

## SUBMISSION

### REVIEW OF AUCKLAND INTERNATIONAL AIRPORT'S PRICING DECISIONS & EXPECTED PERFORMANCE (JULY 2017 – JUNE 2022)

#### OVERVIEW OF SUBMISSION

Airlines for Australia & New Zealand believes that the major airports in New Zealand have set prices that are not in the long-term interest of consumers, and that more must be done to protect airport users from the market power exerted by monopoly airports. As such, A4ANZ supports the Commerce Commission's review of Auckland International Airport's pricing decisions and welcomes the opportunity to provide a submission to the Commission.

In response to the areas of focus outlined by the Commerce Commission, A4ANZ has undertaken to provide a submission with particular reference to the following focus areas and the associated findings outlined in the Commerce Commission's draft report:

- Expected profitability,
- Investment efficiency, and
- Pricing efficiency.

In addition to addressing the findings pertaining to the above focus areas – A4ANZ has also noted the importance of the Commerce Commission adopting a broader scope to review quality and innovation. Additionally, A4ANZ has also made brief commentary regarding the current regulatory environment and potential regulatory solutions.

#### ABOUT AIRLINES FOR AUSTRALIA & NEW ZEALAND

Airlines for Australia and New Zealand (A4ANZ) is an industry group, established in 2017 to represent airlines based in Australia and New Zealand. Member-funded and representing international, domestic, regional, full service and low-cost carriers, A4ANZ advocates on key public policy issues relevant to airline operations, including efficient access to domestic airport infrastructure.

The A4ANZ Board identified at the time of the organisation's formation that one of its highest priority issues was the regulatory frameworks for Australia and New Zealand's monopoly airports.

#### PERFORMANCE OF AUCKLAND AIRPORT

##### **Profitability**

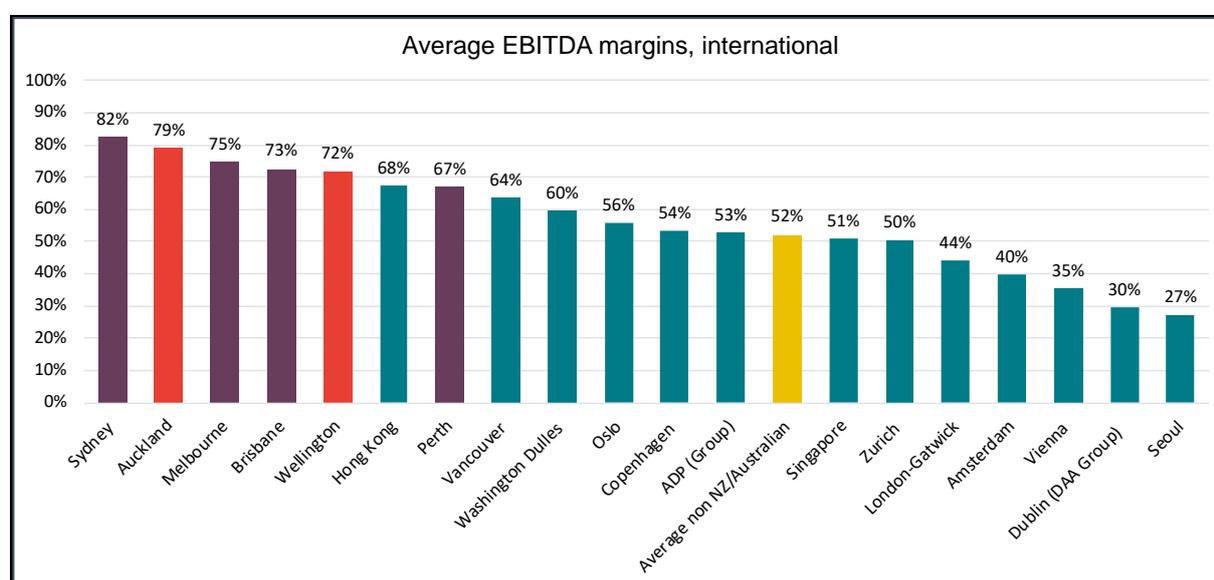
A4ANZ believes that Auckland International Airport is targeting excessive profits. Historically, this has been demonstrable by observing returns to shareholders over the past 19 years. Indeed, an independent analysis by Frontier Economics found that the value of excess returns to Auckland airport are more than \$3.6 billion (in 2017 dollars).<sup>1</sup>

