

BARNZ RESPONSES TO COMMERCE COMMISSION SECTION 56G ISSUES PAPER
RELATING TO CHRISTCHURCH AIRPORT

22 March 2013

This submission, in its entirety, is made on behalf of Air Pacific, Airwork/Express Couriers Ltd, Emirates, Fieldair Holdings/Air Freight, Virgin Australia and Singapore Airlines.

BARNZ held written authority under s2A of the Airport Authorities Act 1966 to represent Air Pacific, Emirates, Virgin Australia and Singapore Airlines (the 'international-only airlines') during consultation over charges with Christchurch Airport.

Airwork and Fieldair Holdings/Airfreight represented themselves during consultation with Christchurch Airport.

In addition, these responses are made on behalf of the Air NZ Group, although Air NZ will also be making a submission of its own directly to the Commission. If there is any matter where Air NZ holds a different view to that expressed by BARNZ, then this will be identified in Air NZ's individual submission.

Jetstar will respond separately to the Commerce Commission on behalf of itself and Qantas.

Is Christchurch Airport earning an appropriate economic return over time?

1. Is Christchurch Airport targeting an appropriate return, and why?

No.

Christchurch Airport adopted a post-tax cost of capital of 9.76% (which it grossed up to a pre-tax cost of capital of 13.6%). This is significantly greater than the Commerce Commission's most recent mid-point estimate released 30 July 2012 of an appropriate post-tax WACC for specified airport services of 6.49% (with a range of 5.51% to 7.48% from the 25th to 75th percentiles).

In percentage terms, Christchurch Airport's WACC is 50% greater than the Commerce Commission's mid-point WACC and 28% greater than the Commerce Commission's 75th percentile WACC.

BARNZ considers that Christchurch Airport is targeting a cost of capital significantly greater than the level required to earn a reasonable return. Advice received by BARNZ is that a post-tax nominal return of 7.06% is appropriate for the characteristics of Christchurch Airport's aeronautical business.

The core differences between the WACC used by Christchurch Airport and the Commerce Commission's WACC Determination for Part 4 information disclosure monitoring are:

- Christchurch Airport has used a 10 year cost of debt of 4.31% for calculating the cost of debt, which is approximately 1.5% higher than the five year cost of debt in July, which is considered the appropriate length of debt by the Commerce Commission.
- Christchurch Airport has used the historical average ten year cost of debt, over the previous ten years, of 6% to calculate the cost of equity, rather than the current, forward looking, five year cost of debt (2.78% as at July 2012) used by the Commission.
- Christchurch Airport has applied a debt premium for a BBB rated firm of 2.35%, rather than the A- rated debt premium considered appropriate by the Commission, 2.18% as at July 2012.
- Christchurch Airport has adopted a leverage ratio of 26% debt, rather than the 17% leverage considered representative of an efficient debt structure for airports by the Commission.
- Christchurch Airport has used an asset beta of 0.70 rather than the asset beta of 0.60 identified as reasonable by the Commission for the airport sector.
- Christchurch Airport has used a PTMRP of 7.5% rather than the 7.0% identified as reasonable by the Commission for all regulated industries.

During consultation BARNZ twice sought advice from Dr Brent Layton of Futures Consultants Ltd (FCL) on whether there is any valid reason for Christchurch Airport adopting different inputs, when calculating its WACC for the purposes of setting prices, than the Commerce Commission inputs developed for the purposes of information disclosure. The reports from FCL are attached as Attachment 1 and Attachment 2. In brief, those reports concluded:

- The debt premium should reflect that of a typical efficient operator (identified by the Commission as an airport with an A- credit rating) rather than the BBB credit rating of Christchurch Airport. There is no justification for a higher debt premium.
- The Commission's methodology of measuring the debt premium on a single day is susceptible to distortions in several ways. The first susceptibility to distortion arises out of the Commission's methodology of measuring the debt premium on a single day. FCL considered that this could be remedied by using the monthly average to measure the debt premium. That suggested a debt premium of 1.64%. The second susceptibility to distortion arises out of recent revelations and admissions that interest rates of a similar nature and derivation to Bloomberg's (specified by the Commerce Commission in its input methodologies) have been subject to systematic and material manipulation by banks in Europe. FCL recommended the use of publicly available yields for AIAL bonds published daily by the NZSE. That suggested a debt premium of 1.68% rather than the 2.18% identified by the Commission as at 1 July 2012 using Bloomberg data.
- The 0.35% debt issuance cost allowed by the Commission is generous and BARNZ and airlines could be justified in arguing that 0.22% is more appropriate.

- The Commission concluded that use of a ten year risk free rate is inappropriate as the Airport has the ability to reset its WACC, and charges, should the rate change during the first five years. Suppliers would be compensated for a risk that they are not taking if a ten year rate was used rather than a five year rate. The term of the risk-free rate is not a firm specific parameter and there is no justification for Christchurch Airport adopting an approach different to the Commission's five year rate.
- The same risk-free rate should be used to calculate both the cost of debt and the cost of equity. There is no justification for using a different and higher risk free rate to calculate the cost of equity. WACC is forward looking and using a historical average of rates is inconsistent with this principle.
- Basing leverage on actual or target leverage, rather than the average leverage of 17% across airports as determined by the Commission, is inappropriate as it would incentivise firms to increase leverage beyond the optimal level in order to raise their WACCs, which is not in the long term interest of consumers.
- Christchurch Airport has a higher percentage of leisure based travel than the other main New Zealand Airports. Since leisure based travel is more sensitive to income movements than business travel, Christchurch Airport warrants a slightly higher asset beta for aeronautical assets than the other main airports as its returns are likely to be more strongly correlated with movements in the overall market. An uplift of 0.05 to the Commission's 0.6 industry wide asset beta may be justified, resulting in an asset beta for Christchurch Airport of 0.65.
- The Commission's 7.0% TAMRP is an appropriate estimate in the New Zealand context. TAMRP is a market specific parameter, not firm specific, and Christchurch Airport have not provided sufficient justification for adopting a different estimate from the Commission.

In essence, FCL concluded that, other than with respect to the methodology for measuring debt premium, debt issuance costs and asset beta, there is no justification for Christchurch Airport adopting different parameter estimates when estimating its WACC for the purposes of setting charges from what the Commerce Commission uses for airports for the purposes of information disclosure. With respect to the three inputs where FCL considered a different input from the Commission was justified, FCL supported:

- Reducing the debt premium to 1.68% to reflect the monthly average and publicly available yields of traded A- bonds;
- Reducing the cost of debt issuance costs from 0.35% to 0.22%; and
- Increasing the asset beta by 0.05.

This resulted in FCL recommending a mid-point post-tax WACC estimate of 7.00%.

In its Alternative Revenue Calculation of Christchurch Airport's Pricing Proposals BARNZ used the Commerce Commission's determination of appropriate WACC inputs, with the exception of asset beta. For the asset beta, BARNZ applied FCL's advice that a 0.05 uplift to the asset beta allowed by the Commerce Commission is justified in the case of Christchurch Airport, to reflect the higher proportion of leisure based travellers moving through the airport.

BARNZ did not reduce the debt premium to reflect the monthly average or the publicly traded debt yields and likewise, did not reduce the allowance for debt issuance costs, as FCL suggested BARNZ could. While BARNZ acknowledges and agrees with the validity of the concerns raised by FCL, this is an issue which we understood the Commission was considering across all regulated industries. The resulting mid-point post-tax WACC with an increased asset beta, but with the debt premium left unchanged from the Commission's 1 July 2012 Determination, was 7.06%, with the 75th percentile estimate being 8.07%.

BARNZ continues to consider it is appropriate to apply an appropriate mid-point estimate WACC based on what an efficient debt structure and costs would be for the industry. A higher level of WACC just increases the likelihood of the asset owner earning excessive returns.

A comparison of the inputs used by the Commerce Commission in its latest Cost of Capital for airports and CIAL/PWC, FCL and BARNZ is set out below:

	ComCom Airports July 2012 Mid- point	CIAL PWC WACC July 2012	FCL WACC September 2012	BARNZ WACC September 2012
Risk-free Rate before Tax (debt)	2.78%	4.31%	3.06%	3.06%
Risk-free Rate before Tax (equity)	2.78%	6.00%	3.06%	3.06%
Debt Premium	2.18%	2.35%	1.68%	2.18%
Debt Issue Costs	0.35%	0.35%	0.35%	0.35%
Market Risk Premium	7.0%	7.5%	7.0%	7.0%
Leverage	17.0%	26%	17%	17%
Beta (Asset)	0.60	0.70	0.65	0.65
Investor Tax Rate	28%	28%	28%	28%
Cost of Debt				
RFRBT + Debt Premium + Debt Issuance	5.31%	7.01%	5.09%	5.59%
Cost of Equity				
Beta (Equity) = BetaA/(1-Lev)	0.72	0.95%	0.78	0.78
RFRBT*(1-Ti)+BetaE*TAMRP	7.04%	11.41%	7.69%	7.69%
Mid-point Post Tax Weighted Average Cost of Capital	6.49%	9.76%	7.00%	7.06%

2. Are there any indicators of superior performance that would justify Christchurch Airport earning higher than normal profits?

