28 November 2017

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Dear Jo,

Review of Auckland and Christchurch Airport's third price setting events – Process & Issues paper

Executive Summary

1. A full and independent review of the recent pricing decisions by Auckland and Christchurch Airports is essential. Both airports have set prices that are not in the long-term interest of consumers and more must be done to protect consumers from the harm caused by monopoly pricing and monopoly service provision.

2. BARNZ and our members support the Commerce Commission carrying out a review of the pricing decisions and publishing a report on its findings. It is essential to have a clear statement of whether the pricing decisions are consistent with the Purpose of Part 4 of the Commerce Act 1986.

3. We support the Commission's proposed timeframe for the review, but are concerned that the proposed scope is too narrow (ie the consultation paper proposes that quality of service, innovation and prior year expenditure efficiency will not be part of the review). If these items are excluded, the Commission will struggle to reach a full view of the performance of the airports and to determine whether the Part 4 Purpose is being met. More importantly, without a review of airport quality, innovation and efficiency, there is a real risk of consumers continuing to pay for inefficient airport costs, or receiving poor quality service or not benefitting from innovation. There is a direct link between investment levels, expenditure efficiency and service quality – these items cannot and should not be separated for the review. We do not believe the scope proposed in the consultation paper would be consistent with the Act as it excludes key limbs of the Part 4 Purpose.

4. We consider that a better approach is available, one which incorporates all relevant information so a full view of airport performance can be reached. BARNZ recommends that the Commission carries out a summary and analysis of price setting event disclosure information and annual disclosure information at the same time, so it can come to a rounded and informed view. As far as we know, the Commission has never undertaken a summary and analysis review of Airports' annual disclosure information, so this is well overdue and reviewing this information as part of the review of the price setting event disclosure makes sense and should achieve efficiencies.

5. We believe that a wider scope should be manageable for the Commission. For example, BARNZ was able to complete (attached) assessments of each pricing decision reasonably quickly and with limited resources, so we are confident that a broader scope is very feasible for the Commission to complete.

However, BARNZ would accept a three-month extension to the review timeframe, if that was necessary to accommodate the wider scope.

6. Table 1 highlights the areas where airlines have the greatest concerns about the pricing decisions and the airports' operations. These topics should be given most attention during this review.

Table 1: Key areas of concern for airlines regarding the recent pricing decisions

Issue	Comment
Target return (WACC) of both airports	Both airports have set a WACC higher than the mid-point of the range determined in accordance with the Input Methodologies. The airports have targeted high WACCs despite the Commission's view that an uplift above the mid-point of the range is not justified in the case of Airports because the return obtained from complementary unregulated activities (in which Airports enjoy significant market power) serves the purpose that justifies the uplift in price-quality regulated industries.[1] Neither airport has provided the information on the profitability of complementary activities that would be necessary to refute the Commission's reasoning. The arguments that Auckland and Christchurch Airports have offered to justify setting a WACC higher than the mid-point of the range are different and contradictory – they cannot both be correct. BARNZ is concerned that the regulatory framework is producing a situation where each airport finds their own reason to justify an uplift, but those reasons are not consistent over time or with each other. We suggest the Commission needs to decisively reject this type of unorthodox claim regarding WACC estimation. The analysis put forward by each Airport in support of a higher WACC have also been refuted in advice by John Small that is attached to this submission. The effect of the inflated WACC, at both airports, is to overcharge consumers by \$75m over five years relative to the situation where the mid-point WACC was used. The Airports have not demonstrated that these higher costs are required to incentivise investment[2]. The higher WACCs are not delivering any commensurate consumer benefits in return for the higher prices. We therefore do not accept that these proposals to set WACCs above the mid-point are in the long-term interest of consumers.
Auckland Airport's runway land charge	It is not acceptable or reasonable to charge airlines and passengers for an asset that does not exist and which they cannot use. The attached report from Pat Duignan provides a discussion of factors to consider when assessing the runway land charge. This discusses the potential for the charge to: • Reduce the airport's incentive to expedite completion of the runway once construction begins • Provide an inefficient pricing signal

[1] Commerce Commission, Input Methodologies Review Decisions – Topic Paper 6: WACC percentile for airports, 20 December 2016, section 5.

[2] There is a risk that Airports will delay investment beyond the optimal timing but increasing WACC is a very inefficient and costly way of addressing that issue.

Issue	Comment
	• Not necessarily deliver a sustainable price path. The runway land charge also creates inter-generational inequity as those airlines and passengers that would pay the charge from 2021 would not necessarily use the runway once it is built.
Operating efficiency at both airports	Operating efficiency trends at both Auckland and Christchurch Airports are causing airlines concern and are leading to inflated opex forecasts. Christchurch Airport's opex per passenger has grown by 50% over PSE2, which implies their starting opex for PSE3 will be inflated above what is reasonable. Auckland Airport is growing rapidly, which we would expect to lead to efficiencies (ie reduced costs per passenger), but the airport has stated that it expects "diseconomies of scale" over PSE3 and is passing these inefficiencies onto airlines. The BARNZ view is that if the Airport cannot find a way to achieve efficiencies through growth then it should face the consequences of this rather than expecting the Airport's customers to pay for its own inefficiency. Auckland Airport's position is particularly concerning since it can be expected that the Airport will argue, when the second runway comes into service, that operational costs per passenger will increase because utilisation will be low initially. We do not see any meaningful incentives for airports to achieve opex efficiencies within the current regulatory settings.
Forecast capital expenditure levels at both airports	Auckland Airport's capital plan is very large and should be reviewed for cost efficiency and deliverability. We have concerns that Auckland Airport set prices for PSE3 based on a high capex forecast that it may not be able to deliver. According to Forsyth Barr's report of the Airport's Investor Day, the Airport seems to have set its capex forecasts at the upper end of the potential range rather than the mid-point. The report of what Auckland Airport said was:[3] "Capex assumptions used for AIA's recent aeronautical repricing were at the ceiling of its needs for the next 5–10 years. The company suggested that there was some flexibility to the programme, albeit any change would be lower rather than higher capex." Christchurch Airport's capital plan is smaller but still includes questionable projects such as the 'terminal reconfiguration' project, which has not been identified or consulted on.
Christchurch Airport's international demand forecasts	These demand forecasts are unduly conservative as they do not incorporate any recovery in Christchurch's share of New Zealand's international travel, despite the recovery from the earthquake and a significant reduction in international landing charges at Christchurch, which should stimulate demand. We consider that the forecasts should assume Christchurch's share

[3] Forsyth Barr, *Auckland Airport Investor Day – Capex is Key*, 20 November 2017

Issue	Comment
	of New Zealand international passengers will be restored to pre-earthquake levels within PSE3.
Quality of supply at Auckland	The quality of the airport service is of great importance to airlines and passengers and has a major impact on the total travel experience. The quality of service at Auckland Airport is not currently at an acceptable standard, as is demonstrated most clearly by the problems experienced during summer peaks. Current KPIs are consistently not being met and airlines would like to see a stronger focus on continuous improvement. No service level agreements are currently in place at Auckland Airport, although it has agreed to develop them with airline customers.

