VERSION FOR PUBLIC RELEASE

AIRLINE INFORMATION REMAINING CONFIDENTIAL HAS BEEN REDACTED

Section 53B review of Auckland Airport's price setting disclosure for PSE3: cross-submission on process and issues paper

19 December 2017

Auckland Airport

1. Introduction

This cross-submission responds to airline submissions on the Commerce Commission's process and issues paper for the review of Auckland Airport's third price setting event ("**PSE3**").

We note that airlines have encouraged the Commission to broaden the scope of its review beyond the topics indicated in the process paper, and have included material in their submissions covering quality, innovation and efficiency performance areas. We refer the Commission to the submission from the NZ Airports Association on process issues, which supports the Commission's original focus areas for the review. We consider this approach will enable the Commission to form a view on whether the airports' price setting behaviour is consistent with Part 4 of the Commerce Act, within an efficiently-run and focused review process.

2. Scope of this cross-submission

We are pleased that airlines have recognised a number of positive aspects of Auckland Airport's performance and of our pricing decision for PSE3.

In terms of the PSE3 pricing decision:

- BARNZ has noted that the price development process at Auckland Airport is transparent to substantial customers, and that Auckland Airport consults extensively on its prices with substantial customers and provides descriptions and explanations of its proposals.[1]

- BARNZ acknowledges that Auckland Airport's pricing methodology is relatively stable and that changes made for PSE3 are mostly incremental (although it considers the Runway Land Charge and new check-in charges are exceptions).[2] BARNZ considers Auckland Airport's price structure is broadly efficient – with the exception of the runway land charge, and some aspects of cost allocation and check in charging. BARNZ also notes that the evidence appears to support the fact that Auckland Airport is trying to improve price structure efficiency over time (again, with the exception of the Runway Land Charge in its view).[3] BARNZ notes that Auckland Airport has removed subsidisation between different charges and costs, and introduced new charges that are intended to encourage efficient use of apron space and check-in space.

- Airlines agree that the amendments to information disclosure have increased the transparency of Auckland Airport's target profitability – both for airlines and for interested persons not involved in the airline pricing consultations.[4] Air New Zealand acknowledged that information disclosure has assisted it to understand Auckland Airport's approach to the Runway Land Charge, and BARNZ noted that the information disclosure schedule assists with understanding how the revenue stream will be treated.[5]

- BARNZ has also acknowledged the impact of information disclosure on Auckland Airport's target return – noting that Auckland Airport reduced its target return in response to submissions and also provided a substantial amount of justification for its target.[6]

- Airlines have acknowledged the process undertaken by Auckland Airport to produce demand forecasts for PSE3 is robust, and that the resulting forecasts appear reasonable. Air New Zealand acknowledged that it "had the opportunity to review the DKMA forecast

---

1 BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 8.
2 BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 7.
3 BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 8.
4 BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 9, Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraph 15.
5 BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 16.
6 BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 12.

throughout the consultation process and provided its own forecasts to AIAL", and that it considered the DKMA methodology to be sound.[7] Although Air New Zealand notes that its own forecasts were "slightly higher" than those developed by DKMA, it acknowledges that it was not party to other airline's forecast information that also informed the DKMA forecast. BARNZ has acknowledged that the demand forecasts used by Auckland Airport are reasonable.[8]

In terms of our performance in areas not covered by the Commission's proposed topics for the review, we are pleased that:

- Although BARNZ notes that quality outcomes at Auckland Airport are mixed, it acknowledges that Auckland Airport's customer survey scores are reasonable, and that we are willing to work with airlines and agencies to deliver improvements.[9] We note that BARNZ's quality issues appear to be focused on capacity at peak times.

- BARNZ has noted that Auckland Airport is generally willing to respond to customer concerns and help partners deliver better and more efficient services, and cites as an example that Auckland Airport listened to airline concerns over the bussing product and has made changes in response. BARNZ also notes that Auckland Airport has introduced ground power at international gates and stands (which assists aircraft efficiency), and has taken steps to resolve reliability issues, such as the reliability of the baggage handling system.

- BARNZ also states that it is comfortable with Auckland Airport's agreement to work with airlines to develop an improved approach to service levels over PSE3.

- BARNZ has recognised that Auckland Airport seeks to deliver innovative solutions in some areas, either to improve passenger experiences or to avoid capex, and that Auckland Airport has introduced innovations where a pressure point has emerged.[10]

- BARNZ acknowledges that Auckland Airport engages well with consumers on operational matters and capital planning.[11]

Although airlines have encouraged the Commission to broaden the scope of its review, our interpretation is that the majority of issues raised in airline submissions fall into four key themes – which align with the Commission's original intended focus areas:

- Auckland Airport's target return;

- The reasonableness of the Runway Land Charge;

- Whether Auckland Airport's operating expenditure projections are reasonable (including the historic baseline used to support the PSE3 forecast); and

- Auckland Airport's capital investment plan, including the approach to risk allocation.

We respond to airline submissions under these headings. Although we consider that the majority of key points raised by airlines fall within the topics identified in the Commission's process and issues paper, we have also provided a shortened and annotated version of BARNZ's attachment to its main submission – which discusses quality, innovation and efficiency considerations (**Appendix A** to this cross-submission). Should the Commission

---

[7] Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraphs 29-30.

[8] E.g. BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 13.

[9] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 19.

[10] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 19.

[11] BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 18.

decide to broaden the scope of its review, we request an opportunity to respond to BARNZ's views on these topic areas in more detail.

As with our first submission, our explanations below draw from the information set out in our pricing decision reasons paper and our price-setting disclosure (except where airlines have raised new arguments not put to us at the time of pricing). We have tried to avoid repeating this material in its entirety, and we anticipate the Commission's primary source for understanding our pricing decision will be the thorough explanations we have previously provided about our pricing approach in these documents.

3. Auckland Airport's target return

The key theme of airline submissions is that Auckland and Christchurch Airports are together targeting $75 million of excess returns over PSE3, based on a comparison between the mid-point regulatory WACC and each airport's target return for PSE3.

These submissions highlight that the airlines still see the mid-point airport sector-wide regulatory WACC estimate as the only appropriate return for all New Zealand airports – despite the Commission's clear statements through the IM review process that the regulatory WACC should not be treated this way.

These kinds of headline comparisons should be avoided in the section 53B review, as they are misleading to consumers and interested parties, and they contradict the Commission's commitment to contextual analysis.

The danger of this comparison is that it strongly implies returns above the mid-point regulatory WACC estimate are automatically "excess returns" which may then be "justified" following analysis of a range of airport-specific and contextual factors. Our point – which is consistent with the Commission's stated approach in the IM review – is that the contextual analysis must come first. In other words, contextual and airport-specific factors are necessary to understand what an appropriate range for "normal returns" looks like, rather than factors which may justify "above-normal returns".

A simplistic comparison between the regulatory mid-point WACC estimate and an airport's target return is in direct contrast to the Commission's guidance that the mid-point WACC estimate is not a target rate of return or a specific returns benchmark that airports must achieve. It also reinforces the misconception that airlines do not need to engage with the airport-specific factors put forward during pricing consultations, and encourages airlines to simply point back to the mid-point regulatory WACC estimate when airports attempt to generate discussion about the appropriate target return in their particular circumstances.

In our pricing disclosure, we explained our view that an efficient cost of capital for Auckland Airport lies within the range of 6.85% to 8.1%. Our target return of 6.99% for pricing activities and 7.06% for total aeronautical activities lie toward the bottom of this range. We consider that the evidence demonstrates that our target return for PSE3 is consistent with a normal return for Auckland Airport in light of our observable systematic risk and our efficient debt costs, and that there are no excess returns targeted. This reflects the Commission's view that a logical airport would ensure the prices charged for airport services reflect the returns required by the airport to cover all its costs, including *its cost of capital*, on its investment to provide those services.[12]

As we explained in our pricing disclosure:[13]

- At the time we set prices, we considered that:

[12] Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for* airports, 20 December 2016 at paragraph 63.

[13] Auckland Airport *Price Setting Disclosure for PSE3*, 3 August 2017, Commentary at Section 4.3.

- the evidence was clear that Auckland Airport will face a real and substantial increase in operating leverage and systematic risk over PSE3, which clearly distinguishes us from our historical baseline as well as the comparator companies used to generate the Commission's industry-wide WACC estimate. We considered that the use of Auckland Airport-specific parameters to inform our choice of target return was a fair and reasonable response to the unprecedented circumstances we face at this point in our investment cycle. We also considered that making a decision informed by these parameters would ensure that we determined a target return for PSE3 that would help to support the investment pathway and deliver long-term benefits for consumers;

- we have a large forecast capital plan, and the characteristics of this plan influenced our approach to setting an appropriate target return for PSE3, including the size of the plan and the potential risks involved. However, we did not consider it was appropriate to constrain efficient investment that our customers value and which is in the long-term interest of consumers in order to back-solve to a target return that was equivalent to the Commission's mid-point sector-wide WACC estimate;

- the most appropriate way to deliver long-term benefits to consumers was to focus on developing a capital expenditure plan that meets the needs of existing users and addresses the capacity required to provide for forecast growth, and then to set an appropriate target return that would help to support that plan. We considered that a target return of 6.99% would help achieve this objective, while representing a balanced approach that sought to mitigate the price impact on airlines and passengers and which acknowledged that Auckland Airport will also carry material risk in PSE3; and

- on average over the next five years, we are forecasting to invest the equivalent of $15 per passenger per year on common use infrastructure to deliver long-term value for passengers and airlines. As discussed elsewhere in the pricing disclosure, we considered the forecast investment plan provides substantial long-term benefits for consumers,[14] and that our target return was appropriate in this context.

- Although judgement is required to set a target return, and it is impossible to determine the "right" or "optimal" numerical value, we sought to provide confidence to customers that we were targeting a normal economic return by:

  - carefully cross-checking the target return against the Commission's mid-point sector-wide WACC, by making airport-specific evidence-based adjustments that are consistent with and justified under the Commission's overall approach;

  - targeting a return that is materially lower than our best point estimate, informed by expert evidence from NERA, of Auckland Airport's WACC. We did this by drawing a distinction between economy-wide factors we considered the Commission might dismiss due to precedential concerns and airport-specific factors that we considered the Commission would find compelling; and

  - not seeking to recover all of our investment funding costs through aeronautical prices. Although we have a robust balance sheet, given the size and nature of the capital plan set out in our price setting disclosure and the material works under construction, we will need to consider a range of capital management levers during PSE3.

- Ultimately, Auckland Airport considers that the target return of 6.99% for Aeronautical Pricing Activities is in the long-term interest of consumers. This level of return will provide consumers with a higher degree of confidence that we can deliver on an investment plan to alleviate current capacity constraints across terminal and airfield infrastructure, enable efficient peak growth, maintain or improve service quality across the airport system, take the first major step towards an integrated terminal facility, and upgrade the resilience and performance of the transport and access network surrounding the airport.

[14] Auckland Airport *Price Setting Disclosure for PSE3*, 3 August 2017, Commentary at Section 7.