No

3. What wash-ups, discounts or other discretionary adjustments have been applied to the forecast revenue requirements?

There was a wash-up of revaluations over PSE1 that had not previously been treated as income and there was also a small adjustment to assets to reflect the retention by Christchurch Airport of the \$5 component of the international passenger charge that was previously passed onto the Government to meet Avsec and CAA costs.

Treatment of previous revaluations as income

Christchurch Airport treated virtually all revaluations which occurred during PSE1 as income as it set charges in PSE2.¹ This was because the Airport had adopted a Moratorium on asset revaluations as it set charges in PSE1 and had not taken into account any forecast revaluations as it set charges in 2008.

These revaluations amounted to \$33.5m. Christchurch Airport's financial model treated these as income spread evenly over the 4 year seven month pricing period, with an allowance for the opportunity cost of capital applied to compensate airlines for the time value of money. The full credit in nominal terms was \$48.2m. Note there is an outstanding difference between BARNZ and Christchurch Airport in relation to the calculation of tax in relation to revaluation gains where a pre-tax WACC is used.²

Adjustment to assets for retention of \$5 of international passenger charge

There was a \$1.8m adjustment to asset values representing the 'over-payment' of the international departure charge which occurred from 2005 until March 2009 as a result of the departure charge paid by international passengers to the Airport remaining unchanged at \$25, despite airlines assuming responsibility for meeting Aviation Security costs and CAA levies, which had previously been paid by the Airports out of the revenue collected from international passengers in the departure charge.

The then Avsec and CAA charges amounted to \$5 per departing international passenger. At that time, all international airports were undertaking unexpected modifications to their terminal buildings to allow hold stow baggage screening equipment to be installed. Christchurch Airport and airlines agreed that the international departure charge should remain at its current level of \$25 until charges were next reset, with the Airport retaining the \$5 previously paid to Avsec and CAA, with this amount used to meet the capital expenditure associated with the previously un-forecast security requirements, and any remaining monies treated as a credit when charges were reset. While Auckland and Wellington Airports made this adjustment by way of a credit of the amount when charges were next reset, Christchurch Airport elected to make it by removing assets to the value of the remaining money from the asset base on which charges are set.

¹ The exception is the first five months of FY13 which Christchurch Airport's financial model does not treat as income due to the mechanics of how the part year adjustment occurs in the financial model. This amounts to approximately \$3.4m of forecast revaluations from PSE1 not treated as income in PSE2.

² This is discussed in question 11 below.

The majority of these assets related to facilities in now demolished parts of the terminal building and are therefore no longer relevant. However some \$1.8m of airfield assets purchased with the credit are still in use and were removed from the pricing asset base by Christchurch Airport.

4. How reasonable is Christchurch Airport's revenue forecast for the second PSE compared to the first PSE forecasts, and why?

Christchurch Airport set charges in both PSE1 and PSE2 at levels forecast to earn substantial excess returns.

In PSE 1 BARNZ estimated that the additional revenue which would be paid by airlines and passengers above the level necessary to provide a reasonable return was \$43m over three years.

Over the four years and seven months years of PSE 2 BARNZ analysis indicates that additional revenue will be paid by airlines and passengers of between \$38m and \$64m across the mid-point to 75th percentile WACC range.

The primary matters in contention have changed between the two pricing periods. In the first pricing period the key issues were the asset base valuation and treatment of revaluations. In PSE 2 the key differences are the level of WACC and the mechanics of treating revaluations as income in a pre-tax pricing model.

The level of forecast revenue in both pricing periods is significantly above that necessary to provide a reasonable return and, in both cases prices were set at a level to target excessive returns. In BARNZ's view, the level of revenue forecast for the second PSE is no more reasonable than the level of revenue forecasts for the first PSE, and in both cases Christchurch Airport exercised monopoly power to set charges significantly above those which would occur in a workably competitive market. Information disclosure under Part 4 has not proved effective at limiting the ability of airports to extract excessive profits.

Summary of PSE1 Charges

When Christchurch Airport set charges in 2008 it did so on the basis of a \$162.5m revaluation of its aeronautical pricing assets, virtually none of which had been, or was, treated as income in the charge setting process.³ Christchurch Airport then proceeded to forecast revaluations at nil, advising it was adopting a moratorium on revaluations for two pricing periods until 30 June 2016, stating this provided '*a means of ensuring CIAL is not compromised from a cash perspective and reduce[d] the uncertainties arising from estimating future revaluation rises*'.

³ Financial Models from the charge setting process undertaken by Christchurch Airport in 2000 show that \$8.8m of revaluations were forecast at that time and included as income in the charge setting process in 2000. Thus \$153.7m of the \$162.5m revaluations undertaken by Christchurch Airport from 2000 to 2007 have never been treated as income in the charge setting process, despite Christchurch Airport setting charges using a nominal WACC.

This approach was unilaterally adopted by the Airport despite strong objections from BARNZ and airlines at the time that Christchurch Airport’s approach resulted in a windfall gain for the airport and would result in significant excess returns.

BARNZ originally analysed Christchurch Airport’s required revenue on the basis of both a rolled forward asset base excluding revaluations, using the asset base from when charges were previously set in 2000 as the base year, and a revalued asset base treating the revaluations as income. However when it became apparent that Christchurch Airport was not prepared to treat any of the unforecast \$154m of revaluations gains as income in the charge setting process, then BARNZ undertook its final analysis on the basis of a rolled forward asset base from 2000.

Christchurch Airport set charges so as to result in revenue of \$137.2m over three years.⁴ BARNZ’s analysis at that time was that over a three year period, required revenue was \$93.7m. The difference in terms of additional revenue paid by passengers and airlines was therefore forecast to amount to \$43.5m. The difference in relation to the level of the various charges for PSE 1 is set out below:

Outcome of BARNZ and Christchurch Airport Financial Models for PSE1

	CIAL Revised Proposal	BARNZ Revised Assessment
Airfield	60% average increase	19% increase
International Terminal Charge	Unchanged at \$3.39 per departing passenger	Unchanged at \$3.39 per departing passenger
International Passenger Departure Charge	Unchanged at \$11.11 per arriving and departing passenger	47% reduction to \$5.83 per arriving and departing passenger
Domestic Terminal Charge	Unchanged at \$1.62 per departing passenger	75% reduction to \$0.41 per departing passenger

Summary of outcome for PSE 2

Overall, BARNZ assesses that the charges and charging structure Christchurch Airport has set will result in it earning excess returns of between \$21m and \$37m over the second pricing period across the Commerce Commission WACC range, individualised for Christchurch Airport with a higher asset beta. This represents additional revenue which will be paid by airlines and passengers of between \$38m and \$64m across the WACC range.

This over-recovery is almost entirely attributable to the increases in airfield charges, and in particular the combination of the proposed introduction of a fixed charge of \$150 per departing aircraft together with substantial increases to MCTOW rates.

There are two key areas where Christchurch Airport’s building block model diverges markedly from the Commerce Commission’s framework.

⁴ Christchurch Airport Aeronautical Pricing Model, version 7, 27 February 2009.

The first major departure is in relation to WACC. The airport set its WACC using higher interest rates than the current rates, together with a higher asset beta, higher MRP and higher leverage ratio, which combined together to result in a 9.8% WACC. The Commerce Commission's WACC estimate for information disclosure purposes is currently 6.49% (with a range of 5.51% to 7.48%).⁵ As set out in response to question 1 above, based on advice from Futures Consultants Ltd, BARNZ considers that the appropriate mid-point WACC estimate for Christchurch Airport is 7.06% (with a 75th percentile estimate of 8.07%).

The second significant departure arises over the tax calculation. Christchurch Airport uses a pre-tax WACC. Had all income been taxable, the same result would have been derived, but revaluations are not taxable. In deducting revaluations to determine the allowable revenue, Christchurch Airport has not grossed them up for tax. It has thereby lifted allowable revenue (by reducing the deduction). As the revaluations amount to about \$90m in Christchurch Airport's financial model, the model overstates required revenue by approximately \$35m for this one aspect. This is discussed in greater detail in response to question 11.

Other issues, albeit of a less material impact, include:

- The Airport is not appropriately allocating its circulation space and thoroughfares in its land-side areas of the Terminal, with an insufficient allocation of this common space to commercial activities. The impact of this adjustment is in the vicinity of a reduction of \$5.5m to the pricing asset base.
- Forecast increases in domestic jet MCTOW and departing seats are understated and appear not to have taken sufficient account of Air NZ's upgrading of its domestic jet fleet to A320s which are 25% heavier, and which have a seating capacity 29% greater than the current 737s.
- The Airport has calculated its allowance for tax using regulatory depreciation, rather than tax deductible depreciation. This has the effect of under-stating tax.
- There remain unresolved issues regarding the appropriate amount of land to be included within the airfield asset base, with Christchurch Airport including a larger than justifiable allowance (of 70 metres) around the runway so as to include all land within a building line restriction of 10 metres in height.

