ISBN no. 978-1-991085-41-2
Project no. PRJ0046448

PUBLIC

Review of Christchurch Airport's 2022-2027 Price Setting Event

Consultation paper

Date: 26 September 2023

CONTENTS

Glossary

Acronym/abbreviation	
AAA	Airport Authorities Act 1966
Air NZ	Air New Zealand
Airports IMs	IMs for specified regulated airport services
the Act	Commerce Act 1986
BARNZ	Board of Airline Representatives New Zealand, Incorporated
CAPEX	Capital expenditure
Christchurch Airport	Christchurch International Airport Limited
CPI	Consumer price index
ID	Information disclosure
IM	Input methodology
IRR	Internal rate of return
OPEX	Operating expenditure
PLEXIT	Christchurch Airport's potential power and lighting asset purchase from Airways NZ
PSE	Price setting event
PSE3	Price setting event for the period 1 July 2017 to 30 June 2022
PSE4	Price setting event for the period 1 July 2022 to 30 June 2027
PV	Present value
Qantas	Qantas group of companies, including Jetstar
RAB	Regulatory asset base
TAMRP	Tax-Adjusted Market Risk Premium
WACC	Weighted-average cost of capital

Executive summary

Purpose of this report

X1 This report contains our review of Christchurch International Airport Limited's (**Christchurch Airport**) pricing decisions for the period 1 July 2022 to 30 June 2027. We consider whether its pricing decisions are likely to promote the purpose of Part 4 of the Commerce Act 1986 (the Act) being the long-term benefit of consumers.

X2 We are seeking your feedback on our initial views, which will inform our final report. Submissions are due by 24 October 2023. You can find details of how to submit in Chapter 1.

Context of this report

X3 Christchurch Airport is one of three international airports subject to information disclosure regulation under Part 4 of the Act.[1]

X4 In June 2022, Christchurch Airport reset its prices for the period 1 July 2022 to 30 June 2027 following consultation with its substantial customers, including airlines. This is referred to as its fourth price setting event (PSE4). Christchurch Airport provided the required disclosures for PSE4 on 18 August 2022.

X5 We are publishing our consultation under section 53B(2)(b) of the Act, which requires us to publish a summary and analysis of information disclosed by Christchurch Airport, including information about its price setting event.

X6 To promote greater understanding of Christchurch Airport's performance, this report contains our analysis and draft conclusions on Christchurch Airport's pricing decisions and expected performance over the PSE4 period. Our review primarily focuses on:

X6.1 **Expected profitability** – is Christchurch Airport limited in its ability to earn excessive profits?

X6.2 **Other decisions** – has Christchurch Airport made pricing decisions in line with the purpose of the Act?

[1] Alongside Auckland and Wellington international airports.

Our draft conclusions on Christchurch Airport's cost of capital

X7 Christchurch Airport estimated its weighted average cost of capital (WACC) to be 6.65% for the PSE4 period. This is an important input to setting the price and is a subject of our review. Overall, we consider that Christchurch Airport's estimate of the post-tax WACC of 6.65% is reasonable. Christchurch Airport's use of a credit rating that deviates from the benchmark credit rating has not had a material effect on the WACC used in the price-setting process.[2] Further, its target return is lower than the WACC estimate (discussed in paragraph X10).

X8 When estimating its WACC, Christchurch Airport departed from the Input Methodologies (IMs) by using its actual credit rating thereby a higher debt premium, and a different Tax-Adjusted Market Risk Premium (TAMRP) value (7.5%) to what is provided in the Airports IMs (7.0%).[3]

X9 We consider using a TAMRP of 7.5% was reasonable when Christchurch Airport set prices in June 2022. We have therefore adjusted our benchmark mid-point WACC of 6.32% upwards to 6.62% to reflect an increase in TAMRP from 7.0% to 7.5%. Christchurch Airport's WACC is marginally higher than the adjusted benchmark due to its use of a lower credit rating for debt costs.

Our draft conclusions on Christchurch Airport's expected profitability

X10 Christchurch Airport is targeting a return from all its regulated services of 6.26% for the PSE4 period. At 6.26%, Christchurch Airport's target return on its total regulatory asset base (RAB) is lower than its estimated WACC of 6.65%, mainly because the airport, in consultation with its customers, decided to exclude the cost for incentivising new routes (ie, route incentive payment) from the price-setting.

X11 We consider the target return to be the appropriate measure for profitability, as it is the internal rate of return (IRR) derived from the forecast cash flows for the PSE4 period, a continuation of the approach during PSE3.

X12 As a result of not seeking to recover the cost of route incentive payments from its customers, Christchurch Airport's target return of 6.26% is below both our mid-point WACC of 6.32% and the adjusted WACC of 6.62%. We consider that the target profitability is reasonable.

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2 See *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010,* paragraph 5.4 (5)(a)(iii) for the benchmark credit rating.

3 *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010*. A copy of the current consolidated determination (ie, including subsequent amendment determinations to 20 December 2016 for ease of reference) can be accessed via our website. In this report we sometimes refer to the consolidated determination, including the subsequent amendment determinations to 20 December 2016, as the '2016 IMs'. Commerce Commission "Airport Services Input Methodologies Determination 2010" (20 December 2016), paragraph 5.2(7).

Our draft conclusions on other decisions made by Christchurch Airport for PSE4

X13 In forming our views on Christchurch Airport's other pricing-related decisions for PSE4, we considered to what degree the decision is consistent with the purpose of Part 4. We consider that overall, these decisions are reasonable and aligned with the purpose of Part 4 of the Act.

X14 The following key decisions have been made by Christchurch Airport in setting the PSE4 prices:

X14.1 **Change to transfer pricing** – Christchurch Airport is now only charging for one leg of a transferring passenger's journey. The international carrier attracts the charge, or alternatively (where there is no international carrier), the greater of the two charges will be paid. If both are equal, the arriving leg attracts the charge.

X14.2 **Tilted annuity depreciation** – Christchurch Airport used the same depreciation method as in PSE3, which was a change welcomed by airlines compared to the previous levelised method.

X14.3 **No price smoothing or deferral** – Christchurch Airport decided that although a smoothing mechanism or deferral may reduce upfront costs to customers, the risk of larger increases in the later years of the pricing period outweighs any benefits. We note the use of tilted annuity depreciation already had the effect of lowering prices earlier in the pricing period.

X14.4 **PLEXIT** – PLEXIT describes the potential purchase of power and lighting assets from Airways New Zealand. Christchurch Airport indicated that if the RAB is significantly changed following the purchase, it may consider repricing. If prices are reset, they can be re-examined.

X14.5 **Capital Expenditure (CAPEX)** – Christchurch Airport indicates a total CAPEX of $173.8 million during the pricing period. The new expenditure is primarily compliance-driven. During the pricing consultation Christchurch Airport reviewed its CAPEX projects, based on feedback to remove or defer projects that were not strictly necessary during PSE4.

Chapter 1 Introduction

Purpose of this report

1. This report contains our review of Christchurch International Airport Limited's (Christchurch Airport) pricing decisions for the period 1 July 2022 to 30 June 2027.

2. Christchurch Airport is one of three international airports subject to information disclosure regulation under Part 4 of the Commerce Act 1986 (the Act).[4]

3. We are publishing this report under section 53B(2)(b) of the Act, which requires us to publish a summary and analysis of information disclosed by Christchurch Airport, including information about its price setting event.[5]

4. We are seeking your feedback on our draft views, which will inform our final report. Submissions are due by 24 October 2023. You can find details of how to submit at the end of this chapter.

Structure of this report

5. The report is structured as follows:

   5.1 **Chapter 1** provides the context, focus and approach we have taken, and details how you can provide your views.

   5.2 **Chapter 2** contains our assessment of Christchurch Airport's cost of capital.

   5.3 **Chapter 3** contains our analysis and draft conclusions on the appropriateness of Christchurch Airport's target return.