7. However, the BARNZ represented airlines are comfortable with:
    a. Christchurch Airport's new per-passenger pricing structure and tilted annuity depreciation method.
    b. Quality of supply at Christchurch Airport.
    c. Consultation with airlines at Auckland Airport and the Airport's agreement to work with airlines to develop improved SLAs.
    d. Auckland Airport's demand forecasts.
    e. Auckland Airport undertaking some steps to prepare for the northern runway (eg securing the necessary RMA approvals). We agree the runway will be needed at some point, although the timing is still to be determined and, as noted, we do not agree with the runway land charge.

BARNZ submission

Introduction

8. BARNZ welcomes the opportunity to respond to the Commission's consultation paper *Have your say on the review of Auckland and Christchurch Airport's third price setting events (July 2017 – June 2022)*, dated 20 October 2017.

9. This submission is made on behalf of the airlines[4] which BARNZ has written authority under s2A of the Airport Authorities Act 1966 to represent during consultation over charges with Auckland and Christchurch Airports.

10. Attached to this submission are:

    a. Assessments carried out by BARNZ of each airport's pricing decision, based on the questions that were asked in the Commission's 56G reports into the PSE2 pricing decisions.

    b. Expert reports provided by Dr John Small to BARNZ through the pricing consultation process. Dr Small's two reports relating to Christchurch Airport are not confidential. Following a request by

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

Auckland Airport, all three of Dr Small's reports relating to Auckland Airport should be kept confidential and not published.[5]

c. A note by Pat Duignan on issues to consider in relation to the Runway Land Charge.

BARNZ supports the timeframe for the review

11. BARNZ is pleased that the Commission is progressing this review. It is important to have timely reviews of airport pricing decisions, while the process followed and fact base used for the pricing decisions are still reasonably current. We are also pleased that the Commission will complete the review before Wellington Airport's pricing decision is made next year, so the review findings can inform Wellington Airport's pricing consultation. However, as discussed below, BARNZ would support a three-month extension to the timeframe if this was needed to accommodate the broader scope we think is necessary.

But the scope of the review is too narrow

12. Our interpretation of the consultation paper is that the Commission plans to focus its review on material information that is included in the price setting event disclosures. This would include target profitability, asset valuation, prices, forecast operating and capital expenditure and forecast revenue. However, this would exclude other items that require an assessment of information published by airports as part of their annual disclosures, for example quality of supply, innovation or expenditure efficiencies.

13. BARNZ believes that this scope is too narrow and will not enable the Commission to reach a clear view of whether the pricing decisions made by Auckland and Christchurch Airports are in the long-term interest of consumers.

14. In addition, in its reviews under section 56G of the PSE2 pricing decisions the Commission concluded that it was too early to reach a view on the effectiveness of information disclosure on three aspects of the Part 4 Purpose: operational expenditure efficiency, efficient investment and sharing the benefits of efficiency gains, because the Commission decided that a longer time series of information was needed before a view could be reached.[6]

15. If these items are now not analysed as part of this review, that would mean there has been no proper review of Airport performance in relation to how efficient their expenditure is and whether they are sharing efficiency gains with consumers since Part 4 was enacted. This is a major gap in terms of scrutinising airport performance that is of material concern to airlines.

16. BARNZ also disagrees with the proposal in the consultation paper that the Commission should not review the appropriateness of Christchurch Airport's capital plan because it is relatively small. While Christchurch Airport's capital plan is much smaller than Auckland's, it is still material and includes controversial projects such as the terminal reconfiguration project. It is important to review the appropriateness of all capital expenditure by regulated airports, as otherwise this indicates that a small capital plan will not be scrutinised and thus airports will have more scope to include unnecessary expenditure provided the total capital plan remains below some level of materiality threshold.

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[5] Auckland Airport has asked BARNZ to notify the Commission that the statements by Auckland Airport and references to NERA's analysis that are quoted in Dr Small's report are information that is owned by Auckland Airport.

[6] For example, see page 5 of Commerce Commission, *Final Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 July 2013.

The proposed scope appears inconsistent with the Commerce Act

17. The starting point for any inquiry by the Commission is “the long-term benefit of consumers within New Zealand”. This is the foundation in section 1A of everything done under the Commerce Act. The importance of this cornerstone of the scope of the Commission’s powers is repeated, specifically in the context of Part 4, by section 52A stating the purpose of Part 4 is “to promote the long-term benefit of consumers”.

18. The “benefit of consumers” is described by section 52A, requiring outcomes that “improve efficiency and provide services at a quality that reflects consumer demands” (sub-section (1)(b)) and “share with consumers the benefits of efficiency” (sub-section(1)(c)).

19. We note the Commission’s view (at paragraph 18 of the consultation paper) that it is not required to consider all aspects of performance at one time. This leaves open the question of when the Commission will consider all other aspects of performance? Section 53B(2)(b) requires a summary and analysis to promote greater understanding of performance. This requires that all contributors to an airport’s performance must be considered to permit a properly informed understanding of the performance of an airport. This is particularly true of issues most directly affecting consumers, namely quality of service, innovation and expenditure efficiency.

20. The essential inquiry for the Commission is whether the regulatory regime for airport pricing is driving a quality of service for consumers that justifies the prices charged. That is what occurs in a competitive market where consumers have choice.

