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Input Methodologies Review 2023
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Input Methodology Review Draft Decision

This is a submission by Auckland Airport International Limited ("**Auckland Airport**") in response to the Commerce Commission's ("**Commission**") 2023 Input Methodology Review ("**IM Review**") Draft Decision ("**DD**"). Auckland Airport is a party to the New Zealand Airports Association's ("**NZ Airports**") submission, which we support, including the independent expert report by Competition Economics Group ("**CEG**"). This submission is in addition to our previous submissions to the IM Review and NZ Airports previous submissions (which we are party to).[1] This submission does not contain any confidential information and can be published on the Commission's website.

Auckland Airport considers that the asset beta IM adopted in the DD is not in the long-term interest of consumers, and that it fails to meet the purpose of Part 4 of the Commerce Act.

Auckland Airport cannot understand how the DD finds that New Zealand airports have materially less systematic risk than was measured by the Commission prior to the COVID-19 pandemic, or how New Zealand airports could have lower systematic risk than the UK Civil Aviation Authority ("**UKCAA**") has most recently assessed for Heathrow Airport (allowing for its 8.5 basis points equivalent Traffic Risk Sharing ("**TRS**") mechanism).

Heathrow is one of the largest and most capacity constrained airports in the world, providing substantial natural protection from demand fluctuations which primarily impact the secondary London airports that take Heathrow's overflow during normal times. As analysed and explained in detail by CEG in its independent advice, following the UKCAA's latest decisions, Heathrow now also enjoys a large suite of non-asset beta related regulatory protections from demand shocks that provide far more financial protection than any of New Zealand's regulated airports enjoy. Therefore, Auckland Airport also cannot understand how the Commission's assessed differential in systematic risk between New Zealand airports and Heathrow airport could have changed so dramatically post-pandemic.

In the 2016 cost of capital IM, the Commission estimated New Zealand Airports' asset beta to be 0.60[2] (or 0.65 excluding the now discredited 5 basis points downwards adjustment) versus Heathrow's asset beta then of 0.50. This represented a 10 (to 15) basis points margin above Heathrow's assessed asset beta at that time. But per the DD, the Commission has now estimated New Zealand Airports' asset beta to be 0.55 versus Heathrow's latest estimate of 0.53, or more accurately 0.615 before applying the TRS, i.e. only a 2 basis margin above Heathrow (net of TRS), or more accurately a 6.5 basis points margin below Heathrow's latest assessed asset beta. This dramatic 16.5 (to 21.5) basis points downwards swing in the Commission's relative assessment of New Zealand airports' asset beta versus Heathrow is not supported by the evidence presented by the Commission or the airlines during the IM Review.

We set out in this submission why we disagree with the DD and the key issues we believe the Commission must reconsider for its final decision in order to meet the purpose of Part 4 of the Commerce Act, i.e. ensuring that any regulatory changes are for the long-term benefit of consumers.

[1] As an aside, we note that Auckland Airport's Price Setting Event 4 ("PSE4") consultation materials on our target return for PSE4 traverse very similar issues and also include independent expert analysis and recommendations.
[2] 2016 Input Methodology Review Final Reasons Paper

Our investment plans are in the long-term benefit of consumers

Auckland Airport currently has a planned multi-billion dollar pipeline of investment to ensure that New Zealand's largest airport meets the long term needs of airlines and customers. This programme of aeronautical infrastructure investment will address significant legacy infrastructure deficits that can be traced back to when the airport was first built in the 1960's. This will unlock future long-run aeronautical capacity requirements and ensure our airport infrastructure is resilient now and into the future.

Any failure to invest now because of the unjustifiably low and unpredictable long-term returns that the Commission will find acceptable when reviewing future airport pricing decisions implied by this DD would result in future aeronautical capacity constraints that both limit customer choice and, as demonstrated by the air fare increases seen today due to constrained airline capacity post-pandemic (e.g. fleet and staff shortages), would result in airfare increases that far exceed any reductions in airport prices due to lower future airport returns that the Commission would consider acceptable going forward under the DD.

