total	522	332	563
Difference	232	-430	-1021
Cumulative difference	232	-198	-1,219

¹⁷⁶ BARNZ submission, pg 2.

¹⁷⁷ BARNZ submission, pg 7.

¹⁷⁸ Auckland Airport submission, pg 5.

Analysis of actual investment

- 4.112 In our PSE3 review, we found that overall Auckland Airport had not had issues with under-delivery of capital expenditure in PSE2. Relative to its PSE2 forecast, the Airport spent \$232.1 million more on capital expenditure, due to passenger growth and changes to project plans. During PSE3, COVID-19 disrupted major investment plans and substantial customers agreed to the pause. The pause included the development of the DJF, a previous version of the new domestic terminal. The project was announced in February 2020 and was scheduled to start in August 2020, but was terminated in March 2020 due to COVID-19.
- 4.113 It appears that in the years pre-dating COVID-19 in PSE3 (2018-2019), there was a significant underspend in capital expenditure. This lack of delivery was due to extensive consultation with substantial customers on the design of interrelated projects, including the new domestic terminal. We note that during the COVID-19 period in PSE3, although Auckland Airport paused major growth driven projects, it continued to undertake and bring forward asset renewals, taking advantage of the low traffic environment when the border was closed.
- 4.114 So far in PSE4, it appears that Auckland Airport is on track to deliver its capital expenditure forecast. As of 31 December 2023, it had spent over \$600 million during the second year of the pricing period against its year two forecast of \$902 million.¹⁷⁹
- 4.115 When viewing PSE2, PSE3 and the beginning of PSE4, Auckland Airport has largely delivered on its investment goals, except for the beginning of PSE3 which followed a period of over-spend relative to its forecast, delivering additional capacity demanded by market growth. The significant under-investment over the COVID affected period in PSE3 ought to be treated as an outlier and not reflective of regular practice. Overall, we do not have significant concerns over planned over and under-investment historically; under-delivery risk in PSE4 is also mitigated by the one-way capex delivery wash-up introduced by Auckland Airport.

Capex delivery wash-up

- 4.116 Auckland Airport has introduced two wash-up mechanisms for PSE4. One of them is a one-way capital expenditure wash-up mechanism that would favour airlines if triggered. The wash-up would be triggered if the total assets commissioned fall short of forecast by 7.5% or more and there is an actual post-tax priced Internal Rate of Return (IRR) that exceeds target return by 0.75% or more. If triggered, the value carried forward to PSE5 opening RAB would be equal to the lesser of the economic value of the capex shortfall over and above the 7.5% threshold, and the IRR surplus over and above the 0.75% threshold.

¹⁷⁹ Auckland Airport: [Interim Results Presentation](#) (13 February 2024), pg 13.

4.117 The capex delivery wash-up will compensate airlines if Auckland Airport under-delivers on the expenditure forecast to a certain extent and it drives the actual PSE4 return above what is targeted in the forecast.

4.118 On the capex wash-up BARNZ submitted to our Process and Issues paper:¹⁸⁰

BARNZ was pleased to see AIAL propose this initiative. However, we consider the 15% trigger is too high. This wash-up would only apply if the airport failed to deliver some \$400 million in capex. BARNZ considers this would be more appropriately set to 5%. Given airlines are required to pay prices regardless of whether capex is delivered, this seems a more reasonable position given the scale of the proposed investment.

4.119 Auckland Airport responded in its cross-submission:¹⁸¹

The capex underspend threshold was reduced during consultation in response to airline feedback. It was originally proposed at 15%, the threshold cited by BARNZ in its submission, but was reduced to 7.5% in Auckland Airport's final decision, which is closer but still slightly higher than the 5% called for by BARNZ in its submission to the Issues Paper.

4.120 Air NZ stated:¹⁸²

Air NZ considers the threshold AIAL proposes before this is triggered is far too high. Air New Zealand estimates that, all other things being equal, AIAL would need to underspend PSE4 capex by ~20% / \$530m before any adjustment would be required. This equates to excess revenues (return of and on capital) of ~ \$160m before any adjustment is required.

