



**SUBMISSION ON
PROCESS AND ISSUES PAPER ON THE REVIEW OF
AUCKLAND AND CHRISTCHURCH AIRPORTS' THIRD
PRICE SETTING EVENTS FOR AIRPORT SERVICES**

28 November 2017

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NEW AERONAUTICAL FEES

DESIGNED TO MAXIMISE PRODUCTIVITY OF AIRPORT ASSETS, SERVICE AND OPTIMAL CONNECTIVITY FOR TRAVELLERS TO AND FROM THE SOUTH ISLAND THROUGH:

1

Continuous improvement in efficient use of the terminal and airfield for airlines and improved service for travellers with planes closer to lounges and amenities

2

Encouraging and harnessing innovation, such as 'swing gates' that can be used for both domestic and Trans-Tasman services and gate power that allows airlines to save money and reduce carbon while planes are at the terminal

3

Flexible infrastructure to allow airlines to optimise fleet, schedules, customer experience and productivity

KEY PRIORITIES FOR PSE3

- **Productive and efficient use of CIAL's existing aeronautical assets**
- **Maintaining CIAL's position as a leader in the provision of high quality of service for airlines and passengers**
- **Earning an appropriate return, calculated in accordance with the IM/ID regime**
- **Transparency and simplicity in CIAL's prices and disclosures**

FULSOME AND CONSTRUCTIVE ENGAGEMENT WITH CUSTOMERS

FEATURE/STAGE	DATE
Initial Proposal and model published, along with the proposed consultation timetable	16 Nov 16
Feedback from customers on the timetable and process	23 Nov 16
High level briefing on the Initial Proposal and model	29 Nov 16
Clarification questions from customers on Initial Proposal	5 Dec 16
Answers provided to clarification questions	19 Dec 16
Formal feedback received on Initial Proposal and model	7 Feb 17
Teleconference on specific Capex items	21 Mar 17
Revised Proposal published	10 Apr 17
Feedback on Revised Proposal received	5 May 17
Further proposals relating to the cross-wind runway extension and price structure, and WACC update, sent to substantial customers	25 May 17
Written feedback on further proposals received from BARNZ and Air New Zealand	8 Jun 17
PSE3 pricing decision and model sent to substantial customers	19 Jun 17
PSE3 prices take effect	1 Jul 17

- Process gave sufficient time and information for substantial customers to consider and provide feedback.
- Experts engaged to assist process.
- Meaningful consultation focused on a discrete number of issues.
- Professionalism and good faith from all parties.
- Material changes made once CIAL had heard the perspectives of its customers.

PART A: INTRODUCTION

- 1 This submission responds to the Commerce Commission's (**Commission**) process and issues paper on the review of Auckland and Christchurch Airports' third price setting event disclosures for specified airport services (the **Paper**). The background to this process is:
 - 1.1 On 19 June 2017 Christchurch International Airport Limited (**CIAL**) concluded seven months of consultation with its substantial customers on prices for the period from 1 July 2017 to 30 June 2022 (**PSE3**).
 - 1.2 On 14 August 2017 CIAL disclosed to the public information relating to the PSE3 price reset (**PSE3 Disclosure**). That information is available on CIAL's website: www.christchurchairport.co.nz.
 - 1.3 The Commission is now required by section 53B(2)(b) of the Commerce Act 1986 to publish a summary and analysis of CIAL's PSE3 Disclosure "for the purpose of promoting greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time."
 - 2 If there are any questions in relation to this submission please contact:

Michael Singleton
General Manager Corporate Affairs
(03) 353 7046 / michael.singleton@cial.co.nz
 - 3 The Commission's Paper also relates to Auckland International Airport Limited's (**AIAL**) PSE3 disclosure, which was also made in August 2017. CIAL has not commented in this submission on the Commission's Paper where it is relevant only to the assessment of AIAL's disclosure.
- Further information on CIAL's PSE3 consultation and disclosure**
- 4 The Commission has asked at paragraph 32.3 of the Paper for views on the way airports have taken account of interested parties' views in their pricing decisions. CIAL undertook a robust consultation with its substantial customers, including an in-person briefing and Q&A session, two rounds of general consultation on all aspects of the proposal, and the provision of six independent expert reports to substantial customers.
 - 5 A full overview of CIAL's PSE3 consultation process is set out at Appendix B of CIAL's PSE3 Disclosure (as above, available from www.christchurchairport.co.nz). We also provide with this submission all formal PSE3 consultation documents from CIAL, substantial customers and advisors, plus a summary document with detailed references to those documents.¹
 - 6 Expert reports provided in support of CIAL and its substantial customers' submissions include:
 - 6.1 initial and revised demand forecasts by Three Consulting for CIAL;
 - 6.2 reports by Incenta Economic Consulting (**Incenta**) for CIAL covering price structure, depreciation, allocation of implied depreciation and asset beta;
 - 6.3 reports by John Small for BARNZ covering depreciation and WACC; and

¹ CIAL also provided initial, revised and final pricing models to its substantial customers and the Commission. CIAL has not made those models public, but CIAL's substantial customers and the Commission may use and refer to CIAL's model throughout this section 53B process.

