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

Dear Jo,

## Cross-submission on the Review of Auckland and Christchurch Airport's third price setting events – Process & Issues paper – issues and questions

### Introduction

1. BARNZ welcomes the opportunity to provide this cross-submission on the Commission's consultation paper *Have your say on the review of Auckland and Christchurch Airport's third price setting events (July 2017 – June 2022)*, dated 20 October 2017. We respond to the submissions of Auckland Airport, Christchurch Airport and the New Zealand Airports' Association (NZAA).

2. This cross-submission covers the issues raised and questions asked in the consultation paper. A separate cross-submission discusses process, timing and scope considerations. No part of this submission is confidential.

3. This cross-submission is made on behalf of the airlines[1] which BARNZ has written authority under s2A of the Airport Authorities Act 1966 to represent during consultation over charges with Auckland and Christchurch Airports.

4. For the most part, the case made by the airports in favour of their decisions is not new to BARNZ and we believe we have effectively responded to their points in our previous submission in most areas. The purpose of this submission is to respond to anything new, or where we consider that additional material is needed to respond to an argument made by the airports.

5. Overall, nothing in the airports' submissions has changed our view that both Auckland and Christchurch Airports are targeting excessive profits and more needs to be done to protect consumers from harm caused by monopoly pricing and monopoly service provision.

[1] Air Calin, Air China, Air Tahiti Nui, Air Vanuatu, Airwork, American Airlines, Cathay Pacific Airlines, China Airlines, China Eastern, China Southern, Emirates, Fiji Airways, Hong Kong Airlines, Korean Air, LATAM Airlines, Malaysia Airlines, Philippine Airlines, Singapore Airlines, Tasman Cargo Airlines, Tianjin Airlines, Thai Airways International, United Airlines, Virgin Australia.

## Issues being considered in the review

**Target return / WACC**

***Justifications for a WACC uplift***

6. Auckland and Christchurch Airports put forward their case for setting a WACC higher than the Commission's mid-point estimate. Christchurch Airport states that their adjustments to the Commission's estimate reflect its specific circumstances.[2] These points do not change our view that both airports are targeting a WACC that is too high and that they have failed to demonstrate that these higher WACCs are in the long-term interest of consumers.

7. Auckland Airport and NZAA discuss what they see as the key points of the Commission's December 2016 Airport WACC percentile decision.[3] BARNZ considers that the airports have managed to overlook key aspects of the Commission's 2016 decision paper (despite BARNZ pointing out these aspects in submissions during the consultation process).

8. While it is correct that the Commission's decision paper said there may be grounds for airports to set a WACC above the mid-point, the airports overlook that the Commission also said:

    a. The risk of the regulatory WACC estimate constraining investment is much lower for airports than for energy businesses[4]

    b. Even where the regulatory WACC is a potentially binding constraint on an airport's targeted return, there are other airport-specific factors (ie the dual till) which mean this has a more limited impact on investment than in the energy sector. There is only a limited amount of investments that do not influence Till 2 revenues.[5]

    c. Any under-investment that does occur is also less likely to result in a withdrawal of service than in the energy sector. In general, the Commission expects any under-investment to instead result in delays to capacity expansion which is likely to lead to a lower quality of service (such as delays at peak time or shifting of demand out of peak periods). The Commission also notes that some consumers will be able to adapt their travel arrangements in response to delays.[6]

    d. Any deterioration in quality is likely to build up over time, providing opportunities for airports and airlines to find solutions before the cost to consumers becomes too high.[7]

9. The Commission noted that an uplift to the Commission's mid-point WACC estimate "could be justified **if the benefits to consumers** from the higher WACC **outweighed the costs of the higher prices** that will result from an additional uplift on the WACC"[8] [emphasis added]. It is clear this test has not been met in relation to the Auckland and Christchurch pricing decisions.

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[2] Christchurch Airport submission, paragraph 28.
[3] Auckland Airport submission, page 10. NZAA submission, page 7.
[4] Commerce Commission, Input Methodologies Review Decisions – Topic Paper 6: WACC percentile for airports, 20 December 2016, paragraph 138.
[5] Ibid, paragraphs 139 and 171.
[6] Ibid, paragraphs 150-151.
[7] Ibid, paragraph 152.
[8] Ibid, paragraph 146.

