CROSS SUBMISSION BY BARNZ ON COMMERCE COMMISSION DRAFT SECTION 56G REPORT ON CHRISTCHURCH AIRPORT

26 NOVEMBER 2013

There are five matters which BARNZ wishes to highlight in this cross submission on the submission made by Christchurch Airport:

- Christchurch Airport's challenge to the Commission's conclusion that information disclosure regulation had a minimal effect on limiting the ability of the Airport to extract excess returns;
- The effect of the changes Christchurch Airport has indicated that it will make to its approach going forward for PSE3 and subsequent periods, on the modelling the Commission has undertaken of the returns Christchurch Airport is targeting;
- The appropriate risk free rate to use in the WACC estimate against which the reasonableness of the targeted returns is assessed;
- The Airport's proposals for future disclosure and articulation of its non-standard depreciation approach; and
- The Airport's challenge of how the Commission has phrased its conclusions regarding incentives and outcomes around innovation, service quality and pricing efficiency.

In addition, BARNZ wishes to respond to the following three points made within the submission by the NZ Airports Association:

- The view that the Commission needs to confine its analysis and conclusions to the disclosure and prices set by Christchurch Airport for the current pricing period, without undertaking any analysis of the financial modelling or returns targeted for the 20 year period;
- The assertion that information disclosure is effective if the section 56G reviews identify issues or concerns with the conduct of the three airports, which the airports subsequently respond to; and
- The allegation that the Commission's approach is discouraging commercially based pricing decisions.

COMMENT ON CHRISTCHURCH AIRPORT SUBMISSION

1. The minimal effect of information disclosure on Christchurch Airport's approach

Christchurch Airport is challenging the Commission's draft view that information disclosure has had minimal influence over Christchurch Airport's behaviour. The Airport has submitted that:

- It adopted all but two aspects of the input methodologies;
- It changed its asset valuation approach, timing of revaluations and common cost allocation methodology; and
- None of the transparency and discipline would have happened without information disclosure.

The two input methodologies not adopted by the Airport were the estimation of WACC and the calculation of tax. In addition, the Airport applied a pre-tax approach which differs from the post tax approach which formed the foundation of the Commission's input methodologies. Using a different WACC and a different methodology for calculating tax had a significant effect on the level of returns being targeted by the Airport. It is disingenuous for Christchurch Airport to characterise itself as following all but two input methodologies, when the two aspects of the input methodologies it chose to depart from had such a marked impact on the level of returns being sought by the Airport, and were directly responsible for the level of excess target returns identified by the Commission. In its submission on the Issues Paper for Christchurch Airport, BARNZ showed that the Airport's incorrect tax approach resulted in an unjustified impost of $35m on airlines over PSE2 compared with tax calculated using the input methodologies.

BARNZ has previously acknowledged that Christchurch Airport's valuation methodologies and treatment of actual and forecast revaluations as income in its price setting process were in accordance with the input methodologies. However, it is less clear whether this was a change attributable to information disclosure regulation under Part 4. Christchurch Airport adopted an MVAU based valuation methodology for its land as it set charges for PSE1 – before the input methodologies had been developed.

BARNZ is perplexed as to what the change is that Christchurch Airport is referring to in relation to its cost allocation methodology. The methodology (so far as BARNZ is aware) is the same cost allocation methodology previously adopted by the Airport – it is simply the assets that have changed with the commissioning of the new terminal. Part 4 information disclosure and input methodologies do not appear to have resulted in any discernable change to common cost allocation.

Finally, BARNZ has to take issue with the Airport's assertion that none of the transparency or discipline would have occurred without information disclosure. Consultation under the AAA is a well-established process which Christchurch Airport has undertaken at least three times. Consultation results in significant transparency to interested parties (albeit that it is not able to prevent prices being set at levels which target excess returns).

BARNZ's assessment of the effect of information disclosure on Christchurch Airport's price setting behaviour is that the Airport made certain changes such as treating actual revaluations as income and indexing the value of specialised assets (rather than undertaking a new ODRC valuation) but in two important aspects it completely disregarded the input methodologies so that it would not be prevented from targeting the high level of returns which its shareholders had apparently directed the Board to achieve. The level of return targeted was not influenced or constrained at all by information disclosure regulation.