- Further, we consider that our proposed approach shows that we have carefully considered the regulatory framework and feedback from our substantial customers as key constraining factors, and sought airport-specific evidence to support and justify our approach. We consider that our target return of 6.99% strikes the right balance between acknowledging the airport-specific challenges and risks we will face at this stage in our investment cycle, providing a return that will help incentivise and support the delivery of an investment plan that provides significant long-term benefits for consumers, and demonstrating that we have been cognisant of the Commission's economy or sector-wide views and the need to minimise the pricing impact for our airline customers and passengers.

- Ultimately, having weighed all relevant factors, Auckland Airport considered that a target return of 6.99% for aeronautical pricing activities and 7.06% for total regulated activities is evidentially supported by an asset beta range which can reasonably be calculated from market data for Auckland Airport and with reference to Auckland Airport's efficient forecast debt costs. We consider this return demonstrably achieves an appropriate balance between encouraging efficient investment in infrastructure that will improve the quality and efficiency of service, and earning a normal economic return over time.

- Our target return is below the mid-point of our Auckland Airport-specific WACC calculation based on Auckland Airport historical asset beta data. We reference the future impact of the high forecast PSE3 and PSE4 aeronautical capital expenditure plan on Auckland Airport's operational leverage and hence on systematic risk (beta) as a key justification for departing from the Commission's sector-wide mid-point WACC estimate. But our Auckland Airport-specific mid-point WACC estimate does not factor in all of this expected future increase in Auckland Airport's beta as it is based on historical information. Furthermore, our PSE3 target return is less than that midpoint WACC estimate. All of which, in our opinion, further emphasises the very reasonable and defensible approach we followed to establish our PSE3 target return.

Airline submissions do not comment in detail on the airport-specific arguments put forward by Auckland Airport in support of our target return, but have made a few brief points which we respond to below.

- Air New Zealand claims that Auckland Airport's target return relies on two key departures from the mid-point regulatory WACC estimate which have previously been dismissed by the Commission – use of a "total business" asset beta rather than adjusting this downwards to reflect the difference in systematic risk between aeronautical and non-aeronautical activities, and the use of a TAMRP of 7.25%. In response, we note that:

  - As we explained to airlines through the pricing consultation process, although we take a different view on these aspects of WACC estimation to the Commission, neither of the points raised by Air New Zealand ultimately underpinned our choice of target return.

  - In our final pricing decision, we acknowledged that the Commission has clear views on the appropriate values for market-wide parameters of the cost of capital, such as the TAMRP, and that it would be unlikely to accept the evidence of our expert advisors that different estimates of these parameters are appropriate. As such, although we considered that our expert's estimates were sound, our target return for PSE3 did not depend on these views, and was consistent with a target return estimate derived using the Commission's market-wide parameters with adjustments to other parameters to reflect Auckland Airport-specific evidence.

  - In our final pricing decision, we undertook a cross-check that reflected our understanding of the approach the Commission might take to assess the appropriate target return for Auckland Airport. This "bottom-up" cross-check took the Commission's 50th percentile estimate as a starting point, and reflected the Auckland Airport-specific empirical evidence we anticipated the Commission would consider when assessing the reasonableness of a target return that differs from that starting point. We explained that, in our view, this was likely to give a conservative estimate of the appropriate range of returns for Auckland Airport, because it did not consider the full set of contextual

factors that influenced our choice to target a return of 6.99% for pricing activities. Nevertheless, we considered it to be a useful cross-check of the reasonableness of our approach.

Along with its consideration of the contextual factors supporting our target return, we anticipated the Commission would assess the impact of two key pieces of empirical evidence – Auckland Airport's forecast cost of debt based on our observable and efficient forecast debt costs, and the impact of Auckland Airport's unprecedented capital expenditure programme on our exposure to systematic risk and hence cost of equity relative to the global comparator airports used to derive the Commission's notional industry-wide WACC estimate.

On cost of debt, we considered it would be reasonable for the Commission to have regard to empirical evidence about the historical and projected debt financing costs for Auckland Airport. This is because the cost of debt for Auckland Airport is real and observable. Our existing debt in place today must be serviced, and we considered that the company's forecast cost of debt funding provided a better reflection of the true cost to our business of current and future debt – consistent with the Commission's view that a logical airport company would ensure that the prices charged for its services covered all its costs, including the cost of capital.[15] We also considered this approach was broadly consistent with views that had previously been put forward by BARNZ. In a submission to the Commission in 2016, BARNZ put forward a pragmatic approach to calculating the cost of debt which recognised that efficient firms will have a proportion of debt that was fixed during a previous pricing period, and a proportion that will need to be renewed over the upcoming period. This approach is similar to that which we adopted for our forecast debt costs for PSE3. We also received third party advice (referenced in our Draft Pricing Proposal) that our debt funding practices were highly efficient compared to market benchmarks, and we considered it was appropriate to reflect these actual efficient practices when estimating our Auckland Airport-specific WACC.

NERA also noted that financing of the capex plan will be challenging for the company and expressed concern that the A- credit rating may come under stress – confirming our own views. Given the size of the capital expenditure programme, NERA's advice indicated it may be unrealistic for Auckland Airport to expect to pay debt premiums adopted for the sector wide estimate.

NERA explained that international regulators often consider whether the allowed rate of return allows the company to finance its activities at the cost of debt assumed and, if that is not going to be the case, adjust the allowed rate of return. NERA stated that, even in the absence of an express statutory obligation imposing a "financing duty", ensuring financeability is a key concern for the financial sustainability of a company subject to price or revenue caps over a certain period of time. In NERA's report, it noted that where financial sustainability is at risk, companies may be discouraged from making new investments, and that financial sustainability would be a key concern for Auckland Airport in ensuring the price path would enable funding of efficient investment over the pricing period without risking financial distress. NERA noted that risks related to financeability are not captured in the CAPM and are therefore not reflected in WACC estimates. For that reason, NERA noted that there was a strong case for Auckland Airport setting the target return above the Auckland Airport-specific WACC estimate.

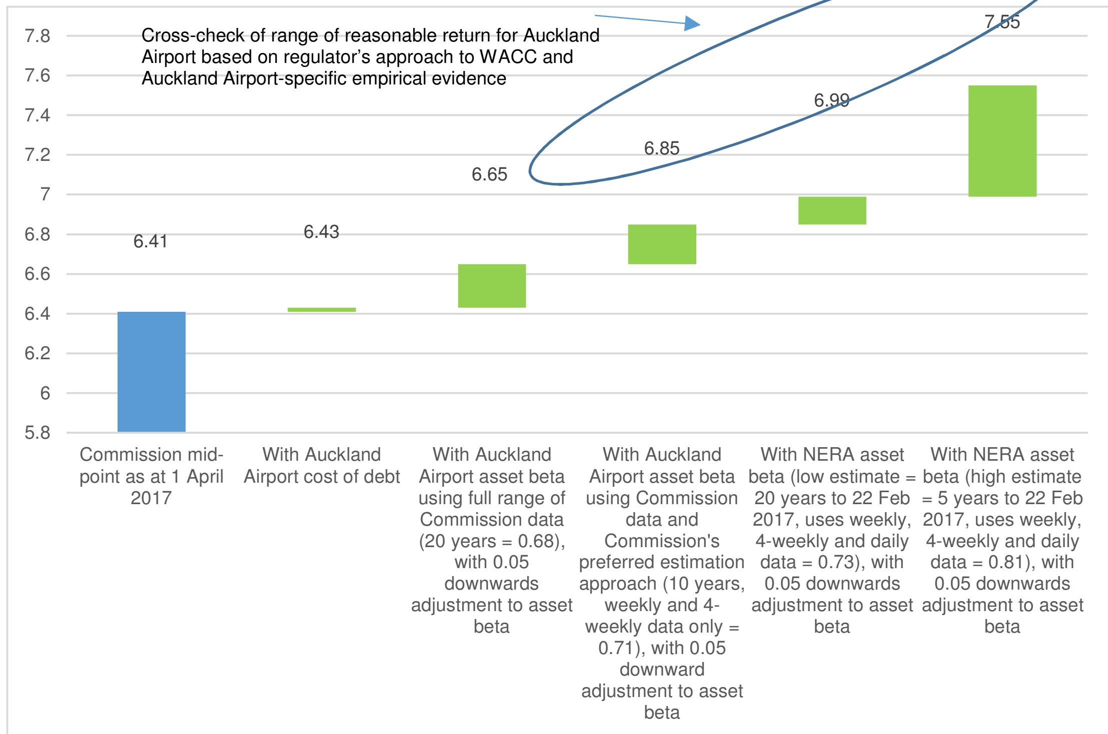
Although we did not do this in our pricing decision, financeability was a further contextual factor that informed our view it was appropriate to reflect Auckland Airport's forecast cost of debt in our cross-check, rather than the notional sector-wide estimate in the Commission's regulatory mid-point WACC estimate. Financeability considerations also informed our judgement as we determined the appropriate target return.

[15] Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for* airports, 20 December 2016 at paragraph 63.

When it came to asset beta, we sought to explain to airlines that we did not believe the sample of firms used to derive the asset beta in the WACC IM was appropriate for Auckland Airport – particularly where empirical data about Auckland Airport's asset beta was available. When developing our cross-check, we therefore took guidance from a range of asset beta estimates for Auckland Airport based on different time series of observable historic market data.

We did not agree that a downwards adjustment to these asset beta estimates was required to reflect any difference in systematic risk between Auckland Airport's aeronautical and non-aeronautical activities for pricing purposes, and we explained to airlines that we did not consider the downwards adjustment of 0.05 made by the Commission to its sector-wide asset beta estimate to be a specific value quantified by evidence. Our expert advisor's empirical analysis showed no evidence that would justify a downwards adjustment for Auckland Airport's asset beta. However, we acknowledged the Commission was unlikely to shift its view on this matter, or to agree with our position. For the purpose of informing a target return that we considered the regulator would see as reasonable and appropriate, we therefore made a downwards adjustment of 0.05 to each of the asset beta estimates in our cross-check.

This bottom-up cross-check applying the Commission's expected position on these key parameters (shown in the chart below) indicated that a target return in the range of 6.85% to 7.55% was appropriate and supported by adjustments to the regulatory mid-point WACC estimate based on Auckland Airport-specific empirical evidence. The cross-check also shows that the two criticisms raised by Air New Zealand in its submissions (the use of a TAMRP of 7.25% and the use of a "total business" asset beta rather than applying a downwards adjustment) do not underpin our target return selection for PSE3.



As noted above, although we consider this approach to be a useful cross-check of the reasonableness of our approach, we consider that this approach is likely to give a conservative estimate of the appropriate range of returns for Auckland Airport. In part, this is because it does not reflect the full range of factors that lead NERA to conclude that Auckland Airport should target a return above the mid-point of its estimate of our airport-specific WACC range of 7.5% - 8.1%, including financeability and loss of timing flexibility (real options) considerations. This cross-check is also likely to be conservative because it

does not consider the full set of contextual factors that have influenced our choice to target a return of 6.99% for our aeronautical pricing activities, as set out in extensive detail in Section 4 of our price setting disclosure and Section 10 of our pricing decision reasons paper.