   5.4 **Chapter 4** provides our draft views on other pricing-related decisions.

Context for this report

Christchurch Airport has reset its prices

6. In June 2022, Christchurch Airport reset its prices for the period 1 July 2022 to 30 June 2027 following consultation with its substantial customers, including airlines. This is referred to as its fourth price setting event (PSE4).

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4 Alongside Auckland and Wellington international airports.

5 Christchurch Airport is required to publicly disclose information about its price setting event in accordance with the *Airport Services Information Disclosure Determination 2010.* A copy of the current consolidated determination (ie, including subsequent amendment determinations to 18 June 2019) for ease of reference) can be accessed via our website. Commerce Commission "Airport Services Information Disclosure Determination 2010" (18 June 2019).

7. Christchurch Airport has been subject to information disclosure (ID) regulation under the Act since 2011. In addition to the requirements of ID regulation, Christchurch Airport must consult (and has consulted) with airlines concerning proposed price changes under the Airport Authorities Act 1966 (AAA).

8. Under the current AAA regime, airports are able to set prices they consider appropriate, but must consult with airlines at least every five years prior to fixing or altering charges.[6] Consultation on the price setting event also includes the inputs to the prices being set, such as: cost of capital, expenditure programmes and demand forecasts.

9. The substantial customers that Christchurch Airport has consulted with during PSE4 are Board of Airline Representatives New Zealand Incorporated (BARNZ), Qantas Group (Qantas), Air New Zealand (Air NZ) and Freightways.

Christchurch Airport has provided information disclosure for its pricing decisions

10. After a price setting event, the airports subject to ID regulation must publicly disclose information relating to their forecast total revenue requirement for their regulated services.[7] This includes (but is not limited to) information about their pricing, a summary of the consultation process they have engaged in with customers, and information regarding the rationale behind forecast inputs. Christchurch Airport provided the required disclosure for PSE4 in August 2022.[8]

11. While not the subject of this report, each regulated airport must also publish historical information annually on its financial position in relation to specified airport services and the quality of those services.[9]

12. The two categories of regulated services addressed in Christchurch Airport's PSE4 disclosure and this report are as follows:

    12.1 '**Priced services**' - regulated services for which standardised prices are set for the pricing period, after the airport consults with 'substantial customers'; and

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6 Specifically, s 4B of the AAA requires airports to consult with "substantial customers", the meaning of which is set out in s 2A of the AAA.

7 Under s 53B(1) of the Act, every supplier of goods or services that are subject to ID regulation must publicly disclose information in accordance with the ID requirements set out in the relevant s 52P determination. For airports, the relevant determination is the *Airport Services Information Disclosure Determination 2010,* above n 5.

8 Christchurch Airport's PSE4 disclosure can be found on its website: https://www.christchurchairport.co.nz/about-us/who-we-are/financial-reports/regulatory-disclosures/

9 *Commerce Act (Airport Services Information Disclosure) Determination 2010,* above n 5, clauses 2.3 and 2.4.

12.2 '**Other regulated services**' – services funded through contractual arrangements with individual customers (rather than on standardised prices). The length and start dates of these contracts may not necessarily align with the pricing period.

13. Christchurch Airport also offers services that are not regulated under Part 4 of the Act and are outside the scope of this report. Examples of priced and other regulated services are provided in Table 1.1 below.[10]

Table 1.1 Examples of regulated airport services

Priced services	Other regulated services
• **airfield landing facilities and services, such as the provision and maintenance of airfields, runways and taxiways.** • **airfield parking facilities and services.** • **specified passenger terminal activities such as passenger seating areas, thoroughfares, and air-bridges.**	• aircraft and freight activities – facilities and services that help maintain aircraft and the handling of freight transport by aircraft. This could include facilities and services for the refuelling of aircraft, flight catering, waste disposal, and the storing of freight. • other specified passenger terminal activities, which may include identified leases, facilities and services for the operation of customs, immigration, quarantine checks, security and police services, terminal lounges, and collection facilities for duty-free purchases.

We must publish a summary and analysis of Christchurch Airport's disclosed information

14. Under section 53B(2)(b) of the Act, we are required to publish a summary and analysis of the information disclosed publicly by Christchurch Airport as soon as practicable. The purpose of the summary and analysis is to promote greater understanding of Christchurch Airport's performance, its performance relative to other regulated airports, and changes in its performance over time.

15. To promote greater understanding of Christchurch Airport's performance, this report contains our analysis and preliminary conclusions regarding both Christchurch Airport's pricing decisions and forward-looking performance over the PSE4 period of 1 July 2022 to 30 June 2027.

Focus of our review

16. Our review of Christchurch Airport's pricing decisions and expected performance for the PSE4 period focusses on:

[10] These regulated services are defined in s 56A of the Act and in further detail in s 2 of the AAA.

16.1 **Expected profitability** – is Christchurch Airport limited in its ability to earn excessive profits?

16.2 **Other decisions** – are Christchurch Airport's other decisions aligned with the purpose of the Act?

17. We have reviewed these aspects of Christchurch Airport's performance to assess whether they are likely to promote outcomes which are consistent with the purpose of Part 4 of the Act.

> The purpose of Part 4 as set out in s 52A(1) of the Act is to:
>
> promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
>
> (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
>
> (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
>
> (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
>
> (d) are limited in their ability to extract excessive profits.
>
> Section 52 refers to:
>
> markets where there is little or no competition and little or no likelihood of a substantial increase in competition.

18. Our focus on profitability does not cover all outcomes reflected in the Part 4 purpose. We have not explicitly addressed Christchurch Airport's innovation (section 52A(1)(a)), efficiency improvements, and service quality (section 52A(1)(b)), or its sharing of efficiency gains (section 52A(1)(c)).

19. As price setting disclosures contain forward-looking information, they provide the most detail about expected profitability, prices and forecast operating and capital expenditure (CAPEX). PSE disclosures do not provide fulsome information about the appropriateness of airports' level of innovation and quality of services, or whether the operational expenditure and investment is efficient.

20. The historical information disclosed annually by airports provides more comprehensive insight into these areas of performance, but are not the subject of this review.

Our approach to assessing pricing decisions and expected performance in this report

21. In this report, we consider the decisions and rationale used by Christchurch Airport in setting its revenue and target return, as described in its PSE4 disclosure. We do this in the context of the input methodologies (IMs) relevant to regulated airport services (Airports IMs).[11]

22. IMs are the rules, requirements and processes we must determine for services that are regulated under Part 4 of the Act.[12] The Airports IMs contain clear rules for our estimation of the weighted average cost of capital (WACC), which we use as a benchmark for assessing profitability. For clarity, the IMs which apply and form the basis for the processes of this review are the 2016 IMs.

23. Where IMs are less prescriptive, we assess whether Christchurch Airport's PSE4 produces outcomes that we would expect under workably competitive market conditions. In particular, we consider any reasons provided for a pricing decision that appears to be inconsistent with the purpose of Part 4 of the Act.

24. The purpose of the analysis is to assess whether the expected outcomes of Christchurch Airport's pricing decisions are consistent with the purpose of Part 4 of the Act. This analysis does not determine the specific choices that Christchurch Airport ought to have made in its pricing decisions, nor what we would have done in its place. In this sense, we are not required to identify alternative approaches unless we choose to do so. To the extent that we find the outcomes of the airport's pricing decisions are consistent with the purpose of Part 4 of the Act, we have described those decisions as being reasonable.

How you can provide your views on this consultation paper

25. We have elected to follow a more abbreviated review process, without an initial paper on process and issues because we considered this approach proportionate to the complexity of this price setting event. This consultation paper instead includes our draft views on whether Christchurch Airport's pricing decisions are broadly reasonable.

26. Please note that we have used Christchurch Airport's price setting disclosure as the basis of our draft views. The PSE disclosure outlines the rationale for Christchurch Airport's pricing decisions and the airport's interpretation of stakeholder views.