Adjusting the building block analysis of required revenue for the matters listed above produces the following NPV outcomes for Christchurch Airport's proposed prices at the Commerce Commission updated WACC range from the mid-point WACC of 7.06% to the 75th percentile WACC estimate of 8.07%:

⁵ Cost of Capital Determination for Information Disclosure Year 2013 For Specified Airport Services (with a June year end) [2012] NZCC 20.

NPV Outcomes of Charges Set by Christchurch Airport for PSE 2

	CIAL Financial Model at 13.6% pre-tax WACC	BARNZ Alternative Revenue Analysis at 8.07% post-tax WACC	BARNZ Alternative Revenue Analysis at 7.06% post-tax WACC
Airfield	\$0.5m	\$28.0m	\$36.8m
International Terminal	(\$16.5m)	(\$6.7m)	(\$2.5m)
Domestic Jet Terminal	(\$8.5m)	\$1.4m	\$4.3m
Domestic Turbo-prop Terminal	(\$2.9m)	(\$1.9m)	(\$1.5m)
Combined Outcome	(\$27.4m)	\$20.9m	\$37.1m

BARNZ's Alternative Revenue Model setting out this analysis is attached as Attachment 3.

As a result of this analysis BARNZ's Assessment of the reasonableness of the various proposed charges was as follows:

Charges proposed by CIAL	Assessment by BARNZ
Overall 49% increase to jet MCTOW rates over the pricing period	Combination of increases to MCTOW rates and introduction of fixed charge result in substantial excess returns, both on the airfield and across all pricing activities. CIAL can only justify one change or the other, ie: <ul style="list-style-type: none"> • Annual 7% increases to all MCTOW rates with no fixed charge; <u>or</u> • Introduce the fixed charge with all MCTOW rates remaining unchanged at current levels for the pricing period
Overall 27% increase to turbo-prop MCTOW rates over the pricing period	
Introduction of a \$150 per departure fixed charge, increasing by 2.1% thereafter, with a 50% reduction for aircraft less than 20 tonnes	
International terminal charges and PSC remain constant over pricing period but with current 2 to 11 year old exemption from the PSC removed	Proposed charges reasonable
425% increase over the pricing period to domestic terminal charge on departing seats on jet aircraft	Initial increase in charges not unreasonable, however the subsequent 37% uplift in January 2015 is not fully justified and will result in over-recovery and in charges in the last two years of the pricing period exceeding required revenue.
68% increase over the pricing period to domestic terminal charge on departing seats on turbo-prop aircraft	Overall increase in revenue not unreasonable

It is worth noting that the proposed airfield charges will result in over-recovery of between \$28.0m and \$36.8m over the 4 years, 7 months of the new pricing period. The combination of both the proposed new fixed charge and the substantial increases in MCTOW rates in FY14, FY15 and FY16 creates significant over-recovery on the airfield cost centre. It seems apparent that Christchurch Airport is endeavouring to recoup the shortfall on its terminal investment by over-charging for use of the airfield.

5. To what extent did actual results for the first PSE differ from forecasts, and why?

The Christchurch earthquakes in 2010 and 2011 resulted in a considerable reduction in passenger movements through Christchurch Airport. Thus the revenue forecast to be earned by the Airport as it set charges in 2009 was not achieved.

Forecast vs actual revenue earned by Christchurch Airport during PSE 1

	Forecast Revenue from charges	Actual revenue from charges disclosed in Financial Disclosure Statements
FY09	\$41.2m	\$39.4m
FY10	\$45.4m	\$42.8m
FY11	\$50.9m	\$41.5m

In addition, damage caused by the Earthquake resulted in unforecast increases in operating costs and capex in order to fix damage not covered by insurance policies.

6. What is the extent of differences, if any, between cost allocation methodologies and cost categories used for 2011/12 historical reporting under information disclosure and the second PSE price-setting?

The only differences that BARNZ is aware of between the cost allocation methodologies used by Christchurch Airport in price setting and those used in information disclosure historical reporting are that:

- The pricing asset and cost base is only a subset of the financial disclosure asset and cost base. The pricing asset base thus excludes leased activities and activities where charges were set separately.
- Christchurch Airport altered its allocation of route development costs during consultation, to exclude costs which were airline or route specific from the costs used to set charges. The impact of this change was a reduction of \$0.8m in FY13 or \$4.5m over the pricing period.⁶

⁶ Refer Christchurch Airport Revised Pricing Proposal, 31 July 2012, page 24.

7. How reasonable are Christchurch Airport's asset valuations and why?

Christchurch Airport's 2011 MVAU land valuation is considered reasonable.

During consultation BARNZ sought advice from Zomac Planning Solutions (ZPS) and Property Advisory Ltd (PAL) on the 2009 and 2011 MVAU valuations undertaken by Seagars (based on an alternative land use plan prepared by Planit). ZPS and PAL were both requested to peer review the Seagar MVAU land valuation and the Planit alternative land use plan using the Commerce Commission's land valuation methodology as set out in Schedule A of the Commission's Input Methodologies Determination dated 22 December 2010. These reports can be provided to the Commission should it wish to review them.

ZPS advised BARNZ that it considered both of the land use plans proposed by Planit are plausible, although a note of caution was sounded with respect to the level of residential development likely to be permitted in the area, as opposed to less intensive rural-residential. Given the overall conclusion by ZPS that the alternative land use plans were plausible, no further comment is necessary with respect to planning matters.

PAL initially identified concerns regarding the Seagar MVAU land valuation having taken into account matters post the 30 June 2009 valuation date (in particular, planning changes) in assessing the value of the Airport's aeronautical land holdings. It was noted that while these matters were undoubtedly relevant to an MVAU being undertaken as at today's date, they should not have been taken into account in a valuation undertaken as at 30 June 2009 — as directed by the Commission in its input methodologies. Given that Christchurch Airport then updated its MVAU valuation to 2011, and treated the revaluation gains from both the 2009 and 2011 revaluations as income, there was not any valid reason to continue to pursue this issue from the perspective of determining charges.⁷

In its Revised Pricing Proposal and Final Pricing Decision Christchurch Airport applied the Commerce Commission input methodology to determine the valuation of its specialised assets – namely indexing forward the 2009 disclosed valuation together with adjustments for capital expenditure, depreciation, disposals and lost and found assets.⁸ BARNZ considered Christchurch Airport's valuation approach appropriate as it both followed the Commission's input methodologies and it treated the revaluations as income as it reset its charges.⁹

8. What do parties consider to be the most likely basis of asset valuation used to set prices after 2017?

Christchurch Airport's Final Pricing Decision applied the Commerce Commission asset valuation input methodologies as it set its charges for PSE2.

⁷ BARNZ does however note that this is still a relevant issue from the perspective of the Commerce Commission, in its task of assessing regulatory income in FY11 and FY12.

⁸ Christchurch Airport's Initial Pricing Proposal was based on new ODRC revaluations of specialised assets.

⁹ There does however remain the issue of the appropriate treatment of revaluations when a pre-tax pricing model is adopted. BARNZ considers that Christchurch Airport has not treated revaluations consistently with its pre-tax approach, and is thus effectively not treating 28% of revaluations as income.

However, the Airport has not made any commitments as to the approach it will adopt in PSE3.

During consultation BARNZ sought clarification from Christchurch Airport as to what aspects of the methodology and what inputs were being committed to by the Airport going forward.

The answer was '**NONE**'.

Christchurch Airport stated:¹⁰

CIAL is required to consult on prices every 5 years. The Airport Authorities Act requires CIAL to approach each consultation with an open mind. Hence, while CIAL can consult on a preferred proposal at the next price re-set, it cannot close its mind to options.

As a result, the regulatory environment for the airport price setting makes it impossible for the CIAL to give a "commitment" now that purports to take something off the table in 5 years' time.

BARNZ does not think that any assumption can be made that Christchurch Airport will apply the same valuation methodologies in PSE 3 as it did in PSE 2.

Christchurch Airport's first financial model provided to the airlines during consultation was based on a 2011 MVEU of land and 2010 and 2011 ODRC revaluations of specialised assets.

Christchurch Airport's financial reporting has adopted asset valuations based on MVEU for land and new ODRC valuations for specialised assets.

Christchurch Airport is party to the current merits review proceeding submitting that the input methodologies should be based on new MVEU valuations of land and new ODRC valuations of specialised assets.

During the development of the input methodologies by the Commerce Commission, Christchurch Airport also strongly submitted that MVEU and new ODRC valuations should be adopted. Moreover, Christchurch Airport's first financial model provided to the airlines was based on new ODRC valuations of its specialised assets.

The current regulatory regime for airports, comprising information disclosure under Part 4 of the Commerce Act coupled with the ability of airports to set prices as they think fit under section 4 of the Airport Authorities Act, leaves an airport open to adopt valuation approaches which differ to the Commission's input methodologies. Judicial decisions on the power to set charges under the Airport Authorities Act have highlighted how unlimited and unconstrained this power is, with the Courts holding that airport charges set under s4A of the Airport Authorities Act cannot be challenged by judicial review on the grounds of unreasonableness.¹¹

¹⁰ Written responses by Christchurch Airport to questions asked by airlines at a briefing on 23 August 2012, page 5.