- BARNZ states that the operational leverage rationale put forward by Auckland Airport sets a "terrible precedent" and encourages airports to spend more on capex to justify a higher target return.[16] In response, we note that:

  – This argument does not rebut the legitimacy of the operational leverage rationale put forward by Auckland Airport and NERA through the pricing consultation and explained in our price setting disclosure. It is another example of airlines raising concerns after-the-fact based on theoretical incentives that do not reflect the actual decision-making of Auckland Airport at the time we set prices, and which are not consistent with our demonstrated conduct over time.

  – It is not credible to think that airports are going to (or can) inflate capital expenditure unnecessarily in order to justify a higher target return. Auckland Airport consults thoroughly with our airline customers on the capital plan that underpins prices, and has no incentives to proceed with capital investment projects if they do not reflect the balance of customer requirements or are inconsistent with the long-term interest of consumers.

  – The evidence for PSE3 is clear that we did not seek to inflate our capital forecasts to support a higher target return. Rather, our primary focus was on developing a capital plan that was informed by airline requirements and would deliver long-term benefits for consumers. As we discuss elsewhere, there was a high degree of alignment between Auckland Airport and our customers on the need for investment and the projects in the capital plan for PSE3.

  – Given the broad support for the investment plan from the majority of our airline customers during the pricing consultation process, we then turned our mind to the return that was necessary to support the delivery of that plan and which reflected the risks we were likely to face over PSE3 – taking into account all relevant circumstances. This will remain our approach in future pricing periods. If our operating leverage changes in the future, we will need to consider the impact of that on our target return in light of all relevant circumstances at that time.

  – Further, we note that given that our target return for PSE3 is below the mid-point of our Auckland Airport-specific WACC range (7.5% - 8.1% as estimated by NERA), we have no economic incentive to gold plate the future capex programme.

  – As noted above, we sought to explain to airlines that Auckland Airport-specific factors meant that the average airport from the sample used to derive the input methodologies asset beta was not a good proxy for the systematic risk we are likely to face over PSE3. This included reflecting on advice from NERA that Auckland Airport was facing a real increase in operating leverage over PSE3, which leads to an increase in systematic risk (beta) relative to our historic baseline, as well as an increase relative to the companies used by the Commission in its sample of airport comparators. This increase in systematic risk is specific to Auckland Airport and to this stage in our investment cycle. Figures 2.1, 2.3 and 2.4 in the NERA report (pp 4 - 7) demonstrate the large increase over PSE3 in Auckland Airport's capital expenditure relative to revenue and the asset base as compared with both past years and with Wellington and Christchurch Airports (based on information available at the time). Table 2.1 also provides evidence that Auckland Airport's relative levels of capital expenditure are higher than the comparators in the Commission's beta sample. NERA observes that:[17]

[16] BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 11.

[17] NERA Economic Consulting *A Peer Review of Auckland Airport's Approach to WACC and Target Return for Aeronautical Pricing*, 22 March 2017 at page 6.

Auckland Airport sets a price path for 5 years, and is hence subject to volume risk during that period. In the upcoming pricing period PSE3 (1 July 2017 to 30 June 2022), Auckland Airport is likely to face a relatively higher share of fixed costs than in previous years, due to the large investment programme for both terminals as well as significant airfield investment, Specifically, it will face large cash outflows during the construction process, which cannot be scaled back or reversed easily (ie. They are likely to be largely sunk) in case of a material decrease in demand, e.g. due to a change in economic conditions. These cash outflows can hence be considered fixed. During the construction phase, Auckland Airport is therefore expected to have higher operational leverage than in the past and relative to comparators that do not undertake such large-scale capex projects.

- As we explained to airlines in our final pricing decision, the link between the effect of higher capital expenditure on operational leverage and beta has been recognised by regulators elsewhere in the world. Uplifts to asset beta due to increased operational leverage have been applied by a number of regulators worldwide to particular companies within a sector for particular pricing periods, based on the specific investment circumstances and challenges of those companies. This includes the UK airport sector, where the UK Competition Commission has considered operational leverage as part of its assessment of relative systematic risk between Heathrow, Gatwick and other airports.

- Auckland Airport's guidance to the market since early 2014 on its capital expenditure plans has provided an indication of a major step change but not to the level of the only recently finalised PSE3 capital expenditure plan. Nevertheless, this suggests that the market had some awareness of the significant structural change taking place at the time we set prices.

- NERA advised that using the most recent estimates of Auckland Airport's asset beta was the best way to reflect the impact of Auckland Airport's forecast capital plan, and the increase in operating leverage that this will introduce over PSE3. NERA considered that its recommended approach may still underestimate the impact of Auckland Airport's planned capex on the asset beta, since its approach was based on analysis of historical observed data points that would not reflect the full extent of the upcoming capital plan. The estimated WACC range of 6.85% to 7.55% (shown in the chart above), reflects ten-year and five-year sampling periods respectively.

- Ultimately, we agreed that it was appropriate for our target return to reflect available empirical estimates of Auckland Airport's systematic risk. The operational leverage rationale was put forward as one example of how Auckland Airport differed to the comparator sample used to derive the Commission's notional asset beta estimate. It also supported our view that it was appropriate to use observable estimates of Auckland Airport's asset beta when setting a target return that reflected our specific risk profile for PSE3 – not to justify an "uplift" or "higher target return" in the way suggested by BARNZ.

• BARNZ is concerned that the regulatory framework is producing a situation where each airport finds its own reason to "justify an uplift" to the regulatory mid-point WACC estimate, but those reasons are not consistent over time or with each other. In response, we note that:

  - The Commission has expressly recognised that there are a variety of reasons why an airport's target return may be different to the mid-point regulatory WACC estimate, and anticipated that airports would put forward airport-specific and time-specific

explanations to support their target return.[18] The fact that Auckland and Christchurch Airports have different rationale behind their target return is perfectly consistent with this guidance.

- Although we have not reviewed Christchurch Airport's price setting disclosure in detail, we understand that both Auckland and Christchurch Airports have put forward explanations of how their systematic risk compares to a notional asset beta based on the Commission's comparator sample. There could be different but equally valid reasons as to why different airports have a higher systematic risk than that notional estimate. The fact that one New Zealand airport has a systematic risk higher than the global comparator sample average does not automatically imply that other New Zealand airports have a systematic risk lower than that sample average.

- Air New Zealand argues that Auckland Airport has considered aeronautical returns in isolation from overall airport returns, which is an artificial construct that does not reflect market practice.[19] BARNZ considers that the presence of complementary revenue streams should be sufficient to incentivise Auckland Airport to invest at a target return that is equivalent to the Commission's mid-point regulatory WACC estimate.[20] In response, we note that:

  - Our focus through the pricing consultation process was on setting a normal return for our regulated business given the risk associated with those activities. We consider that we have achieved this objective.

  - We have explained in the past (through the IM review) that we do not agree with high-level and simplistic assumptions about the effect of complementary revenue streams on investment incentives. The relevance of non-regulated activities to aeronautical investment decisions at Auckland Airport is not all-pervasive or straight-forward. For example, parts of the forecast aeronautical capital plan such as the staged integration of all passengers under one terminal roof will involve partially stranding and splitting non-aeronautical facilities. The business case for this development is challenging because it is relatively risky, involves carrying hundreds of millions of dollars of work in progress for a long period, and the incremental returns in the early years of the development are likely to be negative for the non-aeronautical business.

  - Non-regulated activities are considered in the allocation of upcoming projects – where direct non-aeronautical costs are carved out, and the aeronautical allocation of shared costs is lower than would be the case if there was no multi-activity benefits from the project in question.

  - Although we do not agree that there is evidence of a difference in systematic risk between Auckland Airport's aeronautical and non-aeronautical activities, we have made a downwards adjustment of 0.05 to our Auckland Airport-specific asset beta estimate when conducting a cross-check of the reasonableness of our target return for PSE3 – consistent also with airline views that this is an appropriate way to set a return for the regulated business.

  - Finally, as we explained in our final pricing decision, Auckland Airport faces choices in how we plan to deliver required capacity. If the level of target return is not sufficient to cover our real capital costs or provide compensation for the material risks that Auckland Airport is facing, this could affect our investment priorities and the nature of the planned investment over a pricing period, impacting on the long-term benefits we are able to deliver for consumers. For example, under this scenario investments may tend towards "core" investments in safety, security, and capacity expansion where it is proven that this will result in additional traffic volume and where there are no available alternatives.

[18] Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for* airports, 20 December 2016 at paragraphs 111, 132.

[19] Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraph 20.

[20] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 11.

If this is the case, service quality-focused investments and innovative projects may be less likely to proceed, Auckland Airport may be incentivised to prioritise the least-cost alternative for a project rather than the alternative with the highest value-creation to the aviation community or the greatest long-term benefit to consumers, and peak capacity investment could potentially be delayed.

Under these circumstances, Auckland Airport may also be less incentivised to invest in the types of projects valued by our substantial customers. For example, we may prefer capacity expansion through increased use of remote stands and greater bussing – a less capitally intensive option for Auckland Airport that delivers the same capacity to cater for volume growth as contact stands, but an option that is not preferred by the majority of our airline customers beyond industry norms.

Overall, when we set prices for PSE3 we considered the better approach was to target a return to help support a base case capital plan that included investments not only in safety, security and capacity, but also material investment in projects that reflect the service priorities of our airline customers and that will deliver better service outcomes to consumers over the long-term.

- BARNZ has commented on the difference between the target return for Auckland Airport's pricing activities and the effective return for non-pricing (other regulated) activities – noting that returns for other regulated activities "seem particularly excessive". We note that:

  - The forecast post-tax IRR for total regulatory assets of 7.06% is the combination of the target return for aeronautical pricing activities (6.99%) and the forecast revenue for other regulated activities. We have not targeted any particular WACC estimate for other regulated activities (predominantly aircraft and freight activities). As noted in our price setting disclosure, the forecast revenue for other regulated activities is based on revenue from negotiated leases that are subject to standard commercial dispute resolution processes, rather than calculated using a building blocks model targeting a particular return that aligns with Auckland Airport's five-yearly aeronautical pricing reset cycle. For this reason, there is a slight difference between the target return for aeronautical pricing activities and the effective return for total regulated activities.

  - This was also the case for PSE2, although the effective return for aircraft and freight activities was lower than for aeronautical pricing activities (as acknowledged by the Commission in its section 56G analysis). In the past, airlines have recognised that returns on these activities are linked to market evidence and are effectively a proxy for returns that would be produced in competitive markets. For example, in the IM Review BARNZ noted that:[21]

    > *Often airports target a significantly higher level of return on their pricing assets than they are able to achieve through leased areas, as leases often contain a term linking rental rates to market evidence. In the past BARNZ has been provided with information indicating that in some instances the return earned from market based leased rates can be nearly 50% less than the level of return produced by the building block methodology. This raises questions over whether the level of profitability being targeted by the airports on the assets priced under the Airport Authorities Act price setting power is not excessive, given it is so far above that produced in workably competitive markets.*

  - We think it is realistic to expect that the effective return for other regulated activities may be above the target return for aeronautical pricing activities in some periods, and below in other periods, given the different methodologies used to set prices for each set of activities. Given that Auckland Airport has maintained a consistent approach to setting rental rates for other regulated activities (i.e. negotiations linked to market evidence), and BARNZ has previously recognised the validity of this approach in the

[21] BARNZ *Submission on IM review Draft Decision*, 4 August 2016.

past, we do not consider the difference between returns on priced and non-priced activities for PSE3 to be a concern under the regulatory framework.