21. As the Commission is well aware, the entire Part 4 regime is deficient insofar as any airport company can legally ignore the outcome and simply continue to set prices as it sees fit (section 4A Airports Authorities Act 1966 (AAA) and paragraph 8 of the consultation paper). This makes the scope of the Commission’s review of any airport’s performance under section 53B all the more important. If overall performance is found to be inadequate (or indeed for any reason), the Commission has the ability under section 52H to initiate an inquiry and subsequently report to the Minister (section 52K). That in turn enables the Minister to recommend an Order in Council (section 52N) which can amend the type of regulation required. This appears to BARNZ members to be the only way to add a realistic threat of regulatory change if an airport seeks to rely on section 4A, AAA and ignore the Commission.

22. To conclude: (a) an inquiry into pricing absent consideration of service quality does not meet the fundamental purpose of the Act; and (b) to maintain the regulatory threat, it is essential that the review of the price setting decisions is rigorous and comprehensive.

The Commission’s proposed scope would miss critical information

23. It seems that the Commission’s current intention is to:

    a. Review pricing disclosure information for each airport every five years, following the price setting event – this would mostly focus on forward looking information

    b. Provide periodic (annual?) summaries of annual backward-looking information disclosure information published by the airports. It is not clear if these would include any review or analysis, or whether they would just be summaries of disclosed data.

24. This approach is not likely to deliver high-quality, complete assessments of airport performance, because:

    a. It is difficult to conclude that a pricing decision is or is not in the long-term interest of consumers without considering all aspects of an airport's performance. For example:
        i. It is difficult to assess the value of expenditure plans without assessing efficiency or quality of supply
        ii. It is also difficult to assess whether expenditure forecasts are reasonable without considering how accurate past forecasts have been, and how the airport's expenditure benchmarks against other airports.

    b. To put it another way, it is of limited value to consumers to understand that pricing is calculated correctly when there is no correlation with service quality, or maintaining innovations that could improve service and/or reduce prices, or whether expenditure is efficient. This will be particularly relevant during an extended period of passenger inconvenience while Auckland Airport catches up on overdue investment in terminal and related facilities. Do prices reflect that sub-optimal service quality?

    c. If the Commission's approach to reviewing annual disclosures only involves publishing dashboard information (as is the current practice for energy network businesses) then the Commission itself will never reach a view on such important matters as the reasonableness of the quality of service, innovation and cost efficiency at major New Zealand airports. Given the critical importance of the infrastructure to the national economy and that airports are not subject to any form of regulation other than information disclosure, we do not see how this can be justified.

    d. We have seen that the Commission's annual summaries of information disclosure data have been delayed, or not completed at all.

A better approach is available

25. BARNZ considers that a better approach to reviewing airport information disclosure is available, one that incorporates all relevant information so a full view of airport performance can be reached, while still managing costs.

26. BARNZ recommends that the Commission:

    a. Summarises and analyses price setting event disclosure information as soon as practicable after it has been disclosed – consistent with the current practice.

    b. Does not summarise or analyse historical disclosure information annually (as the trends identified in historical disclosures are unlikely to move much within a year) – this should avoid unnecessary cost. BARNZ and other interested parties would still review and utilise the annual disclosures each year.

    c. Summarises and analyses historical disclosure information (for the prior 5 years) at the same time as it carries out the reviews of the price setting events for each airport.

27. This would mean the Commission is carrying out a full review of all airport disclosure information at the same time, which means it can reach a clear view of the performance of each regulated airport.

28. We do not believe that a wider scope should lead to an unmanageable workload. For example, attached to this submission are assessments prepared by BARNZ in recent months on the pricing decisions, including all items that we believe should be in scope. As BARNZ was able to complete these assessments reasonably quickly and with limited resources, we are confident that a broader scope is very feasible for the Commission to complete. However, BARNZ would be comfortable with a three-month extension to the review timeframe, if that was necessary to accommodate the wider scope.

Issues for consideration in the review are discussed in the Appendix and attachments

29. The consultation paper posed specific questions about the airports' pricing decisions and their performance. We respond to these in the Appendix. More detail is contained in the attached BARNZ assessments of the pricing decisions.

30. We also provide information in response to questions that we think should have been asked in the consultation paper (ie that relate to quality, innovation and cost efficiency).

31. The Appendix therefore describes BARNZ's position on the issues of importance to the reviews of each airport's PSE3 decision.

Contact details

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

Yours sincerely,

Ian Ferguson
Regulatory Manager

Appendix: Answers to questions

This appendix provides answers to questions asked in the consultation paper (Tables 2 and 4) and also to questions that were not asked in the consultation paper but we think should have been, in order to carry out a fully scoped review of the pricing decisions (Tables 3 and 5). Further detail is contained in the attached BARNZ assessments of the pricing decisions.

Table 2: Responses to consultation paper questions about Auckland Airport

No.	Auckland Airport question	BARNZ response
1	Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Auckland Airport?	Yes. Schedules 18 and 19 have been helpful in assessing the target profitability of Auckland Airport.
2	Is Auckland Airport's targeted return appropriate and why?	No. Auckland Airport is targeting excessive profits. It has set a target WACC of 6.99% or 7.06% (depending on whether aircraft and freight services are included), compared to the Commission's mid-point estimate of 6.41%. The Airport is targeting a WACC at the 65th or 67th percentile of the Commission's range. The inflated WACC results in a transfer of wealth from passengers and airlines to the airport of approximately $65m over PSE3. The WACC of 7.93% for aircraft and freight services seems particularly excessive. As context, the Airport has recently announced (for FY17) a 9.7% increase in revenues (to $629m) and a 16.5% increase in underlying profit (to $248m).[7] In 2014 the Airport undertook a capital return of $454m to shareholders, money which could have been used to fund investment.[8] The Airport has also indicated that it intends to maintain its policy of passing on 100% of profits to shareholders as a dividend; thus shareholders are not being asked to share the cost of the airport expansion, even though they will enjoy long-term benefits from the increased passenger and freight volumes. Similarly, the Airport wants to maintain its A- credit rating.[9] It is not clear that this is in the long-term interest of consumers – ie the cost of higher prices to support the credit rating may well exceed the increased borrowing costs that would result from a credit

[7] Auckland Airport, FY17 Annual Report.
[8] Auckland Airport, FY14 Annual Report.
[9] Auckland Airport, Price setting disclosure presentation, slides 4 and 16.