¹¹ *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98.

9. Has Christchurch Airport appropriately excluded assets held for future use?

BARNZ has not identified any issues regarding Christchurch Airport's exclusion of assets held for future use.

However, an outstanding issue does exist around identification of the land used to provide the regulated services.

The question is how much land around the airfield is necessary in order to provide the regulated services? Christchurch Airport has included land out to the point that a building 10 metres high could be erected. This is 70 metres from the edge of the strip (given the 1:7 transitional side surface explained below). This amounts to 36.5ha. The 10m height is a subjective point adopted by Christchurch Airport despite the fact that other uses can be undertaken for said land, as is clearly highlighted around Wellington Airport.

Chapter 4, AC 139-6 addresses obstacle limitations. Paragraph 4.1.15 provides for transitional side surfaces at a gradient of 1:7 moving out from the edge of the strip. It provides that buildings or obstacles should not penetrate this surface, although exemptions appear to be allowed following an aeronautical study. The effect of chapter 4 is to restrict the height of buildings and other structures close to the runway, with permitted height increasing further from the runway. For example, land 14m from the edge of the strip would be permitted to have a structure 2m high placed on it, while land 28m from the runway would be permitted to have a 4m structure placed on it.

There is no justification for including land 70m from the runway strip in the airfield asset base. This land is not required for the provision of the regulated activities. It does not have to be owned by the airport. It is available for commercial uses, subject to the restrictions on the height of obstacles. Airlines should not be required to pay for land which is not required for the airfield to operate.

10. Do parties consider that the prices set for PSE2 will result in a permanent under-recovery of \$16 million, as stated in the Executive Summary of the 2012 Pricing Decision on page 7 of Christchurch Airport's Price Setting Disclosure?

No.

BARNZ's analysis is that the prices set for PSE2 will result in excess returns with a NPV of between \$21m and \$37m over the pricing period across the Commerce Commission WACC range, individualised for Christchurch Airport with a higher asset beta. This represents additional revenue which will be paid by airlines and passengers of between \$38m and \$64m over the four years and seven months of PSE2.

Christchurch Airport's financial model incorrectly portrays the charges it has set as resulting in a loss by virtue of using a significantly overstated WACC (9.8% as compared with the Commerce Commission's mid-point estimate for Christchurch Airport for the FY13 year of 6.49%) and as a result of Christchurch Airport's pre-tax financial model not treating all revaluations correctly as income (by virtue of it having treated the revenue earned from revaluations as being taxable).

Greater detail of BARNZ's analysis and these two key issues is set out in response to question 4 above and question 11 below.

11. Do parties consider that the prices set by Christchurch Airport will result in an appropriate recovery of the tax allowance?

BARNZ identified two concerns with respect to the calculation of the tax element in Christchurch Airport's financial model. First, the Airport did not appear to have reflected the new taxation rules regarding the non-deductibility of depreciation on buildings with lives of more than 50 years. Second, the Airport did not take into account the fact that tax is not payable on that portion of its required return met from asset revaluations. In both of these matters the Airport's approach to the calculation of tax payable is inconsistent with the Commerce Commission's approach.

Non-deductibility of building depreciation

Recent tax changes in New Zealand make depreciation on buildings non-tax-deductible. This has implications for the calculation of tax in the building block model, if the intention is to have the tax figure reflect the tax which is forecast to be payable, in which case an adjustment will be needed to the profit on which tax is calculated to reflect the fact that depreciation on most building structures will be non-tax deductible. This adjustment is reflected in the Commerce Commission's formula for calculating 'regulatory taxable income', where the formula adds back 'regulatory depreciation' and deducts 'tax depreciation'.¹²

Christchurch Airport did not make this adjustment, advising BARNZ that the Airport was participating in a process seeking to have the IRD recognise that airport terminal buildings have lives of less than 50 years.

Given that there did not appear to have been any success in the IRD review process, BARNZ made an adjustment in its alternative revenue model to reflect the non-deductibility of depreciation of building structures. The ratio of tax depreciation to regulatory depreciation for regulated airport assets in Auckland Airport's disclosure is 87% and in Wellington Airport's disclosure is 78%. BARNZ assumed that Christchurch Airport's tax depreciation will be closer to Wellington than Auckland and therefore applied a ratio of tax depreciation to regulatory depreciation of 80% for Christchurch. As a simplifying assumption, BARNZ assumed that tax depreciation will equate to regulatory depreciation in the airfield cost centre, with the differences occurring in the terminal cost centres. A ratio of tax depreciation to regulatory depreciation of 80% is achieved if it is assumed that 66% of terminal depreciation is deductible and 34% is non-deductible.

¹² Refer Commerce Act (Specified Airport Services Information Disclosure) Determination 2010, page 31.

Taxability of return met from asset revaluations

Christchurch Airport's financial model includes allowances for \$89.4m of revaluations treated as income over the 4 years 7 months, comprising \$48.2m of previous revaluations¹³ from 2009 to 2012 and \$41.2m of forecast or indexed revaluations.

Christchurch Airport has converted its 9.8% post tax WACC to a pre-tax WACC of 13.6%, and has applied this pre-tax WACC to its regulatory asset base to calculate its required pre-tax return on capital. In doing so, it has failed to treat the revaluations consistently, misrepresenting the allowable revenue to be \$34.8m higher than it should be.¹⁴

The Airport's approach is inconsistent with the Commerce Commission's Determination which deducts 'revaluations' from 'regulatory profit' when calculating the 'regulatory taxable income' on which the tax is computed.¹⁵ This was despite the Airport's Initial Pricing Proposal having stated that the Airport '*will calculate its tax costs consistent with the tax input methodology for airports*' (refer page 35).

Christchurch Airport's financial model is structured so that it applies the gross WACC to the asset base to obtain the return on capital and tax without distinguishing between profit on which tax is payable and revaluations which are not taxed.

The Commission's approach instead deducts the revaluations from the profit before calculating the tax, as is made very clear by the Commission both in the Commission's Airport Services Information Disclosure Determination at page 31 where Regulatory Taxable Income is defined, with the formula deducting revaluations from the regulatory profit, as well as in the Commission's Input Methodologies (Airport Services) Reasons Paper which states at paragraph 5.1.5 that:

Tax costs associated with the supply of specified airport services must consequently be calculated by applying the corporate tax rate to regulatory taxable income. Regulatory taxable income is the total regulatory income less expenses associated with the supply of airport services. These expenses are allocated to specified airport services by applying the cost allocation IM, but adjusting for any revenue or expenses not recognised as assessable or deductible under tax legislation (e.g. revaluation gains or losses). (Emphasis added)

Having first applied the gross WACC to the asset base, Christchurch Airport then deducts the revaluations as income in determining the allowable revenue, but, in doing so, it has failed to also deduct the tax that it has erroneously applied when calculating the gross return. In this way, Christchurch Airport has added the tax on the revaluations to its required revenue without subsequently deducting it. As the revaluations were \$89.4m, the amount by which the deductions should be increased is $\$89.4m \times 0.28 / (1 - 0.28) = \$34.8m$. Christchurch Airport has overstated its required revenue by this amount.

¹³ These previous revaluations amounted to \$33.5m. Christchurch Airport's financial model treated these as income spread evenly over the 4 year seven month pricing period, with an allowance for the opportunity cost of capital applied to compensate airlines for the time value of money. The credit included in the financial model, after allowance for the time value of money, was \$48.2m.

¹⁴ Putting aside the question of whether a 9.8% WACC is overstated in the first place.

¹⁵ Refer Commerce Act (Specified Airport Services Information Disclosure) Determination 2010, page 31 and Commerce Act (Specified Airport Services Input Methodologies) Determination 2010, para 5.1.5.

A table summarising the calculations by the method used by Christchurch Airport and the method that the Commission has stipulated may be found at the end of the response to this question. In addition, a spread-sheet, which uses Christchurch Airport’s final financial model to show the full workings of the calculations assessing the difference between Christchurch Airport’s approach and that of the Commission and of a consistent pre-tax WACC approach, is attached as Attachment 4.

By way of illustration, these calculations are summarised below for FY15. For simplicity, operating expenses have been omitted from the calculation.

CIAL Financial Model using a pre-tax WACC FY15		
Depreciation		\$15.0m
Return on capital	$\$441.1m * (0.0976 * (1 + (0.28 / (1 - 0.28))))$	\$59.8m
+ Tax	Included above	
– Revaluations		\$18.7m
Allowable revenue		\$56.1m

Commerce Commission Method from the Information Disclosure Input Methodology Determination FY15		
Depreciation		\$15.0m
Return on capital	$\$441.1m * 0.0976$	\$43.1m
+ Tax	$(\$43.1m - \$18.7m) * 0.28 / (1 - 0.28)$	\$9.4m
– Revaluations		\$18.7m
Allowable revenue		\$48.8m

The gain achieved by Christchurch Airport from this error in methodology is \$7.3m in FY15 ($\$7.3m = \$18.7m \times 0.28 / (1 - 0.28)$). Taking the 4 years and 7 months pricing period, the gain is \$34.8m, as shown in the table at the end of this question and in the spread-sheet in Attachment 4.

