

19 December 2017

Jo Perry
Chief Advisor, Compliance and Performance Analysis
Regulation Branch
Commerce Commission
regulation.branch@comcom.govt.nz

**Cross submission on issues raised in submissions to the Process and Issues Paper:
Auckland and Christchurch Airports' third price setting events (July 2017-June 2022)**

Dear Ms Perry,

We welcome the opportunity to provide cross submission on issues raised in response to the Commission's process and issues paper for the review of Auckland and Christchurch Airport's third price setting event.

Airport submissions overwhelmingly focus on their compliance with the input methodologies and information disclosure regime. Air New Zealand does not consider that the Commission's 53B review should focus on compliance with the regime, but instead assess the outcomes delivered both in PSE2 and targeted in PSE3.

Using both information disclosure and the submission process, sufficient information exists so that the Commission may assess whether prices and target returns set by airports will deliver long-term benefits to consumers.

Air New Zealand considers that the price setting disclosures show evidence of airports' pattern of targeting excessive profits. Hallmarks of PSE3 include WACC targets beyond what a workably competitive market would deliver, inflated aeronautical capex, and asymmetric passenger forecasting. Christchurch airport has constructed a price methodology that benefits the airport and is not subsidy free.

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

Yours sincerely,



Rob McDonald
Chief Financial Officer
Air New Zealand

Purpose of the 53B(2) review

1. In the submission process to date, specified airports and the New Zealand Airports Association (“**NZAA**”) have described their compliance with the information disclosure regime. They have described their detailed and well documented consultation process. They have set out how the regulatory regime allows them to set prices, and how they may recover a return.
2. However, the 53B(2) review of the third price setting event for Auckland and Christchurch airports does not ask ‘how compliant are airports with the current regulatory regime?’ Rather, it asks, ‘is information disclosure providing sufficient information to ensure the purpose of Part Four of the Commerce Act 1986 (“**Act**”) is being met?’
3. Part Four of the Act provides for regulation of price and quality of services or goods where there is little or no competition. The purpose of Part Four is to promote the long-term benefit of consumers by promoting outcomes that are consistent with outcomes produced in competitive markets, such that suppliers innovate and invest in assets, improve efficiency and provide services at a quality that consumers want, share with consumers the benefits of that efficiency, and do not extract excessive profits.
4. It is clear that the information disclosure regime is not delivering outcomes consistent with the purpose of Part Four.
5. The Commission’s 53B(2) review asks whether the current regulatory regime provides enough information to ensure the purpose of Part Four is being met. Air New Zealand considers the Commission is entitled to use all information available to it, and ask any questions it sees fit, to ensure specified airports are providing services which meet the purpose of Part Four.

Consultation

6. NZAA submit that that the Commission’s review under 53B(2) should not be a re-litigation of the consultation process.¹ Air New Zealand considers that the Commission’s review may ask questions of the consultation process, and of any other part of the way that prices are designed, set and recovered, to ensure those prices are set to the long-term benefit of consumers.
7. Under current legislative and regulatory settings, specified airports hold the power during price consultation. The Commission’s review should certainly address whether price consultation is effective, and delivers benefits to consumers. Examining issues raised during consultation, and how these were treated in pricing, is the only way for the Commission to do this.

¹ NZAA submission paragraph 24

8. Air New Zealand and other substantial customers submit to the price consultation process in good faith, notwithstanding that required consultation does not deliver the benefits of commercial negotiation. However, our experience is that our suggestions for price mechanisms that could allow consumers to share risks and benefits with airport companies are not taken up. This has certainly been the case in price consultation for PSE3 with respect to risk allocation mechanisms.

Have amendments to IM and ID determinations been effective at increasing transparency of target profitability at Auckland [and Christchurch] Airports?

