Cross-Submission on responses to the Commerce Commission Process and Issues Paper for its review of Auckland Airport's 2022 – 2027 price setting event

21 February 2024

Table of Contents

1. Introduction 3
2. Executive Summary 4
3. Response to submissions on the purpose and scope of this section 53B review 7
   - 3.1. Information disclosure regulation is effective 7
   - 3.2. Auckland Airport has consulted with an open mind, consistent with its consultation obligations 8
   - 3.3. The Commission is correct that it is not its role to consider alternatives in this review 9
   - 3.4. Decisions on prices for PSE5 have not yet been made 10
   - 3.5. Review of returns on non-priced assets 11
   - 3.6. Airlines submissions must be put in context 11
4. Response to submissions on capital investment 14
   - 4.1. Incentives for capital investment are calibrated correctly and have the right checks and balances 14
   - 4.2. Airline claims that Auckland Airport has a history of underspending on capex are incorrect 15
   - 4.3. Air New Zealand and BARNZ supported a capital plan that cost just 5% less in 2021 19
   - 4.4. Airlines have not presented a viable alternative solution 20
   - 4.5. Capital cost estimates reflect the cost of construction in the New Zealand market 23
   - 4.6. Capital cost allocations 23
   - 4.7. Reconciliation of capital investment forecasts 24
5. Response to submissions on the cost of capital 25
   - 5.1. Airlines are inconsistent in their views on how the pandemic should have been treated 25
   - 5.2. Cost of capital inputs adopted are consistent with the approach outlined in the price freeze proposal supported by airlines 26
   - 5.3. Inputs adopted to determine the cost of capital 26
6. Response to submissions on other issues 29
   - 6.1. Passenger demand forecasts 29
   - 6.2. Depreciation forecasts and asset useful lives 30
   - 6.3. Accelerated depreciation 31
   - 6.4. Capex wash-up 31
   - 6.5. Two-way wash-up 32
   - 6.6. Operational cost forecasts 33
   - 6.7. Operational cost allocations 33
   - 6.8. Treatment of tax losses 34
   - 6.9. Correction of errors 35
   - 6.10. Innovation 36
   - 6.11. Freightways and New Zealand Post submission 36

Appendix A – CEG reports 38

1. Introduction

The Commerce Commission ("**Commission**") has commenced its review of Auckland International Airport Limited's ("**Auckland Airport**") fourth price setting event, covering prices for the July 2022 – June 2027 period ("**PSE4**"). On 7 February 2024, the Commission published the responses it had received from its process and issues paper ("**Issues Paper**").

Auckland Airport refers to the Commission's comment in its Issues Paper that it intends to focus its review on Auckland Airport's PSE4 price setting disclosure ("**PSD**") and our submissions are aligned to that focus. However, Auckland Airport would be happy to provide further information to the Commission to aid its review.

2. Executive Summary

Auckland Airport welcomes this section 53B review which follows our pricing decision for PSE4. These reviews play an important role in the information disclosure (“**ID**”) regulatory framework for airports in New Zealand.

The regulatory regime for airports in New Zealand has been designed for the long-term benefit of all consumers. It has been subject to a number of reviews and revisions over the years to ensure it remains fit-for-purpose as the industry evolves.

The long-term planning of airports and short-term objectives of airlines do not always align, as starkly demonstrated by the submissions from Air New Zealand, Qantas and the Board of Airline Representatives (“**BARNZ**”). These parties seek to reduce airport charges by advocating for delays to investment and undermining the current regulatory regime. Auckland Airport is concerned that the short-term commercial objectives of airlines will result in material additional cost to all consumers over the long-term.

Ordinarily, Auckland Airport would seek to limit its cross submission to points relevant to the matters raised in the Commission’s Issues Paper and to the scope of the section 53B review. However, given a number of submissions go beyond the scope of the section 53B review, Auckland Airport is responding to these out-of-scope matters so that the Commission has the appropriate context for it to assess that Auckland Airport’s performance is indeed consistent with the purpose of Part 4 and promotes the long-term benefit of New Zealand consumers.

Charges make up only a fraction of airfares and fund airport investment

Auckland Airport is New Zealand’s main gateway and the first and last place that over 77% of visitors to the country experience New Zealand. This is a responsibility Auckland Airport takes very seriously and investment in the gateway is essential if we are to remain resilient for the future. We must ensure our operations and the infrastructure we build balance the many divergent interests of all stakeholders that operate on the airport precinct, whilst also supporting economic activity and social connection through travel, trade and tourism. Failure to do so will come at a significant economic cost to consumers and our economy.

Auckland Airport’s domestic charges have been extremely low for a long time, less than half of Wellington and Christchurch airports since 2011, reflecting the age of our assets. These low charges have reduced the cost of domestic operations for Air New Zealand and with it benefited its shareholders since 2011 by over $470 million.[1]

With investment, Auckland Airport acknowledges that airport charges will need to further increase into the next pricing period. However, no decisions have been made on those charges. These will be subject to consultation with Substantial Customers prior to the commencement of PSE5. Price increases for a charge that makes up less than 5% of an airfare benefits consumers and the economy, by funding the essential infrastructure needed to provide a quality service and to accommodate sufficient competition. This is in contrast to Air New Zealand increasing domestic and regional airfares by an average of $70 (or 56%) post the pandemic in the absence of any material increase to airport charges and with little impact on demand.

Integrated terminal received broad support from airlines in 2021

Auckland Airport has consulted with its Substantial Customers for over 10 years on a replacement domestic terminal, with integration being included in the 2014 Master Plan. There have been 21 designs considered before the integrated terminal pathway was approved by the Auckland Airport Board in 2021. At the time of that decision, the integrated terminal pathway proposal, later called with Terminal Integration Programme, was supported by both Air New Zealand and BARNZ. Despite this original support, both have since withdrawn their support for the investment programme.

[1] Compared to the average prices charged by Wellington and Christchurch Airports

Auckland Airport

Airlines oppose higher prices rather than disagree with increased capital investment

The claims of both Air New Zealand and BARNZ in their submissions, combined with their opposition to the proposed investment at Auckland Airport, are inconsistent with their previous positions of supporting a capital investment plan at Auckland Airport of a similar overall cost, that was within 5% of the capital plan that is now proposed.

Auckland Airport has acted responsibly, through re-calibrating its capital investment plan, including changing the scope and timing of projects, in response to airline feedback and material construction cost inflation. This has mitigated the impact on aeronautical prices, by keeping the overall capital envelope largely unchanged.

The airlines' real issue is that recent increases in cost of capital caused by higher interest rates have increased the indicative projections of the PSE5 domestic price path, compared to forecasts at the time they supported the capital investment plan. Auckland Airport is committed to setting PSE5 prices that provide no more than a fair return on investment, and to exploring alternative (e.g. long term) price paths to mitigate PSE5 price increases.

There is widespread commentary around the infrastructure deficit in New Zealand and the challenges this is posing in a number of sectors including water and transport. The New Zealand Treasury's Infrastructure Action Plan, stated in May 2023 that "we not only need to build more and better infrastructure, but we need to prepare to mitigate the impacts of climate change on our built environment."[2] This is exactly what Auckland Airport is doing.

Alternative terminal proposed by Air New Zealand is not viable

Auckland Airport did not receive any alternative terminal proposals from Air New Zealand prior to its decision to re-affirm its commitment to the Terminal Integration Programme in March 2023. Seven months after that decision, Air New Zealand put forward a preferred alternative terminal option (developed by its consultants Arup). This proposal is a theoretical design which fails to consider the realities of an operating airport and the quality of experience required by all users of the airport system, including government agencies. Limited consideration has been given to the operational model for this alternative, and a proposal to split domestic jet operations across two terminals will challenge the airport system and travellers.

Air New Zealand has claimed that the alternative design would result in a reduction of costs of $1 billion, but this reflects the early stage of desig47n and limited work conducted on the operational efficacy of the plan. Auckland Airport, with the benefit of more detailed data and analysis of operating requirements, estimates that the real cost differential to Auckland Airport's current plan is less than 5%. The differential could be even closer when you factor in the significant additional spend that will be required to extend the life and capacity of the existing domestic terminal building. The reality is, however, that a further delay to the necessary investment, and any longer delivery duration, would materially risk additional construction cost escalation above forecast and result in greater overall expense. Change of mind by airlines undermines delivery of long-term infrastructure.

The theoretical design proposal from Air New Zealand has similarities to the pre-pandemic terminal development pathway that included a more adjacent terminal solution. In 2021 Air New Zealand supported Auckland Airport's decision to move away from this design, and to adopt a pathway to deliver an integrated terminal solution because of the benefits it would bring.

Its current proposal indicates that it has changed its mind. This is not compatible with the development of long-lead time infrastructure. Airlines have a track record of claiming that Auckland Airport has under-invested in the past but plans to over-invest in the future. These themes have been repeated in this review, as it remains in airlines' interests to oppose airport investment and undermine a regulatory regime that is designed to ensure outcomes are consistent with those that are achieved in competitive markets.

[2] He Whakakaupapa mō, Te Hanganga o Aoteraroa The Infrastructure Action Plan (May 2023), page 2

Undermining the current regulatory regime will come at a cost to consumers

Airline submissions call for the Commission to examine the current regulation of airports.

This is a regime that was carefully and thoughtfully developed and calibrated. It has been examined and tested a number of times. It has (rightly) not been developed for the benefit of airlines or airports, but for the benefit of consumers.

There are a number of examples in airline submissions where new objections or concerns with the approach adopted for the PSE4 pricing decision have been raised for the first time, and not put to Auckland Airport through the consultation process. This denied Auckland Airport the opportunity to consider these issues ahead of setting prices. It also gives the erroneous impression that the current regulatory framework is not fit for purpose, by seeking to undermine Auckland Airport's credibility, when Auckland Airport has in fact followed a transparent, objective and thorough consultation process where airline feedback has affected changes from initial proposals to final decisions.

The processes we adopt as we consult and make these important decisions must consider the complete picture. We cannot ignore the facts that do not suit us. The regime is set up that way. This ensures that Auckland Airport delivers an airport service which brings consumer benefits over the long-term, consistent with the purpose of Part 4 of the Commerce Act.

Recommendations in response to airline submissions

After reflecting upon the airline submissions, Auckland Airport reiterates the following points to the Commission as it undertakes this review.

This is not a review of the regulatory regime, nor is one required

The regulatory regime delivers outcomes consistent with those in competitive markets. The regime operates for the benefit of consumers whose interests are not always aligned with that of airlines.

It is also not a review of whether Auckland Airport has fulfilled its consultation obligations (which it has). The Commission should maintain its proposed scope for this review, which is to consider information available to Auckland Airport at the time, and to consider whether Auckland Airport's PSE4 pricing decision is consistent with the purpose of Part 4.

The Commission should maintain its proposed scope for this review

The Commission should recognise that airlines have their own commercial incentives to oppose airport investment and keep airport charges down. While such objectives are entirely legitimate from a commercial perspective, airline views must not be the sole measure of success of the ID regime, which is delivering outcomes consistent with the Part 4 purpose statement. Capital investment is required at Auckland Airport, and no submission made in this process has argued against that need.

3. Response to submissions on the purpose and scope of this section 53B review

3.1. Information disclosure regulation is effective

Airline submissions claimed that the current ID regime is not fit for purpose[3] and doesn't operate to deter inefficient investment.[4] Air New Zealand has called for this review to be expanded to include the effectiveness of the ID regime. We agree with BARNZ[5] and IATA[6] that an assessment of ID regulation is not within the scope of this review. However, BARNZ and IATA have called for a subsequent inquiry into the regulatory regime that applies to Auckland Airport.[7]

Auckland Airport believes such an inquiry is unnecessary, as the current ID regime is working effectively and consistently with the purpose of Part 4. The current regulatory framework that applies to airports, including the dual till regime and ID regulation was carefully and deliberately designed to ensure that airports are incentivised to make decisions that are aligned to the interests of the New Zealand community over the long-term. This does not necessarily mean that the outcomes are in the best interest of airlines, but rather reflect outcomes that are consistent with those reached in competitive markets.

Calls for change by airlines were considered and rejected by the Government when it recently developed and passed the Civil Aviation Act 2023. Further review is not necessary or warranted.

The current regime provides the appropriate incentives for airports to make decisions that are best for consumers

The regulatory framework has been carefully calibrated to ensure that airports have appropriate incentives to innovate and invest, provide services that are efficient and at a quality that customers expect, set prices that deliver a reasonable and fair return on investment, and share the benefits of these outcomes with consumers, by achieving outcomes that are consistent with those in competitive markets.

