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Jo Perry
Chief Advisor, Compliance and Performance Analysis
Regulation Branch
Commerce Commission
regulationbranch@comcom.govt.nz

Dear Jo

Re: Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)

1. Air New Zealand welcomes the opportunity to submit on the Commission's draft report on Christchurch International Airport Limited's (CIAL's) pricing for price setting event three (PSE3).

CIAL is disguising its true target return via Information Disclosures

2. During price consultation with its airline customers, CIAL targeted a return of 6.82% and set prices for customers on this basis. Yet its PSE3 information disclosures, CIAL disclosed target returns of 6.44% for priced services - significantly closer to the Commission's mid-point.

3. CIAL's application of a cost of capital of 6.82% during consultation means that prices paid by airlines are higher than they would otherwise be if a return of 6.44% had been targeted during price consultation.

4. CIAL still considers its own cost of capital to be 6.82%. It has not changed its mind, or changed its prices which meet that target return. What CIAL has done instead is wash in forecast incentive payments to its PSE3 Information Disclosures, bringing down the apparent rate of return.

5. The inclusion of discretionary incentive costs as revenue requirements in Information Disclosure is counter to CIALs declared intention that these incentives would not be included in their building blocks model for price setting.

6. The inclusion of these costs as revenue requirements is a method of disguising higher target returns. Air New Zealand submits that the Commission should exclude these incentive costs from disclosed revenue requirements, as was CIALs stated intention in price consultation, and assess the resultant target cost of capital as it remains without this accounting construction

Incentives as a revenue requirement

8. It is possible that CIALs payment of incentives has risen steeply over the previous two financial years. Variances noted in information disclosure on operational expenditure note an additional $6.3m paid over forecast in FY17 and an additional $5m over forecast in FY16. Information disclosure does not reveal total incentives paid.

9. Air New Zealand submits that it is a payer of prices set by CIAL to make a regulated return of 6.82%, and yet is not in receipt of a share of incentive payments pro rata to its share of those prices. We consider that as domestic carrier we have been assigned an unfair price burden, and that we are delivering to CIALs own target return of 6.82%, rather than CIALs 'information disclosure return'.

CIAL excluded incentives from price building blocks

10. Air NZ questions the Commission's acceptance of CIAL's explanation that the reduction in expected return for priced services from 6.82% to 6.44% is driven primarily because it is providing pricing concessions to incentivise new airline routes.

11. During consultation, CIAL set out quite clearly that it had included forecast costs associated with aeronautical development/marketing and general marketing of the Airport itself, as follows:

Marketing cost components	FY18	FY19	FY20	FY21	FY22
Aeronautical marketing	2.02	1.84	1.89	1.92	1.96
Airport marketing	0.94	0.89	0.91	0.93	0.95
Total	2.95	2.73	2.8	2.85	2.91

12. CIAL explained that its demand forecasts took account of this forecast spend "meaning forecast demand and growth is consistent with CIAL's marketing plans."

13. CIAL then stated that it:

"…has not included in its model the cost of airline-specific discounts or rebates…

During PSE3 CIAL may spend additional amounts on general marketing, airline-specific marketing, or discounts to particular airlines – all aimed at increasing demand.

Decisions on this additional marketing and incentives will be made by CIAL during the pricing period, and are irrelevant to CIAL's building blocks model or PSE3 price setting event information disclosure."[1]

[1] CIAL Indicative Pricing Proposal, p.56

14. To now claim that this additional spend, which may or may not occur at CIAL's whim, is a legitimate factor to include when assessing expected returns is fallacious. It also fails to recognise that any spend which results in additional passengers will also increase non-aeronautical revenues at no expense to the non-aeronautical business, particularly when this is associated with an uplift in international passengers.

Incentives also affect demand forecasting

15. The Commission has noted that it considers it appropriate to take the cost of these incentives into account when assessing CIAL's expected returns as these were taken into account in the demand forecasts. Air NZ questions whether the forecast incentives *not included in the pricing model*, as opposed to the marketing spend which *was included*, were in fact taken into account when developing demand forecasts.

16. In Air NZ's view, the forecasts adopted by CIAL were by no means stretch forecasts and would not require additional incentive spend to be achieved. Indeed, the starting point forecasts (FY18 vs FY17 actual) were extremely conservative with international passengers forecast to increase only 0.33% and domestic passengers to increase by only 2.5%. CIAL reports international passenger growth in the period JUL17-APR18 of 7.3% and domestic passenger growth of 4.2%. Annualised, this equates to FY18 aeronautical revenue above forecast of more than $2 million.