9. As noted in our submission, the Commission’s amendments to the Input Methodologies (“IMs”) and Information Disclosure (“ID”) requirements have increased the transparency of target profitability of airports. Air New Zealand considers it is clear to the Commission, and to substantial customers who assess these complex disclosures and then align these to separately disclosed explanatory material, that airport companies are targeting and achieving excessive profits.
10. These excessive profits are achieved by applying pressure to the levers available in the building blocks methodology such as capex, opex and cost allocations, and principally by setting a far higher return on capital than the market would demand when considering the total commercial returns of Auckland and Christchurch Airports.
11. AIAL and CIAL submit that they have disclosed information transparently, and that the IRR disclosure was used during price consultation.
12. Air New Zealand considers that CIAL has disclosed a WACC return which does not match that used in price consultation, discussed below.² However, the question that the Commission asks is, have the changes to IMs and ID increased transparency around target profitability within the information disclosure regime?
13. It is clear that both AIAL and CIAL are targeting profits which benefit the airport shareholder to the dis-benefit of consumers. The use of the IRR calculation during consultation process allows airlines to see the airport’s profit intentions during consultation. However, the use of the IRR calculation in itself does not restrain airports from excessive profit taking.
14. The total shareholder return (“TSR”) of AIAL highlights the capitalisation of long term excessive profit. The TSR also highlights that financial markets believe that there is little prospect of the regulator taking action.

² Paragraph 50

Is Auckland Airport’s target return appropriate and why?

15. NZAA, Auckland and Christchurch airports submit that as they have followed due process, been transparent about departures from the input methodologies, and explained their various unique circumstances, that the Commission cannot now suggest that their target return is not appropriate. To quote the NZAA *“airports should not be criticised for seeking to comply with that framework”*.³
16. Air New Zealand considers that the airports view of compliance with the regulatory framework should not be used as a defence to recovery of excessive profits. AIAL is targeting a WACC for PSE3 at the top of the Commission’s range – and this target may be exceeded in actual returns.
17. With final information disclosures for PSE2 now available, AIAL’s WACC return of 10.84% for FY17 is a stark reminder of how much commercial benefit is available to shareholders under the current regime. Even making adjustments to this figure to allow direct comparison to earlier disclosed returns, the FY17 WACC return is significant.⁴ In their 2017 information disclosure summary information AIAL discuss only an 8.5% average IRR return over the total period against the target of 8%. This is an attempt to disguise excessive profits, and does not address over-recovery through the period.
18. Allowing target WACC to be set such that it is far higher than what a workably competitive market would return represents a failing of regulation of the airport monopoly, which will only be heightened if AIAL beat the regulatory contract again over PSE3.
19. As submitted by BARNZ, Forsyth Barr calculate AIAL’s true WACC to be between 5-6% for the listed group.⁵ To target WACC of 6.99% on pricing assets and 7.99% on non-pricing assets is to target excessive profits, which is not likely to be in the long-term interest of consumers.
20. The departures from the input methodologies that AIAL has made to inflate the target return (using a total-business asset beta and a TAMRP of 7.25%) are both approaches the Commission declined to adopt during the IM review. The airport’s ability to apply such departures arises from the conflict between the Airports Authorities Act 1966 (“AAA”) and the Commerce Act.
21. Despite the AAA legislation, and in contrast to submissions from airport companies, Air New Zealand expects that the Commission as competition regulator is able to define an expected return for both airport companies, and compare this to the disclosed target return. We expect that the Commission will use both information disclosures and other methods of assessment, including scenario analysis, as it sees fit.

³ NZAA submission paragraph 38

⁴ Adjustments to opening RAB values would show a WACC return of approximately 10.07%

⁵ BARNZ submission page 11

Did Auckland Airport make effective use of risk allocation adjustments? In particular, were any risk allocation adjustments proposed by stakeholders during Auckland Airports consultation but not implemented, and what was the rationale for the proposed adjustments?