Investing in infrastructure that responds to climate change is also a key challenge for the aviation sector. Auckland Airport will have a key role to play to enable the New Zealand aviation sector to reduce its carbon emissions, and ensure air travel services remain resilient to climate change impacts. These are challenges that are common across all infrastructure sectors in New Zealand, investing to meet these challenges is to the benefit of the New Zealand and the travelling public.

The Draft Decision undermines regulatory certainty for the New Zealand airports sector

The DD comprises fundamental changes to the Commission's approach to estimate asset beta, moving from its well-established approach of adopting a wide sample set of comparable airport companies and using a rolling 10 years of data, to a much narrower sample set, and an unpredictable mix (looking forward to the next IM review) of short and long term sample periods that exclude COVID-19 impacted data.

These changes if adopted in the final decision, would dramatically reduce the Commission's mid-point post-tax WACC estimate for airports. Based on the advice from the Commission's expert adviser, CEPA, the 2016 IM approach would estimate an asset beta of 0.79, and has been estimated by CEG (Auckland Airport's and NZ Airports' expert WACC advisor) at 0.81, versus the DD of 0.55. This reduces the Commission's midpoint WACC estimate by 1.6-1.7 percentage points relative to the CEPA and CEG estimates.

In its review of Auckland Airport's PSE3 prices, the Commission noted that the purpose of the IMs is to promote stability:

> *'the purpose of IMs is to promote certainty in the rules and assumptions to assess performance. This certainty would be undermined by ad hoc adjustments.'*[3]

Such fundamental changes to the Commission's approach to estimate asset beta per the DD would dramatically undermine this purpose and do away entirely with the Commission's previous track record of stable economic regulation of airports in New Zealand.

The changes adopted in the DD appear to be 'ad-hoc' and, in the absence of compelling evidence supporting the proposed changes, appear aimed at achieving a predetermined view of an acceptable target return in the current market conditions, rather than rectifying any compelling problems with the Commission's previously staunchly defended methodology.

The DD gives surprisingly little consideration of the implications of removing regulatory certainty going forward. Regulated airports, their lenders and their shareholders will find it impossible to predict with any confidence the approach that the Commission will take in future IM Reviews as it's very hard to see what the Commission will do if and when other economic shocks inevitably work their way in and out of the data and/or the DD methodology results in a midpoint WACC estimate that no longer aligns with the

[3] Final-report-Review-of-Auckland-International-Airports-pricing-decisions-and-expected-performance-July-2017-June-2022-1-November-2018.pdf (comcom.govt.nz)

Commission's view of the right answer. This makes it impossible to predict the returns that the Commission will find acceptable over the long term from the many billions of dollars of critical multi-generational aeronautical infrastructure investment that regulated New Zealand airports are currently planning.

Investor response calls for aeronautical investment to be reduced

Queries from Auckland Airport investors spiked immediately after the DD was released. Auckland Airport's Chief Financial Officer fielded around 20 separate investor calls following the release. Investors unanimously urged Auckland Airport to reduce investment. In some cases investors called for aeronautical capital investment to entirely stop if the Commission retains the draft WACC methodology in its final IM determination.

Investors also noted that the regulatory certainty that has existed under the current regime since 2010 is a thing of the past. Some investors considered that the DD was goal-seeked to achieve the Commission's pre-determined view of an 'acceptable' target return, rather than based on a principled analytical methodology.

Sample set adopted does not reflect the systematic risk faced by New Zealand airports

The DD reduces the sample set of comparable airports down from 26 to eight airport companies. The new reduced sample includes seven of the nine airport companies from the original wide sample set with the lowest asset beta, plus Auckland Airport. As noted by CEG, excluding Auckland Airport, five of the seven airports that remain in the sample set have demonstrably lower systematic risk regulatory environments where far more demand risk is shared with airlines, and all seven airports have lower exposure to demand volatility compared to New Zealand airports. In summary, the changes made have resulted in a sample set that bear little or no resemblance to New Zealand airports, particularly when compared to the previous practice of a wider sample set.

