Air NZ Limited

Post-conference cross-submission to the Commerce Commission

Commerce Act 1986, Part 4

Section 56G Review of Christchurch Airport

AIR NEW ZEALAND

19 June 2013

Introduction

1. The Commerce Commission ("Commission"), as part of its s 56G review of Christchurch Airport, held its conference on Christchurch Airport on 24 May 2013. This submission responds to issues raised at the Conference and relevant specific questions asked by the Commission following the Conference.

2. Air New Zealand's ("Air NZ") contact person for this submission is:

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3. A feature of the conference was the widespread lack of clarity which Christchurch Airport's approach to pricing had introduced to the consultation process and which was evident continues now. The focus on Christchurch Airport's so-called long run levelised pricing approach and any difference between the tax payable and tax expense approaches over the life of that approach masks the real issue at the heart of Christchurch Airport's pricing decision, i.e. Christchurch Airport is targeting a return in excess of what would be appropriate in a competitive market and as a direct result the prices set by the airport are in excess of those appropriate in a competitive market.

4. During the course of the consultation Christchurch Airport provided three different financial models, all purporting to explain its approach:

   - The pricing model (updated with each proposal and the final decision)
   - The "medium term" model including an earlier simplified version of the tax "cross check" (tax payable vs expense) example – provided on 4 September 2012
   - The MAR model – provided with the pricing decision documentation in October 2012

Return expectations – Is CIAL under-recovering?

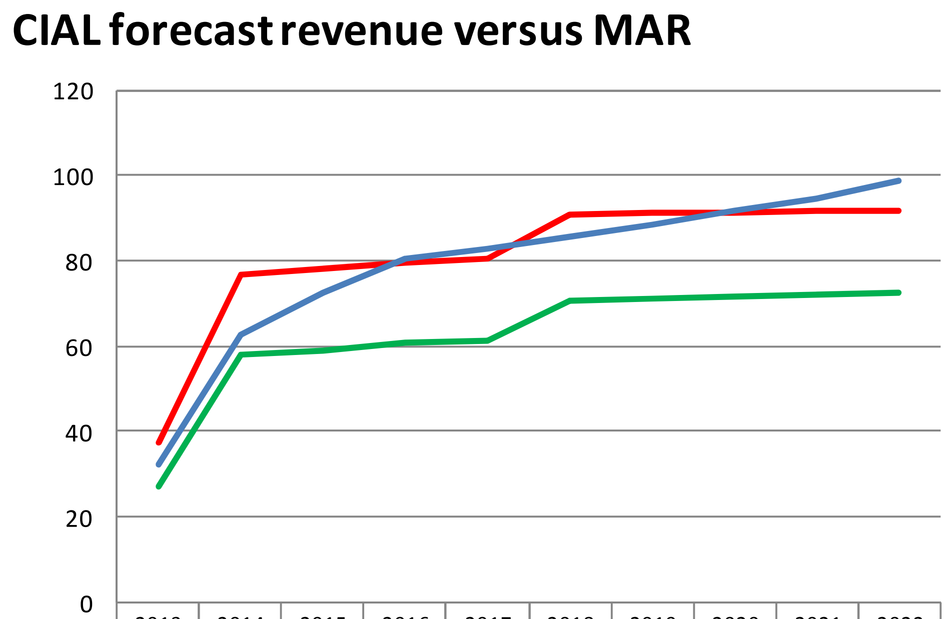
5. Of the 3 models provided, the most relevant to considering Christchurch Airport's assertions that its pricing path indicated an under-recovery of allowable revenues versus the approach advocated by the airlines is the MAR model provided in October 2012. Christchurch Airport claims that its forecast revenue results in an under-recovery of $18.7 million (in PV terms) over PSE2[1].

6. This calculation is based on application of a 9.76% post-tax WACC.

7. Applying the 6.49% 50th percentile WACC determined by the Commission at 30 July 2012[2] results in a very different, and alarming, outcome. These

[1] And an under-recovery relative to the levelised constant real price – see Pricing Decision D1, p.19
[2] Noting that Air NZ considers the WACC should be updated to reflect market conditions closer to the actual pricing decision, i.e. mid-September 2012.

different scenarios, along with Christchurch Airport's forecast revenue, are plotted on the chart below:



	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
MAR @ 9.76% (simple sum)	37.2	76.7	77.9	79.7	80.5	91.0	91.1	91.3	91.5	91.8
Forecast revenue (simple sum)	32.1	62.6	72.4	80.4	82.7	85.6	88.3	91.6	94.5	98.7
MAR @ 6.49% (simple sum)	27.2	58.0	59.1	60.7	61.3	70.8	71.1	71.5	71.9	72.4

8. Christchurch Airport's forecast revenue is $64 million in excess of allowable revenue over PSE2, with further excess revenue of $100 million over PSE3.