Air NZ believes that the adjustment mechanism, as proposed, incentivises AIAL to set capex forecasts which it would under any scenarios exceed and essentially guarantees that AIAL will earn, ex post, its target return on capital. This is not consistent with the concept of ex-ante regulation or financial capital maintenance.

Air NZ believes that the capex wash-up should not include the IRR test, so that the adjustment would be paid out if AIAL underspend its forecast capex. This is consistent with the IRIS approach applied under DPP regulation.

4.121 In response to Air NZ's second point above, Auckland Airport stated:¹⁸³

Auckland Airport is not entirely sure what point Air New Zealand is attempting to make with this statement and struggles to follow some of the logic. It is unclear to Auckland Airport why the mechanism incentivises Auckland Airport to set capex forecasts that it is likely to exceed given the thresholds. But if it did, would this not mitigate the unfounded concerns raised by airlines in their submissions that Auckland Airport has incentives to underinvest. It is also not clear why a capex wash-up that is one way and can only benefit airlines, would guarantee Auckland Airport achieving its target return on capital.

4.122 And in response to the third point, Auckland Airport stated:¹⁸⁴

¹⁸⁰ BARNZ submission, pg 7.

¹⁸¹ Auckland Airport cross-submission, pg 32.

¹⁸² Air NZ submission, pg 15.

¹⁸³ Auckland Airport cross-submission, pg 32.

¹⁸⁴ Ibid, pg 32.

The IRR test is an important element of the capex wash-up, as the intent of Part 4 is to ensure that Auckland Airport is constrained in its ability to earn excess profits, and the IRR trigger is consistent with this outcome. If the capex wash-up without an IRR trigger applied in PSE3, as suggested by Air New Zealand, this would have resulted in a wash-up to the favour of airlines, despite airport returns being well below target. It would have penalised Auckland Airport for making reductions to the capex plan that were responsible and prudent at the time. Auckland Airport once again emphasises that the capex wash-up is one-way and can only benefit airlines.

- 4.123 In our PSE3 review, we considered that Auckland Airport could consider introducing a carry-forward/wash-up mechanism to manage the delivery risk of the significant Terminal Development Programme (the previous iteration of the TIP). In our PSE4 review of Wellington Airport, we noted that risks should be allocated to suppliers or consumers depending on who is best placed to manage them, unless doing so would be inconsistent with the purpose of Part 4.¹⁸⁵ We did not have concerns over the demand, revenue and net revaluation gain wash-ups that Wellington Airport agreed with its customers.
- 4.124 We consider that the introduction of the one-way capex wash-up mechanism for PSE4 shows that Auckland Airport is cognisant of the risk of under-delivery. Without any mechanism, the underinvestment risk primarily sits with airlines. Auckland Airport is better placed to manage the investment delivery risk. We consider the mechanism provides the right incentives, and was reached following concession during consultation with substantial customers (with the 7.5% value previously set at 15%).

¹⁸⁵ Commerce Commission, [Review of Wellington Airport's 2019-2024 Price Setting Event](#) (28 September 2022), paragraph X20.