The dual-till regime provides an important commercial incentive for airports to ensure it keeps price as low as possible (including investment efficient), to minimise any potential impacts on passenger volumes from higher prices, as passenger volumes are a key driver of non-regulated airport revenues. This is an important incentive, purposefully included in the current regime, and completely ignored by airlines in their submissions.

The Commission should take comfort during this review that the regulatory settings are designed to achieve outcomes consistent with the purpose of Part 4.

Commercial incentives for airlines are not always aligned to optimal outcomes

Airlines have strong commercial incentives to keep airport charges as low as possible, because minimising airport charges reduces operational cost for airlines. Airlines may prefer to have lower operational costs, with lower service quality. However, lower service quality can impact on all airport users, not just airlines. That is why the airport is the party accountable for delivering the right service that consumers demand – quite rightly it is the airport's social licence at stake if a poor service is provided.

As airlines use revenue management and dynamic pricing to set airfares, these costs are not always passed directly onto the consumer in the form of higher prices. Lower airport charges can directly drive higher airline profitability. Airlines, particularly incumbent home carriers, can benefit from constrained airport capacity. These dynamics were considered by the Australian Productivity Commission in 2019

3 Air New Zealand submission, page 3
4 Qantas submission, page 10
5 BARNZ submission, paragraph 5
6 IATA submission, at page 5
7 BARNZ submission, paragraph 5; IATA submission, page 5.

when it undertook its inquiry into the economic regulation of airports in Australia where it found (emphasis added):

> *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.*[8]

Auckland Airport considers that this is highly relevant in the current context, particularly where Air New Zealand, the incumbent home carrier, holds 86% of the capacity in the domestic market. The commercial incentives for airlines to delay or oppose investment and minimise airport charges is strong. The Commission should take this into account as it considers submissions from airlines to this review, to ensure that outcomes consistent with those in competitive markets are achieved and are therefore aligned with the purpose of Part 4.

3.2. Auckland Airport has consulted with an open mind, consistent with its consultation obligations

A review of consultation process is not necessary, nor within the scope of this review

Airlines in their submissions have raised concerns over the consultation process that has been undertaken by Auckland Airport. Auckland Airport strongly rejects these claims.

These claims misrepresent the significant consideration that Auckland Airport gave to airline feedback received during the consultation process, both for capital investment over the previous decade, and more recently the two years leading up to the PSE4 pricing decision. A thorough process, involving a significant amount of detailed analysis was undertaken and this has not been fairly reflected in the airline submissions.

That airlines do not agree with the decisions taken by Auckland Airport does not mean that Auckland Airport's consultation obligations have not been met. Auckland Airport provided significant amounts of detailed information that set out the consultation process that was followed in reaching recent decisions on capital investment and pricing. The Commission can take comfort in the detail that has been included in these disclosures that a robust consultation process has been followed.

As highlighted in this submission, there are numerous examples where airlines have only engaged with select pieces of information and ignored other relevant information that must be considered when making an informed decision. Cost is one factor that Auckland Airport has considered in arriving in this decision, but there are many others. This includes airport safety and resilience, particularly by enabling contingent runway operations, and identifying the investment pathway required to provide the capacity necessary to meet long term demand, and to ensure that our service meets the quality that all customers, airport users and passengers expect.

Auckland Airport cannot ignore these other essential elements of providing an airport service - it must consider the bigger picture and all relevant information. All information that was available at the time of taking these decisions, including information provided by airlines, was considered and changes were made as a result, before making decisions on capital investment and aeronautical prices.

Auckland Airport notes that BARNZ requested that this review include consideration of the consultation process undertaken by Auckland Airport.[9] Auckland Airport highly respects the legal consultation obligations that it has with Substantial Customers, and they are an important part of what is an effective and fit for purpose regulatory regime. Auckland Airport also acknowledges that the Commission will

[8] Australian Productivity Commission, Economic Regulation of Airports (21 June 2019), page 306
[9] BARNZ submission, paragraph 13

review the pricing disclosures (made in accordance with clause 2.5(1)(m) of the ID Determination) to assess Auckland Airport's engagement with customers and its consideration of their feedback on capex projects to assess customer demands. That is an important part of assessing whether Auckland Airport's capital expenditure decision-making is consistent with the purpose of Part 4.

However, considering whether Auckland Airport has met its legal consultation obligations to substantial customers is not the purpose of this section 53B review. These obligations lie under the Airport Authorities Act 1966 ("**AAA**") and are therefore outside the scope of this review.

Nevertheless, if the Commission intends to place any weight on the claims that question the consultation process while undertaking this section 53B review, Auckland Airport can provide the Commission with further detailed and extensive evidence which demonstrates that Auckland Airport considered all the feedback received, consulted with an open mind, and met its legal consultation obligations.

Finally, we consider it worth emphasising the following points set out in our PSD:

- As Auckland Airport has explained in its previous communications with Substantial Customers, while capital expenditure forecasts are a key input into the PSE4 pricing decision, these are in fact two separate decisions under the AAA, each requiring consultation;
- Specifically, Auckland Airport is required to consult with Substantial Customers prior to the setting of standard aeronautical charges for PSE4 pursuant to section 4B of the AAA, and prior to approving significant capital expenditure pursuant to section 4C of the AAA; and
- It is simply a coincidence, and not by design, that after a decade of consultation with airlines, with 21 different designs having been considered, the Auckland Airport Board's 16 March 2023 decision to approve further expenditure on design of the Terminal Integration Programme without airline support, and reaffirm its commitment to the May 2021 Paheko East integrated pathway decision which previously did have airline support, occurred in close temporal proximity to the tail end of the PSE4 aeronautical pricing consultation.

Auckland Airport stands by its thorough and robust consultation process.

3.3. The Commission is correct that it is not its role to consider alternatives in this review

In response to the submissions from airlines, Auckland Airport reiterates its submission to the Issues Paper that it agrees with the Commission's proposed approach when it comes to considering alternatives:

> *The purpose of our analysis is to assess whether the expected outcomes of Auckland Airport's pricing decisions are consistent with the purpose of Part 4 of the Act. This analysis does not determine the specific choices that Auckland Airport ought to have made in its pricing decisions, nor what we would have done in its place.*[10]

Further, on capital investment, Auckland Airport endorses the Commission's approach as set out in the Issues Paper:

> *Furthermore, we propose to consider whether the airport is investing in its assets appropriately and in a way that meets the quality consumers demand. We intend to rely principally on the investment plan information in the PSE4 disclosure to draw conclusions in our summary and analysis, but may gather limited additional information where necessary.*[11]

Auckland Airport does not consider that the airline submissions warrant any change to the Commission's proposed approach.

Auckland Airport notes that airlines have made submissions claiming that there are viable capital investment alternatives. Despite airline claims, the truth is that there are not viable alternatives. Auckland Airport addresses the detail, credibility and accuracy of those claims later in this submission.

[10] Commerce Commission, PSE4 issues paper, paragraph 17
[11] Commerce Commission, PSE4 issues paper, paragraph 20

Capital investment planning and designing is inherently complex. Auckland Airport is best placed to make these decisions, which is another reason why the Commission should not consider alternatives for capital investment projects in this review.

3.4. Decisions on prices for PSE5 have not yet been made

Commission's review cannot extend to PSE5 pricing

Air New Zealand[12] and BARNZ[13] have called for the Commission to expand the scope of its review to include both PSE4 and PSE5.

Auckland Airport considers that it is appropriate for the Commission to examine and consider the information included in the PSE4 PSD as is required, including the planned capital investment plan over the 10 years to FY32. This longer-term view for capital investment reflects that investment in airport projects requires long-lead times and a longer-term view. These forecasts will once again be updated when it comes time to set prices for PSE5.

However, this section 53B review is of Auckland Airport's aeronautical prices for PSE4, and that scope should remain unchanged. No decisions have been made on prices for PSE5 meaning there is no decision for aeronautical prices during this period for the Commission to review. It is simply not possible to review prices that are five years into the future and that are yet to be set by Auckland Airport.

Auckland Airport acknowledges that the capital investment plan set out in the PSE4 PSD will mean that if delivered to forecast, prices will increase again in PSE5 given the significant amount of investment that is commissioned. This approach is consistent with the IMs and the building blocks methodology and follows an extended period when prices have been low at Auckland Airport.

Auckland Airport's domestic charges have been more than 50% cheaper than Wellington and Christchurch airports since 2011. These lower prices have provided materially lower costs for all customers, for example Air New Zealand's costs at Auckland Airport have been $470 million lower since 2011 compared to the prices charged at Wellington and Christchurch. In today's dollars, this value would be substantially more.

What the Commission can and should consider in this review is whether Auckland Airport's infrastructure plan set out in the PSE4 PSD delivers long-term consumer benefits and is therefore consistent with the purpose of Part 4 of the Commerce Act. Whether this investment is in the short-term commercial interests of airlines is not a relevant consideration.

Investment decisions have been made for projects that Commission in PSE5

Auckland Airport notes that Qantas submitted:

> *Although AIAL states that no decisions have been made on the PSE5 aeronautical capital expenditure projects and suggests that prices during PSE5 are uncertain*[14]

Auckland Airport wishes to clarify that the first part of this statement is incorrect. Decisions have been made with regards to capital expenditure that will commission in PSE5, namely elements of the Terminal Integration Programme, and this has been communicated to airlines. It would not be possible to deliver the necessary airport infrastructure and complete construction of these assets within a single 5-year pricing period given the long-lead times required to deliver significant airport infrastructure.

However, as Qantas correctly notes in the second half of this statement, prices for PSE5 remain uncertain, and no decisions have been made with regard to these prices.

[12] Air New Zealand submission, paragraph 79
[13] BARNZ submission, paragraph 36
[14] Qantas submission, p. 8

Option to mitigate price increases in PSE5 was opposed by Substantial Customers

Air New Zealand submitted that:

> *AIAL has consistently refused to consider alternative solutions or make material concessions to find workable solutions to mitigate these price shocks*[15]

As set out in the PSE4 PSD, Auckland Airport's prices in PSE4 are well in-line with comparable benchmark airports. Claiming that the PSE4 pricing decision is a 'price shock', could only be due to Auckland Airport prices being compared to an historical low - on average less than half of those at Christchurch and Wellington airports since 2011.

The Air New Zealand submission implies that if these price shocks in PSE4 are a concern, then any outcome other than for the unsustainably low domestic charges to continue into the future is completely unacceptable.

Auckland Airport did in fact consult with airlines on options that could be taken in PSE4 to mitigate future price increases. The most effective option identified was to bring forward revenue into PSE4 using the carry-forward mechanisms as stipulated under the IMs. This can be a powerful tool, as the holding costs of the revenue compound at the rate of target return and could materially reduce PSE5 prices. Despite demonstrating this option could have a material impact to reduce future price increases, after considering the feedback received from Substantial Customers during consultation, the proposal was ultimately not adopted by Auckland Airport.

Auckland Airport will continue to engage with airlines ahead of PSE5

Auckland Airport will continue to actively engage with Substantial Customers ahead of PSE5, and once again consult with airlines in accordance with our regulatory obligations, before a PSE5 pricing decision is due in 2027. Auckland Airport is committed to ensuring its prices are efficient, and delivering outcomes that are consistent with those reached in competitive markets, and therefore aligned with the purpose of Part 4.

3.5. Review of returns on non-priced assets

We note that Air New Zealand has considered the Commission should undertake a longer-term analysis of returns for non-priced aeronautical assets, and that the Commission should request Auckland Airport for details of proposed contract renewals relating to non-priced assets.[16]

Auckland Airport considers that such a review would go beyond the scope of this section 53B review and summary and analysis of Auckland Airport's PSD. In any event, the need for such a review has not been demonstrated, given the returns forecast for this segment. Non-priced returns for this segment are forecast to be lower than the priced target return, given the significant new investment that is also planned for non-priced assets, and the inability to make a recovery on indirectly allocated non-priced assets that do not directly drive revenue. Annual ID provides the Commission with sufficient information to make an assessment if there is cause any for concern. In this case, further investigation is unwarranted.

3.6. Airlines submissions must be put in context

Auckland Airport has gone to considerable effort in this cross-submission to respond to many of the claims made by airlines in its submissions to the Issues Paper, and to put them into context. Additional context is important, given airlines' commercial incentives to oppose airport investment and to minimise airport charges.

Auckland Airport seeks to supplement airline claims that do not consider the full context with additional relevant information that have been excluded, or are, in Auckland Airport's view, incorrect. Some examples of such claims are outlined in the following table.

