POST CONFERENCE SUBMISSION BY BARNZ AFTER CHRISTCHURCH AIRPORT SECTION 56G CONFERENCE

18 June 2013

BARNZ thanks the Commission for holding the Conference to explore the issues surrounding the effectiveness of information disclosure regulation in promoting the purpose of Part 4 in relation to Christchurch Airport and for providing this opportunity for parties to respond on further matters identified by the Commission.

As noted at the Conference, BARNZ acknowledges that Christchurch Airport has appropriate levels of quality, innovation, service levels and investment. It also considers that due to the unique circumstances facing the Airport of two major earthquakes, and construction of a significantly larger new terminal building, it is not possible to reach any definitive conclusions with respect to efficiency.

The key issue which the BARNZ represented airlines have with Christchurch Airport's conduct is with respect to its price setting. Specifically, Christchurch Airport's use of its market power to set charges at levels which will earn it significant excess returns, both in the present pricing period and in future pricing periods.

The two decisions by Christchurch Airport which result in this significant level of over-recovery are its use of a 9.8% post tax cost of capital and its treatment of income from revaluations as being taxable. Both of these decisions increase the total cost of service, and hence the long run prices established by the Airport.

The ability of Christchurch Airport – like the other Airports – to pick and choose which input methodologies it will apply, and to adopt different inputs where it so chooses, has left the Airport unlimited in its ability to extract excessive profits. Information Disclosure Regulation has therefore been ineffective at promoting the purpose of Part 4 in the vital area of limiting excessive profits at Christchurch Airport, and has failed to produce outcomes which replicate those found in workably competitive markets.

Treatment of revaluations for tax purposes

BARNZ continues to consider that Christchurch Airport's approach of applying a pre-tax return on capital, without reflecting the fact that income from revaluations is not taxable, results in the Airport's assessment of its required revenue being significantly overstated, due to it seeking to recoup tax on non-taxable income, and resulting in excess profits being extracted from consumers of regulated airport services.

The tax input to CIAL's financial model is clearly over-stated

That Christchurch Airport is lifting its required return to recoup tax on non-taxable income can be seen very clearly in the 'full cost of service calculations' in the last 16 lines of the airfield, international terminal, domestic jet terminal and domestic turbo-prop terminal worksheets of Christchurch Airport's financial model. In calculating the 'full cost of service' the Airport grosses up all its required return on capital to include tax (ie to be a pre-tax figure) without making any adjustment to reflect the fact that a substantial portion of the required return, and hence required revenue, is being met through income from revaluations, which are not taxable. This was discussed by BARNZ at pages 15 to 18 of its Response to the Commission's Issues Paper.

The 'full cost of service' calculations in those four worksheets directly feed into Price Option 1 entitled 'Prices to meet full cost of service' at the beginning of the Pricing and Revenue worksheet where Christchurch Airport determines its charges. The 'LRMC pricing path' (Price Option 2) is set so as to result in the same present value outcome over 20 years as Price Option 1 – the 'full cost of service'. The prices actually set – entitled 'proposed pricing path' or Price Option 3 – result in a claimed $16m under-recovery relative to the 'LRMC pricing path' (which as noted above produced the same present value outcome as Price Option 1 – 'prices to meet full cost of service'). The over-statement of tax in the 'full cost of service' calculations therefore directly leads to an overstatement of the 'LRMC pricing path', which forms the basis against which the prices actually set are judged. In terms of the revenue path slide presented by Christchurch Airport at the Conference, the error by Christchurch Airport in relation to its tax treatment results in the total cost being overstated, which in turn causes the 'levelised price' to be significantly over-stated. The error is therefore directly relevant to the adopted price.

As noted by BARNZ in its Response to the Commission's Issues Paper, Christchurch Airport should have excluded revaluations from the income on which it calculated tax (which is the approach mandated by the Commission for information disclosure purposes). Alternatively, if it insisted on applying a pre-tax WACC, then revaluations should have been notionally grossed up when they were deducted as income so as to cancel their effect in building up the allowable revenue. Such a treatment would have given the same result as the Commission's method.

Christchurch Airport acknowledged at the Conference that the treatment outlined above by BARNZ was correct if a single year is being considered.[1] If correct for a single year, then logically it is correct for the calculation of the full cost of service for a 20 year period because the mistake results in an overstatement of tax in each year that is affected by revaluations.

