CROSS-SUBMISSION ON COMMERCE COMMISSION'S REVIEW OF CHRISTCHURCH INTERNATIONAL AIRPORT'S PRICING DECISIONS AND EXPECTED PERFORMANCE (JULY 2017 – JUNE 2022) - DRAFT REPORT

6 September 2018

CHRISTCHURCH AIRPORT

CONTENTS

PART A: INTRODUCTION & EXECUTIVE SUMMARY

1 On 19 June 2017 Christchurch International Airport Limited (**CIAL**) set prices for its "airport activities" for the period from 1 July 2017 to 30 June 2022 (**PSE3**). On 14 August 2017 CIAL disclosed information to the public in accordance with the Airport Services Information Disclosure Determination 2010 (the **ID** regime).

2 On 19 July 2018 the Commerce Commission (**Commission**) published a draft review of CIAL's pricing decisions and expected performance for PSE3 (**Draft Report**) in accordance with section 53B(2) of the Commerce Act 1986. On 16 August 2018 CIAL and other interested parties made submissions in response to the Draft Report. This cross-submission responds further to the Draft Report and other parties' August submissions.

3 CIAL's PSE3 consultation material and various submissions made during the Commission's section 53B process are available on the Commission's website here. CIAL's PSE3 disclosure is available on CIAL's website: www.christchurchairport.co.nz.

4 If there are any questions in relation to this submission please contact:

Michael Singleton
General Manager Corporate Affairs
(03) 353 7046 / michael.singleton@cial.co.nz

Executive summary

5 CIAL reiterates the points made in its 16 August submission. In particular:

5.1 CIAL welcomes the Commission's finding that CIAL is targeting reasonable returns on its priced services and is acting in an efficient manner, including in relation to its new price structure.

5.2 The Draft Report is a helpful aid to understanding CIAL's efficiency and expected profitability.

5.3 There are several topics where CIAL believes the positives could be better highlighted, or the Commission should add further emphasis or re-prioritise its analysis.

5.4 The message that the Commission is "not satisfied" regarding CIAL's profits for other regulated services is vulnerable to misinterpretation by interested persons either directly when reading the Draft Report or indirectly via media coverage.

Broad agreement on many topics

6 CIAL is pleased to see through airlines' submissions that there's broad agreement on a number of topics, reflecting a long and thorough consultation process and a high degree of understanding by all the parties involved. Areas of general agreement include:

6.1 price structure, where the Commission and the majority of airlines (through the Board of Airline Representatives New Zealand – **BARNZ**) agree that CIAL has set efficient and subsidy-free prices;

6.2 depreciation, where BARNZ continues to state its support for CIAL's tilted annuity approach. The Commission agreed in its Draft Report that CIAL's approach is more transparent than the approach previously used; and

6.3 the Commission's suggested approach to assessing returns over non-priced / other regulated services. CIAL and airlines all agree that it's appropriate to consider these services separately and over a longer period, given their distinct nature.

IRR is the accepted measure of profitability

7 CIAL has aligned (where possible) its pricing asset base with its regulated (disclosure) asset base. That move increased transparency and aligned CIAL's price setting exercise with the process the Commission is now undertaking in assessing CIAL's returns.

8 CIAL participated in the Commission's recent Input Methodologies (**IM**) review process. In that process the Commission, following input from the industry, developed the internal rate of return (**IRR**) measure of airports' profitability. We elaborate from paragraph 11 below.

9 CIAL approached its PSE3 price setting exercise in that context and on the basis that airlines have engaged in the IM review and have a working understanding of the IMs and the Commission's process.

10 In that context:

10.1 Air New Zealand should not be expressing surprise that growth incentives were excluded from CIAL's building blocks model and yet are relevant to the Commission's IRR assessment of profitability;[1] and

10.2 BARNZ cannot reasonably claim it was unaware of the relevance of IRR and needed more information (not requested at the time) on that profitability indicator during consultation on CIAL's building blocks model.

PART B: FURTHER DISCUSSION

Target returns and profitability

11 The Commission's key finding is that CIAL's PSE3 target return on its priced services is reasonable. The Commission has rightly used an internal rate of return calculation, as clearly signalled by the Commission and expected by all relevant parties.

12 In particular, the Commission's 2016 IM review decision focuses on the relevance of IRR as the best determinant of airports' profitability (compared to, for example, considering ROI or only WACC). The Commission in its final reasons paper also noted BARNZ's support for the approach:[2]

> BARNZ reiterated its support for "using a five-year IRR, with a limited set of items carried forward to the next period, and considers that this methodology would best promote the purpose of 52A, and represents the most appropriate balance between the various competing objectives contained in the purpose statement".