6.4 a Deloitte report for CIAL, as requested by substantial customers, on CIAL's asset base and opening adjustment to its regulatory asset base (**RAB**).

PART B: EXECUTIVE SUMMARY

- 7 CIAL approached its PSE3 price setting process with the following key objectives in mind:
 - 7.1 the productive and efficient use of CIAL's existing assets, without incurring substantial additional capex in the medium term;
 - 7.2 good quality of service for airlines and passengers;
 - 7.3 an appropriate return, calculated in accordance with the Input Methodologies (**IMs**) / Information Disclosure (**ID**) regime; and
 - 7.4 transparency and simplicity in CIAL's prices and price setting event disclosure.
- 8 To that end, in developing its PSE3 pricing proposal, CIAL:
 - 8.1 aligned its pricing asset base with its regulated (disclosure) asset base. This approach was requested by the Commission and substantial customers after PSE2, and aligned CIAL's price setting exercise with the process the Commission is now undertaking;
 - 8.2 engaged Incenta, Three Consulting and Deloitte to provide independent expert advice and give assurance to CIAL's substantial customers, including in relation to the alignment of pricing and regulated asset bases discussed above; and
 - 8.3 proposed a price structure aimed at simplicity, transparency, and maximising the productive and efficient use of CIAL's existing assets.
- 9 CIAL and its substantial customers engaged in a thorough consultation process over a seven month period (as discussed in more detail from paragraph 4 above and in Appendix B of CIAL's PSE3 Disclosure). Features of that consultation process were:
 - 9.1 fulsome and constructive engagement from CIAL's substantial customers;
 - 9.2 a small number of topics of interest; and
 - 9.3 significant changes made by CIAL as a result of customer feedback – in particular an adjustment to the price path for PSE3 (see paragraph 61.5) and the removal of \$20m in proposed expenditure to extend CIAL's cross-wind runway (see paragraph 51).
- 10 As a result, CIAL reached a final PSE3 pricing decision influenced by:
 - 10.1 the IM/ID regime;
 - 10.2 feedback from PSE2 – in particular in relation to the importance of transparency and aligning CIAL's pricing and regulated (disclosure) asset bases; and
 - 10.3 feedback from CIAL's substantial customers over the seven month consultation period.
- 11 The Commission's section 53B process is useful to give further assurance to stakeholders and ensure public understanding of airports' performance. Care will need to be taken to ensure the Commission's assessment takes into account:
 - 11.1 the information available and arguments made at the time of PSE3 consultation; and
 - 11.2 all aspects of airports' performance, to allow stakeholders to understand each airport's performance in its full context.

PART C: COMMISSION'S PROPOSED PROCESS

Stages and timing

- 12 CIAL is generally supportive of the Commission's proposed stages and timetable as set out at paragraph 28 of the Paper. However CIAL notes there is only a two week period for responding to submissions. If substantial new information is added during submissions (in particular, information relevant to pricing that was not presented during PSE3 consultation – which we would not expect to be the case), then more than two weeks for cross-submissions may be required.

Key areas of focus

- 13 Section 53B(2)(b) requires the Commission to undertake a summary and analysis of CIAL's price setting event disclosure to promote greater understanding of performance.² CIAL:
- 13.1 acknowledges that the Act does not expressly require the Commission to assess all aspects of performance at one time;³ and
- 13.2 accepts the Commission's selected key focus areas for CIAL of:
- (a) profitability, including assessment of target returns, value of the regulated asset base, demand forecasts, forecast expenditure and risk sharing (see paragraph 21 of the Paper);
 - (b) price structure (see paragraph 22 of the Paper); and
 - (c) the impact of recent amendments to the IMs and ID Determination in promoting transparency in relation to profitability (see paragraph 25 of the Paper).
- 14 While accepting the selected focus areas, participants in the process must be mindful of the risk of distortion by omission (and CIAL understands the Commission is alert to this point). The process and its focus on profitability will meet the purpose of section 53B if interested parties are given an understanding of performance in its full context (for example, including understanding of airports' productivity and innovation, passenger experiences, and roles in the national and local economies).