9. Christchurch Airport's own modelling illustrates that its forecast pricing would deliver it an effective 8.82% post-tax WACC return over PSE2, clearly in excess of any competitive market outcome.

10. Christchurch Airport's long run levelised pricing approach is predicated upon setting "*prices that are stable in real terms over the life of the assets*"[3]. As expressed at the conference Air NZ considers that a long-term approach to pricing would be consistent with workably competitive markets, particularly in relation to the recent investment in the ITP which is a long term asset at the commencement of its useful life.[4]

11. However, what is missing from Christchurch Airport's approach is an attempt to marry this long-term price modelling approach with a long-term contract with users consistent with that long-term approach. Instead, and as was evident at the conference, there remains considerable uncertainty around

[3] Revised Proposal, 31 July 2012, B1, p.6
[4] Transcript, p. 63

future pricing, and the inputs to modelling at future price setting events[5]. There also remains the potential for the prices set in October 2012 to be revisited during PSE2 with Christchurch Airport's commercial advisor drawing the distinction between "*normal commercial risk*" and "*extreme circumstances*" as a trigger for reopening the prices.[6]

12. Rather than adopt a commercial approach consistent with Part 4 and conclude a binding long-term arrangement, the airport's stated preference was to engage in "*commercial discussions with airlines after the AAA consultation process has ended*"[7], i.e. once it had established pricing at levels consistent with its ability to set prices as it saw fit. As noted by the airport, "*agreement cannot of course be guaranteed..*"[8], meaning airlines would be stuck with those prices. This is not consistent with a competitive market outcome as the airport is unconstrained in its ability to determine the bounds of any negotiation and airlines would effectively be negotiating with both hands tied behind their backs.

Tax payable versus tax expense

13. Christchurch Airport asserts that its "simplified" approach results in "*over the economic life of the assets,… no material effect on the levelised price from the implied tax allowance using our simplified calculation compared to an allowance which would be derived from calculating the tax payable for each year.*"[9] The airport claims that its modelling verifies its approach over the 20 year term.

14. However as the airport goes on to say "*It is clear that there would be timing differences between the two approaches…*".[10] Air NZ considers that Christchurch Airport's model clearly illustrates that the "timing differences" have a very real impact on revenue requirements at the beginning of the period being modelled i.e. PSE2 – with allowable revenue over-stated by $56 million[11]. Christchurch Airport's model also illustrates that this over-recovery does not begin to be offset until after year 13 of the model, i.e. up until that time consumers will be required to meet a greater level of revenue than under the tax payable approach.

15. Christchurch Airport justifies this on the basis that it is not pricing at the allowable revenue level and therefore the issue is academic. However, as illustrated above, such a view is heavily reliant on the level of return being targeted. Given that Christchurch Airport is targeting a level of return well in excess of what is justifiable its approach results in consumers being required to contribute more than is appropriate now.

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5 Transcript pp.19-20
6 Transcript pp 24
7 Final pricing Decision, Part E, p.24
8 Revised Pricing Proposal, Part B6, p.17
9 Pricing Decision p.13
10 Ibid
11 Per CIAL-submission-CIAL-s56G-process-and-issues-paper-Appendix-3-Tax-building-block-calculation-22-March-2013, line 75

16. Christchurch Airport acknowledges that its approach results in an over-statement of revenue over the PSE2 period:

"*After these changes and using the revised proposal prices, the present value of the 'IM approach' revenue over the period to 30 June 2017 is in the range of $225 million to $235 million compared to the present value of the revenue of the revised pricing proposal revenue of around $250 million – that is, the difference is in the order of only 8 per cent.*"[12]

17. While Christchurch Airport characterises this anticipated excess revenue of 8% as being not material, Air NZ does not share this view. Through its approach to taxation, Christchurch Airport has set charges at a level which is forecast to earn it revenues, and profits, in excess of what would occur in a competitive market. This is clearly contrary to the purpose of Part 4.

