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24 October 2012

Dear Ruth,

The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport

Thank you for the opportunity to provide feedback on Auckland International Airport Limited (**AIAL**)'s disclosures and consultation process. In addition to the Qantas Group's (consisting of Qantas Airways and Jetstar Airways) submission to AIAL please find feedback to the questions posed by the Commerce Commission as part of the review.

SECTION 1: Overarching issues for all aspects of performance

1.1 Has information disclosure had any impact on AIAL's performance and in understanding AIAL performance relative to the first price setting event (PSE), and why?

The Qantas Group's view is that information disclosure has resulted in an improvement in understanding AIAL's performance relative to the first PSE.

The price setting disclosure made in 2011 in relation to the first PSE improved the information that was provided to major customers. Information provided as part of the 2007 consultations was less detailed and included substantial increases in valuations, cross subsidisations and above market rates of returns. Little information was provided publically and AIAL was able to set prices as it saw fit.

Whilst AIAL's approach to consultation has been more open during the FY11 consultation the legislative environment ultimately limits a truly effective and equitable pricing outcome. There still remains a substantial imbalance whereby under New Zealand legislation AIAL is required to consult however not required to reach agreement with airlines. AIAL is also not required or prepared to provide an agreed level of service or rebates if AIAL fail to deliver that level of services.

1.2 Has information disclosure had any impact on the effectiveness and scope of consultation as part of AIAL's second PSE relative to the first PSE, and why?

The section 56G Review has encouraged AIAL to adopt a more sensible and transparent approach to its price setting. AIAL aimed for a WACC of 9.16% in the Initial Pricing Proposal however the Final Pricing Decision was determined with AIAL targeting a return of 8.5%. While this is closer to a WACC reflective of the market a few years ago, this is still significantly higher than the Commerce Commission and current market interpretation.

The Qantas Group is also concerned that AIAL is not required to reach an agreement with airlines regarding proposed capital expenditure and the ability of AIAL to deliver on the capital expenditure plan. In the previous pricing period expected capital expenditure projects were delayed or not completed with the capital expenditure falling 'again' into the next pricing period. There is incentive in the fixed price modelling to delay capital expenditure which results in prefunding and double dipping of depreciation and return on non-existent assets. Likewise there is no disincentive to over spend on capex in the later years as the investment cost risk is limited when the assets soon become part of the asset base in the subsequent period without much scrutiny.

The Qantas Group is significantly concerned with the inconsistency with which the input methodologies developed by the Commission have been applied. In the case of WACC, AIAL continued to use its own adviser's views, applying only some of the components of the Commission's input methodology, particularly when estimating an appropriate WACC. Throughout the consultation process the Qantas Group implored AIAL to be consistent with the findings of the Commerce Commission with little success.

1.3 What aspects of performance and conduct should we focus our efforts on for this review for AIAL?

During the consultation process the Qantas Group stated that it does not endorse asset revaluations and thus supported AIAL's decision to retain the moratorium in the pricing cycle. The Qantas Group also understands that the moratorium will no longer apply in the next PSE. The Qantas Group supports valuations based on historic cost and the useful life of assets and would like to express preference for the continuation of the moratorium on a permanent basis.

The Qantas Group is also concerned by the lack of obligation for AIAL to invest the capital proposed in the PSE in a timely manner. Productivity measures and benchmarks need to be set with appropriate incentives and risk sharing mechanisms. For example, Qantas believes AIAL did not deliver the capex at the timing proposed in the first PSE and thus customers have paid for assets that never eventuated.

Another key concern for the Qantas Group is the international terminal charges set by AIAL. The Qantas Group understands that AIAL may have set prices as it sees fit to extract excessive profits

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from international airlines evidenced by receiving a return on non-delivered capex and the redistribution of revenue from international to domestic and regional in this PSE

Finally, the Qantas Group is concerned by the significant increase in domestic charges (circa 30%) in the first year of the PSE, largely driven by excessive (abortive) capital expenditure to expand the domestic terminal over a limited life of five years. This creates a price shock that could have been avoided through a stepped pricing approach over the term of the PSE.

Finally, the Qantas Group is concerned with AIAL's the lack of willingness to incorporate services levels for the provision of aeronautical services and facilities.

SECTION 2: Any additional issues including explanation of why they are important?