No.	Auckland Airport question	BARNZ response
		rating downgrade. We do acknowledge that the Airport has established a dividend reinvestment policy, but this is a very limited way of shareholders contributing to the investment. Auckland Airport's core justification for setting a WACC above the mid-point is analysis by NERA that states the Airport's large capital programme will increase the Airport's operational leverage and thus its risk, and this means Auckland Airport requires a higher beta and therefore WACC.[10] Airlines are very concerned about the implications of this analysis, which go beyond airports. We are concerned that: a) Most importantly, the NERA analysis is a very troubling precedent to set in the New Zealand regulatory context – if it were accepted, then all a regulated supplier would have to do to justify a higher beta, and therefore WACC, is substantially increase its capex forecast (and then the supplier would get the higher return on the inflated expenditure plan as well as all sunk assets). b) Orion, Transpower and Powerco have, or are about to, undertake investment step changes. These businesses did not require a higher WACC as part of those step changes. In fact, Orion's WACC under their customised price-quality path was lower than it would have been under the default price-quality path. c) Auckland Airport has not committed to setting a lower WACC in future when its operational leverage reduces. In PSE2 the Airport had a 75th percentile WACC despite much lower operational leverage. d) Dr John Small has identified in detail inconsistencies and other problems in NERA's analysis. These are described in the attached expert advice from Dr Small. e) Christchurch Airport, which is not facing a capex step change in PSE3, has not considered operational leverage as a factor in setting its target WACC and has used a different rationale (the, in their view, greater risk of operating an airport with a higher proportion of leisure travel) to justify its own WACC uplift. Auckland's status as an

[10] Auckland Airport, Price Setting Disclosure commentary paper, pages 26-27.

No.	Auckland Airport question	BARNZ response
		airport with a lower proportion of leisure travel has not been used by Auckland Airport as a reason to set a lower WACC for them. Nor has Christchurch's position as an airport with lower operational leverage encouraged them to target a lower WACC. BARNZ is concerned that the regulatory framework may be producing a situation where each airport finds their own reason to justify an uplift, but those reasons are not consistent over time or with each other. We suggest the Commission needs to decisively reject this type of unorthodox claim regarding WACC estimation. Auckland Airport argues that the higher WACC is necessary to incentivise investment.[11] However: a) Forsyth Barr calculates that Auckland Airport's true WACC is between 5%-6% (and this will apply to the listed Group, including higher-risk unregulated activities), so 6.41% should be more than adequate to incentivise investment. b) We believe all, or at least the vast majority, of the investment would go ahead if a 6.41% WACC was applied. The Airport's commercial till will benefit from the growth that expanded terminal and airfield capacity will provide. Very few of the Airport's capex programmes would not improve commercial till revenues. The Airport's recent profit announcements for the FY17 year demonstrate just how much value increased growth delivers for the Airport. Therefore, BARNZ is not convinced that any target return beyond the Commission's mid-point estimate is needed in a dual till environment. c) It is relevant that Auckland Airport's target WACC percentile (65th for priced services only, 67th when aircraft and freight included) is very similar to the pricing WACC percentile (67th) for energy companies, who have no dual till. d) In conclusion, BARNZ does not accept that the higher WACC will be in the long-term interest of consumers as consumers will pay higher prices but will not receive any commensurate benefit. We agree that Auckland Airport is "pushing the boundaries" of what is acceptable in terms of target return. More broadly, Auckland and Christchurch Airports differ from most overseas comparators in not facing competition from rail in regard to nearly all domestic travellers and not any land

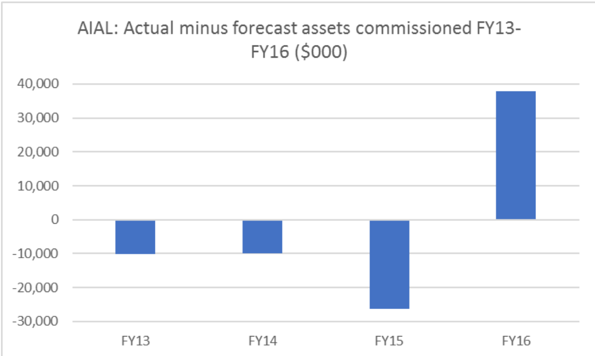
[11] Auckland Airport, Price Setting Disclosure commentary paper, page 36.

No.	Auckland Airport question	BARNZ response
		competition at all in regard to international travellers. Arguably this absence of competing (lower cost) alternatives would tend to reduce the sensitivity of the volume of travel to economic downturns and therefore tend to reduce beta compared to overseas comparators. Thus a mid-point WACC based on a beta derived from an international comparator sample should be more than sufficient for New Zealand airports. For further analysis and evidence supporting this position, we refer the Commission to section 4 of the attached BARNZ assessment of Auckland Airport's PSE3 pricing decision.
3	Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Auckland Airport's price setting event?	Yes. The expert reports received by BARNZ during the consultation process are attached to this submission as well as a new expert report from Pat Duignan. BARNZ endorses all of the expert reports we received in relation to Auckland Airport's price setting, with the exception of paragraph 3 of the letter entitled 'WACC for AIAL' dated 11 February 2017. BARNZ supports Airports setting prices for PSE3 on the basis of a mid-point WACC that is developed using the parameters in the December 2016 Cost of Capital IM and a debt premium and risk-free rate that are current at the time prices are set.
4	Do the asset values used by Auckland Airport provide an appropriate basis for assessing expected returns and why?	BARNZ has not identified any issues of concern with the asset values provided by Auckland Airport. However, given the materiality of the asset values to target returns, we agree it would be useful for the Commission to review the asset values used.
5	Did Auckland Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Auckland Airport's consultation but not implemented and what was the rationale for the proposed adjustments?	During the PSE3 pricing consultation, BARNZ proposed that the Airport include a capex wash-up in its pricing decision to ensure customers only had to pay for assets that were actually commissioned (our primary concern was in relation to the deliverability of such a major step-up in capital projects and the risk of delayed commissioning of assets). The Airport rejected this approach and claimed that it bears the risk and reward of actual performance in PSE3.[12] We disagree that the Airport bears all of the risk and reward – where the Airport includes the recovery of a return on and of commissioned asset values in its pricing but does not commission the assets in question, it is airport customers that bear the risk of paying for assets that are not built, or are built later than forecast. BARNZ is comfortable with the risk allocation adjustments relating to Pier B and the moratorium asset base.

[12] Auckland Airport, Price Setting Disclosure commentary paper, page 72.