Chapter 5 Pricing Structure

Overview

- 5.1 This chapter contains our analysis and draft conclusions on the extent to which Auckland Airport's pricing method is likely to result in prices that raise efficiency concerns.
- 5.2 This analysis is relevant to the extent to which Auckland Airport has incentives to set prices that are likely to promote efficiency (s 52A(1)(b) of the Act).
- 5.3 Auckland Airport indicated in its disclosure that the pricing structure is largely unchanged from PSE3, and that the main change is to the wash-up mechanisms.¹⁸⁶
- 5.4 For PSE3, we concluded that Auckland Airport had made changes to its pricing structure that were likely to improve efficiency. These efficiency improvements included the introduction of differential charges for domestic passengers travelling on trunk and regional routes, the introduction of parking charges for planes with time on the ground over six hours and differentiated charges for check-in services. We also concluded that Auckland Airport appeared to have set prices transparently in PSE3 and had regard to price stability and certainty for stakeholders.
- 5.5 Given that Auckland Airport has made minimal changes to its pricing structure from PSE3, and given our conclusions for PSE3, we have limited our review of Auckland Airport's pricing structure for PSE4 to matters raised by stakeholders. We have not discussed the wash-up mechanisms in this chapter as we have covered this matter in chapters 3 and 4.
- 5.6 A pricing issue of concern to stakeholders is the change to aircraft parking charges. Auckland Airport introduced aircraft parking charges in PSE3, and in PSE4 has changed the method for setting these charges. For PSE3 charges were set on a per hour basis, with an exemption for freighters of 48 hours before charges were incurred. For PSE4, the 48-hour exemption period for freighters has been reduced to 12 hours.
- 5.7 Stakeholders are also concerned about the relatively high increase in regional charges.

Draft conclusion

- 5.8 Given that there are minimal changes to the pricing structure, we have no reason to change our overall conclusion from the PSE3 review that in general, Auckland Airport's pricing method does not result in prices which raise efficiency concerns.

¹⁸⁶ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 65.

- 5.9 In relation to the pricing structure changes that have been made, we consider that Auckland Airport has not provided sufficient explanation for making the change to the 48-hour parking exemption for domestic freighters. We welcome more information from Auckland Airport on how it considers the change will lead to the more efficient use of airfield parking space.

Stakeholder Views

- 5.10 Auckland Airport explained the reason for the change to aircraft parking charges as follows:

One driver of current congestion challenges is parked domestic freighter aircraft which currently have an exemption from aircraft parking charges for the first 48 hours of time on ground. As was summarised in CP2, such freighters are only charged aircraft parking charges on an hourly pro-rata basis after that 48 period. The operation of this exemption is having the effect of undermining the purpose of the aircraft parking charges, being to support the efficient use of the airfield space for aircraft traffic given the scarcity of available space. Auckland Airport has also identified that in the absence of any reasonable justification for this exemption, its operation is disadvantaging airlines who are required to pay parking charges in excess of 6 hours of parking.¹⁸⁷

- 5.11 Freightways and NZ Post, who were not party to Auckland Airport's consultation process because they are not substantial customers, submitted on our Process and Issues paper that it is not possible for them to avoid the parking charges that will be incurred because of the reduction in the exemption period:

Accordingly, our aircraft are parked for up for between 13 to 16 hours per day and 67 hours during the weekend. It is not possible for FRW and NZP to operate flights outside of current hours because New Zealand businesses demand freight operations that allow them to manufacture or load out orders all day typically for pick up around 5pm which allows for delivery nationwide the next day (and to businesses by 9am). Our respective networks are based around this operating model and therefore there is no way for FRW and NZP to avoid the proposed parking charges.¹⁸⁸

- 5.12 Freightways and NZ Post have calculated that the change to the exemption period will cause their combined costs to increase by \$1.17 million per annum (139% per annum) for the next three years.¹⁸⁹

¹⁸⁷ Auckland International Airport Limited: *Price Setting Event 4 Reasons Paper* (June 2023), pg 62.

¹⁸⁸ Freightways & NZ Post submission, pg 2.

¹⁸⁹ Ibid, pg 3.

5.13 Additionally, Freightways and NZ Post have submitted that there may be an error in the building block model because they have been advised by Auckland Airport that the total increase in parking revenue is \$1 million for 2025, which is less than the increase that they are expecting ParcelAir to pay.¹⁹⁰ ParcelAir is their service provider, which is 50% owned by Freightways/NZ Post, and according to Auckland Airport accounts less than 5% of airfield parking revenue.¹⁹¹

5.14 BARNZ criticised the process that led to the change to parking charges:

Submissions from Freightways and New Zealand Post demonstrate the frustration felt by customers of the airport, and support BARNZ's submission that attention needs to be paid to those customers who are price takers for AIAL pricing but who are not consulted with as they are not members of BARNZ.¹⁹²