Airfield Charge

17. In considering whether CIAL's price structure is likely to result in cross-subsidy between operators of different aircraft, the Commission appears to have accepted without comment CIAL's (and Incenta's) claim that the airfield asset-related cost base is largely unaffected by the type and level of aircraft use, and a focus on the forward-looking cost (i.e. pavement maintenance) is therefore appropriate. This ignores the fact that a substantial portion of the airfield cost relates to assets already in place which are scaled to service the needs of larger, heavier aircraft, and which are not required for the smaller aircraft servicing domestic routes. Capital-related costs comprise ~60% of CIAL's airfield revenue requirement and reflect the investment in longer, wider and stronger runways, taxiways and aprons required to service those larger aircraft.

18. It should be noted that airline unit costs are already higher for the smaller turbo-prop aircraft than for larger jet aircraft and CIAL's price structure increases that penalty. In this sense while CIAL's adopted structure is theoretically efficient from its point of view, it imposes inefficiencies on its airline customers through increasing that unit cost differential. Smaller turbo-prop aircraft are used on routes where the market size and infrastructure would not support larger aircraft, or where customer convenience can be improved through operating more frequently with smaller aircraft.

19. CIAL also claims that its pricing structure encourages assets to be used in a way that minimises forward-looking costs. Air NZ questions whether this is the case. Reducing cost for larger international aircraft should theoretically result in more movements of this type of aircraft, resulting in increased maintenance requirements and potentially need for additional infrastructure to cater for growth, all increasing forward-looking costs (as well as underlying costs).

20. Taken to its extreme such an approach could also incentivise inefficient investment in assets to serve larger aircraft. Once this investment is sunk, charges associated with these assets can then be levied on smaller users which do not need those assets on the basis that it is only forward-looking costs which are important. This could, for example, see Wellington Airport investing in a runway extension to service new long-haul routes which is then paid for by users which do not require the additional runway length to operate. This would be an extremely inefficient use of funds and not in the long-term interests of those consumers.

21. Air NZ would also question the stand-alone cost of a turbo-prop only airfield arrived at by Incenta. Airfield costs associated with turbo-prop only airports around the country are in the order of 25% of those estimated by Incenta. Acknowledging that there may be some additional costs associated with serving the larger market at Christchurch (mainly associated with operational expenditure), it would appear that CIAL's forecast revenue from turbo-prop aircraft could well exceed the stand-alone cost.

Efficient terminal pricing

22. As the Commission notes, CIAL's pricing structure differentiates charges based on whether a passenger is international, domestic, or regional. A domestic passenger is classified as one travelling to/from Auckland or Wellington, or otherwise using the integrated terminal. Consequently any passenger travelling between Christchurch and Wellington is charged at the (more expensive) domestic passenger rate, regardless of whether or not they are using the more expensive facilities included in the integrated terminal.

23. The Commission appears to consider that this is likely to be more efficient overall, "sending better signals to users of the regional terminal." Air NZ disagrees. The price structure would not result in turbo-prop services re-locating from the regional terminal to the integrated terminal as the integrated terminal and particularly the international portion of the terminal is not configured to easily handle turbo-prop operations. Use for this purpose would be inefficient and add considerable operational cost to ground handler and airline operations.

24. The Commission notes that CIAL is proposing to spend $10.4 million reconfiguring its terminal to increase flexibility and create efficiencies in the use of the facility. Air NZ agrees with the Commission that "if successful" this project is preferable to incurring

substantial capital expenditure to increase capacity in one area while other areas remain under-utilised. Air NZ's concern is that CIAL has moved to implement a pricing structure which reflects this fully flexible utilisation of the terminal when the physical and operational changes to enable this have not been implemented and CIAL acknowledges that it has yet to develop detailed plans let alone engage with airlines on these.

25. As things stand, and given the limited ability for all jet passengers to fully utilise the whole integrated terminal facility, CIAL's pricing structure is undermining the productivity of the current "domestic" airside facility which processes significantly more passengers than the earlier built "international" airside facility. As noted in our response to CIAL's IPP, this structure also ignores the reality of the nature of international facilities which are required to provide for larger groups of passengers dwelling longer in airside facilities due to international processing requirements. While we would welcome the outcome, Air NZ remains sceptical that the entire integrated terminal airside areas will ever become fully flexible, and as such objects to its domestic passengers paying for international facilities.