The risk profile of New Zealand airports in the current regulatory regime was spectacularly demonstrated during the pandemic, with Auckland Airport's revenues impacted significantly. During Price Setting Event Three ("**PSE3**"), Auckland Airport's total regulated revenues were $573 million (32%) below the forecast at the time PSE3 prices were set. Auckland Airport will not recover any of these pandemic-related PSE3 revenue losses going forward. Based on recent correspondence with Copenhagen Airport, we understand that many European regulators, on the other hand, have been discussing specific mechanisms (that weren't contemplated pre-pandemic) with regulated airports that will recover COVID-19 related revenue losses over future pricing periods.

Approach to adjusting for COVID impacts

The Commission has excluded COVID-19 impacted data and attempted to apply adjustments to reflect a forward looking view of pandemic risk. We note that the Commission didn't similarly adjust for the global financial crisis or any other past significant economic shocks in previous IM Reviews, and we disagree with the principle of making ad hoc adjustments to the regulatory regime in response to shock events. It undermines regulatory certainty and consistency, as it requires arbitrary judgement calls over time regarding which shocks should be adjusted, which should be ignored and how new shocks on top of old shocks should be accounted for. Estimating the impact of any particular shock on asset beta also requires arbitrary decisions to be made. This adds unpredictable complexity and heightened uncertainty to the regulatory regime.

We agree with CEG's advice that retaining the 10-year rolling sampling period under the current asset beta IM, without seeking to make adjustments for shock events, is the best approach. It is the most stable and predictable way to ensure that shock events are accurately incorporated in asset beta estimates over the long term.

The DD refers to the recent decisions by the UKCAA for Heathrow Airport. However, analysis by CEG finds that the approach adopted by the Commission does not follow the UKCAA approach correctly and it significantly understates the adjustment required to compensate for future pandemic risk.

As CEG sets out, the UKCAA decision provided for Heathrow Airport an equivalent asset beta uplift of 0.395, when all risk sharing mechanisms and adjustments are taken into account. This is almost twenty times higher the 0.02 adjustment adopted by the Commission in its DD. If the Commission retains the DD approach in its final asset beta IM of excluding pandemic impacted data, and instead making adjustments to reflect future pandemic risk, the adjustment process must be robust. The UKCAA approach incorporating all the pandemic related adjustments as summarised in CEG's report (e.g. RAB uplift, Traffic Risk Sharing mechanism, and reduced price setting traffic forecasts), not just the residual 3 basis points asset beta uplift, would provide a far more thoroughly evidenced precedent than the Commission's DD.

Draft Decision's impact of $2.90 per passenger at Auckland is a fraction of the increase in post-pandemic airfares

The purpose of Part 4 is to promote the long-term benefit of consumers by promoting outcomes that are consistent with competitive markets. Auckland Airport considers that the DD is not consistent with this purpose, as it has placed far too much weight on its new and much more modest view of what would be considered to be excess profits than on promoting incentives to invest.

Auckland Airport has recently set prices for Price Setting Event 4 which covers FY23-27. Based on the forecast priced asset base for PSE4, the revenue differential between a WACC based on the DD (7.19% post-tax) and the WACC inputs proposed by CEG consistent with an updated 2016 cost of capital IM (8.90% post-tax) would be $2.90 on average per passenger across the pricing period. This is despite Auckland Airport's forecast RAB more than doubling over the period as shown in the following table.

Auckland Airport	**FY23**	**FY24**	**FY25**	**FY26**	**FY27**
Closing RAB ($m)	1,463	1,730	2,551	2,824	3,321
Passenger Forecast (m / pax)	15.4	18.4	19.9	21.6	23.0
Revenue differential ($m)	34.8	41.1	60.6	67.1	78.9
Revenue differential per passenger (updated 2016 IM vs DD)	$2.3	$2.2	$3.1	$3.1	$3.4

As we have seen post-pandemic, airfares have increased significantly owing to COVID-19 related airline capacity shortages (e.g. aircraft and aircrew) as passenger demand has recovered. New Zealand-wide, post-pandemic airfares are up around 60 per cent in nominal terms – or by around one-third after inflation.