BARNZ trusts that in undertaking its IRR analysis the Commission will:

- Calculate Christchurch Airport's expected return using cash flows net of tax;
- Use its input methodology for the calculation of tax; and
- Compare the resultant IRR with the Commission's net WACC

[1] Conference transcript, page 44, lines 3 – 5.

— as per the approach taken by the Commission to tax in its analysis of the other airports.

The 'check model' does not answer BARNZ's concerns

Christchurch Airport has acknowledged that its approach over-states the amount of tax the airport is likely to pay during PSE2.[2] However, it goes on to allege that this is *'not relevant'*, stating that *'in the long-run model, the effect of the tax treatment on prices does not depend on whether the 5-year forecast is right. It depends on whether the present value of the tax allowance over the 20 year period is right'*.

Christchurch Airport has provided the Commission with a 'check model' which purports to show that over 40 years the present value of its tax approach is equivalent to the tax payable approach specified by the Commission in the input methodologies. The airlines were not provided with this 'check model' (or anything similar to it) by the Airport during consultation over charges. Nor was it included in the Airport's information disclosure subsequent to pricing.

However, three days before consultation was due to finish, the airlines were provided with a shorter, simpler, hypothetical model prepared by Christchurch Airport[3] which purported to show that the NPV of the tax expense and tax payable approaches were the same over the life of a 25 year asset. BARNZ requested Dr Layton of Futures Consultants Ltd to review that model. Dr Layton's advice was incorporated in a note by BARNZ to Christchurch Airport dated 12 September 2013 where the key points made were that:

- Christchurch's hypothetical model did <u>not</u> demonstrate that the present values of the two approaches were the same.
- The model indicated that the implicit tax allowance was above the tax payable level for about 15 years for assets with a 25 year life (or 4% depreciation rate), but below it after that point. Christchurch's approach therefore resulted in a material increase in required revenue for the early to mid-life years of long lived assets.
- The model did not include any allowance for additions to the RAB over time. If additions occurred as the Airport expanded (as is likely) then Christchurch's approach will lead to required revenue being perpetually higher than under the tax payable approach.
- What Christchurch Airport was proposing was that airlines accept a tax treatment approach which would have them paying significantly higher fees to Christchurch Airport for an extended period of time in the expectation they will eventually face lower fees in 3 or 4 pricing periods into the future, even though the Airport has not provided any commitment over pricing beyond the current pricing period.

[2] Christchurch Airport Response to Commerce Commission Issues Paper, 22 March 2013, page 33.
[3] This is not the tax 'cross check' model which Christchurch Airport now appears to be promoting, which is not a document seen by BARNZ during consultation, and which is completely different and significantly more detailed to what was provided by Christchurch Airport to airlines in consultation.

BARNZ does not believe that the present value of Christchurch Airport's approach to the calculation of its tax requirements and the Commission's formula for calculating tax obligations are the same. Indeed, Christchurch Airport's check model itself demonstrates that there is a significant difference between the two approaches in NPV terms over 40 years with the Airport's tax approach being $37.5m greater than the regulatory tax allowance.[4] Christchurch Airport might claim that in simple terms, the nominal difference is lower at $11m, however this fails to sufficiently recognise the significant over-recovery of tax in the first ten years of Christchurch Airport's financial model.

Christchurch Airport's approach significantly advantages the Airport to the detriment of airlines and passengers

In BARNZ's view, Christchurch Airport's approach to tax is simply a means for the Airport to extract excessive profits from its business, by the means of overstating its tax obligations and collecting additional revenue to reimburse it for tax that is not payable. Information disclosure regulation has not been able to prevent this deliberate manipulation of the charge setting process by the Airport to its financial advantage.

During consultation Christchurch Airport advised the airlines that it was *'irrelevant'* that *'no tax is payable on the notional income'* and the approach that it had adopted meant that *'any tax incentives provided by the Government are treated as a benefit to the investor, rather than passing those incentives to the consumer … [which] is precisely how tax incentives are supposed to work'*.[5] (Emphasis added).

The simple fact of the matter is that revenue from revaluations is not taxable in New Zealand. This is why the Commission's input methodologies require income that is non-tax-assessable (such as revaluations) to be deducted from the regulatory income before tax is calculated. Christchurch Airport has not done this, and has not provided any valid reason for failing to do this, or any valid reason for relating the charges they set to a total cost of service which includes an over-stated estimate of tax.

