



Section 53B review of Auckland Airport's price setting disclosure for PSE3: response to process and issues paper

28 November 2017

PSE3 at Auckland Airport: Key elements of pricing decision



\$1.9 bn capex, prices flat

- \$1.9 billion investment programme (2017 dollars) including forecast delivery of domestic jet facility by FY22; taxiway, stands and apron investment; expansion of international check-in, public dwell, and MPI / arrivals areas; second runway earthworks
- Average real revenues per passenger (2017 dollars) decreasing by 1.7% per annum for international, increasing 0.8% per annum for domestic (excluding Runway Land Charge)



Pace of demand growth slowing

- Very strong growth from FY15 to the end of PSE2 (FY17)
- Overall forecast growth of 3.7% per annum over FY17-FY22
- 4.2% per annum forecast growth for international passengers, 3.2% per annum for domestic passengers
- Published 10-year demand forecasts for passengers, landings, and MCTOW – totals and busy hour / day forecasts



Commitment to service quality

- Commitment to establish working group on service levels
- Aim is to define monitoring measures, assess baseline and set targets, track metrics to understand baseline performance, and to agree process for improving below target performance
- Commitments to improve bussing and baggage handling



Increased pricing efficiency

- Runway Land Charge – recovers holding costs on land held for stage 1 of the second runway. Effectively incentivises industry to collectively exceed targeted efficiency improvements on the existing runway or trigger construction in/after FY21
- Airfield parking charges – targeting improved stand and apron efficiency. Charges apply after 6 hrs, some exemptions
- Check-in – different prices for different check-in options
- Different charges for domestic passengers on trunk and regional routes

PSE3 at Auckland Airport: Key priorities for FY18-FY22



Delivering an efficient capital investment programme



Earning a fair and reasonable return over time



Committed to operating efficiently and effectively



Consumer-centric approach, delivering value and choice



Delivering quality services and meeting customer expectations



PSE3 at Auckland Airport: Robust consultation and response to customer feedback

Consultation Milestone	Date
Consultation overview and initial briefing	June 2016
Informal early discussions with substantial customers	June – Sept 2016
Release and exchange of information and exploratory views – three information packs released for review and feedback, with meetings held to discuss each pack and written responses invited	Sept – Nov 2016
Draft Proposal released	Dec 2016
Meetings with customers on Draft Proposal and written responses received and considered	Feb – March 2017
Revised Proposal released	March 2017
Meetings with customers on Revised Proposal and written responses received and considered	March – April 2017
Substantial Customers meet with Board sub-committee	May 2017
Final Pricing Decision	8 June 2017
New standard charges operative (unless expressly identified as delayed implementation)	1 July 2017

- Auckland Airport aimed to facilitate an effective and meaningful consultation process, and valued the feedback we received from substantial customers
- Priority was to ensure the consultation process gave sufficient information and time for customers to consider and provide views on Auckland Airport’s proposals
- Supported by inputs from separate consultation on terminal development plan for international and domestic facilities (commenced Jan 2016)

1. Introduction

The Commerce Commission (“**Commission**”) has commenced its review of Auckland Airport’s third price setting event, covering prices for the July 2017 – June 2022 period (“**PSE3**”).

In this submission, we:

- Endorse NZ Airports’ views on the proposed scope of the review;
- Explain the impact of information disclosure regulation on our pricing decision; and
- Respond to the topic areas and the Auckland Airport-specific questions in the Commission’s process and issues paper, including providing our views on the approach to assessing our performance for each topic area.

This submission should be read alongside Auckland Airport’s price setting disclosure for PSE3, published on 1 August 2017. The price setting disclosure provides an overview of Auckland Airport’s pricing decision, supporting rationale, and relevant information and forecasts.

This submission should also be read alongside the submission from the NZ Airports Association on the review, which Auckland Airport is a party to and supports.

2. Scope of the section 53B review

Auckland Airport supports NZ Airports’ submission on the appropriate scope of and approach to the s53B review, and the associated regulatory framework issues discussed by NZ Airports.

We wish to emphasise that the focus of the s53B review should be on summarising and analysing the decisions and approaches summarised in Auckland Airport’s price setting disclosure. Although we understand the Commission is interested in airline views on our pricing decision, we stress that Auckland Airport was only able to consider and respond to those views shared with us through the pricing consultation process. The s53B review should therefore focus on our conduct at the time our pricing decision was made, based on the information available to us at that time.

3. Impact of information disclosure on transparency of Auckland Airport’s pricing decision

As we explained in our price setting disclosure, Auckland Airport was materially guided by the information disclosure regime when developing our aeronautical pricing decision. We are conscious that all parties were engaged in the development of the regulatory regime, and we felt it was sensible to leverage the considerable resources that have been invested in that process when setting prices. Where appropriate, Auckland Airport adopted approaches that are consistent with the Commission’s methodologies and/or with the spirit and intent of Part 4 regulation.

However, we were also conscious that the Commission’s approaches represent a sector-wide model that has been developed for the purpose of performance monitoring. Although these approaches informed our thinking, we considered it was appropriate to ensure we adopted pricing approaches that best reflected the circumstances and pricing considerations unique to Auckland Airport. As noted above, we nevertheless sought to align approaches to be consistent with the information disclosure regime where appropriate.

The Commission is interested in understanding whether the recent amendments to the IM and ID determinations for airports were effective in promoting greater transparency.¹ The

¹ Commerce Commission *Have your say on the review of Auckland and Christchurch Airports’ third price setting events (July 2017 – June 2022): Process and Issues Paper*, 20 October 2017 (“**Process and Issues Paper**”) at paragraph 25.

Commission is particularly interested in whether these amendments have been effective at increasing the transparency of target profitability at Auckland Airport.²

Auckland Airport is committed to working constructively with the information disclosure regulatory regime to increase transparency about our pricing approaches and performance over time. Consistent with this objective, we made a number of decisions through the pricing consultation process that were designed to ensure transparency of Auckland Airport's performance and target profitability. We discuss these decisions further in response to the Commission's specific questions on profitability (in Section 4.1 below).

4. Comments on topic areas and response to Auckland Airport-specific questions

Auckland Airport's price setting disclosure provides interested parties with a range of information about our pricing decision, with supporting explanations and evidence where appropriate. Auckland Airport has also provided the Commission with a copy of the reasons paper provided to airlines in support of the final pricing decision for standard aeronautical charges, which includes our consideration of and response to airline feedback through the pricing consultation process.

We anticipate the Commission will carefully review these documents as part of its s53B review, and have tried to avoid repeating material in this submission. If there are parts of Auckland Airport's pricing reasons paper that the Commission wishes to rely on in its draft decision but which are not yet publically available, we are happy to work through these issues with Commission staff.

In the following sections, we provide some brief comments on the topic areas and specific questions raised by the Commission in its Process and Issues Paper.

4.1 Profitability

4.1.1 Overview of our decision and approach

Auckland Airport's approach to setting the target return for PSE3 is set out in detail in our price setting disclosure. This includes a detailed explanation of why Auckland Airport's target return is appropriate in the context of our airport-specific circumstances, as well as information about how the information disclosure framework and airline feedback influenced our final decision.

Our price setting disclosure also explains the difference between our target return on aeronautical pricing assets (set following airline consultation), and the effective return for other regulated assets (the product of market leases that are periodically renegotiated with our customers).

The effective return on Auckland Airport's total regulatory activities is 7.06% - which is the combination of the target return for aeronautical pricing activities (6.99%) and the forecast revenue for other regulated activities. As noted in our price setting disclosure, the forecast revenue for other regulated activities is based on negotiated leases with a range of maturities 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 cycle reset on 1 July 2017. For this reason, there is a slight difference between the target return for aeronautical pricing activities (approximately 92% of Auckland Airport's regulated asset base) and the effective return for Auckland Airport's total regulated activities.

² Process and Issues Paper at paragraph 45.

4.1.2 Assessing our target profitability

During the IM review, the Commission provided some guidance about its approach to profitability assessment, including the relationship between its published cost of capital estimate (the regulatory WACC) and an airport's target returns.

We welcomed the Commission's clear statements throughout the review that airports are not subject to regulatory price control and do not have to apply the mid-point regulatory WACC estimate when setting prices or for disclosure purposes.³ We also took comfort from the Commission's assurances that the mid-point regulatory WACC estimate was not supposed to be a "bright-line test" for assessing airport profitability.⁴ That said, we recognised that the mid-point regulatory WACC would be a key reference point for the Commission when analysing our pricing decision, and that we would need to carefully explain why Auckland Airport's circumstances required an airport-specific target return.

We interpreted the draft and final IM Review decisions to mean that the regulatory WACC was just one part of the information set that the Commission would refer to as part of its future assessments of airport profitability, and we strongly agreed that was the right approach.⁵ As we discuss below, this understanding informed our view at the time of pricing that our target return for PSE3 was fair and reasonable.