² As the Commission has noted, this process is different to the section 56G process undertaken following the airports' second price setting events.

³ See paragraph 18 of the Commission's Paper where it states it is "not required to consider all aspects of performance at one time".

PART D: ASSESSING CIAL'S TARGETED RETURNS

Appropriate focus for the Commission's assessment

- 15 CIAL observes that there are two separate concepts relevant to an assessment of an airport's profitability, which are:
- 15.1 the estimate of the weighted average cost of capital (**WACC**) the airport applies if it chooses to adopt a building block method of determining prices; and
 - 15.2 the estimate of the return that is expected over the new pricing period – that is, the expected internal rate of return (**IRR**).
- 16 These two values need not be the same, even for the set of services for which the prices were determined (which we discuss further below).
- 17 In addition, the expected return (at least) can be defined over either:
- 17.1 the set of services for which the prices were re-determined during the price setting event (the "priced" services); or
 - 17.2 the total set of the specified airport services, including:
 - (a) the priced services; and
 - (b) those services whose terms are set in long term contracts (and hence the prices for which are only renegotiated infrequently), which are referred to below as the "non-priced" services.
- 18 The values corresponding to the above for CIAL as disclosed in its PSE3 Disclosure are set out in the table below (the "n/a" values in the table reflect the fact that, as CIAL has not reset prices for the non-priced services during the price setting event, it has not been required to estimate the cost of capital for these services).

Services	Estimated cost of capital		Expected return (IRR)	
	Rate	Percentile of CC WACC	Rate	Percentage of CC WACC
Priced services	6.82%	61%	6.44%	51%
Non-priced services	n/a	n/a	7.87%	84%
Total specified airport services	n/a	n/a	6.65%	57%

- 19 Below, CIAL makes two points in relation to the appropriate focus of the Commission during its summary and analysis of CIAL's PSE3 Disclosure.

Focus should be on profitability over priced services

- 20 First, in CIAL's opinion the principal focus of the Commission when summarising and analysing the price setting event disclosures should be on the profitability that is implied for the priced services. This reflects the fact that the priced services are those that were reviewed and re-determined as part of the price setting event.

- 21 CIAL recognises that the scope of the ID regime extends to all specified airport services and that, as a consequence, transparency as to the profitability across the aggregate of specified airport services clearly is intended. However, the long term (and thus slow changing) nature of these services makes the transparency provided through the annual disclosure process (rather than the pricing-specific disclosure at hand) particularly informative.
- 22 CIAL also notes that substantial caution is required when seeking to interpret the returns for non-priced services. Priced services apply to the market as a whole, are set for five year periods, and trigger substantial customer-wide consultation obligations and a price setting event disclosure. In contrast, non-priced services:
- 22.1 are set through negotiated commercial agreements that take into account the nature of the specific non-priced services;
 - 22.2 may be priced to take into account unique considerations and ancillary arrangements between CIAL and specific customers; and
 - 22.3 will typically have prices agreed at a different time (and potentially a different interest rate environment) and for a different time period to priced services.
- 23 In developing its proposed PSE3 prices CIAL undertook substantial work to ensure a principled allocation of costs between the different categories of specified airport services that can be repeated (and hence tracked against) over time. Moreover, CIAL's allocation method was a key topic of consultation with, and feedback from, substantial customers.

Focus should be on expected return, not WACC

- 24 Second, in CIAL's opinion the principal focus of the Commission when summarising and analysing CIAL's anticipated profitability over PSE3 should be the expected return over the period rather than the WACC that was estimated and applied when setting the prices for priced services.
- 25 While these two returns are identical when the Commission determines "building block" prices for the energy networks, CIAL's expected return over PSE3 is materially lower than CIAL's estimate of its cost of capital. The key reason for the differences in returns is the effect of the concessions that have been provided to airlines (and that extend into PSE3) in order to encourage additional services to be established and maintained (CIAL has, once again, accepted this cost as a commercial concession to its customers).
- 26 CIAL's experience has been that incentives are often required to encourage airlines to establish new services, and maintain and grow existing services – which reflects CIAL's substantial reliance on the leisure market for current traffic and growth – but the creation and maintenance of such services offers substantial benefits (including, ultimately, a reduction in prices to airlines). However airports have historically received significant push back to suggestions that airline-specific incentives should be recovered from current airlines through the price setting process.
- 27 Having said that, CIAL welcomes the Commission's assessment of its estimate of the cost of capital associated with its priced services. CIAL's consultation with substantial customers was focussed on the appropriate return for CIAL's priced services (even though this return was above the return that ultimately was expected) and CIAL remains of the view that the value it adopted is appropriate. CIAL's approach to WACC is explained in the section below.

