16 August 2018

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

Dear Jo,

Draft Report on Christchurch Airport's pricing decisions and expected performance: PSE3

Executive Summary

WACC, target return and transparency

1. BARNZ considers that Christchurch Airport's disclosed target return of 6.44% for priced services is reasonable. However, the Airport's estimate of its own cost of capital of 6.82%, which was used in the 2017 pricing consultation with airlines, has not been justified and prices are higher than they would (and should) have been had a reasonable WACC been used for price setting.

2. We would have liked to see more transparency during the pricing consultation process about what the airport's target return would be (and other key points such as the airport's cash-flow timing assumptions). Had a full set of information been provided, we could have had a more constructive and effective pricing consultation process. We think it is a reasonable expectation of airlines that there are no 'surprises' in the disclosures that differ from information provided during the preceding pricing consultation. However, this was the first pricing review since the 2016 Input Methodology amendments and there are some learnings from this process that can be applied in future.

3. In terms of the adjustments made by Christchurch Airport to derive its own cost of capital estimate of 6.82%:

    a. We agree with the Commission that Christchurch Airport's asset beta uplift to compensate for the supposed higher risk of having a higher proportion of leisure travellers is not justified and the evidence provided by the airport for this uplift is weak.

    b. We are not convinced that sufficient analysis has been done to demonstrate that a BBB+ credit rating for Christchurch Airport will be in the long-term interest of consumers – using a regulated supplier's own credit rating could create perverse incentives for the firm and is a departure from the standard regulatory approach of the Commission.

Pricing structure

4. BARNZ agrees with the Commission that Christchurch Airport's new charging structure does not raise significant efficiency concerns in relation to the airlines that we represent. Overall, we support the pricing structure that has been introduced.

Assessment of other regulated services

5. BARNZ agrees that a new approach to assessing returns on other regulated services is needed (ie services that are not subject to standard aeronautical charges). For other regulated services, the airport is likely to have market power (in general, users of these services cannot easily relocate to a different location – they include airlines that need office space, ground handlers and border agencies that must be based at airports) so scrutiny of the charges is necessary.

6. We would be open to exploring options for reviewing returns on these services over different timeframes than a standard 5-year pricing period. We think the starting point is to gather more information (at an aggregate level) about the nature of the services, the timeframes of the contracts and how the charges are set. Once there is a clear understanding of the nature of the other regulated services and how their pricing is structured, it should be possible to identify a way forward that can provide sufficient comfort that the charges are reasonable.

Expenditure and cost allocation issues

7. The Commission may have misunderstood airline concerns regarding Christchurch Airport's $10.4 million terminal reconfiguration capex project. Our concern is a principled one that we do not believe this project was fully consulted on before being included in pricing, because the airport was not able to describe in detail how the funds would be spent. While the airport indicated the types of project it could be used for, airlines were not able to review the project itself and provide feedback on it, or identify better alternatives, before the funds were included in the pricing decision.

8. BARNZ shares Air New Zealand's concern that 100% of the cost of the Antarctic Apron has been included in the pricing asset base even though it is not used to provide priced services. We agree this will under-state the disclosed return on the assets that really are priced assets.

BARNZ submission

Introduction

9. BARNZ welcomes the opportunity to respond to the Commission's consultation paper *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, dated 19 July 2018.

10. This submission is made on behalf of the airlines[1] which BARNZ has written authority under s2A of the Airport Authorities Act 1966 to represent during consultation over charges with New Zealand Airports and which currently operate scheduled services at Christchurch Airport.

11. As discussed in our submission on the Process and Issues paper, BARNZ's preference was for this review to have a stronger focus on quality of service, expenditure efficiency and innovation. However, we

[1] Cathay Pacific Airlines, China Airlines, China Southern, Emirates, Fiji Airways, Singapore Airlines, Virgin Australia.

support the Commission's proposal to review these matters based on airports' annual historical disclosures, once Wellington Airport's FY19 disclosures are available.

