16 August 2018

INTRODUCTION

1. This is the New Zealand Airports Association ("**NZ Airports**") submission on the Commerce Commission's ("**Commission"**) draft report "Review of Christchurch International Airport Limited's pricing decisions and expected performance (July 2017 – June 2022)" ("**Draft Report**").

2. The NZ Airports contact for this submission is:

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3. As with our previous submissions as part of this review process, NZ Airports has focussed its comments on regulatory framework matters raised by the Draft Report.

EXECUTIVE SUMMARY

General comments

4. The Draft Report is a positive endorsement of Christchurch Airport's performance. It paints a picture of an airport performing consistently with the Part 4 purpose, and provides further evidence of the effectiveness of the ID Regime. In particular, the Commission has made positive findings with respect to:

   (a) target returns;

   (b) forecasts used in pricing;

   (c) investment efficiency;

   (d) the changes to pricing structure and the potential for improved efficiency; and

   (e) the treatment of non-priced services.

5. We welcome the Commission's findings that recent amendments to the ID Regime have increased transparency and/or influenced airport conduct and performance. We think the positive findings on how Christchurch Airport has constructively responded to ID signals should receive greater prominence in the body of the Commission's findings (rather than appearing in Attachment D only).

Target returns and WACC

6. The Commission has correctly found that Christchurch Airport is targeting reasonable returns on priced services for PSE3.

7. Regarding the Commission's draft views on a "sufficiently justified" WACC against which Christchurch Airport's target returns were assessed:

   (a) It is positive that the Commission has accepted that Christchurch Airport's cost of debt should be determined in a manner that best reflects its actual circumstances. Clearly, if the industry-wide WACC estimate does not fairly reflect the efficient debt costs of an airport, then the airport should be entitled to use its airport-specific costs (provided they are fully evidenced and justified).

   (b) Although the Commission has signalled an intention to be open to the same principle applying to cost of equity (i.e. airports can justify airport-specific estimates), the draft findings on Christchurch Airport's asset beta have not alleviated our previously expressed concerns that the assessment framework adopted by the Commission is unduly onerous to allow this to happen in practice. We encourage the Commission to consider ways to more accurately convey to interested parties that the IM asset beta estimate is not a precise estimate for each New Zealand airport, whose systematic risk profile will depend on their specific circumstances.

   (c) More broadly, the WACC estimation undertaken by the Commission conveys artificial precision and, in practice, treats the WACC IM mid-point as a bright line benchmark for each airport. Potential ways to mitigate this problem in the final reports include:

      (i) more clearly demonstrating that its assessment takes into account that the mid-point of the WACC IM is not based on airport-specific evidence, is materially based on a benchmark derived from an international airport sample, and is subject to model and estimation error;

      (ii) more explicitly acknowledging that estimating an appropriate WACC (and target return) for any airport requires exercise of judgement (in the same way as determining the WACC IM required substantial judgement); and

      (iii) summarising the airport-specific data and describing the key issues and challenges that the airport has identified as informing their exercise of judgement on WACC and target returns (i.e. more contextual analysis).

8. In order to make the Final Report more accessible for interested parties we encourage the Commission to draw together the big picture contextual analysis which has led it to correctly judge Christchurch Airport’s return as being in the long-term interests of consumers.

Pricing efficiency

9. We welcome the positive findings on Christchurch Airport's price restructuring and the potential to generate efficiencies.

10. We note the Commission's view that price stability and predictability are important for airlines' ability to plan and invest over the long-term where airlines are also undertaking risky investments. Airports are aware of the impact of adjustments on airlines when they set

prices, and do their best to smooth these to the extent allowed by the building blocks model and/or customers' willingness to accommodate smoothed price paths. Where price changes are required, then these will be transparently signalled in advance.

11. That said, we have not seen evidence that demonstrates a link between airport price stability and airlines' long term investment decisions (e.g. fleet acquisitions), and more directly their deployment decisions, noting that airlines have greater flexibility regarding short-term deployment of already acquired assets. Conversely, airports do not have this flexibility as once long term investments are committed, they cannot be changed. This is why price stability and predictability is also very important to airports, and why obtaining sustained regulatory stability and predictability after a prolonged period of change and uncertainty is of critical importance.