AIAL attempted to implement new Airport Terms and Conditions through the consultation process. The proposed Terms and Conditions were provided late in the process and were heavily weighted in favour of AIAL and very onerous on the Qantas Group. Such documentation should be provided upfront and should also incorporate a list of service levels KPIs to be met by AIAL and appropriate accountability. It is inequitable for a customer to pay significant amounts for services without having an understanding of what they are paying for or any recourse if targets are not met.

SECTION 3: Is AIAL earning an appropriate economic return over time?

The Qantas Group considers the approach to calculating a market representative WACC estimate to be appropriate and the midpoint of 6.49% is a reasonable estimate for the point of time it was calculated. Given the time lapse between the Commerce Commission calculating a range and AIAL proposing its final price, the risk free rate and debt margin elements should be finalised just prior to the price becoming applicable.

The aviation industry experiences variable growth and airports should not be immune to market conditions. Airports are a very long term asset and should have a long term view that there will be higher and lower levels of returns. In order to maintain and stimulate demand, airports need to accept the lower levels of return as their customers do.

The pricing of large, expensive, long life infrastructure using a short term building block model is an inequitable methodology as early users of assets are pay more for excess capacity compared to users later in the life of the asset. Airports need to approach the return and pricing of such assets over a far longer period and more moderately in the early years of the asset life without generating monopoly returns on the asset.

3.1 What is an appropriate level of target return for AIAL, and why is the level appropriate?

An appropriate level is that which would be consistent with the efficient operation of a similarly rated airport at a similar point in the market cycle. The Commerce Commission's figures should be representative of this benchmark.

In the Commerce Commission's Information Disclosure Determination for Specified Airports it is observed that the mid-point estimate of the WACC should be the starting point for assessing the profitability of airports. Despite this determination, AIAL employed the 75th to 85th percentile estimates of WACC when considering pricing. The Qantas Group urged AIAL to employ the Commerce

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Commission mid-point estimate rather than a percentile that positions AIAL to earn excessive returns.

It is not appropriate or economically efficient for airports in a monopoly position to be extracting higher returns than the market is experiencing. Overall, the Qantas Group believes the charges set by AIAL from in the second PSE will produce an over recovery in aeronautical revenue.

3.2 What is an appropriate level to reflect normal performance, and why?

It is inappropriate and not in the best interests of the local and state economy for airport customers to be paying for anything but an efficient level of return for an airport. The Qantas Group believes the efficient level of returns to be the Commerce Commission's midpoint estimate of WACC using current market values. Setting an efficient level of return encourages the airport to innovate or achieve efficiency. Direct pass through of costs and asset revaluations for a company that is a natural monopoly encourages complacency.

In a highly competitive industry, airlines must set fares and generate operational efficiencies in order to survive in the market. For example, Qantas' 'Next Generation Check–in' system was developed to remove the need to expensively expand terminal footprint for manual check-in and bag drop. It has been eminently successful in Australia's major airports by reducing costs, infrastructure requirements, staff and operational expenditure as well as improving the customer experience. A similar incentive for efficient operations needs to be set for airports in New Zealand.

3.3 What is an appropriate level to reflect superior performance, and why?

The airport should target efficient, optimised performance rather than 'superior' performance. Setting returns at an efficient level encourages such performance. Airports have the added flexibility to generate substantial incomes from non-aeronautical, lease assets and advertising revenue. It should be in their interests to encourage passenger growth to support non-aeronautical revenue streams.

3.4 Have there been any wash-ups, discounts or other discretionary adjustments to the forecast revenue requirements. If so, how should these be dealt with for assessing profitability?

There has been some wash up in the past particularly with the Terminal Services Charge. Over recovery is not an ideal situation as the higher or lower cost is inefficiently factored into the business model and results in either prefunding or costs not factored into the business costs.

In AIAL's final pricing proposal there are no mechanisms for a wash up thus profitability should not be adjusted.

3.5 How reasonable is AIAL's revenue forecast for the second PSE compared to the first PSE forecasts, and why?

The Qantas Group did not see any overall substantial improvement from the first PSE to the second PSE. There is an overall increase between the current pricing and the final proposed pricing without any substantial growth benefits.

AIAL's revenue forecast is too high and therefore does not encourage innovation, operational

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efficiency or prudent investment in infrastructure. The inflated returns expected by AIAL may come at the expense to economic growth and productivity.