Auckland Airport also agrees with NZ Airports' submission on the assessment of airport profitability. In particular, we note the following points:

- There is considerable judgement involved in estimating the WACC and determining an appropriate return for a business – as the Commission is aware from its own experience. Although we have provided explanations for the approach that we ultimately took, with this approach informed by expert evidence, we trust that the Commission will recognise that it is not possible for evidence to quantify the relevance of every contextual factor or to provide an exact answer about the optimal level of return. We also trust the Commission will continue to recognise the potential for estimation error when dealing with WACC estimates (which Auckland Airport sought to address through our pricing consultation process by taking guidance from a range of data points).
- We are concerned at suggestions the Commission may generate a different estimate of our expected return for PSE3 and/or make adjustments to our disclosed returns. We understood that the Commission decided to generate its own estimate of airports' expected returns when assessing our PSE2 decisions because the information disclosure templates did not ask airports to state their overall target return at that time. This is no longer the case under the new information disclosure requirements. The internal rate of return disclosed in Schedules 18 and 19 represents our pricing intent for PSE3, uses the calculation methodology prescribed by the Commission, and is consistent with how we understood the Commission would estimate our effective target return.
- Like NZ Airports, we have some doubts about the value of scenario analysis for interested parties. The focus of the review should be on what Auckland Airport has done, not assessing what might have been the case if different inputs were used or a different calculation method adopted. Although we acknowledge that actual outcomes will differ to forecast, we undertake a robust process to generate unbiased projections informed by airline feedback, expert advice, and the interdependency between different forecast variables. We would be concerned if scenario analysis effectively amounted to second-guessing pricing inputs that have been subject to rigorous internal testing and which have been debated and refined through a robust consultation process.

³ Commerce Commission *Input methodologies review draft decisions: Topic paper 6 – WACC percentile for airports*, 16 June 2016 at paragraph 41; Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for airports*, 20 December 2016 at paragraph 36.

⁴ Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for airports*, 20 December 2016 at paragraphs 123-124.

⁵ Auckland Airport *Review of Input Methodologies: Submission on Commerce Commission Draft Decision*, 4 August 2016 – see e.g. paragraph 48.

- The Issues Paper notes that there are theoretical incentives for airports to be conservative in projecting demand for services, and aggressive in projecting expenditure, such that there is a higher likelihood of demand being greater than forecast, and a higher likelihood of expenditure being less than forecast. As we have done in the past, we encourage the Commission to assess Auckland Airport based on our real-world conduct rather than by reference to these types of theoretical incentives. Auckland Airport's track record demonstrates a fair and balanced approach to aeronautical pricing (including the development of forecasts), informed by independent evidence and supported by thorough engagement with our customers.

4.1.3 Response to specific questions

Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Auckland Airport?

Auckland Airport works hard to provide transparency about our regulated business. As the Commission will be aware, decision-making in regulated sectors can be complex – particularly when considering the appropriate target return. Our price setting disclosure is extensive and seeks to provide a thorough description of our target profitability and other aspects of our pricing decision. We consider that we have done everything possible to ensure that interested parties (including the Commission and airlines) have a clear understanding of the decisions we have made and the supporting rationale.

The recent amendments to the IM and ID determinations have enabled us to provide increased transparency about Auckland Airport's pricing approaches and therefore we consider they have been effective at increasing the transparency of target profitability. For example:

- Auckland Airport carefully considered the impact of the changes made by the Commission to the asset valuation input methodologies in the 2016 review in light of the moratorium on revaluations for assets related to Aeronautical Pricing Activities first introduced in PSE1 (the “**moratorium**”). Ultimately, we decided that the best way to provide transparency to interested parties about Auckland Airport's approach was to restate our regulatory asset values to exclude revaluations from the start of the information disclosure regime. Auckland Airport used these restated regulatory values as a starting point to determine the asset base for determining Standard Charges. As such, the amendments to the asset valuation IM have allowed Auckland Airport to reflect our moratorium in our information disclosure asset values going forward – eliminating the previous mismatch between “pricing” and “regulatory” asset values.
- Auckland Airport also elected to make and disclose a further downwards adjustment to remove the impact of revaluations between the start of the moratorium in 2006 and the start of the information disclosure regime in 2010 – using the carry-forward mechanism introduced by the Commission in 2016 to provide transparency to airlines and interested parties about the impact of this decision. In this way, the inclusion of a carry-forward mechanism in the ID determination has enabled us to provide additional transparency about the ongoing impact of the moratorium – allowing Auckland Airport to clearly demonstrate the difference between our information disclosure and pricing asset values (due to the impact of the moratorium before the start of ID regulation).
- When considering whether to introduce the Runway Land Charge, and the appropriate mechanism for the charge, we carefully considered how interested parties would be able to assess the impact of this charge over time. We considered that the ultimate form of the charge – a separately identifiable charge disclosed and tracked against the value of land held for future aeronautical use – was consistent with providing clear transparency and understanding over time (BARNZ preference during input methodology workshops). Auckland Airport was therefore able to provide transparency about its runway land charge using the new forecast assets held for future use schedule in the ID determination, supported by the IM changes that clarified revenue on assets held for future use should be

disclosed on a post-tax basis. These changes mean that interested parties can see the forecast impact of this charge, and will be able to track its impact over time through annual disclosures. The ID amendments also required Auckland Airport to explain its approach to the runway land charge – providing information to help interested parties understand the rationale for the charge.

- A key feature of the changes made by the Commission in 2016 was the addition of an internal rate of return (“**IRR**”) disclosure schedule to the price setting disclosure requirements. Auckland Airport used this IRR disclosure template to share information with airlines through the pricing consultation process – providing a consistent tool that allowed airlines to understand the impact of our proposals and final decision. This also meant that the information provided to airlines about our profitability through the pricing consultation process matched the information that was later publicly disclosed – consistent with greater transparency.
- The changes to the ID determination also required Auckland Airport to disclose the difference between its target return on the sub-set of aeronautical activities covered by standard charges (and consulted on with airlines through the pricing consultation process) and the effective return across total regulated activities. We anticipate that interested parties who requested this breakdown of forecast information will value the information that has been provided.
- We were guided by the input methodologies in our modelling approach, and invested in a peer review of the pricing model by the regulatory team of a big-six accountancy firm.
- When our pricing decision and price-setting disclosure were made public, we supplemented the announcement and the information disclosure templates with presentations that focused on explaining key elements of the pricing decision using graphs and charts to help interested parties to understand our approach.
- When assessing target profitability and Auckland Airport’s overall performance, we recognise that consumers may be more interested in actual or expected changes to the services they receive. We acknowledge that material parts of the services provided by airports are “behind the scenes”, and we are continuing to assess how we can better explain our approach to consumers. A tangible starting point is to describe to the travelling public what is on the investment horizon at Auckland Airport, including through the use of information boards and interactive tools that aim to increase the accessibility of information about our upcoming capital projects. Our latest investment interactive will be publically available in early December at airportofthefuture.co.nz.

Is Auckland Airport’s targeted return appropriate and why?

As we explain in our price setting disclosure, Auckland Airport has sought to develop an airport-specific target return for PSE3 that is informed by a wide set of data points and which represents a fair return on investment and an affordable price path for customers.

Our target return has been informed by the Commission’s view on the industry-wide cost of capital that it uses for regulatory monitoring purposes, guidance from the Commission and its expert advisor about how that industry-wide cost of capital would be used to assess airport profitability, expert advice on the Auckland Airport-specific cost of capital and feedback from our substantial customers through the pricing consultation process.

In particular, at the time we set prices, we understood that the Commission:

- Acknowledged that it was for airports to determine the appropriate level of return to target in pricing and to explain why their target return is in the long-term interests of consumers, including by reference to airport-specific factors and broader contextual issues;⁶
- Recognised that airport target returns could be above the mid-point regulatory WACC for a variety of legitimate reasons;⁷
- Agreed that care needs to be taken when using the regulatory WACC to assess airport profitability;⁸ and
- Would take a flexible approach to its profitability assessments in the future, which would include robust consideration of the airport-specific and wider contextual factors put forward by an airport in support of its target return.⁹

We anticipated the Commission's assessment approach in the s53B review would be consistent with this guidance.

