Commerce Commission New Zealand

Level 9, 44 The Terrace

Wellington 6011

Via email: im.review@comcom.govt.nz

RE: 2023 Input Methodologies Review - Process and Issues/Draft Framework Submission

Dear Commerce Commission,

Airlines for Australia and New Zealand (A4ANZ) welcomes the opportunity to comment on the Commerce Commission's *Part 4 Input Methodologies Review 2023*.

As the Commission would be aware, A4ANZ is an industry group representing airlines based in Australia and New Zealand, including international, domestic, regional, full service and low-cost carriers. Established in 2017, A4ANZ's members include Air New Zealand, Qantas, Virgin Australia, Regional Express (Rex), and Jetstar.

The scope of A4ANZ's comments – in response to the Commission's Process and Issues Paper – will be limited to issues relating to the cost of capital, including the impact of COVID-19 on the aviation market, asset beta considerations, and issues relating to the tax adjusted market risk premium (TAMRP).

Impact of COVID-19 on New Zealand's Aviation Sector

While the entire aviation industry has been impacted and devastated by COVID-19, in the 2019-20 financial year, all three of New Zealand's major airports still managed to record a net profit, compared to the significant net losses experience by airlines.[i] Additionally, in the 2020-21 financial year, while airlines and airports have both recorded losses, the scale of airlines' losses is exponentially larger than those of airports.

Indeed, this is demonstrated in analysis by Frontier Economics (see Figure 1), which shows that the relative impact of global events is significantly worse on airlines' profitability than that of airports. This has been borne out both historically, through the Global Financial Crisis – with airline and airport profit margins decreasing by 168% and 3% respectively, and recently throughout the COVID-19 pandemic, which saw profit margins for airports decline by 65%, compared to a decline of 273% for airlines.[ii]

In the Process & Issues Paper, the Commission questions whether there is a need to consider any adjustments to the way the Commission estimates parameters using data that includes the COVID-19 period, for example, the significant stock market movements that occurred in 2020 when estimating beta.

A4ANZ agrees with the submission from BARNZ and TDB Advisory, who note that the Commission should resist pressures from airports for "compensation" for the effects, and lost revenue, of the COVID-19 pandemic.[iii] In a recent statement from the former Australian Competition & Consumer Commission Chairman, Rod Sims AO, there was a similar note of caution against this practice: "*We would be very concerned if the major Australian airports sought to use their monopoly position to charge airlines excessive prices in order to recover any lost profits from the pandemic. This could limit an already vulnerable sector's ability to recover, and impact on both consumers and the economy*."[iv]

Accordingly, the New Zealand Commerce Commission should be looking to make a determination appropriate for a post-COVID environment.

A4ANZ believes that the Commission should maintain its principles-based approach to valuing the cost of equity. A4ANZ would also note that any increase to the asset beta or TAMRP will likely result in a two-speed recovery within the sector, allowing airports to recover at the expense of airlines.

Figure 1 - The relative impact of global events on New Zealand airline and airport profitability

Asset Beta Considerations

As stated earlier, A4ANZ believes that the Commission should resist arguments from airports about increasing the asset beta, to account for lost revenues from the impact of COVID-19.

Across the aviation sector, it is widely accepted that risk events, such as a pandemic, are already provided for in airport asset betas and WACCs. Indeed, as noted by TDB and BARNZ, pandemics have long been cited, along with other catastrophic events, such as natural disasters, by airport owners and operators in offerings to investors, as risks that are already built-in to the asset beta.[v]

As such, we would urge the Commission to maintain the asset beta at 0.6, as any further adjustments to "compensate" for the risk from COVID-19 would be, in effect, double-counting the risk assessment elements in the cost of capital methodology.[vi]

Tax Adjusted Market Risk Premium Considerations

A4ANZ notes that the Commission are considering using the 2020 estimate of the TARMP – that is 7.5% - in the current review.