AIAL's reallocation of costs between the aviation segments shows that it was substantially under recovering from regional airlines. This persistent uneconomical cross subsidisation of other segments has perpetuated a situation whereby it becomes increasingly difficult to reset. AIAL needs to take responsibility for inefficient pricing and assist regional and general aviation operators to adjust over time with lower expected returns but not at the expense of international operators.

3.6 To what extent did actual results for the first PSE differ from forecasts, and why?

Despite actual passenger numbers being lower than forecast, AIAL earned more than appropriate revenue in the first PSE due to the high WACC adopted. AIAL should have suffered from the Global Financial Crisis along with the rest of the industry, but the results demonstrated that airports are substantially insulated from global economics and are generating inefficient revenue.

A particular issue for airlines is the level of capex and timing of the capital spend. The Qantas Group believes AIAL did not deliver the capex at the timing proposed in the first PSE and thus customers have paid for assets that never eventuated. The capex that has shifted to the second PSE will be payed for twice as it's included in a higher opening asset base as well as included as future capex.

3.7 to 3.9 - The Qantas Group is not in a position to comment.

3.10 How reasonable are AIAL's asset valuations, and why?

AIAL retained the moratorium on asset revaluations in this pricing which the Qantas Group endorsed. The Qantas Group does not support the revaluation of assets for pricing purposes as this does not reflect the true cost of investment. The Qantas Group supports pricing based on the historic cost and useful life of assets. This is a fair and reasonable methodology for appropriate, efficient and equitable pricing of investments made. It is not appropriate to pay for the replacement of assets prior to that event as it amounts to prefunding.

3.11 What is the appropriate treatment for pricing purposes of assets held for future use?

The Qantas Group does not support the inclusion of land assets for future infrastructure. Assets that are being held for future productive use should not be in the aeronautical asset base as they do not have present aeronautical value or productive use. Should these assets have a non-aeronautical use in the intervening period then the airport has that discretion to generate non-aeronautical returns on those assets. To include assets in the aeronautical assets base that may not be used for aeronautical services does not drive appropriate investment decision on timing. Airports need to have a long term vision and prepare in the most efficient way.

The Qantas Group has made it clear that it does not support the prefunding of assets. In a response to Brisbane Airport Corporation's request for airlines to pay in advance for a new $1.3 billion runway due for completion until 2020, Qantas Group CEO Alan Joyce publicly likened this to Apple promising to deliver an iPhone 10, in 10 years' time but asking people to pay for it now. The Qantas Group believes airports should fund capital project and charge airlines as they utilise the assets.

SECTION 4: Is AIAL operating and investing in their assets efficiently?

4.1 Where and when do any capacity constraints occur at AIAL, and is additional investment necessary to address these constraints?

- The domestic terminal is currently constrained, particularly security screening, gates and apron. Development to relieve congestion is underway with AIAL allocating $29 million of capital expenditure in the Final Pricing Decision.

- International terminal check-in counters, security, customs and baggage reclaim areas are currently constrained in peak periods; however this can be alleviated by better slot management rather than through additional capital investment by the airport.

- The shared international taxiway used by aircraft accessing Piers A and B is also constrained, with work currently underway to alleviate.

4.2 What factors outside AIAL's control have contributed to the capex and opex forecast for the second PSE and to changes in expenditure since the first PSE?
To some extent, insurance and regulatory costs have increased beyond AIAL's control. However AIAL has significantly increased regulatory costs through increasing related consultancy costs and including the costs of the merits review proceedings. It is not appropriate for AIAL to include the costs of its merit review and judicial review proceedings as this is not required for the provision of aeronautical services and were not requested by airlines. The recovery of such costs should follow the order of Court and not be met wholly by users.

4.3a How reasonable are AIAL's capex forecasts for the second PSE, and how do these compare to forecast and actual expenditure from the first PSE?

The investment of $29 million on the domestic terminal is unreasonable given AIAL is depreciating the asset over five years. An implied useful life of only five years for this investment indicates inefficient capital spend by AIAL. If the terminal is to facilitate another purpose after five years then those future users of that facility should contribute to the return of that asset. In addition, with a tax life of 20 years, the tax 'write off' benefit after the five years falls into the next pricing period thus is not factored into the current pricing.