13 The IRR approach takes account of what CIAL is actually forecast to earn. Several factors mean CIAL will earn less than would be assumed based on its headline PSE3 prices, including the fact that CIAL gives growth incentives to encourage the establishment of new routes or capacity (discussed in more detail from paragraph 17).[3]

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[1] CIAL explained its treatment of growth incentives in its 16 November 2016 initial proposal from paragraph 196.

[2] Commerce Commission *Input methodologies review decisions – Topic paper 5: Airports profitability assessment* (20 December 2016) at paragraph 177.2 (**IM Decision: Topic paper 5**).

[3] For interested parties: the result is a difference between the WACC used in CIAL's building blocks model to calculate prices and the IRR which represents CIAL's actual expected returns. This is an expected outcome.

14 This consideration of incentives and other factors in the calculation of IRR/profitability was clearly signalled by the Commission during the IM review. See for example the Commission's final reasons paper:

> In cases where an airport does not intend to recover the amount [of commercial concessions in future pricing events], the commercial concession can simply be viewed as relatively lower target revenue, and thus profitability will rightfully be assessed to be lower.[4]
>
> …
>
> Requiring airports to disclose the aggregate impact of pricing incentive forecasts as part of price setting event disclosures will help interested persons understand whether or not the forecast effect of pricing incentives are included in an airport's target revenue. This will improve transparency and help interested persons assess an airport's profitability with and without any route incentives as a sensitivity test.[5]

15 Airlines have focused on CIAL's WACC and claim that IRR is some form of distraction, despite that it is the Commission's clearly articulated and well understood approach. WACC – a building block – was front and centre during consultation and was clearly disclosed in ID. As expected and explained to all parties including airlines in the IM review, the Commission is now focusing on IRR as well.

16 Nonetheless, the Draft Report does go into substantial detail on WACC inputs as well as IRR. As set out in CIAL's submission, we appreciate the further guidance the Commission has given about the evidence that CIAL provided in its proposal and on the further matters the Commission would like to see addressed.

Relevance of incentives

17 CIAL considers incentivising airlines who propose to service new routes, or add new capacity, to and from Christchurch Airport. These incentives are not subsidies; rather they ultimately operate as adjustments to the per passenger prices associated with new routes and/or capacity, in order to encourage growth. They help establish and stimulate new routes and/or capacity, with a view to those services paying standard headline prices in the medium term once established.

18 Growth incentives and the resulting new passengers benefit all airlines operating out of the Airport. New routes increase demand without incurring substantial additional cost. CIAL's PSE3 demand forecasts took into account the forecast benefits of growth incentives, meaning prices for all airlines were spread across more passengers. As the Commission has identified:[6]

> Generally, we consider that some sharing of risk for volumes associated with route development activities is appropriate. This is because the route development activities may increase demand relative to a situation where these activities were not undertaken. Airlines may subsequently benefit from lower unit costs resulting from these increased volumes and economies of scale over the long-term.

19 Air New Zealand has attempted to characterise incentives as some form of subsidy that it pays for the benefit of other airlines or types of passengers. That description is not accurate.

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4 IM Decision: Topic paper 5 at paragraph 692.

5 IM Decision: Topic paper 5 at paragraph 701.

6 Draft Report at paragraph B92.

CIAL's headline prices are set based on CIAL's cost-based building blocks model. As discussed by the Commission, and later in this cross-submission, CIAL's headline PSE3 prices efficiently recover costs and are subsidy free.

20 Any airline (whether or not currently flying to Christchurch Airport) can approach CIAL and discuss growth incentive options. There is no weighting towards new airlines or international routes over others.

Price structure

21 CIAL set its PSE3 prices on a per-passenger basis. Per passenger prices increase the simplicity of prices and align CIAL's and airlines' interests. Per passenger prices were strongly supported by BARNZ and Qantas Group throughout consultation.

22 CIAL's prices are efficient, appropriately reflect forward-looking costs, and don't include any cross-subsidies. The Commission agreed, noting the importance of considering forward-looking costs and identifying that the price structure does include cross-subsidies or raise efficiency concerns.

Airfield prices

23 The Commission found that "Christchurch Airport's pricing methodology is unlikely to result in cross-subsidisation between operators of different aircraft… That is, Christchurch Airport's per-passenger airfield charges are likely to recover an aircraft's contribution to costs."[7] BARNZ had the same view during consultation, noting that CIAL's price structure "avoids arbitrary distinctions… that are not based on technical, operating or economic grounds."

