6 September 2018

INTRODUCTION

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

2. The NZ Airports contact for this submission is:

Kevin Ward
Chief Executive
PO Box 11 369
Manners Street
Wellington 6011

Email: kevin.ward@nzairports.co.nz

EXECUTIVE SUMMARY

3. There is an interesting divergence of views in the airlines' submissions on the Draft Report – particularly in respect to expected returns and pricing structures. It is important to NZ Airports that, in the interests of regulatory predictability, the Commission adheres to the profitability assessment signalled in the ID schedules, which it has done in the Draft Report. It should not now be distracted by submissions from individual airlines that disregard the clear ID requirements.

4. Accordingly, the airline submissions do not provide any reason to alter the positive endorsement of Christchurch Airport's performance in the Draft Report – in particular that its expected profitability for priced services is reasonable. For the Final Report, we repeat our earlier encouragement that the Commission better reflects this positive performance in its executive summary and media statements.

5. We disagree with BARNZ's view that the Commission's assessment of debt premium is inconsistent with regulatory precedent. To the contrary, the Commission's approach will achieve an appropriate balance between ensuring airports are not under-compensated, while ensuring they do not have incentives to inappropriately increase gearing.

6. We are pleased to see a great deal of common ground on an appropriate flexible assessment for non-priced services. Stakeholders agree that assessment must take place over a longer period of time.

EXPECTED RETURNS

7. NZ Airports is pleased that BARNZ agrees that Christchurch Airport's expected returns for priced services are reasonable:[1]

---

[1] BARNZ *Submission on Draft Report on Christchurch Airport's pricing decisions and expected performance: PSE3*, 16 August 2018 ("**BARNZ Submission**") at 12.

> Christchurch Airport has disclosed a target return of 6.44% for priced services in PSE3. This is close to the mid-point of the Commission's range at 6.41% and the Commission's adjusted mid-point (discussed below) of 6.47%. The Commission considers that the 6.44% target return is reasonable. BARNZ agrees.

8. The concerns expressed by Air NZ focus on Christchurch Airport's airport-specific pricing WACC, and how that impacts on prices paid by Air NZ. It therefore appears that the differences in views between airlines reflect each party's assessment of how the prices set will impact on their own commercial interests over PSE3.

9. However, the Commission's task is to assess whether Christchurch Airport is limited in its ability to extract excessive profits. Following lengthy consultation as part of the IM Review, the Commission has established clear ID requirements to allow it (and other interested parties) to make that assessment, using IRR as the measure. As such, the Commission is correct to focus on expected returns in accordance with the ID schedules when assessing profitability.

10. A positive feature of the ID regime is that airports have flexibility in setting prices, including providing incentives to encourage route development, as Christchurch Airport has over PSE3. Incentivising route development is a legitimate commercial decision that the ID regime intended airports to still be able to make, like firms in competitive industries.

11. The Commission noted that Christchurch Airport absorbed the cost of incentives under existing contracts, but allowed for the effect of currently forecast incentive spend on its forecasts of demand. There is no suggestion that Christchurch Airport's approach was inappropriate, such that pricing incentives should not be incorporated in expected returns in the manner anticipated by the ID requirements. To the contrary, if Christchurch Airport is successful in stimulating growth, there will be considerable benefits for consumers in the long term, including:

    (a) lowering Christchurch Airport's unit costs over time;[2] and

    (b) greater choice in air services, and potentially lower prices, for passengers.

12. It is helpful for interested parties to understand that the Commission considers route development investment to be in the long term interests of consumers. The Commission has emphasised that is important to keep the bigger picture in mind, rather than having a narrow focus on which airline pays what prices:[3]

> While route incentives appear to be simply a lower price for a particular airline, there are benefits to other airlines. The other airlines can benefit in the long run through the fixed (if not constrained) airport costs being spread over more flights once the route incentive is lifted and the new route has established itself at the airport (or during the route incentive period, if the remaining charge is greater than the short run incremental cost). This benefit could flow through to consumers in the form of increased competition between airlines and, as a result of increased competition, lower prices.

13. Christchurch Airport has transparently disclosed pricing incentives in accordance with the IRR schedules established at the conclusion of the IM Review. NZ Airports therefore

[2] Draft Report at [B92]. As noted by the Commission, airlines gain this benefit without having to pay for it.
[3] IM Review Decisions, Topic Paper 5, 20 December 2016 at [679].

believes the concerns airlines have raised about the way Christchurch Airport has presented its disclosure compared to what they understood at the time of pricing are unjustified. They knew what the disclosure requirements were and, as noted by BARNZ, there is no impact on profitability in any event.

