

# Christchurch International Airport Limited:

Additional material on the reset of  
aeronautical prices for the period  
1 July 2017 to 30 June 2022

**Public version**

**Updated - 28 June 2018**

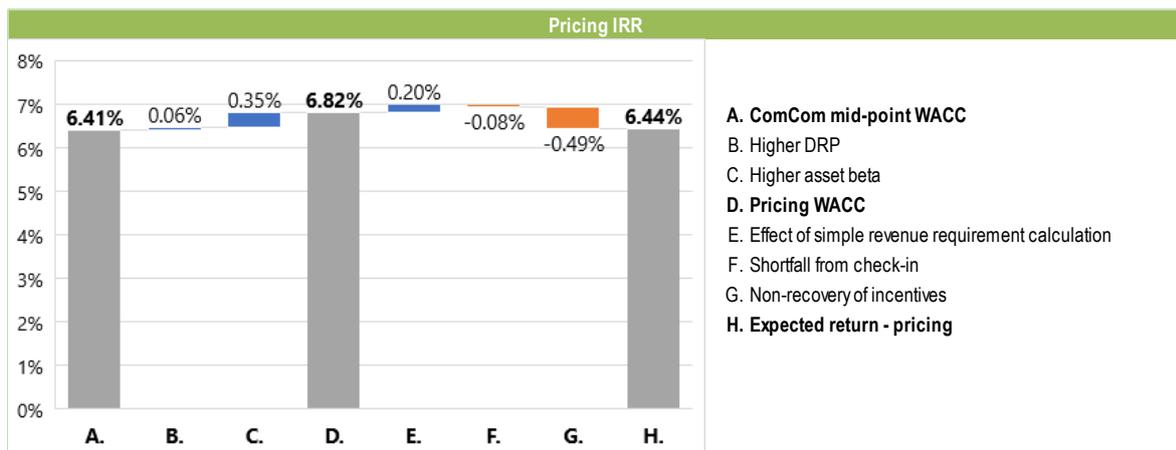
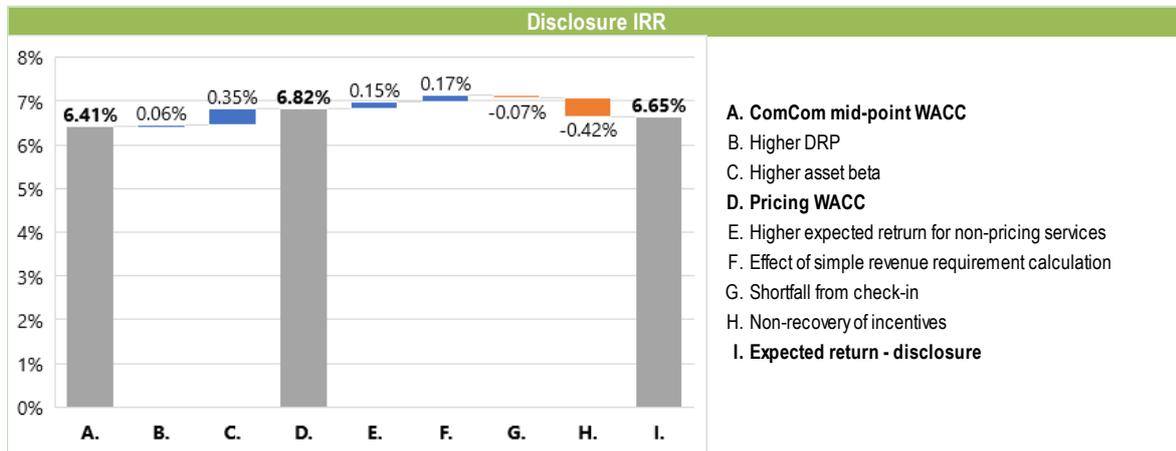


## INTRODUCTION

- The Commerce Commission (**Commission**) and Christchurch International Airport Limited (**CIAL**) have been discussing additional information that would assist the Commission’s review of CIAL’s aeronautical prices for the period 1 July 2017 to 30 June 2022 (**PSE3**). Additional information is provided below, with further reference material appended.

## RELATIVE CONTRIBUTIONS TO THE IRR CALCULATION

- The Commission requested further detail on the relative impact on CIAL’s target returns of the use of a simplified version of the building blocks calculation, the exclusion of pricing incentives from the cost base, and the reduction in revenue from check-in activities resulting from existing contracts.
- Our “waterfall” analysis is shown below. CIAL has shown this for both the IRR across our total disclosure and for the IRR across our PSE3 pricing decision. The difference is the inclusion in the total disclosure IRR of non-priced services (regulated services provided under contracts, discussed in more detail below).



- To explain each step in the waterfall:

### Debt Risk Premium

- CIAL used its own credit rating of BBB+ rather than the Commission’s benchmark credit rating of A-. This resulted in a debt risk premium of 1.84% rather than 1.45%.

