Mrs. Charlotte Reed
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New Zealand Commerce Commission
Input Methodologies Review 2023
PO Box 2351 Wellington 6140
New Zealand

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By e-mail: IM.Review@comcom.govt.nz

Dear Mrs. Reed,

INPUT METHODOLOGIES (IM) REVIEW ON AIRPORT SERVICES - IATA CROSS-SUBMISSION COMMENTS

IATA commends the Commerce Commission (the Commission) for transparency in its IM review by making all the submissions received available and allowing stakeholders to provide additional comments through this consultative process. Our cross-submission does not contain any confidential information and can be published unaltered by the Commission on its website.

Several themes have emerged from the submissions made by New Zealand Airports Association and the airport operators/investors. Our comments below are to dispel the erroneous notions and assumptions made, and to reiterate the need for the Commission to maintain its proposed changes outlined in the Draft Decisions.

1. Regulatory Framework

Christchurch International Airport Limited (CIAL) reminded the Commission that the current regulatory framework permits airports to set their own prices, i.e., there is no legal obligation for the regulated airports to adhere to the views of the Commission. This further demonstrates that there is an underlying indifference and lack of regulatory impetus for airports to approach consultations and negotiations with fairness and on a level footing with those they are consulting or negotiating with, leading to an undesirable adverse state for all parties. Unless this regulatory gap is addressed, the Commission will not be able to fully deliver outcomes that mimic a competitive environment for the regulated airports which are indisputably monopoly service providers.

Airport Service quality monitoring – IATA would also like to reiterate that there is currently no regulatory mechanism to effectively monitor airport performance in return for the facilities and services airline users pay for. The current ID regime requires the airport to report on its own performance but falls short of establishing the expectations/targets which would need to be agreed upon with users i.e. airlines. There is a direct cost relatedness between the facilities and services airports provide, and airport charges airlines pay for – any customer should expect an understanding of the service quality and level of service. However, this is not the case. The impact of this is likely to be poor passenger experience and asset reliability, with a focus on the airports unnecessarily sweating their assets and focusing on commercial revenues, rather than consumers and airport users. The IM can be further strengthened in this area by specifying the service level expectations/requirements with a clear link to the pricing of the specified airport services (and the overall rate of returns for the airport operator).

2. Regulatory Certainty

The submissions by New Zealand Airports Association and the airport operators argued that the changes being considered by the Commission undermine the purpose of the IM to promote stability and predictability – *"airports are asking for certainty by maintaining the regulatory status quo*". We can only deduce that this is in reference to threatening their expectations of high returns enjoyed over the years, which the Commission is attempting to rectify through the current IM Review. By the same argument, airport users would expect the same commitment from airports for stability and predictability, but this is currently a far fetch reality based on airlines' past experiences and given the current light-touch regulatory regime, evident in AIAL's Price Setting Event 4 (PSE4) announced recently.

While we understand that reforms to the regulatory regime are not within the scope of the current IM Review, IATA remains convinced that the Commission would need to strengthen its regulatory framework and be accorded the necessary authority to more directly regulate the airports with significant market power in New Zealand; such as allowing the Commission the authority to determine and authorize the level of charges similar to other regulated industries, or at the very least more readily invoke the negotiate-arbitrate requirement with an effective regulatory backstop of price-regulation. This will help deliver outcomes that meet its primary purpose as set out in Part 4 Section 52A of the Commerce Act more effectively, and to provide the certainty that all parties are looking for.

3. Asset Beta and WACC

A considerable amount of efforts by the airports have been to challenge the asset beta and changes to the comparator airports adopted by the Commission. We can all agree that these can only be estimated in the absence of real/actual asset or equity betas. Perhaps, in addition to the current approach, it is timely for the Commission to consider moving towards assessing and determining the efficient levels of Opex and Capex specific for each regulated airport that will lead to a more accurate level of reasonable returns?

Airports have restructured their finances during the pandemic by relying on debt/bond funding which will be recovered from users over the coming years. This, to a certain extent, leads to the questionable arrangement of airports recouping their losses (e.g. incurred during the COVID-19 pandemic) in coming years unless there is a clear process of segregating the losses and writing them off. We request that the Commission consider and review this aspect to ensure that no recovery of losses is allowed.