Non-priced services

12. We agree with the Commission that it is more appropriate to assess target returns for non-priced services over a longer period of time.

13. The mechanisms used to set prices for leased services are tried and tested, and provide customers with full ability to negotiate terms that suit their requirements. There is no evidence of a market problem that could justify the Commission seeking to influence different outcomes under the ID Regime. Accordingly, NZ Airports supports a considered approach to the assessment, and agrees with the Commission that the ID Regime should not create incentives to align negotiated contracts with the pricing consultation cycle.

14. Any proper assessment therefore needs to consider trends over time. This is demonstrated for Christchurch Airport through its non-priced assets being below the Commission's benchmark for PSE2, but now above in PSE3. Notwithstanding the issues with the accuracy of comparing the return for non-pricing assets against the return for priced services over a pricing period, this shows that it would be flawed to draw conclusions on a per-pricing period basis.

15. The assessment approach should be considered, flexible and strike a balance between:

(a) taking into account the relative lack of airport market power for non-priced services generally, and a wide range of other factors that differentiate non-priced services from priced services; and

(b) recognising that they are nevertheless regulated services, and that the Commission must be able to provide comfort to interested parties that returns are not excessive over the long term.

16. However, we do not think it is necessary or appropriate to determine a new detailed assessment approach or framework as part of this review process.

GENERAL COMMENTS

17. It is clear from reading the entire Draft Report that it is a positive endorsement of Christchurch Airport's performance. To illustrate, the Commission considers that Christchurch Airport:

(a) has set a reasonable target return over the PSE3 on its 'priced services';[1]

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[1] Commerce Commission, *Draft Report – review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 22),* 19 July 2018 ("**Draft Report**") at X8.

(b) has appropriately forecast its asset values, demand, operating expenditure and capital expenditure;[2]

(c) has sought to set prices to better distribute capacity among its existing facilities rather than unnecessarily incurring substantial capital expenditure;[3] and

(d) has set per-passenger charges that are simple to understand, transparent and are likely to reduce airlines' exposure to demand risk.[4]

18. For the final report, we encourage the Commission to better reflect this positive performance in its executive summary and media statements.

19. For example, paragraph X4 of the Draft Report states that:

> This draft report contains our analysis and draft conclusions on whether Christchurch Airport's pricing decisions and expected performance are likely to promote the long-term benefit of consumers (consistent with Part 4 of the Act).

20. Yet there is no readily discernible answer to that question in the Draft Report. Based on the Commission's analysis and conclusions, we think a headline statement in the final report that "Christchurch Airport's pricing decisions and expected performance are likely to promote the long-term benefit of consumers" is fully justified, and would be helpful for interested parties.

21. In particular, we consider that in its final report the Commission should emphasise the steps Christchurch Airport has taken to alleviate concerns about the transparency of its pricing model and approach to depreciation that the Commission expressed as part of the section 56G review.

22. It is apparent from the tone and the substantive content of the Draft Report that Christchurch Airport has carefully listened to, and aligned its behaviour with, the Commission's subsequent guidance. This includes the Commission's findings that amendments to the ID Regime have increased transparency and influenced airport conduct for the long-term benefit of consumers.[5]

23. For example, the Commission states in the Draft Report that Christchurch Airport's PSE3 disclosures have improved its transparency regarding its "forecast cost of capital, the return it has targeted through prices and the rationale for these when compared to its PSE2 disclosures."[6]

24. The Commission also notes positively in the Draft Report in respect of Christchurch Airport's approach to depreciation:[7]

> Christchurch Airport's disclosure of its asset valuation, including its disclosure of its non-standard depreciation, is consistent with current IMs and ID requirements for airports.
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> …

[2] Draft Report at X32.
[3] Draft Report at X39 – X40.
[4] Draft Report at X43.
[5] This includes recent amendments to the IM and ID determinations for internal rate of return and carry forward determination, cost of capital, the returns on prices services and other regulated services, forecast over and under-recoveries, depreciation and timing of cash flows.
[6] Draft Report at D15.
[7] Draft Report at D35 - D36.