6 This approach has been confirmed by recent market experience with CIAL having just recently completed a listed bond issue in the domestic debt capital markets with a six-year maturity.

7 The issue was rated BBB+ by S&P Global Markets and priced consistently to secondary trading marks for comparable BBB+ bonds.

#### **Asset beta**

8 As the Commission is aware, CIAL consulted on and used an asset beta estimated to reflect CIAL's circumstances. This was higher than the Commission's benchmark asset beta.

#### **Expected returns from non-priced services**

9 In PSE3 the expected returns from non-priced services (regulated services provided under existing contracts and not included in the PSE3 pricing decision) are higher than the expected IRR reflected in CIAL's PSE3 pricing decision. In PSE2 the situation was reversed, and expected returns from non-priced services were lower than the pricing IRR.

10 The issues associated with benchmarking the IRR of non-priced services are discussed in more detail below.

#### **Effect of simple revenue requirement calculation**

11 When preparing and consulting on its PSE3 pricing model CIAL used a model that assumed most cash flows happen at the end of the year. This reflects an earlier iteration of the Commission's IMs. The alternative was to apply the Commission's more recent treatment of introducing intra-period cash flows.

12 This was a deliberate decision to keep the pricing model calculation as simple, understandable, and informative as possible. CIAL constructed the model with the intention of providing it to its airline customers and wanted it to be as transparent and usable as possible. The model was provided during consultation.

#### **Shortfall from check-in**

13 In PSE2, check-in services were provided to each airline under separate agreements as a non-priced service. In PSE3 CIAL bought check-in services into the priced services, including both costs and revenues in the price model.

14 However, existing contracts mean that CIAL's revenue from check-in activities will be lower than the revenue requirement.<sup>1</sup>

#### **Non-recovery of incentives**

15 We discuss CIAL's treatment of incentives next.

#### **TREATMENT OF INCENTIVES**

16 The Commission asked for more information on CIAL's treatment of incentives, and whether they are included in opex and demand forecasts.

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<sup>1</sup> Pricing Event Disclosures for PSE3, items 18(v) and 19(v), contained in second text-box under these items.

- 17 CIAL undertakes two forms of market stimulation:
- Direct expenditure on general marketing activities, covering aeronautical development and marketing, including promotion of specific destinations and routes, and general marketing of the airport itself, and
  - Bilateral arrangements with airlines that agree rebates (or similar) to encourage the establishment of new services or capacity.
- 18 Only the costs of the first kind of activity are included in CIAL's PSE3 pricing model (as opex). Our airline customers gave strong feedback that the cost of the second activity should be excluded from the model. This approach has been consistently applied across both PSE2 and PSE3 pricing models.
- 19 In terms of quantum of marketing included in the opex forecasts, the forecast levels in PSE3 are relatively consistent and comparable with actual base rate spend in PSE2.
- 20 For the purposes of pricing disclosure, CIAL was required to disclose both forms of incentives and its disclosures reflect that requirement. The pricing incentives that CIAL included in its PSE3 disclosures reflected the rebates forecast under agreements in place at the end of PSE2, as well as an assumption that one of those agreements will be extended in substantially similar form.
- 21 Both kinds of market stimulation activities are taken into account when forecasting demand. The demand forecasts were made on the basis of these market stimulation activities occurring, both marketing spend and agreed arrangements. The bottom up forecasts were based on scheduled capacity that directly reflect such activities and arrangements.
- 22 It is possible that additional passenger growth will occur during PSE3 as a consequence of CIAL's market development activities and the consequent creation of new routes / services. However, it would not be expected that growth from this source would add a material increment to the expected IRR over the period.
- 23 While each market development / incentive package is different:

[REDACTED]

[REDACTED]

[REDACTED]

- 24 CIAL's view is that the active promotion of growth in traffic through the airport – including through the active encouragement of new services / routes – is in the long-term interests of passengers – its ultimate customers. Airports are in a position from which they can seek to influence airlines to expand the choices to passengers flying from and into a location.

25 Pricing incentives are challenging to accommodate in an *ex ante* cost-based price determination. As noted above CIAL has faced substantial resistance from airline customers to recovering the cost of pricing incentives through PSE3 prices, even for incentives that clearly relate to volumes that are being factored into prices. However without recognition of these costs, the apparent expected return will overstate the true expected return and the incentive / ability of an airport to promote growth will diminish.

**PSE2 forecasts vs actuals**

26 The promotions and airline incentives forecast in PSE2 pricing disclosure are of the same type as CIAL had included in PSE3 pricing disclosure, although for PSE2 this was mainly general marketing of the airport, with limited costs in respect to destination and route marketing.

