COMMERCE COMMISSION NEW ZEALAND
Te Komihana Tauhokohoko

Auckland Airport 2017-2022 pricing review

Draft report

26 April 2018

Deputy Chair Sue Begg

Overview

- Second review of Auckland Airport's (AIAL) pricing decisions since information disclosure requirements came in under Part 4
- Airport regulation 'light-handed' – we review pricing decisions to provide greater understanding of performance

- In this review we have focussed on:
  - reasonableness of target returns
  - efficiency of investment
  - efficiency of pricing

Draft conclusions

- We have no significant concerns with:
  - AIAL's pricing efficiency
  - Its planned cost and timing of investment
  - The forecasts used to set prices

- Our main concern relates to AIAL's target cost of capital
  - We are concerned AIAL's profits may be too high

Framework for considering target returns

- Airports do not have to apply our cost of capital approach when setting prices
- We use our estimate as a benchmark for assessing whether expected returns are appropriate
- The IMs require an airport to provide evidence to explain difference between its target cost of capital and our benchmark

Reasonableness of target returns

- AIAL targeting returns of 7.06% on all regulated assets, above our mid point benchmark of 6.41%

- Difference could result in:
  - Customers paying an additional $65 million over 5 years
  - 4% more in total revenue over 5 years
  - 61 cents more per passenger per flight
  - AIAL earning additional $47 million in profits (after tax)

- There may be legitimate reasons for some of the difference but yet to be convinced

Aeronautical pricing

- AIAL targeting returns of 6.99% (65th percentile of our WACC range)
- Difference between AIAL's target return and our benchmark mainly due to cost of equity
  - AIAL expects its operating leverage to increase over PSE3, due to its large capital expenditure programme
  - Therefore, AIAL considers it will have a greater exposure to systematic risk (a higher asset beta)
- AIAL relies on estimate of its own asset beta to measure the operating leverage impact

Our view on aeronautical pricing

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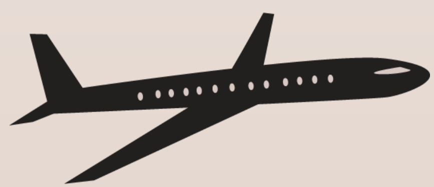
- Conceptually, we agree an increase in operating leverage may increase AIAL's exposure to systematic risk
- But we are not convinced that:
  - AIAL's operating leverage significantly higher than other companies in comparator sample
  - The difference is sufficient to justify the magnitude of AIAL's increased asset beta
- Beta estimate based on a single company (AIAL) is unreliable
- We are open to receiving additional evidence



Other regulated services

- We estimate that AIAL expects to earn 7.9% returns on other regulated services
- AIAL says it has not targeted any particular return and has set returns based on individually negotiated agreements, not standardised prices
- Explanation is not sufficient to conclude that:
  - The existence of a difference is appropriate
  - The magnitude is reasonable
- We are open to receiving additional evidence

Contingent runway land charge (RLC)

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- AIAL can capitalise value of holding cost of future use assets at its own (higher) cost of capital
  - Results in $8 million increase in asset value for second runway assets compared to our benchmark which AIAL can recover
- The RLC will allow AIAL to bring forward the recovery of this $8m
  - but AIAL's ability to earn additional $8m arises irrespective of RLC
- No other aspects of the RLC raised significant concern
  - Stakeholders generally agree second runway needed
  - Revenue will be offset against carrying value of assets

Forecast capital expenditure

- No significant concerns with the cost, timing or consultation for planned $1.8 billion redevelopment
  - we recognise strong passenger growth putting pressure on facilities and expenditure
  - will continue to monitor actual expenditure versus forecast
- We have also considered expected quality performance
  - challenge for AIAL to manage construction while keeping airport open
  - redevelopment expected to result in a long term improvement in service quality

Other forecasts

- No concerns with the forecasts for:
  - Demand
  - Operating expenditure
  - Opening and closing investment values

- We have used AIAL's forecasts for these in assessing expected profitability

Improvements in pricing efficiency

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- AIAL has introduced differential charges which:
  - Reduce likelihood of cross subsidisation between customer groups (eg, domestic trunk versus regional)
  - Allow airlines to make price-quality trade-offs (eg, check-in service options)
- New parking charges for planes to improve airfield efficiency
- AIAL should have given greater consideration to differentiating charges between peak/off-peak
  - Accept peak period users may not be responsive to peak pricing
  - May be efficient to recover fixed costs from peak users

Have your say

- Submissions due 25 May
- Cross submissions due 8 June
- Final report in September 2018 (at same time as Christchurch)
- Draft report can be found at www.comcom.govt.nz
- Email submissions to regulation@comcom.govt.nz

Airport regulation

We regulate certain key facilities and services to get people and cargo on and off aeroplanes at New Zealand's three major airports.

Regulated services

Airfield

This includes: runways, taxiways, plane apron parking; air and ground traffic control facilities; airfield maintenance, safety and emergency services.

Passenger terminal activities

This includes: check-in and baggage handling; security, customs, immigration and quarantine facilities; passenger facilities, seating, and duty-free collection areas.

Aircraft and freight

This includes: aircraft servicing, refuelling, maintenance and hangar facilities; freight handling and storage, security, customs and quarantine services.

Services *not* regulated

This includes: retail facilities; car parking; and access for taxis, shuttles and buses.

Information disclosure regulation

The Commission does not regulate airport *prices*. We review airport pricing decisions to promote greater understanding of their performance.

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