BARNZ considers that Christchurch Airport’s financial model needs to be corrected either by:

- Separately calculating the tax element of the building block model on the taxable income, which excludes the revaluations, as opposed to calculating it on the regulatory income. It would then be in line with the Commission’s methodology; or
- If Christchurch Airport insists on using a Gross WACC, it should do so correctly by grossing up the revaluations when it deducts them as income when calculating allowable revenue so as to cancel their effect in building up the allowable revenue.

The second method of correction is illustrated below. BARNZ notes this was the approach taken by Wellington Airport when it applied revaluation and capex wash-up credits from the previous pricing period into its new pricing period as it reset charges earlier this year. The allowable revenue under this method is identical to that calculated by the Commission’s method using a net WACC.

Corrected CIAL financial model using a pre-tax WACC FY15		
Depreciation		\$15.0m
Return on capital	\$441.1m * 0.1356	\$59.8m
+ Tax	Included above	
– Revaluations grossed up for tax	\$18.7m/(1-0.28)	\$26.0m
Allowable revenue		\$48.8m

During consultation BARNZ drew the error in Christchurch Airport’s approach to its attention, asking ‘whether, in treating revaluations as income, the model is over-stating the required tax by applying a pre-tax WACC without adjustment for the fact that tax is not payable on the portion of the return provided from revaluations’. Christchurch Airport responded that it was ‘irrelevant’ that ‘no tax is payable on the notional income’ and the approach that it had adopted meant that ‘any tax incentives provided by the Government are treated as a benefit to the investor, rather than passing those incentives to the consumer ...[which] is precisely how tax incentives are supposed to work’.¹⁶

BARNZ observes that Christchurch Airport’s approach to the treatment of revaluations results in outcome which is greater than NPV = 0, thereby breaching the fundamental FCM principle which underlines the approach the Commission has adopted to applying regulation under Part 4.¹⁷

As noted above, through this error in applying the gross WACC Christchurch Airport’s model has lifted the revenue it is purportedly requiring by \$34.8m. This is one of the most material corrections required to Christchurch Airport’s financial model, and is responsible for a significant portion of Christchurch Airport’s over-statement of the level of revenue it believes is required (and its erroneous claim that its charges will result in a permanent under-recovery).

¹⁶ Christchurch Airport Responses to Airline Queries, 20 April 2012, page 3.

¹⁷ Refer for example Commerce Commission *Input Methodologies (Airport Services) Reasons Paper*, December 2010 para 2.6.28 and 2.8.13 and footnotes; Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, para 3.42 and footnotes; Commerce Commission *Input Methodologies Discussion Paper*, 19 June 2009, pages 192 – 193.

CIAL METHOD

	FY13	FY14	FY15	FY16	FY17
	(7 mths)				
Asset base opening ('000s)	415,491	434,972	441,157	444,624	448,553
WACC pre-tax	13.55%	13.55%	13.55%	13.55%	13.55%
Capital charge (pre-tax) ('000s)	32,851	58,956	59,794	60,264	60,797
Building blocks					
Depreciation ('000s)	8,037	14,592	15,002	15,579	15,961
Capital charge ('000s)	32,851	58,956	59,794	60,264	60,797
Less revaluations indexation ('000s)	(4,828)	(8,862)	(9,098)	(9,135)	(9,266)
Less revaluations 09-12 ('000s)	(9,644)	(9,644)	(9,644)	(9,644)	(9,644)
Capital allowance ('000s)	26,416	55,043	56,055	57,064	57,848

CC METHOD

	FY13	FY14	FY15	FY16	FY17
	(7 mths)				
Asset base opening ('000s)	415,491	434,972	441,157	444,624	448,553
WACC pre-tax	9.76%	9.76%	9.76%	9.76%	9.76%
Capital charge (pre-tax) ('000s)	23,653	42,448	43,052	43,390	43,774
Building blocks					
Depreciation ('000s)	8,037	14,592	15,002	15,579	15,961
Capital charge ('000s)	23,653	42,448	43,052	43,390	43,774
Tax	3,570	9,311	9,454	9,571	9,669
Less revaluations indexation ('000s)	(4,828)	(8,862)	(9,098)	(9,135)	(9,266)
Less revaluations 09-12 ('000s)	(9,644)	(9,644)	(9,644)	(9,644)	(9,644)
Capital allowance ('000s)	20,789	47,847	48,766	49,762	50,494

CORRECT GROSS METHOD

	FY13	FY14	FY15	FY16	FY17
	(7 mths)				
Asset base opening ('000s)	415,491	434,972	441,157	444,624	448,553
WACC pre-tax	13.55%	13.55%	13.55%	13.55%	13.55%
Capital charge (pre-tax) ('000s)	32,851	58,956	59,794	60,264	60,797
Building blocks					
Depreciation ('000s)	8,037	14,592	15,002	15,579	15,961
Capital charge ('000s)	32,851	58,956	59,794	60,264	60,797
Less revaluations indexation ('000s)	(6,705)	(12,308)	(12,636)	(12,688)	(12,869)
Less revaluations 09-12 ('000s)	(13,394)	(13,394)	(13,394)	(13,394)	(13,394)
Capital allowance ('000s)	20,789	47,847	48,766	49,762	50,494
CIAL overstatement ('000s)	5,628	7,197	7,288	7,303	7,354
Total					34,769

12. Is Christchurch Airport's approach using a pre-tax WACC likely to cause any issues in the long-term or for this section 56G review?

As discussed above, Christchurch Airport has not correctly applied its pre-tax WACC in relation to the treatment of revaluations as income. This results in a significant over-statement of the revenue Christchurch Airport believes it requires, and results in revaluations being applied in a manner which breaches the NPV = 0 principle.

13. Are there any issues likely to result from Christchurch Airport's use of a 4.5 year pricing period rather than a full five year period?

BARNZ considers that the Commerce Commission's analysis needs to be undertaken for the four year seven month pricing period that Christchurch Airport set charges for.

Christchurch Airport did not complete consultation until late October 2012. New charges did not take effect until 1 December 2012. In July 2012 (which was the start of FY13) consultation was both incomplete and not programmed to be complete and the previous charges applied (excepting in relation to the counters which had new charges set under a separate process). If a five year analysis period is applied, then the possible under-recovery in the last months of PSE1 will be absorbed within PSE2, which will effectively reduce the NPV outcome over PSE2.

If the Commission were to undertake a five year analysis, then it would need to obtain further information from Christchurch Airport on the timing of the various key stages of the new terminal coming into use. Currently, Christchurch Airport's financial model has made a simplifying assumption that the full terminal (excepting Apron works) entered the asset base at 30 June 2012. This is not the case in practice. There was a complicated staging plan of construction works, involving at least seven (if not more) different stages. While the check-in hall was most likely in use as at 30 June 2012, the landside and airside circulation areas were not, and nor were the gates and air-bridges. Indeed, at the time of writing this response there are still some airside circulation areas and air-bridges yet to be completed or released into common use.

Adopting the Airport's assumption that the terminal was in use as at 1 July 2012, some nine months earlier than key components started to be used, will result in the Airport's required revenue being over-stated (by virtue of the return on and of the terminal being charged for before the terminal was in use). Moreover, over-recovery would continue over the long term due to the common practice of including an allowance for finance during construction in the final value of the assets.

Given that Christchurch Airport had not completed consultation by 1 July 2012, that the Airport and airlines consulted on a pricing period from 1 December 2012 to 30 June 2017, that the ITP facility will not be fully in use until April 2013 and that charges did not change until 1 December 2012, BARNZ considers that the Commerce Commission needs to undertake its analysis on a four year and seven month time-frame, aligning with the pricing period charges were set for.

All of BARNZ's analysis of Christchurch Airport's performance has been undertaken on a four year seven month pricing period, running from 1 December 2012 to 30 June 2017.

Is Christchurch Airport operating and investing in their assets efficiently?

BARNZ attended the February Christchurch Airline Operators Committee (AOC) meeting in order to obtain feedback from airline operational staff on the quality, innovation and investment questions posed by the Commission. The following answers reflect that feedback.

14. Where and when do any capacity constraints occur at Christchurch Airport, and is additional investment necessary to address these constraints?

The following areas were identified by operational staff as either having capacity constraints or being close to capacity:

- The check-in hall
- Regional gates and apron
- The international arrivals baggage reclaim belts
- The interface between parking aprons and the taxiway where aircraft push-back off gates

The check-in hall

Operational staff continue to have doubts as to whether the check-in hall is deep enough to provide sufficient space. However, it is acknowledged that increased automated check-in technology such as remote on-line check in either via computers or smart phones and automatic check-in via cell-phones or RF ID will in the future significantly reduce the number of passengers needing to actually check-in in the check-in hall, with some of the space being likely to be reconfigured to a bag drop-off zone in the future. For example, Emirates advise that over 25% of their check-in is now undertaken via mobile phones and the internet. In addition, the use of self-service check-in kiosks by airlines such as Air NZ and Jetstar significantly reduces the processing and dwell time in this area, thus allowing a greater volume of passengers to be processed in the same amount of space. Overall, it is not considered that any additional investment is needed in the next pricing period in relation to the check-in hall.