5.15 In relation to other pricing structure matters, Air NZ requested that we consider whether customer groups are getting value from a given price increase. For example, Air NZ requested we compare:

[the] price increases for passengers transiting between international and domestic jet flights, to passengers transiting between domestic jet and regional flights.¹⁹³

5.16 BARNZ submitted that a concerning aspect of the pricing structure was the effect on small airlines:

AIAL may have retained pricing structures, but the price rises applied across structures are not uniform. As well as the transit charges and parking changes noted by the Commission, AIAL has introduced a step change to regional aircraft. These changes disproportionately impact small airlines operating from Auckland Airport.¹⁹⁴

Analysis

5.17 In our report on PSE3, we concluded that Auckland Airport appeared to have set prices transparently in PSE3 and had regard to price stability and certainty for stakeholders. Our conclusion was as follows:

Overall, we consider that Auckland Airport has continued to seek improvements to the efficiency of its prices. We note several positive steps, including the introduction of:

differential charges for domestic passengers travelling on trunk and regional routes, further reducing the likelihood of cross-subsidisation between customer groups;

parking charges for planes with time on the ground over six hours (with specified exemptions), in order to improve stand and apron efficiency; and

differentiated charges for check-in services (to distinguish between traditional check-in counters, common-use bag drop facilities and dedicated kiosk/bag drop

¹⁹⁰ NZ Post & Freightways submission, pg 3.

¹⁹¹ Auckland Airport, Response to Commerce Commission request for information, (2 May 2024).

¹⁹² BARNZ cross-submission, paragraph 7.

¹⁹³ Air NZ submission, paragraph 72.

¹⁹⁴ BARNZ submission, paragraph 47.

facilities), which have improved the ability for airlines to make price-quality trade-offs.¹⁹⁵

5.18 This conclusion was based on an assessment of whether Auckland Airport’s pricing method was likely to result in prices which raised efficiency concerns after considering the following pricing efficiency principles.¹⁹⁶

5.18.1 Prices should be subsidy free;

5.18.2 Prices should have regard to consumers’ demand responsiveness;

5.18.3 Where a good or service is scarce, the price should help ensure that the good or service is consumed by those that value it the most;

5.18.4 Prices should enable consumers to make price-quality trade-offs or nonstandard arrangements for services, where practical, to reflect the value they place on services; and

5.18.5 The development of prices should be transparent, and promote price stability and certainty for consumers, where demanded.

5.19 We have limited our review of Auckland Airport’s pricing structure for PSE4 to matters raised by stakeholders, as Auckland Airport has made minimal changes to its pricing structure from PSE3.

Aircraft parking charges

5.20 We understand that Auckland Airport was concerned that the 48-hour parking exemption for freighters did not provide an incentive for freighters to more efficiently use the airfield space. Auckland Airport indicated that the freighter exemption “was having the effect of undermining the purpose of the aircraft parking charges, being to support the efficient use of the airfield space for aircraft traffic given the scarcity of available space”.¹⁹⁷

5.21 Our understanding of the main concern raised by Freightways/NZ Post is that the change to the parking exemption period will result in additional charges that cannot be avoided.

¹⁹⁵ Commerce Commission “[Review of Auckland International Airport’s pricing decisions and expected performance \(July 2017 – June 2022\)](#)”, paragraph 322.

¹⁹⁶ This is consistent with our approach in the section 56G review. For example, see Commerce Commission “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– Section 56G of the Commerce Act 1986” (31 July 2013), paragraph D15.

¹⁹⁷ Auckland International Airport Limited: *Price Setting Event 4 Reasons Paper* (June 2023), page 62.