Certain arrangements, such as the wash-up mechanism introduced by AIAL in PSE4 will lower their business risk on the demand side (i.e. clawing back the under-recovery in the next price-setting period) and this should be taken into consideration by the Commission.

While the regulated airports operate under a dual till arrangement, it would be useful for the Commission to have sufficient visibility of information concerning the non-aeronautical activities as well, in addition to the specified airport services. This will enable the Commission to establish a holistic view; to understand the overall performance and profitability of the airports and make better regulatory decisions.

The submissions from the airports have several claims that the Commission has not complied with its framework and disregarded the previous decisions by the High Court, followed by the threat of legal repercussions[1] if the Commission does not maintain the regulatory status quo.

IATA advocates for regulatory independence to allow economic regulators such as the Commission to implement the necessary changes to deliver its mandates effectively. The approach and or decision by the Commission should (ideally) not be subject to other influences and interventions including the Civil Court system which can be a protracted and costly process, further undermining the authority of the Commission, and leading to more uncertainties (rather than certainty as claimed by the airports).

4. Savings will not be passed on by airlines to passengers[2]

Reading these submissions, it gave the impression that the airport operators are attempting to divert the focus and discussion of the IM Review on **specified airport services** by raising the unsubstantiated notion that airlines will pocket the reduced (airport) aeronautical charges. The submissions by the airports also hold misguided views that recent increases in airfares are a direct proxy for airlines' profitability.

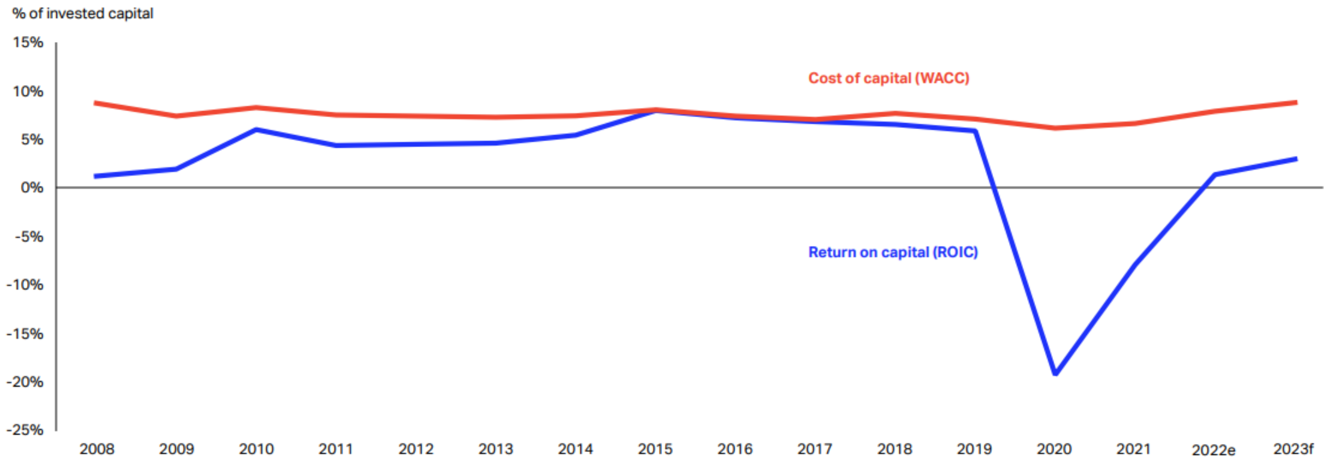
It is important to note that airfares have decreased significantly since the start of commercial air travel with much-improved service offerings due to intense competition. On the contrary, we continue to see increases in airport charges (and fees and

[1] WIAL's submission "expose the Commission to no small legal risk if its draft decision is not reversed"
[2] AIAL's submission "Commission must consider the likelihood that reduced aeronautical charges flow through to lower airfares for passengers, or higher airline profits"

taxes) and demand for higher returns by airports while airlines have mostly been in the red. When we do make a profit, it is far from what the airports and their investors are demanding.

Historically the air transport industry has struggled to deliver the returns that equity investors expect for risking their capital. Put another way, the return on invested capital (ROIC) is typically lower than the weighted average cost of capital (WACC), as depicted in the chart below.

