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REVIEW OF CHRISTCHURCH AIRPORT'S 2022-2027 PRICE SETTING EVENT (PSE4) – SUBMISSION ON THE COMMERCE COMMISSION'S CONSULTATION PAPER

This is Christchurch International Airport Limited's (**CIAL**) submission on the Commerce Commission's (**Commission**) consultation paper about its review of CIAL's 2022-2027 price setting event (**PSE4 Review**).

No part of this submission is confidential.

Appropriate to use CIAL's actual credit rating of BBB+
We acknowledge the Commission's draft conclusion that our use of a credit rating that deviates from the benchmark credit rating has not had a material effect on the weighted average cost of capital (**WACC**) used in the price-setting process.[1] The difference between CIAL's credit rating and the benchmark is therefore not material to the Commission's assessment of whether CIAL is targeting a normal return.

However, we disagree in principle with the Commission's draft decision that we should have used the benchmark credit rating. In this submission, we address the Commission's arguments that the reasons we provided for departing from the A- credit rating specified in the Input Methodologies (**IMs**) were not strong.[2]

When are departures from the Commission's benchmarks appropriate?
Previously, the Commission has specifically contemplated departing from the Commission's IM-compliant mid-point estimate of WACC where that can be justified:

- the Commission's Airport Services Information Disclosure Determination 2010 requires airports to publicly disclose an explanation for any differences between (i) the post-tax WACC at the price setting event and the forecast cost of capital, and (ii) the forecast cost of capital and the forecast post-tax IRR;[3] and

[1] PSE4 Review, at [X7].

[2] *ibid*., at [62].

[3] Commerce Commission, Airport Services Information Disclosure Determination 2010 (20 December 2016), at clause 2.5(i). Available at: https://comcom.govt.nz/__data/assets/pdf_file/0020/60554/Airport-Services-Information-Disclosure-Determination-2010-consolidated-as-at-20-December-2016.pdf

- in its 2016 IM Review,[4] the Commission stated:

  "*when an airport targets a return that is different from our mid-point estimate of the cost of capital, we want to understand the extent of, and rationale for any variance... We note that we remain committed to undertaking a contextual assessment of airport performance*".[5]

Further, and as acknowledged in the PSE4 Review, the Commission has previously accepted the use of actual credit ratings in the CIAL PSE3 and the Wellington International Airport Limited (**WIAL**) PSE4:

- **CIAL PSE3**: the Commission was satisfied that we had provided legitimate reasons to apply our own debt premium estimate, based on CIAL's actual credit rating of BBB+ (compared to the Commission's benchmark of A-).[6] In explaining that it considered our cost of debt estimate to be reasonable, the Commission noted:[7]

  - CIAL's actual credit rating of BBB+ is still an adequate investment grade rating, and is sufficiently high to ensure there is an adequate buffer against the possibility that economic downturns or shocks lead to financial distress,

  - CIAL's credit rating appears to be consistent with a prudent level of debt financing, and

  - BBB+ is consistent with the benchmark credit rating the Commission uses for regulated electricity lines and gas pipelines businesses.

- **WIAL PSE4**: the Commission determined the use of a BBB+ credit rating, in departure from the benchmark credit rating of A-, was appropriate based on the same reasons as those set out above and, additionally, because a debt premium uplift consistent with a BBB+ credit rating appears to have been accepted by airlines.[8]

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4 Commerce Commission, Input Methodologies Review Decisions – Topic Paper 5 – Airports Profitability Assessment (20 December 2016). Available at: https://comcom.govt.nz/__data/assets/pdf_file/0022/60529/Input-methodologies-review-decisions-Consolidated-reasons-papers-20-December-2016.pdf

5 PSE4 Review, at [91].

6 We noted in our PSE3 pricing proposal that there are a number of reasons as to why CIAL is unable to maintain the credit rating assumed in the IMs even though our level of financial leverage is similar to the IMs' benchmark, which include CIAL's:

- small size relative to the international sample of airports applied to derive the benchmark asset beta and leverage assumption,
- exposure to leisure traffic, and
- the repeated exposures to natural disasters, including the Canterbury earthquakes and the Covid-19 pandemic, and their impact on CIAL's underlying credit metrics.

We also stated that we consider a BBB+ credit rating is more relevant to its specific circumstances because:

- BBB+ is consistent with its "stand-alone" credit profile (i.e. excluding the effect of government ownership), and
- it is the stand-alone credit profile that is relevant to the estimation of WACC for pricing purposes (to avoid including an element of government subsidy).