10. The Commission also considered that the most relevant evidence to assess when determining whether a higher WACC is justified was "evidence on why the targeted return needs to be higher than the Commission's mid-point estimate of WACC in the airport's specific circumstances and **evidence on the long-term benefit of consumers from the specific investment** being considered"[9] [emphasis added].

11. BARNZ considers that neither airport has done enough to justify its WACC uplift in terms of consumer net benefits. It is clear that the higher WACCs will cost passengers more ($75m over five years). It is not clear what benefits passengers will get in return for these higher payments, or that those benefits are worth more to the passengers than $75m:

    a. Christchurch Airport does not appear to have considered this question
    b. Auckland Airport has stated that the increased WACC will make it more likely that it will undertake investments that would benefit consumers.[10] However, BARNZ considers that the investments would go ahead anyway as they will be needed to sustain the airport's Till 2 revenues.

12. BARNZ agrees with the Commission that the correct test for assessing a decision to set the WACC at a level different to the Commission's mid-point is whether the long-term benefit to consumers from the different WACC outweighs the cost. Neither airport has demonstrated that this test has been met.

13. BARNZ also agrees with Air New Zealand that:

    > "In setting their WACC, the dual till model allows both airports to ignore their commercial till. The commercial income earned by both airports lowers their commercial risk. In a workably competitive market investors would not ignore this, and nor should the Commission when assessing appropriate cost of capital."[11]

***Christchurch Airport's target WACC and expected return***

14. Christchurch Airport has said that, although it developed its standard prices based on a WACC of 6.82%, it should be assessed against what it believes is its expected return over PSE3 of 6.44%. Christchurch Airport explains that the "key reason for the difference is the effect of concessions that have been provided to airlines (and that extend into PSE3) in order to encourage additional services to be established and maintained). We also understand that the 6.44% IRR also takes account of reduced revenues through commercial check-in arrangements with one or more airlines.

15. As a first point, this appears to be an acceptance that 6.44% (very close to the Commission's mid-point of 6.41%) is an acceptable return for an airport to be targeting. This should give comfort to the Commission that departures from the mid-point are not necessary.

16. From a positive perspective, the airport is not directly seeking to recover the cost of these concessions from its airline customers – this is a welcome decision and we would hope other New Zealand airports will follow this lead. We also acknowledge that some airlines and passengers will be benefitting from these concessions.

17. However, in principle we question whether the revenue and cost structure that leads to the expected 6.44% target should be the focus of the Commission's review. The airport consulted on prices based on a

[9] Ibid, paragraph 158.
[10] Auckland Airport submission, page 11.
[11] Air New Zealand submission, page 1.

WACC of 6.82% and these prices are now the standard charges. Christchurch Airport is asking the Commission to take into account the cost of separate deals with selected airlines that were made on a commercial basis and where the cost was excluded from airline consultation and also excluded from the model used to develop the standard prices. Some, probably most, airlines that fly to and from Christchurch will need to pay the standard charges and these are the charges the airport is able to apply as a natural monopoly. A few will pay lower charges, as a result of commercial negotiations. Part 4 regulation only applies to airports because they are natural monopolies and it seems more appropriate to assess target returns based on the monopoly charges.

18. In practical terms, if the Commission was to accept that 6.44% should be the basis for the review, it will need additional information to review Christchurch Airport's expected return (ie detailed information about the cost of the concessions to confirm the values stated in the disclosure are correct). This is because some of the inputs that Christchurch Airport has used to calculate its 6.44% will be commercially confidential and were not subject to pricing consultation; so would require more detailed review by the Commission.

**Runway land charge**

19. Pages 16-19 of Auckland Airport's submission discuss its decision to create a runway land charge (RLC), which may be imposed from 1 July 2020. BARNZ has set out its view on the runway land charge in our submission and we have only a few additional points to make in response to Auckland Airport's submission. We continue to believe it is unacceptable to charge consumers for an asset that does not exist and cannot be used.

20. BARNZ agrees it is prudent for Auckland Airport to hold the land for the second runway and start the planning process for its development.

21. BARNZ disagrees that the RLC will deliver "a more equitable distribution of currently accruing holding costs over both current and future users". It is not equitable to allocate a cost to a party that cannot benefit from it.

22. BARNZ also disagrees that the RLC will "provide greater confidence" that the runway will be built when needed – as explained in the Pat Duignan report attached to our submission, the introduction of the charge reduces incentives for the airport to complete construction once it has begun.