CHC-WLG

26. Use of turbo-prop aircraft on WLG-CHC sectors is a more efficient and customer responsive strategy for airlines serving this market which enables a more frequent service for customers. Reverting to 171 seat jet operations on this sector, which appears to be CIAL's objective, would effectively result in halving of frequencies. In Air NZ's view efficiency considerations should not be focussed solely on the impact on the airport but should take account of impacts on airport customers and their networks.

27. As noted by the Commission, Air NZ disagrees with CIAL's contention that this aspect of the pricing structure reflects the regional lounge agreement. As noted in our response to CIAL's IPP,

28. *"…the Regional Lounge arrangements do not require that WLG be treated as a "main trunk route". Rather it is noted that the Regional Lounge is intended for the use of passengers* ***predominantly*** *to and from regional airports, being airports other than Auckland and Wellington. Notwithstanding that Air NZ has moved to serve more passengers travelling to/from WLG through the Regional Lounge,* ***the predominant use of the lounge remains that of passengers travelling to regional airports****."* (emphasis added)

29. The majority use of the regional lounge remains that of servicing of passengers travelling to/from ports other than Wellington.

Price structure and increased revenues

30. CIAL revenues underperformed over PSE2. Analysis of information disclosures tell us that international passenger numbers under-performed, while domestic passenger numbers over performed.

31. For PSE3, we have seen CIAL entirely change its price structure with a focus to increase domestic revenue. Given that as a domestic carrier, Air New Zealand is already paying prices to return to CIAL's stated 6.82% cost of capital, enabled by application of multi-million dollar annual incentive payments, it is particularly frustrating to then be penalised for domestic passenger growth via increasing terminal and tarmac prices.

32. Incentives designed to attract additional international passengers will have a further positive impact on non-aeronautical revenues, with international passengers dwelling longer in the terminal and spending more on food and beverages, amenities, and duty-free.

33. In this sense, Air NZ rejects CIAL's assertion that it has no incentive to increase revenue through price structure. While this may be true in respect of regulated revenues, it fails to recognise the incentive for airports to target passenger groups which deliver greater revenue through non-regulated services. This incentive can only be observed when considering the overall performance of the airport rather than limiting review to the artificial construct of the aeronautical till only.

Air New Zealand's fleet choice has not contributed to CIALs returns

34. The Commission appears to accept CIAL's assertion that it is Air NZ's move to a higher proportion of turbo-prop aircraft than originally forecast which has been a contributing factor to CIAL not recovering its forecast revenue over PSE2.

35. Analysis of CIAL's disclosures over PSE2 shows that movements across all category of aircraft were below forecast and that in every year except FY2017, landings of domestic flights in the 3-30 tonne category varied from forecast by a larger percentage than the domestic above 30 tonne category. It should also be noted that during PSE2, Air NZ domestic jet operations transitioned to an all A320 fleet with both weight and capacity ~25% greater than the previously used 737-300 fleet.

Other regulated services at all specified airports

36. As was the case with the Commission's draft report on Auckland Airport's PSE3 pricing, this draft report has highlighted the importance of ensuring there is adequate transparency of pricing activities versus other regulated activities. In both cases, the

Commission has highlighted that returns on other regulated activities will be above what the Commission considers appropriate, reversing the situation during PSE2.

37. Air NZ considers it is important that reviews of price setting events focus on the prices and returns for the activities which were the subject of consultation. In an ideal world, the prices and returns disclosed would in fact match those airport companies had consulted on. Returns on other regulated activities are, clearly, also of interest but should not be a consideration when determining whether prices/charges for priced services are generating excess returns.

38. Air NZ believes it is appropriate that greater flexibility be applied when considering returns on other regulated services, with analysis of these considered over the longer term, generally reflecting the tenure of contractually agreed arrangements and the nature of those arrangements (e.g. provision for rent reviews, etc). Air NZ also agrees with the Commission that lower returns on other regulated services should not be offset by higher returns on priced services.

39. It is nevertheless important that the Commission maintains an oversight of returns on other regulated services. While these are generally subject to formal contracts, as the Commission has noted, the extent of alternative options available is an important factor in determining whether an airport may be able to leverage market power to impose inappropriate outcomes. For example, an airline wishing to develop a lounge to cater for its premium customers does not have an alternative to provide facilities outside the airport precinct, let alone the terminal. The level of service it is able to provide is dependent on securing appropriate access from the monopoly airport owner.

40. Air New Zealand is supportive of further discussion on how other services provided by airports may be regulated.

Regards,

Jeff McDowall
Chief Financial Officer
Air New Zealand