At this stage the Qantas Group has not conducted a detailed review of forecast and actual expenditure from the first PSE.

4.3b How reasonable are AIAL's opex forecasts for the second PSE, and how do these compare to forecast and actual expenditure from the first PSE?

AIAL included marketing and route development expenses in its opex forecast for the second PSE. It is not equitable for incumbent airlines to fund costs to promote new airlines. This discretionary cost is not required in the provision of aeronautical services and is entirely within AIAL's control.

At this stage the Qantas Group has not conducted a detailed review of forecast and actual expenditure from the first PSE.

4.4 To what extent does the demand forecast presented by AIAL as part of the second PSE

accurately reflect expectations of future demand, and why?**

The Qantas Group believes AIAL's passenger forecasts are particularly conservative when compared with historic growth and internal passenger forecasts. Domestically AIAL forecast only 3.1% annual passenger growth, well below historic growth rates. Jetstar continues to drive significant domestic growth, as evidenced by the basing of two additional A320 aircraft from mid-November 2012.

Forecast International growth is also conservative and well below the average growth of 5% YOY for the last 14 years. Passenger numbers are also likely to benefit from the opening of new markets through the introduction of the B787s and the arrival of A320-neo aircraft throughout the pricing period. The Qantas Group also notes that AIAL has publicised a projection of 24 million passengers (4.2% CAGR) by 2025 – an outlook that the Qantas Group believes is a much more accurate picture of Auckland passenger growth.

4.5 to 4.7 - The Qantas Group is not in a position to comment.

SECTION 5: Is AIAL innovating where appropriate?

The Qantas Group believes that AIAL is not considered an early adopter of airline innovation internationally but does lead innovation among other New Zealand airports which is fitting as AIAL is a major international hub in the South Pacific and the largest airport in New Zealand

There has not been any drastic change in the level of research and development or other innovation activities as a result of information disclosure regulation but there has been some improvement in AIAL's awareness and appreciation that the future success of its operation is dependent on its ability to provide the infrastructural solutions for the changing needs of the aviation industry.

Three examples illustrate how AIAL has embraced this challenge and shown a willingness to invest and partner with airlines:

- Airlines are progressively rolling out self-service kiosks to speed up the check-in process. AIAL has supported the introduction of these kiosks at both the International and Domestic terminals and have installed in-floor cabling where this has been required.

- AIAL instigated a study of airport best practice and now have a program in place to install 'alligator' connections at the air-bridges that will enable Ground Power Units to be more easily connected to aircraft allowing the aircraft Auxiliary Power Units to be safely shut down with resultant cost savings on fuel and maintenance.

- Collaborating with Jetstar on domestic ground boarding and arrival via the simultaneous use of the front and rear doors of the aircraft to speed up the boarding process and reduce the aircraft turnaround times.

SECTION 6: Is AIAL providing services at a quality that reflects consumer demands?

AIAL is extremely image conscious and prides itself on providing an airport that is a positive experience in its own right. AIAL is developing a good understanding of the needs of the various

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airport users, and recent management has improved awareness of and responsiveness to the needs of the wider airport community. Matters of quality in the aeronautical space have improved over the last four years. An example of this is AIAL's willingness to bring forward capital expenditure as a result of Jetstar's addition to its domestic fleet. However these changes in receptiveness are a result of change in management style rather than the information disclosure regulation.

The changes in quality which have occurred since the introduction of information disclosure regulation includes the provision of reporting on interruptions to align with the service monitoring and on-time performance monitoring measures as part of the information disclosure requirements.

SECTION 7: Is AIAL sharing the benefits of efficiency gains with consumers, including through lower prices? Do the prices set by AIAL promote efficiency?

7.1 How do the prices set by AIAL reflect previous efficiency gains? How did the prices set by AIAL for the first PSE reflect previous efficiency gains?

The Qantas Group believes there is no evidence to indicate that the prices implemented by AIAL reflect any efficiency gains from the previous pricing period, as aeronautical charges continue to increase significantly. Based on a preliminary review of operating expenditure has also increased on a per passenger basis from the previous period; particularly due to the inclusion of significant marketing spend and the cost of the merit review.

7.2 To what extent do changes in the pricing structure at AIAL at the second PSE better reflect efficient pricing principles (for example, are prices subsidy-free, do they have regard to service capacity, do they take account of consumers' price sensitivity) relative to the first PSE?