No.	Auckland Airport question	BARNZ response
6	To what extent does the demand forecast, presented by Auckland Airport as part of PSE3, reasonably reflect expectations of future demand and why?	BARNZ considers that Auckland Airport's passenger volume forecast appears reasonable. However, individual airline submitters will have access to better passenger forecast information than BARNZ does.
7	Are there any concerns that Auckland Airport's capital or operating expenditure projections are not reasonable?	Yes. BARNZ has substantial concerns in this area. **<u>Opex</u>** We are concerned that Auckland Airport's current operating expenditure is inefficiently high, which will mean the starting point for PSE3 opex forecasts is also inefficiently high: a) The Airport has high opex per passenger, high corporate opex per passenger and high maintenance opex as a proportion of RAB value compared to other NZ airports. b) We note that this is not just a recent trend. The Airport's total opex per passenger has increased/is forecast to increase by an average of 0.5% per year above CPI over the period FY06-FY22 (FY06 is the starting point for this analysis as it is the earliest year for which disclosure data is available). In terms of forecast operating costs over PSE3, Auckland Airport has stated that it expects to encounter "diseconomies of scale"[13] in PSE3 and has built these diseconomies into its prices (if there are diseconomies, we believe these are likely to be due to high dividends and insufficient investment in prior years now hampering the delivery of services to a growing passenger base). BARNZ does not believe it is legitimate to pass these inefficient costs through to airlines and passengers. If the Airport cannot find a way to achieve efficiencies through growth then it should face the consequences of this and bear the diseconomies of scale itself rather than expecting the Airport's customers to pay for its own inefficiency. More broadly, it is not clear that the pricing / regulatory framework provides any meaningful incentives for airports to seek out operating efficiencies.

[13] Auckland Airport, Price Setting Disclosure commentary paper, page 44. We note Figure (7) on page 40 of the same paper, which shows improving opex efficiency over PSE3 relative to PSE2. However, BARNZ has not been able to replicate the real opex values shown in Figure (7) and real opex per passenger looks like it is increasing from FY17, indicating that any recent efficiency gains are not going to be sustained.

No.	Auckland Airport question	BARNZ response
		For these reasons, we consider that Auckland Airport's opex projections are likely to be excessive and include inefficient costs that should not be passed on to consumers. For the analysis and evidence supporting this position, we refer the Commission to Section 5 of the attached BARNZ assessment of Auckland Airport's PSE3 pricing decision. **Capex** Auckland Airport's capital plan is very large, and while the investment is generally required, some of it is happening too late (for example, the current constraint in the Airport system is the capacity of the biosecurity processing function for arriving passengers; but the new biosecurity processing area is not due to be commissioned until 2020). Also, some of the forecast costs seem very large and BARNZ is not certain of the Airport's ability to spend the full amount as forecast. As airlines are paying prices that are based on forecast commissioning dates, we are concerned that the Airport may commission assets later than forecast but still receive revenues based on the forecast commissioning dates. In PSE2, the Airport's commissioned asset investment spending was deferred – in total, the value of commissioned assets was quite close to forecast, but the Airport underspent in early years and overspent in later years. We are not certain why this pattern of expenditure occurred, but we note it is a profit-maximising strategy within the pricing framework. This spending pattern is shown in the chart below.  *Source: BARNZ analysis of Auckland Airport PSE2 and FY13-FY16 disclosures*

No.	Auckland Airport question	BARNZ response
		In addition, in PSE2 the Airport underspent against forecasts in particular projects, but then spent more on projects that were not forecast at the time prices were set. This all implies that the Airport's PSE3 expenditure forecasts are unlikely to be realised in practice. Taking a broader perspective, it seems plausible that the delays in expenditure during PSE2 have contributed to the poor service quality outcomes that all airport users are now living with. This reinforces our view that excluding quality from the review of the PSE3 pricing decision is a flawed approach as the quality of service is inextricably tied to the investments that are made. For the analysis and evidence supporting this position, we refer the Commission to items 6)a), 6)c), 6)d), 6)g) and 6)h) of the attached BARNZ assessment of Auckland Airport's PSE3 pricing decision.
8	Are there concerns relating to Auckland Airport's introduction of a contingent 'runway land charge'? In particular, is the proposed timing of Auckland Airport's returns on its assets held for future use appropriate?	The BARNZ represented airlines have significant concerns about the 'runway land charge'. While the BARNZ represented airlines support the airport's activities in planning for a second runway, subject to appropriate timing, they do not consider that the runway land charge is justified or acceptable: a) Paying for an asset many years before it can be used creates inter-generational and inter-airline equity problems. b) While technically the charge is NPV neutral for the Airport, the charge is not value neutral for them – they are getting cash up front which clearly reduces (an already low) level of risk and assists with maintaining their dividend policy. For customers to pay for the runway as it is built lowers the Airport's financial risk associated with the investment, but this does not appear to be reflected in the target return. c) The Airport argues the land charge is necessary to smooth prices, but airlines will pay the prices and they have a strong preference for the step up to occur when the runway is commissioned – if it is truly NPV neutral to the Airport, airlines consider that it should take heed of customer preferences not to pay in advance of the asset being commissioned. d) Importantly, runway timing is very sensitive to demand changes. Airlines are generally up-gauging and steps are being taken to improve the efficient use of the current runway by all airlines. These initiatives will defer the point at which the current runway

No.	Auckland Airport question	BARNZ response
		reaches capacity. If demand drops after FY21 and the runway is delayed, airlines could end up paying the charge for years before the runway is commissioned. e) This charge has a precedent effect at a regional level and is causing international concern. BARNZ has had airlines and airline associations from Australia and the Asia-Pacific region contacting us with concerns about the precedent. f) BARNZ has modelled the charge on a 40-year NPV basis and airlines are clearly worse off with the charge (due to a difference between airline and airport rates of return). The attached report from Pat Duignan provides a discussion of factors to consider when assessing the runway land charge. This discusses the potential that the charge could: • Reduce the airport's incentive to expedite completion of the runway once construction begins • Provide an inefficient pricing signal • Not necessarily deliver a sustainable price path. For the analysis and evidence supporting this position, we refer the Commission to items 3)a), 3)c), 3)d), 4)f) and 6)i) of the attached BARNZ assessment of Auckland Airport's PSE3 pricing decision.
9	Has information disclosure assisted in promoting stakeholder understanding of Auckland Airport's proposed approach to the 'runway land charge'?	Yes. Section ix of schedule 18 assists with understanding how the revenue stream will be treated. However, it seems that Auckland Airport may interpret the Commission's decision to include this disclosure requirement in Schedule 18 as an endorsement of the concept of the runway land charge. In that sense, the disclosure is somewhat unhelpful.
10	Does Auckland Airport's pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?	BARNZ does not consider that the runway land charge, which is a flat charge for all passengers, is an effective price signal for the cost of investment in the second runway. As discussed in Pat Duignan's report the pricing of fares by airlines reflects constraints on throughput at peak periods. Additional uniform charges such as the runway land charges reduce rather than improve airport pricing efficiency. However, we acknowledge that the introduction of a peak congestion price signal would be unlikely to have a material effect on runway usage, unless the signal was extremely (impractically) strong. Airlines choose slots based on demand for travel at particular times, co-