24 The Commission also confirmed that consideration of forward-looking costs is appropriate and efficient (see paragraph 176). Nonetheless, Air New Zealand in its submission challenged the appropriateness of focusing on forward-looking costs, although it hasn't offered any evidence in support of this position despite analysis undertaken by CIAL's expert advisor, Incenta, and the Commerce Commission.

25 Air New Zealand's particular concern is that a "substantial portion of the airfield cost relates to assets already in place which are scaled to service the needs of larger, heavier aircraft, and which are not required for the smaller aircraft servicing domestic routes." CIAL responded to this concern in detail during consultation, and see in particular the discussion from paragraph 27 of CIAL's 10 April 2017 Revised Proposal and the expert report, Annex A – Incenta response to Air NZ comments, attached with the Revised Proposal.

26 The premise of Air New Zealand's point is incorrect in any event. During consultation Air New Zealand referred CIAL to the analysis CIAL undertook in setting PSE2 prices in relation to the avoidable and standalone costs of serving different aircraft types (referring specifically to BECA, who provided the cost estimates that fed into that analysis). In response, Incenta reapplied the standalone cost test, and the results confirmed that turboprop aircraft cannot be said to be subsidising an airfield for larger aircraft (see Incenta's 10 April 2017 analysis from section 2.3.3).

Terminal prices

27 CIAL's per passenger terminal prices were also supported by BARNZ and identified by the Commission to be unlikely to result in cross-subsidisation (including taking into account the transitional path introduced in response to airline submissions during consultation).

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7 Draft Report at paragraphs 174 – 175.

28 Air New Zealand has queried the extent to which CIAL's terminal is flexible, claiming in particular that CIAL's integrated terminal is "not configured to easily handle turbo-prop operations."

29 The recently commissioned gates 15 and 16 at Christchurch Airport's first floor integrated terminal are fully operational and able to service turboprop aircraft arriving from and departing to any destination.[8] CIAL has worked with airlines' operational representatives at the Airport to make these gates available. Air New Zealand is free to use these gates for turboprop aircraft on any routes, and is in fact doing so.

Approach to other regulated services

30 The Commission and all submitters have similar views about possible approaches to assessing returns on other regulated services. In particular, CIAL agrees with Air New Zealand and BARNZ that greater flexibility is required, and other regulated services are best considered over the longer term reflecting the nature of the arrangements. BARNZ is right that more information and consideration of approach is required at this stage.

31 CIAL also agrees with Air New Zealand that returns on non-priced /other regulated services shouldn't be offset by higher returns on priced services. As set out in CIAL's submission, the two sets of services are different in nature and have substantially different sets of customers.

Minor comments on building blocks components

Inclusion of the Antarctic apron

32 CIAL's approach was to align (where possible) its pricing asset base with its regulated asset base, increasing transparency generally and resulting in CIAL setting its PSE3 prices based on its regulated asset base as defined by the Input Methodologies. The Antarctic apron at the Airport is inside CIAL's IM-defined regulated asset base (**RAB**) and so was included in CIAL's pricing asset base. The Commission has accepted CIAL's approach to RAB and RAB values.

33 BARNZ has now claimed that CIAL's inclusion of the Antarctic apron is inappropriate because it's not used for priced services. In fact it is – as explained during consultation in CIAL's 10 April 2017 revised proposal:[9]

> [T]he Antarctic apron is also used by a variety of non-passenger aircraft that are assumed in the price calculation to pay the standard airfield price for non-passenger services. The name of the apron indicates its location; the apron is not dedicated to Antarctic services.

34 This point was illustrated as far back as CIAL's 16 November 2016 initial pricing proposal. The table at paragraph 114 of that proposal shows CIAL's PSE3 RAB build up from PSE2, including the Antarctic apron. In that proposal and throughout consultation CIAL clearly set a non-passenger price to recover revenue associated with its priced assets.

Depreciation

35 The Commission and interested parties all support CIAL's tilted annuity approach to depreciation, with BARNZ specifically reiterating that support in its August submission. This was an important positive step taken by CIAL to increase transparency in PSE3 and, as also set out in our submission, is worth highlighting as a key area of agreement.

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[8] These gates are additional to gates 1 to 14 in CIAL's Regional Lounge and capable of servicing turboprop aircraft. CIAL has a total of 35 gates servicing all aircraft.