27 CIAL’s view is that the actual spend in this area for PSE2 is the relevant matter when comparing to PSE3 forecasts (i.e., whether the purpose is to assess the reasonableness of the PSE3 opex forecasts, or to test whether the PSE3 demand forecast is consistent with the items included in the PSE3 opex forecasts).

28 At the time that the PSE2 forecasts were put together, there was significant uncertainty around the impact of earthquakes on demand etc.

29 As CIAL progressed through PSE2, significant work was required to stimulate/recover demand which came at a cost which was well above that forecast at the start of PSE2. Consequently, as CIAL has highlighted in each of its annual disclosures between FY13 and FY17, its actual costs in this area have exceeded forecast:

30 Actual costs through PSE2 were as follows:

	FY13	FY14	FY15	FY16
Marketing Expenditure (\$m)	\$2.3m	\$1.8m	\$2.5m	\$4.9m

31 Hence as noted above, PSE3 forecasts have been assessed based on comparability with actual costs incurred in PSE2.

**DEMAND FORECAST COMPARED TO RECENT EXPERIENCE**

32 The Commission asked for any available information on how passenger numbers were turning out compared to the forecasts CIAL used in its PSE3 pricing decision.

33 The table below shows our forecast compared to actual for FY17, and the current picture for FY18 (ending 30 June) is also provided.

PSE3 Forecast			Actual (+FY18 Forecast)			Pricing vs Actual		
	FY17	FY18		FY17	FY18		FY17	FY18
Jet+WLG	3,565,948		Jet+WLG	3,562,850		Jet+WLG	-0.09%	
Regional	1,331,064		Regional	1,348,245		Regional	1.29%	
Int NB	1,071,470		Int NB	1,109,439		Int NB	3.54%	
Int WB	550,243		Int WB	546,064		Int WB	-0.76%	
Dom Total	4,897,012		Dom Total	4,911,095		Dom Total	0.29%	
Int Total	1,621,713		Int Total	1,655,503		Int Total	2.08%	
Total	6,518,725		Total	6,566,598		Total	0.73%	

(Note NB = narrow bodied; WB = wide bodied).

34 CIAL's initial reactions to how its forecasts are comparing to out-turn results:

- In FY17, the passenger numbers overall were only slightly higher than forecast, although there was some differences within the subsets [REDACTED]
- The current forecast for FY18 (determined using 10 months actual figures and 2 months forecast demand) is that passenger numbers will exceed the forecast by [REDACTED] overall, and with material variances in some categories.
- However, CIAL's additional revenue will not move one-for-one with this additional passenger growth because a portion of passenger growth [REDACTED] is subject to pricing incentives. The forecast [REDACTED] variance in FY18 is currently expected to generate an additional [REDACTED] of revenue net of incentives. CIAL explains this approach as follows:
  - Firstly, for each category of passenger above forecast (i.e. regional, domestic & international) – CIAL applied the standard published price per passenger ("Published Price") as outlined in its PSE3 disclosure to determine Gross Revenue;
  - Then for each such passenger, and taking into account the current incentive programs in place that roll across FY18, CIAL assessed whether the actual amount that will be charged to that passenger is less than the Published Price;
  - The actual increase in revenue to be billed (Net Revenue) is then calculated as the Gross Revenue less any incentives i.e. what we actually bill the customers rather than revenue based on Published Prices.

This exercise is performed on an airline customer by airline customer basis to reflect the differing incentive arrangements in place.

## OPERATING EXPENDITURE FORECASTING

- 35 The Commission asked for information to better enable a comparison of opex forecast trends across PSE2 and PSE3, in particular the treatment of general marketing incentives.
- 36 As discussed above, CIAL undertakes two forms of market stimulation:
- Direct expenditure on general marketing activities, covering aeronautical development and marketing, including promotion of specific destinations and routes, and general marketing of the airport itself, and
  - Bilateral arrangements with airlines that agree rebates (or similar) to encourage the establishment of new services or capacity.
- 37 Only the cost of the first kind of activity are included in CIAL's PSE3 pricing model (as opex). Airline customers gave strong feedback that the cost of the second activity should be excluded from the model. For PSE3 CIAL agreed to do so. The same decision was made for the PSE2 pricing model.
- 38 In relation to CIAL's annual PSE2 disclosures, there was a change in practice with respect to the disclosure of pricing incentives (rebates) during PSE2. For FY13 and 14, these were treated as an offset to revenue and so not included in opex, (although they were disclosed separately in the appropriate section of the disclosure). For FY15 onwards, incentives were included in disclosure opex and revenue is gross of incentives.
- 39 The figures for a consistent treatment of incentives across PSE2 and PSE3 are as follows (\$nom):

	PSE2 (actuals)					PSE3 (forecasts)				
	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Operating expenditure (ex. incentives) (\$m)	30.5	32.7	35.3	34.8	33.4	35.2	35.6	36.4	37.2	37.9
Incentives	6.0	13.3	2.5	4.9	5.0	5.6	2.4	2.2	2.2	2.2