18. This acknowledgement is also remarkable in light of Christchurch Airport's claims of its commitment to "sharing the burden" "to assist in the recovery of the Canterbury region."[13] Contrary to this assertion Christchurch Airport appears to be front loading its recovery while providing no assurances that the supposed benefits of its approach – which would not even theoretically begin to accrue for more than a decade – will indeed eventuate.

Airfield vs Terminal

19. As highlighted by the different airline representatives at the Conference, the issue with Christchurch Airport's airfield pricing is not so much that it results in airfield users cross-subsidising the terminal, but that the level of recovery sought on the airfield is excessive. At Christchurch's adopted WACC, this excessive level of airfield charges offsets revenue shortfalls in the terminal but when considered against a realistic and market reflective WACC is nothing more than excess revenues (some $37 million in NPV terms over PSE2).

20. Air NZ considers the Commission is correct to query Christchurch Airport's rationalisation for increasing airfield charges to the extent it has given the major investment it has made in recent years is in the terminal. While noting, and understanding, the concerns of freight operators regarding the impact on them of the increase in airfield charges, it should be remembered that all passenger operators are also users of the airfield and face similar excessive charges. Airfield charges for Air NZ's fleet will, over PSE2, increase by between 55% for the 171 seat domestic A320 and a staggering 138% for the 19 seat Beech 1900. All domestic operators are also facing staggering increases in terminal charges (which international operators are not being required to bear).

[12] Revised Pricing Proposal, Part B4, p. 12
[13] Pricing Decision, pp.20-1

WACC Percentile

21. As submitted in our response to the Commission's draft report on Auckland Airport, and supported by NZIER in its report to Air NZ also submitted as part of our response, Air NZ considers the Commission has in that report erroneously focussed on the 75^{th} percentile WACC when reaching its draft conclusions regarding Auckland Airport. Air NZ urges the Commission not to make the same mistake when undertaking its analysis of Christchurch Airport. The IM's clearly contemplate the 50^{th} percentile as the starting point for analysis, being the best estimate IM-compliant cost of capital. This should be the point on which the Commission's conclusions are based.

Responses to Specific Questions

22. Air NZ comments below in response to some of the specific questions asked by the Commission following the conference.

Please clarify when the tax 'cross check' model was provided to the airlines.

23. Christchurch Airport referred to the results of modelling of its alternative tax treatment approach in its 31 July 2012 Updated Proposal. Following a briefing session on 23 August, airport and airline advisers were tasked with discussing this issue further. As noted by the airlines' independent expert (Dr Brent Layton) at the Conference, "…it certainly wasn't clarified in my mind that it was exactly right…"[14]. A simplified (and truncated) version of the 'cross check' model Christchurch Airport has included in its submissions on this review was provided to airlines on 4 September 2012 with airline submissions on Christchurch Airport's updated proposal due on 5 September 2012.

Given the stated preference of all parties for the Commission's analysis to be undertaken for the 4 years 7 months for which prices have been set, how should the Commission establish the opening asset value to be used in our IRR analysis? What assumptions need to be made about the opening value (eg, when did the portions of the new terminal come into use?) and how do we ensure that the forecast of capex over PSE2 is consistent with the opening asset value assumptions?

24. Air NZ considers it appropriate to assume the opening asset base incorporates all ITP terminal expenditure as at 1 December 2012. Associated airside apron capex was forecast to be completed in April 2013 and should be added to the asset base at this time. As discussed at the conference Christchurch Airport is able to readily identify the relevant values and ensure that appropriate adjustments are made to forecast capex in 2013 to ensure there is no double counting.

In our analysis of Wellington Airport we stated that if the opening asset vale used in the IRR analysis included unforecast revaluation gains related to the previous period, it was appropriate to gross up the revenue forecast for the current period when assessing expected returns (ie, to attribute the wash up as relating to the previous period). This would ensure that the return in the current period was not depressed as a result of over-recoveries from the previous period.

We did not have to make any adjustment to Wellington Airport's forecast revenues in relation to the revaluation wash-up. This is because we did not use an opening asset value for Wellington Airport based on a MVEU land valuation)to which Wellington Airport's revaluation wash-up related) and therefore we did not recognise the existence of any revaluation wash-up in our expected returns analysis.

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[14] Transcript, p. 43

We recognise that all parties at the conference were from in respect of treating revaluations as income when setting prices.

Given that Christchurch Airport has set its prices for PSE2 by treating revaluations related to the previous period as income, how should we treat the revaluations associated with the previous period when assessing Christchurch Airport's expected return?