With respect to the calculation of tax, BARNZ specifically referred Christchurch Airport to the formula in the input methodologies for calculating taxable income and regulatory tax, and to the passages in the Commission's reasons papers which explained how and why the tax input methodology had been specified in that manner, but Christchurch Airport continued to ignore the very clear input methodology on tax, which was inconsistent with the approach the Airport had decided to take.

With respect to the estimate of an appropriate WACC, Christchurch Airport again disregarded the Commission's input methodologies, adopting a different approach to the Commission to estimating the risk free rate, debt premium, leverage, market risk premium and the asset beta – in all cases with the Airport's approach resulting in a significantly higher cost of capital.

BARNZ agrees with the Commission's overall conclusion that information disclosure had minimal influence on Christchurch Airport's behaviour.

2. Christchurch Airport confirms many of the adjustments required to the Commission's analysis

Christchurch Airport has committed itself to make a number of changes to its financial model going forward in response to matters identified by the Commission, several of which were factors the Commission considered created risks that its analysis understated the returns being targeted by the Airport. With the Airport committing to making these changes, the Commission needs to likewise update its analysis in order to reflect Christchurch Airport's clarified intentions.

In its submission on the Commission's draft report BARNZ concluded that the Commission was significantly under-estimating the returns being targeted by Christchurch Airport as a result of the Commission:

- Not treating the unforecast revaluations made by Christchurch Airport during PSE1 and at the transition to PSE2 as income in the calculations of required revenue for PSE2 (as Christchurch Airport and BARNZ did);
- Not increasing prices for the last ten years of the pricing model annually by forecast CPI as Christchurch Airport's explanations of its intended application of its levelised constant real pricing path indicated would occur;
- Choosing to reduce the prices specified by Christchurch Airport in its financial model for PSE3 down to the levelised constant real pricing path, rather than applying Christchurch Airport's indicated pricing of applying CPI increases from the 1 January 2015 uplifted pricing path;
- Using end of year cash flows for its modelling, despite Christchurch Airport's own financial modelling being undertaken on mid-year cash-flows;
- Not including any allowance for capex after the first five years in its analysis; and

- Not having sufficient information from Christchurch Airport's disclosures to enable the effective 'levelised depreciation' path to be ascertained.

Some of these items were matters which the Commission itself identified as risk factors suggesting that expected returns could be greater than the Commission's estimates.[1] With the Airport now making a number of these amendments, this confirms the submission made by BARNZ that the Commission needs to make these adjustments to its assessment of the level of returns being targeted by the Airport.

Increasing prices for PSE4 and PSE5 by CPI and including forecast CAPEX in PSE3, PSE4 and PSE5

The Airport has undertaken to:[2]

- Correct its pricing path for the last ten years of the model to reflect the annual CPI increases the Airport intends to make to its prices, thus resulting in higher revenues in the last ten years of the model; and
- Include forecast capital expenditure for the last three periods of the model, which will increase the levelised pricing path.

Given that Christchurch Airport has now indicated that it will be making these changes, the Commission likewise also should make these adjustments to its analysis of the level of returns being targeted by Christchurch Airport.

Not reducing PSE3 prices

In response to the Commission's reduction of prices in PSE3 down to the level indicated by the levelised price path (rather than the higher charges included by the Airport in its financial modelling), Christchurch Airport has committed that it will ensure prices are 'set no higher than the levelised pricing path'.[3] This undertaking is not the same as committing to the downwards adjustment to prices which was made by the Commission.

In particular, it is not an undertaking that PSE3 prices will be reduced to the *current* levelised constant real price path, given the Airport's recent revelation that it now intends implementing its pricing model as a series of overlapping 20-year models. The inclusion of forecast capital expenditure in PSE3, PSE4 and PSE5 (which was not previously included in the Airport's model) will mean that the levelised price path will increase, i.e. the 20-year model that starts in PSE3 will imply a higher price path than the one that started in PSE2. Therefore, higher charges, potentially similar to those specified by the Airport in its financial model will be the outcome. Given that the Airport has not undertaken to reduce the prices indicated for PSE3 downwards, then the Commission should not be making this downwards adjustment to prices in its analysis.

[1] Commerce Commission, Draft Report to Ministers of Commerce and Transport on how effectively Information Disclosure Regulation is promoting the purpose of Part 4 for Christchurch Airport (hereafter Commerce Commission draft report), 15 October 2013, para E85.
[2] Christchurch Airport s56G Submission, para 46.
[3] Christchurch Airport s56G Submission, para 351.