- 40 More generally, the opex forecasts used in CIAL's PSE3 pricing model adopted its business plan operating expenditure forecasts for FY18 and FY19, and then for the remainder of PSE3 assumed:
- a zero growth in quantity of inputs;
  - an average growth in input prices of CPI, except for rates (5.5% p.a. on advice of the Christchurch City Council<sup>2</sup>) and wages (2.5% p.a. based on remuneration advice obtained by CIAL and used for business planning)
- 41 CIAL's opex experience across PSE2 and PSE3 has reflected the following drivers:
- 42 Through FY14/15 the new ITP terminal came into full operational effect. Increasing costs reflected operating the new bigger terminal and gaining experience with terminal operations.

<sup>2</sup> Christchurch City Council rates increased by an average of 5.48% for the 2018/19 year. The Long Term Plan currently under consultation provides for annual increases of 5.72%, 5.5%, 5.0% and 4.5% for FY18/19, 19/20, 20/21 and 21/22.

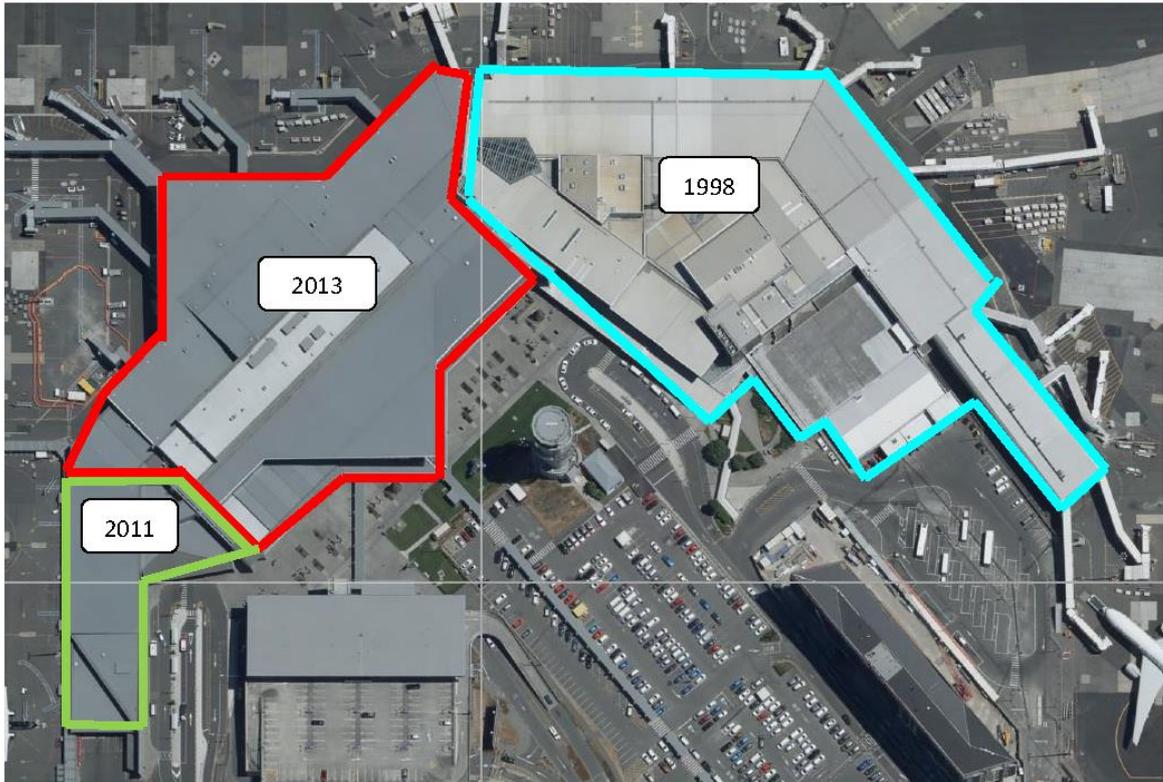
- 43 Through FY16 and FY17 CIAL's opex showed some cost efficiencies particularly in respect to energy efficiency as CIAL explained in consultation.
- 44 FY17 opex was further reduced due to the CIAL Airport Fire Service manning the autogates (rather than this service being performed by AvSec) and a reduction in consulting costs relative to FY16, in particular costs associated with the District Plan Review and regulatory IM review process.
- 45 So CIAL's starting base for FY18 incorporated these efficiencies achieved over FY16 and FY17.
- 46 However CIAL does see a cost pick up in FY18, for the following reasons:
- *Maintenance* – a move towards more proactive asset maintenance works and the development of more detailed terminal and infrastructure asset management plans. This will reduce the likelihood of increased maintenance in the future i.e. smoothing out over next 5 -10 year period.
  - *AvSec* – costs dropped off in FY16/FY17 due to the CIAL Airport Fire Service manning the autogates, but from FY18 onwards the manning of these gates has reverted to AvSec, and so this cost has increased.
  - *Heating costs* – opex reduced over FY16/FY17 as result of efficiency initiatives, but with the ability to extract further efficiencies being restricted (until technology advances) CIAL anticipates an increase in the base cost of electricity per kwh and in diesel costs.
  - *Insurance* – Total insurance costs dropped in FY16 and held for FY17 with premium rates remaining constant under CIAL's long term agreement. However as a consequence of hardening in global insurance markets following the severe losses incurred by insurers in those markets from the many significant natural catastrophes during 2017, CIAL faces a premium increase of 5% for 2017/18, 7.5% for 2018/9 and a nil increase for 2019/20. Also, a 40% increase in fire levies as a result of a funding review for Fire and Emergency New Zealand hit in FY18.
  - *Rates* – increases continue broadly in line with original predictions for foreseeable future in Christchurch based on Council Long Term Plan currently under consultation
  - *Staff costs* – wage increases on average 2.5% to meet tight labour market for necessary skills (based on expert remuneration advice used for business planning.
- 47 In PSE2 CIAL's actual opex exceeded our forecast by around \$21.7m or 14.9%. Consistent with the allocation of risk in the building blocks model, CIAL incurred that shortfall.