- 5.22 In relation to the concern raised by Freightways/NZ Post that there may be an error in the model, we have not found evidence of an error. Auckland Airport indicated that the removal of the aircraft parking exemption is expected to increase revenue by approximately \$1.5 million per annum from the 2025 fiscal year.¹⁹⁸ This is more than the increased amount that Freightways/NZ Post are expecting to pay, and indicates the concern raised by Freightways/NZ Post that there may be an error in the model is not apparent.
- 5.23 Auckland Airport has advised us that the additional revenue that this change is expected to recover has been offset against airfield landing charges, as parking and landing charges are within the same cost category (airfield assets).¹⁹⁹
- 5.24 We sought clarification from Auckland Airport about the extent that higher parking charges being faced by ParcelAir will be offset by lower landing charges to ParcelAir. Auckland Airport responded that ParcelAir's landing charges would be lower by 1% because of the change to the exemption period.²⁰⁰
- 5.25 Our understanding of the change to the exemption period, therefore, is that it will result in a transfer of revenue from freighters to Auckland Airport's customers who incur airfield landing charges. The change will not directly affect Auckland Airport's revenue.
- 5.26 While we understand why Auckland Airport would want to make a change so that prices are charged consistently across customer groups, in this situation, it is not clear from the information provided how the change will lead to an improvement in the efficiency of Auckland Airport's prices. This is because Freightways/NZ Post have indicated that they are not able to change their operations, which means that the pricing change may not result in a more efficient use of the airfield space.
- 5.27 Overall, we agree that the change to the exemption period for freighters will provide a consistent signal to all users of the value of airfield parking. However, we do not consider that Auckland Airport has provided sufficient explanation for making this change. We welcome more information from Auckland Airport on how it considers the change will lead to the more efficient use of the airfield parking space.

Effect on regional airlines

- 5.28 As noted above, BARNZ requested that we review the effect the price increases have on small airlines operating out of Auckland Airport and Air NZ requested we review the different pricing effects on domestic and regional customers.

¹⁹⁸ Ibid, page 62.

¹⁹⁹ Auckland Airport, Response to Commerce Commission request for information, (22 April 2024).

²⁰⁰ Auckland Airport, Response to Commerce Commission request for information, (2 May 2024).

5.29 The disclosure indicates that between 2023 and 2024 revenue per passenger for regional services increased by \$2.67 (from \$4.43 to \$7.10, or 60%) whereas revenue per passenger for domestic jet services increased by \$3.52 (from \$6.73 to \$10.25, or 52%) and revenue per passenger for international services increased by \$9.38 (from \$23.39 to \$32.78, or 40%).²⁰¹

5.30 Auckland Airport has explained the increase in domestic charges as follows:

Domestic charges have been 40-50% lower than comparable airports in the Australia and New Zealand region for a number of years. The PSE4 increases will bring prices in-line with those at comparable airports.²⁰²

5.31 and

For FY24, notwithstanding the step-up following the price freeze, domestic and regional charges will remain well below that of Christchurch and Wellington airports. In FY27 real domestic jet charges will be slightly lower than both Christchurch and Wellington airports' real FY24 charges, while real regional charges will be lower than Wellington, and consistent with those at Christchurch.²⁰³

5.32 Auckland Airport has not provided specific information on the reasons for why the pricing effects on domestic and regional customers are different. However, the domestic and regional charges are the outworkings of the expenditure and demand assumptions in the building block model. There is no particular reason why increases should be uniform (the same percent change) as BARNZ suggests. Auckland Airport has noted that the new prices will result in greater alignment between the domestic and regional charges across New Zealand airports.

5.33 Overall, we have no basis for considering the regional charges are inefficient.

²⁰¹ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 14.

²⁰² Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 13.

²⁰³ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 15

Chapter 6 Innovation

Overview

- 6.1 As we originally noted in the s 56G reports, airports generally have incentives to maximise profits through improved performance, including innovation. We consider Auckland Airport's innovation practices as part of this consultation paper.
- 6.2 In our Auckland Airport PSE3 review, we stated that as PSE disclosures contained forward-looking information, they did not provide much information about the appropriateness of an airport's level of innovation. However, an airport can disclose some information about its innovation as part of a PSE disclosure. For example, Christchurch Airport's PSE4 disclosure contains some useful information about its approach to innovation and innovative examples.