- We anticipate the Commission's focus for the section 53B review will be on the overall return across Auckland Airport's regulatory assets, as well as the target return set as part of the aeronautical pricing consultation. This is consistent with the revisions to the price setting disclosure template, which require information to be disclosed for the overall regulatory asset base, and the aeronautical pricing subset.

Finally, we note that Air New Zealand continues to argue that information disclosure regulation is not able to restrain excessive profits. This argument has been correctly rebutted by the Commission on a number of occasions. It is also directly contradicted by BARNZ's feedback, which acknowledges that information disclosure is limiting excess profits (although in its view not enough), that Auckland Airport reduced its target return in response to submissions and provided a substantial amount of justification for its target,[22] that Auckland Airport's target return is a lower percentile-equivalent of the Commission's WACC estimate than in PSE2, which BARNZ assumes is due to recent changes to the WACC IM, and that the target return is below our mid-point Auckland Airport-specific WACC estimate.[23] Together, these comments show that Auckland Airport is genuinely constrained by the regulatory framework and airline feedback, and has provided significant justification about our approach – including why we consider our target return is reasonable and consistent with the long-term interest of consumers.

The context of Auckland Airport's price setting event makes clear that our customers perceive a risk of underinvestment at Auckland Airport. Whilst it may not be the nature of a major outage like in energy, it is still very clear on balance customers do want the planned investment programme to go ahead and they do care about service quality and peak congestion costs. Auckland Airport targeted a return necessary to incentivise that investment plan, and provided qualitative explanations of how we considered the proposed investment programme to be in the long term interests of consumers.

As we explained in our final pricing decision, given the broad support for the investment plan from the majority of our airline customers, Auckland Airport did not seek to precisely quantify the benefits to consumers and convert them into financial metrics for airlines and passengers. As the Commission has indicated in the past, this process is not straightforward and can be extremely time consuming and expensive. In addition, a number of the benefits to consumers from the investment plan involve increased resilience and quality of service, which is difficult to translate into numerical terms. For the same reasons, Auckland Airport did not seek to precisely quantify the potential costs to consumers if we did not proceed with this investment plan.

4. The reasonableness of the Runway Land Charge

Airline submissions state that:

- The Runway Land Charge is pre-funding of a regulated asset and is unreasonable, arbitrary and inconsistent with a competitive market. As the charge is NPV-neutral to Auckland Airport, we should have agreed with airline preferences and not introduced the charge;
- Auckland Airport "summarily dismissed" the option of smoothing prices from the time the second runway is commissioned, which is the broad outcome that would be seen in a competitive market;
- The charge does not meet the purpose of smoothing any price spike when the runway is commissioned into use;
- The charge creates inter-generational and inter-airline equity problems;

[22] BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 12.
[23] BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 12.

- Auckland Airport appears to believe that the design of Schedule 18 of the disclosures is essentially a 'green light' from the Commission to apply the Runway Land Charge; and
- The Runway Land Charge is not NPV-neutral to airline customers.

As we explained to airlines through the pricing consultation process, we disagree with airline views that the Runway Land Charge is pre-funding. The charge is to recover holding costs that Auckland Airport is currently accumulating in relation to an existing aeronautical asset, where no parties have suggested it is anything other than prudent and efficient for Auckland Airport to hold this land.

Claims that the charge amounts to pre-funding also do not sit neatly with airline views provided to Auckland Airport at the start of the consultation process when we began exploring the concept of a potential charge to signal the impact of today's demand in bringing forward the need for a second runway. Air New Zealand noted that it appreciated the economic principles underpinning a charge that would better reflect the long-run cost of using runway capacity today, and that it was willing to discuss the use of a long-run costing approach alongside the standard five-year building blocks model once further work had been undertaken by Auckland Airport.[24] BARNZ stated that some of its airlines may be prepared to consider a new charge given the rate at which holding costs were accumulating on the second runway, and that it would consider the question further after modelling work had been carried out to indicate the impact of any such charge on landing charges before and after the commissioning of the second runway. BARNZ noted that airlines had steadfastly opposed charges for infrastructure before it was in use in order to discourage expansionist tendencies from airports, but went on to state that the case of the land held for the second runway was significant and different in nature to constructed infrastructure.[25]

At the time we set prices, we explained that the impending price impact of the second runway was not an issue that could be ignored by the industry. We explained that we were pleased at the preliminary feedback from Air New Zealand and BARNZ noted above, which signalled a more constructive approach and a sense that the industry was prepared to consider and discuss potential options to address the impact of this once-in-a-generation investment and the implied price path impact of that investment. We acknowledge that later feedback from airline customers in the pricing consultation indicated they would prefer to take the price spike at the time of commissioning than to have a Runway Land Charge now. However, we considered that it was important for Auckland Airport to balance this feedback against what we considered to be in the interests of all consumers (including passengers) over the long-term. We acknowledged that it was rational for airline customers to seek to reduce their short-term costs and to oppose any new charges that would impact that objective. However, we did not think this approach was sustainable or in the interests of consumers over the long-term. We therefore remained of the view that a charge in PSE3 was fair and reasonable, and remained hopeful that the form of the final Runway Land Charge would assure airlines that our intentions were consistent with the long-term interests of all consumers.

We also recognised that the Commission has previously been clear that there could be a range of outcomes in workably competitive markets ahead of the commissioning of significant new capacity, and that there is no specific pricing or disclosure treatment implied by the comparison to a competitive marketplace.[26]

In response to the other points raised in airline submissions, we note that:

- In our final pricing decision, we explained our view that the long-term price path for consumers will be more affordable if we are able to find principled methods to smooth the price path *both in advance of and following* the introduction of the second runway. Auckland Airport considered that the decision to introduce a Runway Land Charge was a modest first stepping stone towards achieving a long-term price path for existing and future

[24] Air New Zealand *Aeronautical Pricing Consultation – Information Pack 1*, 5 October 2016 at pages 4-5.
[25] BARNZ *Response to Information Pack 1*, 24 October 2016 at page 4.
[26] Commerce Commission *Input Methodologies (Airport Services) Reasons Paper*, 22 December 2010 at paragraphs 4.3.74-7.3.79.

customers that is affordable, and would reduce the prospect that a price shock becomes the key barrier to the realisation of a second runway. We were clear that Auckland Airport remains open to price smoothing after the second runway is commissioned, but that we consider smoothing both in advance of, and after, the commissioning of this major asset to be the most principled approach. We considered the Runway Land Charge would provide a practical solution for smoothing in advance that is closely linked to the real challenges we and our customers face as holding costs continue to compound on existing land held for the second runway development. As such, we acknowledged that the Runway Land Charge was a small step toward smoothing prices and making the new capacity more affordable to airlines and their passengers over the long term.

- Much like other infrastructure challenges in Auckland, we understand that consumers focussed on the short term will want to delay paying for infrastructure for as long as possible, but equally these consumers do want planning and construction to occur in a timely manner.

- We do not agree with airline views that introducing the Runway Land Charge would be unfair or inequitable for current users. During the pricing consultation process, we explained that, in our view:

  - Today's users contribute to the investment decisions that will create costs for future users. The second runway will have a long planning and construction lead time. A decision to invest in the runway and commit to a commissioning date will need to be made many years in advance. If Auckland Airport thinks the runway will be required in 2028, a number of key decisions will need to be made over PSE3, and substantial work will need to begin in this pricing period. For example, the capital plan shows earthworks would need to begin in mid-PSE3 if the runway is to be commissioned in 2028. Demand over PSE3 will inform our projections of future demand and trigger key decisions to commence construction and build towards the commissioning of the second runway.

  - We also note that the broader resilience of the system will be a key consideration in the decision-making regarding the second runway. As demand grows today, this will result in a flatter profile across the operational day, which will have little resilience to recover or accommodate abnormal conditions, e.g. weather disruptions or unexpected runway incidents.

  - Current airlines and passengers will benefit from lower charges in the period leading up to the commissioning of the second runway as utilisation of the existing runway increases, while also contributing to a significant investment decision about the timing of the second runway that will impact future users.

  - At the same time, Auckland Airport is accruing holding costs today on the land set aside for the second runway development. The carrying value of this existing land asset is forecast to increase by $130.1 million over PSE3 due to these current period holding costs. In the absence of any Runway Land Charge, the burden of these additional costs that we are accruing today will fall solely on future passengers.

  - In light of these factors, we considered the most equitable approach, and the one which would best reflect the long-term interest of consumers, was to start taking incremental steps now to help reduce the impact of currently-accruing holding costs on land set aside for the second runway investment.

- We did not consider the Schedule 18 amendments to be a "green light" to introduce the charge. As we explained in our final pricing decision, we expected the Commission to carefully review and comment on the appropriateness of our approach in its summary and analysis, including the rationale underpinning why we had included revenues associated with land held for future use in our PSE3 charges. We provided thorough explanation of our decision, including the challenges facing Auckland Airport and consumers in the

transition to a second runway, and explained how we had carefully considered airline feedback and available regulatory guidance.

We materially adjusted both the level and timing of the Runway Land Charge having considered the airline feedback and our assessment of factors the Commission would likely consider. Ultimately, we considered that seeking a partial recovery on existing assets held by Auckland Airport was a robust and equitable method toward a sustainable price path over time, was consistent with the relevant regulatory principles established by the Commission, and was in the long-term interest of consumers. We summarised our understanding of the available regulatory guidance (explained in more detail in section 12 of our pricing decision and section 6 of our price-setting disclosure) in our first submission on the section 53B review, and we considered that linking the introduction of the charge to a construction-based trigger was consistent with this guidance. [ ].[27]

- Auckland Airport is conscious that the Runway Land Charge differs from most other elements of its pricing proposal, as it seeks to address limitations of the five-year building block approach. This charge will therefore provide a NPV neutral revenue stream which will be transparently offset against future revenue requirements based on the actual value of levies collected. We acknowledge that airlines may have a different cost of capital, but we consider the appropriate lens is whether Auckland Airport has the right incentives, and whether the outcomes are in the interests of end-users. In this context, what matters is ensuring that Auckland Airport does not receive a gain at the expense of consumers through the Runway Land Charge revenue – a principle that is satisfied with a charge that is NPV-neutral from Auckland Airport's perspective.

Airline submissions also include a number of points about the Runway Land Charge that were not put to Auckland Airport during the pricing consultation process. In particular:

- Air New Zealand now argues that Auckland Airport does not have the legal ability to set a Runway Land Charge under the Airport Authorities Act 1966 ("**AAA**"), as the charge does not relate to the use of the airport or any associated services or facilities. Auckland Airport does not intend to dwell on this point, as the section 53B review process is not the right forum for this discussion. We expect that the Commission is already comfortable that it does not need to engage with this argument as part of its review, given the long history of debate under Part 4 regarding the proper treatment of assets held for future use, where it has never been suggested that airports have no legal power to charge for these assets. Nevertheless, we note that:

  – Air New Zealand's position contradicts its own feedback during Auckland Airport's pricing consultation, where it acknowledged that airports are able to set prices for assets which are not in use under the current regulatory regime for airport pricing.[28]

  – It is also not consistent with the statutory definition of specified airport services in section 2 of the AAA, which the High Court has acknowledged includes: "on the basis of the way the various activities and services comprising specified airport services are defined, the holding of any facilities and assets for the purpose of providing specified airport services *in the future*."[29]

  – Air New Zealand's view is also directly inconsistent with the High Court's acceptance that "[t]he extent to which an Airport seeks to recover the costs of assets held for future use, in the pricing it sets under the AAA, remains ultimately a decision for it. To the

---

27 [ ].