Chart 24: Return on capital invested in airlines globally, 2008-2023

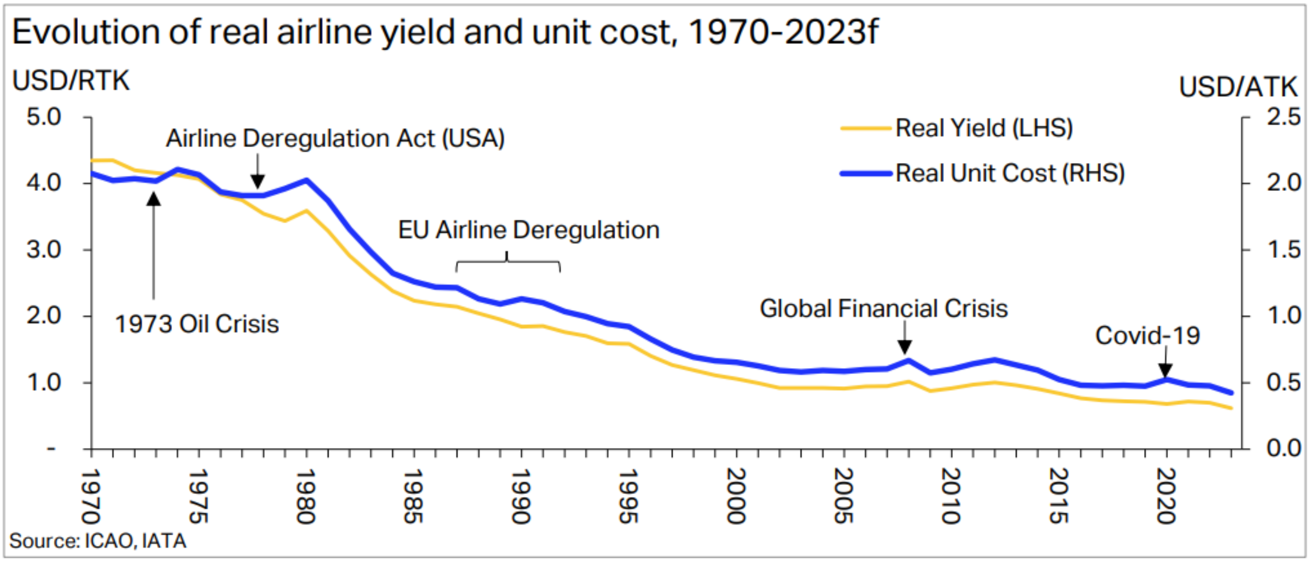


Source: IATA Sustainability and Economics

Airlines are operating in a very competitive environment and fares are set optimally by considering various factors; notably passenger demand (and cargo) for the seats or capacity available, and operating costs such as commercial jet fuel plus various charges, fees and taxes imposed outside the control of aircraft operators. Airlines would also need to employ a network view instead of isolating a particular airport and the routes served from that location in the review of its business strategy and asset allocation etc. to secure a level of often elusive profitability.

Over the past five decades, the airline industry has seen a remarkable decrease in real unit costs by over four times, and a nearly six times reduction in real yields. This trend, fuelled by technological progress and significant regulatory changes, remained consistent even through the various global macroeconomic shocks the industry faced over the years, and it is expected to continue in 2023.

Declines in unit cost and yield expected to continue in 2023



From the analysis above, we can see that the real yield of airlines has tracked very closely to the real unit cost over the years. This is clear evidence that the reduction in costs e.g. reduction in airport charges has no strong link to increasing the airlines' yields i.e. profitability as claimed by the airports. The industry is returning to profitability in 2023, only three years after the historic loss of USD 140 billion in 2020. Total airline revenue is expected to recover to around 93% of the 2019 figure, with operating profits reaching USD 22.4 billion. The net profit forecast for this year is USD 9.8 billion, and the net margin is a slim 1.2%. This equates to USD 2.25 per passenger.

The focus of the IM Review should be on establishing effective policies and a conducive environment to support a robust and competitive aviation market; by delivering competitive outcomes through the regulatory intervention of the monopoly service providers i.e. airport operators. The Commission has set out to do this through this IM Review, and we fully support this endeavor and the draft decisions.