[15] Air New Zealand submission, p. 3
[16] Air New Zealand submission, paragraphs 7 and 8

Airline submissions state that…	It is also important to recognise that...
Auckland Airport has historically under-invested in aeronautical infrastructure.	The Commerce Commission has looked at this a number of times and concluded that Auckland Airport has invested appropriately. The only period the Commission has not reviewed is the most recent one – where investment was halted with broad airline support during the middle of the COVID-19 pandemic.
Auckland Airport's prices are not consistent with outcomes in competitive markets.	Auckland Airport's domestic prices have been very low for an extended period of time – on average less than half of Wellington and Christchurch since 2011 – these increases are off a low base. Price increases in this pricing period only bring Auckland Airport in line with other comparable airports. These unsustainably low prices have significantly reduced the costs of operation for Air New Zealand at Auckland Airport by over $470 million since 2011.
They are frustrated by the delivery of capex to date.	They strongly oppose the capital investment plan going forward.
Auckland Airport has ignored airline views on the capital investment plan.	Auckland Airport has consulted on 21 terminal designs over the last 10 years. Many changes to the plan, programme and terminal design have been made in response to airline feedback. The Terminal Integration Programme reflects the terminal integration pathway supported by Air New Zealand and BARNZ in 2021.
Retail space included in the terminal design will cost travellers.	Costs for non-regulated activities are not recovered through aeronautical charges, rather paid for by the lessees.
The terminal designs are too large and should be smaller.	There has been previous airline support for terminal designs of similar size and scope. The terminal has been designed with reference to IATA's level of service design benchmarks.
A viable alternative terminal design has simply been ignored.	Auckland Airport has considered the theoretical alternatives presented in detail, assessed them accordingly, and not considered them to be viable alternatives that meet all requirements. This proposal was only given to Auckland Airport well after decisions had been made, following the completion of over a decade of consultation. The proposal is a 'back-flip' from Air New Zealand after it supported Auckland Airport discarding the similar domestic jet facility design for a more integrated solution it supported in 2021.
Viable alternative designs are $1 billion cheaper.	Auckland Airport analysed the proposal and found the cost gap was closer to $100 million, with the potential that it could even be more expensive when other unquantified costs are included. Air New Zealand's terminal proposal would be inferior to the Terminal Integration Programme and result in a poorer passenger experience.
Auckland Airport has waited to invest, only when returns are at the 'top of the cycle'.	The investment programme has been contemplated for a number of years, as evidenced by Auckland Airport's external communications.
The cost of Auckland Airport's capital plan must be drastically reduced.	Both Air New Zealand and BARNZ supported a capital investment plan that was only 5% lower in overall cost in 2021. Auckland Airport's investment plans are in-line with and exceeded by investments at other overseas airports that are also investing significantly in new facilities (see below at 4.1)
Auckland Airport should have adopted a risk free-rate of 2.67% when setting the cost of capital.	This approach was not raised by airlines during consultation. The approach to use 3.6% was not opposed during consultation by that same airline.
Cost of capital input parameters should be strictly applied from the 2016 IM.	The risk of airport investment has changed materially due to the pandemic, and that a pre-COVID measure of airport risk is no longer relevant.

In isolation, such claims could be considered with less scepticism. However, when considered in totality, this demonstrates a pattern of behaviour that undermines the credibility of these submissions. Themes that Auckland Airport has observed include:

- **claims of historic underinvestment** - in this review, and in previous reviews the record shows that there is a pattern of airlines claiming that Auckland Airport has under-invested historically, but plans to over-invest in the future, despite there being no evidence of either;
- **alternatives being used to cast doubt and slow progress** - the introduction of alternative approaches or solutions can be used to cast doubt over airport plans and approaches, with relatively little information or evidence required to substantiate this doubt;
- **inconsistent airline views and positions** - whether it is support for approaches to capital investment, or views on Auckland Airport's approach to determining the cost of capital input parameters, these are examples (which are further discussed in this submission) where airlines now have different views to those that were communicated during consultation, without any material change in circumstances, yet still imply an expectation that these alternative approaches should have been adopted.

Auckland Airport considers this behaviour is consistent with the airlines' commercial incentives to delay and defer airport investment and minimise aeronautical charges. Unfortunately, it also undermines the operation of the current regulatory regime and makes it more challenging for the Commission to undertake its review of the PSE4 pricing decision, as it has to navigate through these issues from an outside looking-in perspective.

Given the evidence set out in this cross-submission, Auckland Airport considers that the Commission should carefully consider the credibility of airline submissions and if there is any relevant evidence (or lack thereof) to support their claims, when determining how much (if any) weight can be placed on the claims made in their submissions.

4. Response to submissions on capital investment

4.1. Incentives for capital investment are calibrated correctly and have the right checks and balances

Air New Zealand has submitted that:

> *In fact, the ID regime incentivises AIAL to maximise capex during the price setting process and under deliver on capex when the regulator's review is complete.*[17]

BARNZ submitted that:

> *AIAL is New Zealand's largest airport monopoly which has for many years underinvested in its assets. Airlines have called for investment for years – as evidenced in submissions to the Commission's PSE3 review. Now that construction prices and regulated returns sit at the height of the cycle, AIAL is undertaking a capital plan which is larger than any airport in New Zealand has undertaken, and larger than any privately owned airport in the Asia-Pacific region.*[18]

Auckland Airport is the largest airport in New Zealand - it serves almost three-times the amount of passengers as the next largest airport. It is logical that it would have a capital plan that is larger than other New Zealand airports. Other airports are also investing significantly in new facilities:

- Brisbane Airport - **over $5 billion AUD** over 10 years – investment at a very comparable airport to Auckland in terms of size, this investment follows the construction of its second runway;[19]
- Hong Kong - **$19.3 billion USD** for a new runway, taxiways, aprons, and terminal expansion;
- Bangkok - **$6.5 billion USD** for expansion, a new runway, and apron resurfacing;[20]
- New York JFK new Terminals 1 & 6 - **combined $14.1 billion USD**.[21]

To respond to airline claims that Auckland Airport has under-invested, Auckland Airport considers it is important to clarify the incentives to invest under the current regulatory framework, and to put these submissions into context.

There are two time horizons that are relevant:

(1) within pricing periods or the short-term incentives to invest; and
(2) longer-term incentives that span multiple pricing periods.

Airline submissions focus on short-term incentives. Auckland Airport considers that both short- and long-term incentives are relevant and important.

Short-term incentives for airports to invest within pricing periods

The benefit of airports carrying this capex risk within a pricing period is that it provides an incentive for airports to deliver capital investment efficiently, and at the lowest possible cost. However, incentives to minimise costs also means an airport could benefit through increased returns within the pricing period if it did not deliver the projects that it forecast to deliver.

This is where the ID regime ensures that there is sufficient information to scrutinise whether airports are investing appropriately. The Commission reviews capex performance when it reviews airports' pricing decisions. Despite calls from airlines claiming Auckland Airport has under-invested in the past (when it has invested over $1.5 billion over the past 10 years), the Commission has found no concerns previously with Auckland Airport's investment within pricing periods.

However, recognising the increase in forecast capital expenditure, and the greater risk of delivering this capex to forecast given the ramp-up, Auckland Airport has introduced a one-way capex wash-up to ensure that it did not gain a material benefit from under-delivering capex to forecast. The wash-up was calibrated to balance the tension of capex incentives within a pricing period - to minimise any benefit

[17] Air New Zealand submission, p. 2
[18] BARNZ submission, paragraph 7
[19] Future BNE
[20] ACI cross submission
[21] JFK Terminal 6, JFK Terminal 1

where capex is not delivered to forecast while ensuring that there remained an incentive to minimise costs and deliver capex as efficiently as possible.

More comments on the Commission's previous assessments of Auckland Airport's investment, and the capex wash-up introduced as part of the PSE4 pricing decision, are outlined later in this submission.

Long-term incentives for airports to invest across pricing periods

To ensure that Auckland Airport delivers the long-term infrastructure that is required, the regime incentivises long-term investment across periods that is efficient and aligned to consumer requirements. Financially, this is enabled by allowing for completed assets to be included in the RAB, and for airports to set prices that provide a fair return on the capital invested.

Importantly the dual till regime provides a strong incentive to maximise passenger volumes as this also maximises non-aeronautical revenues for airports. This provides an incentive for airports to invest efficiently, to ensure airport capacity is sufficient to meet demand, but to not over-invest as to un-necessarily increase charges (which can also impact on demand).

In addition, there are consultation obligations with Substantial Customers that airports are required to meet. Other elements of the ID regime monitor airport performance to ensure that airports are providing the service quality and airport capacity that is required. These outcomes are difficult to achieve without the delivery of efficient airport investment.

4.2. Airline claims that Auckland Airport has a history of underspending on capex are incorrect

Auckland Airport has invested appropriately in the past

Airline submissions have suggested that Auckland Airport has an incentive to over-state planned capital expenditure, and then to under deliver during the pricing period.

Air New Zealand submitted:

> *Air NZ has been frustrated by AIAL's lack of delivery. In its PSE3 submission, Air NZ welcomed AIAL's "long overdue" $2.4b PSE3 capex plan but cautioned that AIAL was incentivised under the ID regime to over-state and under deliver capex – and that is exactly what has happened.*[22]

Airlines have also called for the Commission to review Auckland Airport's historic capital investment. The Commission has previously considered whether Auckland Airport has planned to invest appropriately in the past and found that it has. Auckland Airport has invested over $1.5 billion in aeronautical assets over the past 10 years.

Commission found Auckland Airport invested appropriately in PSE1

This was considered by the Commission in 2013 in its review of the PSE2 pricing decision, where the Commission was comfortable with the level at which Auckland Airport was investing:

> *H16 There is no evidence of any planned under or over investment in Auckland Airport's capex forecast for PSE2. Airlines generally consider that the projects planned for PSE2 reflect an efficient level of investment and have taken into account the priorities of the airlines.*
>
> *H17 The evidence available suggests Auckland Airport did not plan to under or over- invest in PSE1, with the potential exception of the planned investment in the Northern Runway as discussed below. Submissions have raised few other concerns with under or over investment at Auckland Airport in PSE1. Auckland Airport's reprioritisation of various projects planned in PSE1, as discussed in paragraph H19, may also indicate that it actively sought to avoid any under or over investment.*
>
> *H18 Submissions generally agree that investment planned for PSE2 is taking place at an appropriate time. We are unable at this time to assess whether investment is subsequently undertaken at an appropriate time.*

[22] Air New Zealand submission, p. 2

H19 While airlines have concerns that investment was not planned for an appropriate time in PSE1, there is some evidence that Auckland Airport subsequently undertook investment at an appropriate time. BARNZ considered that the planned investment in the Northern Runway in PSE1 was occurring ahead of time. Auckland Airport subsequently postponed work on the Northern Runway as a result of the economic recession and increased aircraft size. Airlines have not expressed any concerns regarding the efficiency of this reprioritisation of the Northern Runway or any other project that occurred in PSE1. We also observe that Auckland Airport's timing of actual capex in PSE1 did not deviate significantly from that planned in its forecast. This suggests that it did not systematically forecast capex to occur earlier in the regulatory period than the investment is likely to occur so as to earn higher profits. This was raised as a concern by airlines in relation to Wellington Airport.[23]

In PSE2 Auckland Airport invested materially more than was forecast

In its review for PSE3, the Commission considered Air New Zealand's views at the time that Auckland Airport was late in delivering capex during PSE2, which included delivery of a new Domestic Terminal:

> *Air New Zealand considers that consultation on the Terminal Development Plan has been underway for longer than indicated by Auckland Airport. It notes that at the commencement of PSE2, Air New Zealand was involved in consultation with Auckland Airport on the best location of the new domestic terminal. At the time, Air New Zealand commissioned Intervista Consulting, who completed concept planning for the alternative Southern Terminal Option, and delivered this work to Auckland Airport in March 2012.*[24]

Auckland Airport noted at the time that it had invested more in PSE2 than had been priced for, and was supported by airlines during PSE2 (emphasis added):

> *Auckland Airport suggests that airlines were broadly comfortable with its forecast capital investment for PSE2 at the time it set prices.* ***It states that it reduced its proposed capital expenditure in response to certain airlines' requests but then went ahead with the originally planned investment (even though it had not priced to recover this)*** *due to higher than forecast demand growth.*[25]

This is further demonstrated, as set out in Auckland Airport's 2017 ID commentaries (emphasis added):

> *As a consequence of changing market conditions (e.g. new regional entrants) and exceptional growth, we have responded to new requirements (e.g. regional capacity) and brought forward projects (e.g. Pier B contact stands).* ***For the year ended 30 June 2017 actual capital expenditure was $233m, materially above the $48m PSE2 pricing forecast. Consequently, total PSE2 capital expenditure of $522m exceeded the pricing forecast by 80%.***[26]

Auckland Airport notes that investing more than was forecast during a pricing period would reduce airport returns and profitability - not increase them. The Commission at the time found Auckland Airport's investment plans were appropriate:

> *While airlines are concerned that this investment is occurring too late, at the time of setting prices for PSE2, we concluded that Auckland Airport's decision to exclude any capital expenditure in the new domestic jet terminal from PSE2 pricing was reasonable and appeared to be in response to airlines' concerns.*[27]

To summarise, airlines considered that ahead of setting prices for PSE2, Auckland Airport had planned to over-invest, so plans for the Pier B international expansion were removed from the investment plan and aeronautical prices.