Use of an implicit economic depreciation approach

The Commission expressed concern that its analysis of PSE2 outcomes understated the likely returns being targeted by the Airport because it represents returns on an RAB which is not being depreciated consistently with Christchurch Airport's long term pricing proposals.

Christchurch Airport has accepted that there is a mismatch between the annual depreciation amounts that it has calculated using a straight-line depreciation method and the implicit return of capital that it expects to receive under the levelised price in each year.[4] It has undertaken to prepare supplementary disclosures showing this information, but these will not be ready until 2014.

In its final report the Commission thus needs to treat the lower levels of returns appearing to be earned in PSE2 (as compared with the remainder of the 20 year model) with caution. It is the returns across the full 20 year period which provide the full picture of the level of returns being targeted by the Airport.

Treatment of unforecast revaluations as income in calculation of required revenue

Christchurch Airport has confirmed that its approach of deducting the present value of revaluations undertaken during PSE1 and at the transition to PSE2 from the revenues collected from its airline customers was both agreed with customers and was required because the Airport's PSE1 pricing decision was explicit that a forecast of revaluations was not included, hence those revaluations had not been 'booked against prices'[5] in PSE1.[6]

By contrast, the Commission has not treated any of the actual revaluations made by Christchurch Airport during PSE1 and at the transition to PSE2 as income in the Commission's calculation of the estimated required returns for PSE2 under the building blocks approach.

BARNZ reiterates that the Commission needs to similarly treat those revaluations as income in its calculations of required revenue for PSE2. As BARNZ has previously noted, such unforecast revaluations cannot be treated as income in the initial pricing period (PSE1 in this case), and must therefore be treated as income in the following pricing period (PSE2 in this case) because they are unknown when prices are set for the first pricing period. If they are not treated as income in the calculations of required revenue in the subsequent pricing period, then the NPV = 0 principle will not be met and airports will have an incentive to under-forecast their revaluations in order to avoid the requirement to reduce required revenue to offset revaluation gains.

BARNZ notes that in its preliminary information package on asset revaluations, Wellington Airport is also proposing to adopt the same approach as Christchurch Airport going forward – that is, any actual revaluations which are under or over what was forecast in the pricing period just finishing, will be treated as income (positive or negative as the case may be) in the calculation of required revenue for the immediately following pricing period. The approach in the Commission's draft report would mean that unforecast revaluations would not be taken into account for assessing the reasonableness of prices under a building block methodology in either pricing period, which is not appropriate and violates the NPV = 0 principle.

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[4] Christchurch Airport s56G Submission, para 180.

[5] In other words, those revaluations had not been treated as income when prices were set for PSE1.

[6] Christchurch Airport s56G Submission, para 352.

3. The appropriate WACC to assess target returns against

Christchurch Airport is continuing to submit that a risk free rate of 6%, representing the 10 year historic average, should be utilised in estimating the WACC rather than the 5 year government stock rate which was current at the time Christchurch Airport reset its prices in October 2012.

The Airport's proposition that a historic average rate of 6% should be utilised in the WACC calculations reflects a fundamental misunderstanding of the conceptual basis of the capital asset pricing model and the WACC derived from using it. The CAPM model is designed to provide a *forward looking* estimate of a firm's cost of capital – not a historical average. The use of a 6% risk free rate at a time when bond rates were approximately 3% is extraordinary.

Christchurch Airport is characterising government risk free rates in 2012 as being anomalously low and therefore inappropriate to use. However, McKinsey Global has observed that recent reductions in nominal and real interest rates are simply part of a steady decline of long term interest rates in developed countries which has been occurring over the previous 30 years.[7] There is nothing anomalous which would make the October 2012 cost of obtaining debt inappropriate to include in the forward looking estimation of Christchurch Airport's cost of capital. The Airport and its investors have benefitted from the lower costs of obtaining finance presently available, and those same risk free rates should form the basis of calculating the Airport's cost of capital for the purposes of setting charges and assessing the reasonableness of its targeted levels of return.

Christchurch Airport further argues that it is inappropriate to judge the reasonableness of the returns being targeted over twenty years using the October 2012 five year risk free rate. BARNZ disagrees. Christchurch Airport has clearly articulated that at each five year reset, it will update its WACC, and will recalculate the levelised constant real pricing path. That is, at each pricing reset Christchurch Airport will both update its WACC as well as its charges.