#### **FORECAST TAX DEPRECIATION**

- 48 The Commission asked for a forecast of tax depreciation for PSE3 across the total RAB, and opening tax asset values as at the start of PSE3. While tax depreciation forecasts were included in CIAL's pricing model, it did not include information on the derivation of tax depreciation for assets that were in place at the end of FY16. This information has been provided in a further updated version of the pricing model that CIAL has provided previously, which accompanies this note.

## TERMINAL RECONFIGURATION PROJECT UPDATE

- 49 The Commission asked for an update on our terminal reconfiguration project.
- 50 The context for this project is the out-workings of our Integrated Terminal investment. In physical terms, the integrated terminal investment created a facility that can operate as one flexible and integrated terminal by placing a new terminal building and integrated check-in and baggage handling facilities in between an existing regional lounge that is at times over-capacity and an international terminal that is currently under-capacity. The terminal layout with the dates on which construction of its component parts was completed is set out below.



- 51 Now that the investment is in place, the commercial challenge becomes using all the terminal assets as productively as possible to give effect to that flexibility and integration, rather than incurring substantial capex in one area when other parts of the facility are under-utilised. CIAL's terminal planning process looks ahead to how passenger volumes might grow across regional, domestic and international routes, and looks to maximise the use of the existing facilities. However to do that CIAL needs to make physical changes (walls, security areas, passenger facilities) and that requires a modest amount of capex.
- 52 CIAL's PSE3 pricing model forecast some terminal reconfiguration capex to be undertaken in FY20 (the third year of PSE3).
- 53 A Terminal Precinct Plan has been completed and a Terminal Activation Group established. As part of the Terminal Precinct Plan and in conjunction with the fact that congestion is starting to occur at bottle necks in the terminal at certain times (early morning and evening), the Terminal Precinct Plan is being accelerated with focus on creating a single route through the building with better way-finding and less congestion. CIAL will engage with airlines on its more detailed plans in due course.

54 CIAL remains confident the forecast terminal reconfiguration capex will occur:

- possibly earlier than forecast, and
- with a likely cost to be not less than forecast.

55 On performance in PSE3 to date (FY18),



56 For the PSE2 period actual capex was \$179m compared to forecast of \$145m. Further details are in CIAL's annual disclosures.

### **BENCHMARKING THE IRR OF NON-PRICED SERVICES**

57 CIAL provided an explanation of non-priced regulatory services, and the difficulties of making an IRR assessment, in CIAL's response to the Commission's draft report on AIAL's PSE3 pricing decision.

58 For convenience CIAL repeats this below, and then follow with some information on CIAL's non-price arrangements.

*Other regulated services, or non-pricing services, comprise leasing arrangements negotiated with individual customers, rather than being priced under the AAA consultation regime.*

*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.*

*CIAL's circumstances are similar to AIAL in that:*

- *All of CIAL's non-priced services are provided under agreements negotiated commercially with a single customer rather than subject to the consultation regime under the AAA;*
- *These are normally a lease over buildings and / or land, and often have a long term;*
- *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 CIAL customers;*
- *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.*

*When assessing these agreements, some relevant factors include:*

- *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);*
- *processes used to set the agreement terms against market (e.g. valuer reports; rent review mechanisms that align rents with market levels);*
- *the voluntary nature of the arrangements;*
- *in a number of instances there are alternative suppliers of land and buildings.*

*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:*

- *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;*
- *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;*
- *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.*