> Airlines appear to have a greater understanding of Christchurch Airport's non-standard depreciation methodology for PSE3 compared to PSE2 and appear to be more comfortable with the outcomes for pricing.

25. We consider that these positive steps should be more clearly conveyed to interested parties so that they can have confidence that the ID Regime is working and that the interests of consumers are being promoted. The positive findings on how Christchurch Airport has responded to ID signals should receive greater prominence in the body of the Commission's findings, rather than appearing in Attachment D only (other than stating it exists, the body of the Draft Report does not mention the findings in Attachment D). It is material that the trend of the effectiveness of the ID Regime is positive and that airports are seeking to understand the Commission's guidance and align their behaviour with the Commission's expectations.

NON-PRICED SERVICES

26. For the reasons set out below, NZ Airports submits that it is appropriate for the Commission to confirm its view that non-priced services should be assessed on a more flexible basis, over a longer period of time.

Terms for non-priced services are set in an appropriate way

27. The Commission correctly notes that:[8]

> Unlike priced services, other regulated services are priced under individual contracts that have a variety of lengths and start dates, which do not necessarily align with the five-year pricing period.

28. Both Christchurch and Auckland Airports have explained how their arrangements for non-priced services differ to priced services. In summary:

    (a) Unlike priced services (i.e. common use airfield and terminal assets), each asset that forms part of non-priced services is typically used exclusively by one customer - such as leases or licences for space or buildings. These customers include many who do not consume priced services.[9]

    (b) The leases are entered at different times, and typically for materially longer terms, than the standard 5 yearly pricing consultations.[10]

    (c) The rent payable at the commencement of a lease is typically set by having regard to market conditions, and most leases include provisions that determine the rent payable at any subsequent rent reviews by reference to market evidence from both airport and off-airport. This assists customers to negotiate with airports.[11]

    (d) Leases include dispute resolution provisions that provide leasing customers with the ability to contest the payable rent. This can involve:[12]

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[8] Draft Report at [108].

[9] Auckland Airport *Submission on draft report for review of Auckland Airport's pricing decision and expected performance* July 2018 ("**Auckland Airport Submission**") at [155] and Christchurch Airport *Submission on draft report for review of Auckland Airport's pricing decision and expected performance* 29 May 2018 ("**Christchurch Airport Submission**") at [12].

[10] Christchurch Airport Submission at [12].

[11] Auckland Airport Submission at [158].

[12] Auckland Airport Submission at [159] – [160].

(i) dispute resolution whereby each party puts forward a valuation prepared by respective expert valuers; and

(ii) if no agreement can be reached, lease terms can be resolved by arbitration or the parties' appointed valuers appointing a third valuer to make a final decision.

29. The result is a fundamental difference in the way prices are set compared to priced services. A building blocks methodology plays no part in determining the prices for leases. In our view, this is appropriate, as the process to set prices for non-priced services reflects a competitive market process.

30. NZ Airports considers that it would not be in the best interests of consumers if the ID Regime provided incentives for airports to move away from existing or historic arrangements where prices are set in accordance with extensive market evidence. The use of a building block methodology for these types of arrangements would not promote better outcomes for consumers:[13]

(a) It would harm the ability for leasing customers to participate in the price setting process as many are not familiar with the building blocks approach – and would prefer the property market approach which is well understood and for many will align with their off-airport property portfolio. We also note that for some customers, such as government agencies and freight distribution companies, airport property may not make up a large percentage of their total portfolio, such that it could be a disproportionate burden for them to get to grips with new pricing methodologies.

(b) Given the longer terms, the returns from these services would still get out of sync with the prevailing interest rate in a pricing period for priced services. If the intent was to achieve an acceptable return for the period across all regulated services, then this would imply adjustments to priced services. This would distort prices and require major customers to accept the surplus or deficit in any particular period.[14]

(c) If a building block derived rent was above the market rent, this could result in spaces or buildings not being leased out (or tenants moving from the airport where circumstances allow) as lessees would not want to pay more for the use of a facility than what they would in the open market. The current approach means that prices are likely to better reflect what lessees would pay in an open market, and therefore better ensures that facilities are more efficiently used.