Given that the Airport has signalled that it will be updating its levelised price to reflect an updated WACC at the commencement of each price setting period, then BARNZ considers the Commission's approach of utilising the 5 year risk free rate from when charges were set is appropriate. If the Commission were to utilise forecasts of the future risk free rate to estimate a WACC for subsequent pricing periods, then the Commission would similarly need to adjust the forecast levelised price to reflect that different WACC. The two adjustments would largely offset each other.

As an aside, BARNZ notes that Christchurch Airport's forecast of future risk free rates of of 4.5%-5%, 5.5% and 6% for PSE3, PSE4 and PSE5 respectively are too high. If one is calculating forecast risk free rates then this should include study of the forward looking yield curve – which produces variations in the risk free rate significantly lower than those put forward by Christchurch Airport. For instance, comparing the October 2012[8] 10 year rate of 3.51% to the 5 year rate of 2.97% applicable at the same time, establishes that the forecast of the 5 year rate for PSE3 was 4.05% when charges were set in October 2012; – not 4.5% to 5.0% as put forward by Christchurch Airport in its submission or the 6% used by Christchurch Airport when its set charges. If there was a flat yield curve, the 5 year rates for PSE4 and PSE5 would be 3.75% and 3.90% respectively. With a slightly increasing yield curve the rates for PSE4 and PSE5 would be 4.20% and 4.35%, not 5.5% and 6% as put forward by

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[7] McKinsey Global Institute, QE and Ultra-low Interest Rates, November 2013, page 10.
[8] Being the point at which Christchurch Airport was setting its charges.

Christchurch Airport. In addition, if the risk free rate is updated, then likely changes to the debt premium would also need to be taken into account, as debt premiums tended to rise as risk free rates fell, and would thus be expected to fall going forward if the risk free rate rises.

BARNZ also notes that Christchurch Airport has criticised the Commission for not applying an increased asset beta of 0.7 in the light of what it describes as 'an issue where there was agreement between CIAL and its customers'.[9] BARNZ observes that it is not quite accurate to characterise there as being 'agreement' on asset beta. The advice received by BARNZ from Futures Consultants Ltd was that there was some justification for increasing the asset beta by 0.05 in the circumstances applicable to Christchurch Airport – which resulted in an asset beta of 0.65. This is not the same as the asset beta of 0.7 which Christchurch Airport considers appropriate. In any event, while the BARNZ represented airlines adopted the 0.65 asset beta, Air NZ did not and BARNZ is not aware of Qantas or Jetstar accepting the recommendation from Futures Consultants for a higher rate either.

4. Comments on Christchurch Airport's proposed approach for non-standard depreciation

In Appendix A Christchurch Airport discusses its proposed approach to implementing a non-standard depreciation plan, as well as details regarding how it intends to reset prices in PSE3.

While BARNZ supports changes that improve transparency, and welcomes the opportunity to have a dialogue with Christchurch Airport over such matters, we do not consider exchanges via a cross-submission to the Commerce Commission in its final stages of its s56G review of Christchurch Airport's pricing and information disclosure are the appropriate means of achieving this. Moreover, many of the matters discussed by Christchurch Airport are of a highly technical nature, and it is difficult to be able to meaningfully comment or fully understand the implications of a particular approach without being able to see the details underlying it and the interaction of the various elements of the Airport's pricing model.

With that in mind, BARNZ has restricted its comments to three aspects of Appendix A – the proposals regarding adjusting for the over-recovery of tax inherent in Christchurch Airport's current approach; the proposals regarding the adjustment from straight line depreciation to a depreciation profile consistent with the levelised pricing path; and Christchurch Airport's indication that it now intends to reset prices going forward using a series of overlapping 20 year periods. These comments are of a preliminary nature only and should not be regarded as being in any way of a definitive nature or of preventing BARNZ from commenting further when the details of how Christchurch Airport proposes to implement these matters are released.

Proposed adjustment for over-recovery of tax (para 189-190)

BARNZ agrees with the Airport that it is inappropriate for Christchurch Airport to retain any over-recovery of tax in PSE2 as a result of the manner in which it applied its pre-tax WACC approach. The question is whether effectively subtracting this over-recovery from the RAB via the economic depreciation calculation will reduce future revenues by an amount that has a present value exactly equal to the value of the over-recovery that has occurred.

[9] Christchurch Airport s56G Submission, para 393.