23. BARNZ disagrees that the RLC will provide a useful pricing signal to airlines to work with the airport and Airways to increase the utilisation of the current runway. Airlines are already motivated to do this in order to achieve efficiencies and avoid the unnecessarily early cost of the second runway – the benefit of avoiding an RLC is not a material factor in this context. BARNZ and major airlines are already participating in the Airport Capacity Enhancement project, which is intended to find efficiencies on the current runway and defer the need for the construction of a second runway.

24. On page 19, Auckland Airport refer to the method used to disclose the RLC and track revenues from it over time as "BARNZ preference during input methodology workshops". BARNZ agrees with the method for disclosing the RLC if one is introduced, but this does not affect our principled opposition to the charge itself.

25. Page 22 of Auckland Airport's submission set out why the airport does not believe a peak price would be useful. For the most part, BARNZ agrees with this analysis. We agree a peak price is not an optimal solution, for the reasons set out in our submission on the Process and Issues paper.

**Opex efficiency**

26. BARNZ remains concerned about operating cost efficiency at both Auckland and Christchurch airports.

27. In our previous submission BARNZ discussed Auckland Airport's opex efficiency, including that we were unable to reconcile the numbers in Figure (7) of Auckland Airport's PSE3 disclosure companion paper. With the FY17 disclosures available (they were published after submissions were made on the Process and Issues paper), we are now able to reconcile those values.[12]

28. With a full picture of Auckland Airport's opex efficiency now available, we make the following observations:

    a. The Airport is still forecasting to have diseconomies of scale. BARNZ remains of the view that these diseconomies should not be passed on to customers. We do not believe this would happen in workably competitive markets – a company that cannot find efficiencies through growth should bear the inefficiencies itself.
    b. Real opex per passenger increases in both FY18 and FY19 before resuming something close to the pre-2017 downwards trend; we would have expected that more of the savings in per passenger expenditure could have been retained.

29. Had investment kept pace with demand, we would have expected the airport would have been able to achieve scale economies and declining costs per passenger in PSE3.

30. For Christchurch Airport, paragraph 47 of their submission states that "opex is unlikely to be material in assessing CIAL's profitability". We are not sure what this means – CIAL's opex forecasts will have a material effect on its disclosed target IRR. In any event, it remains important to review expenditure efficiency at all regulated airports.

**Other**

***Cost allocation***

31. Page 26 of Auckland Airport's submission states that "cost allocation with respect to the investment programme was not a major focus of the pricing consultation process". For the record, the concerns raised by BARNZ in terms of the 'company-wide model' that is applied to shared costs[13] also apply to the shared assets for which that allocator is used.

***Risk allocation and incentive regulation***

32. Auckland Airport discusses risk allocation in relation to capital spending on pages 26-27 of its submission. BARNZ remains of the view that airlines/passengers bear the risk of capex under-spending if an airport cannot deliver on its forecast capital plan (as they need to pay for assets that are not delivered until the start of the next pricing period).

33. BARNZ also notes the quoted Commission view from the time of the review of PSE2 prices, that setting fixed prices for a period gives suppliers an incentive to outperform their forecasts, consistent with the design of incentive regulation. BARNZ believes that this view is misplaced in relation to airports. Incentive regulation does not work in an industry where the supplier has the ability to price as they see

[12] This is an example of helpful new information that has become available since the pricing decisions were made and is useful to take account of in this review.
[13] See item 12 in Table 2 of BARNZ's submission on the Process and Issues Paper.

fit because it will always be easier to set forecast costs higher than expected costs than it is to find genuine efficiencies. To obtain the outcomes expected by incentive regulation, it would first be necessary to properly apply incentive regulation to airports.

***Outcomes of the review***

34. BARNZ agrees with Air New Zealand that:[14]

> "At the conclusion of this review process, the Commission should be able to heighten the regulatory threat for any airport found to be targeting excess profits, swiftly moving them to a different regulatory model. If the Commission is not empowered to do this in the current legislative framework, change must be made."

## Contact details

35. If you have any questions about this submission, please contact me on 09 358 0696 or at ian@barnz.org.nz.

Yours sincerely,

**Ian Ferguson**
Regulatory Manager

[14] Air New Zealand submission, page 2.