22. In our submission, Air New Zealand noted that the risk sharing mechanisms proposed by Air New Zealand relating to passenger forecasts, and by BARNZ for capital expenditure, were not taken up by AIAL.
23. AIAL submit that risks or rewards are best borne by the party who can control those risks. With respect to capex in particular, it is true that AIAL is best placed to control risks of timing and actual expenditure. In PSE2 we have seen AIAL under spend in the early years of the period, and spend over forecast in the final years. AIAL was well placed to control such expenditure, and also well placed to benefit from this spend pattern as it recovered prices against forecast capital cost.
24. Air New Zealand believes that risk sharing mechanisms are unlikely to be applied by AIAL or other regulated airports under current settings, as they have the effect of lowering the asset beta and therefore the rate of return. Such mechanisms would adversely affect airport profitability, and airports will not willingly enter into them.
25. Risk sharing mechanisms are indeed beneficial to consumers, both in allowing consumers to share both risk and benefits, but also because they would drive AIAL to behaviours such as spending forecast capex and/or reducing prices when passengers exceed forecasts. The current regulatory regime is not designed to encourage such mechanisms.

To what extent does the demand forecast, presented by Auckland Airport as part of PSE3, reasonably reflect expectations of future demand and why?

26. Air New Zealand set out in our submission that our own forecasts are slightly higher than those developed by DKMA for AIAL. We note that one of the methods that regulated airports can use to beat the regulatory contract is to soften forecast demand and then work to increase that demand over the period. This is certainly behaviour AIAL have engaged in over PSE2, spending from their “regulated” budget to market their airport to new airline customers.
27. AIAL submit that final forecasts are ‘fair and reasonable’, and note that capacity since withdrawn from the market was announced too late to impact forecasts used for pricing.
28. Air New Zealand is unable to review alternative forecast views other substantial customers shared with AIAL in the price consultation process, but we consider there to be a risk that they remain soft, allowing possibility for over-recovery. AIAL notes that risk allocation

adjustments were proposed by airlines, but “we did not think risk allocation adjustments were required or consistent with encouraging efficient behaviour over PSE3 (including efficient investment delivery).”⁶

29. Air New Zealand does not consider that the introduction of risk allocation mechanisms for forecast risks would drive inefficiency. Air New Zealand submits that AIAL’s reluctance to agree to risk allocation mechanisms arises from the potential for these mechanisms to undermine profitability.

Are there any concerns that Auckland Airport’s capital or operating expenditure projections are not reasonable?

30. AIAL submit that consultation on capital priorities was commenced in 2016, as part of an iterative process that began with the revised masterplan in 2014.⁷ Air New Zealand considers that consultation on the terminal development plan has been underway for a much longer period of time.

31. At the commencement of PSE2, Air New Zealand was involved in consultation with AIAL on the best location of the new terminal. As AIAL disclosed in their Price Setting Disclosure for PSE2:

32. *“Preliminary discussions with domestic operators on the domestic capacity issue commenced in mid 2011. In November 2011, Auckland Airport held a workshop with industry parties to present its preferred option at the time, called the Integrated Terminal Facility (“ITF” or “North Option”), which was a two stage development of a domestic terminal facility located to the North of the ITB. At this workshop, the initial concept design of an alternative “southern” terminal option was also presented by a Substantial Customer (“South Option”). In January 2012, Auckland Airport released its Initial Pricing Proposal, which proposed to include the ITF in the standard charges. Auckland Airport then issued a consultation paper by Auckland Airport in February 2012 seeking feedback on the ITF.”*⁸

33. Air New Zealand worked closely with AIAL on proposals for the integrated terminal facility. We commissioned Intervista Consulting, who completed concept planning for the southern option, and delivered this work to AIAL in March 2012. We would be happy to provide this to the Commission if required.

34. As we enter 2018, the capital expenditure projections to deliver the Southern Terminal Option remain high level cost estimates. In the intervening seven years from 2011 to 2017, little progress has been made on the integrated terminal. This has been to the clear dis-benefit of consumers and to the clear benefit of AIAL shareholders.

⁶ AIAL submission 4.1.3 (page 13)

⁷ AIAL submission 4.3.1 (page 23)

⁸ Auckland International Airport Price Setting Disclosure, 2 August 2012 2.4.3 (iii) (page 42)

Are there concerns relating to Auckland Airport’s introduction of a contingent runway land charge? In particular, is the proposed timing of Auckland Airports returns on its assets held for future use appropriate?

Has information disclosure assisted in promoting stakeholder understanding of Auckland Airport’s proposed approach to the runway land charge?