More specifically, we anticipated that the Commission's approach to profitability assessment would reflect the expert advice that it received from Professor Yarrow through the IM review process. As we set out in submissions through the IM review,¹⁰ we understood Professor Yarrow's advice to be that:

- There is a clear, conceptual distinction and separation between the exercise of setting a WACC for information disclosure, and assessing information that has been disclosed about airport returns.¹¹
- There is also a clear conceptual distinction between the allowable rate of return in a regulatory context (for airports, the "acceptable" or "appropriate" rate of return) and the cost of capital, including a solid theoretical justification for why an appropriate rate of return should be above the cost of capital.¹²
- For the purpose of assessing disclosed information and making judgements about airport performance, assessing whether airport returns are appropriate is not as simple as comparing ex ante or ex post returns estimates to a WACC estimate (regardless of the percentile value of that estimate).¹³
- Where returns are different to any given WACC estimate, that does not mean those returns are excessive, and it would be arbitrary to conclude they were without analysis of the underlying reasons for any differences. A broad contextual assessment is required, and the published WACC estimates should not have primacy in that assessment.¹⁴

Overall, Professor Yarrow cautioned that the application of great care was required when using the regulatory mid-point WACC as an indicator of reasonable price levels under an information disclosure regime, particularly when that assessment is made on a forward-looking basis. In his view, assessing the appropriate target return for a business is a judgement that can only be made on the basis of all relevant factors that might reasonably be taken into account.¹⁵

⁶ Commerce Commission *Input methodologies review draft decisions: Topic paper 6 – WACC percentile for airports*, 16 June 2016 at paragraphs 62, 88-89.

⁷ Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for airports*, 20 December 2016 at paragraphs 87, 94, 154, 170.

⁸ Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for airports*, 20 December 2016 at paragraph 58.

⁹ Commerce Commission *Input methodologies review decisions: Topic paper 6 – WACC percentile for airports*, 20 December 2016 at paragraph 91.

¹⁰ Auckland Airport *Response to Commerce Commission's emerging views on the WACC percentile for airports*, 16 March 2016.

¹¹ Professor George Yarrow *Expert advice on airport WACC percentile*, February 2016 ("**Yarrow Paper**") at page 19, 20-21.

¹² Yarrow Paper at pages 11-12, 20.

¹³ Yarrow Paper at page 4, 6, 8, 20, 22.

¹⁴ Yarrow Paper at page 4, 6, 8, 20, 22.

¹⁵ Yarrow Paper at page 20.

Auckland Airport agrees with this view. As such, we shared the range of factors that informed the development of our target return with airline customers for feedback through the pricing consultation process, and explained these factors in our final pricing decision and price setting disclosure. We anticipated the Commission would take these factors into account when analysing Auckland Airport's target return for PSE3.

Ultimately, Auckland Airport considered that a target return of 6.99% for aeronautical pricing activities was in the long-term best interest of consumers:

- We considered that this level of return would 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.
- We 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. This should provide consumers with confidence that we are not targeting excess returns.

We therefore considered that our target return of 6.99% (informed by our forecast WACC range of 6.85% to 8.1%, including NERA's mid-point Auckland Airport-specific WACC estimate of 7.8%) 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.

Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Auckland Airport's price setting event?

The Commission has referenced our statement that Auckland Airport's target return is based on a range of contextual factors, including empirical evidence about our systematic risk and expert evidence from NERA Economic Consulting. However, the Commission goes on to note that Auckland Airport's price setting event disclosure does not contain the evidence referred to by Auckland Airport, and that it would welcome the opportunity to review this.¹⁶

Two reports received from NERA through the pricing consultation process (and provided to airlines through consultation) have been provided to the Commission on a confidential basis as Confidential Attachment A and B. Our pricing decision reasons paper and price setting disclosure explain how we took the NERA reports into account, and the price setting disclosure refers to parts of the reports that we are comfortable being in the public domain. For the avoidance of doubt, we emphasise that the expert advice received from NERA is *part of* the broader evidence set relied on by Auckland Airport to determine an appropriate target return – it is not the only evidence on which our decision was based.

Our price setting disclosure and pricing decision reasons paper contain a considerable amount of contextual evidence explaining how Auckland Airport reached our target return and why that return is fair and reasonable. As the Commission is well aware, determining an appropriate target return is not a precise science, and it is not possible to quantify all factors relevant to that decision. That does not mean these factors are less important or influential, and we anticipate the Commission will thoroughly engage with the explanations and material set out in our previous documents, in addition to its review of NERA's expert advice.

¹⁶ Process and Issues Paper at paragraph 50.

Do the asset values used by Auckland Airport provide an appropriate basis for assessing expected returns and why?

Our approach to determining the opening asset valuations for pricing purposes was described in section 4.2 of the price setting disclosure. We consider these asset values provide an appropriate basis for assessing Auckland Airport's expected returns over PSE3.

As we explained in our price setting disclosure, Auckland Airport was committed to providing regulatory transparency about the asset values used in pricing for PSE3 and any differences between these and regulatory disclosure values. We sought to take an approach that would ensure regulatory disclosures, including the price setting disclosure, would be an accurate forecast of Auckland Airport's target returns. This approach included:

- an extensive bottom-up process to generate restated regulatory asset values for all individual assets – removing revaluations on terminal and airfield assets from the start of information disclosure regulation from the RAB, consistent with the amendments to the IMs made by the Commission in December 2016; and
- using the carry-forward mechanism to disclose the impact of the moratorium on asset revaluations between the start of the moratorium in 2006 and the start of information disclosure regulation in 2010.

We are pleased the Commission has acknowledged that Auckland Airport's approach to restating the RAB appears consistent with the IMs, and that it is unaware of any concerns with our approach to restating Auckland Airport's asset values.

This is a clear example of Auckland Airport's commitment to transparency, constructive engagement with the information disclosure regime, and to honouring our pricing assurances over time. Although the process was extensive and time-consuming, we believed that restating our RAB at an individual asset level and utilising the carry-forward mechanism was the clearest way to provide transparency to airlines, the Commission and other interested parties about the ongoing impact of Auckland Airport's moratorium and the commitment we have made in the event that the moratorium is lifted in the future and a revalued asset base used to set prices.

We signalled this intended approach to airlines from the start of the pricing consultation process, and substantial customers supported our approach. Given the importance of the restated RAB for disclosure purposes, we shared with airlines that our restatement approach and the resulting asset values had been audited. No customers raised concerns with this approach.

Did Auckland Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Auckland Airport's consultation but not implemented and what was the rationale for the proposed adjustments?

Auckland Airport's carry-forward adjustment is made up of two parts – a positive adjustment relating to the recovery of revenue for the Pier B development that was deferred from previous pricing periods, and a negative adjustment to account for the ongoing impact of the moratorium (i.e. the difference in asset values between the start of the moratorium in 2006 and the start of information disclosure in 2010). No customers opposed these adjustments.

Although Auckland Airport made effective use of the carry-forward mechanism in our price setting disclosure to transparently record these pricing arrangements, the disclosed adjustments did not represent changes to the default position on risk allocation for PSE3.

As noted by the Commission, Auckland Airport has not included any other risk allocation adjustments and will bear all of the risks or rewards if actual outturns are different to forecast. We considered this was appropriate for PSE3 and consistent with providing the right incentives to Auckland Airport over the pricing period. We also considered this was consistent with

regulatory guidance from the Commission, which had previously signalled that risks should be borne by the party best placed to control the probability of an occurrence, mitigate the costs of occurrence, and absorb costs where they cannot be mitigated.¹⁷ The Commission had also expressly noted that airports are best placed to manage the risk associated with capex projects.¹⁸ We note that during the forums hosted by Commission staff to assist with its 2016 review of the information disclosure Input Methodologies, these risk allocation principles were clearly communicated to airlines, their representatives and the regulated airports.

As part of the pricing consultation process, Auckland Airport considered risk allocation adjustments proposed by airlines – relating to the timing and quantum of capital expenditure, and to demand forecasts. Auckland Airport carefully considered the airlines' views. On balance, we did not think risk allocation adjustments were required or consistent with encouraging efficient behaviour over PSE3 (including efficient investment delivery).

Ultimately, we considered it was the interaction between demand, opex and capex that makes it appropriate for Auckland Airport to manage and bear the consequences of actual outcomes differing to forecast. For this reason, we considered that wash-ups on capital expenditure and demand forecasts were not appropriate.

Our view on capex risk allocation was supported by our PSE2 performance. Over PSE2, we used a combination of operating solutions and capital solutions in different situations to respond to the circumstances we faced over the pricing period. At the time we set PSE3 prices, our PSE2 period to date performance was within 0.1% of the forecast target return set in 2012, despite material changes between the underlying forecast and actual outcome for a number of pricing elements. Although demand has been higher than forecast, the "reward" from this upside was balanced by higher-than-forecast operating and capital expenditure over the period to respond to that demand, to customer service requirements, and to other changing market conditions. In practice, our ability to trade across all pricing elements through the pricing period – including demand – was a key facilitator of these outcomes.