*For these reasons a higher level assessment of the approach of an airport to non-priced services seems appropriate.*

59 CIAL has reviewed its database of these arrangements. This analysis confirms some of the advice that CIAL provided earlier in qualitative terms, that is:

- the average term of the contracts is materially longer than the pricing periods (between 16 and 26 years on average, depending on how customers' options for extension are treated);
- the agreements are, on average, somewhat dated – with the average execution or commencement date approximately 9 years prior to the commencement of PSE3;
- Incenta's preliminary estimates are that a risk free rate component of the WACC that is consistent with the term of these agreements and the date they were entered into is in the order of 2 percentage points higher than the rate CIAL applied when resetting its prices. A copy of Incenta's analysis is included as Appendix B. A summary of CIAL's non-pricing agreements is included as Appendix C.

## CIAL'S PRICING STRATEGY

- 60 The Commission asked for a table contrasting average prices in 2017 and 2018, as a way of understanding the effect of the change in price structure. More generally we discussed the rationale for the change and how that was incorporated into the demand forecast process.
- 61 The table below uses published prices for FY18 from CIAL's pricing disclosure (adopting the smoothed pricing approach) and figures for FY17 from that year's annual information disclosure.

	Average Charge per PAX FY17 Per Information Disclosure			Average Charge per PAX FY18 - First year of PSE3			Difference		
	PSE2			PSE3					
	Airfield	Terminal	Total	Airfield	Terminal	Total	Airfield	Terminal	Total
Total - All	\$5.78	\$6.35	\$12.13	\$4.75	\$6.30	\$11.05	-\$1.03	-\$0.05	-\$1.08
Int Total	\$7.80	\$13.15	\$20.95	\$4.75	\$8.01	\$12.76	-\$3.05	-\$5.14	-\$8.19
Dom Total	\$5.10	\$4.06	\$9.16	\$4.75	\$5.70	\$10.45	-\$0.35	\$1.64	\$1.29
Dom Regional	\$4.26	\$2.00	\$6.26	\$4.75	\$2.14	\$6.89	\$0.49	\$0.14	\$0.63
Dom Non-Regional	\$5.41	\$4.84	\$10.25	\$4.75	\$7.10	\$11.85	-\$0.66	\$2.26	\$1.60

- 62 In the table, CIAL has:
- 62.1 broken down FY17 average charges from information disclosure between regional and non-regional;
  - 62.2 in terms of the FY17 terminal charge split between regional and non-regional, updated this to reflect actual outcomes for FY17; and
  - 62.3 provided an estimate of average price for domestic in FY18.
- 63 In addition, AirNZ pays an annual rental for the use of the Regional Lounge facility, which together with outgoings/opex was ██████ in 2017 and forecast to be ██████ in 2018. The effect of this charge in per passenger terms depends on the use of that part of the terminal:
- 63.1 The charge in per passenger terms was \$0.98/pax in 2017 and was forecast to be \$1.38/pax in 2018; however, a substantial part of this change is attributed to the change in treatment of flights to and from Wellington.
  - 63.2 If flights to and from Wellington had been served through the first floor integrated terminal in 2017 in accordance with the Regional Lounge lease, then the implied per passenger charge for use of the regional lounge would have been \$1.41/pax.
- 64 CIAL's restructuring of prices for PSE3 was principally driven by commercial considerations. However, the proposed changes were cross-checked from an economic perspective. The key considerations and economics were:
- *Promoting the achievement of productivity gains* – encouraging assets to be used in a way that minimises forward-looking costs. In the previous price structure international terminal charges were substantially higher, and yet this part of the terminal has spare capacity. The new joint terminal charge is more consistent with the plans for the terminal to become increasingly integrated / flexible. That is, CIAL views the terminal as an asset where specific areas cannot be said to be associated with any particular type of traffic, but rather as an asset that jointly provides all

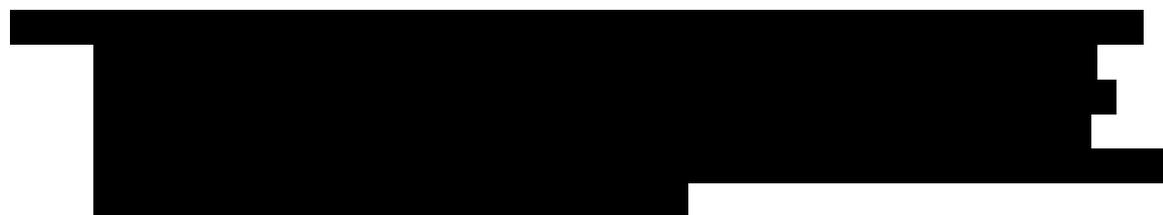
services and where any latent capacity is available to be deployed where it is most needed;

- *Reducing CIAL's risk exposure from airline's decisions* – recover sunk / fixed costs in a manner that has least impact on the use of the airport, and avoids creating perverse incentives for behavioural change. In the previous price structure airfield charges per passenger were much higher for larger aircraft, disproportionate to the cost impact, and the structure of check-in charges encouraged airlines to change check-in practices, unrelated to cost. The new per passenger basis is likely to be the least susceptible to providing perverse incentives;
- *Reducing complexity* – creating conditions that are more conducive to the entry of new airlines and the creation of new services / routes. Previous charges for an airline bringing a passenger were a mixture of: aircraft weight (landing), fixed per aircraft (landing), per seat (terminal), per hour (check-in). The new charging basis – per passenger – is the simplest for airlines to understand and implement (and for CIAL to market).