28 Air New Zealand *AIAL Draft Proposal for Standard Charges: Air New Zealand Response*, 22 February 2017 at page 6. Although Air New Zealand described this as an example of why it believes the regulatory regime is inadequate, it has nevertheless accepted that the charge is consistent with the Airport Authorities Act as it currently stands.

29 *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 at [905].

extent it considers appropriate, it can set prices to recover a return on such an asset, and comment on any apparently excessive ROI when it makes its ID disclosure."[30]

- BARNZ now states that requiring customers "to pay for the runway as it is built" lowers the airport's financial risk associated with the investment, but claims that this does not appear to be reflected in the target return.[31] This position was not put to Auckland Airport during the pricing consultation process. In any event, we have been clear that the Runway Land Charge relates to currently accruing holding costs on the land held for the second runway – it is not requiring customers to pay for the cost of building the runway (with associated capex forecast at approximately $202 million over PSE3, with no return over the period).

- Airlines argue that there is no mechanism to account for delays or abandonment of the second runway, and the charge provides no incentives for Auckland Airport to implement the second runway on schedule. In response, we note that:

  - During the pricing consultation our focus was on considering the feedback received, the reasonable level of the charge and a fair trigger for commencing the charge. In the Draft and Revised Pricing Proposals, the charge was proposed to start from FY18 – the beginning of PSE3. We carefully considered airline feedback ahead of the final pricing decision, and made a number of changes to the charge – including introducing the construction-based trigger to respond to airline concerns that changes in demand could result in customers paying the Runway Land Charge for a period of time without any runway being constructed. The trigger-based nature of the final Runway Land Charge was designed to provide customers with comfort that a decision to introduce the charge was linked to a Board decision to commence construction – which would only be made after consultation with substantial customers on the need for and timing of the second runway.

  - We did not turn our mind to what would happen if the Runway Land Charge was triggered and then construction of the runway was delayed. If such as a scenario does occur, Auckland Airport will consult with the airlines and do the right thing in the circumstances, keenly aware that the reasonableness of that decision will be assessed by the Commerce Commission. The Commission has previously highlighted to Auckland Airport the areas where it will be particularly watchful of Auckland Airport's conduct. We also note Air New Zealand's view during the pricing consultation that, once airlines are paying a charge, pressure would build on the airport to develop the asset.[32]

- BARNZ has also introduced a new expert report from Pat Duignan, which raises a number of new arguments – including some which contradict the views put forward by BARNZ and its other expert (John Small) during the consultation process. In particular, during the pricing consultation BARNZ and John Small provided feedback that peak pricing was an alternative to the Runway Land Charge in that it would help to reduce the extent of any price step associated with the construction of the second runway, and that this would signal the cost of landing planes at peak times and should help to manage congestion. This appears to be inconsistent with Pat Duignan's view that, unless Auckland Airport moved to an implausibly extreme variation in its charges between peak versus off-peak, it is difficult to see that the pattern of these charges will have any material effect on when the second runway will be required. We agree with these observations from Pat Duignan. Although we acknowledge that pricing will be relatively rather than completely efficient by our decision to implement a uniform charge rather than a peak/off-peak charge at this stage, we remain of the view that it is reasonable and efficient to apply the Runway Land Charge to all passengers, and not to have a peak/off-peak differential in Auckland Airport's general charging structure at this time. The rationale for our approach is set out in our final pricing

[30] *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 at [908].
[31] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 15.
[32] Air New Zealand *AIAL Draft Proposal for Standard Charges: Air New Zealand Response*, 22 February 2017 at page 6.

decision, and summarised in our first submission on the section 53B review. Auckland Airport will of course remain open-minded on this matter over time.

5. Auckland Airport's operating expenditure projections

Airline submissions state that Auckland Airport's opex projections are likely to be excessive and include inefficient costs that should not be passed on to consumers.[33] Airlines consider that:

- Auckland Airport's current operating expenditure is inefficiently high, which means the starting point for PSE3 opex forecasts is also inefficiently high;
- Auckland Airport has built expected "diseconomies of scale" into its prices for PSE3, which means customers are paying for its inefficiency; and
- The regulatory framework does not provide any meaningful incentives for airports to seek out operating efficiencies.[34]

BARNZ also notes that it has not been able to replicate the real opex per passenger projections included in Auckland Airport's price setting disclosure, and that it believes opex will increase in real terms over PSE3, rather than decrease as described by Auckland Airport.

In response, we note that:

- During the pricing consultation process we explained that the base year forecasts represented an efficient level for the services we provide, supported by international benchmarking showing that Auckland Airport's operating costs compared favourably to other international airports. Using analysis set out in Leigh Fisher's Airport Performance Indicators 2016 Report, we benchmarked our operating costs per passenger, total costs per air traffic movement and total costs per passenger. When costs are ranked from high to low, Auckland Airport ranks:
  - 40th out of Leigh Fisher's total global sample group of 50 airports for operating cost per passenger (so 10th lowest);
  - 40th out of 50 airports in terms of total costs per air transport movement (again, 10th lowest); and
  - 37th out of 50 airports (or 13th lowest) for total cost per passenger.

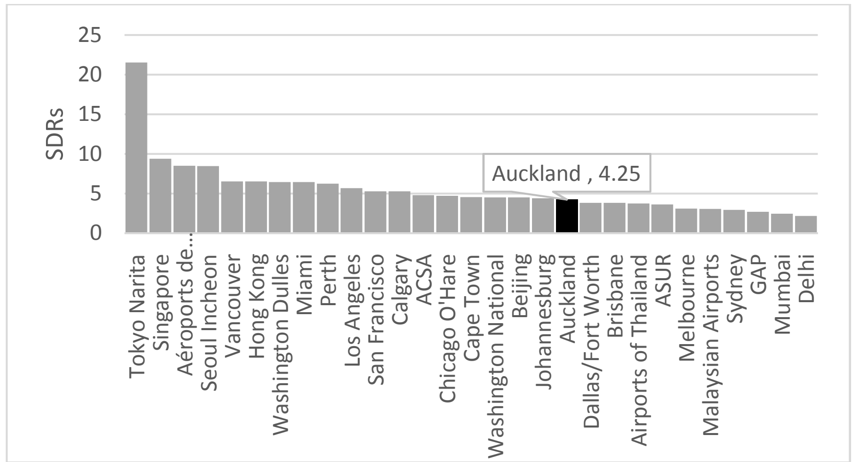
  Among non-European airports (which typically have lower total cost metrics than European airports), Auckland Airport also benchmarks well. Again when costs are ranked from high to low, Auckland Airport ranks:
  - 11th lowest in terms of operating cost per passenger (out of a sample of 29 airports), as shown in the following chart:

    Operating costs per passenger – Non-European Airports (SDR)[35]

[33] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 14.

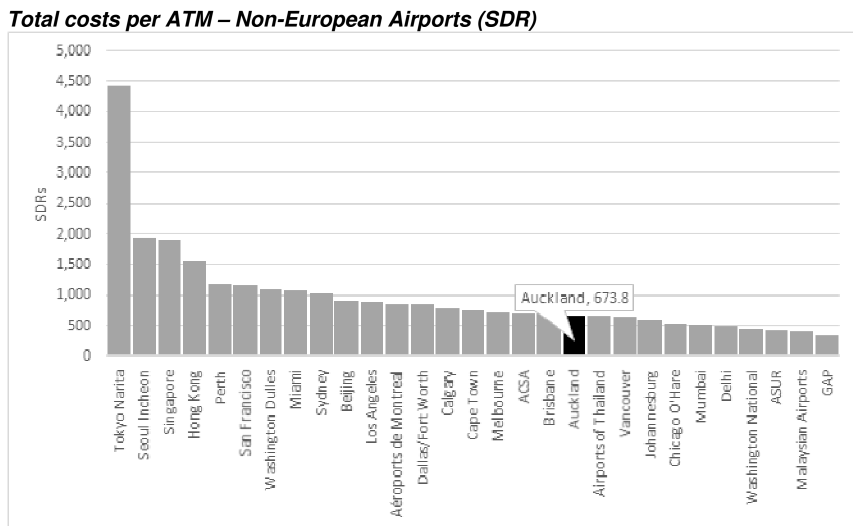
[34] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 14.

[35] To allow comparisons between the airports, Leigh Fisher converts the local currency data into a common unit of currency, called the Special Drawing Right ("**SDR**"). This is based on the trade-weighted values of a group of major currencies from the G8 nations. This unit is intended to allow comparisons to be made over extended periods of time which smooth out some of the larger fluctuations in currency values that can occur using a single currency such as the US Dollar.



– 11th lowest in terms of total costs per air transport movement, as shown in the following chart:

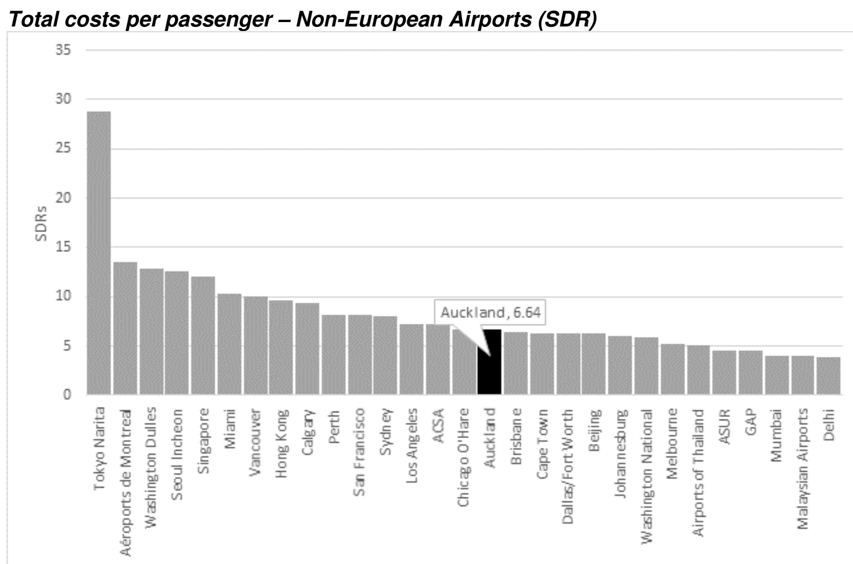
Total costs per ATM – Non-European Airports (SDR)



Source: Leigh Fisher, Airport Performance Indicators 2016 Report.

– 16th lowest for total cost per passenger, as shown in the following chart:

Total costs per passenger – Non-European Airports (SDR)



Source: Leigh Fisher, Airport Performance Indicators 2016 Report.

