

CIAL POST-CONFERENCE SUBMISSION

SECTION 56G REVIEW

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Public Version

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EXECUTIVE SUMMARY

- 1 Christchurch International Airport Limited (CIAL) appreciates the opportunity to comment on the matters traversed at conference. Our focus in this submission is to address:

- 1.1 the Commission's specific questions arising from the conference; and

- 1.2 any remaining points of contention or misunderstanding.

Advances in understanding made at conference

- 2 However, before turning to the areas which require further clarification, we think it is useful to reflect on the areas where we believe understanding between CIAL, our customers and the Commission was advanced at conference.
- 3 First, we think there was a general understanding of the advantages of a long term approach to setting prices for long-lived infrastructure assets. The Commission asked useful questions about how our approach compares to other possible approaches (including the Commission's deferred depreciation approach). While we are confident that our approach is more transparent (as we explain later in this submission), this is a useful debate that should lead to improvements in price setting. It is important to emphasise that this kind of debate and the resulting improvements are precisely what the ID regime is intended to facilitate.
- 4 We also believe that considerable progress was made in dispelling the myths about our treatment of tax. The Commission staff made a useful suggestion on yet one more way to compare our approach with the more conventional treatment. We present the results of this comparison in the submission. The results confirm again that our treatment does not result in any over-recovery of the tax allowance.
- 5 There was broad agreement at the conference on the best approach to ensuring consistency between the Commission's IRR model—used to assess airport profitability in PSE2 and our long term pricing approach. Since the long term pricing approach requires that future revenue at the levelised constant real price must exceed future cost of service (reversing the "shortfall" in PSE2), the terminal value in the IRR model—which is a proxy for future pricing intentions—needs to be adjusted to reflect that trend. The appropriate adjustment is to include the accumulated difference between the full cost of service and the forecast revenue at the levelised constant real price into the terminal value (by adding it to the closing asset base). We have implemented such an adjustment and report the result in this submission.
- 6 Finally, there was a general understanding that our fixed/variable pricing structure for the airfield was implemented not in response to congestion issues, but rather in order to get a closer alignment between the costs imposed by different types of aircraft and our charges. Clearly, any cost allocation model has a degree of discretion, and reasonable people can disagree about how closely the methodology aligns cost causation and pricing. However, there seemed to be general agreement that our pricing structure is reasonable.

Long term pricing model

- 7 A number of questions about our long term model remained following the conference. The first such issue is whether our model is the best way to achieve our stated objective. It is important to emphasise that with identical inputs, our model would produce the same price path as the Commission's deferred depreciation approach. However, we believe that our approach is considerably more transparent in enabling our users to understand the differences between our commercial prices, the constant levelised price and full cost of service. Airlines can also use our model to understand permanent under-recovery. By contrast, deferred depreciation is essentially deferred recovery, so that airlines cannot use

information on deferred depreciation to get a clear picture about the relationship between current commercial prices and future pricing intentions.

- 8 We also note that there was some residual confusion about what should be fixed and what should be reviewed at each price reset when implementing a long term pricing approach. Some presenters appeared to think that a levelised constant real price must mean a price fixed for 20 years. As we explained at conference this is not the case. There will be adjustments at five-yearly intervals – principally to volume and cost forecasts – to ensure that the price path continues to conform to the NPV=0 principle. This does not, however, undermine our public commitment to the long term model and price path.
- 9 We also wish to clarify our approach to demand risk. The pricing approach adopted by us is based on the orthodox position that CIAL bears normal commercial risk of deviations from the forecast volume within the price reset period, while reviewing forecasts at each future price reset. Our WACC is set to remunerate us for such normal commercial risk.
- 10 However, CIAL's WACC does not compensate CIAL for variations in demand that are outside normal commercial parameters – for example, that which occurs as a result of events such as major earthquakes. If a demand risk of this magnitude crystallised, we would need to consider the possibility of re-consulting on our charges. We expect that, if this were to occur, it would be done on a forward-looking basis. We have no particular intention of doing so at this stage, but we also have to be realistic about the unique circumstances CIAL operates in – as much as we would like to, we can't simply wish away the considerable uncertainty around the timing of the earthquake re-build and the possible consequences of another seismic event. This is a challenge that all businesses trading in Christchurch have to grapple with, airlines included.
- 11 Finally, there appeared to be some confusion at the conference concerning our approach to long term contracts. We would like to emphasise that CIAL is open to long term contracts, but sees such discussions as the subject for post-consultation negotiation, rather than as part of the consultation process. The reason for this is simple—the price setting consultations are carried out within the context of the legislative regime that requires periodic engagement with all substantial customers, and which results in a standardised pricing regime. However, different customers have different attitudes to risk. Some wish to commit to long term contracts, while others wish to have the flexibility of short term arrangements. This will depend on each customer's business strategy. We appreciate that commitment to a long term contract transfers some risk from CIAL to the customer. It is a matter for bilateral commercial negotiations with each customer to arrive at the degree of risk transfer, and fair remuneration for such transfer.

Profitability

- 12 As the Commission has highlighted, disagreement about WACC is difficult to avoid given the divergent incentives of the parties. It is not unusual that our customers would prefer we earned less profit—regardless of what that profit is. We believe, however, that one of the benefits of the ID regime is that concerns about profitability can be discussed openly and empirically. In this context, we are pleased to implement the numerical tests proposed by the Commission. The Commission staff suggested that a further way to assure all concerned that we do not overcharge due to tax treatment is to compare present values of post-tax cash flows, discounted at the post-tax WACC that would result from our pricing model or from the conventional building blocks model. We attach to this submission such a comparison. It shows that the results are the same, given the margin of error, with a small bias in favour of our customers.

- 13 We have also implemented the IRR model with an increase in the terminal value for PSE2 as a proxy for future price trends. This terminal value incorporates the difference between the revenue that would have occurred at the constant levelised price and the full cost of service during the period. As requested by the Commission, the model is for the 4 year 7 month period. The post-tax IRR for the total regulated activities is 7.90%. This is less than the Commission's estimate of WACC.
- 14 We would like to emphasise that this estimate is conceptually the highest possible estimate: the 4 year 7 month model in effect assumes that CIAL did not incur any financing costs on ITP assets that were in place on 1 July 2012 for both the period post commissioning and pre 30 June 2012 (stage 1, May 2011, and stage 2, April 2012) and the 5 months prior to the commencement of the new price period. This is clearly not a realistic assumption. Similarly, the 4 year 7 month model effectively assumes away the low level of cost recovery that CIAL experienced during the 5 months in which we could have, but did not, commence new prices.
- 15 We have also implemented a stand-alone IRR model for the airfield. Our post-tax IRR for the airfield, using the 4 year 7 month model with the terminal value adjusted for the difference between the revenue at levelised prices and the full cost of service, is 7.60% - slightly lower than across all regulated activities. This should dispel any myth that we are earning our target return on the Airfield in PSE2.
- 16 Various comments at the conference appeared to highlight some confusion between two distinct issues: the relationship between price increase and new investment and the relationship between price increase and historical price levels. Airfield prices have increased because:
- 16.1 airfield prices at the end of PSE1 were not recovering efficient costs. Absent any other factors, airfield prices would need to have increased in order to earn a reasonable return;
- 16.2 there is investment in the airfield from the ITP development and major maintenance investment forecast for PSE2 which we need to recover; and
- 16.3 the major downward shift in demand following the Canterbury earthquakes has meant that we need to recover costs from fewer flights. This increases the per unit charge.