65 CIAL tested with its expert economic advisor the question raised during consultation of ensuring the new price structure is subsidy free. This is a more complex issue than was presented during consultation. Expert advice was that there are no material concerns and that overall the new price structure significantly improves incentives.

66 The new price structure attracted support from the majority of airline customers with opposition from Air NZ during PSE3 consultation process. CIAL reflected on competing feedback and introduced an even annual change to prices for regional and international passengers from FY17 prices for each group, resulting in a single price for domestic (non-regional) and international passengers by the end of PSE3.

67 The price structure put out to consultation, and the changes made as a result of consultation, were advised to our independent demand forecast expert when advising on the demand forecasts used in the PSE3 model. The assessment was made by the independent expert that the new price structure did not materially impact on the passenger demand forecast (the methodology CIAL's independent expert used in assessing the PSE3 price structure is set out in Appendix F). In relation to the changes made as a result of strong feedback during consultation, introducing a transition to the single per passenger charge for domestic (non-regional) and international passengers, this was seen as an essential measure to maintain the original demand forecast in light of airline feedback.



69 Some further context is that, as shown in the table above comparing the effect of the two price structures, as an overall assessment charges per passenger did not change significantly – they went up for some sectors, and down for others. Hence, an increase in revenue for price modelling purposes against the demand forecast would only be expected if the price restructuring would be expected to raise demand overall (i.e., prices increased for the least price responsive segments, and vice versa) or that the pattern of demand moved from where CIAL's charges are lower to

where its charges are higher (noting that CIAL had corrected for a lot of this potential, especially in airfield).

- 70 Prices went up for regional (albeit phased in), and for these passengers airport charges are likely to be the largest share of airfares (meaning larger potential demand response). But AirNZ has a monopoly on these routes and so it is difficult to predict how much of these costs increases will be passed through. And in domestic, for Wellington passengers previously on ATRs, there is a large cost increase for AirNZ – but these passengers were previously getting charged by AirNZ the same as if they were on jets.
- 71 Prices went down materially for international passengers. But airport charges are likely to be a smaller share of their total ticket price. In addition, [REDACTED]. Moreover, where there are additional international flights at the expense of domestic flights (i.e., direct rather than through the AIAL hub) there is little effect on CIAL’s revenue.
- 72 More generally, the growth in passenger numbers that is possible from a change in prices is dependent on airline capacity being introduced to support that growth, and airline decisions to add or subtract capacity from a route, or commit to or withdraw from a route altogether, are made in response to a wide range of factors that feed into network planning. These factors include changes in aeronautical prices but they also include forecast changes in operating costs, forecast demand conditions, the opportunity costs of servicing one route in a domestic or international network over another, and the importance of viewing the performance of a network as a whole. For this reason CIAL approached its price structure with the intention of lowering the likelihood of perverse incentives, rather than attempting to proactively incentivise a particular outcome.

### **REGIONAL LOUNGE**

- 73 The Commission asked for further information on CIAL’s Regional Lounge arrangements. A summary of the arrangements is included in Appendix A. These are commercially sensitive and for that reason the context of Appendix A is redacted from the public version of this note.

### **OPERATING LEVERAGE**

- 74 In light of the Commission’s statement that it will understandably want to be consistent across airports, CIAL has asked Incenta to prepare advice on the operating leverage indicators highlighted by the Commission. Incenta’s advice is included in Appendix D.

### **UPDATED AIRPORT SERVICE QUALITY REPORTING**

- 75 As an update on information previously provided to the Commission, we also include the Airports Council International (ACI) Airport Service Quality (ASQ) report for CIAL for Q1 2018 in Appendix E. Appendix E also includes ACI’s global ASQ barometer report for Q1 2018. CIAL remains the highest ranked airport within the Australasian airport data set for overall satisfaction with a rating of 4.36 which exceeds the global overall satisfaction rating of 4.21.