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[11] As airports can set prices as they see fit, the Airports IMs (Commerce Commission *"Airport Services Input Methodologies Determination 2010 – consolidated as of 20 December 2016)* only apply to Airports ID for the purposes of assessing whether the purpose of Part 4 is being met, and do not apply to the way airports set prices.

[12] A review of most IMs, including Airports IMs, was last completed in December 2016. We have begun our next review of the IMs and must complete our review by December 2023.

Process and timelines for submissions

27. We invite submissions and cross-submissions from interested parties on the draft views within this paper, which will inform our final report that we intend to publish by January 2024.

28. Submissions must be provided to us no later than 5pm, 24 October 2023. We will invite cross-submissions for a period of two weeks after publication of submissions, soon after they are received.

29. Please e-mail your submission to: infrastructure.regulation@comcom.govt.nz, and include "Christchurch Airport Price Setting Event 4 Review" in the subject line.

    We prefer submissions in formats suitable for data analysis and for publication on our website, such as a Microsoft Word or a PDF document.

Confidential submissions

30. We encourage public submissions so that all information can be tested in an open and transparent manner. We recognise that there may be cases where parties wish to provide information in confidence. We offer the following guidance:

    30.1 if it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is considered to be confidential;

    30.2 where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information;

    30.3 both confidential and public versions of the submission should be provided and clearly labelled accordingly; and

    30.4 the responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

31. If we consider disclosure of information in the confidential version to be in the public interest, we will consult with the party that provided the information before any such disclosure is made.

32. Please note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we do not publish unless good reasons existed under the Official Information Act 1982 to withhold it. We would normally consult with the party that provided the information before any disclosure is made.

Chapter 2 Our assessment of Christchurch Airport's cost of capital

Purpose of this chapter

33. This chapter contains our analysis and initial conclusions regarding whether Christchurch Airport's reported estimate of its cost of capital of 6.65% is sufficiently justified.

Our draft conclusions

34. Overall, we consider that Christchurch Airport's estimate of the post-tax WACC of 6.65% is reasonable. We accept the use of the higher Tax-Adjusted Market Risk Premium (TAMRP) adopted in the Fibre and Gas IMs that prevailed when Christchurch Airport set its prices for PSE4. We note that its use of a credit rating that deviates from the benchmark credit rating had a negligible effect on the WACC used in the price-setting process.

Structure of this chapter

35. This chapter sets out:

    35.1 our framework for assessing Christchurch Airport's estimated cost of capital, taking into account the relevant context of the IM Review undertaken in 2016, our reviews undertaken in 2013 and 2014 in accordance with section 56G of the Act (s 56G reports),[13] our 2018 Review of Christchurch Airport's PSE3, and our 2022 Review of Wellington Airport's PSE4; and

    35.2 our assessment of Christchurch Airport's reported estimate of cost of capital, focussing on the reasons and evidence it has provided for adopting a higher debt premium and TAMRP than our benchmark values.

Our framework for assessing Christchurch Airport's estimated cost of capital

36. This section outlines our approach to assessing Christchurch Airport's estimate of its cost of capital in this review.

[13] Section 56G of the Act, as was in effect at the time of the reviews, was a transitional provision requiring the Commission to report to the Ministers of Commerce and Transport on how effectively ID regulation was promoting the Part 4 purpose in respect of specified airport services. The report was to be made 'as soon as practicable' after any new price for airport services was set in or after 2012. We produced the final reports for Wellington, Auckland and Christchurch Airports in February 2013, July 2013 and February 2014 respectively. Section 56G has since been replaced by way of amendment in October 2018. The current s 56G relates to the Commission conducting an inquiry and making a recommendation to the Minister as to whether one of negotiate/arbitrate regulation, default/customised price-quality regulation or individual price-quality regulation should be imposed on the specified airport services in addition to ID, and, if so, how it should apply.

37. We have developed a framework for assessing Christchurch Airport's reported estimate of its cost of capital in this review, taking into account the relevant context of the s 56G reports, the changes made during the IM Review in 2016, and lessons from recent PSE reviews.

38. Our high-level framework for assessing Christchurch Airport's reported estimate of its cost of capital, including the key factors we have considered, is set out below. This framework was also used in our review of Wellington Airport's last price setting event.[14]

Departure from mid-point: Is the airport's estimate of its WACC different to our mid-point WACC estimate?

- The mid-point WACC represents our starting point when assessing returns for profitability analysis, but we accept that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate.[15]
- If the airport has departed from our mid-point WACC estimate, what are each of the parameter values used? Has the airport applied an uplift to its mid-point cost of capital (eg, due to asymmetric risks), and if so, what adjustment is made?

Legitimate reasons for departure in relation to each WACC parameter: For each WACC parameter (including any overall WACC uplift), what is the explanation for departing from our IM-based estimate?

- What evidence is provided to support the departure? (For example, is there support from academic articles or other regulatory decisions?). Note: the onus is on airports to provide evidence/sufficient reasoning on any relevant factors.[16]
- Has the airport considered consistency with its past pricing decisions (ie, has it applied the same logic consistently over time, or considered the trade-off between short-term fluctuations in parameter values vs predictability)?
- Are we satisfied that the evidence provides legitimate reasons for the departure from our benchmark value, in light of the Part 4 purpose (particularly the section 52A(1)(d) requirement to limit the ability of airports to earn excessive profits)?[17]

[14] Commerce Commission "Review of Wellington Airport's 2019-2023 Price Setting Event" (28 September2022), paragraph A16.
[15] Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 87.
[16] Ibid, paragraph 99.
[17] Ibid, paragraphs 87 and 94.

- **If we are not satisfied there are legitimate reasons, then the airport-specific adjustment to that parameter is unjustified.**

Legitimate reasons for the *size* of departure in relation to each WACC parameter: Is the quantum of the adjustment to each parameter (including any overall WACC uplift) justified?

- What evidence is provided to support the quantum? (For example, quantitative analysis demonstrating firm-specific difference from our benchmark value, evidence from academic articles, or other regulatory decisions?). Note: the onus is on airports to provide evidence/sufficient reasoning on any relevant factors.[18]
- Are there counter-arguments (or other off-setting considerations) which would reduce the size of the adjustment made by the airport? (For example, consider whether arguments made by the other regulated New Zealand airports would work in the opposite direction for the specific airport in question).
- Is the evidence/reasoning sufficient to support the value of the adjustment made to our benchmark value considering the Part 4 purpose (particularly the section 52A(1)(d) requirement to limit the ability of airports to earn excessive profits)?
- **If the evidence/reasoning is not sufficient, then we consider the airport-specific adjustment to that parameter is unjustified.**

Legitimate reasons for departure in relation to overall WACC: Is the airport's overall estimate of its WACC (combining each of the individual parameter values) reasonable?

- Are there any additional factors relevant to the airport's overall WACC (for example, off-setting considerations regarding other parameters)?
- If each of the individual parameter adjustments are acceptable, and there are no other off-setting considerations, then we consider that airports have legitimate reasons to target above our mid-point WACC estimate.
- However, if there are some adjustments we consider not sufficiently justified (or there are other off-setting considerations), then the airport's cost of capital is unjustified.

[18] Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 99.

Our assessment of Christchurch Airport's cost of capital

Is Christchurch Airport's estimate of its WACC different to our mid-point WACC estimate?

39. When considering Christchurch Airport's estimate of its cost of capital for this review, the key reference point is our mid-point WACC estimate for airports.

40. Previously, in our section 56G reports, we considered a range from the mid-point WACC estimate to the 75th percentile WACC estimate when assessing airport profitability.

41. However, in the 2016 IM Review, we amended our approach choosing to use the mid-point WACC to resolve the two issues within the framework:[19]

    41.1 the upper limit of our WACC range had become the de facto benchmark when assessing airport profitability; and

    41.2 there was limited and weak rationale for using the 75th percentile as the upper limit of the WACC percentile range.