As Christchurch Airport notes in paragraph 190.1, the Commission's view is that over-compensation for tax in early years under a pre-tax WACC approach is not exactly offset by under-compensation in later years, in present value terms. Therefore it is not clear that deducting the over-recovery earned to date from the RAB via the non-standard depreciation will lead to an appropriate offset. Christchurch Airport appear to acknowledge this uncertainty in paragraph 190.3 where they state that their proposal 'should' resolve the Commission's concerns in relation to tax.

It will be necessary to review in detail the way that Christchurch Airport actually implements its proposed depreciation approach and the interaction with the treatment of taxation in order to determine whether the Airport retains any over-compensation for taxation in PSE2.

Proposed adjustment to move to a depreciation profile consistent with the levelised price path (para 200-202)

Christchurch Airport has specified the formulas it intends using to calculate the return of capital and to update the RAB at paragraphs 185 and 186. BARNZ notes that these formulas are silent with respect to asset revaluations.

Christchurch Airport notes that it has used straight line depreciation to determine the residual values of assets at the end of the 20-year modelling period, and that it intends to continue to do so under a non-standard depreciation approach. It seems unnecessary for the Airport to maintain two parallel but inconsistent depreciation calculations in order to implement its pricing methodology. In particular it is not clear why the non-standard depreciation approach cannot also be used to calculate the residual values, nor what the implications for pricing will be of maintaining two different depreciation methodologies. In any case, this seems relatively complex and may lead to confusion about asset values in future.

In paragraph 201, Christchurch Airport also proposes the calculation of what it calls the 'PSE2 residual RAB', reflecting the difference in depreciation during PSE2 between the non-standard and straight line depreciation approaches. In particular, since straight line depreciation implies a higher return of capital during PSE2 than non-standard depreciation (due to Christchurch Airport's implementation of the levelised pricing path), the 'PSE2 residual RAB' will be positive and the overall value of the asset base at the end of PSE2 will increase as a result.

Viewed in this light, the 'PSE2 residual RAB' has exactly the same characteristics as an upwards revaluation of Christchurch Airport's assets. The Airport was previously assuming that the assets would be depreciated during PSE2 at a faster rate than is actually consistent with its levelised pricing path. By now adopting a depreciation methodology that is consistent with its pricing, Christchurch Airport is effectively revaluing its assets upwards at the end of PSE2. It follows that the 'PSE2 residual RAB' should be treated in exactly the same way as other asset revaluations, that is, recognised as income, and revenues in PSE3 should be correspondingly lower as a result.

Finally, BARNZ also notes that at paragraph 188 Christchurch Airport has signalled its intention to undertake these calculations on the basis of end of year cash flows, which it describes as being the Commission's preference. While the Commission has used end of year cash flows in its analysis of the returns being targeted by the airports in the s56G reviews, BARNZ is not aware that this is the Commission's preference. The Commission has described its current use of end of year cash flows as 'a conservative assumption as it is most likely that cash flows are likely to be spread over the year and will therefore occur on average earlier than the end of the year'.[10] Moreover, the Commission has moved to using mid-year cash flows for information disclosure requirements for electricity distribution and gas pipeline businesses.[11]

Indication of intention to apply a series of over-lapping 20 year periods

At paragraph 199 Christchurch Airport has indicated that when it comes to reset prices in PSE3, it proposes to do so by another set of calculations over a 20 year period, describing the outcome as 'a series of overlapping 20 year periods'. The Commission has noted this observation and asked Christchurch Airport whether it is an intention it has previously articulated and whether the airlines were aware of it during consultation.

BARNZ advises that this was not an intention which was disclosed by Christchurch Airport during consultation. In fact, BARNZ's understanding was that a pricing path was being developed for one 20 year period, which would involve lower returns in the early years of the period, followed by higher returns in the later years of the pricing period, but with the Airport achieving its (in BARNZ's view, overstated) target return over the 20 year period. That was the clear understanding which BARNZ had from explanations by Airport management and consultants, the written materials provided during consultation and the information disclosure provided after consultation had been completed.

The first indication BARNZ had that the Airport was intending resetting its 20 year model back to year one every five years was when this was mentioned by Mr Sundakov on behalf of Christchurch Airport during oral presentations at the conference held by the Commission. We particularly recall hearing this statement because it was new to us and not something which Christchurch Airport had previously articulated or disclosed during consultation.