Draft conclusion

- 6.3 Auckland Airport lists innovation and continuing efficiencies as one principle underpinning its price setting decisions. We consider that Auckland Airport has not demonstrated significant innovative practices. Auckland Airport may be innovating appropriately, however there is little evidence of this in its disclosures.
- 6.4 It is understandable that other aspects of the PSE disclosure are the primary focus, such as capital expenditure and profitability, however we consider that Auckland Airport could have included more context on its innovative practices in the disclosure. Auckland Airport is welcome to provide further information on innovation by way of submissions to this paper if it chooses to.

Stakeholder views

- 6.5 BARNZ in its submission stated:²⁰⁴

BARNZ agrees that Innovation is an important matter to examine but cannot provide evidence of innovation as proposed by AIAL. We consider projects such as baggage systems, multi-use check in kiosks, or analysis of passenger throughput to be business as usual matters.

- 6.6 In our report on Auckland Airport's PSE3, we noted that innovation is the discovery and use of new information, leading to the development of new goods or services, and/or more efficient production techniques, and that innovation is not the same as the adoption of industry best practice from New Zealand or overseas.

- 6.7 Air NZ stated:²⁰⁵

For AIAL, Air NZ considers it very difficult to point to clear evidence of any of these three being delivered. By contrast, the airlines have been the main source of seeking cost

²⁰⁴ BARNZ submission, paragraph 49.

²⁰⁵ Air NZ submission, paragraph 74.

efficiencies, seeking greater value for customers and innovating. During PSE4, this can be demonstrated most notably in the alternative design for the integrated terminal, but also in other areas such as seeking innovative solutions to manage runway renewals in order to reduce disruption and potentially find cost savings.

In a workably competitive environment creating efficiencies, including through innovation, is a core element of competition. However, in the current environment where airports remain unconstrained, excessive capex is favoured over innovation.

6.8 Air NZ appears to be concerned that Auckland Airport is relying too heavily on capital expenditure as a solution to increases in demand or capacity needs, rather than coming up with innovative solutions to improve efficiency at the Airport.

6.9 In the PSE4 disclosure, Auckland Airport notes that:²⁰⁶

A key component of Auckland Airport's corporate strategy is to be innovative and efficient in how we operate. In doing so, we aspire to set our operating costs at a level that maintains sound and reliable service levels whilst also seeking to optimise our costs of operation to provide efficiencies to our customers. Auckland Airport also considers potential trade-offs between operating and capital solutions when making capital expenditure decisions.

6.10 In its submission on our Process and Issue paper, Auckland Airport states it is being innovative in a range of ways. Particularly:

6.10.1 a new operations centre that supports activity through a data feed of flight schedules, key functions and passenger flows;

6.10.2 flexible staffing adding shifts at peak times and allowing staff to select shifts that suit them rather than rigid patterns;

6.10.3 reducing queue times through new processes;

6.10.4 big data and machine learning is being used to reduce unnecessary taxi times on the runways and reduce fuel burn; and

6.10.5 a new baggage hall and combined check in system is being constructed.

Analysis

6.11 Auckland Airport's forecast opex per passenger is decreasing in real terms, returning to pre-COVID levels. Efficiency gains may be indicative of innovation however this is not always the case.

²⁰⁶ Auckland International Airport Limited: *Price Setting Disclosure* (17 August 2023), pg 11.

- 6.12 Auckland Airport shows some innovative practices, some of which appear to lie closer to abiding by industry standards rather than innovation. Auckland Airport is welcome to add to the information currently disclosed to expand on its innovative practices in submissions to this paper.
- 6.13 The new operations centre and use of machine learning/data to reduce unnecessary taxi times would seem likely to promote efficiency in Auckland Airport's airfield operations.
- 6.14 Overall Auckland Airport appears to be innovating to some degree, however more evidence of innovative practices would be needed to show that the Airport is improving its performance through innovation.