42. For the calculation of the mid-point WACC, we consider 1 April 2022 is the appropriate reference point as it is the date of our most recent WACC determination prior to Christchurch Airport setting its prices on 23 June 2022.[20] Christchurch Airport used 1 April 2022 as the reference date as well. This reference point is also consistent with the Reserve Bank of New Zealand's *Monetary Policy Statement*,[21] which provided the latest inflation forecast available when Christchurch Airport set its prices.[22]

43. The parameter values used to calculate our WACC estimate for this review as of 1 April 2022 are shown in Table 2.1 below, alongside the parameters used by Christchurch Airport for its own estimate.

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19 Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph X4.

20 The relevant cost of capital determination was for electricity distribution businesses and Wellington International Airport. See Commerce Commission "Cost of capital determination for disclosure year 2023 for information disclosure regulation. Electricity distribution businesses and Wellington International Airport" (3 May 2022).

21 Reserve Bank of New Zealand "Monetary Policy Statement" February 2022.

22 This inflation forecast, which was also used by Christchurch Airport's when setting its prices, assumes values of 2.6% for 2023, 2.3% for 2024 and 2.0% for 2025, 2026 and 2027. These forecasts are available from table 5.1 of the Reserve Bank's data pack released in February 2022. It is important that the reference point is consistent with the time when the inflation forecasts are made as Christchurch Airport adjusts prices based on the difference between forecast inflation and outturn inflation, and the forecast inflation values are assumed to be consistent with the estimate of the risk-free rate at the reference point.

Table 2.1 Parameters used to calculate Christchurch Airport's WACC estimate

Parameter	Commission	Christchurch Airport
Risk-free rate (as of 1 April 2022)	2.67%	2.67%
Average debt premium (as of 1 April 2022)	1.24%	1.43%
Leverage	19%	19%
Asset beta	0.60	0.60
Equity beta	0.74	0.74
Tax adjusted market risk premium (TAMRP)	7.0%	7.5%
Average corporate tax rate	28%	28%
Average investor tax rate	28%	28%
Debt issuance costs	0.20%	0.20%
Cost of debt	4.11%	4.30%
Cost of equity	7.11%	7.48%
Standard error of midpoint WACC estimate	0.0146	0.0146
Mid-point vanilla WACC	6.54%	6.87%
Mid-point post-tax WACC	6.32%	6.65%

44. In comparison to our estimate of 6.32%, Christchurch Airport estimates that its cost of capital is 6.65% (post-tax) as shown in the third column.

For each WACC parameter (including any overall WACC uplift), what is the explanation for departing from our IM-based estimate?

45. When estimating its cost of capital, Christchurch Airport has used IM-consistent inputs except for TAMRP and credit rating. Christchurch Airport has used:

    45.1 a TAMRP of 7.5% rather than our benchmark of 7.0% specified in the IMs; and

    45.2 a credit rating of BBB+ rather than the A- specified in the IMs, resulting in a higher average debt premium of 1.43%.

Our assessment of Christchurch Airport's TAMRP

46. Christchurch Airport indicated in its disclosure that 7.5% was the TAMRP value that was estimated for the fibre IM decisions, which were published in November 2020, and for our amendment to the gas transmission services IMs, which was published in March 2022. [23] [24] These decisions were available when Christchurch Airport finalised its prices in June 2022.

47. Based on these decisions, Christchurch Airport considered that 7.5% was the appropriate market rate when it set its prices.[25]

48. We are reviewing our estimate of the TAMRP for our 2023 review of the Part 4 IMs. The estimate of 7.0%, published in the draft decision, was effectively unchanged from the previous estimate for specified airport services.[26]

49. However, we do not consider this estimate is relevant to this PSE review. The relevant reference point for this review is the value in the IMs when Christchurch Airport finalised its prices in June 2022, which for airports was 7.0%.

50. We agree with Christchurch Airport that the TAMRP is an economy-wide parameter and that the latest estimate that was available when Christchurch Airport finalised its prices was 7.5%. We consider it reasonable that an airport operating in a workably competitive market would use the latest estimate of the TAMRP when setting its prices. We consider that the use of a 7.5% TAMRP, in the circumstances, is consistent with the Part 4 purpose, particularly the section 52A(1)(d) requirement to limit the ability of airports to earn excessive profits.

51. Our preliminary conclusion in relation to the TAMRP is that Christchurch Airport had a legitimate reason for using a TAMRP which departs from the value specified in the Airports IMs at the time of setting prices.

Our assessment of Christchurch Airport's use of a BBB+ credit rating

52. Christchurch Airport has based its decision to use a BBB+ credit rating rather than an A- credit rating and the associated higher debt premium on four arguments:

    52.1 small size relative to airports in the comparator sample;

    52.2 exposure to leisure traffic;

    52.3 exposure to natural disasters including pandemics; and

    52.4 its own credit rating is BBB+.

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[23] Commerce Commission "Fibre input methodologies: Financial loss asset final decision – reasons paper" (3 November 2020), paragraph 3.24.3.

[24] Commerce Commission, "Gas Transmission Services Input Methodologies Amendment Determination (No.1) 2022" (25 March 2022).

[25] Christchurch International Airport Limited "Disclosure Relating to the Reset of Aeronautical Prices for the Period 1 July 2022 to 30 June 2027" (18 August 2022) , paragraph 145.3.

[26] Commerce Commission, "Cost of Capital topic paper. Part 4 Input Methodologies Review 2023 – Draft Decision" (14 June 2023). The TAMRP is discussed at paragraphs 4.160 to 4.208.

53. We consider that the arguments relating to size, exposure to leisure traffic and exposure to natural disasters are not typically matters that are considered in relation to credit rating. To the extent that these matters are systematic they would be accounted for in the asset beta.

54. In addition, Christchurch Airport has not provided evidence as to why these factors would affect their credit rating, or why it considers their exposure to be greater than for other airports.

55. This latter point is important because we assume the benchmark airport has characteristics similar to the average of the comparator sample.[27] This assumption avoids exposing consumers to inefficient prices when the regulated firm is structured in a way that deviates substantively from the benchmark airport.

56. Christchurch Airport indicated in its disclosure that we accepted a BBB+ credit rating in its PSE3 pricing proposal and that its own credit rating was BBB+. We note that Christchurch Airport's credit rating was BBB+ when it set its prices for PSE4.

57. We consider it more appropriate to use a benchmark cost of debt estimate in the WACC estimate rather than Christchurch Airport's actual debt costs. The relevant estimate of the cost of capital for an investor considering adding an airport to its diversified portfolio is the market's view of the cost of capital for providing the service. This cost of capital is not based on the debt costs of a particular firm which may or may not be efficient.

58. In addition, in the 2016 IM Review we noted that we specify a notional benchmark credit rating when estimating the debt premium because "if suppliers' actual credit ratings were used, there may be an incentive for them to increase leverage, leading to adverse implications for consumers".[28]

59. We also noted in the 2010 IM Review that the margin needs to protect against the possibility that economic downturns or shocks can lead to financial distress, but also provide suppliers with flexibility over the level of leverage and the choice of debt instruments.[29] A BBB+ credit rating is above the Standard & Poor's minimum long-term credit rating considered to be investment grade, which is BBB-.

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27 As set out in the IMs, the WACC is estimated because it cannot be observed directly, and the relevant estimate is the market's view of the cost of capital for providing the service, not the cost of capital specific to one regulated supplier, or a regulated supplier's view of its cost of capital for that service.

28 Commerce Commission "Input methodologies review decisions - Topic paper 4: Cost of capital issues" (20 December 2016), paragraph 252.

29 Commerce Commission "Input methodologies (airport services): Reasons paper" (December 2010), paragraph 6.3.23.

60. We accepted a BBB+ credit rating for the Wellington Airport PSE4 pricing decision and for the Christchurch Airport PSE3 decision.[30] In those decisions, we considered that a BBB+ credit rating was consistent with a prudent level of debt financing and was consistent with the benchmark credit rating we used for regulated electricity lines and gas pipeline businesses. We concluded that there were legitimate reasons for Wellington Airport and Christchurch Airport to depart from the A- benchmark credit rating.