#### **CONTEXTUAL ASSESSMENT UNDER PART 4**

- 76 Finally, in its cross-submission on the AIAL draft report, CIAL highlighted some key points regarding the contextual assessment required under Part 4, and CIAL's approach in PSE2 and PSE3 (which, to the long term benefit of its customers, elected to make permanent, and not bring into PSE3, its under-recovery in PSE2, and, through its choice of depreciation methodology, deferred recovery of \$41.94m allowable revenue (in NPV terms) in PSE3).
- 77 These points are relevant to the Commission's PSE3 review for CIAL (and reflect sections D2 and D3 of CIAL's initial PSE3 pricing proposal and section G3 of CIAL's pricing disclosures). Accordingly, a copy of that cross-submission is attached as Appendix G together with updated tables illustrating the difference between the straight line and tilted annuity methodologies both for depreciation for all disclosure assets and allowable revenue for pricing services.

[REDACTED]

<p>[REDACTED]</p>	<p>[REDACTED]</p> <p>[REDACTED]</p> <p>[REDACTED]</p> <p>[REDACTED]</p>
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[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]

**APPENDIX B: INCENTA ANALYSIS – RISK FREE RATE ASSOCIATED WITH  
CIAL'S NON-PRICED AGREEMENTS**

## **APPENDIX C: INCENTA ADVICE – OPERATING LEVERAGE OF CIAL**

**APPENDIX D: ACI AIRPORT SERVICE QUALITY REPORTING**

## **APPENDIX E: SUMMARY OF NON-PRICING AGREEMENTS**

## **APPENDIX F: METHODOLOGY USED BY INDEPENDENT EXPERT IN ASSESSING PSE3 PRICE STRUCTURE AND ARRIVING AT RECOMMENDED DEMAND FORECASTS**

- 1 The methodology used by CIAL's independent expert, 3 Consulting, in arriving at its recommended demand forecasts was described in the 3 Consulting Report attached as Annex 3 to the Initial Proposal for the Reset of Aeronautical Prices for the period 1 July 2017 to 30 June 2022 ("**Initial Proposal**") (previously provided to the Commission), and in subsequent consultation material.
- 2 In overview, 3 Consulting's methodology was to use airline scheduling forecasts for the years they were available as the best evidence of likely volumes in the near term, and for the years beyond that to extrapolate forecasts based on macro variables. In practice that meant "bottom up" schedule-based forecasts for the first year of domestic demand and the first two years of international demand.
- 3 CIAL briefed 3 Consulting on the price structure proposed in its initial pricing proposal, and the change to the price structure proposed as a result of feedback received during consultation. 3 Consulting was aware of the change in price structure from that used by CIAL in PSE2, and aware of the size of the changes proposed during consultation.
- 4 The advice from 3 Consulting was that its recommended forecast demand did not change as a result of these changes to price structure. In part this was a function of the 3 Consulting methodology, which is driven first by airline scheduling and then by macro factors. In part this was also an exercise in expert judgment, that overall volumes would not be expected to be influenced by changes in price structure of this magnitude.
- 5 This advice accorded with CIAL's commercial experience, and for that reason CIAL used the 3 Consulting advice during the consultation process.
- 6 CIAL's commercial view during the consultation process was that it did not expect these changes to price structure to impact on overall demand levels. Airline decisions to add or subtract capacity on routes, or entire routes, are influenced by much more significant factors such as changes in operating costs, the opportunity costs of servicing one route in a domestic or international network over another, and the importance of viewing the performance of the network as a whole.
- 7 Where CIAL did have information the price structure would impact on expected demand – such as the feedback CIAL received from Air New Zealand during consultation on the potential impact of the proposed price structure on regional volumes – we changed our proposed price structure to ameliorate that.
- 8 Where price structure can come into play is in the incentives created for a given expected volume. The price structure was intended to remove incentives on airline customers to alter fleet mix in ways that did not reflect forward looking costs, and to put in place incentives (and remove barriers) to make more efficient use of the capacity in the full integrated terminal to minimise future capital expenditure requirements. In parallel, the price structure change was also intended to reduce CIAL's financial exposure to decisions by airlines that change the way passengers arrive at Christchurch, which may be driven by factors that are completely independent of routes in or out of Christchurch (for example, capacity issues in relation to other routes).

- 9 CIAL didn't expect or intend these to impact on overall demand, but on the way a given level of demand used CIAL's facilities. Rather, to the extent that CIAL expected the new structure could cause a behavioural response, it was for the airlines to bring the same passengers to Christchurch in a different manner (for example, more Wellington passengers arriving jets and fewer by turbo-props, or possibly more international passengers arriving directly into Christchurch rather than via another New Zealand airport).
- 10 Under the price structure in place for PSE3, these types of behavioural responses would be approximately neutral (noting the effect of the transitional tariff) to CIAL.

**APPENDIX G:**

- **CIAL CROSS-SUBMISSION ON AIAL DRAFT REPORT**
- **UPDATED TABLES ILLUSTRATING DIFFERENCE BETWEEN DEPRECIATION METHODOLOGIES**