35. AIAL argue in their submission that the IM and ID amendments allow the runway land charge, (“RLC”) therefore it may be levied. They do not comment on the overwhelming feedback from substantial customers that we would prefer to pay for the runway when the asset is commissioned.

36. The Commission asks whether the Information Disclosure changes have promoted understanding of AIAL’s approach to the runway land charge. We believe we understand what the charge is, when it will be levied, and how it will benefit the airport. We do not agree that the charge should be levied as a flat charge to pre-fund a regulated asset, in the face of overwhelming opposition from substantial customers.

37. AIAL makes references to a judgement of the High Court⁹ and the Commerce Commission’s *Input methodologies review decisions – Topic paper 5: Airports profitability assessment*.¹⁰ As set out in our submission, Air New Zealand’s position is that AIAL does not have the ability under section 4A(1) of the AAA to set a RLC. To the extent that the references to the High Court and Commission paper are relevant, each identifies criteria for such changes that are not met by the RLC. For example, for the reasons set out in our submission, the second runway is not “likely reasonably imminent” and the RLC is not sufficiently “identified and justified” so as to minimise the risk of disguising excessive returns.

38. Our submission, and that of BARNZ, sets out in detail why we believe the runway charge both cannot and should not be levied. Inter-generational inequity, the up-front cash benefits present for AIAL and the risk of delay in constructing the runway while the charge continues to be levied are all strong arguments for the charge to be amended so that costs are recovered in an NPV neutral manner after construction.

Does Auckland Airport’s pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?

39. Both AIAL and Air New Zealand submit that peak pricing or congestion charging is not a pricing methodology which could be easily implemented or one that airlines are able to respond to.

⁹ AIAL submission page 17

¹⁰ *Input methodologies review decisions – Topic paper 5: Airports profitability assessment, 20 December 2016 at paragraphs 581-586.*

Is Auckland Airport's forecast investment sufficient to meet expected demand and desired service quality over PSE3?

How appropriate is Auckland Airport's approach to cost allocation when determining its capital expenditure projections?

Are there concerns that Auckland Airport will not be able to achieve its capital expenditure forecasts over PSE3?

40. AIAL's submission notes that the forecast capital plan for PSE3 is substantial. As we comment in our submission, it is difficult at this stage to make a proper assessment of whether expected demand and service quality will be met, as many projects in the capex plan for PSE3 are in the early stages of planning.
41. AIAL have listed a number of projects in its submission that it claims will benefit consumers. It claims that its capex plan for PSE3 will result in faster journeys to and through the airport, alleviate congestion, and deliver a very good quality of service.¹¹ In conducting its 53B(2) review, the Commission asks whether AIALs capex plan is sufficient to deliver service quality and whether this capex plan is deliverable. The Commission should consider the risk that consumers will pay a high price for improvements that are not delivered.
42. It will usually be to the consumers dis-benefit when a monopoly infrastructure owner under-invests in its regulated asset to recover additional returns for shareholders. That is the position customers of Auckland Airport find themselves in today. AIAL consider that the degraded state of the regulated assets it owns has arisen from unforeseen growth, and from the difficulty in progressing a brownfields development of the integrated terminal. Air New Zealand considers that the degraded state of the regulated assets arises from vigorous marketing and subsidies to attract new operators, delayed investment, and AIAL's prioritising of shareholder benefits.
43. Looking back over PSE2, Auckland airport has returned more in dividends to shareholders than it has spent on aeronautical capex. AIAL's special dividend of \$454M paid to shareholders in 2014 would have made a significant contribution to the required aeronautical infrastructure investments, but the regulatory regime allowed for the shareholders to benefit instead.
44. Air New Zealand submits that AIAL's elevated capex programme in PSE3 gives the airport more opportunity to under-deliver that capex and for shareholders to continue to benefit. We consider AIAL is 'stacking the regulatory deck' such that the over-recoveries of PSE2 are repeated in PSE3.

¹¹ AIAL submission 4.3.3

Is Christchurch Airport’s target return appropriate and why?