Pricing efficiency

- 17 The topic of pricing efficiency at the conference was dominated by our charges for freight providers. As we explained at the conference, we understand the particular circumstances of freight service providers and have demonstrated our willingness to ensure that they are able to operate cost effectively. The consultation process is not designed to address the specific needs of every user of the airport—the legislation quite clearly requires us to consult with our major users. We are not required to consult with every customer below the threshold of 5% such as air freight operators and general aviation, although their views are always welcome. This is not a matter of us being legalistic. It makes commercial and economic sense that our standard pricing structure should be designed to be efficient for the commercial aviation sector. Consultation on the pricing structure would become unwieldy if it tried to accommodate every possible variation on the use of the airfield.
- 18 As standard prices, if charged directly to freight providers, do not address the needs of those customers in a granular way, we believe that the specific circumstances of freight providers are more appropriately addressed in commercial arrangements. We are currently negotiating with freight providers to agree to arrangements that meet their particular needs.

Information disclosure had a major impact on CIAL's pricing decision

- 19 The new Information disclosure (*ID*) regime had a major impact on CIAL's pricing decision. Below we list specific examples of how ID influenced our position, but, speaking generally, we do want to make it clear to the Commission and interested parties that the ID regime and the Input Methodologies (*IMs*) were central to our decision-making.
- 20 We knew when making our decisions that the details and overall picture of our pricing would be disclosed in the price setting event disclosure and subsequent annual disclosures, and that all interested parties would be closely scrutinising that information. We also knew that parties would view the *IMs* as a performance benchmark and that any decision to deviate from the *IMs* would require sound supporting reasons.
- 21 Only where we could be confident that our position was commercially justified – in the sense of giving our shareholders a reasonable expectation of a normal return and considering the commercial position of our customers – did we then decide to do something different from that implied by the *IMs* and ID. In a world of full transparency, competitive pressure from other airports, and countervailing power from airlines, it simply doesn't make commercial sense to test the boundaries.
- 22 The general picture just described translated into the following specific examples of how ID influenced the price reset:
- 22.1 **Limited our ability to extract excessive profits:** Our forecast return is below the Commission's WACC estimate. While we would seek normal returns with or without ID, the additional transparency allows parties to definitively see that we will not be extracting excessive profits, and provided us with a strong incentive to ensure that our returns were demonstrably appropriate;
- 22.2 **Asset valuation:** We changed our valuation approach to be consistent with the asset valuation *IM*;
- 22.3 **Revaluations:** We weren't required to include the opening revaluation arising from our opening *IM* consistent valuation at 30 June 2009 as income, but we chose to do so to uphold our previous commitment to treat future revaluations post the termination of the asset revaluation moratorium as income. The transparency provided by ID gave us an extra incentive to make this decision;
- 22.4 **Tax:** Our approach to tax was intended to produce practically the same result in NPV terms as if we had applied the approach implied by the *IMs* – in other words the tax *IM* had a direct impact on our pricing decision. We would have liked this to have been more clearly understood by our customers, but we did make considerable effort to explain our approach. This included cross-checks against the tax payable approach of the tax *IM* and the approach taken by BARNZ in their consultation response. The evidence shows that over the long term (i.e. the period over which the levelised price path was determined) our tax approach is consistent with the tax *IM*;
- 22.5 **Pricing model:** We considered the building blocks approach that the ID regime is based on, but decided that it would be more beneficial to our customers and CIAL if we adopted a long term pricing approach. Again, we made a considerable effort to explain how the long term approach compared to the building blocks approach, and why a departure from that approach was justified. Without the ID regime in place, the incentives to clearly explain and justify our pricing model would not have been as strong;

- 22.6 **Consultation with our customers:** Obviously ID did not eliminate all contentious issues during consultation. What it did do was reduce the number of issues in contention, and where contention remained, ID provided a reference point and common language with which to discuss those issues. We note in particular:
- (a) that without the ID regime, asset valuation would almost certainly have been contested. Because CIAL applied the asset valuation IM, asset valuation was hardly discussed. This saved parties time and expense;
 - (b) there was still much discussion about tax, but because of ID and the IMs the key issue could be narrowed to whether CIAL's approach was equivalent in NPV terms with the approach implied in the IM. In our view, it was very helpful to have the tax IM and the results of its application as a benchmark to show that our tax approach was appropriate. If the tax IM did not exist, the debate would have been much more wide-ranging and time-consuming;
 - (c) though CIAL's approach to WACC departed from the WACC IM, our reasons for departing were all made with reference to the WACC IM. So our reasons for departing were transparent, and interested parties can assess for themselves whether the departure is justified;
 - (d) the airlines suggested that the level of detail provided under the current pricing proposal was no different to previous resets. This is not true. We knew that we would need to disclose detailed information as part of our Price Setting Event disclosure, and this meant that we generated and provided much more detailed information to our customers during consultation. The information we provided about cost allocation is a good example: we took particular care to ensure that the appropriate allocation drivers were applied and that the rationale applied to how such drivers were determined was transparent.
- 22.7 **Release of key pricing documents to Commission:** For the first time for a price reset, we released to the Commission our key pricing documents, including our Initial Pricing Proposal, Revised Pricing Proposal and Final Pricing Decision. This was in addition to the Price Setting Event disclosure and provided an additional level of transparency;
- 22.8 **Commitment to long term pricing model:** We specified in our Price Setting Event disclosure our commitment to the long term pricing model. All interested parties now have that information, and we would be held accountable if we chose to depart from that in future resets. ID therefore provides a strong incentive to stay the course, and that is what we clearly intend to do;
- 22.9 **Price Setting Event Disclosure:** The Price Setting Event Disclosure has provided interested parties – including the Commission in its Sec 56G review – with detailed information about our pricing decisions. Because we knew that this scrutiny would happen, we knew our decisions had to be credible. The questions at conference on CIAL's pricing efficiency showed that the scrutiny was real, and we demonstrated that we had sound reasons supporting the efficiency of our pricing decisions. ID made us double-check our reasoning.

OUR LONG TERM PRICING MODEL

Key points

- CIAL adopted the long term levelised price approach to avoid the price shocks that pricing based on a building blocks model would produce after a major investment. The long term approach smooths the price path and avoids distortions created by changing demand. This benefits CIAL and its customers.
- CIAL believes the long term levelised price approach is more transparent than the deferred depreciation model because it allows interested persons to better understand the trends in the total cost of service and resulting asset returns.
- There are two key features of CIAL's approach to demand risk:
 - Normal commercial demand risk is borne by CIAL, with our WACC compensating us for this level of risk;
 - However, our WACC does not compensate us for extraordinary demand risk, such as that resulting from major events such as earthquakes. If a demand risk of this magnitude crystallised, we would need to consider the possibility of re-consulting on our charges. We expect that, if this were to occur, it would be done on a forward-looking basis.
- We have always expressed our willingness to engage with our customers on commercial arrangements, including for longer term contracts. This is evidenced by statements made during consultation and subsequent behaviour. We remain open to commercial arrangements.

Why we chose the long term levelised price approach

Could you please explain why you consider continuing your approach to setting a levelised price is more transparent than using the Commission's alternative depreciation profile methodology in future?

- 23 At the conference, the Commission raised the question as to why CIAL chose its long-run levelised price approach to deal with the increasing utilisation of long-life assets over time. In particular, we were asked why we did not use the Commission's approach of using an alternative depreciation profile.
- 24 In this context, it is important to emphasise that in principle, with the same inputs, the two approaches produce identical results—manipulating the depreciation profile in line with volume forecasts to produce a levelised constant real price will result in the same level as goal-seeking the price from the present value of building blocks and the demand profile.
- 25 Both approaches would also require revisions to volume forecasts, WACC, new capex and operating expenses at the five-yearly price resets.
- 26 The main differences between the two approaches relate to their transparency. The deferred depreciation approach effectively requires an airport to maintain three sets of depreciation books: tax depreciation, accounting depreciation for financial reporting and implied depreciation required to maintain the levelised price. It is impossible to reconcile these depreciation numbers without complicated modelling. Such an approach would reduce the

value of the information disclosure in disciplining the interactions between the airports and their customers.