Even if Christchurch Airport's claim that the net present value of the two approaches is the same over 40 years (which is refuted by BARNZ and appears to be shown to be wrong by Christchurch Airport's own 'check model'), airlines and passengers are not neutral to the outcome. In fact the approach significantly disadvantages airlines and passengers and further heightens their exposure to potential future extraction of excess profits by the Airport:

- The tax included in Christchurch Airport's financial model is significantly front-end loaded. Taking the figures in the Airport's 'check model', the tax included in the Airport's model exceeds the regulatory tax allowance by $56m in PSE2 and by $21m in PSE3.[6] The outcomes under the two approaches in PSE4 are largely equivalent. It is not until PSE 5 (FY28 – FY32) that the positions reverse and the regulatory tax allowance exceeds the tax included in the Airport's financial model. Christchurch Airport has used too high a benchmark which will

[4] Christchurch Airport tax check model, cell F80.
[5] Christchurch Airport Responses to Airline Queries, 20 April 2012, page 3.
[6] Christchurch Airport tax check model, line 75.

result in the airlines paying charges that include a significantly higher tax element for an extended period of time with the dim prospect that four pricing periods later they will allegedly start to face charges that contain a lower tax element.

- Under Christchurch Airport's interpretation of the current regulatory regime, it has declined to provide any commitment beyond the current five year pricing period. Airlines therefore can rightly feel quite sceptical that they would ever see the corresponding benefit in PSE5 and PSE6 to the higher charges applicable in PSE2 and PSE3 under Christchurch Airport's approach. The previous 'commitment' provided by Christchurch Airport that it would not revalue its assets for two pricing periods lasted all of three years before the Airport changed its approach — as the AAA regime allows it to do. There is no guarantee at all that the future 'unders' will ever eventuate to off-set the current 'overs'. Any change in ownership would render this prospect even more highly unlikely.

- Indeed, the Airport explained during the Conference that its intention is that the levelised pricing model will be updated each pricing period by adding a further five years – so the model will always look forward 20 years.[7] Thus airline charges will always be set for the first five years of the model. Charges will never eventuate to years 6 to 10, or 11 to 15, and significantly will never reach the fourth pricing period in the model (PSE5) at which Christchurch Airport alleges its tax treatment approach will fall below the tax payable method. Thus Christchurch Airport is intending airline charges to be perpetually based on an over-stated tax estimate. Airlines will be forever trapped in the first five years of the pricing model during which the implicit tax allowance is above the tax payable approach, and will never enjoy the later years of the model when the tax allowance is allegedly lower. The required revenue will be perpetually higher, to the advantage of the Airport, and the disadvantage of the airlines – just as Christchurch Airport intended when it designed its pricing model so as to ensure (as it explained to BARNZ during consultation when these concerns over tax were raised) that '*any tax incentives [would] benefit … the investor*'.[8]

Establishment of opening asset base

Given the preference of all parties for the Commission's analysis to be undertaken for the 4 years 7 months for which prices have been set, the Commission has asked:

a. How should the Commission establish the opening asset base to be used in its IRR analysis?

b. What assumptions need to be made about the opening value, eg when did the parts of the new terminal come into use?

c. How should the Commission ensure that the forecast CAPEX over PSE2 is consistent with the opening asset value assumptions?

[7] Conference transcript, page 17, lines 18 to 21.
[8] Christchurch Airport Responses to Airline Queries, 20 April 2012, page 3.

BARNZ confirms that it considers that a 4 year 7 month period of analysis is appropriate given that charges were set for this period, and adoption of a longer period of analysis (such as five years) would result in the return to the Airport over PSE2 appearing lower than is the case due to the presence of the initial five months for which charges remained at PSE1 levels and were not reset.