In summary, our approach means that Auckland Airport is the party bearing the risk and reward for demand, operating costs and capital costs. As such, we:

- Have a strong incentive to ensure that capital expenditure within our control is efficient;
- Have the ability to repurpose capital expenditure in ways that best promote efficiency – including deferring investment where appropriate;
- Are able to adapt our overall operating model and investment delivery to reflect changing demand conditions; and
- Have the right incentives to ensure that total expenditure is efficient, and balance operating expenditure and capital expenditure solutions to provide the most efficient overall outcome.

As we explained to airlines when we set prices, we consider that our demand and capex forecasts are robust and were subject to ongoing refinement following extensive consultation with our substantial customers. As part of our decision that it is appropriate for Auckland Airport to manage the risk for these variables over this pricing period, we have committed to monitoring aeronautical capital expenditure and returns during PSE3 compared to the price setting forecasts, and will seek to balance across multiple pricing elements to respond efficiently to changing circumstances as they arise to the extent possible and to ensure our overall expenditure is appropriate in light of those circumstances – as we did over PSE2.

¹⁷ Commerce Commission *Input methodologies review decisions – Topic paper 5: Airports profitability assessment*, 20 December 2016 at paragraph 389.

¹⁸ Commerce Commission *Input methodologies review decisions – Topic paper 5: Airports profitability assessment*, 20 December 2016 at paragraph 443.

To what extent does the demand forecast, presented by Auckland Airport as part of PSE3, reasonably reflect expectations of future demand and why?

When setting our demand forecast for aeronautical pricing, Auckland Airport seeks to use an objective projection based on the best information available at the time prices are set. For PSE3, Auckland Airport began a comprehensive demand forecasting process in January 2016, when we commissioned DKMA to prepare passenger and air traffic forecasts to inform aeronautical pricing and the parallel capital consultation process on the terminal development plan and domestic processor. An early draft of DKMA's throughput demand forecasts was released to airlines for feedback in May 2016, with feedback and questions from airlines, along with Auckland Airport's own feedback on the report, provided to DKMA in June 2016. The network planning teams were invited to confidentially provide indicative forecasts of annual passengers, landings and requirements by aircraft code by year for the FY17-FY27 period to DKMA. Some airlines took this opportunity.

Auckland Airport released DKMA's updated draft passenger, landing and MCTOW demand report in September 2016 as part of the first information pack shared with airlines in the pricing consultation process, and invited further feedback. At the same time, Auckland Airport invited feedback on DKMA's methodology for developing its busy day forecast. Further feedback on the draft forecasts was invited throughout the pricing consultation process as part of the draft and revised pricing proposals ahead of the final pricing decision.

We made a key change to Auckland Airport's demand forecasting approach for PSE3 compared to PSE2. In PSE2, Auckland Airport developed separate forecasts for aeronautical pricing (based on throughput) and for facilities planning (generally based on peak hour forecasting). For PSE3, we aligned the forecasts – using one independent expert to develop demand forecasts for pricing, capital planning, and second runway timing projections. This gave Auckland Airport a unified set of forecasts based on independent advice and informed by airline feedback and economic and industry commentary.

Auckland Airport considers the final forecasts are fair and reasonable. The use of a single forecast for multiple purposes means that any changes to the demand forecast would imply changes to the level of capital expenditure required over PSE3 and PSE4, as well as impacting the estimated timing of the second runway commissioning. This gave Auckland Airport a further incentive to ensure the demand forecasts used were the most accurate and reasonable projection of future growth.

We acknowledge that actual outcomes will differ because aviation market conditions are dynamic. When we set prices the airport had just experienced two years of rapid growth. We considered there was both upside and downside risk to the demand forecast – with the downside risk in the baseline year highlighted by Emirates announcing the withdrawal of its A380 Sydney-Auckland service on the cusp of the pricing announcement (too late to be incorporated into the forecasts used for pricing). As explained in our pricing decision and price setting disclosure, at the time of pricing we considered that the DKMA demand forecast provided a comprehensive and robust central forecast for capital planning and pricing purposes. Since our PSE3 pricing decision, Emirates has announced further capacity reductions that will cease all its trans-Tasman services to Auckland (cancelling the Melbourne and Brisbane services from March 2018).

We note that:

- Our goal was to reflect the latest thinking when setting the demand forecasts, within the context of broader reasonableness checks. The latest thinking was informed by airline feedback, expert advice, and economic and industry commentary.
- The growth experienced in the last two years of PSE2 was rapid. Auckland Airport has had a relatively stable set of approximately 18 airlines for over 10 years, but this has markedly changed in the last 22 months with the onboarding of 11 new airlines. Growth has been largely driven by the Jetstar domestic expansion, Air New Zealand's and foreign carriers'

international route development and a strong economy (which also includes strong tourism inputs).

- DKMA considered feedback provided by airlines through the pricing consultation process, and emphasised the importance of evaluating the demand forecast within the context of the very rapid recent growth. DKMA considered that “one-off” type events (e.g. Jetstar expansion) were unlikely to be repeated and that while the economy (and tourism) will remain strong, growth is projected to taper off (even from emerging markets such as China). Further, it has become more uncertain – especially in light of the prospective policies that the new US Administration may enact and their potential impact on the global economy.
- At the time we set prices, recent market commentary highlighted the strength of tourism growth to Auckland and New Zealand and how recent growth rates were not sustainable given that oil prices appeared stable, inbound visitor growth rates have peaked and are now declining, airline capacity additions have slowed due to less favourable NZ route economics, and tourism infrastructure will limit near term arrivals growth.

Ultimately, Auckland Airport decided to align the near-term aeronautical pricing forecasts with our forecast FY17 outturn and the FY18 budgeting demand forecast, with the medium-term forecast aligning to DKMA’s projected volumes by FY22.

Are there any concerns that Auckland Airport’s capital or operating expenditure projections are not reasonable?

The basis for our capital expenditure projections are discussed in Section 4.3. In this section we discuss Auckland Airport’s operating expenditure forecasts for PSE3.

As described in section 4.4 of our price setting disclosure, Auckland Airport aimed to set a fair and reasonable operating cost forecast for PSE3 based on known information about service level requirements and forecast changes / trends. We also tested the efficiency of our operating costs through benchmarking.

Auckland Airport used our forecast outturn for the year ending 30 June 2017 as the base to forecast operational expenditure for the FY18 corporate Budget and then incorporated the Board approved FY18 Budget forecasts into year one of the FY18-FY22 aeronautical pricing forecasts. Forecasting was then undertaken to determine the company-wide operating costs for the remainder of PSE3. Specific adjustments were made for any anticipated changes to the baseline (positive or negative). For each key area of operating cost, cost drivers were estimated to establish forecast operating costs for PSE3. Auckland Airport also sought to identify any forecast efficiency gains, which may help to reduce forecast growth in operating costs.

When preparing its operating cost forecasts, Auckland Airport also considered requests from airline customers to both increase and reduce service levels. In response to these requests, Auckland Airport quantified the cost impact of the changes, tested proposals with customers to understand to what extent there were aligned views on whether service levels should change, and made changes to the operating cost forecasts where we considered that was appropriate.

As explained above, Auckland Airport has used the same base operating cost forecast to inform the Aeronautical Pricing Decision as the company-wide budget for FY18.

Ultimately, we consider that Auckland Airport has developed an efficient and reasonable operating cost forecast for PSE3. Operating costs per passenger are forecast to reduce in real terms over PSE3 from the FY18 forecast, consistent with realistic per passenger reductions in operating cost items where possible over the period. Having said this, we note that it is not realistic to expect continuing per passenger reductions in all operating cost line items across all time, particularly:

- in light of the complexity created during brownfields developments and periods of high construction; and

- since Auckland Airport has, for a long time, had a highly efficient cost base compared with global airport comparators and now faces intensive development after a long period where economies of scale have been delivered.

Are there concerns relating to Auckland Airport's introduction of a contingent 'runway land charge'? In particular, is the proposed timing of Auckland Airport's returns on its assets held for future use appropriate?

Section 6 of Auckland Airport's price setting disclosure provides a comprehensive summary of the rationale and justification for the Runway Land Charge. As discussed in that disclosure, Auckland Airport's objectives behind the Runway Land Charge was to provide a tool that can help create a sustainable price path for the second runway development over time and to provide a clear price signal to airlines on the limits of the existing runway.

Essentially, Auckland Airport carefully considered all relevant guidance on assets held for future use provided by the Commission and the High Court, and made a decision that we firmly believed should be acceptable to the Commission because it promoted the long-term benefit of consumers.