WACC, target return and transparency

Christchurch Airport's disclosed target return for priced services is reasonable but was not sufficiently transparent during consultation

12. Christchurch Airport has disclosed a target return of 6.44% for priced services in PSE3. This is close to the mid-point of the Commission's range at 6.41% and the Commission's adjusted mid-point (discussed below) of 6.47%. The Commission considers that the 6.44% target return is reasonable. BARNZ agrees – we are pleased Christchurch Airport has targeted a return on priced services that is close to the mid-point and this shows airports can reasonably operate and deliver services at a mid-point WACC.

13. However, Christchurch Airport did not consult with airlines on a target return of 6.44%. Instead it consulted on its own WACC estimate of 6.82%, which we thought was excessive and the Commission has now concluded was not justified. At no point during the consultation process with airlines did Christchurch Airport indicate that its disclosed target return for priced services would be 6.44%.

14. What the Airport has done is included route development incentive costs in disclosed aeronautical opex (and made some other adjustments) to reach a target return of 6.44%. But what it consulted on was excluding the incentive costs from aeronautical costs and prices and a WACC of 6.82%. While it may be seen in hindsight that the net effect on prices is approximately the same, this was not apparent to airlines at the time as we had no information on the quantum of the route development costs.

15. BARNZ welcomes Christchurch Airport's decision to exclude route development incentive costs from the prices that were set. Unfortunately, this welcome decision has been undermined by the disclosure treatment of the costs – ie while the costs were not an input into the airport's aeronautical charges, they have been used to support the airport's case that its overall target return is reasonable and thus mitigate any concerns raised by airlines and the Commission in relation to the 6.82% WACC estimate that was used for price setting purposes.

16. There are several other areas where Christchurch Airport has provided more information to the Commission for its review than was provided to airlines during the pricing consultation. These are:

    a. The use of year-end cash-flow timing assumptions in the pricing model, rather than the mid-year timing assumptions now set out in the IMs
    b. The terminal reconfiguration capex project
    c. The rationale for the new pricing structure.

17. BARNZ is concerned that airlines were not fully consulted on Christchurch Airport's pricing proposals as some important information only emerged after prices were set. Had this been provided, we could have had a more constructive and effective pricing consultation process. However, this was the first pricing review since the 2016 Input Methodology amendments and there are some learnings from this process that can be applied in future.

18. We suggest that in future all airports follow the approach Auckland Airport took in its 2017 pricing consultation of including a draft Excel version of Schedule 19 in the pricing consultation material. This meant airlines could see what the expected pricing target return was. If adopted by all airports, this

would help to prevent similar confusion arising in future. It may be helpful for the Commission to set out an expectation that all airports to do this.

The 6.82% WACC Christchurch Airport used to set prices is not reasonable

19. As discussed above, Christchurch Airport consulted and set prices using its own estimated WACC of 6.82%, above the Commission's mid-point of 6.41%. We agree with the Commission that Christchurch Airport's proposed 0.05 uplift to the asset beta, which is the main driver of the higher WACC estimate, is not justified. We agree with the Commission that:

    a. As Dr Small, for BARNZ, noted, Incenta's analysis did not provide evidence to a conventional level of statistical significance even though Incenta was seeking to use statistical analysis as the basis for differentiating Christchurch Airport's risk from that of other airports
    b. There is no data comparing the proportion of leisure travellers at Christchurch Airport to the comparator sample
    c. The data indicating the difference in the proportion of leisure travellers at Christchurch Airport relative to other New Zealand airports is limited and outdated
    d. The relative proportion of international and domestic leisure travellers has not been identified. This is an important factor because the correlation between international leisure air travellers with changes in the national stock market is limited.

20. As the 6.82% WACC was not justified, Christchurch Airport's aeronautical charges are higher than they would have been had a reasonable and justifiable cost of capital been used to set prices.

The credit rating adjustment accepted for Christchurch Airport is a departure from regulatory precedent

21. In its pricing consultation Christchurch Airport used its own credit rating of BBB+ to determine the debt premium, rather than the A- credit rating specified in the Airport Services Input Methodologies. The Commission's Draft Report accepts that this is reasonable.