Assuming the Commission undertakes a 4 year 7 month analysis beginning 1 December 2012 then BARNZ's response to the Commission's specific questions is as follows:

a. In the case of Christchurch Airport, which set charges for PSE2 using the input methodology compliant asset values, then the opening asset base used in the IRR analysis should be the FY2012 closing RAB value, updated by five months. Pages 26 and 38-39 of CIAL's Price Setting Disclosures set out the Airport's assessment of the difference between the FY2012 closing RAB and the pricing asset base as at 1 December 2013.

b. BARNZ has checked that the first floor airside and landside circulation spaces were largely in use by 1 December 2012. Overall BARNZ therefore confirms that, like Air NZ and Christchurch Airport, it considers 1 December 2012 a reasonably pragmatic date for assuming the new passenger terminal was in use. The airside apron works of $18.7m should be treated differently. These were scheduled to be complete circa April 2013, and therefore should not form part of the 1 December 2012 opening asset base. Instead, they should be treated as capex occurring in the first year of the pricing period. This is how they were treated by Christchurch Airport in its financial model.

c. If a 4 year 7 month analysis period is adopted, then BARNZ considers that the Commission needs to apportion FY13 capex as follows:

    a. Assume that 41.7% (5/12s) of the FY13 forecast capex, excluding the IPT apron works, will be in use at 1 December 2012;

    b. Split the remaining 58.3% (7/12s) of the FY13 forecast capex, excluding IPT works, between the opening (1 December 2012) and closing (30 June 2013) asset bases; and

    c. Have the $18.7m of IPT apron works enter the asset base at 1 April 2013.

    In summary, this results in the $34.5m of FY13 forecast capex entering the asset base as follows:

    - $11.2m in the opening asset base at 1 December 2012
    - $18.7m (IPT airfield airside works) at 1 April 2013
    - $4.6m at 30 June 2013

Determination of the closing asset base

BARNZ considers that the Commission needs to undertake two scenarios in its analysis – one reflecting Christchurch Airport's final determination which utilised an input methodology compliant asset base and the other reflecting Christchurch Airport's initial pricing proposal which was based on updated ODRC revaluations of specialised assets and a new existing use valuation of its land.

Christchurch Airport's final pricing decision in PSE2 was based on input methodology compliant asset valuations. Its indicative long run model suggests it will continue with this approach. That indicates that one appropriate scenario for assessing CIAL's IRR is to use an input methodology compliant asset base.

However, by itself, this analysis will not present a complete picture of reasonably likely outcomes.

During consultation, Christchurch Airport specifically refused to make any commitment to continuing with this approach – despite BARNZ requesting Christchurch Airport to identify which aspects of its pricing model were being committed to by the Airport.[9] This refusal to commit to continuing to use an input methodology compliant asset base was confirmed by the Airport in its response to the Commission's Issues Paper in April.[10] However, at the Conference Christchurch Airport appeared to indicate that asset valuation methodology was being committed to by the Airport.[11] There is thus an inconsistency between Christchurch Airport's position during consultation, which was repeated in its response to the Commission's Issues Paper, and the responses given by the Airport at the Conference, which requires resolution. Nevertheless, even if Christchurch Airport gave such a commitment, it still has the option of changing its mind – as occurred in 2012 when despite an unequivocal commitment made by the Airport in 2009 to not revalue its assets for two pricing periods, the Airport nonetheless moved to use asset revaluations for the purpose of resetting its charges in 2012, just three years later.

BARNZ therefore considers that the Commission needs to undertake a second analysis based on Christchurch Airport reverting to its previously stated preferred position of regular ODRC revaluations and MVEU or highest and best use valuations of its land. These latter approaches formed the basis of Christchurch Airport's Initial Pricing Proposal to airlines in March 2012 which was based on a financial model using the following inputs:

- A 30 June 2011 'market value highest and best use' valuation of its land by Seagar and Partners which adopted land values taking into account the land's existing use as an airport, its alternative uses and the reproduction cost of the land;[12]
- A July 2010 ODRC revaluation of Runways, Taxiways, Aprons and Infrastructure Assets by Opus International Ltd;[13] and
- A 2011 ODRC revaluation of the international terminal building by Opus International Ltd.[14]