CIAL's estimate of WACC

- 28 In setting its PSE3 prices CIAL used the Commission's inputs for all WACC parameters except CIAL's credit rating and asset beta. The approach effectively takes the Commission's best

estimate of a reasonable rate of return and adjusts it in these two cases for CIAL's specific circumstances.

- 29 CIAL's rationale for using its own credit rating and asset beta is detailed from paragraph 112 of CIAL's PSE3 Disclosure document. In short:
- 29.1 **Credit rating:** CIAL used a credit rating of BBB+ to derive the debt risk premium in its WACC calculation. BBB+ is consistent with CIAL's "standalone" credit profile (i.e. the rating that ignores the effect of government ownership).
- 29.2 **Asset beta:** CIAL used an asset beta that is 0.05 higher than the asset beta for the average New Zealand airport calculated by the Commission. CIAL's rationale was that:
- (a) CIAL has a greater exposure to holiday / leisure travellers, and therefore greater systematic risk relative to other New Zealand airports; and
 - (b) proxy analysis undertaken by Incenta to assess systematic risk at airports in the Commission's sample also suggests that CIAL has a materially greater degree of systematic risk than the "average airport" in the Commission's sample. Incenta concluded that the 0.05 increment that CIAL applied to the average-airport asset beta appeared reasonable for PSE3.
- 30 As discussed in CIAL's PSE3 Disclosure and throughout consultation, Air New Zealand disagreed with CIAL's use of its standalone credit rating, and Air New Zealand and BARNZ (with advice from Dr John Small) disagreed with the addition of an increment to the Commission's asset beta.
- 31 Dr Small advised that he believed there to be technical issues with the proxy beta that Incenta had undertaken. He also commented that his testing of the dataset (based upon his preferred specification) implied that the differences in the proxy asset beta did not satisfy conventional levels of statistical significance. Incenta disagreed with the suggested technical errors, but accepted that its analysis did not provide proof to conventional levels of statistical significance that CIAL's beta was higher than the average of the Commission's sample. However, Incenta also commented that this implied an evidentiary hurdle that was very high (and inappropriately so), and which was a hurdle that had not been applied universally in the Commission's calculation of the airport asset beta.
- 32 CIAL remained of the view that its use of CIAL-specific factors for the credit rating and asset beta parameters was reasonable.

Commission's Input Methodology/Information Disclosure amendments

- 33 The Commission has asked whether its recent amendments have been effective at increasing transparency of target profitability. CIAL appreciates the effort the Commission has undertaken to improve the ease with which airports are able to communicate their pricing decisions (and the target profitability embedded within), and expects these changes to assist interested parties to interpret pricing decisions and price setting event disclosures.
- 34 There are three areas CIAL considers worth highlighting, where the Commission's recent amendments have assisted CIAL in being transparent about target profitability:
- 34.1 *Carry forward adjustments:* the new scope to articulate carry forward adjustments (and with the carry forward then able to be transparently carried forward over time) has assisted CIAL's efforts to align its pricing decision with its past and future annual disclosures;

- 34.2 *IRR calculation*: establishing the expected IRR as the focus of a pricing event disclosure – and setting out its calculation – has also assisted airports with communicating their pricing decisions. Notably, this change means interested parties are no longer required to interpret annual rates of return that may vary materially between years; and
- 34.3 *IRR compared to WACC*: the structure of the disclosure templates envisages that:
- (a) airports' expected IRRs may differ from their estimated WACC; and
 - (b) for that estimated WACC in turn to differ from the Commission's estimate of the WACC.
- 34.4 CIAL sees this as a useful acknowledgement (and signal to interested parties) of the need for the Information Disclosure regime to cater for a variety of different contexts across the New Zealand airports and over time.

PART E: OTHER CONSIDERATIONS RELATING TO TARGETED RETURNS

35 The Commission is considering the relevance of several specific cost components to the assessment of CIAL's expected returns, outlined in the Paper from paragraphs 21.2 to 21.5 (and also reflected in the Commission's questions). We address each in turn.