As we explained in our price setting disclosure and final reasons paper:

- Auckland Airport considers the long term benefit of consumers is better promoted by the introduction of the Runway Land Charge compared to an approach of only recovering accumulated holding costs once the runway is commissioned. Over the long term, the Runway Land Charge will lower the price at commissioning of the second runway and therefore required landing charges relative to no Runway Land Charge, as compounded holding costs will reduce;
- the Runway Land Charge ensures a more equitable distribution of currently accruing holding costs over both current and future users;
- the introduction of a small Runway Land Charge in PSE3 also provides greater confidence that the second runway will be constructed when needed, because a small step has been taken toward smoothing prices and making the new capacity more affordable to airlines and their passengers over the long term;
- the charging mechanism is linked to an existing cost that is currently accumulating through PSE3 on specific and existing land assets that are currently held by Auckland Airport for the second runway development;
- the forecast revenues provide for a only a partial recovery of currently accruing holding costs, which together with the \$50 million second runway expenditure trigger provides the right incentives for Auckland Airport to seek to maximise the efficiency of the existing runway and commission the second runway at the right time;
- Auckland Airport considers the charge is consistent with economic principles, including providing signals about the cost of demand in the transition to a second runway. The presence of the charge and its trigger-based nature provides airlines with a clear signal and a corresponding opportunity to influence when the charge comes into effect through behaviour change that could efficiently delay the need for the second runway (e.g. involvement in initiatives with the Airfield Capacity Enhancement programme to increase the efficiency of the existing runway by adopting new pilot operating protocols, peak spreading);
- the charge is also consistent with and has been informed by available regulatory guidance, including a consideration of the impact on Auckland Airport's indirect incentives. Auckland

Airport has also taken guidance from the High Court, which has indicated that price smoothing in advance of commissioning future assets may be economically efficient;

- we have not been able to find evidence of other global airports that systematically exclude unimproved land from the regulatory asset base for pricing purposes; and
- the information disclosure regulatory regime enables the revenue from the Runway Land Charge to be transparently disclosed and tracked over time because it has been established as a separate identifiable charge.

When we set prices, we anticipated that the Commission would have reference to its, and the High Court's, previous guidance when analysing the introduction of the charge.

For example, in the context of considering the rules that apply to the disclosure of Auckland Airport's aeronautical regulatory asset base, the High Court has:¹⁹

- Agreed that price smoothing ahead of the commissioning of future assets may be an economically efficient approach;
- Indicated that this might suggest some inclusion of the value of soon to be commissioned assets in the regulatory asset base in an information disclosure context, but (faced with an "all or nothing" choice) ultimately considered that full inclusion of future use assets would not necessarily deliver the right incentives in all circumstances; and
- Been clear that airports will not be precluded from price smoothing under the Commission's input methodologies and information disclosure approach, but are required to identify and justify their approach.

Further, as part of the review of its input methodologies and information disclosure rules completed in 2016, the Commission has now made changes so that:²⁰

- Revenues associated with assets held for future use are clearly not part of an airport's regulatory income – instead, these revenues are disclosed and assessed separately from revenues on the general regulatory asset base;
- There will be no immediate expectation of excessive profits if an airport chooses to price in a way that recovers revenue associated with assets held for future use; and
- It can track and assess the extent to which early revenues have been returned to airlines, and can assess if an airport's approach to charging for assets held for future use is NPV-neutral.

We also note that the Commission's original rationale for excluding land held for future use from the aeronautical regulatory asset base for information disclosure purposes was not based on an analysis of outcomes in workably competitive markets. The Commission considered that there could be a range of outcomes in workably competitive markets ahead of the commissioning of significant new capacity, and that there was no specific pricing or disclosure treatment implied by this comparison. Instead, its rationale for excluding this land was based on the indirect incentives it would create, and the Commission was clear that it did not want its approach to provide incentives for airports to acquire or hold land imprudently. It also considered that the risk of any non-development of this land should lie with airports rather than consumers.²¹

The Commission also recognised that its decision to exclude land held for future use from the information disclosure asset base could lead to airports attempting to commission new capacity

¹⁹ *Wellington International Airport Limited v Commerce Commission* [2013] NZHC 3289 at paragraph 919.

²⁰ See *Commerce Commission Input methodologies review decisions – Topic paper 5: Airports profitability assessment*, 20 December 2016 at paragraphs 581-586.

²¹ *Commerce Commission Input Methodologies (Airport Services) Reasons Paper*, 22 December 2010 at paragraphs 4.3.74-7.3.79.

imprudently or in advance of the time that they otherwise would have (although it considered that interested parties would be able to assess whether such an attempt has been made).²²

We designed the Runway Land Charge to strike the right balance in the face of these potentially competing incentives. In particular, introducing this charge:

- Does not create any concerns about Auckland Airport having “indirect incentives” to imprudently acquire or hold land. We understand that all parties agree that it is prudent for Auckland Airport to hold this land for the second runway development, and we greatly appreciate the support of our airline customers and BARNZ through the ongoing planning processes and statutory protection exercises to preserve our ability to develop this land for future runway use;
- Is consistent with ensuring that Auckland Airport has no incentive to commission the second runway into use before it is efficiently required, by providing for only a partial recovery of currently accruing holding costs and by requiring at least \$50 million of expenditure to have been incurred (largely on permissions and design) before the charge can begin. Although we emphasise that the Runway Land Charge will recover holding costs that are being incurred today, and does not seek to recover construction costs, we note that Auckland Airport’s forecast Runway Land Charge revenues of \$37 million (post tax, in nominal dollars) over PSE3 compare with our forecast second runway related capex over the same period of \$270 million (in nominal dollars). As we note elsewhere, we are committed to working with Airways and our airline customers to increase the effective capacity of the existing runway in order to maximise its efficiency and delay the need for the second runway if possible; and
- Is linked to a decision to commence construction of a second runway, and therefore does not pass any risk of non-development of this land to consumers.

The general analysis of incentives reflected by the Commission in its original IM decision and referred to in its 2016 IM Review also reflects commentary from the Commission’s 2002 inquiry into airfield services at Auckland, Wellington and Christchurch Airports. In that decision, the Commission made the following comments (emphasis added):

The Commission considers that, given the judgemental nature of the decision to commence acquiring land, which falls largely to AIAL, and from which point net holding costs start to accrue, it is appropriate that AIAL bear the risk of non-development. That risk should provide some incentive on AIAL not to acquire land imprudently. However, as noted above, AIAL would recover its costs, so long as the land is developed. This approach would require net holding costs (on the historic cost of land) to be accumulated, rather than charged out on an annual basis. **The Commission also considers that the appropriate point for the capitalised net holding costs (on the historic cost of land) to enter the charging base is once construction has commenced. From that point, the risk of non-development largely ceases to exist. They consider this is similar to the risk that AIAL would bear in a competitive market.** However, it is recognised this might create an incentive for AIAL to bring forward a development, or start early and take longer to complete, in order to commence charging sooner. The capitalised net holding cost (on the historic cost of land) to that point should be treated as a specialised asset, to be written off over the medium-term. From that point, the land would be valued at opportunity cost in the asset base.

In summary, we believe that the Runway Land Charge aligns with the indirect incentives the Commission has sought to establish under its IMs. Aligning the charge with construction commencing should remove any concern that a charge will weaken Auckland Airport’s incentive to efficiently develop the land for aeronautical use. Further, it is consistent with the flexibility provided by the new information disclosure assets held for future use revenue tracking mechanism, and will better promote the long term interests of consumers compared to an approach of only recovering accumulated holdings costs once the runway is commissioned.

In setting the level of the charge and the right time to introduce it, Auckland Airport has had regard to previous regulatory guidance on when it is reasonable to recover the holding costs of

²² Commerce Commission *Input Methodologies (Airport Services) Reasons Paper*, 22 December 2010 at paragraphs 4.3.74-7.3.77.

land. On balance we consider that more closely aligning the timing of the charge with the decision to move from design to construction will better enable interested parties to form a view on whether the airport is attempting to commission capacity at the right time, and is consistent with available regulatory guidance.

Has information disclosure assisted in promoting stakeholder understanding of Auckland Airport's proposed approach to the 'runway land charge'?

As part of the IM review, the Commission developed a tracking mechanism which allows interested parties to clearly track all revenue collected in relation to an asset held for future use before it enters the RAB at commissioning. The Commission also indicated that airports would be able to use the carry-forward mechanism to disclose the impact of any such charge if it could not be separately identified.

As noted earlier in this submission, when considering whether to introduce the Runway Land Charge, and the appropriate mechanism for the charge, we carefully considered how interested parties would be able to assess the impact of this charge over time. We considered that the ultimate form of the charge – a separately identifiable charge disclosed and tracked against the value of land held for future aeronautical use – was consistent with providing clear transparency and understanding over time (BARNZ preference during input methodology workshops).

In our view, the information disclosure amendments provide consumers with confidence that Auckland Airport's intention is that any dollar collected will serve to reduce long-term landing charges in an NPV-neutral manner. Information disclosure means that there will also be continued oversight of how the charge is accumulating and how its NPV-neutral impact is accounted for over the course of time.