[9] Written responses by Christchurch Airport to questions asked by airlines at a briefing on 23 August 2012, page 5.
[10] Christchurch Airport Response to Commerce Commission Issues Paper, 22 March 2013, page 30.
[11] Conference transcript, page 19, row 33 – 34, per Mr Sundakov in response to a query from Commissioner Begg, this point was repeated by Mr Cochrane at page 32, line 19.
[12] Attachment 6 to Initial Pricing Proposal, Seagar Valuation, page 12. Christchurch Airport's Financial Model on supporting its Initial Pricing Proposal was based on this this 2011 market value highest and best use (or MVEU) valuation. Refer BARNZ Response to CIAL Initial Pricing Proposal 25 May 2012 at pages 13 – 14. BARNZ notes that Christchurch Airport has challenged this view, advising that its Initial Pricing Proposal was based on an MVAU valuation. That is not correct. The asset base on which CIAL's financial model was based in the Initial Pricing Proposal included the 2011 MVEU land revaluation uplift. It was only in CIAL's Revised Pricing Proposal that it moved to apply an MVAU uplift in 2011.
[13] Attachment 4 to Initial Pricing Proposal.
[14] Attachment 8 to Initial Pricing Proposal.

Treatment of unforecast revaluation gains related to PSE1

As it set charges in 2009 Christchurch Airport adopted two positions, the combination of which were fundamentally opposed by BARNZ:

- It did not treat any of the $153m of unforecast revaluations from 2000 to 2008 as income in the charge resetting process for new charges to apply from 2009.
- It adopted a moratorium on revaluations for the next two pricing periods, and therefore did not include any forecast revaluations in its financial model on which charges were reset in 2009.

Christchurch Airport stated, at the time, that this approach had been adopted as *'a means of ensuring CIAL is not compromised from a cash perspective'.*

Airlines raised concerns over the risk of Christchurch Airport subsequently revaluing its assets, pricing off those revalued assets and not treating those revaluations as income in the charge setting process. In response, Jeff Balchin, in a Statement for Christchurch Airport Ltd, stated:[15]

> The risk that BARNZ has identified is a risk that should not exist. … If a revaluation has not been foreshadowed, consistency requires that the assets <u>must not</u> be revalued at the end of the period. … If CIAL had not committed at the start of a future pricing period to a revaluation at the end of that period – and had not made a forecast of revaluation gains and treated this as income when those prices were set – then a revaluation at the next price review should not occur. (Emphasis included in the original statement.)

There was therefore a clear commitment in 2009 by Christchurch Airport to not revalue assets for two pricing periods and to not forecast any revaluation gains as it set charges in 2009.

As it transpired, Christchurch Airport changed its mind – as it has the ability to do utilising the AAA power to set charges as it thinks fit. It did revalue its assets for pricing purposes at the start of PSE2. However, it treated those revaluation gains (and losses) as income (or a cost) offsetting required revenue in PSE2.

By and large, BARNZ agrees with Christchurch Airport's treatment of these revaluation gains as income in PSE2.[16]

BARNZ considers that the Commission also needs to treat the unforecast revaluation gains from PSE1 as income in PSE2.

The FCM principle underlying the Commission's approach to asset revaluations and the treatment of such revaluations in the input methodologies requires that, if a nominal cost of capital is applied to a revalued asset base, then all revaluation gains must be treated as income in order to effectively monitor profits.[17]

[15] Jeff Balchin, Allen Consulting Group, Statement for CIAL, 16 February 2009, page 6.
[16] Noting that there is the separate outstanding issue of whether these revaluation gains are part of the regulatory taxable income or not.
[17] Refer Commerce Commission, Specified Airport Services Input Methodologies Determination, 22 December 2010, para 2.8.13 – 17.

There needs to be consistency between the treatment of revaluation gains and the asset base used for pricing or for assessing returns against.[18] In the present case, the unforecast revaluation gains relate to the move by Christchurch Airport to align its pricing asset base with the input methodology compliant asset base. The revaluations form the basis of both the pricing asset base and the input methodology compliant asset base likely to be used by the Commission as its opening asset base in its IRR analysis. Falling within the revalued PSE2 asset base, the revaluations also therefore need to be treated as income to the Airport in PSE2.

The situation differs to that applicable at Wellington Airport where the income from part of the unforecast revaluations at the end of PSE1 which were treated as income by Wellington Airport as it set prices in PSE 2 (the revaluation wash-up) related to Wellington Airport's MVEU revaluation, which did not form part of the opening asset base in the Commission's IRR analysis. For consistency, given the asset base used by the Commission in its IRR analysis of PSE2 excluded Wellington Airport's MVEU revaluation uplift, likewise the Commission's assessment of income earned by Wellington Airport in PSE2 did not include the revaluation wash-up.[19]

At Christchurch, the opening asset base likely to be used by the Commission in its IRR analysis for PSE2 will be the input compliant asset base incorporating the revaluations undertaken by Christchurch Airport during (and at the end of) PSE1, which had not been treated as income by the Airport during its PSE1 charge setting process. Those revaluations being included in the PSE2 IRR asset base, means that the revaluations not treated as income in PSE1, likewise need to be treated as income earned in PSE2.