61. However, we noted in the review of Christchurch Airport PSE3 pricing decisions that where an airport's actual credit rating is the same as our benchmark, we did not consider there was a case for a supplier-specific adjustment due to differences in credit rating.[31] Christchurch Airport's credit rating had a positive outlook when Christchurch Airport set its prices for PSE4. Its credit rating was later increased to be the same as our benchmark of A- in November 2022 following Standard & Poor's upgrade of Christchurch City Council's credit rating.[32]

62. Overall, we do not consider that the reasons Christchurch Airport provided for departing from the A- credit rating specified in the IMs were strong. Nevertheless, we recognise that we have previously accepted the use of a BBB+ credit rating by Christchurch Airport. Our assessment of Christchurch Airport's use of a BBB+ credit rating is further informed by the materiality of this decision, which is discussed in the next section.

Is the quantum of the adjustment to each parameter (including any overall WACC uplift) justified?

TAMRP

63. We accept that Christchurch Airport has justified the use of a 0.5% uplift on the TAMRP specified in the IMs as 7.5% was the latest estimate by the Commission when Christchurch Airport finalised its prices in June 2022.

Credit rating

64. Based on a BBB+ credit rating, Christchurch Airport used an average debt premium of 1.43%, which is 0.19 percentage points higher than our benchmark of 1.24%.

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30 Commerce Commission "Review of Wellington Airport's 2019-2024 Price Setting Event. Final report" (28 September 2022), paragraphs A98 to A99; Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022" (1 November 2018), paragraph A115.

31 Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022" (1 November 2018), paragraph A122.

32 See the NZX announcement of the credit rating upgrade.

65. Christchurch Airport's estimate of the BBB+ debt premium is from our cost of capital determination for gas pipeline businesses, which was estimated as of 1 March 2022.[33] There are two issues with applying this estimate to Christchurch Airport's price setting process.

    65.1 The first issue is that the timing of this estimate is inconsistent with that of Christchurch Airport's estimate of the risk-free rate, which was from our cost of capital determination for Wellington International Airport, estimated as of 1 April 2022.[34] An estimate of the BBB+ debt premium that is consistent timing-wise with the estimate of the risk-free rate is from our cost of capital determination for electricity distribution businesses which was estimated as at 1 April 2022, which was a value of 1.51% (rather than 1.43%).[35]

    65.2 The second issue is that this estimate is for electricity distribution, not airport services. An estimate of the debt premium for Airports with a BBB+ credit rating that is consistent timing-wise with the estimate of the risk-free rate may be different to the value used by Christchurch Airport. This is because the method for calculating the debt premium for airports (as per clause 5.4(7) of the Airports IMs) is different to the method for calculating the debt premium for EDBs/GPBs (as per clause 2.4.4(7) of the EDB IMs).

66. We have not calculated the adjustment to our benchmark WACC based on the use of a BBB+ credit rating as our draft conclusion does not depend on this calculation (as explained in the next section).

Is the airport's overall estimate of its WACC (combining each of the individual parameter values) reasonable?

67. Christchurch Airport's overall estimate of its post-tax WACC of 6.65% compares to our mid-point estimate of 6.32%.

68. We have calculated that the main difference between our benchmark estimate and Christchurch Airport's estimate is due to the higher TAMRP. Using the TAMRP estimate of 7.5% adjustment results in the WACC increasing from 6.32% to 6.62%, while the credit rating adjustment (using Christchurch Airport's estimate) accounts for the additional increase from 6.62% to 6.65%.

69. We note that the difference between Christchurch Airport's estimate of the post-tax WACC and our estimate with the revision to the TAMRP is 0.03%.

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33 Commerce Commission "Cost of capital determination for disclosure year 2023 for gas pipeline businesses' 2022-2026/2022-2027)" (1 April 2022).

34 See Commerce Commission "Cost of capital determination for disclosure year 2023 for information disclosure regulation. Electricity distribution businesses and Wellington International Airport" (3 May 2022). The estimate of the average debt premium is from our cost of capital determination for gas pipeline businesses. See Commerce Commission "Cost of capital determination for disclosure year 2023 for gas pipeline businesses' 2022-2026/2022-2027)" (1 April 2022).

35 Commerce Commission "Cost of capital determination for disclosure year 2023 for information disclosure regulation. Electricity distribution businesses and Wellington International Airport" (3 May 2022).

70. On balance, we consider that Christchurch Airport's estimate of the post-tax WACC of 6.65% is reasonable, as its use of a credit rating that deviates from the benchmark credit rating had a negligible effect on the WACC used in the price-setting process and its target return is below our WACC estimates regardless (this is discussed in the next chapter).

Chapter 3 Expected profitability

Purpose of this chapter

71. This chapter summarises and draws conclusions from our profitability analysis on whether Christchurch Airport is limited in its ability to earn excessive profits (section 52A(1)(d) of the Act).

72. This chapter focuses on whether Christchurch Airport's target return, and associated profit, over the PSE4 period, have been sufficiently justified such that it is likely to be in the long-term interest of consumers.

73. Our draft profitability analysis has been published alongside this consultation paper. This analysis uses the same methodology as PSE3.

Our draft conclusions

We consider the rate of return targeted by Christchurch Airport is unlikely to generate excessive profits

We consider Christchurch Airport's target return of 6.26% to be reasonable

74. At 6.26%, Christchurch Airport's target return on its total regulatory asset base (**RAB**) has been adjusted downwards compared to its estimated WACC of 6.65%, mainly because the airport decided to exclude its cost for incentivising new routes (ie, route incentive payment) from the price-setting.

75. We consider the target return to be the appropriate measure for profitability, as it is the internal rate of return (IRR) derived from the forecast cash flows for the PSE4 period, a continuation of the approach during PSE3.

76. As a result of not seeking to recover the cost of route incentive payments from its customers, Christchurch Airport's target return is below both our mid-point WACC of 6.32% and adjusted WACC of 6.62%. We consider that the target rate of return is reasonable.

77. Table 3.1 below provides a summary of the expected returns and associated expected revenue over the five-year pricing period of PSE4.

Table 3.1 Summary table of Christchurch Airport's expected returns and revenue

	Expected return (post-tax)	PV revenue ($m)	WACC percentile
Christchurch Airport's target return on its total RAB	6.26%	$461.72m	48th
Our mid-point WACC estimate	6.32%	$462.35m	50th
Our adjusted WACC estimate reflecting uplift in the TAMRP	6.62%	$470.09m	58th

Our approach to assessing Christchurch Airport's target return

78. For the purpose of assessing the target level of profitability we have focussed on Christchurch Airport's actual target return on its total regulated assets. Christchurch Airport estimated a WACC of 6.65% in setting prices for PSE4, however due mainly to the application of route incentive payments, which is a cost to the airport and not funded from regulatory revenue allowance, the airport's actual target return was adjusted downward to 6.26%. We have assessed the appropriateness of this target return, as it is the key measure that reflects profitability, unlike the airport's estimated WACC in this case.

79. We have used our mid-point WACC estimate provided for in the IMs as a starting point to assess whether Christchurch Airport is targeting excessive profits.[36] Our mid-point WACC was estimated to be 6.32% on 1 April 2022.[37] We compared the target return and revenue against this mid-point WACC and corresponding revenue derived from our modelling.

80. We then compared Christchurch Airport's target return to our adjusted WACC as described in Chapter 2 of the report. Chapter 2 analyses the parameters of Christchurch Airport's **estimated WACC**. We accepted an uplift in the TAMRP of 0.5%, compared to our mid-point WACC estimate, resulting in an adjusted WACC of 6.62%.