(d) It could potentially discourage airports from investing to the same degree in assets that were not required by regulation (e.g. hangars for aircraft maintenance or facilities for parties that provide support services to airlines) due to the complexity of applying this type of methodology, the prospect that lease outcomes would not always reflect competitive property markets and asymmetric risks which could flow from this due to the complexity of applying this type of methodology, and where lease outcomes did not reflect competitive property markets.

(e) Essentially, the mechanisms used to set prices for leased services are tried and tested, and provide customers with full ability to negotiate terms that suit their requirements. There is no evidence of a market problem that could justify the Commission seeking to influence different outcomes under the ID Regime.

[13] See also Auckland Airport Submission at [171].
[14] Christchurch Airport Submission at [16.1].

31. We therefore endorse the Commission's position that:[15]

> We do not wish to discourage commercial agreements (particularly longer-term contracts) between parties when the contract provides mutual benefits and the airport's market power has not unduly affected the terms of the contract.

Greater flexibility in assessment of non-priced services is appropriate

32. In light of the above, NZ Airports welcomes the Commission's acknowledgement that flexibility in assessment of non-priced services is required and that it may be more appropriate to assess target returns for these services over a longer period of time. We agree with the Commission's view that "a proportionate approach to monitoring the returns" should be used, which balances the potential regulatory benefits and harms of the assessment approach that is used.[16]

33. In addition to the limited risk of allowing these existing arrangements to continue – as the leases are only around 15% of regulated revenue - NZ Airports believes a considered approach to assessment is justified because:

    (a) Given the way prices are set, there is less ability for airports to exercise market power with respect to these services meaning a more proportionate approach is justified; and

    (b) Given the nature of the services, it would be inappropriate and unduly burdensome to seek to assess target returns on the same 5 yearly cycle as priced services and/or on a strict building block basis.

Market power is more limited

34. For contracts within the non-priced services portfolio, the way terms are agreed means that airports generally have less scope to exercise market power than for core regulated services. This is because:

    (a) In many cases, there are alternative commercial suppliers of land and buildings for the type of services provided.[17]

    (b) With lease negotiations, price setting occurs between airports and counterparties that are well-resourced and informed about pricing given they have access to professional valuation advice and arbitration. Consequently, counter parties do not ordinarily suffer a power imbalance.

    (c) Counterparties choose to enter into these contracts – they determine the specific services they are seeking, they pay for what they value and consider they gain benefits from. This is why counterparties often enter into exclusive and long-term leases which provide them stability to strategically plan for their businesses, which may be on and off-airport.

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[15] Draft Report at [122].
[16] Draft Report at D23.
[17] Christchurch Airport Submission at [14].

35. NZ Airports submits that a more flexible regulatory approach is appropriate when there is less scope for exercise of market power. This is consistent with Professor Yarrow's view that the degree of market power should influence the relevant assessment approach:[18]

> Since the risks of AEEMP vary across different economic contexts, proportionality indicates that there should be some tailoring of policy responses to reflect the severity of the risks.
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> …
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> the stringency of the enforcement of competition law may vary with the assessed level of market power in a particular case.

It would be inappropriate and burdensome to assess non-priced services on a 5 yearly cycle and/or strict building block basis

36. As submitted by Auckland and Christchurch Airports, the leases and licences that make up non-priced services are entered into at various times, and do not have consistent expiry, renewal and rent review dates.[19] This reflects the different services that are provided and the needs and expectations of different customers.[20]

37. Consequently, this means:[21]

    (a) there is no defined pricing cycle for non-priced services in the same way as there is for the five-year pricing cycle for common use airfield and terminal activities; and

    (b) the effective returns on non-priced services will not align with building block concepts like a five-year estimation of WACC and target return.

38. The Commission has indicated that it would expect pricing review provisions in contracts to mean that there is greater alignment over time with current market conditions, including interest rates. Whilst this could be a relevant factor, although preliminary investigations suggest this may be less likely, it remains the case that there will be a disparity between lease returns and the priced services WACC at any given time, because as discussed above, prices are not determined on a building blocks basis.