25. As discussed at the conference and generally agreed by airlines and Christchurch Airport it is appropriate that the revaluations associated with the uplift in the opening value of the opening asset base for PSE2 are treated as revenue in PSE2.

26. When setting prices for PSE1, Christchurch Airport did so on the basis of a self-imposed valuation moratorium for the preceding two pricing periods. Consequently there were no revaluations included in its forecast modelling.

27. Having changed its mind and revalued the opening asset base for PSE2 and included revaluation gains during PSE2, both these categories of revaluation gains should be treated as income in PSE2 to ensure a consistent treatment of the revalued asset base and the revenue recognised on that asset base.

What is the appropriate WACC date for our IRR analysis, and why?

28. In its draft report on Auckland Airport, the Commission commented that

    "… information available at the time of Auckland Airport's pricing decision should be used when estimating the WACC for assessing its profitability in this section 56G review."[15]

    Air NZ supported this approach in its submission on that draft report and considers the Commission should adopt a consistent approach in its assessment of Christchurch Airport. As such, the WACC should be estimated based on data available in early-mid October 2012.

How do you expect demand to change as a result of the new prices and pricing structure?

29. Air NZ operates in a highly competitive market where costs are ultimately reflected in the prices charged to our customers. This is particularly the case at Christchurch where there are highly competitive markets with significant elasticity. Higher prices will inevitably result in reduced demand.

Please comment on the timing and level of spend on the new terminal – whether efficient and why.

30. The design process for a new terminal facility at Christchurch first commenced in 2004. Following a number of iterations, Christchurch Airport put this project to tender in 2008 notwithstanding a number of outstanding

[15] Draft Report, para. 2.44, p. 19

design details and airline concerns about aspects of the design. As a consequence airline tenants have borne costs associated with variations to the build to meet their needs.

31. On a more general level Air NZ does have concerns regarding the location of the facility and potential constraints on the future development path for domestic operations. These constraints are compounded by the location of the multi-storey car park, the control tower and the proximity of the cross-runway to the terminal location. Short of a green fields development remote from the existing terminal precinct the only real expansion path for domestic operations is a brown fields conversion of the existing international space, with a consequent requirement to create new international space to the north of the existing structure.

32. Similarly the only option for expansion of the baggage make up facilities is through the new domestic baggage reclaim area and into the international arrivals area, requiring a relocation of domestic and international arrivals reclaim and all border activities.

33. The long term efficiency of this investment path is therefore questionable.

Assumptions underpinning Christchurch Airport's IRR Analysis

34. Christchurch Airport, at the request of the Commission, has provided a summary of the assumptions underpinning its IRR Analysis included as part of its original submission on this s56G review. Air NZ wishes to make the following comments on those assumptions:

    Opening Pricing Asset Base

    - While the opening asset base includes revaluations applicable to PSE1 when Christchurch Airport had undertaken not to revalue its assets, this revenue does not appear to be included in the PSE2 forecast revenue. This is contrary to Christchurch Airport's stated approach to forecasting revenue in PSE2 and with the principle of treating the asset base and revaluations in a consistent manner.

    - The IRR analysis includes ITP in a fully commissioned state as at 30 June 2012 which does not reflect the actual commissioning of the asset or the approach taken in the pricing model. As parties indicated at the Conference, a reasonable approach would be to assume commissioning of the terminal elements of ITP as at 1 December 2012 (consistent with the pricing model). Airside apron works should be treated as capital expenditure in relation to FY13 and not be included in the 30 June 2012 opening asset base.

    Closing Pricing Asset Base

    - The IRR analysis excludes revenue to be recovered in future pricing periods. As indicated at the Conference, assuming there is a shortfall to be recovered (which Air NZ considers is not the case due to Christchurch Airport's over-stated revenue requirement), this amount should be included in the closing asset base.

Revenue (excluding revaluation of assets)

- The revenue in FY13 includes the 1 July – 30 November 2012 period, notwithstanding that the pricing decision applies only from 1 December 2012. As accepted by all parties at the Conference, the analysis should be for a 4 year and 7 month period, consistent with Christchurch Airport's pricing decision.

Operating Expenditure

- As per other elements, the operating expenditure for FY13 should be adjusted to reflect the 4 year, 7 month period of PSE2.

Value of commissioned assets

- Christchurch Airport states that commissioned assets are included on the basis of the forecast during consultation. Given the opening asset base assumes all ITP assets were commissioned as at 30 June 2012, the FY13 commissioned assets need to be adjusted to remove those ITP elements which were commissioned during FY13.