- 27 Even more importantly, while the deferred depreciation approach could be made to work in a price control setting, it is relatively less transparent in a competitive setting where prices are set on the basis of commercial judgement. As we have explained in our previous submissions, the competitive constraints faced by CIAL often require us to set actual prices below the levelised constant real price that results in NPV=0. Our approach to setting the levelised constant real price allows us to draw a clear distinction between permanent under-recovery resulting from periods of pricing below that level, and deferred cost recovery.
- 28 By contrast, the deferred depreciation approach makes it hard to distinguish between deferral and under-recovery. In fact, since the deferred depreciation model would be reset every 5 years, with the remaining depreciation recalculated to achieve the new set of levelised prices, permanent under-recovery becomes a form of permanent deferral.
- 29 In effect, the deferred depreciation approach makes it hard to make any sense of the trends in asset returns. In our view, this would reduce the effectiveness of the Information Disclosure regime. By contrast, our approach fits well with the Information Disclosure regime—it enables CIAL and its customers to assess commercially negotiated prices against a clear long term benchmark.

What remains constant in the pricing model and what is updated?

- 30 While the CIAL approach to setting the levelised price provides a more transparent option, it does not mean that the levelised price remains unchanged for the life of the assets (as would also not be the case with the Commission's deferred depreciation approach). Rather, the levelised price adjusts to ensure that—from the day of the adjustment forward—the price path continues to conform to the NPV=0 requirement for the updated costs and volumes.
- 31 In practice, this means that the valuation methodology (MVAU), the asset allocation principles, and the 20 year roll-forward of the model remain the same. By updating the operating cost, capital investment and volume forecasts, the review ensures that:
- 31.1 Efficiency gains in opex achieved in prior periods are passed on to airport customers;
- 31.2 Reductions in the cost of capital are passed on to customers; and
- 31.3 Benefits from faster than anticipated volume growth is passed on to customers.
- 32 Of course, the risks with respect to the movements in the cost of capital and in forward volume forecasts are symmetrical. However, from the example of changes that benefit customers, it is clear why periodic reviews are necessary. It is misleading to suggest—as BARNZ has done—that such reviews undermine the commitment to long term pricing. Rather, such reviews are consistent with the commitment to pass efficiency gains to consumers, and with the expectation that airports would bear risks for which they are remunerated.

Approach to demand risk

- 33 At conference, Commissioners Begg and Duignan raised questions about who bears the demand risk under CIAL's pricing model.¹ There are two key features of CIAL's approach to demand risk:

¹ Christchurch Airport Conference Transcript, pp. 22-23.

33.1 First, CIAL bears the demand risk associated with normal commercial variations in demand during the pricing period. This is because WACC is set to compensate CIAL for normal commercial variations in demand;

33.2 However, CIAL's WACC does not compensate CIAL for variations in demand that are outside normal commercial parameters – for example, that which occurs as a result of events such as major earthquakes. If a demand risk of this magnitude crystallised, we would need to consider the possibility of re-consulting on our charges. We expect that, if this were to occur, it would be done on a forward-looking basis. We have no particular intention of doing so at this stage, but we also have to be realistic about the unique circumstances CIAL operates in – as much as we would like to, we can't simply wish away the considerable uncertainty around the timing of the earthquake re-build and possible consequences of another seismic event. This is a challenge that all businesses trading in Christchurch have to grapple with, airlines included.

Long term contracts

34 There was an implication at conference that CIAL was not willing to consider entering into long term contracts with its customers. This is incorrect. During consultation on our prices, we explicitly said to our customers that we were willing to engage on the issue.

35 In our Revised Pricing Proposal, we said:²

We would also be willing to consider longer term contracting—say ten years—with different price paths that might smooth the revenue over a longer period on an NPV neutral basis.

36 And in our final pricing decision, we stated:³

In the responses received on our revised pricing proposal airlines expressed their interest in considering longer term contracting. CIAL remains open to furthering this consideration post this decision.

37 The key points were that:

37.1 we were open to negotiating commercial agreements with our customers, separate from the standard prices set under consultation; and

37.2 the most appropriate time to enter into negotiations was after we had published our standard prices.

38 One of the key reasons we are open to commercial arrangements is that the allocation of risk under the price path resulting from consultation cannot be tailored to meet the specific needs of all parties. Some of our customers may want the certainty of longer term contracts, while some won't want the commitment that comes with such agreements. Where a commercial agreement re-allocates some of the risk away from CIAL, a lower WACC may be agreed.

39 CIAL's willingness to engage with its customers on commercial arrangements separate from the standard prices established through consultation can be illustrated through a number of longer term contracts already in place with airline customers, including:

39.1 A 20 year lease on the Regional Terminal with Air New Zealand for the departure of turboprop aircraft services;

² Revised Pricing Proposal, p. 17.

³ Final Pricing Decision, p. 24.

- 39.2 A 10 year contract with Air New Zealand for the use of its dedicated check-in counters covered under the Licence to Occupy arrangement in place; and
- 39.3 A potential 20 year contract is presently under negotiation with airlines for the establishment and recovery of the efficient costs of ground power infrastructure to support domestic jet aircraft.
- 40 In any event, there may not be any practical difference between CIAL's long term pricing model and any hypothesised long term contract. A long term contract would almost certainly include provisions to review or recalculate prices based on, for example, up to date demand forecasts. This is essentially what the long term pricing model intends to do – retain the basic shape of the price path while updating it every five years for updated forecasts for factors such as updated forecasts of demand and opex.

Impact of ID

- 41 Overall, our approach to long term pricing was intended to provide a transparent basis for both CIAL and its customers to assess our target price path, as well as for understanding the deviations from that path based on commercial considerations. With the benefit of hindsight, it appears that the use of pre-tax WACC—designed to simplify the presentation—appeared to have the unintended consequence of focusing attention on a side issue and diverting attention from the actual workings of the model. While this diversion is regrettable, it only partially masked the real issue—the disagreement over the level of WACC.
- 42 However, the distraction over the tax allowance, and the process for resolving that issue, clearly demonstrates the impact and benefits of ID: all parties had the information they needed to run the tests they chose to assess the model and to understand its implications. ID data enabled all parties to zero in on the key areas of disagreement and to explore the implications of those disagreements for prices and returns.
- 43 The ID regime was never designed to replicate price control or to enforce a single approach to pricing. Rather, the purpose of the regime is to promote more efficient pricing by removing/eliminating information asymmetry. This has clearly been achieved: the disagreements are clearly identified and the expected returns are in line with competitive market outcomes.

CIAL'S PROFITABILITY

Key points

- We have completed a further cross check on CIAL's NPV of tax allowance as requested by the Commission. It produced a result that is practically the same as that CIAL used for its pricing decision. That is, the NPV of the Commission's approach was \$694m compared to the \$686m used in the pricing decision.
- We confirm that our original cross check model did treat revaluations appropriately: revaluations were subtracted from the post-tax revenue requirement prior to the calculation of the tax allowance.
- Applying the Commission's model, CIAL's IRR for airfield services is 7.60% using the 4 year 7 month model and incorporating the deferred recovery value in the closing asset base.
- While CIAL's IRR for airfield services for PSE2 is lower than the Commission's WACC estimate, our airfield prices have increased because:
 - airfield prices at the end of PSE1 were not recovering efficient costs. Absent any other factors, airfield prices had to increase if CIAL was to earn a reasonable return;
 - there is investment in the airfield from the ITP development and major maintenance investment forecast for PSE2 which we need to recover; and
 - the major downward shift in demand following the Canterbury earthquakes has meant that we need to recover costs from fewer flights with a lower total aircraft weight. This increases the per unit price.
- The appropriate WACC date for the Commission's IRR analysis is 30 June 2013.
- The appropriate terminal value for the IRR analysis for aeronautical services is \$480.5m closing asset base, including the accumulated difference between the full cost of service and the revenue that would have occurred at the constant levelised price (not the actual revenue at prices below that target). This increases the terminal value by \$33.8 million.
- The Commission needs to be cautious in making definitive assessments about profitability solely on the basis of forecast outcomes. This is especially so in the case of CIAL, where actual outcomes are uniquely uncertain and subject to uncontrollable factors. Even at this early stage of the pricing period demand is considerably softer than forecast, which means we may not achieve our forecast revenue.