7 Commerce Commission, 'Final Report: Review of CIAL's pricing decisions and expected performance (July 2017-June 2033)' (1 November 2018), at [118]. Available at: https://comcom.govt.nz/__data/assets/pdf_file/0026/103994/Final-report-Review-of-Christchurch-International-Airports-pricing-decisions-and-expected-performance-July-2017-June-2022-1-November-2018.pdf

8 Commerce Commission, 'Final Report: Review of WIAL's 2019-2024 Price Setting Event' (28 September 2022), at [91]. Available at: https://comcom.govt.nz/__data/assets/pdf_file/0030/293628/Review-of-Wellington-AirportE28099s-2019-2024-price-setting-event-Final-report-28-September-2022.pdf

There are supplier-specific justifications for departing from the Commission's benchmark
First, prices are set on the basis of the parameters prevailing at the relevant time. When we were setting our prices for PSE4, CIAL's actual credit rating was BBB+, notwithstanding that it was subsequently upgraded. We disagree in principle with the Commission's apparent justification of an A- benchmark on the basis that:

- CIAL's credit rating had a positive outlook when we set our prices, and
- CIAL's credit rating later increased in November 2022 to the same as the Commission's A- benchmark.

Apparently in support of this justification, the Commission refers to a note in its PSE3 review, stating:

> "*where an airport's actual credit rating is the same as our benchmark, we did not consider there was a case for a supplier-specific adjustment due to differences in credit rating*".[9]

This note does not support the Commission's justification for its approach, as CIAL's actual credit rating at the relevant time was not the same as the Commission's benchmark. In any event, the application of an A- rating is not justified by the parameters prevailing at the time.

Second, we maintain that an A- rating is artificially inflated, as it arises from an implicit expectation of extraordinary government support. CIAL only receives an A- rating because we are owned by a (local) government entity with an AA rating.[10] On a standalone basis, CIAL's credit rating would be BBB. Even if the benefit from being Council-owned is taken into account, this should imply only a BBB+ rating, given that was the rating that prevailed at the relevant time.

Third, factors such as size, exposure to leisure traffic, and natural disasters should be considered. Those factors are considered by Moody's methodologies[11] and can accordingly affect credit rating. Similarly, Standard & Poor's emphasises in its ratings methodology papers the importance of cyclical (systematic) factors in its credit rating assessments. For example, in its methodology paper on the industry risk component of its credit rating methodology, Standard & Poor's states as follows:[12]

> *"We generally consider the more cyclical an industry's level of profits, the more this factor will contribute to credit risk for the entities operating in that industry… To calibrate the cyclicality component of these criteria, we performed a peak-to-trough analysis of industry revenues and profitability in these recessionary periods… We consider cyclicality calibration as a key component of these criteria because of the importance of cyclicality in determining an industry's and entity's level of credit risk."*

We disagree in principle with the Commission's approach that, to the extent these factors are systematic, they would be accounted for in the asset beta, to the exclusion of their consideration in relation to credit rating. The fact of their inclusion in Moody's and S&P's methodologies means these factors also influence credit rating (and therefore the cost of debt).

CIAL applied an appropriate estimate of the BBB+ debt premium
We continue to hold the view that it is appropriate to apply our estimate of the BBB+ debt premium (taken from the Commission's cost of capital determination for gas pipeline businesses as of 1 March

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9 PSE4 Review, at [61].

10 It is true that, if CIAL was owned by a large infrastructure firm that had a higher rating, it may also get some "Group" benefit. That said, there are very few privately-owned "groups" that tend to have an AA Rating, and for large infrastructure conglomerates, the highest tends to be A. For example, out of the 250 firms currently included in the NZX50 and ASX200 indices, only 5 entities have a credit rating of AA- (Aa3) or better, and all except one of which are the "big four" Australian and New Zealand banks (the fifth is the Australian Stock Exchange itself).

11 Moody's Investor Service, 'Rating Methodology: Publicly Managed Airports and Related Issuers' (10 February 2023). The methodology includes size of the service area, diversity of the service area, and event risk (including natural disasters). Available at: https://ratings.moodys.com/api/rmc-documents/398689

12 Standard & Poor's (19 November, 2013), *General Criteria: Methodology: Industry Risk*, p.5.

2022) to our price setting process. We set out below our arguments in relation to the two issues raised by the Commission:[13]

a. *The Commission states the first issue is that the timing of the estimate is inconsistent with that of CIAL's estimate of the risk-free rate (take from the Commission's cost of capital determination for Wellington International Airport, estimated as of 1 April 2022)*.

We disagree that there was a material inconsistency between the timing of observations that were applied in CIAL's debt risk premium estimate, and the timing of the risk-free rate estimate. CIAL's debt risk premium applied the gas pipeline business debt risk premium that the Commission released in the context of the gas pipeline business price-quality determination, which was based on the average debt risk premia over the five years to 28 February 2022. The end-date to this period was only one month prior to the end-date for CIAL's risk-free rate estimate (31 March 2022). In our view, the increased objectivity that results from applying an estimate of the cost of debt that can be referenced to a decision of the Commission more than outweighs any detriment caused by the one-month mismatch in end-dates for the respective periods.[14] Indeed, if CIAL had simply applied the prevailing airport ID WACC, then the debt risk premium would have reflected the five-year average to June 2021, which would have led to a greater inconsistency with the timing of the risk-free rate.