Christchurch Airport set its charges in PSE1 on the basis of a commitment it chose to adopt to undertake no further revaluations. It therefore did not include any forecast revaluations as income as it set PSE1 charges. Having decided in PSE2 to change its approach and set charges off a revalued asset base, those unforecast evaluations now need to be treated as income in PSE2 in order to ensure both consistency between the treatment of the revaluations and the decisions which were made regarding revaluations of the asset base, and compliance with the FCM principle.

BARNZ therefore considers that all of the unforecast revaluations to Christchurch Airport's assets which occurred during PSE1 or at the beginning of PSE2 need to be treated as income in the Commission's analysis of the returns in PSE2. This is consistent with how both Christchurch Airport and BARNZ treated these revaluations in the process for resetting charges for PSE2.

What is the appropriate WACC date for the IRR analysis?

In BARNZ's view the relevant WACC estimate to apply when setting charges and assessing their reasonableness, is the applicable WACC determined as close as practicable to when charges were

[18] This principle is most clearly articulated by the Commerce Commission in paragraph I28 and I95 and I96 of the Commission's draft section 56G Report on Wellington Airport, which were crossed referenced in the Final Report at footnote 190.
[19] Refer para F54 of Commerce Commission S56G Final Report on Wellington Airport and the fuller explanation at para I31 of Commerce Commission S56G Draft Report on Wellington Airport.

set. This ensures that the WACC represents the prevailing market conditions with respect to the cost of capital elements.

BARNZ notes that this was also Auckland Airport's position when it set charges in both 2007 and 2012, when the cost of debt elements of the WACC were updated some 10 days and 18 days respectively prior to the Auckland Airport Board reaching its determination on new charges.

BARNZ also notes that Wellington Airport updates its WACC close to when charges are set, for example updating its revised pricing proposal in 2007 to reflect changes to the tax and risk free rates while that revised proposal was being considered and responded to by airlines.

BARNZ always updates the WACC advice it receives in the week to ten days prior to it assessing the reasonableness of a proposal by an airport. For example, in the case of its Revised Assessment made to Christchurch Airport on 7 September 2012, BARNZ obtained an updated WACC estimate from Futures Consultants as at 1 September 2012.[20] This approach was taken despite the fact that the cost of debt had actually increased since the previous WACC estimate used by BARNZ in its Assessment of Christchurch Airport's Initial Pricing Proposal.

Christchurch Airport determined its new charges on 24 October 2012. BARNZ considers that the applicable date, on which it is as close as reasonably practicable to update the WACC prior to this decision, falls between 6 and 14 October. BARNZ's preference would be for the Commission to adopt 10 October – thus allowing a full two weeks from the WACC being updated to reflect the current cost of debt into the charge setting decision.

Christchurch Airport's determination of a WACC using the risk free rate applicable as at 31 March 2012 to determine its cost of debt, and the 10 year historical average applicable as at 31 March 2012 for calculating its cost of equity, both fail to reflect a current forward looking cost of capital, and thus contributes to Christchurch Airport's WACC of 9.8%, which significantly exceeds the appropriate WACC range produced from applying the Commission's input methodology for WACC.

Whether the timing and level of spend for the new terminal are considered efficient?

The international airlines which BARNZ represents did not require any of the investment inherent in the IPT. International facilities were largely considered appropriately sized and of a high quality. That said, it was recognised that domestic facilities were extremely constrained and of low quality and investment in new domestic facilities was essential. Overall, the timing of the new terminal development was considered appropriate.

There are no concerns that BARNZ has been made aware of concerning unjustified over-capacity in the IPT. Many areas of the new building are already fully utilised. If anything, there are certain areas where airlines would not have objected to a larger footprint, such as the baggage check-in hall and the baggage make-up area (the ground floor where the baggage sortation system delivers the checked in baggage for baggage handlers to sort, authorise and load onto trolleys or into containers for loading onto aircraft).