Tax

Approach to tax

Please provide a comparison of the revenues generated by Christchurch Airport's tax expense approach and the Commission's tax payable approach on a post-tax cash flows basis using the post-tax WACC as the discount rate.

- 44 In previous submissions and in the models provided to the Commission (as well as during the consultation process), we demonstrated that our simplified approach of using a pre-tax WACC to calculate the building blocks inputs into the levelised constant real price did not result in an over-recovery of the tax allowance. To repeat our key point made both to the airlines and to the Commission as part of this review, it is correct to point out that the implied tax expense in any one year calculated from our pricing model does not correspond to the expected tax payable in that year. However, since the only number that matters for the setting of the levelised constant real price is the **present value**, the year-by-year variation does not matter as long as the present value is unaffected.
- 45 We presented clear evidence through our verification model that the present value is not affected, Commission staff suggested a further empirical test of this proposition: to compare the present values of post-tax cash flows resulting from our proposed approach and from the more conventional building blocks approach, using the same *post tax* WACC as the discount rate. In fact, one advantage of such an empirical test is that it does not depend on the choice of the discount rate to arrive at a pre-tax level. Hence, it should help clarify the distinction between the level of WACC and the effect of using a pre-tax WACC rather than a post-tax WACC.
- 46 We present with this submission the updated tax verification model which compares post-tax cash flows using the conventional building blocks approach and using our levelised constant real path. This includes both the revised check as suggested by Commission staff, as well as an amendment to the opening tax asset based reflecting the closing tax asset base as used in ID to 30 June 2012.
- 47 The calculation of the post-tax cash flows using the conventional building blocks approach is straight forward. It involves adding up the cost building blocks every year and subtracting revaluations to arrive at allowable post-tax cash revenue. The calculation of the post-tax cash flows resulting from the CIAL pricing model is slightly more difficult. We derive the cash revenues by multiplying the levelised constant real price by the forecast volume in each year. We then need to subtract the tax allowance for each year.
- 48 For the avoidance of doubt, the tax allowance for subtraction is calculated using the Commerce Commission's IMs. In other words, for every year, we subtract our present best estimate of tax depreciation, OPEX and the notional interest shield from the pre-tax cash revenue to calculate cash profit for that year. We then apply the corporate tax rate to that amount, and gross it up to calculate the tax allowance. We then subtract the IM-compliant tax allowance for each year from the forecast cash revenue for that year. The result is the post-tax cash flow for that year.
- 49 The attached model shows that the present value of the post-tax cash flows—using the post-tax WACC as the discount rate—is practically the same under the conventional and CIAL approaches. The very small difference — in favour of our customers — is well within the margin of error for such comparisons.

Present value comparisons @ post-tax WACC 9.76%	
Post Tax Present value using the Commerce Commission ID methodology	\$694m
Post Tax LRMC approach - CIAL methodology	\$686m
Variance (undercharge by CIAL to allowable revenue ceiling)	\$-7.6m (1.1%)

- 50 We believe this further modelling exercise should finally dispel any doubt about the effects of our approach to calculating the tax allowance. We would like to emphasise again that none of the additional modelling done by us—either in response to the airlines or now in response to the Commission—relied on information that had not already been made available, either during consultation or latterly as part of the Commission review process. We remain concerned by what appears to be deliberate unwillingness by some of our interlocutors to engage with the evidence that had been provided

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

- 51 The tax “check model” was provided as Appendix 3 to our Sec 56G Submission on the Process and Issues Paper dated 23 March 2013. However, we would like to highlight again that during consultation CIAL had provided essentially the same data to the airlines with a Check summary of Tax Treatment utilising the BARNZ methodology as part of the response to comments made on this subject during consultation.
- 52 The “check model” summarised and streamlined the data that was provided to the airlines during consultation. There were no surprises in the “check model”. Both the “check model” and the material supplied to the airlines demonstrated that there was no over-recovery of the tax allowance, either in PSE2 or in the future.

Tax treatment of revaluations

Do you consider the treatment of revaluations for tax purposes in the tax ‘cross check’ model (line 48) is correct for revaluations which occur in the current period and for revaluations associated with the previous period?

- 53 While the question of tax has been an unfortunate distraction, we expect that the additional modelling as provided should allow us to move on and we respond further to two specific questions raised at the conference.
- 54 First, we would like to confirm unequivocally that our tax “check model” treated revaluations appropriately: revaluations were subtracted from the post-tax revenue requirement prior to the calculation of the tax allowance.
- 55 Second, it is useful to explain again the intuition behind the treatment of revaluations in our pre-tax pricing model. Of course, the various modelling exercises show that—contrary to BARNZ assertions—there was no tax allowance calculated on non-taxable revaluation income. If there was, the present values of the post-tax cash flows could not have been the same. However, apart from the evidence in the numbers, it is analytically easy to see why the present value of the pre-tax return on capital used in our pricing model could not have included an inappropriate tax on non-taxable income.
- 56 Conceptually, the only difference between the tax expense and the tax payable approaches is in the assumed timing of tax liability. The timing difference could lead to permanent differences since the deferral of a nominal liability represents a real reduction. This is precisely what explains the permanent difference between the corporate tax rate and the effective tax rate. However, none of that has anything to do with revaluations. Both approaches subtract revaluations from income. Both approaches ensure that the investor only receives cash returns on un-revalued assets.

Return on airfield services

CIAL's IRR for airfield is 7.60%

- 57 There was a suggestion at conference that CIAL would be earning close to its WACC of 9.78% for airfield services for PSE2. Using the Commission's methodology, we have determined that airfield services will yield a post-tax IRR of only 7.60%. This calculation is derived using a 4 year 7 months model and including \$4.7 million (the difference in the revenue that would have been earned at the constant levelised price and the full cost of service) in the terminal value. As we have explained, this is the highest possible IRR that can be ascribed to the airfield.
- 58 Therefore, while the pricing model's intention is that airfield charges will be nearing CIAL's target levelised constant real price by the end of PSE2, the actual airfield return over the PSE2 pricing period will still be below our estimated cost of service.
- 59 While our forecast return for airfield services (and indeed all aeronautical services) is below the Commission's WACC, CIAL's ability to achieve even this modest return is dependent on volumes evolving broadly in line with the demand forecast.
- 60 Variance between forecast and actual demand is already influencing the likely revenue outlooks for both airfield and terminal services. CIAL advised the Commission at the conference that the volume of aircraft movements and MCTOW on which the unit charges are based are already 9% behind that level forecast for 2013. This illustrates the significant uncertainty that CIAL faced in setting the demand forecast to recover the required revenues over the PSE2 pricing period. Less than one year on it is likely that the level of revenue that will be recovered, will in fact be less than assumed in the IRR model, owing to the uncertainty of future demand.