Regional gates and apron

It was noted that the regional gates are already at capacity and regional operations are having to flow over to the jet gates at times. This represents efficient use of shared facilities at the present time. Seating capacity in the regional lounge is also at a premium in peak times. A potential future solution exists if Air NZ vacates its leased premises currently used for painting aircraft, which would enable the regional apron to be extended. This is forecast to occur in year 2 of PSE2 (FY14) with \$3.1m of capex forecast for this project. It is not envisaged that any additional investment beyond that forecast will be required in PSE 2.

International arrival baggage reclaim belts

The international arrivals baggage reclaim area was identified as being limited due to there only being one large belt. Airline operational staff considered that a second double belt is required. It may be that clearer rules on allocation of belts, with larger aircraft being accorded priority on the

larger reclaim belt might alleviate this issue. However staff considered this matter needed to be addressed sooner rather than later. International through-put is forecast to pick-up again in FY15 and FY16. Work may need to be undertaken at that point extending one or more of the baggage reclaim belts. Given that is close to the end of the pricing period, it is not considered that there would be a material impact on Christchurch Airport's performance or required revenue. Moreover, some \$6m of expenditure has been provided for to allow optimisation of an international stand to allow greater flexibility of aircraft types. It may be that some of that forecast capex could be reallocated to address the baggage reclaim issue which seems to be seen as a higher priority by current users.

Push-back of aircraft

There is conflict between aircraft waiting to push-back from the terminal and aircraft taxiing on the taxiway at peak times. However, this is considered an issue able to be operationally managed at busy times through improved coordination of the timing of movement of aircraft off gates and is not one causing prolonged delays.

15. How reasonable are Christchurch Airport's opex and capex forecasts for the second PSE, and how do these compare to forecast and actual expenditure from the first PSE?

Comment on CAPEX Forecasts

The only capital expenditure item that BARNZ queried was the \$9m originally forecast for optimisation and reconfiguration of the international stands to meet forecast growth in aircraft movements. This was originally forecast at \$4m expenditure in FY14 followed by a further \$5m in FY16. Christchurch Airport subsequently modified its forecast downwards to the optimisation of one stand at a cost of \$6m in FY16.

BARNZ questioned the need for this work in light of the reduced international passenger volumes and aircraft movements as a result of the earthquakes.

International passenger volumes are not forecast to regain the levels they were at in FY08 until FY16.

International aircraft movements are forecast to remain below FY12 levels for the first two years of the new pricing period, before starting to increase at an average of approximately four additional movements per week for the final three years of the pricing period. Altogether, from FY12 to FY17, international aircraft movements are forecast to increase by ten additional movements per week, which is less than two additional movements per day.

While the concept of increased flexibility of stands, through the conversion to MARS configuration, is in principle sound and supported by BARNZ at an appropriate time, the need to spend an additional \$6m on reconfiguring international aircraft stands just does not seem justified in the case of Christchurch Airport during PSE 2. The operational perspective of airlines is that international gates are well under-utilised. BARNZ members would prefer to see this forecast capex being revisited before it is spent, in order to assess whether demand in FY16 justifies this work, or whether the

money is better spent else-where, such as extending international baggage reclaim belts (which would likely only cost a fraction of the \$6m).

While BARNZ's alternative revenue analysis removed the capex forecast for these works, it has to be acknowledged that given that the work is now only forecast to occur in year 4 of the pricing period, the actual impact on charges will be relatively minor in the current pricing period.

Otherwise, BARNZ considered Christchurch Airport's capital expenditure forecasts for PSE2 were reasonable.

The capital expenditure forecasts for PSE1 were dominated by the ITP¹⁸ project. Airlines accepted the need for the old domestic terminal to be demolished and replaced.

Comment on opex forecasts

Operating expenses are forecast to remain relatively flat on a per passenger basis through PSE 2 (approximately \$4.60 per pax).

However, as was the case with Auckland and Wellington Airports, there was a significant uplift in operating expenses at Christchurch Airport in the years immediately prior to the new pricing period. When Christchurch Airport set charges in 2008 in PSE 1 it was forecasting operating expenses for the pricing activities of \$17m in FY11 – a year during which it would have expected to face significant disruption and higher operating costs than normal due to the staging of the new terminal. Operating expenses are now being forecast at a considerably higher level of \$25m for FY13.

While the Airport has commenced using a new terminal building since then, and inevitably has increased maintenance and insurance costs as a result of the earthquakes, the question remains as to whether operating costs in FY12 represent an efficient starting point, given the 50% uplift in forecast operating expenses.

Given the difficulty of quantifying any adjustment, and the fact that there will have inevitably been an uplift in costs due to the new terminal coming on line and increased costs resulting from the earthquakes, BARNZ has not made any change to the forecast operating expenses in its alternative revenue modelling.

16. What factors outside Christchurch Airport's control have contributed to the capex and opex forecast for the second PSE and to changes in expenditure since the first PSE?

The Christchurch earthquakes of 2010 and 2011 will have significantly impacted Christchurch Airport's capex and opex forecasts due to earthquake repairs not covered by insurance and also due to increased insurance costs.

BARNZ will defer to Christchurch Airport quantifying the impact for the Commission, and comment in cross submissions if necessary.

¹⁸ Integrated Terminal Project.

17. What role did information disclosure regulation play in consultations concerning Christchurch Airport's expenditure forecasts?

Given the fundamental shift caused by both the earthquake and the move to a new larger terminal building, historic levels of operating expenditure were considered to be less relevant to Christchurch Airport's forecasts of its operating expenses than was the case in consultation with Auckland and Wellington Airports. Hence BARNZ did not significantly utilise information disclosure in this aspect of consultation.

18. What effect has information disclosure regulation had on the efficiency of Christchurch Airport's investment and operational expenditure

BARNZ has not observed any discernible effect.

Is Christchurch Airport innovating where appropriate?

BARNZ attended the February Christchurch Airline Operators Committee (AOC) meeting in order to obtain feedback from airline operational staff on the quality, innovation and investment questions posed by the Commission. The following answers reflect that feedback.

19. How does the level of innovation at Christchurch Airport compare to innovation at other airports both domestic and international?

Christchurch Airport is considered to be second to Auckland Airport in terms of innovation and willingness to engage proactively with airlines on airline initiated innovation out of the New Zealand airports.

As with other New Zealand airports, Christchurch Airport is not at the forefront of airport innovation internationally, but this is not seen as a bad thing, as early technology is often very expensive, and not necessarily trouble free.

The timing at which new technology is able to be adapted is also dependent upon building programmes. It is not always possible to retro-fit existing buildings with new technology. Because Christchurch Airport has a brand new terminal building, it has been able to include a number of modern processing and building construction techniques. For example, automatic security doors able to sense when a person is moving the wrong way through a door into a secure airside area have been incorporated. Modern swing gates, with sliding glass panels to direct passenger flows have been incorporated. The baggage handling system has been future proofed for RF id bag tags, which is still at the early stages of use overseas but which will likely expand in use going forward.

20. What innovation activities have been undertaken or are forecast to be undertaken by Christchurch Airport, and why?

Examples of aeronautical innovation incorporated within the new terminal building have been outlined in the answer to the question above.

Going forward, Christchurch Airport is carrying out a business case with regard to the installation of ground power units and pre-conditioned air at the gates for domestic aircraft which would avoid the need to run the aircraft engines at the gate to power aircraft systems, thus saving fuel and reducing carbon emissions and noise.

Christchurch Airport has also forecast installation of a MARS gate on an international stand (which is able to service different configurations of aircraft). BARNZ has questions as to whether likely growth justifies this expenditure occurring for FY16. However, it is still an example of planned innovation which, at the appropriate time, airlines would support.

21. How receptive is Christchurch Airport to innovation activity led by airlines?

Operational airline staff stationed at Christchurch Airport advised BARNZ that they considered Christchurch Airport was very responsive and receptive to airline led innovation. Airport management were described as being solutions focused and flexible. Unsolicited positive comment was made of Christchurch Airport's willingness to engage when compared with other airports which staff had had dealings with. While there had at times been some robust debates around particular design aspects of the new terminal building, overall the Airport was considered quite receptive.

The comment made to sum up the perception of operational airline staff was that *'we have a great little airport and we are really proud of it'*.

22. How does the level of innovation at Christchurch Airport compare now to prior to the introduction of information disclosure regulation?

The timing of the majority of innovation at Christchurch Airport over PSE1 and PSE2 has been heavily influenced by the timing of the ITP project. Investment and innovation were understandably deferred at the end of the old terminal's life, and the new terminal contains a number of improvements in processing and innovation.

BARNZ has not observed any discernible difference in the level of innovation attributable to information disclosure moving from under the AAA regime to Part 4 of the Commerce Act.

Is Christchurch Airport providing services at a quality that reflects consumer demands?