39. It would therefore make no sense to seek to assess returns on a 5 year cycle, given that there would be a material mis-match between the timing of entering the lease and the relevant pricing period.

40. Further, if the Commission sought to solve the timing mis-match by imposing a burden on airports to disclose a building blocks target return for each lease at the time the lease (or pricing review) was entered (including by allocating common costs and assets at a granular level), it would be an artificial construct that did not appropriately reflect the way prices were set. It would therefore be a disproportionately onerous burden and is likely to discourage ongoing investment in these services.

41. We also note that the Commission would need to undertake substantial work to determine the correct benchmark to assess the returns for non-priced services – as the current WACC

[18] Professor George Yarrow *Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector* February 2016 at 2 – 3.

[19] Auckland Airport Submission at [163] and Christchurch Airport Submission at [14].

[20] Christchurch Airport Submission at [14].

[21] Auckland Airport Submission at [164].

determined by the Commission on a five year forecast basis (updated annually) for priced services is not appropriate for non-priced services (which have much longer terms).

A potential way forward

42. NZ Airports agrees with the Commission's views on the relevant principles that should inform the assessment approach. In particular:

(a) The approach should avoid creating incentives or disincentives for the use of negotiated contracts when there is no evidence to demonstrate it is in the long term interests of consumers of non-priced services to do so.

(b) There should be consistency over time, and, for example, low returns on non-priced services should not be used as a reason to justify higher returns for priced services (equally, higher returns for non-priced services is not a reason to require lower returns for priced services). This effectively means that non-priced services should be assessed separately and there should be no cross subsidisation between priced and non-priced activities (bearing in mind that there are different customer sets for each category of service).

(c) The assessment approach should be proportionate to the (low) size of risk presented by these services.

43. In our view, the assessment approach should be considered, flexible and strike a balance between:

(a) taking into account the range of factors that affect the prices under the contracts that apply to these services, and recognising that the market process to set prices is materially different to a building blocks approach; and

(b) recognising that they are nevertheless regulated services, and that the Commission must still be able to provide comfort to interested parties that returns are not excessive over the long term.

44. The assessment will need to focus on trends over time. Relevant questions will likely include:

(a) is there evidence that returns on non-priced services are persistently and materially higher than priced services?

(b) if so, is there evidence to confirm this is a result of the exercise of market power, or is there other evidence to demonstrate that such an outcome is reasonable?

45. To date under the ID Regime, evidence of unreasonable returns and/or exercise of market power does not exist, given that for PSE2 returns for non-priced services were generally lower than priced services across the airports.

46. NZ Airports considers that, based on the above principles and our agreement with the Commission that a long-term assessment is appropriate, there is no need to seek to determine a detailed assessment approach or framework as part of this review process.

TARGET RETURN AND COST OF CAPITAL

Target Return

47. We support the finding that Christchurch Airport's target return for priced services is reasonable.

48. For its assessment, the Commission has correctly focussed on Christchurch Airport's target return for priced activities (6.44%), which means that differences in views on a sufficiently justified WACC has appropriately not affected the Commission's overall conclusion of profitability.[22]

Debt Premium

49. The Commission found that 6.47% is a justified cost of capital for Christchurch Airport. This is at the 52nd percentile of the WACC IM range that has a mid-point of 6.41%.[23]

50. This difference reflects that Christchurch Airport has justified a higher debt premium, given that its actual credit rating is BBB+, compared to A- for the WACC IM.

51. NZ Airports supports the Commission's approach to assessing the relevant debt premium. In our view, the relevant debt premium should be airport-specific and based on its actual credit rating.

Asset Beta

52. The Commission does not consider that Christchurch Airport has justified its asset beta estimate of 0.65, which contributed to its estimated cost of capital of 6.82%.

53. We consider that the Commission should clarify that this does not amount to a finding that Christchurch Airport's asset beta is not 0.65 (or is 0.6).

54. Rather, given the way the Commission estimates asset beta, and the assessment framework the Commission has applied, Christchurch Airport has not yet convinced the Commission that it has sufficient evidence to justify its 0.65 estimate.