5. **Claims that airlines are against capital investments**

The suggested notion by airports that airlines would prefer constraints in capacity such as through delays in airport investment to benefit from higher airfares is perplexing. This is untrue as IATA and the airline community have always advocated for demand-driven, timely delivered, functional and cost-effective investments. Our members' key focus is to meet their passengers' expectations and overall experience from the point of origin to their destination. This includes the services provided by others in the aviation value chain, such as airports, air navigation and ground service providers. For this reason, meaningful and effective consultation leading to alignments and agreements is necessary.

The airports have alluded to in their submissions[3] that lowering the expectation on their returns would lead to investments being withheld by their investors. This further demonstrates the significant market power these airports have to extract the maximum returns, to the detriments of services and their customers. A case in point is the recent PSE4 announcement made by AIAL. The admission that the airport is in catch-up mode is clear evidence of negligence/under-investment on its part in not executing proper infrastructure planning over the years, and not only due to the COVID-19 pandemic as claimed. This will inevitably result in a higher overall development cost due to the delays and more projects to be implemented within the same

[3] AIAL's submission: "Investor response calls for aeronautical investment to be reduced", "If the DD is carried into the Commission's final cost of capital IM determination, then the unjustifiably low and unpredictable returns that the Commission will find acceptable going forward will undoubtedly cast serious doubt in the minds of Auckland Airport management, the Board, our lenders and our shareholders as to the commercial business case for that investment. It already has."

(small) window, with airport users picking up the high(er) costs (and operational impacts) from the delayed aeronautical investments.

The underlying issue is a lack of an effective economic regulation enabling airports to behave in this way – ineffective regulatory controls and a lack of incentives to encourage collaboration, consensus decision making and meaningful engagement detrimentally impacts users and consumers.

Key issues include:

- Demand triggers for investment to balance capacity and demand. What infrastructure capacity is required to balance demand, and can this be phased to ensure forecast growth in passenger numbers offsets the costs of investment? This has not been discussed or agreed with the airline community, nor are the underlying traffic forecasts essential to agree upon. We are concerned that excessive capacity could be developed, adding unnecessary costs to the airline community in the next period.

- Lack of meaningful consultation on facilities design and development – what concepts, options, and functionality have been developed and selected, and how do these meet airline users' needs now and in the future? Without effective and meaningful consultation with users throughout key stages of the development process, the airport is simply guessing what users' requirements are. Have the most operationally efficient solutions been selected, that also optimize customer experience with the flexibility to change and grow over time?

  Meaningful consultation is a fundamental requirement missing from the Commission's approach, in order for it and users in the consumers' interest to have assurance investments are required, at the proposed costs. This should be presented as a detailed business case, with a clear return on investment for users paying for these projects. All projects need to be justified, including those relating to sustainability and "green investments."

- Capital efficiency – airports are not held to account or incentivized to be efficient through regulatory or market mechanisms, and airlines receive no assurance value is being delivered e.g. the more airports spend on capital investments, the more return they will receive – this is perverse and particularly sensitive at the current time given post-pandemic recovery period and challenging conditions. As a bare minimum airline should reasonably expect consultation and assurance regarding a number of topics to answer the following questions e.g. :

  - How are prices being benchmarked externally to ensure the best value?

  - How does the procurement strategy offset construction price inflation and leverage economies of scale?

  - Should airports overspend, or deliver project benefits late, what are their implications?

  - How are opex and lifecycle costs considered in the context of capital investments? Unit costs should reduce resulting from any new capital investments

Unless these points are consulted upon and scrutinized in detail, airports have little incentive to be efficient.

We encourage the Commission to review these two IATA best practice papers and consider incorporating the approach in the current regulatory regime; if not in the current IM Review, for other relevant regulatory reviews in the future:

- Airport Infrastructure Business Cases

- Airport Infrastructure Investment – User Consultation

Furthermore, under the dual till approach, we can see airports shifting their focus over the years to grow and enhance the non-aeronautical business at the expense of aeronautical services. This further validates our view that the current regulatory regime must be improved with regulatory intervention strengthened to drive the necessary behaviours and regulatory outcomes.

IATA is committed to supporting the efforts of the Commission by improving and strengthening the IM regime to yield more effective and balanced outcomes. Feel free to contact us should clarification is required or if IATA can support the Commission in any way.

Yours Sincerely,

[redacted]

Matteo Zanarini
IATA Area Manager South West Pacific
[redacted]

cc Richard Tan, IATA Regional Manager Operations, Safety and Security – Asia Pacific