BARNZ attended the February Christchurch Airline Operators Committee (AOC) meeting in order to obtain feedback from airline operational staff on the quality, innovation and investment questions posed by the Commission. The following answers reflect that feedback.

23. What changes in quality have occurred since information disclosure regulation was introduced?

There has been a dramatic improvement in quality of passenger and staff experience, the ambiance of the new terminal and the reliability and quality of aeronautical facilities such as air-bridges and baggage handling systems with the completion of the new terminal building. However, as with innovation, this is not attributable to information disclosure moving from under the AAA regime to Part 4 of the Commerce Act. Rather, it directly relates to the completion of the ITP.

24. What, if any, aspects of quality do you think should or could be improved (or potentially lowered) at Christchurch Airport?

International operators identified the international baggage reclaim facilities as needing to have additional larger belts, capable of handling the baggage volume off wide bodied aircraft.

Way-finding through the new terminal is still considered problematic and in need of improvement. But it is acknowledged that construction is still continuing at the present time and therefore all facilities are not yet in their final locations. It is hoped that this will improve as final signage needs are evaluated and completed.

As the new terminal comes fully into use and is experienced in all seasons issues will undoubtedly arise. Already, at the beginning of Autumn, operators have noticed that when the wind is blowing from a southerly direction Air-bridge 16 lets freezing gusts of air into the terminal, indicating that an 'air curtain' will be required.

The positive feedback from airline operational staff regarding the willingness of Christchurch Airport to engage with airlines on such issues would suggest that such teething issues such as these should be able to be worked through and resolved for the benefit of passengers as well as airline and airport staff and crew.

25. What consultation was undertaken on aspects of service quality during Christchurch Airport's second PSE? How does this differ from consultation on quality at the first PSE?

Service quality did not feature in consultation during the second PSE. This was unchanged from consultation in the first PSE.

However, there was a significant amount of discourse, and, at times robust exchange, on the level of service and quality seen as appropriate by airlines for both passengers and for the supply of aeronautical facilities and services, during the capital expenditure consultation for the ITP which occurred late 2008 under section 4C of the Airport Authorities Act. For example, vigorous discussion and debate occurred over matters such as the necessary size of the baggage make up area, the number of required carousels available for the baggage handling system to discharge departing bags ready to be loaded onto trollies and containers to go onto the aircraft, whether a second out of gauge screening point was required in the check-in hall for oversize and fragile baggage, the width of corridors and access routes, the design of access for passenger flows and ease of way-finding, how swing gates would be configured etc etc.

Normally, however, service quality tends to be managed by airline operational staff located at the Airport, whereas a number of airlines involve subject matter experts at their head office in consultation over charges.

26. What role did information disclosure play in consultations concerning service quality during Christchurch Airport's second PSE?

BARNZ did not observe any role played by information disclosure at Christchurch Airport with respect to service quality in the second PSE. However, going forward, as the staging disruptions of the construction process come to an end, and the new terminal facilities are all on line, it is anticipated that the reliability and interruption measures disclosed will inform ongoing regular engagement on service quality at Christchurch Airport.

Is Christchurch Airport sharing the benefits of efficiency gains with consumers, including through lower prices?

27. How do the prices set by Christchurch Airport for PSE2 reflect previous efficiency gains? How did the prices set by Christchurch Airport for the first PSE reflect previous efficiency gains?

Given the significantly increased operating costs as a result of the expanded new terminal foot-print, and the additional costs caused by the earthquakes, BARNZ does not consider that there are any efficiency gains that were available to be shared in the second PSE.

One area where efficiency gains were available to be shared with airlines in the first PSE (and earlier), which Christchurch Airport failed to pass on, was with respect to the written off and fully depreciated domestic terminal building. For more than ten years Christchurch Airport set domestic terminal passenger charges at levels both forecast to earn, and which had already resulted in, excess profits.

Over the period FY00 to FY07 Christchurch Airport earned a post-tax economic profit on the domestic terminal of \$5.8m. When the Airport consulted over charges in 2008 it left the level of the domestic terminal charge unaltered, despite the previous levels of over-recovery, and despite the fact that its own financial model forecast it earning a further over-recovery on the domestic terminal of another \$5.6m in PSE 1.

Christchurch Airport completely failed to share any benefit with airlines of the domestic terminal having been depreciated down to zero. Airlines had to endure the operational inefficiencies of an old out-dated terminal building, without enjoying any of the benefit of reductions in charges to reflect the fact that charges had already fully met all capital costs of the building.

28. Does Christchurch Airport have any mechanism to share any efficiency gains with consumers during the pricing period?

No.

Do the prices set by Christchurch Airport promote efficiency?

29. How reasonable is Christchurch Airport's demand forecast for the second PSE compared to the forecast from the first PSE, and why?

Christchurch Airport's financial model is based on the following forecast growth:

	FY13	FY14	FY15	FY16	FY17
Jet MCTOW	-1.97%	1.83%	1.81%	2.14%	1.03%
Turbo-prop MCTOW	5.48%	6.19%	0.12%	0.66%	0.89%
Aircraft Movements	2.24%	2.19%	0.83%	0.97%	0.87%
International pax	-3.54%	7.50%	10.00%	3.00%	3.00%
International seats	-8.29%	0.00%	7.88%	5.60%	5.28%
Domestic jet seats	4.48%	8.45%	0.94%	0.53%	-0.19%
Domestic turbo-prop seats	6.54%	5.44%	0.13%	0.75%	1.16%

Broadly speaking, BARNZ considers that while Christchurch Airport's turbo-prop and international forecasts fall within a plausible range, the jet MCTOW and departing domestic seat forecasts are too low as a result of Christchurch Airport not taking sufficient account of the planned Air NZ upgrade of its domestic jet fleet to A320s, which will significantly increase the MCTOW and seats offered by Air NZ on its main domestic trunk routes.

International Forecasts

International passenger and aircraft volumes have particularly fallen at Christchurch Airport in the wake of the earthquakes. Christchurch Airport has endeavoured to model the likely recovery of volumes in light of similar events elsewhere in the world. As a result of this work Christchurch Airport has forecast continuing reductions of international passengers and seats in FY13, with passenger volumes recovering from FY14 and with seats stabilising in FY14 and recovering from FY15 onwards.

While the timing and speed of recovery of passenger volumes and future growth remains highly uncertain, BARNZ considers that the approach taken by Christchurch Airport to forecasting international passenger volumes in light of the experience with similar events is difficult to criticise. The resulting forecasts fall within a plausible range, albeit if slightly conservative in FY13 and slightly optimistic in FY14 and FY15. BARNZ has therefore left the Christchurch Airport forecasts unaltered in its alternative revenue modelling.

Jet MCTOW Forecast

Air NZ is currently upgrading its domestic jet aircraft from its current fleet of 737s to A320s. Ten aircraft remain to be upgraded. These upgrades are scheduled to occur over FY13 to FY17. At the time consultation was taking place BARNZ had been advised that the timing was likely to be one

aircraft in FY13, three in FY14, four in FY15 and two in FY17.¹⁹ This upgrade represents an increase in MCTOW for Air NZ jets from 57 tonnes for a 737 to 71.5 tonnes for an A320, a 25% increase. BARNZ understands that the frequency of Air NZ jets is forecast to remain predominantly unchanged as a result of this upgrade.

Christchurch Airport forecast total jet MCTOW growth over the entire pricing period of 4.9% (which was a reduction from the 6.6% forecast in its Initial Pricing Proposal). While the jet MCTOW forecast by Christchurch Airport is a combined sum representing both international and domestic jet MCTOW, the growth appears significantly understated in light of the 25% increase in Air NZ domestic jet MCTOW. BARNZ forecast the following jet MCTOW growth in its alternative revenue modelling:

	FY13	FY14	FY15	FY16	FY17
BARNZ Jet MCTOW forecast	-1.97%	2.50%	3.50%	2.50%	1.50%
CIAL Jet MCTOW forecast	-1.97%	1.83%	1.81%	2.14%	1.03%

Domestic Jet Departing Seats

Air NZ's fleet upgrade also results in an increase in departing seats per Air NZ jet flight from 135 seats in a 737 to 171 seats in an A320, a 28.6% increase. Christchurch Airport forecast a total 14.8% increase in departing domestic jet seats from FY12 to FY17. BARNZ considers this growth is understated in light of both the significant increase in departing seats which will be operated by Air NZ, and Jetstar's targeted 5% CAGR.

BARNZ forecast the following domestic jet seat growth in its alternative revenue modelling.

	FY13	FY14	FY15	FY16	FY17
BARNZ forecast domestic jet departing seats	4.48%	8.45%	8.00%	1.00%	3.00%
CIAL forecast domestic jet departing seats	4.48%	8.45%	0.94%	0.53%	-0.19%

30. To what extent do changes in the pricing structure at Christchurch Airport at the second PSE better reflect efficient pricing principles (for example, are prices subsidy free, do they have regard to service capacity, do they take account of consumer's price sensitivity) relative to the first PSE?

It is difficult to discern what, if anything, Christchurch Airport is trying to achieve in the way of efficiency from its new pricing structure.