No.	Auckland Airport question	BARNZ response
		ordination of slots with other airports and longer haul route connections. Any price signal that could realistically be introduced would not add much to existing incentives.
11	Is Auckland Airport's forecast investment sufficient to meet expected demand and desired service quality over PSE3?	The forecast investment may be sufficient to meet expected demand and desired service quality in future pricing periods. However, the Airport is 'playing catch-up' in terms of meeting demand and we expect a poor customer experience due to delays to be a feature of Auckland Airport's service at peak times during most, if not all, of PSE3. Information provided during the consultation process indicated the general improvements that were expected from each project, but did not quantify the benefits (eg the information may say that a particular investment would reduce queuing times, but did not say by how much). This makes it very difficult to assess what the quality of service will be when the capital plan is delivered.
12	How appropriate is Auckland Airport's approach to cost allocation when determining its capital expenditure projections?	Direct costs appear to be allocated to the correct places. Auckland Airport has (very reasonably) excluded the new domestic jet processor from PSE3 charges. When that asset is commissioned and there is a partially integrated domestic and international terminal, the approach to cost allocation for commissioned assets will be an important issue. This will be a topic for PSE4 price setting. For PSE3, various allocators are used for different costs. Where a more direct allocator is not available, the Airport tends to use its 'company-wide rule', which allocates 75% of the cost or asset value to aeronautical customers.[14] BARNZ has concerns that this methodology passes on too much cost to airlines and passengers. BARNZ reviewed the range of potential proxy allocators available to the Airport – these are summarised in the table below (drawn from Auckland Airport's FY16 disclosures). ITB terminal space is an allocator that is favourable to the Airport in that it directs more shared costs to aeronautical customers than most other plausible proxy allocators.

[14] Auckland Airport, Price Setting Disclosure commentary paper, page 39.

<table>
<tr><th>No.</th><th>Auckland Airport question</th><th>BARNZ response</th></tr>
<tr><td></td><td></td><td>
<table>
<tr><th>Proxy allocator</th><th>% to aeronautical</th></tr>
<tr><td>AIAL headcount</td><td>78.2%</td></tr>
<tr><td>ITB terminal space</td><td>75.0%</td></tr>
<tr><td>AIAL opex</td><td>68.2%</td></tr>
<tr><td>AIAL property, plant and equipment</td><td>50.2%</td></tr>
<tr><td>AIAL revenues</td><td>50.0%</td></tr>
<tr><td>Net operating surplus</td><td>31.2%</td></tr>
<tr><td>Average</td><td>58.8%</td></tr>
</table>
BARNZ considers that the Commission should explore what an appropriate cost allocator would be for regulated airports to apply to shared costs between aeronautical and commercial.
</td></tr>
<tr><td>13</td><td>Are there concerns that Auckland Airport will not be able to achieve its capital expenditure forecasts over PSE3?</td><td>
BARNZ has raised some concerns in this area during the consultation process. These concerns were the main reason for our proposal for a capex wash-up (discussed in question 5).
Our concerns that Auckland Airport set prices for PSE3 based on a high capex forecast that it may not be able to deliver have now increased, based on recent information. According to Forsyth Barr’s report of the Airport’s Investor Day, the Airport seems to have set its capex forecasts at the upper end of its range rather than the mid-point. The report of what Auckland Airport said was:[1]
<blockquote>“Capex assumptions used for AIA’s recent aeronautical repricing were at the ceiling of its needs for the next 5–10 years. The company suggested that there was some flexibility to the programme, albeit any change would be lower rather than higher capex.”</blockquote>
However, the BARNZ represented airlines and Auckland Airport share the objective of achieving the capital projects through an ongoing capital planning consultation process. We acknowledge that airlines have a part to play in supporting the airport deliver fit-for-purpose and efficient capital investments.
This is an important topic for the Commission to review further.
</td></tr>
</table>

[1] Forsyth Barr, *Auckland Airport Investor Day – Capex is Key*, 20 November 2017

Table 3: Responses to additional questions about Auckland Airport

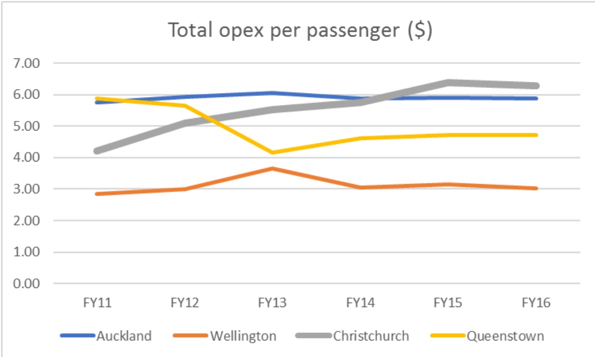
No.	Auckland Airport additional question	BARNZ comment
14	Is Auckland Airport delivering services at the level of quality that consumers demand?	Performance is mixed. The Airport has experienced service quality issues recently due to growth and these may have been avoidable. There are significant capacity problems at the Airport, which are particularly acute during the summer peak – these problems have been driven by investment that has not kept pace with the levels of passenger growth. BARNZ is keen to see sufficient and timely investment being made to improve passenger experience. Performance is currently reported against KPIs for the average passenger processing time through international arrivals and departures. These KPIs are consistently not being met and airlines would like to see a stronger focus on continuous improvement from the Airport and border agencies to improve performance overall. However, the customer survey scores are reasonable and the Airport is willing to work with airlines and agencies to deliver improvements, including the development of meaningful SLAs (we expect to start discussing SLAs with the Airport in the near future). For more analysis and evidence, see section 2 of the attached BARNZ assessment of Auckland Airport's PSE3 pricing decision.
15	Is Auckland Airport innovating appropriately?	Broadly yes, although some collaborative structures could be more effective. Auckland Airport seeks to deliver innovative solutions in some areas, to either improve passenger experiences or avoid capex; eg: • Aviramps to improve bussing product • Kiosks to reduce space needed for check-in (although some airlines are not convinced this will work) • Intending to trial an Airport Operations Centre (APOC). It is not clear whether the Airport has a systematic method for seeking out innovative approaches (and several of the innovations have been suggested by airlines), but it has introduced innovations where a pressure point has emerged. For more analysis and evidence, see section 1 of the attached BARNZ assessment of Auckland Airport's PSE3 pricing decision.