Airlines then claimed at the end of PSE2 that Auckland Airport had been under-investing, despite investing over and above the capital investment forecast that was included in aeronautical pricing.

[23] Commerce Commission July 2013 review of Auckland Airport, p. 125-126
[24] Commerce Commission PSE3 review of AIAL, paragraph 217
[25] Commerce Commission PSE3 review of AIAL, paragraph 222 (Auckland Airport emphasis)
[26] Auckland Airport ID FY17 commentaries, p. 31 (Auckland Airport emphasis)
[27] Commerce Commission PSE3 review of AIAL, paragraph 225

Aeronautical capex in PSE2 was 80% higher than the $290 million that had been forecast for the pricing period, yet airlines still criticised the airport for not having invested sufficiently during the pricing period.

Airlines critical of under-investment in pandemic-impacted PSE3

Consistent with previous practice, we expect the Commission will consider whether Auckland Airport invested appropriately during PSE3.

Air New Zealand submitted with regards to investment in PSE3:

> *Air NZ has been frustrated by AIAL's lack of delivery. In its PSE3 submission, Air NZ welcomed AIAL's "long overdue" $2.4b PSE3 capex plan but cautioned that AIAL was incentivised under the ID regime to over-state and under deliver capex – and that is exactly what has happened. AIAL underspent on capex by 55% ($668m) in the first three years of PSE3, which was during the pre-Covid period (Disclosure Years (DY) 2018 to 2020).*[28]

The above statement from Air New Zealand, while factually correct, omits important points of context. A more complete and objective assessment would have identified the following relevant factors:

- As set out above, Auckland Airport invested more than it forecast in the PSE2 pricing period;
- Almost half of this variance ($315 million) was for assets that were not due to be commissioned during the PSE3 pricing period,[29] as these projects were not scheduled in the plan to be completed until PSE4. This investment was not reflected in the prices set for PSE3 and therefore not paid for by airlines. Any underspend on these projects did not benefit Auckland Airport by the way of excess returns as implied by Air New Zealand's submission, as these investment plans were not a driver of revenue in PSE3;
- The PSE3 pricing period was less than half-way completed when the COVID-19 pandemic closed borders and halted air travel. Whilst some projects related to the international terminal and the airfield were behind the forecast spend during the period, investment was underway and could have been caught-up during the remainder of the pricing period; and
- Decisions then made by Auckland Airport to halt the majority of aeronautical investment in response to the global pandemic, lockdowns and border closures, were supported by the majority of Substantial Customers. Air New Zealand's statement above is inconsistent with its support to halt the programme.

In any case, Auckland Airport did not receive excess returns during PSE3 period, with returns well below the cost of capital at 3.14% for the pricing period.

Airlines have a track record of claiming historic investment has been too low, but future planned investment is too high

When reviewing the planned capex forecast for PSE3, the Commission noted:

> *Our review of Auckland Airport's historic capital expenditure compared to its forecast does not provide evidence of planned under-investment, over-investment, or bias. Nor do we see evidence of a strategy to gain from delaying projects.*[30]

Since the Commission made this assessment, the only new information to judge Auckland Airport's track record when it comes to investment is during PSE3, a period which was materially disrupted by the pandemic. The Commission will no doubt take this into account as it undertakes this review.

Yet all three submissions from Air New Zealand, Qantas and BARNZ claim that Auckland Airport has under-invested in the past. This, along with submissions to previous reviews, demonstrates a pattern of behaviour from airlines in section 53B reviews, to claim historic under-investment (as they have in numerous pricing reviews) at the same time as opposing future investment (as they are now and also did ahead of PSE2).

This is unsurprising given the airlines' commercial incentives to oppose capital investment in airports that benefit all consumers.

[28] Air New Zealand submission, p. 2
[29] Auckland Airport ID FY20 commentaries, Figure 7, p. 26
[30] Commerce Commission PSE3 review of AIAL, paragraph 184

Auckland Airport considers this track record undermines the credibility of airlines to comment on this issue, and the Commission should place limited weight on these elements of their submissions.

Auckland Airport initiated the capex wash-up for PSE4

In the PSE4 pricing period, Auckland Airport has introduced a capex wash-up mechanism, as described in its PSD. Such a mechanism was envisaged by the Commission in its PSE3 review for Auckland Airport:

> *Auckland Airport may have been able to mitigate risk and airlines' concerns that actual capital expenditure may differ from forecast levels to a greater extent through the use of a risk allocation adjustment.*[31]

The introduction of this wash-up upon Auckland Airport's own initiative demonstrates that Auckland Airport is not seeking to game the regulatory regime and benefit from under-investment, but is seeking to achieve the overall outcomes that are consistent with the purpose of Part 4.

If airlines were genuinely concerned that Auckland Airport would not deliver capital investment during the PSE4 forecast period - as is claimed in their submissions to the Issues Paper - then it would have been logical that they would have asked for a risk-sharing mechanism to reduce capex underspend.

At no point during consultation did airlines request Auckland Airport to introduce such a mechanism. Rather, this mechanism was proposed and introduced at the initiative of Auckland Airport.

Auckland Airport responds to specific feedback on the capex wash-up itself later in this submission.

The Commission should consider the risk of long-term under-investment in this review

The above evidence demonstrates that Auckland Airport has not under-invested in the short-term. However, as set out earlier in this section, the longer-term incentives for airports to invest are different to these short-term incentives.

The long-term incentives to invest include allowing for airports to earn an appropriate return on investment, and incentivises keeping capital costs low/efficient through the combination of the short term investment incentives (outlined above) and the dual till regime. There are also the consultation obligations with Substantial Customers that airports are also required to meet.

Under these regulatory settings, Auckland Airport observes that there are two potential areas of regulatory failure in the current regime that could result inadvertently incentivise long--term under-investment:

- countervailing airline market power – where airlines opposing investment during the consultation process and the airport decides not to invest; or
- insufficient returns on aeronautical investment – where the available returns on aeronautical investment are set too low, under-investment could result. Regulatory precedent recognises this risk by allowing for a WACC to be adopted that it is above the mid-point estimate, given the greater costs that can result from under-investment.

Auckland Airport considers that the Commission should give due consideration to both of these two potential causes of long-term under-investment in its assessment of Auckland Airport's profitability (including its target return) and investment decisions in this review, as they are both highly relevant to its assessment as to whether this pricing decision is consistent with achieving the purpose of Part 4.

BARNZ implies airport returns have not been high enough to encourage sufficient investment

BARNZ submitted:

> *AIAL is New Zealand's largest airport monopoly which has for many years underinvested in its assets. Airlines have called for investment for years – as evidenced in submissions to the Commission's PSE3 review. Now that construction prices and regulated returns sit at the height*

[31] Commerce Commission PSE3 review of AIAL, paragraph 189

of the cycle, AIAL is undertaking a capital plan which is larger than any airport in New Zealand has undertaken, and larger than any privately owned airport in the Asia-Pacific region.[32]

In other words, the BARNZ submission implies that you would need to believe that:

- Auckland Airport has intentionally under-invested in aeronautical infrastructure over an extended period of time; and
- Auckland Airport now plans to invest sufficiently because of increased airport returns (due to higher interest rates and the real risk of airport operations revealed by the pandemic) and higher construction costs.

Auckland Airport rejects the premise put forward by BARNZ.

However, it implies that in the view of BARNZ, returns to Auckland Airport to invest in aeronautical infrastructure have not been sufficiently high for Auckland Airport to adequately invest in the past. The most obvious solution to the dilemma posed by BARNZ would be to increase allowable returns to ensure that investment was made when it was needed.

4.3. Air New Zealand and BARNZ supported a capital plan that cost just 5% less in 2021

Air New Zealand and BARNZ both supported the Auckland Airport Board decision to approve the Integrated East terminal integration pathway in 2021,[33] later called the Terminal Integration Programme. This followed an extensive consultation process known as 'Project Paheko'.

As set out in their submissions, both Air New Zealand and BARNZ have since withdrawn support for the development, as both consider that the proposed capital spend across PSE4 and PSE5 is too expensive. BARNZ submitted:

BARNZ members have submitted that the proposed capital costs are far too high, and AIAL should look to drastically reduce these[34]

Air New Zealand described it as 'over-built and unaffordable'[35] and submitted:

Air NZ does not support the ITP in its current design and cost. Air NZ believes the ITP is too big and therefore too expensive[36]

However, both Air New Zealand and BARNZ oppose the capital investment programme on the basis of cost. These submissions imply that capital costs have increased materially far more than what is actually the case.

The Paheko consultation was based on a total value of priced aeronautical capital investment from FY23-32 of $5,389 million to be commissioned into the asset base. The forecast for PSE4 priced base case capital investment plan has increased 5.4% or $293 million over 10 years at $5,682 million, compared to the Paheko capital plan supported by Air New Zealand and BARNZ in 2021.

This demonstrates how Auckland Airport re-calibrated its capital investment plan in response to material construction cost inflation that followed the pandemic, and the concerns that were raised by airlines with cost. While the cost of the Terminal Integration Programme did increase due to post-pandemic cost inflation, this was offset by making changes to the scope and timing of other projects, to mitigate the impact on aeronautical prices.

Auckland Airport considers that while an increase in overall cost is unfortunate, in the context of what is a large and complex capital investment plan, it is a modest cost increase.

[32] BARNZ submission, paragraph 7
[33] Media Release, [Auckland Airport resets precinct-wide infrastructure plan](), August 2021
[34] BARNZ submission, paragraph 42
[35] Air New Zealand submission, p. 4
[36] Air New Zealand submission, p.2

It demonstrates that the airline calls for drastic cost reductions are unfounded, given the cost of the plan has not materially changed in terms of overall cost to airlines, relative to the plan that was endorsed by Air New Zealand and BARNZ in 2021.

This inconsistency from airlines demonstrates the challenges of the consultation process, and why Auckland Airport cannot and should not always make decisions that are only supported by airlines. Such inconsistency would make it impossible to deliver the long lead-time infrastructure the airport requires.

As Auckland Airport has previously explained to airlines, increases in capital investment had not been the key driver of increases in the projections of aeronautical prices in PSE5. Rather, this could be completely explained by the cost of capital, which would again be reset ahead of the next pricing period. Auckland Airport's explanation to airlines during consultation included the following:

- Changes in the capital plan over this time reflect a number of different factors including changes to the timing and scope of projects, and higher construction costs.
- However, the net impact of these changes has not caused an increase in aeronautical charges. Those increases entirely reflect our updated midpoint WACC calculation using the latest available data as at 30 June 2022.
- Undoubtedly the updated midpoint WACC estimate as at June 2027 – when we ultimately set PSE5 aeronautical prices – will differ to today's PSE4 midpoint WACC estimate of 8.73%.

4.4. Airlines have not presented a viable alternative solution

Air New Zealand submitted (emphasis added):

> ***AIAL has consistently refused to consider alternative solutions*** *or make material concessions to find workable solutions to mitigate these price shocks*[37]

This claim by Air New Zealand that Auckland Airport has consistently refused to consider alternative solutions is false and unfair, and the Commission should give it no weight in this review.

Auckland Airport considered all alternatives for capital investment that were presented by airlines during the 10+ years of consultation on the Terminal Integration Programme. The PSE4 PSD set out significant detail on the alternatives that were considered during this consultation, including consideration of 21 different designs, before the Auckland Airport Board re-affirmed its commitment to the Terminal Integration Programme in March 2023.

It was only after a decade of consultation had come to an end, and a decision to re-affirm Auckland Airport's commitment towt the Terminal Integration Programme had been made in March 2023, that seven months later Air New Zealand provided Auckland Airport with an alternative proposal, developed by Arup that Air New Zealand refers to in its submission.

