

29 May 2018

Commerce Commission
44 The Terrace
Wellington 6140

DRAFT REPORT ON AUCKLAND INTERNATIONAL AIRPORT LTD PSE3 PRICING DECISIONS

Introduction

- 1 Christchurch International Airport Ltd (*CIAL*) welcomes the opportunity to respond to the Commission's draft report on Auckland International Airport's (*AIAL*'s) PSE3 pricing decisions.

General comments

- 2 The draft report shows that the Part 4 information disclosure regime is working well, in that the Commission is able to, and does subject regulated airports to detailed public scrutiny.
- 3 The Commission has identified a number of areas where AIAL has performed and is intending to perform in a manner that is endorsed by the Commission. The outcomes for consumers and airlines in these areas are consistent with the regulatory objectives, while AIAL has also been able to commit to its significant investment programme, resolve capacity constraints, and promote competition and new routes.
- 4 Where the Commission has sought further information or justification, the draft report phase provides an opportunity for the airport to engage and respond.
- 5 The next phase – in which the Commission moves from a draft to a final report – is likely to be significant in the life of the Part 4 regime for airports.
- 6 In relation to target returns, the regulatory framework requires an airport to explain any differences between its target returns and the Commission's midpoint WACC estimate. The focus on explanation is the right one. However, the assessment of appropriate returns does not lend itself to absolute proof or quantification. Judgement will accordingly be required as to the level of detail and evidence that can reasonably be provided. Where the Commission sets the bar with its final report will have a strong bearing on whether the framework enables a practical opportunity for airports to set appropriate target returns, and whether interested persons can obtain a contextual understanding of an airports performance over time.

- 7 It will be important, too, how the Commission strikes the balance between consistency of principles and approach when assessing airports, and recognising the differences at each airport, whether that be differences in the capital expenditure cycle, scale, airport operation, demand outlook and so on. We are of course conscious that CIAL is the next airport to be reviewed by the Commission and we appreciate there is an onus on each airport to explain its position and outlook, which will allow the Commission the opportunity to demonstrate how it will apply consistent principles and recognise differences.
- 8 CIAL elaborates on these points below. CIAL supports the response prepared by the New Zealand Airports Association (NZAA).

Expected profitability / target returns

— Pricing services

- 9 As noted above, where the Commission sets its expectation as to the level of detail and evidence required to explain a target return will have a strong bearing on the success of the Part 4 regime.
- 10 Airports must rely on imperfect data sets and apply commercial judgement when setting their target returns. In other words, target returns cannot be objectively identified or measured down to every detail, and the explanation that airports provide will reflect that. Of course, the Commission must still perform its role of enquiring into the return targeted by an airport. There is a balance to be struck whereby the Commission can require a good explanation but also acknowledge the information and quantification uncertainties. Indeed, if the Commission was able to communicate the measurement uncertainties involved to the public in an accessible way this would promote the purpose of information disclosure.
- 11 On a more specific point, CIAL endorses Commission's decision to accept use by AIAL of the forecast of actual cost of debt. Where there is reliable information on the actual cost of capital faced by an airport, it makes sense to use that.

— Non-pricing services

- 12 Other regulated services, or non-pricing services, comprise leasing arrangements negotiated with individual customers, rather than being priced under the AAA consultation regime.
- 13 The Commission notes that such leases are entered into outside of the 5 yearly regulatory pricing period, and at different target returns. The Commission has asked for a more fulsome explanation as to why this dynamic is acceptable and consistent with the purpose of Part 4.
- 14 CIAL's circumstances are similar to AIAL in that:
- 14.1 All of our non-priced services are provided under agreements negotiated commercially with a single customer rather than subject to the consultation regime under the AAA;
- 14.2 These are normally a lease over buildings and / or land, and often have a long term;

- 14.3 The agreements do not map tidily onto the 5 year assessment period cycle introduced by the IMs. They are entered into at different times and for different lengths of time depending on the services being provided and the needs of our customers;
 - 14.4 Expected returns under agreements could be higher or lower than for pricing services, because the pricing methodologies are different. In PSE2, expected returns under our agreements were lower than for pricing services. That has reversed in the current period, and expected returns from non-priced services are higher than for priced services.
- 15 When assessing these agreements, some relevant factors include:
- 15.1 the interest rate environment at the time of agreeing the terms (which impacts assessments of appropriate target returns at the time the lease was entered into);
 - 15.2 processes used to set the agreement terms against market (e.g. valuer reports; rent review mechanisms that align rents with market levels);
 - 15.3 the voluntary nature of the arrangements;
 - 15.4 in a number of instances there are alternative suppliers of land and buildings.
- 16 CIAL recognises that the Commission cannot ignore non-priced services when assessing the outcomes across disclosure overall. On the other hand, there are significant challenges to incorporate these services within a standard IRR assessment. For example:
- 16.1 The returns from these services will get out of line with prevailing interest rates in any Part 4 Pricing Event period. However using the priced services as a swing factor to offset any surplus or deficit from leased services doesn't seem practical. It would distort prices and require major customers to accept the surplus or deficit in any particular period. For that reason, the departure in any Pricing Event period is likely to remain;
 - 16.2 The non-priced services would justify a different benchmark to the one used by the Commission to assess priced services. The term of the services are much longer, and the interest rates at the time that contracts were negotiated will be different;
 - 16.3 The wider context for these services can be taken into account, such as the fact that customers often have options (commercial alternatives, or to take the services as regulated), and the methods negotiated to benchmark against market prices.
- 17 For these reasons a higher level assessment of the approach of an airport to non-priced services seems appropriate.

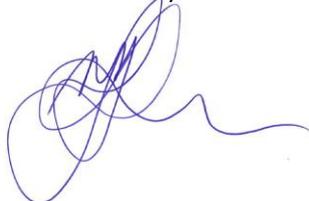
Pricing efficiency / price structure

- 18 While price structure does not influence the level of target returns for a pricing period, it is potentially important in creating efficient incentives.
- 19 The Commission helpfully differentiates between the principles that it will apply on a consistent basis when considering the efficiency of a price structure, and the assessment of a particular airport's price structure at a particular time.
- 20 The circumstances at each airport will be different, and may differ over time. A current example is the respective positions of AIAL and CIAL: we would envisage central to AIAL's pricing will be issues relating to potential capacity constraints and forecast major capex expenditure, whereas CIAL has been through that phase and is now focused on maximising the efficient utilisation of its facilities. The two airports also occupy quite different positions in the domestic and international aviation markets.

Forecasts

- 21 As a general comment the Commission has struck a good balance when assessing the cost and demand forecasts used by AIAL. The Commission has taken note of where there was disagreement during consultation but not assumed that disagreement in itself is evidence of a poor forecast or poor consultation. The substantive question is always whether a forecast is appropriate given the information available.
- 22 Again, we note the Commission will need to be aware of context as it considers each airport. A particularly striking example for CIAL is the magnitude of AIAL's capex forecasts (\$1.9b for the five year period as compared to CIAL's forecast of a total of \$95m across a range of initiatives). These will be sufficient to trigger AIAL's obligations under the Airport Authorities Act for consultation on major capex, a manifestly major exercise, and it is good that the Commission has recognised AIAL's significant efforts during its pricing consultation.
- 23 We look forward to discussing these topics further with the Commission.

Yours sincerely



Michael Singleton

GENERAL MANAGER CORPORATE AFFAIRS

DDI: (+64 3) 353 7046

Email: michael.singleton@cial.co.nz