In addition, CIAL explained to customers its proposal to apply the gas pipeline business 1 March 2022 debt risk premium, including that this would result in greater consistency between the timing of the debt risk premium and risk-free rate.[15] This proposal was not objected to by major customers.

b. *The Commission states the second issue is that the estimate is for electricity distribution, not airport services*.

We also disagree that the estimated cost of debt we applied is inappropriate for airport services with a BBB+ rating.[16] We acknowledge the method for determining the cost of debt in the IMs permits a differentiation between the sectors that are regulated under Part 4 (and, specifically, that greatest regard is applied to observations from within the same sector). However, in practice, the Commission's estimates do not vary materially between sectors. As an indicator of this, we note that the Commission's estimates of the cost of debt have tended to be very similar to the estimate derived from the Nelson-Siegel-Svennson (NSS) method, in which method there is no allowance made for differences across sectors. Of most relevance to the current matter:

- the Commission's estimated debt risk premia for the most recent two airport "debt premium reference years" were slightly below the NSS estimate (1.20 per cent vs. 1.25 per cent) and slightly above the NSS estimate (1.00 per cent vs. 0.98 per cent), and

- the debt risk premium for the last gas pipeline distribution business "debt premium reference year" that CIAL applied in its pricing decision was also very close (slightly above) the NSS estimate (1.10 per cent vs. 1.08 per cent).

Charges for transfer passengers

The Commission notes that CIAL's change to how we charge for transfer passengers[17] will lower prices, likely promote efficient use of assets, and ultimately reduce costs to customers.[18] The

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13 The Commission raises these issues at [65] of the PSE4 Review.

14 Moreover, as the cost of debt was applied as a five-year average, it is unlikely that moving the average forward in time by only one month would have changed the debt risk premium in a material way.

15 CIAL, 2022, Revised proposal, para.77.

16 As noted above, CIAL's estimate of the debt risk premium was based on the Commission's estimate for the gas pipeline businesses, rather than the electricity distribution businesses.

17 Previously, we charged for both the arriving and departing legs of the journey. Now, only one leg will attract a charge. If there is an international leg, the carrier of the international flight will attract the charge. When there is no international leg, the greater of the two charges will be paid, and if charges are the same the carrier of the arriving leg will attract the charge. Disclosure, at [23]–[28], and as referred to at [100]–[102] of the PSE4 Review.

18 PSE4 Review, at [102].

Commission concludes that this change to the pricing structure aligns with the purpose of the Commerce Act 1986 (**Act**).[19]

While we agree that this approach to transfer passengers is consistent with the Act, that is not to say other approaches (including our approach in PSE3) would conflict with the purpose of the Act. In our view the approach to transfer pricing is essentially neutral in terms of the Part 4 purpose statement, and therefore a matter for CIAL's discretion, in consultation with customers.

We have made this transfer pricing change in response to feedback from some of CIAL's customers, and it mirrors the practices of many airports overseas.[20] We have not made this change due to concerns about alignment with the purpose of the Act.

Update on Transfer of Airfield Power & Lighting Assets
In CIAL's Disclosure relating to the reset of aeronautical prices for the period 1 July 2022 to 30 June 2027 (**Disclosure**) (18 August 2022), we noted for completeness that CIAL is in discussions with Airways New Zealand (**Airways**)[21] in respect of the possible transfer of airfield power and lighting assets (**APLE**) from Airways to CIAL.[22] At the time of the Disclosure, the discussions were not sufficiently advanced to include the associated capex in CIAL's PSE4 prices. We noted that, if agreement is reached with Airways and any transfer of assets has material implications for capex or opex in PSE4, we may consider repricing mid-PSE4.[23]

By way of update, positive discussions between CIAL and Airways are ongoing. Airways remain committed to transferring the assets; however no handover dates have been discussed or agreed.

At this time, an appropriate mechanism for CIAL to recover the capital purchase and ongoing operating costs of these assets within the existing regulatory model and PSE4 pricing period has yet to be confirmed and agreed.

Given the complexity of the potential arrangement being discussed, we will ensure it is transparent with our customers if there is a material advancement in these discussions.

If you would like to discuss any aspect of the contents of this submission, please feel free to contact me.

Yours sincerely

[redacted]

Tim May
Chief Financial Officer

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19 *ibid*.

20 Disclosure, at [27].

21 *ibid*., at [124]–[125], and as referred to at [114]-[115] of the PSE4 Review.

22 PLEXIT/APLE was defined in our Disclosure as meaning the power and lighting assets which CIAL is discussing acquiring from Airways. The specific assets under discussion are airfield approach, runway, taxiway lighting, underground cabling, data cabling, power distribution centres and lighting control systems.

23 We noted our anticipation that any repricing would be limited to addressing changes in overall expenditure occasioned by the transfer of the PLEXIT/APLE assets, Disclosure at [125].