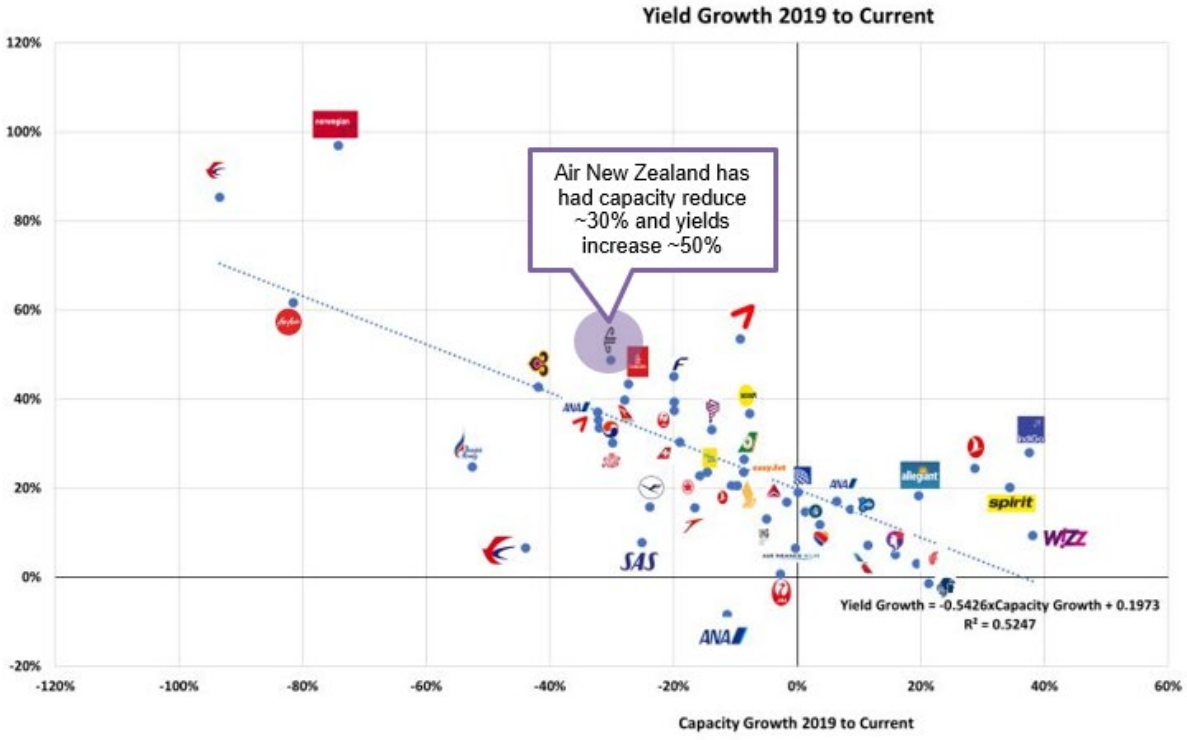
	Nominal		**Real**	
Six months ended	Domestic	International	Domestic	International
April 2019	$163	$595	$194	$706
April 2023	$257	$959	$259	$961
Change ($)	*$94*	*$363*	*$65*	*$255*
Change (%)	*57.6%*	*61.0%*	*33.5%*	*36.1%*

Source: AirportIS (IATA)

Today's elevated airfares provides a real-world example of how significantly airfares can increase when aviation capacity is exceeded by demand. Compared to the $2.90 increase per passenger from adopting CEG's updated 2016 IM asset beta estimates, the real increase in domestic airfares seen today due to COVID-19 related airline capacity shortages is 22 times higher ($65), and the international increase 89 times higher ($255).

If future airport capacity similarly failed to meet demand, airlines would raise air fares until demand fell to match available capacity. The large dollar value differential clearly demonstrates that the risks to consumers from any shortfall in airport infrastructure investment because of the unjustifiably low and unpredictable airport returns that the Commission will find acceptable going forward per this DD completely swamps any benefits to consumers from the circa $3 per passenger reductions in aeronautical charges that would result from replacing the 2016 asset beta IM with the DD.