[20] Futures Consultants Ltd, Update on CIAL's Weighted Average Cost of Capital, 6 September 2012.

How is demand expected to change as a result of the new prices and pricing structure?

As requested by the Commission, BARNZ has sought feedback from the airlines it represents on this issue.

One international carrier has indicated that it will respond directly to the Commission setting out its reaction to the new charges.

Another international carrier has advised that it will factor the higher costs into account as it makes internal evaluations on whether it will operate into, or make changes to the routes and frequency of its services to and from Christchurch Airport. The new charges are such that, for that airline, it is internally proceeding on the basis that there are no planned changes in the near future.

A third international carrier, Virgin Australia, has provided a written statement to BARNZ for it to pass onto the Commission. This sets out the basis for how Virgin Australia reflects airport charges in its decision making process, with the commercial responses it makes to increases in airport charges including:

- A redirection of forward capacity to alternative locations where a better return can be achieved
- Reducing services to the destination
- A decision not to grow services to the destination
- A reduction in promotion of the destination.

Virgin Australia notes that it has not yet decided exactly how it will respond to Christchurch Airport's price increases. It also notes that minimum capacity conditions made in relation to airline alliances make it more challenging for it to make more normal rationale commercial responses to airport pricing decisions.

Comment on Christchurch Airport Assumptions to its IRR calculation

Christchurch Airport has undertaken an IRR analysis as part of its submissions to the Commission. At the request of the Commission it has provided a statement setting out the assumptions it made in undertaking this analysis.

BARNZ makes the following comments about the assumptions adopted by Christchurch Airport:

- The Airport's modelling has assumed that the ITP is 'in its fully commissioned state at 30 June 2012'. BARNZ does not agree with this assumption, which would result in users paying for the terminal before it is complete and fully in use. While the check-in hall and baggage handling areas were complete and in use at 30 June 2012, the upstairs passenger circulation space and airside processing areas were not. Moreover, the final value for the terminal will be likely to include financing costs up until the final completion date as this is standard GAAP practice – thereby resulting in Christchurch Airport counting these costs twice for the final nine to ten months of construction (once through required return and again through capitalisation of financing costs). It appeared to be accepted at the Conference by Christchurch Airport that 1 December 2012 was an appropriate date for assuming the terminal was complete. 1 December 2012 is the date that the terminal building components of the ITP should be added to the asset base.

- The Airport's modelling has also included the $18.7m of airside apron works as being commissioned at 30 June 2012 – when they were not complete and in use until 30 April 2013. During pricing these works were treated as capex relating to FY13, which BARNZ considers is the appropriate treatment.
- Paragraph 5 of Christchurch Airport's IRR assumptions records that commissioned assets are based on the pricing proposal and pricing model capex forecasts. If this is so, then this suggests that there is a double counting of the airside apron works in the IRR analysis because they were part of the FY13 capex forecasts in the pricing model. Christchurch Airport will have included the airside apron works in both the opening asset base (as set out in paragraph 1) and the commissioned assets (capex) (as implied in paragraph 5).
- Christchurch Airport notes in paragraph 2 that 'the closing asset base … excludes revenue to be recovered in future pricing periods' ($19.6m). BARNZ does not accept that there is any short-fall in revenue which then needs to be recovered going forward. However, BARNZ notes that at the Conference there appeared to be acceptance that, if it were valid, the appropriate treatment of this amount would have been as an asset in the closing asset base.[21]
- The Airport's analysis is a five year analysis, when all parties accepted at the Conference that a 4 year seven month period is the term prices were set for and is the appropriate period over which the Commission should undertake its analysis.[22]
- Christchurch Airport has not included income from asset revaluations undertaken during and at the end of PSE 1 as revenue in its modelling. There needs to be consistency between the asset base and the treatment of revaluations. In this case where the revaluations undertaken by Christchurch Airport relate to the PSE2 opening asset base, those revaluations need to be treated as income. The consequence of Christchurch Airport having deliberately not forecast any revaluations in PSE 1, is that these revaluations now fall to be treated as income in PSE2.
- Taxation is stated to be applied to assessable income, which BARNZ agrees with. BARNZ notes that this departs from the Airport's approach in its financial model of calculating tax on all income – even revaluation income which is not assessable.

[21] Conference Transcript, page 48 line 20 to page 49 line 4.
[22] Conference Transcript, pages 46 and 47.