Auckland Airport also notes that the information disclosure amendments, and the introduction of the runway land charge appeared to be well-understood by investment analysts. The reports on Auckland Airport's pricing decision and price-setting disclosure indicated that analysts had a strong understanding that the charge is intended to be NPV-neutral, and will be offset against the value of the land held for the second runway when it is commissioned into the RAB.

4.2 Pricing efficiency

4.2.1 Overview of our approach

Auckland Airport seeks to set prices that reflect the costs driven by the consumption of our services, and which reflect the application of efficient pricing principles. As the Commission has noted, Auckland Airport has largely carried forward the pricing methodology and structure from PSE2 – which was considered to be consistent with efficient pricing principles by the Commission.

As explained in our pricing decision and price-setting disclosure, we have made some changes to our pricing structure in PSE3 to help promote increased efficiency where we think that is appropriate, implementable, and likely to deliver operational or other efficiencies in practice. This included the introduction of aircraft parking charges to help promote more efficient utilisation of airfield infrastructure, a new charging structure for international check-in that is differentiated by check-in mode to encourage more efficient use of terminal space, differentiated charges for domestic and regional passengers, and the Runway Land Charge which provides a pricing signal and should encourage airline customers to work with Auckland Airport and Airways to increase the productivity of the existing runway, potentially efficiently deferring this significant infrastructure investment.

4.2.2 Assessing our decision and conduct

Auckland Airport agrees with the Commission's proposal to not focus on areas where we have largely continued the pricing structure approaches from PSE2. In particular, we welcome the Commission's view that it does not have particular concerns about cross-subsidisation, the ability for consumers to make price-quality trade-offs, or lack of transparency at Auckland Airport.²³

When assessing the efficiency of our prices, we encourage the Commission to focus on summarising and analysing the decisions we have made, rather than questioning whether we should have taken a different approach. We think some care is also required when considering concepts such as peak pricing. In our experience, the potential efficiency advantage of price structure changes needs to be carefully considered alongside practical factors (including substantial implementation complexities) that can affect the likelihood of achieving increased efficiency in practice. As we explain below, although we are not ruling out the concept of peak pricing at Auckland Airport in the future, we did not consider it was the right approach for PSE3 at the time we set prices.

4.2.3 Response to specific questions

Does Auckland Airport's pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?

The Commission has noted that Auckland Airport's pricing structure does not currently incentivise any change in peak demand. It intends to consider whether the absence of congestion charging could send inefficient signals about the timing of the planned second runway.²⁴

In summary, Auckland Airport's decisions reflect our views that:

- Peak pricing would be complex to implement, and it was not clear how this would assist Auckland Airport to help smooth the price path ahead of the commissioning of the second runway; and
- We would continue to work with airlines to promote efficient use of the runway, and to ensure investment in further capacity occurs at the right time. We committed to leading an industry forum to target increased efficiencies of the existing runway. One possible outcome is that investment in the second runway is deferred, such that the Runway Land Charge is not triggered in PSE3.

Peak pricing was not a major issue in the pricing consultation process. However, ahead of the final pricing decision we considered whether peak pricing could be a viable alternative to the Runway Land Charge, by providing a way for Auckland Airport to send pricing signals within the overall building block implied revenue. As we explained in our pricing decision and price-setting disclosure, we remained of the view that a Runway Land Charge was the best way to help smooth towards the commissioning of the second runway, and we did not consider that peak pricing provided an appropriate approach in light of the challenges we will face over PSE3. At the time of pricing, we considered that:

- Although the Runway Land Charge was consistent with economic principles (including providing signals about the cost of demand in the transition to a second runway), Auckland Airport's primary objective behind the Runway Land Charge was to provide a tool that could help create a sustainable price path for the second runway development over time. We also considered that the Runway Land Charge would provide a very clear pricing signal that the second runway is required at Auckland Airport in the near-term unless the industry can work together to change behaviour and efficiently delay the need for the runway. The

²³ Process and Issues Paper at paragraph 75-76.

²⁴ Process and Issues Paper at paragraph 22.1.

trigger-based nature of the charge gives airlines the opportunity to adjust their behaviour to avoid triggering the Runway Land Charge in FY21 – if they consider it is efficient to do so.

- Following the commissioning of the second runway, there is unlikely to be runway congestion that warrants peak pricing differentials. If there is no reason for a peak differential after the second runway is built, then the objective of price smoothing over time is not helped by the introduction of a peak differential now. In particular, while peak charges might help to smooth the price path for peak services by increasing prices now and bridging the gap between today's charges and the implied prices at the time of the second runway, managing these increased prices within the overall building blocks revenue would result in lower off-peak charges compared to today's levels. This would mean that prices for off-peak charges today would be taken further away from the implied price when the second runway is commissioned – creating an even larger price spike for off-peak services at the time of commissioning and exacerbating the problem that we are trying to address. This does not appear to be an efficient outcome or one which is consistent with the long-term interest of consumers. On balance, we consider it is more efficient for the charging structure and price points in the transition to the second runway to be set closer to what the prices would be like after the second runway is built for all passengers.
- Further, as we get nearer to the need for the second runway, demand is forecast to grow and build across the operational day, with the traditional “peaks” becoming less peaky relative to the off-peak periods. This suggests that introducing a peak pricing differential to help address the second runway price spike would be increasingly complex as the peak becomes harder to precisely define, and may end up putting a higher burden on peak traffic when the impact of demand growth across the day on performance and resilience will also be a key factor that influences the timing of the second runway investment.
- Introducing peak pricing would not help to address the impact of the land currently held by Auckland Airport for the second runway development, which is continuing to compound in value over time as holding costs are accrued each year. We continue to consider that a charging mechanism that attempts to address this problem is in the long-term interest of consumers as we transition to a two-runway airport.
- The trigger-based nature of the Runway Land Charge means that material construction decisions will have been made before the charge takes effect, and Auckland Airport will be on a pathway to the commissioning of the second runway. Although peak demand will be a key contributor to the need for and timing of the second runway, the broader resilience of the runway system will also be a key factor in the decision to commence construction on 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. As noted above, this resilience – impacted by traffic across the full operational day – will be a key factor that influences the timing of the second runway investment and the decision to start construction. For this reason, given the charge is to be introduced once a decision to start construction has been made, we consider it is fair and equitable for the charge to apply to all consumers.

Before reaching our final pricing decision, we also considered whether there was merit for peak pricing more generally as part of Auckland Airport's price structure for standard aeronautical charges (that is, whether it should be implemented in addition to the Runway Land Charge). In doing so, we reflected on whether peak pricing has the potential to reduce congestion, provide better signals about the costs of new capacity investment, and could drive efficiency benefits for consumers at Auckland Airport.

We noted that a number of airports world-wide include peak pricing as part of their charging structure, differentiating by season and/or time of the day, and that this can be part of an efficient pricing approach. However, we also acknowledged that the potential efficiency benefits of peak charges can vary considerably depending on the unique nature of individual airports.

To assist in our decision-making, we sought expert advice from Estina on whether peak pricing would be an economically efficient addition to Auckland Airport's pricing structure for PSE3. This advice was provided to airlines as part of our final pricing decision and will be provided to the Commission on a confidential basis (as Confidential Attachment C). In Estina's view, there would be some merit to introducing a peak pricing differential, but there are a number of complex issues that need to be considered. Overall, Estina's considered that there is no compelling case to introduce peak charging for PSE3 at Auckland Airport. We note that:

- Estina advised that peak differentials are more commonly seen at airports that do not have an obvious expansion option and where secondary airports can take some of the load during peak periods.
- Estina advised that peak differentials would need to be dynamically applied to be effective – because the application of a peak differential to move demand out of the peak period shifts the timing of that peak period. Estina notes that as congestion grows the peak period will gradually expand, and the shoulders between peak and off-peak pricing periods can drive perverse behaviour – reinforcing the need to be able to dynamically shift the definition of peak and shoulder periods for pricing purposes. As Estina notes, the idea of setting charges based on shifting peak, shoulder, and off-peak times does not fit neatly with the five yearly consultation process. In Auckland Airport's view, it would also be extremely challenging to provide price certainty and stability to customers over a five-year pricing period if peak periods were to change as demand shifted in response to peak pricing differentials.
- Estina reflected on whether congestion pricing could be used to inform a peak differential – by reflecting how demand at peak causes congestion costs such as delays or lack of availability. However, Estina's view is that users at peak times would directly bear nearly all of these congestion costs, and would not need to be charged any additional costs to provide clear signals about the cost of congestion.
- Estina advised that there may be a case to consider peak pricing to reflect capacity cost drivers if a service provider intended to build capacity to the level of uncongested or unconstrained peak demand – on the basis that reducing peak demand can result in delays to the timing of capacity investment. However, Estina was also clear that the setting of peak differentials to reflect capacity investment timing would be extremely complex, and would require significant work on forecasting demand and costing work. In Estina's view, it was not clear that introducing a peak differential would cause a material and beneficial change in behaviour compared to allowing demand to adjust to the congestion costs experienced in the lead-up to the building of new capacity such as the second runway and/or new apron and terminal infrastructure.
- In this context, Estina also advised that there is a very challenging practical problem in defining what parts of the year/month/week/day should be treated as peak, and how often that decision might need to be reviewed based on responses to the peak prices. In particular, as capacity increases leading up to an investment decision, demand is likely to be spread across a larger portion of the operational day. Peaks will remain, but will be less "peaky" as the overall demand profile increases – i.e. the differential between peak and off-peak demand will be less. This means that the impact of the peak demand on investment timing will also be smaller – making it more difficult to justify the "right" price differential between peak and off-peak periods over time.