- 45. In the section of their submission which deals with WACC estimate¹², CIAL notes that it has adjusted the Commission’s inputs to WACC parameters for both credit rating and asset beta. The explanation provided is that they have been adjusted for *“CIAL’s specific circumstances”*.
- 46. With respect to the upwards adjustment to asset beta, CIAL explains that analysis by Incenta demonstrated that CIAL had *“a greater degree of systematic risk than the average airport in the Commission’s sample.”*
- 47. Air New Zealand would first point out that the Commission’s sample contained a range of airports and risks. CIAL also accepted Dr Small’s contrasting analysis, provided during consultation, that *“the differences in the proxy asset beta did not satisfy conventional levels of statistical significance.”*¹³
- 48. As asserted in paragraph 32 of their submission, CIAL remains of the view that these two CIAL specific parameters used in WACC are reasonable. Air New Zealand is not clear why this is.
- 49. Rather, CIAL consider that as long as they remain compliant with IM and ID requirements, they may target excessive profits. Such excessive profits are not in the long-term interests of consumers, and Air New Zealand contends that there is sufficient information available to demonstrate this is the case.
- 50. During price consultation, CIAL targeted a return of 6.82%. In its price setting disclosure, it has disclosed a target return of 6.44%. This difference has arisen because of CIAL’s practice of individually discounting prices to carriers in side agreements. Air New Zealand considers that this practice lacks transparency, and that CIAL should disclose target returns that match those sought in price consultation. Air New Zealand, CIAL’s largest domestic customer, does not currently hold a discounted pricing arrangement.

Do the asset values used by Christchurch Airport provide an appropriate basis for assessing expected returns and why?

- 51. The concerns raised by Air New Zealand in our submission¹⁴ have not been addressed by CIAL. Assets not required for pricing activities have been included in the pricing asset base. This is inappropriate and acts to mask the return CIAL is targeting on pricing assets.
- 52. Air New Zealand is concerned that the changes made to the IMs have been used by CIAL to their advantage, which maximises returns to shareholders in the monopoly asset. This

¹² CIAL submission paragraphs 28-31

¹³ CIAL submission paragraph 31

¹⁴ Air New Zealand submission, paragraphs 76-79

is not in the long-term interests of consumers and should be considered by the Commission.

Did Christchurch Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Christchurch Airport’s consultation but not implemented, and what was the rationale for the proposed adjustments?

- 53. As noted in our submission, Air New Zealand made suggestions for risk sharing mechanisms relating to capex and forecasting, neither taken up by CIAL. In their submission, CIAL mentions Air New Zealand’s suggestion for risk sharing on demand forecasts, but does not explain why this was not taken up.
- 54. CIAL does not mention Air New Zealand’s suggestion for a risk sharing mechanism relating to capex not agreed during consultation. As noted in our submission, this unagreed capex was included in pricing forecasts by CIAL.
- 55. In response to the question on risk allocation, CIAL described their preference for setting standard aeronautical prices, but making arrangements on an individual customer basis *“with a view to finding mutually beneficial outcomes for growth”*.¹⁵

To what extent does the demand forecast, presented by Christchurch Airport as part of PSE3, reasonably reflect expectations of future demand and why?

- 56. Air New Zealand suggested a risk sharing mechanism to mitigate the risk that growth differs from forecasts. CIAL does not mention this in its submission.
- 57. Air New Zealand’s experience of the consultation process is reflective of this positioning – suggestions for risk sharing are simply not taken up and not mentioned by the airport company. The consultation process, ostensibly in place to allow for negotiation, acts as a framework within which airports can ratify their chosen target returns.

Are there any concerns that Christchurch Airport’s capital or operating expenditure projections are not reasonable?

- 58. CIAL submits:
- 59. *“Importantly, disclosure is not intended to trigger a granular second guessing of airports’ expenditure. Expenditure is disclosed in pre-set cost buckets, at a level to allow the public and the Commission to understand the level of different types of cost, and ensure airports aren’t using expenditure as a vehicle for excessive profits.”*¹⁶

¹⁵ CIAL submission, paragraph 54
¹⁶ CIAL submission paragraph 45

60. Air New Zealand considers that the expenditure disclosed in such ‘pre-set cost buckets’ by CIAL is insufficiently transparent to consumers, and in fact is set to be large enough, and opaque enough to allow CIAL to use that expenditure buckets as a vehicle for excessive profits.