81. In summary

    81.1 Christchurch Airport's **target return** of 6.26% on its total RAB is the key measure reflecting its profitability. It is below the airport's own estimated WACC of 6.65%.

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36 Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph X4.

37 Commerce Commission "Cost of capital determination for disclosure year 2023 for information disclosure regulation. Electricity distribution businesses and Wellington International Airport" (3 May 2022).

81.2 Our estimated **mid-point WACC** of 6.32% is the starting point we use to assess the appropriateness of Christchurch Airport's target return. In Chapter 2 we considered the evidence the airport provided in its disclosure to justify its estimated WACC exceeding our mid-point WACC.

81.3 We concluded in paragraph 63 of this report that Christchurch Airport had a legitimate reason for using a TAMRP that departs from the value specified in the IMs and we reflected this in an **adjusted WACC** of 6.62%, an increase from our mid-point WACC.

81.4 Our mid-point and adjusted WACC estimates are compared to Christchurch Airport's target return to assess whether the airport is targeting excessive profits over the PSE4 pricing period.

82. Note that any references to WACC within this chapter relate specifically to post-tax WACC, unless explicitly stated to be the vanilla WACC.

Profitability assessment methodology

83. The methodology for modelling our profitability assessment was the same as used in PSE3.[38] Our profitability model used Christchurch Airport's information disclosure as required under the ID determination and its pricing model as key inputs. We received additional information from Christchurch Airport regarding assumptions related to the forecasting of other regulated assets in order to be able to model and quantify returns on its total RAB.

84. Using our profitability model, we calculated an IRR forecast when assessing the returns targeted by Christchurch Airport over the PSE4 period and confirmed Christchurch Airport's disclosed target return of 6.26%. Our profitability analysis also allows us to estimate the revenue that would be required to support returns other than the airport's target return. Our profitability analysis has been published alongside this report.

Christchurch Airport is targeting a return of 6.26% on its total regulated asset base for PSE4

Christchurch Airport's target return on its total RAB differs to its estimated WACC

85. During the price setting event process, Christchurch Airport estimated its WACC to be 6.65%, but arrived at a target return across its total RAB of 6.26%.

86. This approach, of setting a different target return compared to estimated WACC, was applied in the previous price setting event (PSE3). The difference arises mainly because the airport provides concessions on expenditure to incentivise new airline routes to encourage additional services to be established and maintained.

[38] See Attachment C of "Review of Christchurch International Airport' pricing decisions and expected performance (July 2017 – June 2022)" (1 November 2018).

87. We accepted this approach applied by Christchurch Airport in PSE3, while noting our expectations that the airport provides "greater transparency on the impact of these route incentive payments in future, including consulting with airlines of price and demand forecast impacts and being transparent about how they affect the overall target return."[39]

88. As part of the PSE4 consultation process, Christchurch Airport reported it disclosed to its "substantial customers the effect on IRRs of excluding the airline-specific incentives"[40] and clarified that the cost of route incentive payments was excluded in the pricing model while the demand forecast did include the effect of such incentives, which was supported by its customers. The theme for PSE4 was "continuity, predictability and transparency", and the approach to price setting in this regard was substantially the same in PSE3 to PSE4.[41]

89. Our focus therefore continues to be on Christchurch Airport's target return, rather than the airport's estimate of its WACC as far as profitability is considered. We assess whether the target return is set at a level that would be expected to result in Christchurch Airport earning excessive profits over the pricing period.

In 2022 we determined Christchurch Airport's post-tax WACC to be 6.32%

90. In our 2022 determination of Christchurch Airport's WACC, we estimated its mid-point post-tax WACC to be 6.32%, as at 1 April 2022. This reflected the parameters in Table 3.2 below. In particular, we applied an A- credit rating, an average debt premium of 1.24%, cost of debt of 4.11%, TARMP of 7.0% and an asset beta of 0.60.

[39] Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)" (1 November 2018), paragraph 81.

[40] Christchurch Airport "Disclosure Relating to the Reset of Aeronautical Prices for the Period 1 July 2022 to 30 June 2027" (18 August 2022), footnote 30.

[41] Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)" (1 November 2018), paragraph 11.

Table 3.2 Parameters used in WACC calculation for Christchurch Airport

Parameter	2022 Commission mid-point WACC	Christchurch Airport estimated WACC	Commission adjusted WACC
Risk-free rate (as of 1 April 2022)	2.67%	2.67%	2.67%
Debt premium (As of 1 April 2022)	1.24%	1.43%	1.24%
Leverage	19%	19%	19%
Asset beta	0.60	0.60	0.60
Equity beta	0.74	0.74	0.74
Tax-adjusted market risk premium (TAMRP)	7.0%	7.5%	7.5%
Average corporate tax rate	28%	28%	28%
Average investor tax rate	28%	28%	28%
Debt issuance costs	0.20%	0.20%	0.20%
Cost of debt	4.11%	4.30%	4.11%
Cost of equity	7.11%	7.48%	7.48%
Mid-point vanilla WACC	6.54%	6.87%	6.84%
Mid-point post-tax WACC	6.32%	6.65%	6.62%

91. We consider our 1 April 2022 mid-point WACC estimate to be the appropriate starting point for assessing the appropriateness of Christchurch Airport's target return.

Christchurch Airport's target return is 0.06 percentage points lower than our mid-point WACC estimate

92. Christchurch Airport's expected returns are compared in Table 3.3 below, along with the associated expected revenue over PSE4.

Table 3.3 Summary table of Christchurch Airport's expected returns and revenue

	Expected return (post-tax)	PV revenue ($m)	WACC percentile
Christchurch Airport's target return on its total RAB	6.26%	$461.72m	48th
Our mid-point WACC estimate	6.32%	$462.35m	50th
Our adjusted WACC estimate reflecting uplift in the TAMRP	6.62%	$470.09m	58th

93. Christchurch Airport's target return of 6.26% is below our mid-point WACC estimate of 6.32% on 1 April 2022. The total revenue targeted by Christchurch Airport over the PSE4 period in a present value term is $0.63 million lower, compared to a scenario where the airport is targeting our mid-point WACC as a return instead.

94. As the target return is lower than our mid-point WACC, we are satisfied that Christchurch Airport's target return is not set at a level that would be expected to result in the airport earning excessive profits over the pricing period.

We have estimated an adjusted WACC of 6.62% for Christchurch Airport, reflecting a higher TAMRP than our mid-point WACC estimate

95. As discussed in Chapter 2, we have adjusted our mid-point WACC estimate for a higher TAMRP. We accept that Christchurch Airport has justified the use of a 0.5% uplift on the TAMRP specified in the IMs as 7.5% was the latest estimate by the Commission when Christchurch Airport finalised its prices in June 2022.

96. Christchurch Airport's target return of 6.26% is 0.36 percentage points below our adjusted WACC of 6.62%, representing $8.37 million less in revenue in a present value term over five years. We are therefore satisfied that Christchurch Airport's target return is not set at a level that would be expected to result in the airport earning excessive profits over the pricing period.

The rate of return targeted by Christchurch Airport over PSE4 is not likely to result in excessive profits

97. Having considered the reasons and evidence provided by Christchurch Airport, the target return of 6.26% is lower than our adjusted WACC of 6.62%, based on an uplift in the TAMRP from 7.0% to 7.5%. We therefore conclude that Christchurch Airport's target rate of return is not likely to achieve excessive profits.

Chapter 4 Other PSE4 decisions

Purpose of this chapter

98. This chapter summarises our preliminary conclusions on other pricing-related decisions made by Christchurch Airport for PSE4.

Summary of other decisions and Commission conclusions

99. A summary of Christchurch Airport's other pricing-related decisions, and our findings, is provided in Table 4.1 below. Overall, these decisions appear reasonable and aligned with the purpose of Part 4 of the Act.

Change to transfer pricing

100. Christchurch Airport is changing how it charges for transferring passengers. Previously, Christchurch Airport charged for both the arriving and departing legs of the journey. Now, only one leg will attract a charge. If there is an international leg, the carrier of the international flight will attract the charge. When there is no international leg, the greater of the two charges will be paid, and if charges are the same the carrier of the arriving leg will attract the charge.