Ultimately, Auckland Airport agreed that there was no compelling case to introduce peak pricing in PSE3 to send signals about the second runway timing or more generally, and that adherence to policy options would provide a better solution to the management of congestion issues for the next five years.

On balance, we considered that differential pricing for peak and off-peak operations would be very complex to implement in practice, for little or no efficiency benefit in this pricing period. In particular, it was not clear to us that introducing a peak differential would cause a material and beneficial change in behaviour compared to allowing demand to adjust to naturally-arising

congestion costs (e.g. cost of delay, increased use of bussing) in the lead-up to the development of new infrastructure including the second runway. In our view, there was limited value in going through a complex exercise to explore differentiated prices for PSE3 when Auckland Airport had available and efficient expansion options that could address capacity constraints in the airport system for the benefit of all users.

At the time we set prices, we considered the better approach was to focus on delivering the right investments at the right time. In that respect, we note that we are not proposing to build for unconstrained peak demand. Instead, we intend to build for efficient peak usage, and to continue to work with our customers to provide efficient solutions to peak challenges and/or to smooth peak demand over time where efficient. This will include encouraging senior management in airline network and strategy teams to assess the impact of their fleet and scheduling decisions on the need for infrastructure development – including the timing of the second runway. In this context, although we have not ruled out the use of peak pricing at Auckland Airport in the future, we were not convinced that it was the right mechanism for PSE3 – particularly given the challenges in designing a mechanism that would encourage efficient behaviour change and was simple enough to implement.

4.3 Appropriate investment in assets

4.3.1 Overview of our approach

Auckland Airport commenced its most recent round of consultation on capital priorities in January 2016, as part of the iterative process that began with the release of the revised Masterplan in 2014. This capital consultation process has informed the versions of the capital expenditure forecast that have been shared through the pricing consultation process, with consultation information based on the status of the terminal development plan and domestic processor feasibility study as well as other relevant capital planning studies at the time that the PSE3 consultation materials were prepared.

The first detailed financial overview of the capital investment outlook over the next five to 10 years was provided in the second information pack, shared with airlines in October 2016. Auckland Airport provided the topics that we were seeking airline feedback on at that stage and a summary of our specific questions to airline customers. Among other things, we explained how the emerging draft of the 10-year capital programme had been developed, and provided background information about current and forecast capacity analysis for the international domestic terminal buildings, along with some background information on roading and terminal access, an appendix summarising the 10-year capital programme priorities from a planning perspective, and an emerging draft of potential projects over the FY18-27 period was also included. This summary provided a broad overview of the preliminary draft capital plan for PSE3 and PSE4, and we invited airline feedback on all aspects of the draft capital plan that airlines wished to share.

Auckland Airport carefully considered airline feedback through the pricing and capital consultation processes before preparing a draft pricing proposal in December 2016. This draft proposal set out a base case capital forecast for PSE3 and PSE4 which represented Auckland Airport's best view at that time (excluding the second runway costs which were not then ready for consultation) based on upcoming priorities and our understanding of customer requirements over the next ten years. We continued to develop our capital plan in response to airline feedback ahead of our final decision on aeronautical charges.

The final plan represents our best estimate of project delivery over PSE3, as at June 2017 (including second runway costs). As in PSE2, we are committed to keeping stakeholders up to date on the delivery of the capital plan and the form, function and scope of major capital expenditure projects. This will include engagement where capital expenditure is materially repurposed compared to the forecast plan.

4.3.2 Assessing our decision and conduct

We consider that the capital investment consultation model that has been in place at Auckland Airport for some time has worked constructively to support our PSE3 capital expenditure forecast. There is meaningful engagement with airlines on capital expenditure, and airline feedback has a material impact on final outcomes.

The current regulatory regime supports robust discussions on capital expenditure, and allows us to explore complex, airport-specific investment challenges directly with our customers – including the relationship between these challenges and the ultimate price path. This helps to produce a capital investment plan that directly reflects consumer requirements, as well as ensuring that our expenditure forecasts are rigorously tested by our airline customers. The consultation framework also provides a circuit breaker that allows Auckland Airport to balance different views and make decisions in the event that agreement cannot be reached across all parties.

In that context, we encourage the Commission to focus on the robustness of our consultation processes when summarising and analysing our investment forecasts. We accept that this includes consideration of how we took into account views provided by consultation participants. However, given that different airlines can have different interests, there will never be a complete alignment of airline views on all issues. We do not think it is the place of the s53B review to attempt to re-litigate the outcomes of our consultation with airline customers. We consider that Auckland Airport has the right processes in place, supported by clear information disclosure, to demonstrate that it is seeking to invest at an efficient level for the long-term benefit of consumers. For PSE3, this has resulted in comprehensive disclosure of our forecast capital plan for PSE3 and PSE4. Further, consultation will continue through the next five years as we work through the next stage of design processes, ahead of actual investment.

4.3.3 Response to specific questions

Is Auckland Airport's forecast investment sufficient to meet expected demand and desired service quality over PSE3?

The forecast capital plan for PSE3 is substantial. For the next pricing period, Auckland Airport is forecasting to invest in aeronautical infrastructure at approximately five times the level we have undertaken historically. Our internal planning suggests a relatively high level of investment will continue into the future as we seek to build long-term infrastructure to support growth, resilience and quality requirements.

Auckland Airport has a well-established consultation process with airlines that is designed to support delivery of fit-for-purpose infrastructure. As discussed above, the capital expenditure forecast for PSE3 was heavily informed by the understanding of customer requirements generated through this consultation process, along with forecast growth assumptions that were consistent between aeronautical pricing and capacity planning. Further requirements will be revealed progressively as we enter the detailed design phase of major projects alongside our airline customers.

In some cases, we note there is divergence between the service levels that are desired by different airline customers. In these circumstances, Auckland Airport seeks to balance airline feedback where possible. Equally important is developing a plan that is consistent with passenger interests over the medium and long-term. This includes engaging with Auckland Airport's passenger experience team, who are focussed on the services and benefits that will be delivered to the travelling public using new or upgraded infrastructure.

As we explained in our price setting disclosure, the consumer benefits that will be delivered by the investment plan are substantial. The investments that will be delivered over the next five years are intended to provide better and faster passenger journeys to the airport, better and faster passenger journeys through the airport terminals, and a very good quality of service to our passengers and airlines. The capital plan is designed to alleviate congestion in current pinch points, cater for existing services and provide for efficient future growth (including efficient

peak growth). This will support faster and more intuitive passenger processing, improved airfield efficiency, and will also support greater on time performance for aircraft. Examples of these projects include:

- a better and faster passenger journey through significant upgrades to international departure processing;
- reducing current airfield congestion and increasing our ability to cater for efficient growth through the delivery of three additional gates connected to the international terminal (Pier B Gates 17, 18 and 19) that can each cater for one large international aircraft or two smaller aircraft;
- a better passenger journey through the international arrivals process, through a staged expansion of the MPI biosecurity and arrivals processing areas;
- expansion and reconfiguration of the international check-in facilities by deepening the building and repurposing existing terminal space for check-in as the arrivals project is delivered;
- upgrades to redevelop and modernise priority gates connected to the international terminal on Pier A, including the transit facility;
- a once-in-a-generation investment in a new domestic jet terminal, removing current capacity constraints, increasing service quality, providing for efficient growth, and significantly improving the passenger experience;
- safer, more reliable and more efficient journeys for aircraft between the runway and the terminal through the realignment and extension of existing taxiways and the construction of new taxiways (development of taxiways Mike and Lima, realignment of taxiway Kilo);
- investment in terminal roads and our wider roading network as part of a coordinated system of land transport improvements by Auckland Airport, NZTA and Auckland Transport; and
- technology investment to enable new modes of operating to drive efficiencies, helping us to enable transformations in airport operations and customer engagement and to respond to customer expectations and demands.