55. The Commission's draft finding has reinforced our concern that, for a parameter that is inherently airport-specific, the Commission nevertheless requires each airport to adopt an asset beta based on a global sample average.

56. There are challenges in estimating an airport-specific asset beta - the Commission stated in its IM Reasons Paper for Airports the difficulty in estimating company-specific betas which require "an even greater degree of judgement than estimating service-specific equity betas."[24] However, we do not think that the answer to this challenge is to require airports to use the IM estimate when it is unlikely that an asset beta produced by an average of a global comparator sample is the correct asset beta for each New Zealand airport.

57. We continue to encourage the Commission to explore ways to better give effect to its intent for the assessment framework to provide flexibility for each airport to adopt approaches that are justified in their specific circumstances. A key part of this is to recognise that estimation

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[22] The Commission's draft finding is that Christchurch Airport has sufficiently justified a cost of capital of 6.47% - which is lower than Christchurch Airport's estimate of 6.82%.

[23] Draft Report at X13.

[24] Commerce Commission, *Input Methodologies (Airports) Reasons Paper*, 22 December 2010 at [E8.10]

uncertainty and error must still be accommodated in the determination of an airport-specific asset beta, and that it is not possible to empirically justify departures from a sample set for which there is little empirical evidence. We would welcome further engagement with the Commission to understand what the Commission might consider justifiable evidence to be given these constraints.

"Sufficiently justified" Cost of Capital

58. Following its analysis of debt premium and asset beta, the Commission has provided draft views on a sufficiently justified WACC for Christchurch Airport for PSE3 (against which it compares Christchurch Airport's target return).

59. As expressed in previous submissions, we are struggling to understand how the Commission's assessment framework does not treat the WACC IM mid-point as a bright line benchmark for each airport's WACC. It is difficult to see where, in practice, the Commission agrees that an airport-specific WACC can depend on the circumstances and context of each airport, and that judgement is required when making that estimate.

60. The Draft Report has not alleviated our previously expressed concerns that the new assessment framework appears to make it very difficult to justify a specific WACC that is judged to be appropriate for each airport's risk profile based on airport specific data and other evidence.

61. We believe that an approach that would more accurately inform interested parties about each airport's profitability would:

(a) recognise that some differences in views on cost of capital are within an acceptable range of returns produced by the standard error;

(b) better summarise airport evidence that establishes a legitimate conceptual reason for departures from the WACC IM, and explains the airport-specific data, other evidence and contextual factors and challenges that were material to each airport's price setting; and

(c) require the extent of explanation for departures from the WACC IM to be proportionate to the magnitude that the airport-specific WACC departs from the mid-point.

PRICING EFFICIENCY

62. NZ Airports welcomes the Commission's positive findings regarding Christchurch Airport's pricing efficiency.[25] In particular, it is pleasing to see that the Commission agrees with Christchurch Airport's decision to charge on a per passenger basis and that the Commission recognises that this intends to:[26]

(a) incentivise airlines to use a fleet mix that reflects Christchurch Airport's forward-looking costs; and

(b) send efficient price signals to airlines about the relative capacity constraints facing its regional and international terminals.

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[25] Draft Report at [133].
[26] Draft Report at [134].

63. We note the Commission's view that airport price stability and predictability are important for airlines' ability to plan and invest over the long-term where airlines are undertaking risky investments.[27]

64. NZ Airports understands that airports are very conscious of this when they set prices, and do their best to smooth any adjustments. The ability of each airport to provide price stability and smooth prices will depend on a material degree to where they are placed in their respective investment cycles. As the Commission is aware, the IM building blocks approach can lead to material price shocks if implemented in practice, and customers do not always support price stability that involves smoothing of prices in advance of asset commissioning.

65. Given price stability and predictability is recognised as important by all stakeholders, NZ Airports also seeks sustained stability and predictability in regulatory settings after a prolonged period of change and uncertainty with the ID regime. Changes in the regulatory framework have a significant impact on airport conduct including pricing, so it is important that the framework remains stable so that airports' ability to implement stable pricing structures is maximised.

[27] Draft Report at [137].