14. Airports work extremely hard to ensure transparency and clarity in consultation and information disclosures. They expend significant time and resources on these processes, and are fully committed to making the regulatory regime effective.

15. Airlines are very experienced and well-resourced participants in consultation processes, and have a deep understanding of the ID regime. Those consultation processes are informed by and responsive to airline feedback. They have every opportunity to ask for further information during consultations, and to assess it in a manner consistent with the ID requirements.

16. In summary, when assessing whether airports are limited in their ability to earn excess profits, the Commission is right to focus on expected profitability calculated in accordance with the ID schedules (which includes adjustments for pricing incentives). It is in the long-term interests of consumers for airports to provide incentives for route development.

DEBT PREMIUM

17. BARNZ states in its submission that the use of Christchurch's own credit rating (BBB+) is a departure from regulatory precedent, and therefore could cause consumer harm.[4]

18. We disagree that there is a regulatory precedent issue here. If BARNZ drew a clearer distinction between price control and the ID Regime, then it would appreciate that the Commission's acceptance of Christchurch Airport's debt premium is entirely appropriate under the new and unique profitability assessment framework for airports. In particular:

    (a) The IMs incorporate a credit rating that the Commission believes provides the right incentives on an industry-wide basis (eg it does not provide an incentive for regulated entities to increase gearing with adverse implications for consumers).

    (b) This does not mean that the IM credit rating is appropriate for each airport – especially if an airport would be under-compensated if it was applied in its circumstances (ie because its actual credit rating was lower).

    (c) Under ID (compared to price control), there is an opportunity to assess whether an airport's use of its own credit rating is consistent with the Part 4 purpose statement. That is, it is possible to assess whether the airport has inappropriately increased its gearing to the detriment of consumers.

    (d) We do not understand the Commission to have established that each airport is automatically entitled to use its own credit rating. The Commission noted that Christchurch Airport's credit rating of BBB+ "appears to reflect a prudent level of debt financing" and that it "reflects our estimate for electricity distribution businesses".[5] Accordingly, there is no risk that the Commission's assessment will incentivise inappropriate gearing.

[4] BARNZ Submission at [21] – [26].

[5] Draft Report at [A78].

19. In summary, there is no evidence that the Commission's assessment of Christchurch Airport's credit rating will create a risk that it will inappropriately increase its gearing to the detriment of consumers. On the other hand, there is clear evidence that Christchurch Airport would be under-compensated if it applied the WACC IM debt premium in its pricing. It is important for all airports that the Commission continues to provide flexibility for each airport to adopt approaches to cost of debt that best meet the purpose of Part 4.

PRICING STRUCTURE

20. The airlines have different views on Christchurch Airport's pricing structure.

21. Air NZ opposes the new pricing structure on a number of grounds, while BARNZ notes that it:[6]

> agrees with the Commission that Christchurch Airport’s new charging structure does not raise significant efficiency concerns in relation to the airlines that we represent. Overall, we support the pricing structure that has been introduced.

22. We agree with the Commission and BARNZ that the right approach is to focus on overall efficiency considerations. The Commission has recognised that Christchurch Airport's per-passenger charges:[7]

    (a) are simple to understand, transparent, and are likely to reduce airlines exposure to demand risk;

    (b) are likely to encourage improved allocation of demand – ie move passengers from the more congested regional terminal to the less congested integrated terminal as opposed to expanding the available terminal space at the cost of consumers); and

    (c) are unlikely to result in cross-subsidisation between operators of different aircraft.

23. Overall, the Commission found that the new charging structure could represent an improvement in efficiency compared to PSE2.[8]

24. In summary, the Commission's assessment approach encourages airports to adopt pricing structures that promise greater overall efficiency in the long term – which Christchurch Airport has done.

NON PRICED SERVICES

25. NZ Airports is pleased that there is good common ground between interested parties in respect of an appropriate approach to non-priced services. We agree with BARNZ that:[9]

    (a) a new approach to assessing returns is likely needed;

    (b) options should be explored for reviewing returns over different timeframes; and

    (c) a consistent approach to non-priced services should be adopted.

---

[6] BARNZ Submission at [27].
[7] Draft Report at [133] – [136].
[8] Draft Report at [137].
[9] BARNZ Submission at [29] – [40].

26. In our view, the common theme between submissions provides a good basis to consider any alternative assessment approach in the future.