[9] CIAL Revised Proposal, 10 April 2017 at paragraph 82.2.

WACC inputs

36 BARNZ has queried the Commission's approach to assessing CIAL's credit rating, noting possible incentives on airports and the fact that the approach departs from the Commission's standard approach.

37 The Commission agreed with BARNZ in general, also noting the risks around incentives where suppliers' actual credit ratings are used. However the Commission went on to satisfy itself in this case, and CIAL supports its approach. The Commission didn't simply accept CIAL's credit rating but rather assessed it and found it to be adequate and represent a "prudent level of debt financing" (see paragraph 82 of the Draft Report).

38 On asset beta, CIAL refers to its submission (see from paragraph 45). We appreciate the further guidance the Commission has given about the evidence that CIAL provided in its proposal and on the further matters the Commission would like to see addressed. CIAL will consider and reflect on this guidance, and has raised two matters where we would appreciate further guidance from the Commission.

Capital expenditure – terminal reconfiguration

39 CIAL has forecast $10.4m in costs for terminal reconfiguration during PSE3, aimed at increasing the efficient and flexible use of CIAL's terminal without incurring substantial additional capital expenditure. For reference, $10.4m is well below the statutory threshold for consultation.[10]

40 Despite this, airports regularly consult with airlines for capital expenditure below the consultation threshold and during consultation CIAL explained the purpose of the project and gave examples of the types of projects that would be considered. We agree with the Commission that it's clear and to be expected that some degree of investment would be necessary to achieve improved flexibility in the integrated terminal.

41 The Commission and airlines in submissions raised no concerns that the level of funding allocated was inappropriate or the allocation wouldn't be spent. Air New Zealand specifically agreed in principle that "this project is preferable to incurring substantial capital expenditure to increase capacity in one area while other areas remain under-utilised." Airlines' only other notes relate to the detail given in consultation. CIAL remains of the view that it was sufficient, and as the Commission has stated some degree of expenditure was to be expected.

Operating costs

42 BARNZ has asked for the Commission to focus on driving efficiencies and not accepting that past costs are a reasonable starting point. The Commission has sufficiently addressed this point already, from paragraph B109 of the Draft Report.

Demand

43 The Commission raised no concerns with CIAL's demand forecasts. In response to Air New Zealand's question: those demand forecasts took into account forecast growth incentives. CIAL's forecast demand used bottom up (or "supply-based") information wherever possible and focused on demand growth, which inherently takes into account incentives and their impact on the starting point demand.

[10] For context: airports are required by section 4C of the Airport Authorities Act to consult on capex projects worth more than 20% of the airport's RAB. CIAL's terminal configuration project is well below this threshold, at approximately 3% of RAB. Nonetheless CIAL considered it useful to consult with airlines and explain its intentions.

44 The Commission considered the impact of growth incentives in calculating CIAL's expected returns because incentives had been taken into account when forecasting demand. The Commission sets this out at footnote 49 of the Draft Report.

PART C: CONCLUSION

45 The ID regime and Commission's process has had a number of key outcomes worth highlighting, especially:

45.1 CIAL is not targeting excessive returns on its priced services, i.e. those that were the subject of its third price setting event;

45.2 CIAL has learned from previous processes and taken a number of positive steps, including:

(a) using a tilted annuity approach to depreciation aimed at increasing simplicity and transparency, supported by airlines and the Commission;

(b) setting efficient and subsidy-free prices that avoid arbitrary distinctions between types of aircraft and passenger origins/destinations, supported by the majority of airlines and the Commission; and

(c) aligning (where possible) its pricing RAB with its disclosure RAB, increasing transparency and ease of understanding.

45.3 CIAL, the airlines and the Commission all largely agree on the approach to assessing returns on non-priced / other regulated services – taking a flexible and separate approach and considering those services over a longer period than five years.

46 The Commission clearly understands the issues at play and has approached its s53B review in an effective manner. We reiterate that there are some areas where CIAL believes the Commission could change its emphasis or highlight positive outcomes. In particular, outcomes such as CIAL's positive change to depreciation should not be lost simply because they are non-controversial. The Commission should also be careful to ensure statements that it hasn't yet formed a view (e.g. on assessment of other regulated services) aren't read as negative statements about CIAL's approach.

47 The price setting, ID and now s53B review processes have been long and thorough. CIAL appreciates the level of effort put in by all stakeholders. This process and the Commission's analysis have set up PSE3 well for CIAL, airline customers, passengers and other stakeholders. We look forward to future engagement in the Airport Authorities Act and ID regimes.

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