Regulated asset base

36 The Commission is considering two related questions concerning the RAB, being:

36.1 "the value of the regulated asset base, as the approach to disclosing this value can mask the expectation of excessive profits if the approach is not transparent";⁴ and

36.2 whether and why the asset values used by Christchurch Airport provide an appropriate basis for assessing expected returns.⁵

37 CIAL's key priority in setting its PSE3 prices was to ensure transparency, with a major focus being RAB. To that end:

37.1 CIAL has (where possible) aligned its pricing asset base with its regulated (disclosure) asset base. CIAL took this approach to increase transparency, as requested by the Commission and substantial customers after PSE2, and align CIAL's price setting exercise with the process the Commission is now undertaking;

37.2 CIAL engaged Incenta to assist with its RAB and one adjustment made to CIAL's opening RAB;⁶ and

37.3 at substantial customers' request, CIAL engaged Deloitte to audit CIAL's opening RAB model. CIAL made all changes recommended by Deloitte (as confirmed in Deloitte's report). A copy of that Deloitte audit report is available within the consultation pack provided alongside this submission.

38 CIAL considers that its asset values provide an appropriate basis for assessing expected returns. CIAL notes:

38.1 As above, CIAL has prioritised alignment between CIAL's price setting exercise and disclosure (i.e. the values the Commission is now using to assess CIAL's returns).

38.2 CIAL chose not to revalue any assets in PSE3 (with land only revalued for CPI), and CIAL's substantial customers did not comment on that choice or suggest an alternative approach.

Forecast demand

39 The Commission is considering the appropriateness / reasonableness of CIAL's demand forecasts.⁷

40 CIAL engaged Three Consulting to advise on its demand forecasts for PSE3. Three Consulting provided an initial forecast in November 2016 and a revised forecast in April 2017. CIAL's

⁴ See Commission's Paper: paragraph 21.2.

⁵ See Commission's paper: Appendix A, paragraph 129.

⁶ To correct an anomaly related to the allocation of implied depreciation (and limited to PSE2 only), using the new adjustment process recently added to the IM/ID regime.

⁷ See Commission's Paper: paragraph 21.3 and Appendix A, paragraph 131.

substantial customers were supportive of CIAL's general approach to forecasting demand and did not provide any alternative demand forecasts.

- 41 No specific feedback was given on the domestic component of CIAL's revised demand forecast. Qantas Group and BARNZ did raise concerns that CIAL's international demand growth forecasts were conservative. CIAL reviewed the assumptions made in the international forecasts, including considering updated FY17 demand figures before releasing its PSE3 pricing Final Decision. CIAL remained of the view that Three Consulting's forecasts were appropriate.
- 42 Importantly, CIAL's price structure is set on a per passenger basis and ensures that CIAL remains indifferent to the type of demand – which types of aircraft airlines use, load factors and numbers of aircraft, and whether passengers are traveling to/from international or domestic locations.⁸ CIAL's price structure, including how it relates to demand, is discussed in more detail in Part F.
- 43 To understand the impact of the IM/ID regime on CIAL's incentives and forecast profitability, the key question is whether CIAL's demand forecasts were reasonable at the time PSE3 prices were set. However CIAL notes for context that nothing in FY18 to date has suggested its forecasts were inappropriate.

Forecast expenditure

- 44 The Commission is considering the appropriateness / reasonableness of CIAL's forecast operating and capital expenditure "to the extent that they could affect [the Commission's] assessment of whether an airport is expected to earn excessive profits".⁹
- 45 CIAL agrees with the Commission – it is appropriate to assess CIAL's cost forecasts to the extent they could affect assessment of profitability. Importantly, disclosure is not intended to trigger a granular second guessing of airports' expenditure. Expenditure is disclosed in pre-set cost buckets, at a level to allow the public and Commission to understand the level of different types of cost, and ensure airports aren't using expenditure as a vehicle for excessive profits. The Commission's focus is rightly aimed at forecast expenditure of a level that could genuinely affect airports' profitability.

Operating expenditure

- 46 CIAL forecast its operating expenditure by:
- 46.1 starting with its budgeted FY18 and FY19 opex costs (these are projected at a granular level as part of CIAL's Business Planning process); and
- 46.2 increasing those costs in aggregate cost buckets for FY20 to FY22 at a pre-set rate (usually CPI).
- 47 CIAL's substantial customers requested during consultation that CIAL review its opex forecast. CIAL then reviewed its FY18 and FY19 opex (as part of its final internal budgeting round), confirming CIAL's opex forecasts as reasonable. CIAL's prices reflect no substantial increases to opex, and opex is unlikely to be material in assessing CIAL's profitability.

Capital expenditure

- 48 As the Commission has noted, CIAL is not proposing significant capital expenditure in PSE3. CIAL's PSE3 capex includes:

⁸ Except to the extent that terminal price changes are being made through a smoothed transition over PSE3. See Part F for more detail.

⁹ See Commission's Paper: paragraph 21.4 and Appendix A, paragraph 132.