Why our airfield prices increased

- 61 While CIAL's forecast return for airfield services for PSE2 is clearly below the Commission's WACC, we do acknowledge that there are significant airfield price increases. Below we explain why airfield prices have increased. The intention is to answer Commissioner Duignan's questions at conference which suggested that, unlike the terminal price increase which is justified by the new ITP, there appeared to be no obvious reason for airfield prices to increase.
- 62 There are three key reasons why airfield prices have increased:
- 62.1 First, airfield prices at the end of PSE1 were not recovering efficient costs. This situation reflected the commercial constraint on setting airfield prices in that period owing to the prevailing impacts of the GFC and low airline returns. Absent any other factors, airfield prices needed to be higher than the level at the end of PSE 1 if CIAL was to earn a reasonable return;
- 62.2 Second, there was investment in the airfield services from the ITP development (\$18.7m) together with major pavement maintenance investment (\$29.8m) forecast for PSE2 which we need to recover; and
- 62.3 Third, the major downward shift in demand following the Canterbury earthquakes has meant that we need to recover costs from fewer flights with a lower total aircraft weight. This increases the per unit charge.

WACC

Impact of the GFC

- 63 The practical challenge at the present time is how to apply the CAPM – together with other tools and sources of evidence from finance theory and practice – to obtain the best estimate of the WACC in the context of very material changes to capital markets.
- 64 We note that Commissioner Duignan has asked whether we are seeking to take the GFC out of our life experience. We are in fact doing the opposite. The Global Financial Crisis clearly occurred, as well as the ensuing sovereign debt crisis in some European states in the subsequent years. What CIAL has asked – advised by Mr Balchin – is whether the CAPM, when applied in a reasonably mechanistic fashion, is expected to deliver an accurate estimate of the cost of equity (and, in turn, the WACC) in the markets we now experience.
- 65 Our questioning in this regard is not an attack on the CAPM itself or the efficiency of capital markets, although it is noted that no one disputes that the CAPM itself rests on a range of assumptions that are not close to being descriptively accurate. Rather, this questioning focusses on how the CAPM is applied in practice.
- 66 The CAPM is unambiguously a forward looking model and yet, for practical purposes, historical values or relationships are used to estimate a number of the key inputs or are highly influential in that regard (namely, the market risk premium and beta). In the context where the forward looking input (namely the risk free rate) has changed so dramatically and where the present is so different to history, it is reasonable to ask whether combining the current forward looking value for the relevant inputs with the historically determined inputs continues to provide the best estimate of the WACC.
- 67 We do not question the beta in this regard (the market average equity beta must remain at 1, and we have no strong grounds to believe that the GFC and subsequent events in Europe have caused the risk of airport operations to change relative to other activities); however, we do believe that it is inappropriate to combine a market risk premium that was determined predominately with reference to historical averages with a spot measure for the risk free rate. Indeed, even if the value in the IMs was calculated on a wholly forward-looking basis, government interest rates have fallen so significantly since that time that it is reasonable to question whether that now “old” forward looking value remains relevant.
- 68 What we have proposed, in effect, is that instead of assuming that the *market risk premium* remains constant in the face of substantial movements in the market, a better assumption is that the *market return* remains constant over time. The effect of this is that changes to spot interest rates compared to the historical average “wash out”, at least for entities with an equity beta close to 1 (CIAL used an equity beta of 0.95).
- 69 The proposition that it is better to assume that the market return is the constant across time is not a novel proposition that CIAL or its advisers invented, but rather as CIAL has set out in material provided previously to the Commission, it is a view that is advocated strongly by key UK academics and has been accepted by the UK regulators, with a strong endorsement by the UK Competition Commission. Irrespective of whether it is believed that the market return remains constant across time as a general matter, CIAL considers it to be prudent to assume that the market return has not dropped dramatically in recent years in line with the fall in government interest rates.

Comment on “Dimson, Marsh and Staunton 2013 Yearbook”

Commissioner Begg invited Jeff Balchin’s comment on the Dimson et al paper.

- 70 First and foremost, it is noted that Commissioner Duignan commented that special weight should be placed upon the 2013 Yearbook because it is published by a major investment bank, Credit Suisse:⁴

So, that it's not just a piece of academic research. It has been put out by a major investment bank which is essentially offering it to its investor clients as being an indication as to what they should expect by way of return, and I think in that sense the Commission takes quite a lot of weight upon such a paper which is how we do link up with the way investors are looking

- 71 CIAL requests that the Commission inquire further as to whether Credit Suisse has indeed factored the advice of Dimson et al into the specific advice that it provides to its clients. We understand from direct enquires that Credit Suisse’s standard practice at the current time, when undertaking valuation exercises, is to adopt a risk free rate of return that is materially above the spot rate, much like CIAL has proposed.
- 72 CIAL also requests the Commission to expand its survey of the advice and practices of the major banks with respect to the cost of capital at the current time to include a wider sample.
- 73 Moreover, in view of the accusation that is often made that investment banks have an incentive to “talk down” the cost of capital in order to “talk up” the values of assets during a transaction, CIAL requests that the Commission widen its sample of market practitioners to include corporate valuers / independent experts, whose opinions are often subject to substantial scrutiny and less likely to be affected by any unintentional bias. CIAL would expect that the results of such a survey would reveal a widespread view that the cost of equity will be understated if the current very low government interest rates are inserted mechanically into the CAPM and that an adjustment should be made, much as CIAL has proposed.
- 74 Turning to the publication itself, the Dimson, Marsh and Staunton annual yearbook is a well-regarded piece of research into the historical returns that have accrued to equities across many major markets by finance academics of world standing. Having said that, the authors would agree that the lessons drawn from the past are not determinative as to what will occur in the future – the only tool that will accurately predict future equity returns is a crystal ball. Furthermore, there is a limit to whether the trends drawn from the average of our past experience will provide clear insight into a specific issue at any point in time. CIAL may forward further specific comment on the specific analysis performed for the 2013 Yearbook during the course of the Commission’s review.

Market risk premium

What is the market risk premium applied in Christchurch Airport’s WACC of 9.76%? Why is that market risk premium appropriate?

- 75 The (tax adjusted) market risk premium adopted is 7.5 per cent, which is the standard value that is used by PwC NZ in all of its commercial valuations, and is a common assumption of NZ market practitioners. This value is also virtually the same as the (classical CAPM) market risk

⁴ Transcript, p.62. While it is noted that BARNZ did quote from this paper, it merely quoted the updated estimates of the historical premium to equities for New Zealand, which had actually increased slightly from the previous edition.

premium of 6 per cent (after adjusting for tax) that is used by PwC Australia together with many Australian market practitioners.

- 76 The key reason as to why a tax adjusted market risk premium of 7.5 per cent has been used – rather than the value of 7.0 per cent that the Commission prefers – is because of a view that the Commission’s figure is biased downwards due to placing weight on an unreliable source of information, and because the Commission’s figure is below the value that the majority of market practitioners apply. These arguments are not new to the Commission and have been set out more fully in material that has provided to the Commission already in relation to this matter, and (amongst other things) during the consultation surrounding the Input Methodologies.
- 77 At the conference, we were asked whether we appreciate that our approach to WACC is equivalent to setting the market risk premium at 8.2%. Indeed, the disequilibrium experienced in the financial markets can be interpreted either as disequilibrium pricing of risk free assets or as a temporary significant increase in the market risk premium. Both are, of course, two sides of the same coin. We have chosen an approach which, in our view, best addresses this disequilibrium. However, in line with this approach, often used by investment banks in asset valuations, we could have used implied current market risk premium derived from market data. In our previous submissions, we showed evidence that such premium is indeed substantially above the long term trend.

WACC date for PSE2 prices and for the Commission’s IRR calculations

On what date did Christchurch Airport fix their cost of capital for PSE2 prices?