A4ANZ believes that Auckland Airport appears to be targeting excessive profits in setting a target weighted average cost of capital (WACC) of between 6.99% and 7.06%. The difference between the

WACC set by Auckland Airport and the Commission’s mid-point WACC estimate of 6.41% is significant. It would result in customers paying an extra \$65 million in airport charges over the five year pricing period, compared to what they would pay if Auckland Airport was targeting the mid-point WACC estimate.<sup>2</sup> A4ANZ agrees with the Commission’s finding that Auckland Airport has not provided sufficient justification to target returns in excess of the mid-point WACC estimate on its asset base.

Margin data from Frontier’s analysis of New Zealand Airports supports these central findings – and demonstrates that New Zealand airports are earning far higher margins than comparable airports, as can be seen in the graph below. EBITDA\* measures the cash-generating performance of business. High EBITDA margins are indicative of market power being exercised – these comparisons demonstrate the extraordinarily high profits of Auckland Airport, compared to airports of a similar magnitude that may have less market power, face increased competition or are subject to regulation.

In fact, Auckland Airport has the second highest margin of all the international airports in the cohort – second only to Sydney Airport, which also operates under a light-handed monitoring regime.<sup>3</sup>



Source: Frontier Economics 2018. Results represent data from 2008 -2015 financial years.

To further assess whether differences in EBITDA margins could be due to different stages of the investment cycle (i.e. high investment leading to high capital charges), Frontier also calculated EBIT margins for the same airports. It was apparent from those data that the EBIT margin at Auckland Airport of 63% is extraordinarily high by international standards (an average 28 per cent).<sup>4</sup>

Based on both historic financial performance, and the recent decision of Auckland Airport to target returns above the Commerce Commission’s mid-point WACC estimate, A4ANZ believe that Auckland Airport is not appropriately constrained in its ability to extract excessive profits over the 2017 – 2022 pricing period.

### Runway Land Charge

As noted by the Commission, Auckland Airport is proposing to build a second runway in 2028 with a view to accommodate future growth. Whilst A4ANZ recognizes that a second runway may become

\* Earnings before interest, tax, depreciation and amortisation (EBITDA) margins provide an indication of the cash-earning potential of a business.

necessary – we question the appropriateness of the proposed runway land charge (RLC). As it stands, A4ANZ does not believe that the RLC is consistent with a competitive market, and that it instead represents Auckland Airport attempting to pre-fund the runway by passing costs on to current airline customers and their passengers – some of whom may not receive any benefits of the second runway.

## QUALITY, EFFICIENCY & INNOVATION

In this review, A4ANZ appreciates that the Commerce Commission has chosen to focus on the reasonableness of target returns, efficiency of investment, and efficiency of pricing. However, A4ANZ would like to reiterate its belief that the Commerce Commission should take a broader view of section 53B(2) requirements and consider quality, efficiency and innovation. These factors are inextricably linked to the economic performance of, and the prices charged by Auckland International Airport.

### **Operating Expenditure**

Although the draft findings from the Commission indicate that Auckland Airport’s forecast operating expenditure does not appear to be unreasonable, A4ANZ members have raised concerns regarding the proposed operating expenditure growth over the 2017 – 2022 pricing period.

Given the passenger growth that Auckland Airport has experienced in recent years, and the forecast of continued passenger growth, A4ANZ would reasonably expect that this growth would enable economies of scale – resulting in operational efficiencies. A4ANZ is concerned that as a result of the market power and monopoly behavior of Auckland Airport, resulting operational efficiencies may instead be captured by the airport rather than shared with airport users.