Auckland Airport has carefully examined the proposal to consider whether it would identify a better pathway and give cause to change the decision to proceed with the Terminal Integration Programme. This examination revealed that it was incomplete, did not provide a better solution, or did not materially lower cost.

As set out above in section 3.3, Auckland Airport agrees with the Commission that it is not its role to reconsider the decisions Auckland Airport ought to have made, particularly when it comes to planning airport capital investment. Auckland Airport also agrees the Commission should primarily rely on the information included in the PSE4 PSD regarding capital investment - sufficient information has been provided for the Commission to assess whether airline feedback and alternatives were considered. However, Auckland Airport responds to the inaccurate claims from airlines on alternative capital investment to give the Commission comfort that this remains the best approach for this review.

[37] Air New Zealand submission, p. 3

Alternatives have been considered during the consultation process

Auckland Airport set out in detail the alternatives that were considered during consultation in its PSE4 PSD.

Qantas submitted it considers that the design includes:

> • *A terminal footprint around twice what is required*[38]

Auckland Airport did consider an alternative theoretical terminal design proposal that was presented during consultation, and this proposal did have a materially smaller footprint – the design as proposed was around the same size as the existing Domestic Terminal Building.

Having examined the design in detail, Auckland Airport found that it did not sufficiently consider constructability or the design considerations and constraints that exist in a brownfield environment, and that it reflected a lower level of service quality.

However, the analysis identified some areas of opportunity for potential savings in the existing design. These were pursued and incorporated in the final design that has been adopted.

Air New Zealand provided its alternative seven months after consultation on the Terminal Integration Programme had closed

Auckland Airport made its decision to re-affirm the Terminal Integration Programme in March 2023 following consultation with its Substantial Customers for over 10 years on a replacement integrated terminal (with an integrated terminal being included in the 2014 Master Plan), with 21 designs being considered before the Domestic Processor was approved by the Auckland Airport Board in 2021 with airline support, and re-affirmed in 2023 without airline support.

The alternative proposal referred to by Air New Zealand was only commenced *after* consultation had been closed and the decision on the Terminal Integration Programme had been made.

Nonetheless, Auckland Airport was willing to receive new information, and consider whether that information would give it cause to reconsider the decisions it had already taken to proceed with the Terminal Integration Programme. For the reasons outlined below, the alternative terminal proposal has not given Auckland Airport cause to revisit its previous decisions.

The alternative Air New Zealand proposal would not cost $1 billion less as claimed

Auckland Airport has completed an in-depth analysis of the high-level design information available for the alternative solution produced by Arup for Air New Zealand. Based on this analysis, a more accurate representation of the difference between the two designs is estimated to be closer to $100 million rather than the $1 billion claimed by Air New Zealand in its submissions.

Air New Zealand provided Auckland Airport with the proposal from Arup that estimated the cost of an adjacent terminal development of $1.1 billion in real terms, with an estimated $161 million of construction cost escalation.

The reality is that any alternative design will be subject to the same construction costs as the Terminal Integration Programme. Auckland Airport identified the following costs that had been excluded in Air New Zealand's costings:

- understated construction cost escalation - **$92 million**;
- financing costs (capitalised interest) - **$62 million**;
- 2 years of delay costs - **$92 million** (a conservative estimate);
- functions missing that are required to operate a terminal - **$246 million;**
- additional international baggage facilities were not included which are being delivered through the Domestic Processor project[39] - **$196 million** (a conservative estimate); and
- costs to close out existing commitments to the Terminal Integration Programme - **$30 million**.

[38] Qantas submission, p. 1
[39] Baggage facilities for the Terminal Integration Programme are shared between domestic and international services

This initial analysis reduced the cost gap between the two solutions by 90%, from $1 billion to $100 million.

Auckland Airport considers this analysis to be a conservative estimate of the costs based on the assumptions made and approach taken. There are other capital and operational costs that would likely also be incurred but could not be quantified based on limited detail that currently exists for this design. This would be expected to reduce the cost gap between the two terminal solutions even further, or quite likely result in the Air New Zealand proposal being more expensive.

When considering the broader Terminal Integration Programme, the proposal from Arup did not avoid the need for the majority of the other investment in the Terminal Integration Programme, with one potential opportunity identified to reduce the cost of the check-in expansion project of $83 million. In total, this resulted in a difference in overall cost of less than 5% of the overall Terminal Integration Programme, at $3.5 billion (compared to $3.6 billion as forecast in the PSE4 PSD).

Auckland Airport shared the above analysis on cost with Air New Zealand in December 2023, well ahead of when it lodged its submission to the Issues Paper. This analysis appears to have been ignored in its submission to the Issues Paper.

Air New Zealand's terminal proposal would be materially inferior to the Terminal Integration Programme

The key features of the Arup design provides for a new pier for domestic jet operations to be constructed in broadly the same location as the Domestic Processor Pier A1. However, this design does not integrate domestic and international operations, maintaining a separate baggage system and check-in, with integration not occurring until 2043 at the earliest. The option relies on continued jet operations out of the western end of the DTB which does not align with the Auckland Master Plan by retaining the DTB at high operational levels until at least 2043 and proposing a terminal operation with 4-front-doors.

The design provided by Air New Zealand can at best be described as high level, but more accurately described as incomplete. Auckland Airport's expert airport planners have analysed the proposal and found the following:

- The design is incomplete, with key operating areas like bus lounges and functional back of house space either not being provided for or not being adequate;
- The design does not meet the requirements of a fully functional terminal. This includes no provision for the operation of non-passenger screening facilities which are an ICAO regulatory requirement, and an unworkable truck dock which is required to move goods and waste in and out of the terminal;
- Continued use of the DTB for a portion of the domestic jet operations would mean high levels of activity at a terminal that is already delivering a sub-optimal customer experience with limited capacity. It also adds complexity into the system by dividing domestic jet operations across two terminals;
- There has been no operational model put forward, and our consideration of possible models to operate jet services from two terminals shows a poor customer experience, particularly with confusion around location of arrivals and departures, and complications for international to domestic connections. There is the further issue of how aviation security and other government services would be staffed across two terminals;
- The design offers a low level of integration, which is something Substantial Customers have been critical of in the past. Instead, they favoured a more seamless integrated experience during consultation on the development of the terminal design.

The proposal is based on a previous design that Air New Zealand supported discarding in 2021

The terminal proposal has similarities to the domestic jet facility design that was being developed by Auckland Airport prior to the pandemic. As Auckland Airport worked through more detailed design and the enabling works it learnt more about the build and the placement of power centres and the baggage system. This resulted in the more developed Domestic Processor design and Terminal Integration Programme, taking advantage of the opportunities presented by the pandemic to undertake critical works while traffic volumes were depressed.

This change in design to the more integrated solution that is now being progressed was consulted on and supported by both Air New Zealand and BARNZ in 2021.

Subsequent investment on the baggage system that forms a core part of the Terminal Integration Programme and was worth hundreds of millions received support from Substantial Customers to proceed as recently as August 2022.

Having considered the proposal, the Terminal Integration Programme remains a materially better option

Auckland Airport has analysed the ideas that have been put forward through the Arup Study and the work that has been undertaken by Air New Zealand to propose an alternative to the current Terminal Integration Programme. Auckland Airport does not consider that the proposed option provides a viable alternative to the Domestic Processor, and it is a materially worse theoretical design when you consider the analysis of the cost, impacts on customer experience, and the required airport operating model. Therefore, the alternative proposal has been considered by the Auckland Airport Board and has not led the Auckland Airport Board to reconsider its decision to progress the Terminal Integration Programme.

4.5. Capital cost estimates reflect the cost of construction in the New Zealand market

Qantas submitted:

> *We believe the terminal (headhouse, apron and pier) should be built for less than $690m not approximately $2b, and the overall aeronautical expenditure for the 10 year capital plan should reduce to less than $3.6b*[40]

These claims in the Qantas' submission are not supported by any evidence. Similarly, no evidence was provided during consultation to substantiate claims that construction costs were overstated.

Auckland Airport has set out how it determines thorough cost estimates in the PSE4 PSD, to ensure construction cost estimates reflect those that are experienced in the New Zealand market.

4.6. Capital cost allocations

Allocation of non-regulated capital costs

Air New Zealand submitted:

> *Furthermore, Air NZ encourages the Commission to consider whether the dual till structure is influencing the size of the terminal / investment proposed, as retail provision more closely aligns with global benchmarks for international terminals than domestic terminals. In the past, AIAL has demonstrated that the profitability of the retail till is a consideration in their investment strategy.* [41]

Auckland Airport is concerned this statement is misleading as it implies that retail space in the new domestic terminal facility will be paid for through aeronautical charges. This is not correct, nor is it within the scope of this review – which is the PSE4 pricing decision.

Airlines are fully aware of the thorough approach Auckland Airport takes to allocating capital costs between regulated and non-regulated activities at Auckland Airport, in accordance with the IMs. Cost allocations were covered in detail during consultation.

The costs of retail facilities at Auckland Airport, including the new domestic terminal facility, are not and will not be recovered through aeronautical charges at Auckland Airport.

Qantas submitted:

> *The Qantas Group believes that there are some inherent issues in current methodologies, as well as some unreasonable splits in PSE4.*[42]

[40] Qantas submission, p. 3
[41] Air New Zealand submission, paragraph 55
[42] Qantas submission, p. 3

There is limited detail in this statement to allow Auckland Airport to adequately respond to this claim. However, Auckland Airport can confirm that it considered all feedback received from airlines with regard to the allocation of costs for the PSE4 pricing decision, which did result in changes in allocation approach in the final decision.

Changes to cost allocation for PSE4

Air New Zealand submitted that Auckland Airport made fundamental changes to our cost allocation practice which changed the opening RAB for PSE4.[43]

Auckland Airport set out in the PSE4 PSD that adjustments were made to the opening RAB from the FY22 disclosure, and that this was due to the impacts of the pandemic on usage-based allocation rules that are used to allocate costs. Given that the Auckland lock-down occurred in FY22, this meant that allocation rules based on usage were distorted due to the low levels of aeronautical traffic and were considered unlikely to reflect usage across the PSE4 pricing period. Accordingly, pre-pandemic allocations were adopted in these circumstances. As was set out in the PSE4 PSD:

> *Allocation rules used were based on the same approach as the allocation rules used for information disclosure. The key changes from the FY22 information disclosure allocation rules was that where allocation rules are based on usage or activity, pre-pandemic allocation rules were used to more accurately reflect the expected activities in the more normal operating environment expected for PSE4. Where space was the basis of the allocation, the same rules used for information disclosure in FY22 were used.*[44]

4.7. Reconciliation of capital investment forecasts

Air New Zealand submitted:

> *Air NZ notes there are discrepancies in the costing information provided in the Price Setting Disclosure presentation and commentary, as well as between summary tables in the commentary and its appendices. These discrepancies range from ~$-100m to ~$+260m with a net difference of ~$210m between the two documents. These discrepancies make a review of the costs in the Price Setting Disclosure challenging and reduce confidence in the transparency and accuracy of the data.*[45]

Auckland Airport has looked at this and found that the discrepancies are not due to errors, but rather the presentation of different capital forecast information that is set out and in accordance with the IMs.

The first set of data in the PSD presentation reflects the value of commissioned assets - that is the forecast value of assets that are completed – and then commissioned into the RAB. This includes assets that commenced during PSE3, and then Commissioned in PSE4.

The PSE4 PSD sets out the forecast cash-flow value of capital investment as required under ID requirements. The key differences to the above are that this does not include any spend on projects prior to 1 July 2022 (whereas the above does) and this explains differences.

Having re-reviewed these materials, Auckland Airport has subsequently identified one error in the 'Terminal Integration – Enabling & airport resilience' part of the PSD presentation on page 8, which appears to be where the Air New Zealand numbers in its submission have been derived from. The correct information is included in the appendix of that same presentation, on page 26.[46]

[43] Air New Zealand submission, paragraph 9
[44] Auckland Airport PSE4 PSD, p. 37
[45] Air New Zealand submission, paragraph 50
[46] Auckland Airport PS4 PSD, Investor Presentation, August 2023

5. Response to submissions on the cost of capital

5.1. Airlines are inconsistent in their views on how the pandemic should have been treated

The different airline perspectives on how the cost of capital should have been set in the submissions to this review demonstrate the challenges Auckland Airport experiences when it consults on pricing. Views and approaches can be quite different even where parties' interests are aligned.

Auckland Airport set the target return for PSE4 in a manner which ensured that the appropriate incentives to invest in the infrastructure required at Auckland Airport were maintained and the targeted profitability remained appropriate. The intention was to find the right balance, so that overall, the purpose of Part 4 continues to be promoted.