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

- 78 To the extent that current market information was incorporated into the WACC applied by CIAL, this reflected the average over the month of March 2012. In view of the fact that many of the inputs to the estimation of the WACC reflect a combination of market information and judgement, an effective and transparent consultation with customers requires the “market period” to be locked in prior to the new prices coming into effect. It is observed, however, that the significance of the precise averaging period is reduced if the cost of equity is not assumed to move one-for-one with movements in government interest rates.
- 79 Regarding the averaging period that is applied by the Commission, first and foremost CIAL reiterates its comment that the significance of the selection of a precise period is overstated where it is assumed that the cost of equity moves one-for-one with government interest rates. Any estimate of the cost of equity also needs to be tested for reasonableness, drawing where possible upon information from outside of the CAPM.
- 80 In view of this, the most appropriate period the Commission could adopt in relation to the cost of equity is the averaging period that was applied to generate the WACC estimates that were produced in the IMs decision paper (the month of June 2010). It is only those cost of equity estimates that were subject to any form of reasonableness check by the Commission – it is inappropriate for the Commission to assume that those reasonableness checks remain current because to do so requires the critical assumption (which is not a fact) that the cost of equity has fallen one-for-one with government interest rates since that time.
- 81 Regarding the cost of debt, CIAL used current market evidence to establish this input, and so the most appropriate period for the Commission to use is the same period that was applied by

CIAL (the average over the month of March 2012). To the extent that a different period is chosen, the potential exists for the choice of averaging period to introduce spurious factors into the Commission's IRR assessment, with the potential to create either a "false negative" or "false positive" result.

- 82 In preparing the initial consultation proposal to airlines as submitted on 12 March 2012 CIAL first set its weighted average cost of capital based on the independent expert advice from Jeff Balchin, PricewaterhouseCoopers. This was considered as part of the consultation process and reviewed by Future Consultants Limited as expert advisers to BARNZ.
- 83 In responding to the points raised by Future Consultants Limited and also to consider the factors at the appropriate point in time a revised estimate of 9.76% post tax WACC was submitted by PwC to CIAL on 12 July 2012. This was the date at which CIAL set its revised weighted average cost of capital and based on the responses through subsequent consultation, identified that there were no further factors that should be considered in determining that final decision.
- 84 The final response from the airlines was received in September 2012 and the final decision was notified to the airlines on 24 October 2012 following significant in-depth consideration by CIAL's management and Board. Considering all these facts the WACC level to be used by the Commission for the assessment of CIAL's economic performance should be as at 30 June 2012.

IRR model

Opening and closing Asset Base

Given the stated preference of all the 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 (e.g. 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? (pg 45 – 47 transcript).

How does CIAL consider the closing asset base should be determined for a 5 year IRR analysis? (pgs 48 – 53 transcript)

- 85 We agree that the 4 year 7 month IRR model more closely matches the price reset assessment period than the 5 year model. In implementing the 4 year 7 month model IRR model attached, we have excluded work carried out over the period from 1 July 2012 through to the dates of practical completion in March and April 2013 and have included this expenditure in commissioned assets as a negative cash flow during the first (7 month) period of the pricing period.
- 86 However, we would like to emphasise that neither approach is perfect. The 5 year IRR model effectively assumes that ITP was available from July 2012. On the other hand, the 4 year 7 month model effectively ignores the opportunity cost of the substantial work completed as of July 2012, but for which remuneration did not commence until the start of the pricing period.
- 87 In principle, the 4 year 7 month period model can be adjusted by including a notional financing charge into the calculation. However, this would partially defeat the advantage of the IRR model of allowing us to focus on the actual cash flows.

- 88 Rather than make further adjustments to the model, we suggest that judgement be used in interpreting the results. While we provide the 4 year 7 month model as requested by the Commission, we would like to emphasise that it somewhat overstates the IRR, and should be interpreted accordingly.
- 89 In implementing the IRR model, we have also increased the terminal value by the amount of the difference between the full cost of service and the revenue that would have been earned at the constant levelised prices during the period. As we have explained, we agree that this is an appropriate adjustment to make the terminal value a better proxy for future pricing intentions. We would like to emphasise that the revenue that would have been earned at the levelised constant real price is, of course, higher than the revenue that will be earned at our commercial prices. This gap—as we have explained before—is permanent under-recovery, and hence should not be (and has not been) included in the terminal value.

Revaluation wash-ups

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 income?

- 90 CIAL has taken a principled approach and has decided that in moving away from the moratorium on revaluations we will treat all historical revaluations as revenue in PSE2. Our constant levelised price was calculated on that basis. It is true that, in theory, some of those revaluations did not need to be treated as revenue in PSE2 and could have been ascribed to PSE1. To stick with the principle, we have also included revaluation revenue even when IM strictly speaking did not require that. The input methodologies required an opening asset base greater than our previous MVAU valuation by approximately \$10.7 million. While the input methodologies did not specify that this revaluation was to be treated as income, CIAL elected to extend this benefit to customers by including this revaluation as a revenue offset in determining the required revenue to be recovered.
- 91 We believe the Commission should accept our treatment of the timing of revaluation income. If the Commission were to re-allocate some of these revaluations to PSE1, it would need to recalculate the levelised constant real price. But such a recalculation would do nothing to help the Commission assess our performance:
- 91.1 First, we have determined our approach to the levelised constant real price. A higher levelised price calculated by the Commission using an alternative approach to revaluations would contain no information on our pricing intentions.
- 91.2 Second, our proposed prices for PSE2 are set on the basis of commercial considerations, and are in any case below the constant levelised price.
- 92 In a purely arithmetic sense, reducing the amount of revaluations ascribed to PSE2 would increase the gap between the revenue at the levelised constant real price and the full cost of service. This additional amount could mechanically be added to the terminal value in the IRR model, increasing the IRR. However, this again would be highly misleading. Such a calculation would ascribe to CIAL a pricing intention—the desire to recover a portion of revaluation revenue—which we clearly do not have.