We acknowledge that benchmarking can be challenging and needs to take into account the different passenger mix at each airport. For example, although our operating cost per passenger is marginally higher than Sydney, Brisbane and Melbourne, our passenger mix is considerably different. As with the New Zealand market, we process a significantly higher proportion of international passengers than these comparator airports. Our operating costs are also lower per passenger than Perth Airport, despite the fact that our proportion of international passengers is almost 20% higher. We remain of the view that our operating costs are efficient and benchmark well by international standards.

- Airline feedback during the pricing consultation generally sought reductions in the base year forecast without any reduction in the level of service that underpinned this forecast and with limited engagement on any specific cuts that should be made to the base year forecast. We nevertheless acknowledged our customers' concerns about the increase in operating costs between FY16 and FY18. We explained that operating efficiency was a key goal for Auckland Airport, and we continued to test and review the operating cost assumptions in conjunction with the business throughout the consultation process.

- Some points of detail on cost forecasts for specific areas were raised by BARNZ as the consultation progressed, which Auckland Airport carefully considered as we produced the final operating cost forecasts. Auckland Airport has developed an operating cost forecast for PSE3 that we consider to be efficient and realistic, and which aims to achieve realistic per passenger reductions in operating cost items where possible over the period. Auckland Airport has used the same base operating cost forecast to inform the aeronautical pricing decision and the company-wide budget for FY18 – which BARNZ acknowledged was positive as the corporate budget would drive expenditure.

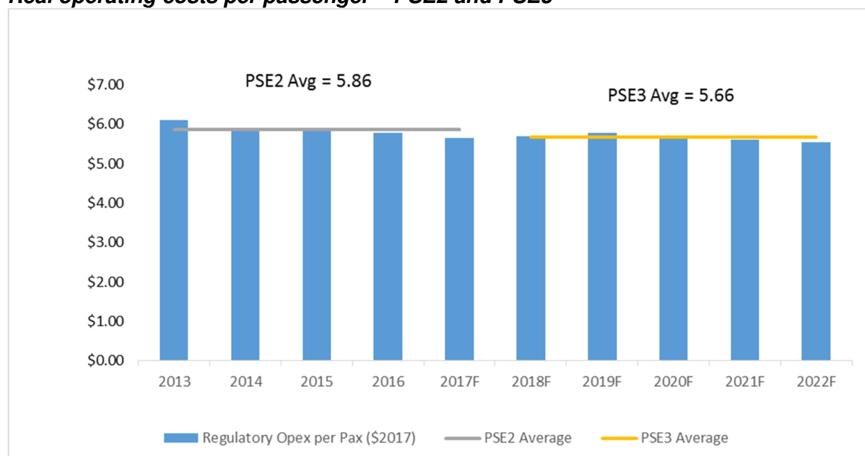
- In the Revised Pricing Proposal, we set out our understanding that Air New Zealand was broadly comfortable with the operating cost forecasts. Air New Zealand's feedback on the Revised Proposal was consistent with this view – providing minor feedback only which was limited to a statement of principle about the inclusion of route development costs in the operating cost forecast, the removal of a minor cost item for a service it no longer required (which was subsequently removed from the opex forecast), and an expression of support for the proposed allocation of terminal costs between domestic and international activities.

- As we explained during the pricing consultation, Auckland Airport's long-term aspiration is to continue to deliver efficiencies of scale, and we strive to reduce operating expenditure per passenger over time. However, we do not consider it is realistic to expect economies of scale in every area of an airport's operation at all times, and passenger growth will not always lead to per-unit cost decreases for every operating cost line item. This is particularly relevant given that Auckland Airport has had a highly efficient cost base compared with global airport comparators (as noted above), and now faces a period of intensive and complex brownfields development. This view was consistent with feedback from BARNZ's advisor that operating costs tend to increase temporarily during construction, which may be contributing to the overall increase in unit costs at Auckland Airport (although we acknowledge BARNZ's advisor also considered an alternative hypothesis could be a lack of competitive pressure based on theoretical incentives).[36]

- We do not agree with airlines' claims that the regulatory framework does not provide incentives for airports to seek out operating efficiencies. Overall, the average forecast operating cost per passenger for PSE3 is lower than the average operating cost per passenger in PSE2, as shown in the following chart. Forecast operating costs for PSE3 are broadly flat in real terms over the period for both total regulatory costs and for the subset of operating costs that relate to aeronautical pricing activities.

[36] John Small *Diseconomies of scale at Auckland Airport*, 24 November 2016 at page 3.

Real operating costs per passenger – PSE2 and PSE3



- We were unaware that BARNZ could not replicate the real opex forecasts in our pricing disclosure until we received its section 53B submission. We have since reviewed the disclosure information and have found a small error in the operating cost information. This affected the information presented for other regulated activities and the total regulated cost forecast (the aeronautical pricing forecasts were not affected, and are the same between our final pricing decision and the pricing disclosure). Our corrected analysis is included below, and shows that forecast opex for PSE3 is effectively flat in real terms on a per passenger basis relative to the FY17 forecast at the time we set prices.

Nominal	2018F	2019F	2020F	2021F	2022F
Operating costs - Aeronautical Pricing Activities and Non-Isolatable activities	105.3	112.9	117.3	121.7	126.8
Operating costs - Other regulated activities	8.4	9.5	10.0	10.3	10.6
Total regulated cost forecast per Schedule 18	113.7	122.5	127.3	132.0	137.4
Passengers (m)	19.8	20.6	21.2	21.9	22.6
Nominal regulated cost forecast per Schedule 18	5.74	5.94	5.99	6.03	6.08
Real regulated cost forecast per Schedule 18	5.67	5.77	5.70	5.62	5.55
Average					5.66

6. Auckland Airport's capital investment plan

Airline submissions state that:

- Although the capital programme is generally welcomed, it is difficult to tell whether the capex is reasonable because the plan is at a very high level and there is not enough detail to assess whether projects are costed accurately or can be delivered in the indicated timeframes.[37]

- BARNZ has concerns about the deliverability of such a major step-up in capital projects and the risk of delayed commissioning of assets. BARNZ considers that Auckland Airport should have included a capex wash-up in its pricing decision to ensure that customers only have to pay for assets that are actually commissioned.[38]

- Investment at Auckland Airport has not happened soon enough to meet demand, and some of the forecast capital plan will be delivered too late (such as the new MPI biosecurity area).[39]

In response, we note that:

- As a result of the capital planning and pricing consultation processes, we considered the capital plan had evolved by the time of the final pricing decision to a point that there was a

[37] Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraph 33.
[38] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 12.
[39] BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 5.

good deal of understanding of the base case capital plan, along with support for the plan from carriers representing over 80% of international passengers. We note that:

- Although BARNZ questioned the size of the capital plan during pricing, by the end of the consultation process BARNZ advised the pricing sub-committee of Auckland Airport's Board that it was generally comfortable with the forecast capital plan, it welcomed the development going ahead, and that it recognised that the time had come to invest.

- In its feedback on the draft pricing proposal, Air New Zealand noted the significant investment programme, and stated that it supported the investment pathway. It did not raise any concerns about the level of detail in the capital plan or question the reasonableness of the forecast costs. Air New Zealand committed to continuing to work with Auckland Airport as the investment pathway was further defined and more detailed analysis and design was completed on the individual components of the capital plan. Air New Zealand confirmed its support for the proposed investment pathway in its feedback on the Revised Pricing Proposal in April 2017 and to the Board sub-committee.

- [ ].

- Auckland Airport acknowledges that our capex forecast for PSE3 is a significant step up from PSE2. This forecast is driven by the rapid change in market conditions the airport has seen in recent years, which presents both challenges and opportunities for us, our airline customers and consumers. Through pricing, BARNZ presented the step-up as a reason why Auckland Airport should consider a capex wash-up – that is, it was concerned that there is a greater risk that capex will be delayed or deferred, and that Auckland Airport "beating" our forecasts in these circumstances would amount to a windfall rather than an efficiency gain in line with the purpose of incentive regulation. We carefully considered these views during the consultation process. On balance, we did not consider that a capex wash-up was required or would be consistent with encouraging efficient investment delivery over PSE3. Key reasons for our decision (as we explained in our final pricing reasons paper) included:

  - We considered there was a high degree of support for the capital plan – airlines representing approx. 80% of passengers are comfortable with the base case capital plan. Although BARNZ considered a wash-up was appropriate, this was not a key issue that it raised with Auckland Airport's Board sub-committee.

  - We considered that not having a wash-up would provide the best incentives for Auckland Airport to achieve efficient expenditure and manage risk, and understood that to be the Commission's "default" position also. We were not convinced that the quantum of capital expenditure for PSE3 provides sufficient reason to disrupt those incentives.

  - In particular, we carefully considered the risk of non-delivery in the capital plan for PSE3. In our view, the capital expenditure that had the most uncertainty and which would impact prices for PSE3 was a relatively small proportion of our overall capital expenditure programme, and variations to the scope or timing of this part of the capital plan were not likely to have a material impact on overall revenues received from consumers over PSE3.

- During the pricing consultation process, BARNZ accepted that Auckland Airport was the party best placed to manage the risk of commissioned asset values being higher or lower than forecast.[40] Although BARNZ considered this provided support for an asymmetric wash-up, in our view this acknowledgement provided support for our position that no adjustment to the default risk allocation approach was required (i.e. that it was appropriate for Auckland Airport to bear both the risk and reward of capex differing from forecast, because it has control over the capital expenditure programme and should be able to manage that programme efficiently).

- BARNZ did not propose a symmetrical wash-up. Rather, BRANZ proposed a methodology that would require Auckland Airport to bear the additional costs if capex was more than forecast but return revenues to airlines if capex was less than forecast. We considered that BARNZ's feedback during the pricing consultation process was more consistent with retaining the default risk allocation approach – where Auckland Airport bears both the upside and downside risk, and is able to manage across demand, opex and capex variables to provide efficient solutions in response to changing market circumstances. BARNZ did not persuade us that its proposed asymmetric washup methodology was appropriate.[41]

- On balance, we were unconvinced that an asymmetric wash-up on one variable in isolation was reasonable, consistent with the Commission's approach to risk allocation, or aligned with ensuring the right incentives were in place for Auckland Airport to act efficiently and consistently with the long-term interest of consumers over PSE3. In particular, we did not think it was appropriate to introduce a wash-up mechanism without also taking steps to preserve the incentive for Auckland Airport to invest efficiently throughout the pricing period, and to preserve the ability for Auckland Airport to efficiently delay or repurpose capital expenditure and/or efficiently substitute between capital expenditure and operating expenditure. In that context, we did not think it was efficient to introduce layers of complicated wash-up and corresponding incentive mechanisms to effectively preserve the same balance of incentives that would already exist under the building blocks approach to price setting.