101. Christchurch Airport notes this mirrors overseas practices and hopes this structure will retain the existing levels of transfers as well as encourage new arrangements.

102. Lowering prices in this manner will likely promote efficient use of assets and ultimately reduce costs to customers. As such, we have concluded that this change to the pricing structure aligns with the purpose of the Act.

Tilted Annuity Depreciation

103. Christchurch Airport has used the same depreciation method as in the last price setting event, PSE3. The change from the linear method used in PSE2 was welcomed by the airports customers as providing more transparency.

104. Christchurch Airport explained their reasons for using this depreciation method in PSE3 as twofold:

    104.1 A depreciation method that resulted in costs being recovered more gradually over time compared to standard depreciation was considered to better promote the efficient use of aeronautical assets, as well as being in the interests of customers. This recognised the substantial latent capacity in Christchurch Airport's terminal and airfield assets that could be applied to serve future demand growth, so it is reasonable to reduce cost recovery in the short term and leave more to be recovered in future periods.

    104.2 Compared with the method used in PSE2 which was to set prices with reference to a 20-year levelised price path, the tilted annuity method was more supported by customers.

105. For PSE4, Christchurch Airport considers the drivers for the application of tilted annuity depreciation remain largely unchanged. The airport states "there remains material capacity to serve future demand in both terminal and airfield assets, with less being recovered from current customers – so that more remains to be recovered in the future – promotes both the efficient use of assets and intergenerational equity."[42]

106. Furthermore, Christchurch Airport states switching back to straight line depreciation would imply a material increase in prices compared to tilted annuity depreciation, and that only changing the depreciation method when there is compelling reason to change supports predictability and the investment environment.

107. Finally, the airport states that during the consultation process, there was no customer disagreement with the tilted annuity depreciation approach.

108. The Commission accepted the use of tilted annuity depreciation in PSE3.[43] There appears to be no reason to depart from this view and we consider that the depreciation method is reasonable.

Price smoothing or deferral

109. Christchurch Airport indicated that during pricing consultations some of its customers raised the desire for a price smoothing mechanism, or a 12-month deferral to spread price increases throughout PSE4 due to the uncertainty in the period when setting prices.

110. Christchurch Airport decided that price smoothing or deferral was not necessary or appropriate for PSE4.

111. While price smoothing may reduce upfront costs, it may result in sharp price increases in the later years of the pricing period. We consider that the use of tilted annuity depreciation involves a back-ended recovery of costs and has the effect of lowering prices earlier in the pricing period. There is little evidence price smoothing would better promote the purpose of the Act in this instance.

112. Christchurch Airport further states that because it now charges customers on a per-passenger basis, rather than a per-aircraft charge (a change introduced in PSE3), it shares the passenger demand revenue risk, with any airport charge revenue only being earned when the airlines earn revenue.

113. We consider that the approach taken by the airport is reasonable and consistent with the purpose of Part 4 of the Act.

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42 Christchurch International Airport Limited "Disclosure Relating to Reset of Aeronautical Prices Jul 22-Jun27, page 29.

43 Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)" page 67.

PLEXIT

114. Christchurch Airport has indicated that it may purchase power and lighting assets from Airways New Zealand (**Airways**). The airport has not indicated how significant the cost would be but indicated if the purchase resulted in a significant increase in the RAB and/or operating expenditure, it may look to reprice during the PSE4 pricing period. If repricing occurs, we may conduct another pricing review.

115. Due to ongoing negotiations, no further information is disclosed by Christchurch Airport or can be commented on in our review. We wish to bring this matter to readers' attention nonetheless.

CAPEX

116. Christchurch Airport discloses that new CAPEX is largely compliance-driven, with other key projects aiming to promote the growth of Christchurch Airport and ensure that its services reflect demand and growth. Its asset renewal and replacement CAPEX forecast is comparable to that of PSE3.

117. We consider the consultation process undertaken by Christchurch Airport to date has been reasonable, while being aware that we have not heard yet from airlines and other customers directly.

Planned CAPEX

118. Christchurch Airport indicates a total CAPEX of $173.8 million (including inflation) during the pricing period, with FY26 and FY27 having the two largest amounts ($66.5 million and $38.9 million) respectively.

119. During the pricing consultation Christchurch Airport reviewed its CAPEX projects, based on feedback to remove or defer projects that were not strictly necessary during PSE4. Three projects were removed or deferred.

120. The CAPEX was broken down into three parts:

    120.1 **Business as usual CAPEX** – $74.1 million. Reflecting regular infrastructure investment, maintenance and plant replacement programs on the airfield and in the terminal, including the annual Airfield Pavement Maintenance Program.

    120.2 **Major projects** – $84.0 million

    120.3 **Minor projects** – $15.7 million

121. Christchurch Airport states that there are five key major CAPEX projects planned in PSE4, excluding the Airfield Pavement Maintenance Program (considered part of business-as-usual CAPEX). Four out of five are compliance driven, with only $2.3m for Regional Stands Development the exception. The projects are::

121.1 Stop bars and guard lights – $7.4 million will be spent on upgrades to aid visibility on the runway, which is required for safety and compliance with regulatory obligation.

121.2 Hold-stow baggage screening – $29.1 million will be spent on upgrading the baggage screening as the government is proposing a move from standard 2 screening to standard 3 screening, involving CAT scan technology as opposed to the current x-ray technology.

121.3 Upgraded central screening point – $24.3 million to be spent on upgrading the central screening point to be able to include regional passengers (regional screening is currently not required under regulation however this will change).

121.4 Regional airside development – $22.1 million will be spent on creating a regional dwell/call-to-gate space, relocating and creating new regional vertical transport, and separating ground floor regional departures and arrival baggage claim. These works flow on from the need to move to central screening for regional passengers.

121.5 Regional stands development (stage 1) – $2.3 million to be spent on allowing additional capacity for aircraft at regional gates. Stage 1 involves building a new passenger walkway and two additional regional stands. Following consultation with its major customers Christchurch Airport decided to defer the other stages of this project until after PSE4.

122. Notable minor CAPEX projects planned by Christchurch Airport include $2.2 million to increase international arrival capacity, $2.8 million to increase capacity through remote stand busing, $2.0 million for self-service kiosks, and $2.1 million for waste management development.

Assessment

123. It appears that Christchurch Airport's forecast CAPEX is largely driven by compliance, with this being the driver for four out of the five major planned projects. We note that Christchurch Airport was responsive to customer feedback by deferring and cancelling some CAPEX projects. We consider that the CAPEX proposed is reasonable and consistent with the purpose of the Act.

Table 4.1 Summary of Christchurch Airport's other decisions, and Commission views

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
Airport Costs				
Investment/ CAPEX	Christchurch Airport forecasts its business as usual and project capex at 173.82m from FY23-27. Christchurch Airport has proposed five key capex projects in PSE4. Christchurch Airport initially proposed and then removed some projects from the PSE4 capex forecasts based on customer feedback including: upgrading its international bio-security screening; Domestic Stand E conversion; the additional stages of the regional stands development; expanding width of Taxiway A; and construction of a new taxiway to link Taxiway F to Runway 1129. Christchurch Airport will reconsider these projects for PSE5.	Christchurch Airport states that the capex spending reflects its long-term business planning. Three projects were deferred/removed due to concerns about their necessity from Christchurch Airport's customers.	Some of the original projects proposed were not seen as necessary by Christchurch Airport's major customers. This was dealt with through feedback and amendments to planned projects. On 23 February 22 BARNZ attended a briefing on major capex having submitted 9 questions for clarification. On 16 March AIR NZ attended a similar briefing. Feedback was filed by BARNZ, Quantas, Air NZ, and Freightways during April. More feedback (although less of it) was filed in June by Quantas, Air NZ and BARNZ, (Freightways indicating it was comfortable with the pricing proposal).	The CAPEX spending is largely compliance based and appears to be reasonable. Christchurch Airport appears responsive to customer feedback during consultation.