### **Investment in Infrastructure**

It is evident that airport charges are directly affected by infrastructure investment decisions. Auckland Airport has experienced strong passenger growth in recent years. As a result of this, and the state of the existing airport, investment in infrastructure is clearly necessary. The Commission has noted that stakeholders have commented favourably on Auckland Airport’s approach to consultation and engagement, and the outcomes have generally been acceptable to participants.<sup>5</sup> A4ANZ would like to reaffirm its belief that in order for the best outcomes to be achieved from this investment, it must be fit-for-purpose; aligned with the needs of passengers using the facilities and demand for air services. The best way to determine requirements and ensure this fit is through industry consultation – reducing the potential for overcapitalisation. Prioritising efficient operations of Auckland Airport would also ensure that consumers are not paying the costs of, and a return on, unnecessary infrastructure through high charges.

A4ANZ appreciates that the Commerce Commission has recognised the need for further exploration of the issues of quality, efficiency and innovation of airport services and operations and is pleased that this may be considered as a future part of the Commission’s workplan, as it is urgently needed.

## REGULATORY ENVIRONMENT

There are a number of potential approaches to solving the problem with the current regulatory environment. However, A4ANZ believes that the most effective regulatory solution, and the one that is most likely to result in genuine commercial negotiations between airlines and airports, and deliver

fair outcomes for airport users – including New Zealand travellers is giving effect to the negotiate-arbitrate model.

Greater oversight by the regulator to encourage and, where required, force constructive, commercial engagement is needed to minimise the negative impact of the airports' monopoly powers. The threat of regulation would result in a genuine commercial negotiation, greater investment by airlines and improved efficiency in the allocation of resources. A closer examination of airport charges is needed to protect and allow growth and innovation in air services within New Zealand. As such, the changes proposed by the Commerce Act Amendment Bill 2018 – including those providing increased scope for the Commerce Commission – are welcomed by A4ANZ.

## CONCLUDING COMMENTS

A4ANZ believes that a vibrant aviation sector will drive efficiency and innovation, which in turn is good for both consumers and the economy. In order to comprehensively address the issue of airport monopolies and market power driving excessive charges, a multi-faceted approach involving genuine industry engagement and consultation will be required. Due consideration must be given to creating a policy and regulatory environment that encourages innovation and efficiency, to ensure that both the community needs of New Zealand and those of the broader economy are met.

A4ANZ members are committed to building, maintaining and improving positive, constructive commercial relationships with airports; with a view to seeing airports, and the whole aviation sector prosper. It is not only in the airlines' interests, but also in their passengers' interests, as well as the Government's and New Zealand economy's interests for this to occur. A4ANZ and its members look forward to working with all stakeholders to achieve this outcome.

A4ANZ would welcome the opportunity to further discuss the issues addressed in this submission with the Commerce Commission.

## A4ANZ CONTACT

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<sup>1</sup> Frontier Economics. 2018. *The performance of airports in New Zealand*. Report prepared for A4ANZ.

<sup>2</sup> New Zealand Commerce Commission. 2018. *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*. At: <http://www.comcom.govt.nz/regulated-industries/airports/airports-information-disclosure-summary-and-analysis/price-setting-event-3-pse3-for-auckland-and-christchurch/>

<sup>3</sup> Airlines for Australia and New Zealand. 2018. *The performance and impact of Australia's airports since privatisation*. [http://a4anz.com/documents/A4ANZ\\_Report-The\\_Performance\\_and\\_Impact\\_of\\_Australias\\_Airports.pdf](http://a4anz.com/documents/A4ANZ_Report-The_Performance_and_Impact_of_Australias_Airports.pdf)

<sup>4</sup> Frontier Economics. Op cit (1).

<sup>5</sup> New Zealand Commerce Commission. Op cit (2).