It would appear that the Airport has either significantly evolved its pricing approach after the conclusion of consultation and after the release of the associated information disclosure five months later, or alternatively, the transparency of both the consultation material and the explanations of Christchurch Airport's pricing methodology in its information disclosure statements were woefully inadequate.

Christchurch Airport's new proposed approach (as presented at the Conference) to commence a new 20 year pricing period every five years as it resets charges raises a number of concerns for BARNZ. The implication of the Airport's 'residual RAB' approach suggests that there would be a series of depreciation adjustments being required to be made as prices would always be being set for the initial stage of a 20 year pricing path, during which the levelised depreciation will be lower than straight line depreciation. The effect of the model spreading revaluation credits over the full 20 years, rather than just the initial pricing period, will also need to be considered. If a new 20 year model is constructed every five years, will previous revaluations have been fully treated as income in the charge setting process or will there need to be a series of revaluation credits being applied to

[10] Commerce Commission, Final Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport, July 2013, footnote 141.
[11] Commerce Commission "Information Disclosure for Electricity and Gas Pipeline Businesses Final Reasons Paper" 1 October 2012, paragraphs E10 to E13.

each proposed new 20 year model? Moreover, as the next significant step in capital expenditure starts to fall within the 20 year horizon, prices will start to reflect the return on and return of the next stepped increase in capacity, despite this investment not yet having been incurred.

All of this unbelievable complexity seriously escalates the costs of price setting both to the Airport and to BARNZ and the airlines, and reduces transparency to users and other interested parties. In the case of the Airport's costs, they form part of its operating costs which are charged back to airlines.

5. Conclusions on innovation, service quality and pricing efficiency

Christchurch Airport has challenged the manner in which the Commission has framed its conclusions with respect to the promotion of innovation, service quality and pricing efficiency, submitting that the conclusions should be worded in a similar manner to the conclusions the Commission reached for Wellington and Auckland Airports. In particular, the Airport challenges:

- The Commission's observation that information disclosure does not appear to have had an additional impact on Christchurch Airport's incentives to innovate, with the Airport submitting that the appropriate conclusion should be that information disclosure has strengthened and is effectively promoting incentives to innovate;
- The Commission's observation that it is not clear that the appropriate quality and levels of service which are being provided at Christchurch Airport result from information disclosure, with the Airport submitting that the appropriate conclusion should be that information disclosure has added to and is effectively promoting incentives to maintain appropriate quality standards; and
- The Commission's conclusion that information disclosure regulation has not been as effective as it would have expected it to be at this point in time in promoting efficient pricing at Christchurch Airport, with the Airport submitting that the appropriate conclusion should be that information disclosure has had a positive impact on Christchurch Airport's pricing efficiency, influencing efficiency enhancing changes made to the pricing methodology, albeit that the potential exists for further improvements to the efficiency of the pricing structure in the future.

BARNZ considers that the Commission has appropriately framed its conclusions and observations regarding the limited nature of the influence of information disclosure on Christchurch Airport's decisions in these respects.

With regard to the Commission's observations in respect of levels of quality and innovation, BARNZ has consistently acknowledged that Christchurch Airport is providing airport services at an appropriate level of quality and that it has appropriate levels of innovation. However, this has not been influenced in any way by the new information disclosure requirements. Rather, it was the Airport's already committed decision to construct the new integrated terminal which was the driving force in improving levels of quality and innovation. BARNZ is not aware of there being any evidence of improved incentives with respect to these matters at Christchurch Airport as a result of the new information disclosure requirements. The Commission's observations are on target.

BARNZ also agrees with the Commission's observations on pricing efficiency. Information disclosure did not feature in any way in Christchurch Airport's articulation of its proposed changes to its pricing methodology or its explanations of why the changes were being adopted. There were four key changes to the Airport's pricing methodology. Three were airline driven. The only proposal originating with the Airport was the introduction of the fixed airfield charge. Taking the changes in turn:

- The previous practice of publishing charges by aircraft type was moved away from at airline request because changes in aircraft weights and seat configuration since the previous methodology had been developed in 2001 meant it was factually flawed by 2012. This change was driven by the airlines – not the Airport and not by information disclosure.
- The implementation of a new terminal charge for turbo-prop passengers was driven by Air NZ's preference to have a leased regional lounge facility, which meant it was meeting a large portion of the costs of space to process turbo-prop passengers through the terminal through lease payments. The domestic terminal charges therefore needed to differentiate between domestic jet passengers and domestic turbo-prop passengers. There have been differentiated international and domestic passenger terminal charges at Christchurch Airport since at least 2000. Again therefore, the new differentiation between domestic jet and domestic turbo-prop passengers was an airline driven change – not an airport driven change and not an information disclosure driven change.
- The move to make children subject to the international passenger services charge was a proposal by BARNZ – not one put forward by Christchurch Airport. BARNZ was concerned about retaining the previous exemption for children in the light of the forecast under-recovery of international terminal costs, and therefore proposed removing the exemption as a means of reducing the under-recovery in the international terminal cost centre. Christchurch Airport had not included this change in its first pricing proposal, but upon receiving BARNZ's submission, it included the change in its revised pricing proposal. For the Airport to claim this change as one it made to enhance efficiency under the influence of the information disclosure regime is patently untrue. This was a change driven by the airlines – not by the airport and not by information disclosure.
- The only change to its pricing structure which the Airport can validly claim to have initiated is the introduction of an additional fixed airfield charge – which was imposed on top of MCTOW charges, which also significantly increase over the pricing period. However, whether this has produced any improvement in pricing efficiency is highly doubtful, as at the same time it introduced the new charge, Christchurch Airport rebalanced its MCTOW rates to off-set the effect of the new charge between different aircraft types.

To expand on the above point regarding the introduction of the new fixed element of airfield charges, BARNZ's position was, and still is, very clear – Christchurch Airport was proposing (and set) airfield charges at levels that will result in substantial excess returns. In BARNZ's view the Airport could either increase the MCTOW rates by amounts similar to those proposed, or introduce a fixed charge of a magnitude similar to that proposed, but not both.

There is no discernable improvement to efficiency caused by the new fixed charge. This is because Christchurch Airport's changes to the MCTOW rates at the same time as it introduced the fixed charge have effectively nullified any efficiency enhancement able to be achieved from the new fixed charge. Christchurch Airport adjusted its MCTOW charges so as to retain the same proportionate level of contribution to airfield costs from jets and turbo-prop aircraft as before, thereby nullifying the effect of the fixed charge. It achieved this by increasing jet MCTOW rates by 49% over PSE2[12] but only increasing turbo-prop MCTOW rates by 27%[13] over the same period. The overall proportionate contribution to costs by the different aircraft types was deliberately left unchanged by the Airport, through the mechanism of applying differential changes to MCTOW charges for the different aircraft weight breaks. This makes the introduction of the fixed airfield charge an illusory change with no overall real purpose other than to obscure the level of increases to airfield charges. There is no efficiency enhancement. The only change is one of packaging or presentation of charges, with the underlying proportions for revenue recovery left virtually unaltered.

BARNZ simply does not see how the overall package of changes to airfield charges makes any meaningful improvement to efficiency.

Be that as it may, in all of the discussions with and explanations by the Airport on the motivations for introducing this additional charge, there was no mention of information disclosure or the input methodologies as being a motivating factor behind this change. Information disclosure simply did not influence the Airport at all as it introduced the new fixed charge and recast its MCTOW rates to leave the proportionate contributions from different users unaltered.

COMMENT ON NZ AIRPORTS SUBMISSION

6. Whether conclusions should be confined to PSE2 or should extend to the 20 year model

NZ Airports submits that the Commission should only be focusing on the current prices set for PSE2, and not on the level of revenue being targeted for PSE3, PSE4 and PSE5.

This submission fundamentally misunderstands Christchurch's levelised constant real price approach, which inextricably links prices in PSE2, PSE3, PSE4 and PSE5, through setting the prices for PSE2 using a pricing path which recovers the Airport's targeted return over a 20 year period.

The Airport has been very clear that its perceived under-recovery in PSE2 (other than the initial $16m) will be recouped over the following three pricing periods. The Airport is thus deferring earning a significant portion of the excess revenue it is targeting through applying a 9.8% post tax

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[12] Specifically, there was an initial 5.6% reduction to jet MCTOW rates from the current rate of $13.01 to $12.28, followed by effective increases of 17.1%, 17.3%, 12.9% and 2.1% each year thereafter leading to a final rate of $19.44 per tonne in FY17. Together these increases represent a 49% increase in jet MCTOW over the pricing period.