22. BARNZ considers that there is some logic that supports this change. However, it is a departure from previous regulatory practice under the Input Methodologies. The Commission has generally not taken an approach of directly aligning the debt premium with the credit ratings of the regulated businesses: just one of the three airports has a credit rating of A-.

23. Also, our understanding is that no electricity distribution business or gas pipeline business has a credit rating that matches the BBB+ notional rating used in the energy sector Input Methodologies. As the Commission has recognised, using a benchmark notional credit rating avoids creating adverse incentives to increase gearing in a way that creates poor outcomes for consumers.

24. The approach of using a credit rating higher than that of many of the regulated firms was challenged by airports and energy businesses during the input methodologies appeal process. The High Court supported the Commission's approach and disagreed that setting the credit rating equal to that of a particular supplier was in the long-term interest of consumers. For example, in discussing Powerco's claim that its own BBB credit rating should be used to set its debt premium the High Court said:

    "[1312] Powerco's proposal is at odds with the s 52A purpose: simply compensating an EDB or GPB for its actual costs as advocated by Powerco would be contrary to that purpose because it would provide no incentive to improve efficiency or limit a supplier's ability to extract excessive profits (s 52A(1)(b) and (d))."

25. Overall, we are not convinced that sufficient analysis has been done to demonstrate that a BBB+ credit rating for Christchurch Airport will not cause consumer harm.

26. If the use of a BBB+ credit rating to set the debt premium is accepted for Christchurch Airport, we think it is important to emphasise that this is a judgement made in the context of Christchurch Airport only (ie based on the Commission's assessment of prudent levels of debt financing for the airport) and is not necessarily transferrable to other regulated airports.

Pricing structure

27. BARNZ agrees with the Commission that Christchurch Airport's new charging structure does not raise significant efficiency concerns in relation to the airlines that we represent. Overall, we support the pricing structure that has been introduced.

28. Although not a matter that directly affects the international airlines we represent, BARNZ has previously raised the issue of the classification of all flights between Christchurch and Wellington as using the upstairs jet departure lounge. From a principled perspective, BARNZ supports pricing arrangements that do not incentivise or penalise the use of particular aircraft types on specified routes.

Assessment of other regulated services

29. BARNZ agrees that a new approach to assessing returns on other regulated services is needed.

30. For other regulated services, the airport is likely to have market power (in general, users of these services cannot easily relocate to a different location – they include airlines that need office space, ground handlers and border agencies that must be based at airports) so scrutiny of the charges is necessary. We share the Commission's concern that the airport's returns on these services may be too high.

31. We note that at a time where target returns on priced services are being pushed downwards following the 2016 Input Methodology amendments, both Christchurch Airport and Auckland Airport are now reporting relatively high returns on other regulated services. More information is needed to reassure consumers that these prices are not too high. We understand that charges for these services are often set based on market rates, but it is not clear how these are estimated or what is the most appropriate market to base the rates on.

32. As we discussed in our cross-submission on the Auckland Airport Draft Report, there is a lack of information available for the Commission or other interested parties to review the returns on other regulated services and determine whether they are reasonable.

33. As leases can last for timeframes that are not consistent with a 5-year pricing period, we support an approach of exploring options for reviewing returns on other regulated services over different timeframes. We think the starting point is to gather more information (at an aggregate level) about the nature of the services, the timeframes of the contracts and how the charges are set. We suggested some information disclosure changes in our previous submission,[2] but for fact-finding purposes a targeted information request under section 53ZD may be the best approach. Once there is a clear understanding of the nature of the services and how their prices are structured, it should be possible to identify a way forward.

[2] BARNZ Cross-submission on AIAL's PSE3 pricing decision, 26 June 2018, pages 18-19.