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
	There were a number of additional projects that Christchurch Airport also adjusted the timing of forecast expenditure for the remaining key capex projects to reflect feedback received in consultation.			
Operating costs	OPEX is forecasted at: FY23 – 32.89m FY24 – 32.56m FY25 – 33.43m FY26 – 34.30m FY27 – 35.21m **Personnel** Christchurch Airport assumed base pay rates would increase on average by 2-2.5% p.a. for FY23-24 and 2.5% for FY25-27. **Contracted costs** Assumed real rates increase of 3% per annum, based on the City Council's 10-year plan. Insurance rates assumed real increase of 3%.	Christchurch Airport started with its budgeted OPEX costs for FY23 and FY24, and forecasted the rest with the goal of keeping the increases under CPI. Christchurch Airport says that before COVID-19, OPEX was "essentially as forecasted" and during the pandemic period, lower than the forecast reflecting the lower activity and passenger numbers overall. **Personnel** While Christchurch Airport expects operational and service head count to potentially increase during FY25-27, efficiency gains would be enough to offset those costs, so no change in head count was assumed for OPEX forecasting purposes.		The OPEX costs appear to be business as usual and do not warrant any significant concerns.

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
	Cleaning costs assumed real increase of 1% pa, and forecasting a base cost unit increase of 3% pa. Christchurch Airport applied an assumed real decrease in energy costs of 0.5% pa, reflecting 2% CPI, and 1.5% forecasted increase in cost.	**Contracted costs** Christchurch Airport consider that efficiency gains in cleaning and energy will largely mitigate the increases leading to the values landed on.		
PLEXIT	Christchurch Airport indicates that it is discussing with Airways the possible transfer of power and lighting assets from Airways to Christchurch Airport.	Christchurch Airport says although this is not confirmed at this stage – if it resulted in a significant increase in OPEX and/or RAB, Christchurch Airport may look to reprice during PSE4.		Once Christchurch Airport has made sufficient progress in negotiations and decided accordingly on any re-pricing, we will review the revised pricing.
Passenger demand				
Passenger demand forecasts	FY23 – 5,701,001 FY24 – 6,445,475 FY25 – 6,771,199 FY26 – 6,950,547 FY27 – 7,806,390	Christchurch Airport's methodology for forecasting passenger demand was done in two paths due to COVID-19 related uncertainty being: • A base case reflecting the current trends and border re-opening plans • A conservative scenario based on further domestic travel restrictions.		The methodology was appropriate in the COVID-19 environment. The forecasts were done at a time when possible COVID-19 travel restrictions were uncertain. Presently, few restrictions exist, however, Christchurch Airport could not have known that when setting prices.

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
	Note: the values above are gross numbers, included both legs of transferring passengers – with Christchurch Airport deciding to only charge for one leg for transferees for PSE4 – an adjustment was made to the forecast of gross numbers to derive the chargeable units	Historically, demand forecasts have been determined using a bottom up and top down approach, which uses filed schedules and known capacity for Years 1 and 2 and then a top down forecast based primarily on economic growth (GDP), aircraft orders, and Christchurch Airport's relative share of key markets (domestic, Tasman, international and transfer). However, forecasting in the current environment was inherently more complex, as passenger numbers were constrained during PSE3 due to restrictions on movement (such as border settings, alert levels and quarantine requirements). It was difficult to predict the recovery of airline travel following these restrictions. This uncertainty was compounded by supply issues as airlines managed financial challenges and supply constraints on crew, operations and aircraft while restarting their global networks		

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
Asset base				
Valuation approach	Christchurch Airport has taken the disclosure RAB for FY21 (determined in accordance with the IMs) as the starting point; Christchurch Airport has then applied the extended asset allocators to separate its disclosure RAB into its pricing RAB and the RAB associated with its non-priced services (Christchurch Airport's non-pricing RAB); and Christchurch Airport has added on the actual adjustment assets and applied inflation indexation and depreciation to these actual adjustment values as specified in PSE3	Consistency with both PSE3 and the IMs		The approach is appropriate.
Revaluations/ CPI	Christchurch Airport applied CPI revaluations following the Commission standard method where an indexed RAB approach is applied. Revaluations have been treated as income when calculating revenue requirement for priced services			The approach is appropriate.

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
Depreciation	Christchurch Airport is using a tilted annuity approach with a tilt factor of 1.5% and 4.37%.	Christchurch Airport considers it is using an IM-compliant approach in tilted-annuity, using the same values as PSE3. Christchurch Airport says: "The effect of this method is to produce a more back-ended recovery of capital costs than would occur under straight line depreciation."	The continued application of the tilted annuity depreciation method was supported by substantial customers.	It is appropriate to continue using the method that was supported by major customers and promotes more clarity than the previous levelised method.
Closing carry forward adjustment	Christchurch Airport corrected an anomaly limited to PSE2 using a carry forward adjustment, which is reflected in both PSE3 and PSE4 disclosures. The adjustment is treated as an asset and is depreciated using the same method as underlying physical assets .	As in PSE3 – Christchurch Airport identified an anomaly which was limited to PSE2 related to the allocation of implied depreciation which depressed the pricing share of the relevant assets and raised the share of assets allocated to other activities		As in PSE3, this remains appropriate.

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
Pricing structure				
Price structure simplification	In PSE3 Christchurch Airport proposed a simplification to its pricing structure, moving to a per passenger basis with a single price for airfield and non-regional terminal services. No material changes to the pricing structure have been made in PSE4 compared with PSE3.	In Christchurch Airport's view this pricing structure: • does not send perverse signals about which types of aircraft airlines should use on Christchurch Airport's airfield, with airlines free to innovate in choosing and changing their fleets; and • a single per passenger terminal price meets the appropriate economic tests, ensuring passengers are paying for the forward-looking efficient costs they use, whilst leaving Christchurch Airport neutral as to where a passenger is travelling to or from, avoiding arbitrary distinctions between passengers		A continuation of the simpler per-passenger pricing structure is appropriate.
Transfer passenger pricing	Christchurch Airport will now only charge for one leg (ie, either the arriving or departing leg) where passengers transfer via the terminal.	Christchurch Airport says this is a refinement on the pricing structure applied during PSE3.		This appears to be a positive change that promotes more transfers through the airport.

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
		This modification was in response to feedback from some of Christchurch Airport's customers and will mirror practices of overseas airports. Christchurch Airport hopes that the reduction in charges will retain existing levels of transfers and encourage new arrangements, promoting the efficient utilisation of Christchurch Airport's assets		
Deferral/ Price smoothing	Because of uncertainty at the time of Christchurch Airport setting prices for PSE4, customers enquired about deferring price increases or applying a smoothing mechanism for PSE4. Neither deferral nor price smoothing was deemed necessary by Christchurch Airport.	**Deferral** Christchurch Airport did not find grounds to justify deferral. Despite uncertainty, Christchurch Airport was confident that the PSE4 prices were the best estimate. In addition, any deferral may create a later price shock in the later years of PSE4.		The depreciation method already acts to smooth prices somewhat. Doubling down with deferral of price smoothing may result in larger increases later in the pricing period. The decision is appropriate.

Topic	Decision	Airport rationale	Airline views (as stated by Christchurch Airport)	Commission view
		Price smoothing Christchurch Airport decided it was not appropriate as: • during the previous pricing periods, Christchurch Airport committed to a consistent levelised price path. It considers this remains the appropriate approach for PSE4; and • any price increases that are delayed in the early years of PSE4 will need to be recovered in the later years of PSE4, causing significant price increases in FY26 and FY27. This would likely create a perverse outcome for PSE5 and is inconsistent with the levelised regulatory price path approach that Christchurch Airport has taken in previous pricing periods		