[13] Specifically there was an initial 16.6% reduction to turboprop MCTOW rates from $9.31 to $7.76 per tonne, followed by effective increases of 12.4%, 17.2%, 12.9% and 2.1% each year thereafter leading to a final rate of $11.79 per tonne in FY17. Together these increases represent a 27% increase in turbo-prop MCTOW over the pricing period.

WACC (or 13.6% pre-tax WACC) until PSE3, PSE4 and PSE5. Christchurch Airport expressly explained to airlines that it was not writing off its perceived under-recovery (other than the initial $16m) – it was deferring the recovery to subsequent pricing periods.[14] PSE2 prices and targeted returns simply cannot be examined in isolation from the pricing path indicated for PSE3, PSE4 and PSE5 because the prices for PSE2 are a product of the intended pricing path for the entire 20 year period of the model.

In the case of the approach taken by Christchurch Airport, the question of whether or not the Airport's ability to extract excessive profits has been limited, can only be assessed by looking at the Airport's intentions over the entire pricing path.

Explanations of the 20 year pricing path to set a levelised constant real price feature heavily throughout Christchurch Airport's price setting disclosures. The suggestion by NZ Airports that the Commerce Commission cannot reference any material or decision other than the one disclosed for the current pricing period is simply not valid in light of the approach taken by Christchurch Airport, which has itself referred to its 20 year long run approach as a 'central feature' of its pricing decision.[15] The fact that the Airport did not disclosure its actual financial model within its price setting disclosures is not a valid ground for suggesting that the Commission is prevented from referring to that information in its review of the effectiveness of information disclosure regulation. To argue otherwise, would be to enable Airports to thwart the purpose of the review process by making limited disclosures following their price setting event which do not provide the Commission or interested persons with the necessary transparency to determine whether excessive profits are being earned.

7. Whether changes post the s56G reviews prove information disclosure is effective

NZ Airports submits that information disclosure regulation is effective if airports make changes to their approaches after completion of the Commission's reviews under s56G into how effectively information disclosure regulation is promoting the purpose of Part 4.

There is an inherent circularity in the submission being made by NZ Airports that information disclosure regulation is effective if, as a result of the s56G review into how effectively information disclosure regulation is promoting the purpose of Part 4, the Airports made changes to address areas where the Commission found information disclosure regulation had been ineffective or had not been as effective as the Commission would have expected.

Moreover, such an approach creates a real risk that while an airport may indicate that it will make changes to address matters the Commission has highlighted as inappropriate, when the time comes for it to again set prices, it will again target excessive returns, as it is permitted to do having the right under the AAA to set prices as it thinks fit.

The submission by NZ Airports is confusing the question of whether the s56G review process has been effective with the statutory question before the Commission under s56G of how effectively information disclosure regulation has promoted the purpose of Part 4. The s56G review is located in the transitional provisions of Part 4 and has been interpreted as a 'one off' review by the

[14] See for example Christchurch Airport Price Setting Disclosure, December 2012, page 15.
[15] Christchurch Airport Price Setting Disclosures, December 2012, page 6.

Commission. It is not part of information disclosure regulation – rather it is a separate one-off process to review the effect of information disclosure regulation in achieving the purpose of Part 4.

8. Whether the Commission's approach discourages commercially based pricing decisions

BARNZ disagrees with the assertion by NZ Airports that the Commission's approach risks discouraging appropriate commercially based pricing decisions. BARNZ does not see how the Commission's report or conclusions create such a risk.

All the Commission has done is observe the practical limitations of a standardised disclosure regime where an airport has adopted an approach tailored to its particular circumstances, and highlighted that standardised information disclosure templates have an inherent limitation in accurately reflecting individual variances.

This is an important observation for airports wishing to undertake individualised approaches to keep in mind as they prepare their disclosures. If solutions which are unique are adopted, then those airports necessarily bear an onus to ensure they provide sufficiently detailed explanations of the approach they have adopted to ensure that transparency exists for both the Commission and interested persons.

Clearly, Christchurch Airport's disclosures have not achieved this necessary transparency, despite the significant amount of time BARNZ, airlines and the Commission have invested in attempting to clarify and understand Christchurch Airport's approach. However, there is no limitation either expressly or implicitly suggested in the Commission's approach to prevent an airport developing commercial solutions. Rather, just a message from the Commission that in such a case, that airport cannot rely on the standardised disclosure templates to provide sufficient transparency of its approach, and the airport must ensure that it provides additional explanations and information to supplement its standard disclosures so as to ensure sufficient transparency exists. BARNZ agrees.