BARNZ's submission to apply the asset beta from the 2016 IM (with no updates or adjustments)[47] requires that Auckland Airport simply ignores the impacts of the pandemic when it comes to assessing the risk to airports. Investors do not ignore such risks. Auckland Airport set out in its submission to the Issues Paper why it is important these risks are reflected to ensure the overall purpose of Part 4 is achieved.

BARNZ's submission is also somewhat inconsistent with its position that Auckland Airport has not adequately invested in aeronautical infrastructure. If the cost of capital does not appropriately reflect investment risk, this can have a direct and negative effect on incentives to invest.

Air New Zealand considers that the asset beta should have been adjusted for pandemic risk.[48] Such adjustments were considered by Auckland Airport ahead of setting prices. It was found that the approach adopted (to update the 2016 IM sample set data) would not provide Auckland Airport with any additional compensation compared to adopting regulatory precedent for pandemic related adjustments.

The Qantas submission appears to implicitly acknowledge that pandemic impacts should be reflected in the target return set by Auckland Airport (i.e. it was inappropriate to use the 2016 IM asset beta):

> *WACC: AIAL is proposing to charge a WACC above the real costs of capital*
>
> *• The WACC claimed is 8.73% as opposed to 8.02% per the recent input methodologies decision*[49]

Air New Zealand's submission also makes a statement that implicitly recognises the 2016 IMs are no longer relevant:

> *The resulting asset beta is also significantly in excess of that determined by the Commission in its 2023 Input Methodologies Review which will be used in determining the annual WACC estimates for information disclosure purposes.*[50]

Auckland Airport disagrees with Qantas that 8.02% is the correct target return, as set out in our PSE4 PSD and submission on the Issues Paper.

Auckland Airport has undertaken a thorough process to determine the target return of 8.73%. To adopt the 2023 IM Review outcomes would also be inconsistent with the terms of the price freeze supported by Air New Zealand and BARNZ, i.e. only data available prior to the start of the price setting event would be considered when setting the target return.

However, what these statements by Qantas and Air New Zealand recognise, unlike BARNZ, is that it is legitimate for Auckland Airport to update its cost of capital to reflect prevailing market conditions, including the pandemic, when setting the target return.

[47] BARNZ submission, paragraph 20
[48] Air New Zealand submission, paragraph 19
[49] Qantas submission, p. 3
[50] Air New Zealand submission, paragraph 20

The Commission should give consideration to this important, and principled recognition, when undertaking its review of profitability. This should include consideration of whether its starting point for the review of an asset beta of 0.60 remains appropriate for a post-pandemic pricing decision.

Given the different approaches recommended by the airlines to estimate the cost of capital in their submissions to the Issues Paper, Auckland Airport attaches the expert advice from Competition Economics Group ("**CEG**") that guided and informed the decisions Auckland Airport took to set target return. These two reports, the second which responds to the feedback received through consultation, are included at **Appendix A**.[51] Both of these reports were provided to Substantial Customers during consultation.

5.2. Cost of capital inputs adopted are consistent with the approach outlined in the price freeze proposal supported by airlines

Air New Zealand and BARNZ have submitted that Auckland Airport should have adopted different cost of capital input parameters. These are discussed in further detail below.

An important piece of context is that, as part of the first round of PSE4 consultation, both Air New Zealand and BARNZ supported Auckland Airport's price freeze proposal in 2021. A key term from this proposal was that Auckland Airport's target return for the full five -year PSE4 pricing period will be determined retrospectively, after a second round of consultation with Substantial Customers, as at 1 July 2022 (the commencement of PSE4) by applying the relevant input parameters as at that date (e.g. including the observable interpolated 5 year risk free rate). The approach adopted by Auckland Airport to set its target return was undertaken in a way that was entirely consistent with the terms of the price freeze proposal.

Auckland Airport notes that the support for this approach in 2021, well in advance of the start of PSE4, demonstrates that it was not seeking to 'game' any changes in market conditions or rates, but rather sought to provide certainty to all parties on a fair and objective approach, in what were volatile and uncertain conditions when Auckland was in lock-down.

The price freeze resulted in Auckland Airport receiving over $100 million less aeronautical revenue for FY23 than if full-returns were targeted. This was effectively a 30% reduction on aeronautical charges for FY23.

The freeze of Auckland Airport's prices supported Air New Zealand's recovery from the pandemic and its record profits in the FY23 financial year. As outlined below, the submissions from Air New Zealand in particular, and to some extent BARNZ, have either overlooked or simply ignored its previous support for this initiative, which provided certainty for all parties during what were highly turbulent and uncertain conditions.

5.3. Inputs adopted to determine the cost of capital

BARNZ submitted:

> *It is also wholly inappropriate for AIAL to select updates of these parameters from an IM Review process which would not have been in flight had prices been set in 2022 as originally set down.*[52]

Auckland Airport has not selected updates of parameters from the 2023 IM Review, as alluded to by BARNZ. The IM Review was still underway when Auckland Airport set its prices for PSE4.

In any case, the IM Review includes some information and data only available following the start of the PSE4 pricing period, so incorporating such information would be inconsistent with the price freeze. That is not what Auckland Airport has done.

Some of the analysis that was considered during the PSE4 pricing consultation, was also submitted to the IM Review. The two processes overlapping was coincidental, but the same analysis was relevant to both processes.

[51] Redactions have been made in accordance with confidentiality obligations where consent for disclosure was not provided.
[52] BARNZ submission, paragraph 20

The analysis Auckland Airport considered for the PSE4 pricing consultation was consistent with the terms of the price freeze (that no input data was included beyond the start of the PSE4 pricing period). That does not amount to choosing selective updates, as alleged by BARNZ.

Risk free rate

BARNZ agreed with Auckland Airport's approach to use the risk-free rate of 3.6% to determine the target return, and that this was in-line with the Commission's cost of capital determination.[53] Air New Zealand, in its submission, did not agree with the approach adopted by Auckland Airport, stating that a risk-free rate of 2.67% should have been used.[54]

This is the first time this issue has been raised by Air New Zealand in relation to PSE4. It was not raised at all during the extensive PSE4 consultation, which included all the input parameters for the cost of capital.

Auckland Airport notes that the risk-free rate published by the Commission in its cost of capital determination is based upon data for the year ended 30 June 2022 – the end of the PSE3 pricing period. The approach to calculating the risk-free rate was outlined well in advance to Substantial Customers in Auckland Airport's price freeze proposal (as outlined above). In calling for a risk-free rate of 2.67% to be used Air New Zealand's submission is inconsistent with its previous position during consultation and the price freeze proposal it supported (as outlined above).

Tax adjusted market risk premium

BARNZ noted in its submission that:

> *We accept that these decisions provide some basis for the Airport's use of a higher TAMRP than that used in the 2016 IM review. Nevertheless, we note that the Commission had reverted to a TAMRP of 7.0% in its draft decision for the 2023 IM review issued in June 2023, before the price setting information disclosure that the Commission received from Auckland Airport on 17 August 2023 While the 2023 IM review is generally beyond the scope of the PSE4 review, if Auckland Airport genuinely wanted to reflect the Commission's latest estimates and thinking regarding the TAMRP, a value of 7.0 would have been more appropriate..*[55]

Auckland Airport notes that this suggested approach would have been inconsistent with the price freeze proposal supported by BARNZ (as outlined above). It is also inconsistent with other BARNZ statements in its submission:

> *It is also wholly inappropriate for AIAL to select updates of these parameters from an IM Review process which would not have been in flight had prices been set in 2022 as originally set down.*[56]

So while BARNZ considers it would be 'wholly inappropriate' for Auckland Airport to update select parameters from the IM Review (which Auckland Airport has not done), it nevertheless submits that Auckland Airport should have done this for TAMRP.

The approach adopted by Auckland Airport for the TAMRP mirrors the approach adopted by Christchurch Airport in its PSE4 pricing decision, and this approach was accepted by the Commission in its recent review of Christchurch Airport's PSE4 pricing decision.[57]

Asset Beta

Air New Zealand submitted that Auckland Airport should not have updated the comparable company data to reflect recent market evidence. Instead, it should have adjusted asset beta estimates for the impacts of the pandemic, and that there was regulatory precedent for this from other jurisdictions.[58] It also noted that the asset beta adopted was in excess of that determined by the Commission in the 2023 IM Review.

[53] BARNZ submission, paragraph 16
[54] Air New Zealand submission, paragraph 22
[55] BARNZ submission, paragraph 17
[56] BARNZ submission, paragraph 20
[57] Commerce Commission, Review of Christchurch Airport's 2022-2027 Price Setting Event, paragraph 63
[58] Air New Zealand submission, paragraph 19

BARNZ submitted that it was entirely inappropriate for Auckland Airport to update asset beta or equity beta estimates, and those estimated in the 2016 IM Review should continue to be used. It discounts the comparator sample analysis of CEPA for the Commission in the IM Review as 'illustrative' and considered that the 0.05 downward adjustment from the 2016 IM should be maintained.[59]

Auckland Airport has set out in detail in the PSE4 PSD and our response to the Issues Paper, the robust, thorough and transparent process that was undertaken to determine the asset beta estimate input in the PSE4 pricing decision. This information addresses many of the points raised above and is therefore not repeated here, but Auckland Airport reiterates the following key points:

- **COVID-19 pandemic adjustments** – Auckland Airport considered the pandemic adjustment approach adopted by the UKCAA. Auckland Airport's assessment was that in aggregate, all of the adjustments made by the UKCAA provided greater pandemic compensation to Heathrow Airport than the approach of not making adjustments adopted by Auckland Airport. This provided comfort that the approach to not adjust the data was reasonable;
- **Appropriateness of updating input estimates** – under ID regulation, it is entirely appropriate to update relevant data at the time of the pricing decision. It is consistent with previous advice from the Commission when assessing Auckland Airport's profitability that it would assess the evidence that supported the target return that had been adopted in pricing. The 2016 IM Review established that it was appropriate to update comparator sample data, which was even more appropriate in Auckland Airport's situation given the impact of the pandemic meant that the 2016 IM estimates were clearly out of date. Auckland Airport has been completely transparent with the approach that has been adopted, which will be considered by the Commission as part of this review;
- **Timing of the 2023 IM Review was coincidental –** the 2023 IM Draft Report had not been released at the time of the pricing decision. Auckland Airport did not seek to pre-judge or second guess the Commission's views as submitted by BARNZ, but rather considered the analysis, evidence and submissions from airlines during the pricing consultation period, some of which was also submitted to the IM Review. Importantly Auckland Airport notes:
  - much of the analysis considered through pricing consultation was the same analysis that was presented to the IM review, just because the timing overlapped did not make the information any less valid to consider, nor require the Commission to consider it before Auckland Airport could. This included the analysis which disproved the validity of the 0.05 downwards adjustment to asset beta that had been adopted in the 2016 IM Review.
  - Auckland Airport could not have anticipated the changes to the sample set of comparator airports made by the Commission in the 2023 IM Review. The Commission departed from well-established regulatory precedent, which came as a shock when the Draft Decision was released. In this context, Auckland Airport considers that the CEPA analysis was more than 'illustrative' as described by BARNZ, but rather it provided a true reflection of how the comparator sample set should be updated in a manner consistent with the regulatory precedent set out in the 2016 IM.
  - The choice on whether to maintain the 0.05 basis points downwards adjustment was different to selecting the sample set. Based on independent expert evidence, Auckland Airport made the decision that the downward adjustment was not empirically justified. The subsequent draft and final IM Decisions demonstrate Auckland Airport's decision was justified.

[59] BARNZ submission, paragraphs 18-25

6. Response to submissions on other issues

6.1. Passenger demand forecasts

Overstating passenger demand would reduce Auckland Airport's profitability in PSE4

Airline submissions claim that increases in Auckland Airport's charges will negatively impact passenger demand materially more than has been taken into account by Auckland Airport. This implies that airlines consider Auckland Airport's demand forecasts are overstated.

All else equal, if the airline claims are correct, then Auckland Airport's profitability will be lower than was forecast for PSE4. Not adopting the approach advocated for by airlines (of higher demand dampening assumptions) has resulted in lower prices due to the higher demand forecast that was used to determine prices.

Auckland Airport does not agree with these claims from airlines, and considers the study provided by InterVISTAS is robust.