In the second PSE AIAL aligned the MTOW rates for aircraft greater than 40 tonnes, whether international or domestic, which is an improvement from the first PSE. However AIAL did not address the significantly lower rates for aircraft less than 40 tonnes.

The Qantas Group believes that charging aircraft less than 40 tonnes 62% less than larger aircraft may not be reflecting the true share of costs. These aircraft contribute about 5% of airfield revenue yet their airfield activity greatly exceeds this contribution (42% of movements, 13% of passengers and 8% of landed tonnes). The cross subsidisation of a material segment of the market based on what can be assumed as 'user pays' methodology is fundamentally flawed. This practice, besides being against ICAO user pays principles, drives false economies and is ultimately a lose-lose situation for users and airports. Under-pricing does not allow this segment to see the actual cost of service as it hides efficiencies and does not drive innovation and cost effective behaviour in order to become more competitive. It falsely stimulates demand of an inefficient, costly segment at the expense of other users and the airport.

In terms of the pricing structure for the terminal assets, the Qantas Group is supportive of the introduction of the Domestic Passenger Charge (DPC) in the second PSE. The DPC fosters fairness, provides transparency and contributes to the costs associated with domestic terminal activities. However the significant increase in the first year of the PSE creates a price shock that could be avoided through a stepped pricing approach over the term of the pricing period.

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7.3 To what extent have airlines and other consumers of AIAL's services been able to make price-quality trade-offs that best meet their needs for the second PSE? How does this compare with the first PSE?

We have not conducted such analysis.

7.4 To what extent do AIAL's prices promote certainty and stability? How does this compare relative to the first PSE?

The removal of the Terminal Services Charge (TSC) was supported by the Qantas Group as we believed all other pass through costs can be appropriately included in the per passenger charge for terminal services. We believed AIAL could reasonably forecast these costs.

What is a concern for the Qantas Group moving into the third PSE though is the potential expiration of the moratorium for asset revaluations. This will certainly create uncertainty in future prices as the moratorium was effective during the first and second PSE.

7.5 How do airlines and other consumers of AIAL's services expect their demand to change in response to the prices set by AIAL in the second PSE?

The Qantas Group is particularly concerned with the significant increase in domestic charges in the first year of the second PSE. Such a price shock for the highly price sensitive domestic and leisure markets is likely to lead to a decline in overall market demand and total revenue. The resulting impact in profitability may ultimately lead to a reduced domestic growth profile and a comprehensive market review. This reduction in activity has a significant impact on tourism and the broader economy and risks AIAL not achieving the desired revenue and forcing airlines to cancel routes. This will come at a time when the nation is actively trying to encourage economic growth with lower interest rates.

7.6 What impact has information disclosure had on the pricing methodology set by AIAL for the second PSE?

None observed.

SECTION 8: Comparator airports

8.1 What airports provide a useful benchmark for assessing the performance of AIAL, and why?

It is a risk comparing one airport to another, as one airport's inappropriate behaviour or by being in a different phase of their investment cycle can be seen as justification for other airports to follow suit. The Qantas Group believes that comparative work and analysis should be based on AIAL's own performance over time. As an illustration, the Qantas Group expects that AIAL's aeronautical expenditure per passenger should reduce over time as an indication of operational efficiencies, economies of scale and improved performance.

SECTION 9: What are the strengths and weaknesses of the current ID requirements?

It was the step change in Information disclosure requirements due to the introduction of the Airport

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Authorities Act in 1999 that allowed airlines to engage in consultation in a more meaningful way. The Commerce Act regulation under Part 4, whilst not providing any immediate incremental benefit over what was already available, will provide a valuable basis for establishing trends over time particularly in being able to compare actual performance (in terms of costs, revenues, activity levels and capital expenditure) against forecasts which were the basis of setting prices.

The information disclosure to the public under the information disclosure regulation would have had a considerable impact for AIAL. The price setting disclosures required by the Commerce Commission would have resulted in more information in greater detail being released to the public to justify its pricing decisions and methodologies.

Qantas appreciates the opportunity to provide feedback as part of consultation and disclosure process. We hope this will prove useful to progress through the next stages. If you have any questions or comments, feel free to contact me.

Yours sincerely,

Fiona Leishman

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