- 48.1 business as usual (**BAU**) capex, which is reasonably constant and highly predictable. CIAL's substantial customers gave no specific feedback on CIAL's BAU capex; and
- 48.2 specific amounts for five reasonably small one-off projects. For context, the total cost of those five projects is approximately 4% of CIAL's FY18 opening RAB.
- 49 CIAL considers these limited and one-off capex items to be reasonable. As explained in Part F, CIAL's strategy is to maximise the productive and efficient use of its terminal without incurring substantial additional capex. Many of these one-off capex items, and in particular some proposed terminal reconfiguration work, aim to maximise the efficient use of CIAL's terminal.
- 50 The full discussion with substantial customers on each capex proposal can be seen in the PSE3 consultation documents provided with this submission. A summary of capex consultation is set out at Part G2 of CIAL's PSE3 Disclosure and Part C2 of CIAL's PSE3 Final Decision.
- 51 CIAL initially proposed a \$20m extension to its cross-wind runway 11/29, which was eventually removed from PSE3's forecast capex as a result of feedback from substantial customers.

Risk sharing arrangements

- 52 In relation to risk sharing arrangements, the Commission is considering:
- 52.1 "The impact of any risk sharing arrangements, including consideration of the use or lack of any opening or closing carry forward adjustments, as these decisions affect which stakeholders bear the risk of actual outturns being different to forecast";¹⁰ and
- 52.2 Did CIAL make effective use of risk allocation adjustments? In particular:
- (a) were there any risk allocation adjustments proposed by stakeholders during CIAL's consultation but not implemented; and
 - (b) what was the rationale for the proposed adjustments?¹¹
- 53 During consultation Qantas Group requested that CIAL investigate the feasibility of a "capped turnaround charge" and growth incentives, and Air New Zealand expressed a willingness to explore sharing the risk of demand forecasts.
- 54 In response, CIAL explained its intention to set standard aeronautical prices and noted that, separately, CIAL is open to discussing specific arrangements on an individual customer basis with a view to finding mutually beneficial outcomes focused on growth. CIAL's substantial customers did not make any further requests for risk adjustments following CIAL's explanation.
- 55 The approach CIAL explained to its substantial customers continues to operate effectively between CIAL and its airlines. CIAL remains open to (and indeed has been active in) discussing specific arrangements on an individual customer basis, with a view to finding mutually beneficial outcomes focused on growth.¹² This approach allows any such arrangements to be bespoke and tailored to particular airlines, rather than applied across the board.

¹⁰ See Commission's Paper: paragraph 21.5.

¹¹ See Commission's Paper: Attachment A, paragraph 130.

¹² See also the discussion of concessions as they relate to understanding CIAL's profitability, from paragraph 24 above.

56 As discussed at paragraph 61.5, CIAL set a gradual change for regional and international prices from PSE2 to the final year of PSE3, in response to airline feedback about potential risks to regional demand.

Opening RAB adjustment

57 The Commission's question refers to the use of opening carry forward adjustments. CIAL made one adjustment to its opening RAB to correct an anomaly, limited to PSE2 only, related to the allocation of implied depreciation.

58 The adjustment was made with advice from Incenta and was subject to Deloitte's audit (commissioned at BARNZ's request). CIAL's substantial customers provided no feedback on the adjustment following the Deloitte audit.

PART F: PRICE STRUCTURE

- 59 The Commission has intentionally left airports' price structures out of the IM/ID regime. As explained by the Commission:

The Commission considers that it is not necessary to have an input methodology for airports' pricing methodologies for the purpose of information disclosure to be met. Interested parties can likely undertake their own analysis of the efficiency of prices, as pricing of specified airport services is not complex (relative to the pricing structures of electricity and gas networks).¹³

- 60 As such, the starting point is that airports may structure prices they consider appropriate (and CIAL notes that the structure of prices has no impact on airports' revenue and profitability). Nonetheless, the Commission has indicated an interest in assessing the efficiency implications of CIAL's price structure. Ensuring CIAL's price structure reflected appropriate pricing principles was a focus of CIAL's in setting its PSE3 prices, and subject to consultation (including CIAL providing to its substantial customers independent advice from Incenta on the topic).

CIAL's PSE3 price structure

- 61 CIAL's price structure is explained in detail in Part D of its PSE3 Final Decision (included within the consultation pack provided with this submission) and Part F of its PSE3 Disclosure (available from CIAL's website). In short:

61.1 CIAL's primary goal is increasing the productivity and efficient use of its existing assets, without incurring substantial additional capex in the medium term.¹⁴

61.2 Accordingly, CIAL set its PSE3 prices on a per passenger basis (except as explained at paragraph 61.5 below). Per passenger prices allow CIAL to increase and incentivise flexible and efficient use of its airfield and terminal. They also increase simplicity of prices and align CIAL's and airlines' interests.