Pre-pandemic passenger traffic was growing strongly

Qantas submitted that:

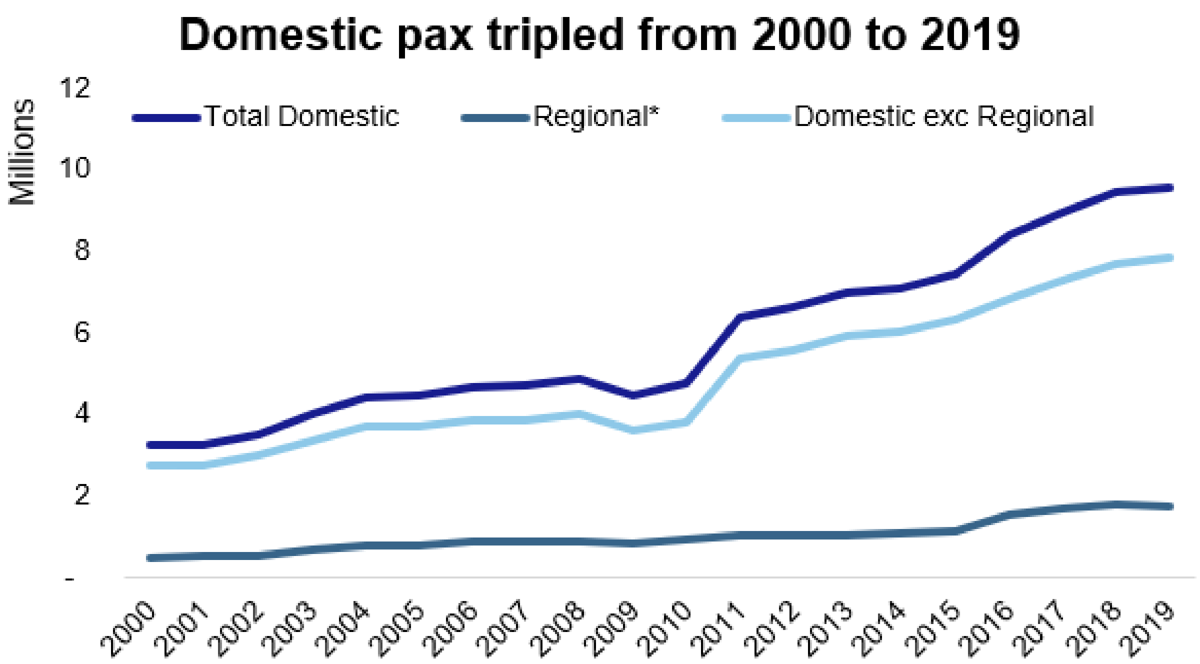
> *Prior to the pandemic, growth had been declining to the point that it was expected to be negative in 2020, and the decline was not solely attributable to Jetstar's withdrawal from regional ports.*[60]

Auckland Airport considered all feedback received on passenger demand through consultation. This included the consideration of the pre-pandemic growth trends, which found that:

- domestic passenger volumes had tripled between 2000 and 2019;
- while growth slowed in 2019, this had followed 4 years of +5% growth;
- regional traffic had been growing at an annual rate of 10.3% p.a. prior to Jetstar's exit from the regional market in 2019;
- the decline in regional volumes in 2019 was largely due to Jetstar's exit from the regional market.

After this more complete analysis, Auckland Airport reached the conclusion that following a significant period of strong, long-run growth, the slowing of domestic growth in 2019 reflected changes in the supply of seats due to the exit of Jetstar from regional services, and a reduction of available seats of domestic trunk routes resulting in higher airfares for a short period of time at the end of 2019. This was prior to when the pandemic began in 2020, and there was no indication of a trend in the softening of passenger demand over this period - changes in volume were driven by supply. These longer-run trends are set out in the below chart:

[60] Qantas submission, p. 5



The regulatory framework incentivises Auckland Airport to maximise passenger volumes

Auckland Airport agrees with airlines that the impacts on passenger demand due to rises in airfares should be minimised. Auckland Airport's incentives are aligned with the passenger in this regard, as the dual till regime means that Auckland Airport benefits the more passengers that travel through the airport, as this supports non-regulated revenues.

Airlines do not have this same incentive, but rather gain the most benefit when airfares are higher or its costs are lower. Domestic charges at Auckland Airport have been unsustainably low for a long period of time, less than half of the equivalent charges at Wellington and Christchurch airports since 2011. This has reduced Air New Zealand's costs materially, in excess of $470 million.

The Commission should take comfort in the carefully designed regulatory settings that create these appropriate incentives that are best aligned to consumer outcomes.

6.2. Depreciation forecasts and asset useful lives

Regarding Auckland Airport's depreciation forecasts and assumed useful lives, Air New Zealand submitted:

> *AIAL has not provided Air NZ with the depreciation rates it has used to estimate depreciation over PSE4. We also note that the Information Disclosure schedules do not enable interested parties to undertake meaningful analysis of airports' approach to regulatory depreciation. Air NZ's ability to analyse AIAL's depreciation forecasts is therefore limited to a high-level review.*[61]

Auckland Airport provided extensive information to airlines through consultation on PSE4 prices on all building block parameters used to determine PSE4 prices. Auckland Airport's approach is also consistent with the ID requirements.

At no point during the extensive consultation did a Substantial Customer (including Air New Zealand) request the asset lives used to forecast depreciation - this is the first time this issue has been raised. If Air New Zealand was concerned with the useful lives used to forecast depreciation to set PSE4 prices, Auckland Airport could have considered this issue as part of the PSE4 pricing consultation.

[61] Air New Zealand submission, paragraph 25

It is difficult to comment on the analysis undertaken by Air New Zealand given the results have been redacted from its public submission. Auckland Airport notes generally that projects are usually made up of different types of assets which have different useful lives. For example:

- not all airfield assets are concrete and asphalt;
- significant investment is planned in renewals of airfield ground lighting assets, which will include technology and other assets that have shorter asset lives; and
- terminal development projects are not limited to structures but include other assets such as IT systems.

Auckland Airport also notes that it would not be appropriate for the Commission to use the summary and analysis of Auckland Airport's PSD to obtain additional information beyond the disclosures because of perceptions that the current disclosure requirements do not result in sufficient information being provided. If it is considered that the current ID requirements can be improved, then a different process, separate to this review, must be followed to amend the ID requirements.

6.3. Accelerated depreciation

In its submissions, Air New Zealand[62] and Qantas[63] both opposed the accelerated depreciation of investment in the Domestic Terminal Building. BARNZ noted that the proposed approach was preferrable to where a 'write-off' of these assets was to occur in PSE5.[64]

BARNZ also submitted that:

> *AIAL has not addressed the issue of how shortened asset lives might apply to the Domestic Terminal Building (DTB), as spend on the DTB would not be spent evenly across the asset. Nor has it addressed what might happen in the event that planned decommissioning of the DTB was delayed.*[65]

These two specific questions had not been raised by Substantial Customers during consultation. Auckland Airport considers that:

- The first answer was addressed through the materials we provided during consultation and is also addressed in the detail as set out in the PSE4 PSD, and the submission to the Issues Paper;
- The answer to the second question is that the IMs would be followed. Under the IMs once an asset is commissioned its asset life would not be adjusted, and the asset would then be depreciated in accordance with that shortened asset life. Importantly, as has been previously stated in the PSE4 PSD this approach is NPV neutral for Auckland Airport.

6.4. Capex wash-up

Air New Zealand submitted that while it supported a capex wash-up mechanism in theory, it disagrees with the thresholds used:

> *Air NZ considers the threshold AIAL proposes before this is triggered is far too high. Air New Zealand estimates that, all other things being equal, AIAL would need to underspend PSE4 capex by ~20% / $530m before any adjustment would be required. This equates to excess revenues (return of and on capital) of ~ $160m before any adjustment is required.*[66]

BARNZ also submitted:

> *BARNZ was pleased to see AIAL propose this initiative. However, we consider the 15% trigger is too high. This wash-up would only apply if the airport failed to deliver some $400 million in capex. BARNZ considers this would be more appropriately set to 5%.*[67]

[62] Air New Zealand submission, page 10
[63] Qantas submission, page 4
[64] BARNZ submission, paragraph 30
[65] BARNZ submission, paragraph 29
[66] Air New Zealand submission, paragraph 62
[67] BARNZ submission, paragraph 35

Auckland Airport gave careful consideration to the thresholds for the capex wash-up. As set out above in this submission, the short-term incentives for capital investment balance between the delivery of the capital investment that is forecast and recovered through prices, and providing appropriate incentives to ensure the cost of capital investment is efficient and achieved for the lowest possible cost. Auckland Airport considers that the thresholds adopted for the capex wash-up threshold balance these two competing priorities.

The capex underspend threshold was reduced during consultation in response to airline feedback. It was originally proposed at 15%, the threshold cited by BARNZ in its submission, but was reduced to 7.5% in Auckland Airport's final decision, which is closer but still slightly higher than the 5% called for by BARNZ in its submission to the Issues Paper.

Air New Zealand submitted:

> *Air NZ believes that the adjustment mechanism, as proposed, incentivises AIAL to set capex forecasts which it would under any scenarios exceed and essentially guarantees that AIAL will earn, ex post, its target return on capital.*[68]

Auckland Airport is not entirely sure what point Air New Zealand is attempting to make with this statement and struggles to follow some of the logic. It is unclear to Auckland Airport why the mechanism incentivises Auckland Airport to set capex forecasts that it is likely to exceed given the thresholds. But if it did, would this not mitigate the unfounded concerns raised by airlines in their submissions that Auckland Airport has incentives to underinvest. It is also not clear why a capex wash-up that is one-way and can only benefit airlines, would guarantee Auckland Airport achieving its target return on capital.

Given these flaws in logic, this claim from Air New Zealand are unfounded as described. Air New Zealand also submitted:

> *Air NZ believes that the capex wash-up should not include the IRR test, so that the adjustment would be paid out if AIAL underspend its forecast capex.*[69]

The IRR test is an important element of the capex wash-up, as the intent of Part 4 is to ensure that Auckland Airport is constrained in its ability to earn excess profits, and the IRR trigger is consistent with this outcome.

If the capex wash-up without an IRR trigger applied in PSE3, as suggested by Air New Zealand, this would have resulted in a wash-up to the favour of airlines, despite airport returns being well below target. It would have penalised Auckland Airport for making reductions to the capex plan that were responsible and prudent at the time. Auckland Airport once again emphasises that the capex wash-up is one-way and can only benefit airlines.

6.5. Two-way wash-up

Auckland Airport notes that airlines have submitted in opposition to the two-way wash-up included in the PSE4 pricing decision. Air New Zealand submitted:

> *Air NZ considers the revenue wash-up is extremely favourable to AIAL. The airport has the potential to earn more than $400M incremental to forecast revenues over the PSE4 period before the wash-up would potentially be triggered (noting there would also need to be a 0.75% uplift to IRR to trigger the mechanism). This $400M incremental revenue is retained by the airport and does not form part of any carry forward adjustment into the next pricing period. Even at a 5% threshold, the increased revenue for the airport would be ~$140M.*[70]

This comment focuses on only one side of what is a symmetrically designed wash-up mechanism, which is not favourable to Auckland Airport but rather is fair and balanced. It ignores the fundamental design of this wash-up, in that it equally exposes Auckland Airport to the same upside and downside

[68] Air New Zealand submission, paragraph 63.
[69] Air New Zealand submission, paragraph 64.
[70] Air New Zealand submission, paragraph 47

risk, not just upside which Air New Zealand has focused on in its submission. Air New Zealand has not justified its claims that the wash-up mechanism is favourable to Auckland Airport.

Auckland Airport notes it has already addressed issues raised by BARNZ that Auckland Airport is being twice compensated[71] in our previous submission and PSE4 PSD, while the comments from Qantas focus on the investment plan, rather than the wash-up mechanism itself.