Actual outcomes are already departing substantially from forecasts

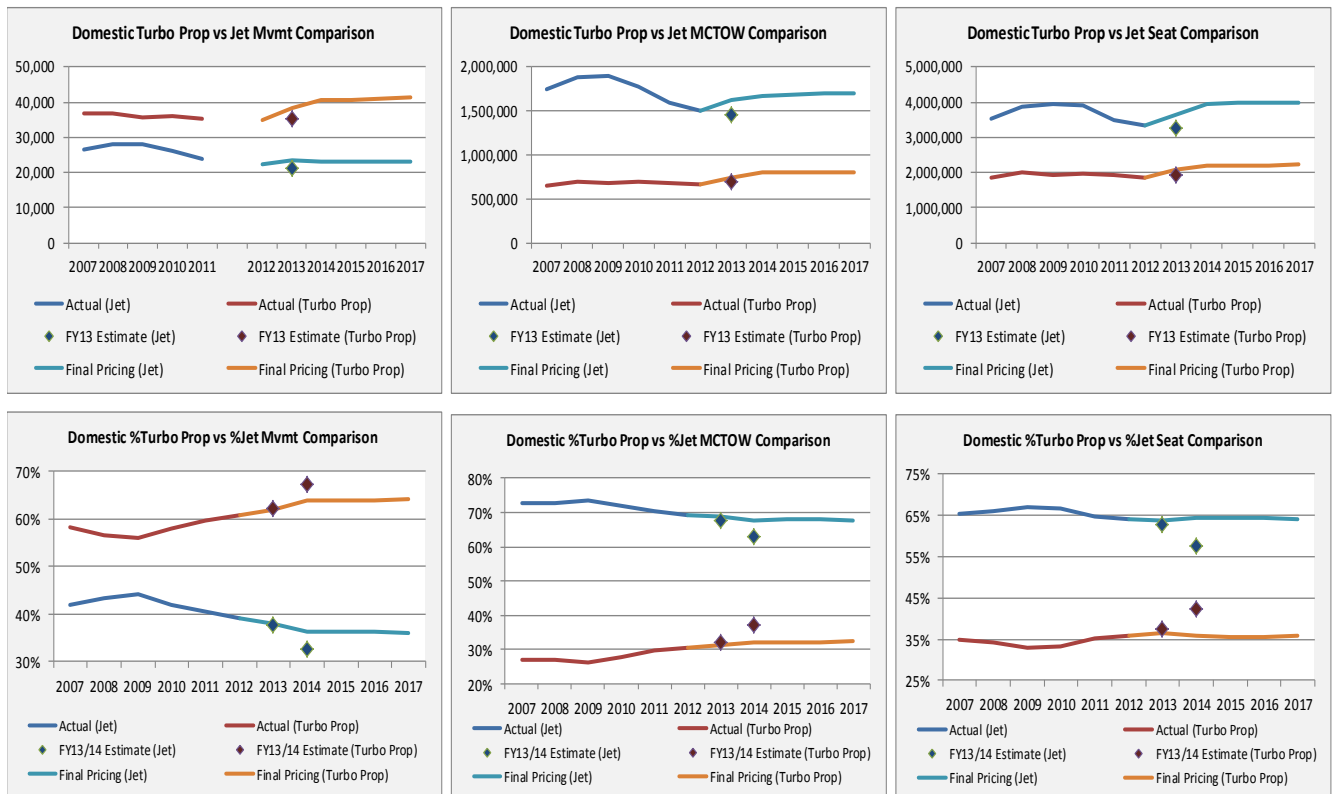
- 93 At various times during the s 56G review process, we have cautioned the Commission against making definitive assessments about profitability solely on the basis of forecast outcomes. In the case of CIAL, where actual outcomes are especially uncertain and subject to uncontrollable factors, we believe a cautious approach is necessary.
- 94 At the conference, we explained that CIAL faces particular uncertainty around the timing of the earthquake re-build and the possible consequences of another seismic event. The Canterbury earthquakes, the consequent damage to Christchurch and loss of accommodation, the significant uncertainty created by 11,000 plus aftershocks, and the uncertainties created in the minds of tourists travelling to the South Island have resulted in an extraordinary demand reduction.
- 95 The continuing effects of the earthquakes are well illustrated in the significant reduction in accommodation now available in Christchurch post the earthquakes (see table below). Full recovery, particularly for hotels, will take some years to occur while the planning and construction of replacement capacity occurs.

Accommodation Available in Christchurch						
	Pre Earthquakes		Current		Reduction	
	No. of facilities	Available Beds	No. of facilities	Available Beds	Facilities	Available Beds
Holiday Parks:	10	384	10	384	0.0%	0.0%
Hotels:	38	4223	16	1516	-57.9%	-64.1%
Motels:	121	1805	119	1845	-1.7%	2.2%
Backpackers:	37	770	24	404	-35.1%	-47.5%
B & B's	118	338	103	280	-12.7%	-17.2%
Apartments/Lodges:	17	289	11	192	-35.3%	-33.6%
Total	341	7809	283	4621	-17.0%	-40.8%

- 96 We can already see this effect clearly playing out. It is evident from the initial results for 2013 (see graphs below), particularly with respect to the number of aircraft movements, resulting seat capacity and aircraft MCTOW, that demand is substantially below forecast.



- 97 The softer than forecast demand is exacerbated by the actual mix between jet and turboprop aircraft and the relative weight comparisons. Under normal conditions, the aircraft mix is fairly stable and predictable. We are already seeing in 2013 that turboprop/jet substitution is significantly greater than forecasted. As a consequence, less fixed charges (due to the lower number of aircraft movements) and less variable charges (on a per MCTOW basis) will be recovered compared to the forecast.



- 98 The above chart shows actuals for 2008-2012 and forecasts for 2013-2017 for both the mix of aircraft movements and the resulting MCTOW weights split between jet and turboprop aircraft. The actual results for 2013 (and current forecast for 2014) demonstrate the degree of deviation from the forecast. Should this continue, this has the potential to have a significant impact on CIAL's economic return over the full reset period.
- 99 In light of this outlook we urge the Commission to be cautious when considering performance based on forecasts when assessing economic returns in line with limb 4 of the purpose statement to Part 4 of the Act, as actual results may differ quite significantly over the reset period.

CIAL'S PRICING EFFICIENCY

Key points

- There are three key aspects to our freight provider charges:
 - Our standard prices that we charge freight providers were developed as part of our airfield charges. The key considerations in developing airfield charges were those of our largest customers – the airlines;
 - Because the standard prices charged to freight providers do not address the needs of those customers in a granular way, we believe that the specific circumstances of freight providers are more appropriately addressed in commercial arrangements. We are currently negotiating with freight providers arrangements that meet their particular needs;
 - Freight charges need to be considered in the context of an airfield forecast return of 7.60%.
- The two tier fixed/variable airfield charging structure has been developed to ensure a more efficient allocation of costs to the respective aircraft types (jet vs turboprop), thereby removing cross subsidisation and providing the correct economic signals to airlines for the aircraft used on various routes.

Freight carrier charges

Please clarify the distinctions between relative changes in the charges for freight and passengers.

100 At conference, there was some discussion concerning the level of charges to freight providers. In this section, we explain:

100.1 how we arrived at the standard prices which are to be charged to freight providers; and

100.2 the distinction between consultation and commercial negotiations to arrive at commercial arrangements that meet the specific needs of smaller customers in specialist segments, such as domestic air freight.

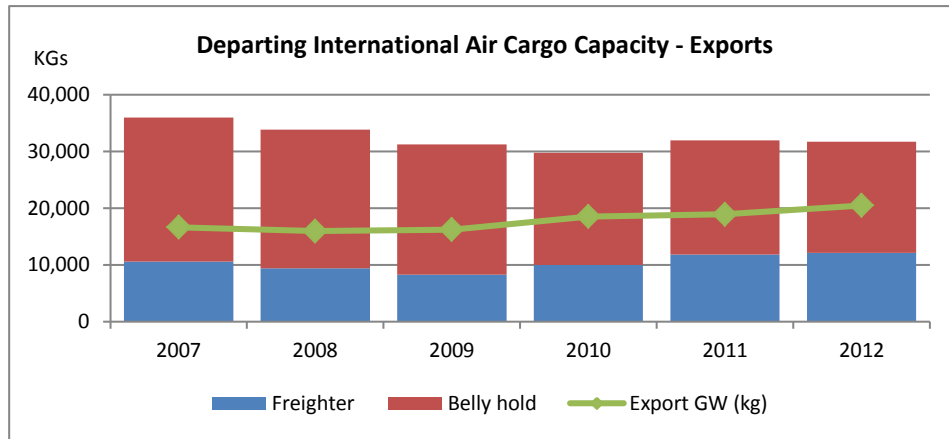
101 The freight market operating to and from Christchurch airport is comprised of two separate segments:

101.1 The import/export volumes transported by commercial airlines, predominantly in the bellyhold of the aircraft. Wide-bodied aircraft such as the Boeing 777 have the ability to carry more freight than a smaller narrow bodied aircraft such as an Airbus 320. In addition this market also includes discrete dedicated freight services operators, with the Qantas Boeing 767 service presently being the predominant service provider; however, some itinerant (infrequent) dedicated freight services are provided through Singapore Airlines.