61. In our submission, we comment on the \$10M allowed by CIAL for ‘terminal reconfiguration’ as an example of opaque expenditure.¹⁷ Air New Zealand offered to further consult on this expenditure. Nonetheless, this expenditure was included in pricing.

Does the pricing structure at Christchurch airport for PSE3 reflect efficient pricing principles?

What impact do you expect Christchurch Airport’s proposed pricing structure and associated incentives to have on demand and revenues?

62. CIAL submits that as there is no specific IM for airport pricing, they may adopt any pricing methodology they see fit. They also submit that the structure of pricing has no impact on airport revenue and profitability.¹⁸

63. Air New Zealand concedes that there is no specific IM for that airport pricing, but it does not follow that airports may adopt a pricing methodology which penalises particular groups of consumers, forces consumers to incur increased cost, and affects the deliverability of consumers services which rely on the monopoly infrastructure.

64. CIAL’s change to pricing methodology has been introduced to *“increase and incentivise flexible and efficient use of its airfield and terminal. [and] ...to increase simplicity of prices and align CIAL and airline’s interests.”*¹⁹

65. Air New Zealand submits the changes in CIAL’s pricing methodology subsidise long haul aircraft at the expense of short haul and domestic aircraft. As we have submitted, airfield charges are normally based on weight of the aircraft, as that is the most significant factor impacting airfield investment requirements.²⁰

66. CIAL’s airfield pricing is designed to attract long haul carriers. The difference in cost per landed tonne for turbo prop (\$20) versus wide body aircraft (\$9) is significant, and significantly disadvantages domestic customers. Air New Zealand considers that the Commerce Commission should have first regard for New Zealand consumers in assessing whether CIAL’s pricing methodology is in the long-term interests of consumers, and it is clear that the pricing methodology established by CIAL disadvantages domestic and regional carriers.

¹⁷ Air New Zealand submission paragraph 88

¹⁸ CIAL submission, paragraph 60

¹⁹ CIAL submission paragraph 61.2

²⁰ Air New Zealand submission paragraphs 92 - 102

67. Over PSE3, terminal charges for domestic and international passengers will move such that they are charged at the same level. This pricing methodology removes the efficiency gains that should arise from the higher productivity of the domestic terminal. The only conclusion that can be drawn is that CIAL's terminal charges do not meet the purpose of Part Four in sharing efficiency benefits with consumers.
68. CIAL submits that its terminal prices leave CIAL neutral as to where a passenger is travelling to or from.²¹ Air New Zealand notes that such pricing does not leave CIAL neutral as to whether an aircraft is small or large. Costs of serving international passengers will be loaded to domestic passengers, and result in regional passengers, who fly on the most economically marginal routes, bearing the greatest penalty.
69. Attracting additional international traffic brings additional retail spend. International passengers in the airport terminal spend more than domestic passengers on average. This adds to the commercial revenues of the airport company as recovered through its second till.
70. Air New Zealand also raised concerns in its submission on the way in which CIAL's pricing methodology differentiates between passengers using the integrated terminal and regional lounge, with the exception of passengers travelling to and from Wellington but who do not use the integrated terminal.²²
71. Passengers travelling to and from Wellington but using the regional lounge will attract charges for areas of the terminal they do not use. The structure of CIAL's pricing methodology, created with full knowledge of the aircraft type and frequency patterns offered by Air New Zealand on this route, is not subsidy free and is not in the long-term interests of consumers who use this route. It is also directly contrary to CIAL's intention that *"...passengers pay for services they use."*²³

²¹ CIAL submission paragraph 63.2(b)

²² Air New Zealand submission paragraphs 110 - 113

²³ CIAL Proposal for the resetting of Aeronautical Prices 16 November 2016 paragraph 213