• Although BARNZ has some concerns about the deliverability of the capex programme, it acknowledges that airlines and Auckland Airport share the objective of achieving the capital projects through an ongoing capital planning consultation process. BARNZ also acknowledges that airlines have a part to play in supporting the airport to deliver fit-for-purpose and efficient capital investments.[42] We agree, and this is our focus for PSE3. As we explained in our final pricing decision:

  - Capex may be lower than forecast in a pricing period because we have made efficient trade-offs between operating and capital expenditure, or because demand has been lower than expected and we have responded appropriately by slowing the capital expenditure programme. In these circumstances, we think the better question for interested parties is the overall efficiency of Auckland Airport's total expenditure, and whether Auckland Airport has incentives to find the overall lowest cost way to provide services over the long term. We do not think it is efficient to introduce a mechanism that may encourage Auckland Airport to favour capital expenditure if that is not the most efficient outcome, or the option that best meets customer needs over the pricing period, particularly as circumstances change. Rather, we think it is more efficient for Auckland Airport to repurpose funds, if required to, where the need is highest, without overly distorting the outcomes that were intended to be delivered by the capital plan.

  - Robust consultation that supports the delivery of the right investment in an efficient and timely manner is important to Auckland Airport. In that context, we are cautious about

[40] BARNZ *Response to Revised Pricing Proposal*, 20 April 2017 at page 14.

[41] There were also some practical challenges with the wash-up mechanism proposed by BARNZ, including that it would wash-up based on a forecast of capex in the final year of the pricing period.

[42] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 18.

introducing a wash-up mechanism that may provide incentives for some airlines to use ongoing consultation on capital expenditure as a mechanism to stall investments in order to invoke the wash-up process.

– At the same time, we recognise that sometimes consultation takes longer than planned for good reasons – such as the extended consultation on Pier B, which airlines consider was crucial to reaching a good outcome for all parties for that particular project. In this way, a project can be delivered later than its forecast commissioning date if additional consultation is required to ensure that the scope and function is likely to best meet customer needs – i.e. for reasons that all parties agree are efficient. On balance, we think there are risks that a wash-up mechanism may distort the consultation process and could interfere with the current incentives that all parties have to ensure efficient and timely, yet thorough, consultation takes place.

- We also note that Air New Zealand did not request a wash-up on capital expenditure at any stage during the pricing consultation process, and did not comment on or express any views in support of BARNZ's request for a capex wash-up. Although Air New Zealand has now raised concerns regarding the deliverability of Auckland Airport's capital expenditure during PSE3, it also acknowledges that a significant portion of the forecast investment relates to large projects which will not be delivered until the end of PSE3 or during PSE4.[43] As we explained to airlines during the pricing consultation process, this was an important factor in our decision not to include a wash-up on capex as part of our pricing decision for PSE3 – because this capex does not in fact influences prices for the next five years.

- We respond to airline claims that investment has been happening too late at Auckland Airport in the following section. On the biosecurity point raised by BARNZ, we note that BARNZ has acknowledged delivering service quality and innovation requires collaboration across multiple parties. Parties have differences in priorities but there is a heightened need for collaboration in the lead time for delivery of new projects. For example, there are a range of initiatives that can provide incremental growth in the processing capacity for the current MPI arrivals space ahead of investment in new infrastructure. Some of these have already been delivered and lead to increased capacity, as reported between FY16 (with the facility at 121% of capacity in the peak hour) and FY17 (with the facility at 89% of capacity in the peak hour). Further initiatives are planned or under development.

Auckland Airport's investment approach and conduct

BARNZ and Air New Zealand's submissions also question Auckland Airport's conduct in relation to capital expenditure forecasting and delivery. These comments are very surprising to Auckland Airport. They do not reflect our investment planning and delivery approach, and they are not consistent with feedback from airlines about how we engage with our customers on capital planning at the time of pricing and on an ongoing basis.

For example, near the end of the pricing consultation process substantial customers were provided with an opportunity to present to a sub-committee of Auckland Airport's Board. Airlines of course took this opportunity to draw attention to the substantive issues that mattered to them the most ahead of the final pricing decision. As part of the meetings, airlines were also asked if they had any feedback on Auckland Airport's consultation process. BARNZ confirmed that that the pricing consultation process had worked well, that there had been good exchanges, and that Auckland Airport had been very professional in the material that had been provided to BARNZ. BARNZ also noted that it appreciated the interaction with Auckland Airport on capital consultation, that it understood capital planning was complex, and that it hoped to keep the good dialogue going throughout the pricing period.

Air New Zealand also stated that it was happy with the pricing and capital consultation processes. Air New Zealand executives noted that the capex consultation process had been very collaborative, and that it was producing very good results such as Pier B. Air New Zealand said that it valued discussion of the wider context which had helped broaden understanding,

[43] Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraphs 61 and 64.

and that the terminal consultation process had been better and richer as a result. [

].

Airline feedback has consistently stated that our consultation process works well, that our engagement on capital planning is good, and that airlines appreciate our willingness to work alongside them as we move into more detailed design and delivery of the forecast programme. This is reflected in other parts of the airlines' submissions on the Process Paper, where:

- BARNZ states that Auckland Airport's consultation on capex projects is probably the best of any airport in New Zealand. BARNZ considers that overall the airport engages well with consumers on capital planning, and has introduced a suitable governance framework for its upcoming capital projects that BARNZ and other airlines are participating in.[44]

- Air New Zealand notes that significant further consultation is underway regarding the concept and detailed design of much of the planned capital expenditure.[45]

- Although the Qantas Group has some questions over the quantum, staging and deliverability of several projects, it notes that it is working closely with Auckland Airport on the scope and concept design of the plan.

Auckland Airport is clearly committed to ongoing consultation through the period as the capital plan is delivered, and we have established a purpose-built consultation forum going forward – which BARNZ acknowledges is a suitable governance framework for upcoming capital projects. This demonstrates Auckland Airport's genuine commitment to responsible and robust capital planning heavily informed by airline feedback – as well as the actions we have taken to develop a governance and consultation framework for this step up in capex through PSE3 that will allow airlines to monitor Auckland Airport's performance against the capital plan and robustly understand proposed variations in projects, timing, and cost.

Given this feedback, and the constructive way that airlines engage with us during capital consultation, we are disappointed at comments in airline submissions claiming that Auckland Airport is engaged in monopoly behaviour when it comes to capex forecasting, that we are not acting as good stewards of monopoly infrastructure, and that Auckland Airport has priced above its true expected capex for PSE3 so that we can "under-deliver" and achieve a higher return.[46]

BARNZ and Air New Zealand rely on a combination of theoretical incentives and commentary from one analyst to suggest that Auckland Airport has priced above its true expected capex for PSE3, and is intending to under-deliver on capex over the coming pricing period so that it can achieve a higher return. BARNZ also puts forward its view that the pattern of commissioned assets at Auckland Airport over PSE2 is consistent with a profit-maximising strategy under the regulatory framework, and implies that Auckland Airport deferred capex until near the end of PSE2 in order to earn higher profits.

In response, we note that:

- We can understand why airline customers may have been upset by the inaccurate Forsyth Barr reporting of our investor day. As we explained to customers through the pricing consultation process, Auckland Airport has developed a robust central capex forecast which has both upside and downside risk. Our audio recording of the investor day discussion shows that Auckland Airport reinforced our commitment to the PSE3 plan to investors, but also recognised that we need to manage infrastructure investment responsibly – which may include changes to the plan if we are faced with material changes in market conditions, such as a massive global event similar to the global financial crisis. We noted that the five-year plan was relatively locked, although we also referenced the well-established regulatory principle that airports should try to find opportunities to optimise

[44] BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at page 19.
[45] Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraph 62.
[46] E.g. Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraphs 34-35; BARNZ *Assessment of AIAL's PSE3 Pricing Decision against Part 4 Criteria*, 28 November 2017 at pages 19-21.

their capex programmes while still delivering the same outcomes and same service levels. We acknowledge that explaining our investment plan and pricing decision to the market is an ongoing education process, and that aspects of the detail can be difficult to understand. We will continue to take steps to ensure that investors and analysts understand our approach. We have written to Forsyth Barr to ask for a correction of their report, and a transcript of the capex comments made during the investor day is attached as **Appendix B** to this cross-submission.

- The design process is iterative and there are far reaching interdependencies. Auckland Airport appropriately works closely with our customers on draft information on a confidential basis, and does not update the market until clear decisions are made and the portfolio implications are understood.

- We have continued to engage with airlines on the next stage of design and delivery of the capital plan since the end of the pricing consultation process. As parties to the consultation will know, these conversations suggest that there may in fact be an increase in airline requirements compared to the assumptions that underpin the base case capital expenditure forecast.

- It is important for Auckland Airport to retain the incentive to deliver the capital programme within the forecast aeronautical capital plan values for PSE3. Whether or not this is achievable will only be known in the fullness of time. The annual information disclosures will provide that context ex post.

- BARNZ's discussion of our PSE2 capex performance does not fully reflect the context for the variations between the forecast and actual capital delivery over this period, as explained in the commentary to our annual disclosures.[47] BARNZ has theorised that Auckland Airport was acting on its incentives to delay capital expenditure in 2013 and 2014. The information disclosures provide greater context to the situation. We note that:

  – When prices were set for PSE2, BARNZ described Auckland Airport as the "poster-boy" for consultation. Through the section 56G process, BARNZ told the Commission that our forecast capital expenditure represented efficient, sensible and appropriate responses to the areas of capacity constraint in then-current facilities, and made sensible use of existing space. BARNZ was also supportive of our proposal to consult separately on the new terminal facility outside the process for setting standard charges. Air New Zealand told the Commission that it considered Auckland Airport's capital expenditure forecasts for PSE2 to be reasonable, and the capital expenditure programme to be a good reflection of customer requirements during this period. Air New Zealand also noted that our consultation on capex was "robust, transparent and inclusive".