No.	Auckland Airport additional question	BARNZ comment
16	Is Auckland Airport's expenditure efficient	See response to question 7.

Table 4: Responses to consultation paper questions about Christchurch Airport

No.	Christchurch Airport question	BARNZ response
17	Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Christchurch Airport?	Yes. Schedules 18 and 19 have been helpful in assessing the target profitability of Christchurch Airport.
18	Is Christchurch Airport's targeted return appropriate and why?	No. Christchurch Airport is targeting excessive profits. The Airport has set its target rate of return at the 61st percentile of the Commission's range (6.82%, compared to the Commission's mid-point estimate of 6.41%), but this is not justified by the actual risk faced by the Airport. The inflated WACC results in a transfer of wealth from passengers and airlines to the airport of approximately $10m over PSE3. We understand that Christchurch Airport has reported a 50% increase in profits for the FY17 financial year so believe there is room for a reduction in target revenues. Christchurch Airport has sought to justify a WACC that is higher than the Commission's estimate on the grounds that it faces greater risk because it operates an airport with a higher proportion of leisure travel. In contrast, as noted above, Auckland Airport has justified its WACC uplift due to the increased operational leverage (and thus risk) it will face through borrowing to fund its capital investment plan. BARNZ remains concerned that the regulatory framework may have produced a situation where each airport finds their own reason(s) to justify an uplift, but these reasons are not consistent across different airports. We would be very concerned if this situation were to continue. Christchurch Airport has not sought to justify the higher WACC in terms of consumer benefits. We consider that its (fairly modest) capital investment programme will go ahead anyway as the investments will support continued commercial till revenues. The consequence of Christchurch Airport's higher target return is, therefore, that consumers are paying higher prices but will not get any benefit from doing so. We have seen no evidence that the higher WACC will be in the long-term interest of consumers.

No.	Christchurch Airport question	BARNZ response
		Also, Christchurch Airport's international passenger demand forecasts appear too low. If actual demand exceeds forecast then the Airport will earn an even higher return than it has officially targeted. For further analysis and evidence supporting this analysis, we refer the Commission to section 4 of the attached BARNZ assessment of Christchurch Airport's PSE3 pricing decision.
19	Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Christchurch Airport's price setting event?	Yes. The expert reports received by BARNZ during the consultation process are attached to this submission as well as a new expert report from Pat Duignan. BARNZ endorses all of the expert reports we received in relation to Auckland Airport's price setting, with the exception of paragraph 3 of the letter entitled 'WACC for AIAL' dated 11 February 2017. BARNZ supports Airports setting prices for PSE3 on the basis of a mid-point WACC that is developed using the parameters in the December 2016 Cost of Capital IM and a debt premium and risk-free rate that are current at the time prices are set.
20	Do the asset values used by Christchurch Airport provide an appropriate basis for assessing expected returns and why?	BARNZ has not identified any issues of concern with the asset values provided by Christchurch Airport. However, given the materiality of the asset values to target returns, we agree it would be useful for the Commission to review the asset values used.
21	Did Christchurch Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Christchurch Airport's consultation but not implemented and what was the rationale for the proposed adjustments?	Christchurch Airport made a carry forward adjustment to reflect a permanent difference between disclosed assets and pricing assets. At the request of airlines, this has been reviewed by Deloitte. BARNZ has not identified any problems with this adjustment, but a check by the Commission would be of value. BARNZ did not propose any additional risk allocation adjustments to Christchurch Airport during the price consultation.
22	To what extent does the demand forecast, presented by Christchurch Airport as part of PSE3, reasonably reflect expectations of future demand and why?	Christchurch Airport's international passenger growth forecasts may be unduly conservative. This is because the Airport's demand forecasts assume that Christchurch's proportion of New Zealand's total international air travel will remain constant over PSE3. This assumption seems unlikely because:

No.	Christchurch Airport question	BARNZ response
		• The Airport's demand forecasting consultants (Three Consulting) considered that there is pent-up demand in Christchurch and passenger volumes at Christchurch have not reached pre-earthquake proportions.[15] • The Airport has reduced its charges to international airlines by 45% on average from FY17 to FY18 and the terminal price per passenger will decline further over PSE3.[16] This should stimulate demand over PSE3 relative to the other New Zealand international airports. For these reasons, we believe that Christchurch Airport's proportion of New Zealand's total international travel will trend upwards over PSE3 towards the level reached before the Canterbury earthquakes and thus passenger volumes are likely to exceed the Airport's PSE3 forecasts.
23	Are there any concerns that Christchurch Airport's capital or operating expenditure projections are not reasonable?	Yes. BARNZ has substantial concerns in this area. **<u>Opex</u>** Airlines are concerned about Christchurch Airport's expenditure efficiency. Christchurch Airport's opex per passenger is the highest of all major NZ airports (in 2016) and has increased substantially in the last few years, as shown in the chart below. This increase has been driven by increasing expenditure in the category "asset management and airport operations".  *Source: BARNZ analysis of FY11-FY16 disclosures*

[15] Three Consulting, Traffic Forecast FY18-FY22 v3.3, 7 April 2017.

[16] BARNZ calculation based on Christchurch Airport's pricing schedules.