61.3 During consultation BARNZ considered per passenger pricing to be "well founded" and "simple", with the simplicity "aligning the interests of airlines with the airport". Qantas Group agreed that it "improved transparency and simplicity in charging mechanisms." Air New Zealand questioned whether CIAL's price structure met efficient pricing principles; see paragraph 63 below on that topic.

61.4 CIAL's price structure resulted in the following prices:

- (a) a per passenger airfield price to apply regardless of where a passenger arrives from or departs to;
- (b) a per passenger non-regional¹⁵ terminal price to be implemented gradually from FY17 to FY22 (see 61.5); and
- (c) per passenger check-in hall and check-in counter prices.

61.5 In response to airline feedback, CIAL included an adjusted rate of change to regional and international passengers. Regional and international terminal prices were set such that they will change annually to smooth the transition from PSE2 prices (as they

¹³ Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" (December 2010) at [2.8.20].

¹⁴ As the Commission has noted at paragraph 24 of its Paper, CIAL "is not proposing significant capital expenditure investment in PSE3."

¹⁵ CIAL's Regional Lounge is subject to a commercial lease with Air New Zealand, and prices set under that lease were not the subject of the PSE3 price reset.

finished in FY17) to a per passenger price structure across domestic and international passengers by FY22.¹⁶ Feedback on this proposal was varied and reflected the competing positions of different airlines.

- 62 Importantly, CIAL's price structure has no impact on its profitability/targeted returns.¹⁷ CIAL calculated its building blocks allowable revenue in accordance with the IMs, and would have targeted that allowable revenue regardless of its price structure. As such CIAL's focus was on increasing productivity and efficiency as identified above.

Efficient pricing principles

- 63 CIAL (with expert advice from Incenta) also ensured that its price structure reflected efficient pricing principles. This analysis showed the following (also summarised throughout Part F of CIAL's PSE3 Disclosure):

Airfield prices

- 63.1 On the efficiency of its airfield price structure, CIAL notes:

- (a) Airlines' fleet decisions have little effect on CIAL's forward-looking costs. There is only a minimal difference in the cost caused by different types of aircraft when using CIAL's airfield, reflecting the fact that the vast majority of the airfield cost being recovered comprises costs that are common (like land) or are "sunk" costs (such as the existing sealed surfaces). As such, any cost-reflective pricing differences that would occur as a result of aircraft-specific airfield pricing would not meaningfully impact airlines' incentives. In this context, CIAL's price structure is efficient as it avoids influencing airlines' fleet decisions in circumstances where doing so is not justified by changes to cost (and CIAL's price structure is also transparent and simple).
- (b) CIAL's airfield prices are also within the "subsidy-free" bounds as defined by economic principles. For more detail see the discussion from paragraph 27 of CIAL's Revised Proposal and Incenta's note attached with the Revised Proposal as Annex A (both included within the consultation pack provided with this submission).

Terminal prices

- 63.2 Substantial detail is provided in Part C of CIAL's Initial Proposal and Part E2 of CIAL's Revised Proposal (both included within the consultation pack provided with this submission). In short, a single terminal price will:

- (a) meet the appropriate economic tests, ensuring passengers are paying for the forward-looking efficient costs for the services they use;
- (b) leave CIAL neutral as to where a passenger is traveling to or from, avoiding arbitrary distinctions between passengers; and
- (c) reduce the commercial barriers to more integrated and flexible use of the terminal, increasing efficiency and maximising use of the terminal without the need for substantial additional capex.

¹⁶ Including shared costs being fully attributed, on a per passenger basis, to regional passengers. Under the commercial leasing arrangements those shared costs are chargeable in addition to the regional lounge lease fee.

¹⁷ And, similarly, there is no difference in CIAL's targeted returns generated by the introduction of terminal price smoothing from FY17 to FY22.

Likely impact on demand and revenues

64 The Commission is interested in the impact of CIAL's proposed pricing structure and incentives on demand and revenues.¹⁸ On each:

Demand

- 64.1 CIAL forecast the PSE3 demand it expected taking account of its proposed price structure and prices, and with expert input from Three Consulting.
- 64.2 CIAL's substantial customers provided no alternative demand forecasts. However, as discussed at paragraph 61.5, CIAL did adjust the rate of change to its new price structure for regional and international passengers, in response to airline feedback regarding the potential impact of prices on regional passengers.
- 64.3 Importantly, CIAL's per passenger price structure is intended to make CIAL indifferent to where a passenger arrives from or departs to (as well as the type and number of aircraft used), such that from CIAL's perspective international and domestic demand will be interchangeable.