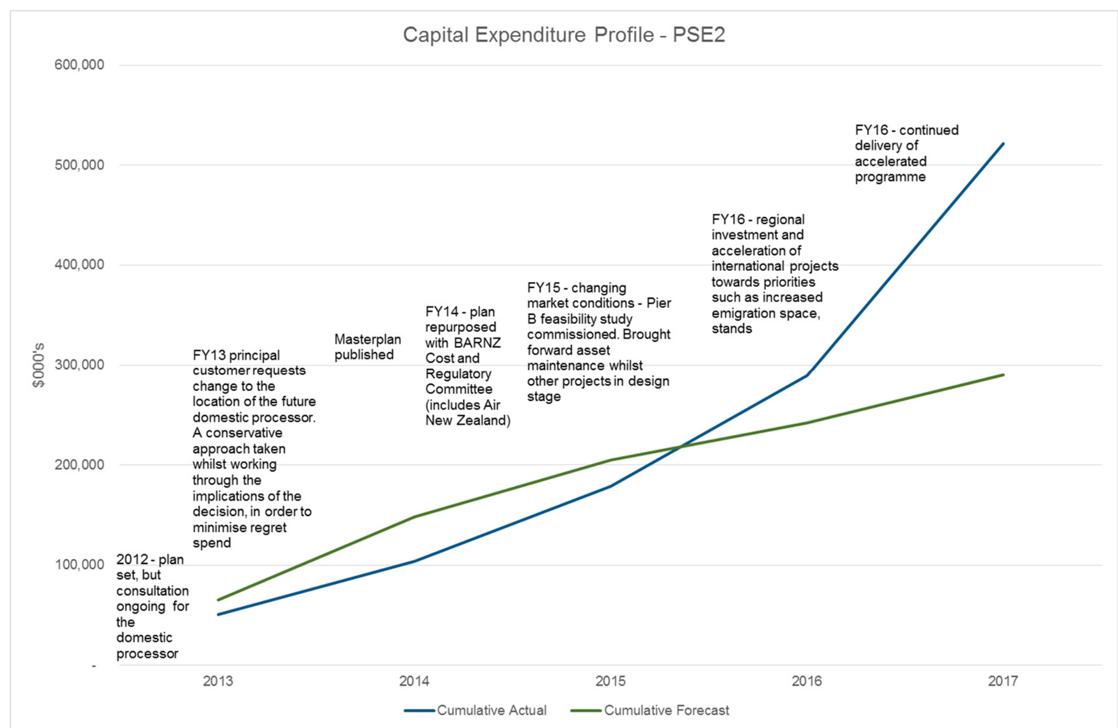
  – Over PSE2, we have taken a disciplined and efficient approach to capital planning and investment delivery. In the early years of PSE2 (when demand was tracking broadly to forecast), we deferred and repurposed investment to reflect new information that emerged as the Masterplan was finalised. The primary driver of the difference between actual and forecast investment in these early years stemmed from a customer request to change the location of the future domestic processor relative to the base case capital plan. Once it became clear there was a prospect of change to a material Masterplan assumption, we took a conservative approach in consultation with our airline customers by not commencing works that would be impacted by the location of the future terminal – to minimise regret spend. After the decision was made to change the location of the domestic processor to the South, and the new Masterplan was finalised, a number of meetings occurred with the airlines on the extent to which the capital plan should be repurposed following this key change. The repurposed plan was responsive to airline recommendations. The circumstances resulted in changes to some projects, a delay to the intended timing of other projects, a need to introduce operating cost solutions over

[47] Auckland Airport FY13 Annual Disclosure, Schedule 6, page 10. Auckland Airport FY14 Annual Disclosure, p7 and Schedule 6.

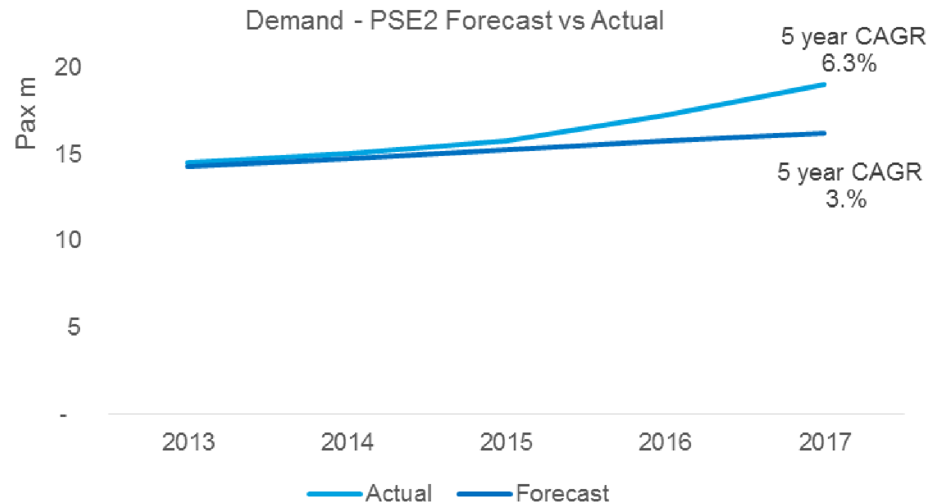
capital solutions in some instances and an acceleration of some asset replacement projects.

- By mid-2015 there were signs of material growth for the forthcoming Christmas, and Jetstar announced its decision to enter into the regional market. This unforeseen event materially reduced available headroom, particularly on the airfield. Market conditions changed rapidly, and Auckland Airport saw a 67% increase in the number of airline customers and an almost 30% increase in the number of passengers over the rest of PSE4. This is a rapid change for any business – and a remarkably fast change for airport infrastructure that involves natural lead times in the design and delivery of infrastructure, and where it is important to ensure that airlines have a good opportunity to contribute to the design process. This has created some challenges over PSE2 as we have sought to respond to changing conditions as quickly as possible, while maintaining service quality as far as possible in the face of rapid demand growth.

- As shown in the chart below, Auckland Airport was responsive to airline requirements and changing market conditions throughout PSE2. Consultation commenced around pier development options in June 2015 and continued steadily, and we worked alongside our airlines to accelerate the capital programme – ultimately spending 80% more than forecast at the time prices were set. Key changes to the capital plan set out in pricing for PSE2 were consulted on with our major airline customers and BARNZ, and we understand that airlines supported the repurposed programme.



- Ultimately, Auckland Airport seeks to provide timely investment that is demand-led, but we acknowledge that forecasts cannot be 100% accurate and it is not always possible to deliver investment perfectly on time, given the long-lead times involved in designing and constructing airport infrastructure. If conditions change rapidly, this can create periods where congestion is experienced before new capacity comes on-stream. This has been the case at Auckland Airport at times in 2016 and 2017. But, it is a fine balance – if we invest too early, we are faced with accusations of over-investing. As the demand chart below shows, we had no cause to advance the investment programme in 2014, and we do not believe our customers were ready to support the acceleration of the programme at that time either.



Finally, we reject any assertions from airlines that Auckland Airport under-invested in aeronautical infrastructure in order to increase dividend payments to investors, including the $454m capital return. Actually we invested $230 million more in PSE2 than the forecast. And during PSE2 consultation, airlines requested that we remove the pier B expansion from the agreed baseline plan. Ultimately, once conditions had changed, we agreed to go ahead and build it anyway. The capital return was solely to achieve credit rating stability as we were on credit watch positive. Had we not taken action, we would have received an unwanted credit rating upgrade that we would not be able to support in the future if/when capex levels increased materially. Credit rating instability, especially when existing investors are hot with mark-to-market valuation losses after a credit rating downgrade - could adversely impact our ability to raise borrowings, putting the capex programme at risk.

Cost allocation of capital expenditure plan

We are pleased that Air New Zealand's submissions acknowledge that the current cost allocation plans for forecast capex may be appropriate. Although Air New Zealand considers that the plans remain high level, it acknowledges that a significant portion of the forecast investment relates to large projects which will not be delivered until the end of PSE3 or during PSE4 – i.e. will have a minimal impact on prices for PSE3. As noted by Air New Zealand, the final allocations will depend on what is actually built and the functions carried out within those facilities.[48] When prices are set for PSE4, much greater information will be available to inform these allocations – which will then underpin future prices once the assets are commissioned.

BARNZ's comments on cost allocation do not appear to be directed at the allocation of the capital expenditure plan, although it states that direct costs appear to be allocated to the correct places, and notes that the approach to cost allocation once the domestic jet facility is commissioned will be an important issue. However, BARNZ acknowledges that Auckland Airport has excluded the new processor from PSE3 charges – which it considers to be a very reasonable approach.[49]

The key theme of BARNZ's comments on cost allocation is the appropriateness of the terminal space rule for the allocation of common operating costs. This issue is of limited relevance to the forecast capital plan. As we explained in our main submission, Auckland Airport took a robust approach to cost allocation of forecast capital expenditure, where cost allocation of larger projects in the plan was based on the nature and purpose of the projects, and business as usual projects were allocated based on assumptions resulting from a deep dive of current business as usual projects. Auckland Airport provided information to airlines showing the unallocated value of capital projects, the regulated allocation, and the pricing allocation. As we explained

[48] Air New Zealand *Response to the Process and Issues Paper*, 28 November 2017 at paragraphs 61 and 63.

[49] BARNZ *Review of Auckland and Christchurch Airport's Third Price Setting Events – Appendix,* 28 November 2017 at page 17.

in our first submission, Auckland Airport was guided by the input methodologies and the expected use of the activity on commissioning when allocating the forecast capital plan – and sought to allocate assets directly where possible. The company-wide allocation rule was used to allocate costs for a handful of projects only.

In this cross-submission, we do not respond to BARNZ's comments on the use of the ITB space rule for general cost allocation purposes, as this appears to be outside the proposed scope of the Commission's review. However, we note that through the pricing consultation process, Auckland Airport provided detailed information to airlines on our proposed allocation methodology and the resulting allocations for both costs and assets. Air New Zealand acknowledged that Auckland Airport's approach to cost allocation has been consistently applied since 2006 and has been subject to review by both airlines and the Commission since that time. Air New Zealand agreed that the cost allocation methodology was reasonable and that the adjustments proposed to translate information disclosure cost forecasts to pricing cost forecasts were appropriate.[50] Air New Zealand was also comfortable with Auckland Airport's asset allocation methodology and considered the resulting allocations appeared reasonable.

7. Conclusion

As we explained in our price-setting disclosure, Auckland Airport considers that our pricing decision has delivered a fair and reasonable outcome for PSE3 that is consistent with the long-term interest of consumers. Our pricing decision results in a decrease in average revenue from standard charges on a per passenger basis for all passenger segments (international, domestic and regional) at the start of PSE3, and overall charges for airlines remaining broadly flat in real terms over the period – both before and after the Runway Land Charge is included.

During our pricing consultation, we carefully considered all feedback from our customers, and our decisions were heavily informed by the available regulatory guidance – particularly when developing our target return and considering whether it was appropriate to introduce the Runway Land Charge (including the nature, timing, and level of the charge). We consider that our conduct throughout has been consistent with the spirit of the Part 4 regulatory regime and with our past commitments (including our approach to restating our asset base and factoring a moratorium adjustment into prices for PSE3).

Overall, we consider that our pricing decision for PSE3 is reasonable given the substantial investment in airfield and terminal infrastructure that we are forecasting to deliver over this period and which is essential to providing quality services to our customers. On average over the next five years, we are forecasting to spend the equivalent of $15 for every passenger on standard infrastructure, and $1.90 for every passenger on second runway infrastructure.

In this context, we do not accept airline views that we are targeting excess returns. We consider that our target return for PSE3 strikes the right balance between acknowledging the airport-specific challenges and risks we will face at this stage in our investment cycle, providing a return that will help incentivise and support the delivery of an investment plan that provides significant long-term benefits for consumers, and demonstrating that we have been cognisant of the Commission's airport sector-wide views and the need to minimise the pricing impact for our airline customers and passengers. Our approach shows that we have carefully considered the regulatory framework and feedback from our substantial customers as key constraining factors, and sought airport-specific evidence to support and justify our approach.

When setting charges, Auckland Airport has also sought to balance economic principles which promote efficient pricing with price structures that are simple for the airport and airlines to administer. Further, we have sought to make use of policy tools alongside pricing signals to help encourage efficient outcomes.

We recognise that service performance will be a key focus for PSE3, and Auckland Airport remains committed to providing quality services to our customers. As part of our pricing

[50] Air New Zealand *Feedback on Information Pack 3 (Cost drivers, forecasts and allocations)*, 29 November 2016 at page 1.

decision for PSE3, we have committed to building on the existing constructive and collaborative approach to service performance by establishing a working group on service levels. The aim of this working group is for the airport, airlines and key stakeholders to work together to develop a set of service measures that all parties value, and to formalise the process for notification and rectification of service level matters.