It is of note that in recent times in Australia, in making WACC determinations in a post-COVID world, Australian regulators have opted to use TAMRPs that are lower than the Commission's existing TAMRP of 7%. For example, the Western Australian Economic Regulation Authority used a TAMRP of 5.9% in its July 2021 WACC decision.[vii] Similarly, the Victorian Essential Services Commission's May 2021 decision on pricing orders for the Port of Melbourne used a TAMRP of 6.54%.[viii]

These recent decisions accord with decisions by other Australian regulators – ie. the Queensland Competition Authority, and the Australian Competition and Consumer Commission – over the past five years, which have used a TARMP of between 6.5%-7%, and 6% respectively, for access undertakings pertaining to rail infrastructure.[ix]

While these decisions are for the Australian market, they draw from different sectors and state economies, and all arrive at a TAMRP well under 7.5%. A4ANZ would urge the Commission to carefully consider whether using a TARMP of 7.5% is appropriate for the New Zealand airports sector. Particularly, because each 0.1 increase in the TAMRP would provide an increase in "regulatory" revenues.[x]

In the case of Auckland Airport, each 0.1 increase would result in an additional $1M of revenue[xi] – this for an airport which has previously been found to set prices that were not in the long-term interest of consumers. In the 2018 review of Auckland Airport's pricing decisions, for example, the Commission itself found that the "airport operators were targeting excessive profits" – and also found that Auckland's target return would result in an additional cost to consumers of up to $53 million.[xii]

A4ANZ shared the Commission's concerns regarding the pricing decisions of New Zealand's major airports in 2018 and continues to share them today.

As we have noted previously, analysis by Frontier Economics found that the total value of excess returns to Auckland and Wellington airports (across all airport operations) since privatisation was more than $3.6 billion and $400 million, respectively, prior to the COVID-19 pandemic.[xiii]

Airports' historical behaviour has come at a cost to the New Zealand community, both financially and through lost opportunities for improving the quality and efficiency of airport services.[xiv]

As we move to a post-COVID environment, the Commission must carefully consider how amending input methodologies – such as the TARMP - will impact the ability of airlines, airports, and the economy more broadly to recover from the devastation of the COVID-19 pandemic.

Climate Considerations

The Commission has also noted that the airport sector is in a period of transition and change in relation to the impact of climate change and the transition to a low carbon economy.

A4ANZ welcomes the Commission's consideration of how the transition to a low carbon economy and achieving net zero emissions by 2050 will impact the New Zealand airports.

However, it is important to recognise that the airline sector will be responsible for the significant majority of actions – and associated costs of such – that need to be taken to decarbonise the New Zealand aviation sector and reach net zero emissions, rather than the airports.

A4ANZ thanks the Commission for the opportunity to make a submission to the *Part 4 Input Methodologies Review 2023* and would be pleased to discuss any part of this submission with the Commission.

Kind regards,

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[i] Analysis of financial data from airline and airport financial reports, and the CAPA database.
[ii] Frontier Economics. Analysis prepared for A4ANZ.
[iii] TDB Advisory. NZ Commerce Commission: Part 4 Input Methodologies Review 2023. A report prepared for BARNZ.
[iv] ACCC Airline Competition in Australia Report. 29 September 2021. https://www.accc.gov.au/media-release/covid-restrictions-bring-domestic-airline-industry-to-a-standstill
[v] TDB Advisory. Op cit (iii)
[vi] TDB Advisory. Op cit (iii)
[vii] Economic Regulation Authority Western Australia. 2021. Determination on the 2021weighted average cost of capital for the freight and urban railway networks, and for Pilbara railways. At: https://www.erawa.com.au/cproot/22087/2/Final-Determination---2021-Weighted-Average-Cost-of-Capital-for-the-Freight-and-Urban-Networks-and-the-Pilbara-Railways.pdf
[viii] Essential Services Commission. 2021. Port of Melbourne - Pricing Order for the 2021-22 Tariff Compliance Statement.
[ix] Access undertakings from QCA and ACCC 2016-2020.
[x] TDB Advisory. Op cit (iii)
[xi] TDB Advisory. Op cit (iii)
[xii] Commerce Commission. 2018. Review of Auckland International Airport's Pricing Decisions & Expected Performance (July 2017 – June 2022): Final Report. At: https://comcom.govt.nz/__data/assets/pdf_file/0023/103991/Final-report-Review-of-Auckland-International-Airports-pricing-decisions-and-expected-performance-July-2017-June-2022-1-November-2018.pdf
[xiii] Frontier Economics. 2018. *The performance of airports in New Zealand*. Report prepared for A4ANZ.
[xiv] https://www.nzherald.co.nz/business/auckland-airport-slammed-for-runway-maintenance-closures-thousands-of-travellers-affected/3K5P3W45CBISUJBM42BZKXYTRU/