Revenue

- 64.4 As discussed in more detail at paragraph 62, CIAL's price structure has no impact on its profitability/targeted returns.¹⁹

¹⁸ See Commission's Paper: Appendix A, paragraph 134.

¹⁹ And, similarly, there is no difference in CIAL's targeted returns generated by the introduction of terminal price smoothing from FY17 to FY22.

APPENDIX A: COMMISSION QUESTIONS OF CIAL

65 The Commission set out a list of specific questions for CIAL (see Appendix A of the Paper, from paragraph 126). The table below identifies, for each question, where CIAL’s answer within this submission can be found and where CIAL has previously addressed the topic during PSE3 consultation.

#	Ref ²⁰	Question	Ref (within submission)	Ref (PSE3 consultation)
General questions				
1	[32.1]	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?	Paragraph 13 onwards and Part D to paragraph 27	N/A
2	[32.2]	Do you have any concerns about the timeframes set out in paragraph 28?	Paragraph 12	N/A
3	[32.3]	Do you have any views about the way the airports have taken account of interested parties’ views in their pricing decisions?	Paragraph 4 onwards	See consultation overview: <ul style="list-style-type: none"> Final Decision: Appendix A
Regarding profitability				
4	[126]	Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Christchurch Airport?	Paragraph 33 onwards	See, throughout consultation documents, CIAL’s: <ul style="list-style-type: none"> reliance on the IM/ID regime alignment of pricing and regulated (disclosure) asset bases steps taken to ensure transparency (including the alignment above, price structure, and selection method of depreciation)
5	[127]	Is Christchurch Airport’s targeted return appropriate and why?	Throughout – in particular Parts D and E	General question – see all CIAL consultation material and specific references

²⁰ From Attachment A of the Commission’s Paper.

				around cost of capital below
6	[128]	Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Christchurch Airport's price setting event?	Paragraph 24 onwards	See: <ul style="list-style-type: none"> Initial Proposal (see Appendix A Part 2, BB4 and Annex B Incenta Report) Revised Proposal (see Part G, BB4 and Annex B Incenta Report) Final Decision (see Part C5)
7	[129]	Do the asset values used by Christchurch Airport provide an appropriate basis for assessing expected returns and why?	Paragraph 36 onwards	See: <ul style="list-style-type: none"> Initial Proposal (see Appendix A Part 2, BB1) Revised Proposal (see Part G, BB1 and Annex D Deloitte Report) Final Decision (see Part C1)
8	[130]	Did Christchurch Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Christchurch Airport's consultation but not implemented and what was the rationale for the proposed adjustments?	Paragraph 52 onwards	See: <ul style="list-style-type: none"> Revised Proposal (see Part I)
9	[131]	To what extent does the demand forecast, presented by Christchurch Airport as part of PSE3, reasonably reflect expectations of future demand and why?	Paragraph 39 onwards	See general discussions of demand: <ul style="list-style-type: none"> Initial Proposal (see Part E and Annex A Three Consulting Demand Report) Revised Proposal (see Part H and Annex C Three Consulting Updated Demand Report)

				<ul style="list-style-type: none"> Final Decision (see Part C6)
10	[132]	Are there any concerns that Christchurch Airport's capital or operating expenditure projections are not reasonable?	Paragraph 44 onwards	<p>On opex, see:</p> <ul style="list-style-type: none"> Initial Proposal (see Appendix A Part 2, BB5) Revised Proposal (see Part G, BB5) Final Decision (see Part C3) <p>On capex, see:</p> <ul style="list-style-type: none"> Initial Proposal (see Appendix A Part 2, BB2) Revised Proposal (see Part G, BB2) 25 May 2017 further consultation letter Final Decision (see part C2)
Regarding pricing efficiency				
11	[133]	Does the pricing structure at Christchurch Airport for PSE3 reflect efficient pricing principles?	Part F	<p>See:</p> <ul style="list-style-type: none"> Initial Proposal (see Part B, Part C and Appendix A Part 4) Revised Proposal (see Part E and Annex A Incenta Report) Final Decision (see Part D, in particular Parts D1 and D2 up to paragraph 55)
12	[134]	What impact do you expect Christchurch Airport's proposed pricing structure and associated incentives to have on demand and revenues?	Paragraph 64	See general discussions around demand and revenue, referenced above



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