6.6. Operational cost forecasts

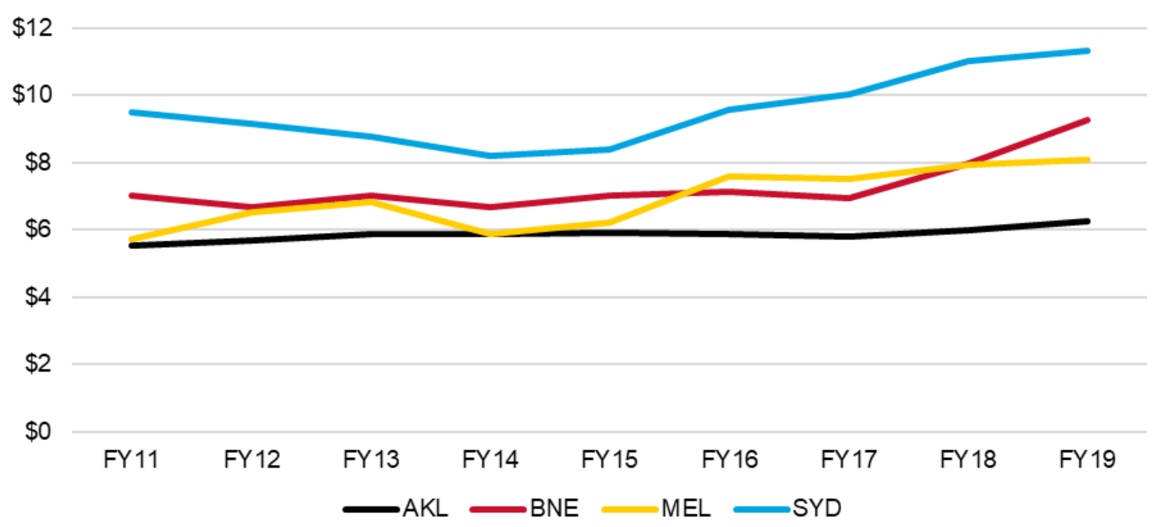
BARNZ made no submission on Auckland Airport's PSE4 pricing operational cost forecasts. However, Air New Zealand submitted it was concerned with the operational cost forecasts.[72] Auckland Airport considers the issues raised by Air New Zealand have sufficiently been addressed already during the PSE4 consultation, the PSE4 PSD, and the Auckland Airport submission to the Issues Paper.

Qantas submitted that:

> *AIAL's opex exceeds multiple Qantas benchmarks by about 200%.[73]*

Qantas provided no evidence in its submissions for this claim, and Auckland Airport considers it to be unfounded. As disclosed, Auckland Airport's operational cost per passenger is forecast to return to pre-pandemic levels in real terms by the end of this pricing period. This will return operational costs per passenger to a level that history proves is efficient and consistently lower when benchmarked against the major Australian airports in the region, as set out in the chart below.

Figure 1: Aeronautical operational costs per passenger, NZD[74]



6.7. Operational cost allocations

Air New Zealand's submission raised concerns about the proportion of corporate costs that are allocated to the regulated business. It claimed that Auckland Airport's allocations to the regulated business are too high, given the relative proportional size of when compared to its peers.

Despite sufficient information on cost allocation being provided to airlines during consultation, this is the first time Air New Zealand has raised this issue and is now calling for the Commission to review the allocation of corporate costs in detail. Nonetheless, a similar question was raised by another substantial customer on the allocation of corporate costs, which considered that that revenue should be used as the basis to allocate shared corporate costs that could not be allocated directly.

[71] BARNZ submission, paragraph 34
[72] Air New Zealand submission, paragraph 58
[73] Qantas submission,
[74] Source: Auckland Airport ID, Australian Competition and Consumer Commission Airport Monitoring Reports

Auckland Airport considered whether this would be an improved cost allocator or not. The conclusion reached was that revenue was not an appropriate proxy indicator to allocate direct costs, in the context of the Auckland Airport business. This is because different elements of the airport business can have very different cost bases. For example, the investment property element of the airport business has a very low level of operational cost relative to the revenues it generates which are largely reflected in the land holdings and rents paid by tenants, and the corporate overheads for this element of the business are very low when compared to the costs of aeronautical operations to deliver airport operations.

Indirect corporate costs are allocated based on the proxy measure of the percentage of aeronautical and non-aeronautical space in the International Terminal Building. This has been Auckland Airport's standard practice and is the basis for ID, which is published and audited externally on an annual basis.

Auckland Airport during consultation considered an alternative approach of allocating indirect costs based on the percentage of direct costs for each business segment. Auckland Airport's analysis found that adopting this approach would have resulted in a slightly higher allocation of corporate costs to the regulated aeronautical business, but materially the allocations were the same. This method was not adopted in the final pricing decision but did provide Auckland Airport comfort that the existing approach did not over-state the aeronautical allocations of corporate costs, as is only now being claimed by Air New Zealand (when it previously did not object to the approach used).

Given that the cost allocations adopted are principled, consistent with the IMs, and consistent with those adopted in annual ID, which are then audited externally each year, Auckland Airport considers that Air New Zealand's calls for a detailed review by the Commission of the allocation of corporate costs are unnecessary, particularly as this issue was not raised at all directly by Air New Zealand with Auckland Airport during consultation on PSE4 prices.

6.8. Treatment of tax losses

Air New Zealand submitted that the Commission should incorporate the tax losses generated by AIAL over PSE3 into its ex-ante PSE4 profitability analysis.[75] This was not an issue that was raised with Auckland Airport during consultation on PSE4 prices. This is the first time that this approach has been suggested.

The tax losses that resulted due to the impacts of the pandemic in PSE3, will reduce the tax payable by Auckland Airport in PSE4. The treatment of tax losses from PSE3 was an issue that Auckland Airport raised, during the Input Methodology ("**IM**") Review.[76]

Auckland Airport then set prices for PSE4 ahead of the release of the Draft IM Review decisions, meaning that the Commission's response to this issue was not yet available. Accordingly, when setting prices for PSE4, Auckland Airport did not include the use of tax losses in its pricing forecasts. This approach was consistent to the treatment of the revenue shortfall in PSE3 of more than $500 million, both were not carried forward into PSE4.

In the Draft IM Decision, released after PSE4 prices were set, the Commission noted that:

> *Our reason for proposing no change is because the Airports IM already provides sufficient flexibility to deal with this issue. The current IM allows Airports to propose wash-ups for past losses as part of their future price-setting events.*[77]

Having considered the Commission's views in the Draft IM Decisions, an alternative approach could have been to include an opening carry-forward adjustment when setting PSE4 prices, to reflect the economic value of tax losses that were carried forward to PSE4. This would have materially had the same effect as the approach that was adopted - that is to not include tax losses in the forecasts when setting PSE4 prices.

The only difference would have been that using a carry-forward would have also allowed for the holding costs of these tax losses to also be recovered through aeronautical prices, which would have increased

[75] Air New Zealand submission, p. 7
[76] Auckland Airport submission on IM Review process and issues paper, p. 3-4
[77] Commerce Commission, Part 4 IM Review 2023 – Draft decision, paragraph 21.3

allowable revenue. Therefore, the approach adopted by Auckland Airport has resulted in slightly lower aeronautical charges than the approach as set out by the Commission in the Draft IM Decisions.

To do what Air New Zealand has suggested, and include tax losses in the PSE4 price path, effectively results in Auckland Airport 'paying twice' for COVID-19 losses, and conveniently ignores the over $500 million in revenue losses that were not carried forward from PSE3. As set out in the FY23 ID commentaries:

> *Auckland Airport's PSE3 aeronautical prices provided no mechanism to recover any of the COVID-19 revenue losses experienced. So to carry tax losses forward from PSE3 would result in forecast PSE4 cash returns being well below our target return, as the full benefit of historic COVID-related tax losses would be transferred directly to airlines, effectively resulting in Auckland Airport 'paying twice' for COVID-19 losses.*[78]

At no time during the consultation on PSE4 prices was this issue raised by Substantial Customers. If the Commission considers that tax losses should be included in its profitability assessment, then we consider it must also include an appropriate opening carry-forward adjustment to reflect the value of tax losses realised and carried forward from PSE3.

6.9. Correction of errors

Air New Zealand submitted that it does not believe it is appropriate for Auckland Airport to include the carry-forward adjustment to reflect asset disposals that were not identified during the pricing consultation process when assessing profitability.[79]

Auckland Airport notes that the carry-forward adjustment reflected three corrections that were identified following the pricing decision. This included land transfers, disposals, and changes operational expenditure. For Air New Zealand to suggest that only the disposals be excluded from the Commission's assessment appears to be an example of 'cherry-picking', as the same logic should be applied to the adjustments made to operational expenditure, which are adjustments that benefited airlines.

Auckland Airport's approach to this has been principled, with these post-pricing decision adjustments all being treated consistently and not selectively. The Commission should adopt the same approach. If the Commission were to adopt Air New Zealand's proposal and ignore the carry-forward adjustment in this pricing review, this would show a lower IRR than the 8.73% that was included in the PSE4 PSD. This is because the recovery of these costs is not forecast to take place during PSE4.

As set out in our disclosures, Auckland Airport noted that it had not consulted on these costs with airlines, and that they would not be recovered during the PSE4 pricing period, but rather Auckland Airport would consult on the recovery of these costs ahead of the PSE5 pricing decision.

> *This approach is considered appropriate because it avoids the alternatives of altering PSE4 prices, incorrectly presenting the pricing disclosure schedules by presenting incomplete forecasts or incorrect information, or forecasting an IRR that is below the appropriate return on capital.*
>
> *This carry-forward adjustment could then be offset in the next PSE5 pricing period. As these adjustments were made following the pricing decision, customer views on this carry-forward adjustment from Substantial Customers have not been sought. Views from Substantial Customers would be sought ahead of any recovery of this carry forward adjustment, which would be via PSE5 charges for priced activities*[80]

These are highly relevant points that were not mentioned in Air New Zealand's submission on this issue.

[78] Auckland Airport ID FY23 commentaries, p. 6
[79] Air New Zealand submission, paragraphs 12-14.
[80] PSE4 PSD, p. 41

6.10. Innovation

BARNZ submitted:

> *An important area for innovation for airports is consideration of infrastructure for decarbonisation of aviation. While sustainable aviation fuels will use existing infrastructure, provision for electric or hydrogen air services is important to plan for. BARNZ has seen little evidence of planning for potential upgrades to electricity supply at Auckland Airport, aside from references to asset management plans of the local electricity distributor. BARNZ asks that the Commission examine whether AIAL's ten-year capital plan considers sufficient infrastructure investment for decarbonised short haul flights under the innovation limb.*[81]

This is an issue that Auckland Airport is actively considering and is engaging with airlines on. Much of the infrastructure necessary to enable low emissions aircraft will be dependent on the type of technology that is adopted. Auckland Airport continues to work with airlines to understand their future plans for low emissions aircraft, to inform the future investment to enable these activities.

6.11. Freightways and New Zealand Post submission

Auckland Airports notes that Freightways ("**FRW**") and New Zealand Post ("**NZP**") have made a submission to the Commission regarding their concerns surrounding the reduction to the aircraft parking charges exemption from 48 hours to 12 hours and the relocation of the Cargo Precinct. As FRW and NZP are not Substantial Customers of Auckland Airport, nor do they directly operate aircraft at Auckland Airport, they were not included in the consultation process for the capital plan or PSE4.

Auckland Airport's submission to the Issues Paper set out more detail on the operational reasons why exemptions to aircraft parking for domestic freighters were changed. These changes were made not to drive revenue but encourage more efficient use of constrained airfield infrastructure.

FRW and NZP submitted:

> *This level of increase is in stark contrast to the parking revenue made public by AIAL which shows total parking revenue increasing from $15.4m to 16.4m, a 15% increase during the same FY25 period.*[82]

When finalising its pricing decision, Auckland Airport made a decision to defer the timing of the imposition of the parking changes by twelve months to 1 July 2024 to give customers time to adjust their operations. Given this change was made right before the final approvals of the pricing decision, the revenue forecasts were not adjusted to reflect this deferral. This meant that Auckland Airport under -forecast revenue in the PSD in FY24, as the revenue assumptions reflected the aircraft parking assumption being lifted in that year - not in FY25 as has been adopted. This explains why there is a smaller increase in parking revenue from FY24 to FY25. From FY23 to FY24, aircraft parking revenue was forecast to increase by 27% or $3.2 million, reflecting the change to the exemptions that applied.[83]

FRW and NZP submitted:

> *Reading the publicly released AIAL Capital Investment Programme dated 17 August 2023 we can see that $284.6m capital is being spent on the development of the Cargo Precinct. However, given AIAL will not share their detailed building block model we are not privy to how this expenditure is being recovered across customers, but our view is that this expenditure is completely unnecessary.*[84]

As neither NZP nor FRW are Substantial Customers, it would not be appropriate for Auckland Airport to share its building blocks model with them, as it contains sensitive commercial information.

This expenditure relates to a cargo facility, which is not recovered through aeronautical prices, i.e. it is non-priced. The revenue related to this facility will be determined through commercially negotiated agreements with users. Auckland Airport continues to discuss with both NZP and FRW the need for

[81] BARNZ submission, paragraph 50
[82] FRW and NZP submission, p. 3
[83] PSE4 PSD, p. 79
[84] FRW and NZP submission, p. 3

investment at Auckland Airport and the impacts on freight operations as the airport invests to deliver the long-run capacity that will be required at Auckland Airport.

Auckland Airport

Appendix A – CEG reports