34. The table below provides some initial comments on areas the Commission has said it is considering in this area.

Issue	BARNZ comment
Whether greater flexibility is appropriate for assessing the expected returns on other regulated services	BARNZ thinks that it could be reasonable to assess returns over timeframes other than 5 years. However, we would not necessarily support greater 'flexibility' in determining what an acceptable return is – the starting point should be that the standard return for non-priced services is the same as for priced services *over time*. The aim should be to reduce any power imbalance between the two parties to the contracts.
How the Commission can ensure that it applies a consistent approach over time - for example, if the expected return on other regulated services is below our benchmark cost of capital, we would want to ensure this lower return is not offset by a higher return on priced services	BARNZ supports a consistent approach over time. We see consistency as being important in terms of how the return is assessed over time. We agree that if returns on other regulated services are assessed over a longer period of time, these returns would probably have to be assessed separately from returns on priced services to avoid offsetting those returns in a way that is not in the long-term interest of consumers.
How the Commission ensures its approach does not incentivise or disincentivise the use of negotiated contracts when it is not in the long-term interests of consumers to do so	BARNZ agrees this is important. There will always be a need for negotiated contracts for other regulated services at New Zealand airports. Scrutiny of the returns earned from those contracts should not have a distorting effect on the market for the services.

Expenditure and cost allocation issues

Christchurch Airport's terminal reconfiguration capex project has not been properly consulted on and creates a poor precedent

35. The Commission considers that the $10.4m terminal reconfiguration capex project "does not appear unreasonable". We think the Commission may have misunderstood airline concerns about this project. The principle here is that airlines should be properly consulted on significant capital projects before they are included in pricing. This includes the airport:

    a. Explaining the expenditure in terms of the problem(s) being addressed and the outcome(s) being provided. These should be quantified wherever possible.
    b. Defining the problem and provide enough information for airlines to assess the proposed solution on a cost-benefit basis and consider whether there are better alternatives available.

36. Had Christchurch Airport, in the consultation, specified what the funds would be spent on and what the benefit(s) would be (for example, convert X international gates into swing gates, to increase domestic jet capacity by Y% at peak times) then airlines could have considered that benefit against the cost and provided meaningful feedback. We may well have supported the proposed expenditure.

37. However, Christchurch Airport said, effectively, that it would need to spend the funds at some point over PSE3 but could not state in detail what it would be spent on. This prevents airlines from giving meaningful feedback on a project that they will ultimately be charged for.

38. Christchurch Airport has stated that it will definitely undertake the project in PSE3. However, our concern is less that the funds will not be spent, or even that they will be spent inefficiently. Our concern is a principled one that we do not believe this project was fully consulted on before being included in pricing, because the airport was not able to describe in detail how the funds would be spent. While the airport indicated the types of project it could be used for, airlines were not able to review the project itself and provide feedback on it, or identify better alternatives, before the funds were included in pricing. We consider that these points of principle call into question the appropriateness of including the project in the pricing proposal.

Tilted annuity depreciation

39. BARNZ supports Christchurch Airport's tilted annuity depreciation method.

Antarctic Apron

40. BARNZ shares Air New Zealand's concern that 100% of the cost of the Antarctic Apron has been included in the pricing asset base even though it is not used to provide priced services. We agree this will under-state the disclosed return on the assets that are actually priced assets. Our calculations suggest that removing the Antarctic Apron from the priced asset base would increase the disclosed target return by approximately 0.07%.

41. In principle, we do not believe airports should charge priced aeronautical services for assets that are not used by those services. We believe the Commission's Final Report should take a stronger position against the inclusion of the Antarctic Apron in Christchurch Airport's pricing asset base.

Expenditure efficiency

42. In our previous submission, BARNZ noted that Christchurch Airport's operating expenses per passenger were higher than other New Zealand airports. The Draft Report notes that "these discrepancies in airports' performance existed over PSE1 – PSE2 and have not changed remarkably to raise significant concern". BARNZ would like to see a stronger focus on driving improved efficiencies across airports – we don't accept that because costs at a particular airport have been relatively high in the past it necessarily means the current relatively high costs are reasonable.

Contact details

43. If you have any questions about this submission, please contact me on 09 358 0696 or at ian@barnz.org.nz.

Yours sincerely,

Ian Ferguson
Regulatory Manager