How appropriate is Auckland Airport's approach to cost allocation when determining its capital expenditure projections?

Auckland Airport took a robust approach to cost allocation of forecast capital expenditure. This involved a series of workshops which examined the larger projects in the capital plan, where the nature and purpose of the projects was discussed and used to inform the cost allocation assumptions in the pricing model. For business as usual projects, cost allocation was based on assumptions resulting from a deep dive of current business as usual projects undertaken prior to the pricing process.

Throughout the pricing consultation process, Auckland Airport provided airlines with information on the cost allocation assumptions for each project in the capital expenditure plan. This provided details of the unallocated value of the capital project (for aeronautical and aeronautical-related projects), the regulated allocation (i.e. the total regulated activities lens) and the pricing allocation (i.e. the aeronautical pricing activities lens - after aircraft and freight activities and leased aeronautical activities had been carved out). Auckland Airport was guided by the input methodologies and the expected use of the activity on commissioning when allocating the forecast capital plan. Projects that would only provide an aeronautical function were allocated directly to airfield or terminal. Where non-aeronautical functions were also to be delivered, an estimate was made of the appropriate adjustment – e.g. small carve outs on MPI / Arrivals and Pier B for minor commercial components, with more material adjustments for the domestic jet facility where a new retail facility is planned to be provided within the project.

For programmes of activity that were broader in nature, Auckland Airport either used existing asset allocation rules (e.g. for network assets or support functions) or undertook further analysis. For example, asset maintenance projects were allocated 71% to aeronautical pricing activities following a deep dive of existing business as usual projects.

Cost allocation with respect to the investment programme was not a major focus of the pricing consultation process, although the nature of the domestic jet facility and its impact on cost allocation principles between international and domestic users was discussed.

Are there concerns that Auckland Airport will not be able to achieve its capital expenditure forecasts over PSE3?

We have been very conscious of the significant step change in capital expenditure relative to previous pricing periods and spent the best part of twelve months over the pricing and capital consultation processes testing the trade-offs that may be available to reduce or delay capex. The base case plan represents Auckland Airport's best view of the capital expenditure required to support common use activities over the next five years, and our best estimates relating to project delivery as at the date of our final pricing decision.

As discussed with airline customers through the pricing consultation, we consider that it is important and efficient for Auckland Airport to retain flexibility in how and when we invest to solve capacity and other operational challenges. A range of options typically exist for resolving any given issue, and there will inevitably be differences between the forecast capital plan and the way investment is actually delivered over the pricing period as new information comes to hand. The capital plan may also flex as we procure the necessary resources to deliver planned projects.

As we explained in our pricing decision and price setting disclosure, we will continue to work with airlines over the next five years to discuss any material changes to timing, costs, or re-purposing of capital expenditure compared to this forecast plan. We consider this process has worked well for PSE2, and enabled Auckland Airport to make the necessary trade-offs to respond to changing circumstances over the period, based on a good understanding of what our customers value.

We agree with the Commission's view that in general, airports are best placed to manage risks associated with capital expenditure projects.²⁵ This issue arose through the pricing consultation process and, although we carefully considered airline feedback, we did not consider that a capex wash-up was required or consistent with encouraging efficient investment delivery over PSE3.

In reaching our view that it was most efficient for Auckland Airport to bear the risk and reward of capital expenditure differing from forecast through the pricing period (with the exception of unexpected regulatory costs or costs associated with airlines' request for additional investment or operating changes), we considered the available regulatory guidance on risk allocation. At the time we set prices, we understood that the Commission considered that particular risks should ideally be allocated to suppliers or consumers depending on which are best placed to manage them. The Commission has said that, when determining who is best placed to manage risks, the main factors are the ability of the parties to control the probability of the occurrence, mitigate the costs of occurrence, and/or absorb costs where they cannot be mitigated.²⁶

In relation to capital expenditure in particular, we were conscious of the Commission's view that:

- Setting prices for a fixed period provides airports with an incentive to invest efficiently so as to outperform the capex forecast in their building blocks model (i.e. have lower actual

²⁵ See Commerce Commission *Input methodologies review decisions – Topic paper 5: Airports profitability assessment*, 20 December 2016 at paragraph 443, cited in Process and Issues Paper at paragraph 84.

²⁶ Commerce Commission *Input Methodologies Review Final Reasons Papers*, 20 December 2016 at paragraphs 124 and 389.

expenditure than forecast), and therefore earn higher profits – consistent with the design of incentive regulation;²⁷

- In some circumstances, deferral of capital expenditure may be an efficient and prudent course of action;²⁸
- An important element in achieving efficiency is to make the correct decision on whether operating or capital expenditure is appropriate;²⁹ and
- The consultation process on large capital expenditure programmes with our substantial customers also has a positive effect on our incentives to invest efficiently.³⁰

Ultimately, we considered that Auckland Airport was best placed to control the risk of actual capital expenditure varying from forecast, and to mitigate the costs if that occurs. This is because we retain the ultimate decision making on capital expenditure, informed by thorough consultation with airlines at the time of setting the capex forecast for a pricing period and then throughout the period as major investment projects proceed through design and to construction and completion.

²⁷ Commerce Commission *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 July 2013 at page 122.

²⁸ Commerce Commission *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport*, 8 February 2013 at footnote 228, page 127.

²⁹ Commerce Commission *Amendments to Input Methodologies for Electricity Distribution Services and Transpower New Zealand – Incremental Rolling Incentive Scheme*, Final Reasons Paper, 27 November 2014 at paragraph 3.19.

³⁰ Commerce Commission *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 July 2013 at page 121.

Appendix: Summary of responses to Auckland Airport specific questions

Question	Page reference in this submission	Page reference in Final Reasons Paper	Page reference in Price Setting Disclosure
<i>General</i>			
Do you agree with the aspects of performance we propose to focus our efforts on for this review, as set out in paragraphs 21 to 23?	See NZ Airports submission	-	-
Do you have any concerns about the timeframes set out in paragraph 28?	See NZ Airports submission	-	-
Do you have any views about the way the airports have taken account of interested parties' views in their pricing decisions?	Discussed throughout submission	Consideration of airline views throughout the document	Airline views on carry-forward adjustments discussed as required (page 53)
<i>Profitability</i>			
Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Auckland Airport?	8-9	-	Disclosure of rationale for target return at pages 25-37
Is Auckland Airport's targeted return appropriate and why?	6-8, 9-11	82-109	25-37
Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Auckland Airport's price setting event?	11, Confidential Attachment A & B	82-109	25-37
Do the asset values used by Auckland Airport provide an appropriate basis for assessing expected returns and why?	12	71-77	16-25; 91-95
Did Auckland Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Auckland Airport's consultation but not implemented and what was the rationale for the proposed adjustments?	12-13	120-128	72
To what extent does the demand forecast, presented by Auckland Airport as part of PSE3, reasonably reflect expectations of future demand and why?	14-15	36-43	85-91
Are there any concerns that Auckland Airport's capital or operating expenditure projections are not reasonable?	15-16	Basis for opex forecasts set out at pages 56-64; capex forecasts at pages 43-55 and Appendix C	Basis for opex forecasts set out at pages 37-46; capex forecasts at pages 60-66 and Appendix B
Are there concerns relating to Auckland Airport's introduction of a contingent 'runway land charge'? In particular, is the proposed timing of Auckland Airport's returns on its assets held for future use appropriate?	16-19	136-155	Disclosure of approach and rationale at pages 54-60
Has information disclosure assisted in promoting stakeholder understanding of Auckland Airport's proposed approach to the 'runway land charge'?	19	Discussion of transparency of charge at pages 147-149	Disclosure of approach and rationale at pages 54-60
<i>Pricing Efficiency</i>			
Does Auckland Airport's pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?	19-23, Confidential Attachment C	151-152	58

Question	Page reference in this submission	Page reference in Final Reasons Paper	Page reference in Price Setting Disclosure
<i>Investment</i>			
Is Auckland Airport's forecast investment sufficient to meet expected demand and desired service quality over PSE3?	23-25	Capex forecasts discussed at pages 43-55 and Appendix C	Capex forecasts discussed at pages 60-66 and Appendix B; consistency of forecast assumptions for expected demand and facility planning at pages 85-91
How appropriate is Auckland Airport's approach to cost allocation when determining its capital expenditure projections?	25-26	General approach to allocation at pages 65-70, capex allocations in Appendix C	General approach to allocation at page 79
Are there concerns that Auckland Airport will not be able to achieve its capital expenditure forecasts over PSE3?	26-27	Discussion of risk allocation at pages 121-127	Capital expenditure planning process at pages 61-63