This is further demonstrated below. Owing to COVID-19 related airlines capacity shortages, Air New Zealand's capacity has reduced by ~30% and its yields have increased by ~50%. This increase in yields is above the trend seen across other airlines globally, and can likely be attributed to the limited competition in the New Zealand domestic market.



Source: Airline Intelligence & Research

Commission must consider the likelihood that reduced aeronautical charges flow through to lower airfares for passengers, or higher airline profits

In terms of assessing against the purpose of Part 4, the Commission must also consider to what extent the circa $2.90 per passenger savings from airports applying the DD would in fact flow through to airfares paid by the consumer. Airlines can and do charge passengers different prices for the same service through dynamic pricing. Where airlines apply dynamic pricing, the extent to which costs are directly passed through into airfares has been questioned. This was considered by the Australian Productivity Commission ("**the PC**") inquiry during its 2019 Inquiry into the Economic Regulation of Airports in Australia (our emphasis in bold).

> *Airlines use price discrimination (charging different prices for the same service) to maximise their revenues and profits. Price discrimination leads to ticket prices that are closer to the value that consumers place on them. Consumers with a higher willingness to pay can select themselves into higher price services (such as business class tickets). People who have a lower willingness to pay can select cheaper tickets (such as economy class tickets or promotional fares). Airlines can match their services to consumers' demands and can increase their profits at the same time.*
>
> ***Airlines that have the ability to price discriminate have little incentive to pass on cost reductions to passengers** — their pricing decisions are based on what passengers are willing to pay, not solely on the cost of providing the service. Airlines only benefit from reducing their ticket prices if it leads to people changing their behaviour in ways that increase profits. **If an airline already has high rates of capacity utilisation at current ticket prices it has little incentive to reduce airfares, even if airport charges fall.***

> *Contrary to the claim made by the airlines and A4ANZ,* ***airfares could be higher if, for example, anticompetitive behaviour successfully delayed necessary airport investment, and this resulted in congestion****.*[4]

In Auckland Airport's view, when considering if its Draft Decision has met the purpose of Part 4, the Commission must consider:

- whether airlines have sufficient incentives to pass-on lower aeronautical charges into airfares paid by consumers, or would it be more likely to result in higher airline profits;
- the risk that changes to the regulatory regime delay or reduce airport investment, and the resulting impact on airfares paid by consumers; and
- whether the DD sufficiently balances the likely direct impact on airfares with the risk of higher airfares if underinvestment in airport infrastructure was to occur.

The PC reached the conclusion that airlines were unlikely to pass through lower aeronautical charges into airfares where they could 'price discriminate' and capacity utilisation is high, and that airfares could be higher if necessary airport investment was delayed and resulted in congestion.

In the New Zealand aviation market, where there is limited competition, it is far less likely that low single digit dollar per passenger savings in aeronautical charges resulting from the DD would result in lower airfares, as airlines are able to set airfares based on passenger willingness to pay.

Conclusion

New Zealand is currently confronting a well-known infrastructure deficit. The private sector has a role to play in meeting this challenge and Auckland Airport is planning to invest billions of dollars to ensure that New Zealand's largest airport meets the needs of consumers and the country. This will be by far the largest revitalisation of the airport in its more than 50 year history. If the DD is carried into the Commission's final cost of capital IM determination, then the unjustifiably low and unpredictable returns that the Commission will find acceptable going forward will undoubtedly cast serious doubt in the minds of Auckland Airport management, the Board, our lenders and our shareholders as to the commercial business case for that investment. It already has.

We cannot see how the DD represents a material improvement over an updated 2016 cost of capital IM determination (with the discredited 5 basis points downwards asset beta adjustment removed). Nor can we see how it would better deliver the purpose of Part 4 of the Commerce Act. We therefore urge the Commission to revert to the 2016 cost of capital IM determination for airports, absent the 5 basis points adjustment, with all comparable company input data updated as at the date of the final 2023 IM determination.

Kind regards

[redacted]

Phillip Neutze
Chief Financial Officer

[4] Productivity Commission 2019, Economic Regulation of Airports Inquiry Report, p. 306