No.	Christchurch Airport question	BARNZ response
		Our analysis shows that the bulk of these cost increases have come from expenditure on the new terminal. BARNZ is surprised by this as the terminal is new and operating well within capacity. We would have expected a new and improved asset to drive lower operating expenditure rather than more, as maintenance etc costs should be reduced. The terminal expenditure at Christchurch Airport seems particularly inefficient. Christchurch Airport is now forecasting opex to remain flat in real terms, while passenger numbers grow (so opex per passenger is forecast to decline), but given the track record seen over PSE2 we are not confident that they will achieve these efficiencies. Therefore, BARNZ believes the starting point for the Airport's opex forecasts will be inefficiently high, even if the forecast is to be kept flat in real terms over PSE3, and that the forecast improvement in opex efficiency may not be realised. **Capex** Christchurch Airport's capital plan for PSE3 is fairly modest, reflecting where the Airport is at in its capital investment cycle. BARNZ was pleased that the Airport chose not to progress with its project to extend the length of the cross-runway, as the benefits of this project did not outweigh the costs. However, airlines do not agree with the proposed 'terminal reconfiguration' capex project, which is included as an $8.5m or $10m cost in Christchurch Airport's capex forecasts.[17] This is not a clearly defined project that airlines provide views on, but appears to be a contingency fund for the Airport to spend, or not, as it chooses over PSE3. BARNZ is not comfortable with this project or the precedent it sets. If an airport can identify a need for a project, it should develop a plan for that project and consult with airlines on it. If the project is supported by the substantial customers, it can then be included in pricing. However, what the Airport has done is to give itself a "blank cheque" to spend without consultation or airline input (or indeed any obligation to spend any of the fund).

[17] The project has a value of $8.5m in Christchurch Airport's PSE disclosures (Schedule 18), but a value of $10.4m in the final decision documentation. This may be due to the way the values are reported.

No.	Christchurch Airport question	BARNZ response
		If it becomes standard practice for airports to include costs in their capital plans that are not tied to any particular process and are not consulted on, it will create a real risk of poor-quality capital investment, or of funds being provided to airports but not being spent on anything.
24	Does the pricing structure at Christchurch Airport for PSE3 reflect efficient pricing principles?	The BARNZ represented airlines support Christchurch Airport's new aeronautical price structure. It is simple, which is beneficial as complexity adds costs to the airport and to airlines. It avoids arbitrary distinctions between turbo-prop, domestic jet and international jet aircraft that are not based on technical, operating or economic grounds. It therefore does not give airlines unnecessary signals for their choices of aircraft types to serve Christchurch Airport. The simplicity assists in aligning the interests of airlines with the airport – both parties would be keen to increase the numbers of passengers through Christchurch Airport, while being clear on the costs to airlines of doing so. However, the pricing structure does include some cross-subsidies: • The Airport has set international passenger charges for PSE3 above where they would otherwise be in order to "smooth" a price increase for domestic regional passengers.[18] While this cross-subsidy is expected to end by FY22, it is not desirable. • Although not an issue for the BARNZ represented airlines, Christchurch Airport has dramatically increased prices for domestic flights to Wellington (BARNZ calculates that the effect is approximately an increase in charges of 110% per flight). This is primarily because Air NZ uses turbo-prop aircraft to fly between Christchurch and Wellington, which depart from the domestic regional area at Christchurch Airport. However, Christchurch Airport's pricing assumes that all flights between Christchurch and Wellington use jet aircraft that depart from the domestic trunk departure lounge.[19] Therefore turbo-prop flights to Wellington are paying a portion of the costs of the upstairs domestic jet departures area which, in general, they do not depart from and therefore do not use. • There is also a small cross-subsidy for passenger aircraft landing charges, as the per passenger application of the charge may not fully reflect the additional costs created by

[18] Christchurch Airport, Disclosure relating to the reset of aeronautical prices for the period 1 July 2017 to 30 June 2022, 14 August 2017, paragraph 55.

[19] See definition of 'Terminal Price – Domestic Services' in Christchurch Airport's schedule of aeronautical charges: http://www.christchurchairport.co.nz/media/873985/aeronautical_prices_and_terms_and_conditions__1_july_2017_.pdf

No.	Christchurch Airport question	BARNZ response
		larger aircraft. This can be seen as a trade-off with the simplicity benefits of applying a per-passenger charge to all services and the BARNZ represented airlines are comfortable with this trade-off. • Finally, the Airport allocates most shared space in the terminal to aeronautical costs even though it is used by retail providers for passenger seating and advertising (ie menus on tables).[20] This has the effect of airline passengers subsidising the costs of airport retail providers.
25	What impact do you expect Christchurch Airport's proposed pricing structure and associated incentives to have on demand and revenues?	BARNZ expects that the significant (45%) reductions in charges to international airlines should result in increased international services being offered into Christchurch over PSE2. Domestic demand may decline somewhat, but domestic demand is likely to be less elastic than international demand. It is not clear how much these demand effects from price changes have been built into Christchurch Airport's demand forecasts.

Table 5: Responses to additional questions about Christchurch Airport

No.	Christchurch Airport additional question	BARNZ comment
26	How appropriate is Christchurch Airport's approach to cost allocation when determining its capital expenditure projections?	Christchurch Airport uses a complex range of allocators for different cost types. These may well be appropriate (and we have not identified any issues), but it can be difficult to identify why a particular allocator has been used for a particular line item.
27	Are there concerns that Christchurch Airport will not be able to achieve its capital expenditure forecasts over PSE3?	Given the size of Christchurch Airport's capex programme, it should be able to deliver on the forecasts. In PSE2, the Airport spent more than the value included in its capex forecast.
28	Is Christchurch Airport delivering services at the level of quality that consumers demand?	Broadly yes (although we understand there are capacity issues for domestic regional services). For example, the Airline Operators Committee recently identified a series of operational concerns at Christchurch Airport (eg they believed improvements to signage and wayfinding were needed). These issues were raised with the Airport and were resolved reasonably quickly. The Airport also

[20] Christchurch Airport, Disclosure relating to the reset of aeronautical prices for the period 1 July 2017 to 30 June 2022, 14 August 2017, paragraph 35.2

No.	Christchurch Airport additional question	BARNZ comment
		made an investment in FY17 to improve airfield efficiency by widening a taxiway to enable A380 aircraft to use the taxiway rather than use the runway as a taxiway to return to the terminal. For more analysis and evidence, see section 2 of the attached BARNZ assessment of Christchurch Airport's PSE3 pricing decision.
29	Is Christchurch Airport innovating appropriately?	The Airport is investing in useful improvements to service quality, but we think more could be done in terms of working with airlines and other partners to find broader benefits. For more analysis and evidence, see section 1 of the attached BARNZ assessment of Christchurch Airport's PSE3 pricing decision.
30	Is Christchurch Airport's expenditure efficient	See response to question 23.