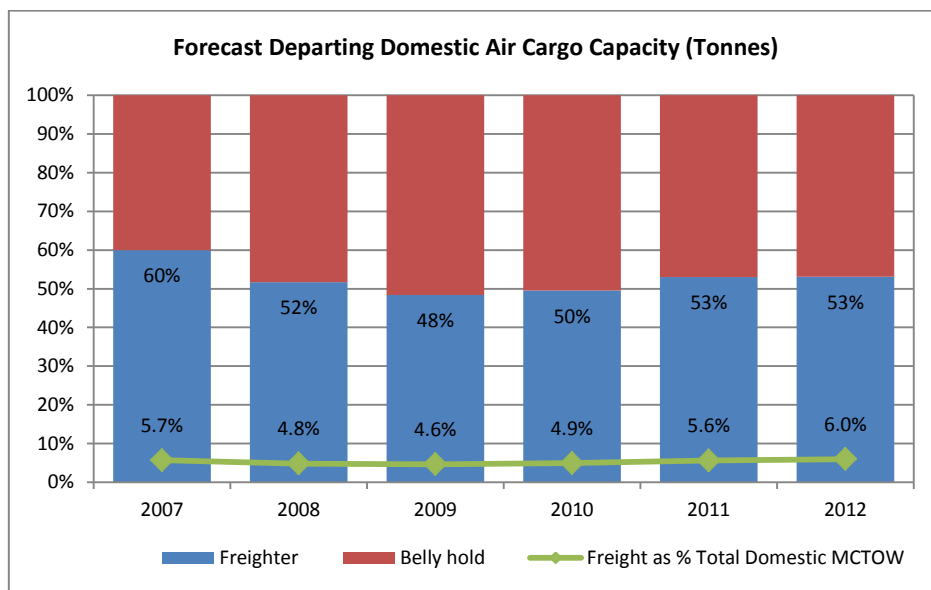
101.2 Domestic freight is also carried within New Zealand in the hold of the commercial airliners and through dedicated services provided by Freight Air, the wholly owned subsidiary of Freightways Limited, and courier carriers Courier Express.

102 The following summary provides an overview of the scale (volume/capacity) of services provided by these two markets.

International



Domestic freight



103 The above charts identify that most of the international freight is carried by commercial aircraft, as bellyhold cargo. The domestic market is slightly different with a roughly even split on the type of capacity available for the carriage of freight – however when considering freight as a percentage of total domestic aircraft movements by weight (MCTOW), freight is a minor percentage of such domestic movements.

104 In considering how charges for freight services were developed it is noted that dedicated domestic freight services only account for approximately 5 - 6% of domestic aircraft movements by weight and only 1.2% of total aeronautical revenues. Accordingly, our recent price consultation was focused on our standard charges and our “substantial customers” as defined by the AAA. As freight carriers are only a minor segment of total airfield services we recognised that separate commercial negotiations would be required with freight customers

who used Christchurch airport. Notwithstanding this point the volume of freight movements (number of aircraft movements and aircraft weight) were taken into account as an item in the demand forecast used to set airfield prices.

- 105 CIAL is very aware of the freight market into and out of the South Island and its increasing importance as freight volumes grow. This also includes the need to minimise “leakage” of freight beyond Christchurch by road transport to northern ports.
- 106 For this reason, we have engaged with our freight customers to progress possible commercial arrangements. As we stated in our pricing documents during consultation, we were willing to engage in commercial arrangements at the completion of consultation and this subsequent step bears out this commitment.

Fixed/variable charges to airlines

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

- 107 CIAL’s fixed and variable charge structure has been designed to recover our revenues in a manner that is more cost reflective. Also, as we have explained at the conference, the purpose of the fixed/variable split was not to manage congestion but rather to avoid creating inadvertent incentives for airlines to substitute between jet and turboprop aircraft simply to reduce airport charges. We appreciate that any cost allocation related to fixed assets is somewhat arbitrary.
- 108 We do not claim that we have hit on the optimal fixed/variable split. As has been noted at the conference, lower charges per MCTOW for turbo-prop aircraft somewhat offset the effects of fixed charges. However, the new charging structure is more cost-reflective overall. We will keep it under review.
- 109 We do not expect that the new pricing structure will lead to a significantly different aircraft mix. There are many reasons why airlines choose particular aircraft that have nothing to do with the airport charges. However, we hope that our pricing structure will avoid distortion.
- 110 We have every incentive to encourage volume growth at CIAL. The very reason why our commercial prices are set below the levelised constant real price is because we were concerned that target prices could have an adverse effect on demand. We have made every effort to calibrate commercial prices to current market conditions to avoid any negative effects on demand.

QUALITY

Service levels

Please explain the service levels, including reasons for those levels.

- 111 CIAL has very clearly identified through the comparative profile of our service performance standards that the service quality being experienced by our airline customers, travellers and users of Christchurch Airport has substantially improved since the commissioning of the new integrated terminal. This has been a consequence of significant innovation in terms of the type of technology that is being utilised by our airline customers through the integrated check-in and baggage handling system, which has reduced the level of investment required for both the footprint of the new terminal and for the number of counters required to that previously experienced prior to ITP. This has provided an efficiency cost benefit trade off in terms of lower capital costs but potentially higher operating costs which in total will provide significant advantage to airlines and travellers alike.
- 112 The Commission has raised several queries relating to the profile of the baggage handling system interruptions over PSE1 and these are detailed in the table below for information;

Service Performance						
Disruption to:	2011			2012		
Responsible	No.	Hrs	Mins	No.	Hrs	Mins
Runways						
Airports	0	0	0	1	2	45
Airlines/other	0	0	0	0	0	0
Undetermined reasons	5	40	29	0	0	0
Total	5	40	29	1	2	45
All caused by Earthquakes - 4 Sep 2010, 22 Feb 2011, 13 June 2011, 21 June 2011						
Baggage sortation system on departures						
Responsible	No.	Hrs	Mins	No.	Hrs	Mins
Airports	0	0	0	6	4	59
Airlines/other	0	0	0	1	0	20
Undetermined reasons	18	38	12	0	0	0
Total	18	38	12	7	5	19
Late in the 2011 disclosure year (April 28) CIAL commenced operation of our new Integrated Baggage Handling System in the new Integrated Terminal. This has operated at a high level with few faults. This is the reason for a large drop in faults						
Contact stands and airbridges						
Responsible	No.	Hrs	Mins	No.	Hrs	Mins
Airports	0	0	0	17	25	45
Airlines/other	0	0	0	3	1	30
Undetermined reasons	7	13	15	0	0	0
Total	7	13	15	20	27	15
The increase in outages was largely due to a repeat fault on one airbridge, much of which did not impact services to the airlines.						
Earthquakes - 4 Sep 2010, 22 Feb 2011, 13 June 2011, 21 June 2011						

CAPEX EFFICIENCY

- 113 At the conference BARNZ outlined an approach for capital expenditure consultation and the benefit that would be provided to both airline customers and the airports regarding early commencement of discussions with airlines. Such an approach would outline the forecast programme concerned, articulating the benefits and also identifying if there were any further expenditure developments that the airlines believed necessary to ensure they were able to deliver the service standards they deemed necessary. We believe this has value and will progress this as part of the PSE3 pricing consultation process.

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

- 114 CIAL conducted an extensive consultation with its customers on the timing and design of the new terminal investment. The result is a new terminal which is an efficient increment in capacity.
- 115 The capex consultation resulted in:
- 115.1 *A significantly shortened development cycle* - a longer timeframe would have constrained the airlines and would not have provided the significant improvements achieved through the integrated check-in hall, advanced baggage handling system and other innovations such as swing bridges; and a reduced capital cost outcome (final cost estimate being only 0.9% over the fixed cost budget) thereby avoiding future inflationary pressures;
 - 115.2 *Delivery of functional requirements* - CIAL met all the functional requirements required by the airlines. It has resulted in a terminal that will cater for future technology changes, particularly with respect to passenger facilitation (through the integrated check-in hall), and the development of an expansion path that can meet the future needs of both international and domestic services expansion at a significantly reduced cost to that prevailing with the old domestic terminal; and
 - 115.3 *Efficient commissioning* - the preparedness, pre readiness training and communication to all parties was extremely effective, resulting in a very successful and efficient implementation of the various stages of development in May 2011, April 2012, March 2013 and April 2013.