The only outcome identifiable to BARNZ is that of the extraction of excessive returns.

The pricing structure adopted by the Airport has loaded costs onto airfield activities. The over-recovery identified by BARNZ is almost entirely attributable to the increases in airfield charges, and

¹⁹ Since then, Air NZ has brought the programmed roll-out forward, advising BARNZ that as at March 2013 A320 replacements of 737 aircraft are scheduled to occur in June, July and November 2013, February, April and July 2014, February and April 2015 and July and September 2016 (all calendar years).

in particular the combination of the new fixed charge of \$150 per departing aircraft over 20 tonnes together with the substantial increases to MCTOW rates, ranging in uplifts of 27% to 49% over the pricing period.

The charging structure will result in operators which only use airfield services (such as freight and military operators) subsidising terminal activities.

Christchurch Airport has no airfield capacity constraints. Fixed charges at airports are most often found where demand is nearing capacity, and the asset owner or operator wishes to send a signal regarding the opportunity cost of using the airfield asset. This is nowhere near the case at Christchurch Airport, which is the least congested of the three airports being considered by the Commission and has the greatest amount of spare capacity.

Freight operators arriving during the night, when the airfield is otherwise unused, are still levied the same fixed charge as operators arriving during busier times of the day, despite the fact there are no other users wishing to utilise the facility. The economic logic is completely absent.

The airlines which BARNZ represented during consultation (Emirates, Singapore Air, Air Pacific and Virgin Australia) consider that Christchurch Airport's new prices result in disproportionately large increases on jet aircraft due to the decisions by the Airport to:

- Increase jet MCTOW rates by 49% or \$6.44 per tonne, while turboprop MCTOW rates only increase by 27% or \$2.48 per tonne, and
- Discount by 50% the fixed per departure charge for turbo-prop aircraft under 20 tonnes, at the same time as increasing the fixed charge for aircraft over 20 tonnes from the originally proposed \$125 to \$150 per departure.

The effect of the new charges is that the Dash 8 – 300, at 19.5 tonnes and 50 seats, will have the lowest effective airfield charge at \$4.52 per available seat (rising to \$6.29 in FY17), of any of the scheduled aircraft operating regular services to Christchurch. By contrast:

- Narrow body jets will incur airfield charges of approximately \$6 per available seat (rising to \$9 to \$10 in FY17)
- Wide body jets will incur airfield charges of \$12 to \$13 per available seat (rising to \$19 to \$20 in FY17).

Overall, BARNZ does not consider that the new charging structure at Christchurch Airport represents efficient prices. It would seem that the Airport is looking to make good its incorrectly perceived under-recovery on the new terminal investment by inflating its airfield charges. In doing so it has placed a disproportionate amount of those cost onto the very large aircraft, which will suffer airfield charges double or even triple than those of smaller aircraft on a per passenger basis. It has also created a charging regime which will result in users which only use airfield facilities, such as freight or military aircraft, subsidising passenger facilities. In addition, users of the facilities in the middle of the night when it is otherwise deserted are still charged the same rate.

There appears to be no logical basis or rationale efficiency driver underlying the charging structure other than the maximisation of profit through the use of monopoly power.

31. How appropriate is the allocation of costs between services?

BARNZ does not consider that Christchurch Airport has always appropriately shared common space within the terminal between aeronautical users and retail users.

Christchurch Airport allocates plant room, toilets and vertical circulation space within the terminal buildings proportionally across all activities utilising the terminal using a 58% allocation to aeronautical pricing activities and 42% to commercial activities. BARNZ supports this approach which reflects the fact that a number of different activities are simultaneously using the terminal buildings.

However, Christchurch Airport does not treat horizontal circulation space (i.e. corridors, walkways and public circulation space) in the same way. Rather, the Airport allocates horizontal circulation space largely to the aeronautical business. The inconsistency is illogical and unsupportable. Horizontal circulation space should be treated exactly the same as vertical circulation space – namely, shared proportionately among all users of the terminal buildings. Instead Christchurch Airport has allocated the public land-space on the first floor (excluding the food court) 88% to aeronautical pricing activities and 12% to retail/commercial activities.

BARNZ considers that the same 58%:42% allocation as is applied to the sharing of vertical circulation space should be applied. The impact of this change is a reduction of approximately \$5.5m to the assets allocated to the pricing asset base.

While Christchurch Airport appears to have appropriately allocated costs between airfield and terminal activities, when it has set its charges it has done so using a charging structure and prices which will result in airfield charges making up Christchurch Airport's perceived shortfall in revenue attributable to its terminal activities.

32. To what extent have airlines and other consumers of Christchurch Airport's services been able to make price-quality trade-offs that better meet their needs for the second PSE? How does this compare with the first PSE?

BARNZ is not aware of any examples of where the BARNZ represented airlines have been able to make price-quality trade-offs. There are not any premium check-in areas available at Christchurch Airport, which is a clear instance of a price-quality trade-off which several airlines have made at Auckland Airport.

Air NZ and Christchurch Airport have reached a commercial agreement regarding the construction and leasing of a separate departure lounge and arrivals area for passengers on regional aircraft. BARNZ is not aware of the content of, or dollar amounts involved in, this agreement or whether it could be classified as a price-quality trade-off or not.

33. To what extent do Christchurch Airport's prices promote certainty and stability. How does this compare relative to the first PSE?

Christchurch Airport has described its approach to pricing as being a long run marginal cost approach to set charges at a constant real level for the next 20 years.

During consultation BARNZ sought clarification from Christchurch Airport as to what aspects of the methodology and what inputs were being committed to by the Airport for those 20 years.

The answer was '**NONE**'.

Christchurch Airport stated: ²⁰

CIAL is required to consult on prices every 5 years. The Airport Authorities Act requires CIAL to approach each consultation with an open mind. Hence, while CIAL can consult on a preferred proposal at the next price re-set, it cannot close its mind to options.

As a result, the regulatory environment for the airport price setting makes it impossible for the CIAL to give a "commitment" now that purports to take something off the table in 5 years' time. ...

To follow this logic, what the CIAL can do – and is doing – is be very transparent now about the basis for this pricing period and the medium term view it is taking. If in 5 years' time the CIAL were to act inconsistently, it will be very obvious to the airlines and the Commerce Commission.

BARNZ therefore does not view Christchurch Airport's prices as promoting certainty and stability. The Airport has been very clear that every input and approach is open to reconsideration and consultation again in five years, foreclosing a long term approach.

34. How do airlines and other consumers of Christchurch Airport's services expect their demand to change in response to the prices set by Christchurch Airport in the second PSE?

BARNZ will defer to individual airline responses in relation to this question.

35. What impact has information disclosure had on the pricing methodology set by Christchurch Airport for the second PSE?

Christchurch Airport used what it described as a Long Run Marginal Cost pricing model. BARNZ does not consider that the Airport's decision to adopt this methodology was influenced or affected in any way by the information disclosure regime.

However, the input methodologies have affected several of the inputs used by Christchurch Airport within its financial model, specifically:

²⁰ Written responses by Christchurch Airport to questions asked by airlines at a briefing on 23 August 2012, page 5.

- Its decision to follow the asset valuation input methodologies (namely MVAU for land and a rolled forward 2009 disclosure value for specialised assets);
- Its use of CPI to index assets forward during the pricing period; and
- Its decision to treat actual revaluations as income (noting however that there is still an outstanding issue as to how this should occur when a pre-tax WACC is applied).

However, the Airport was not influenced by the cost of capital input methodology or how the Commission treats revaluations in relation to the assessment of tax.

Overall, it is fair to say that the input methodologies have had a mixed impact on Christchurch Airport's pricing methodology for the second PSE, with some input methodologies being adopted, and others ignored by the Airport.

What are the strengths and weaknesses of the current information disclosure requirements?

36. How much of the information disclosed during the recent price setting round would have been publicly disclosed, or disclosed to airlines, in the absence of information disclosure regulation?

There was no change in the amount of information which would have been made available to airlines as a result of information disclosure for airports moving under Part 4 of the Commerce Act. Airlines received the same level of information in PSE1 as in PSE2. This is because there are very clearly understood legal principles regarding the level of information which must be made available in a consultation process.

The price setting disclosures following consultation have, however, significantly increased the information available to other interested persons, not party to the pricing consultation. Previously, the Airport only released a relatively small amount of information publicly. The price setting disclosures required by the Commission following any PSE, have resulted in a materially larger, and more detailed, set of information being released by the Airport to support its price setting decisions.

37. What are the benefits to Christchurch Airport, airlines and other consumers of Christchurch Airport's services of using the information disclosed?

BARNZ sees considerable benefit to users going forward in having the ability to measure actual performance (particularly in relation to costs, revenues, activity levels and capital expenditure) against the forecasts made in respect of these matters as prices were set.

38. What additional information could be added to the current information disclosure requirements that would help you to better assess whether the purpose of Part 4 is being met?

BARNZ answered this question quite fully on pages 46 and 47 of its 18 October 2012 Response to the Issues Paper released by the Commerce Commission in relation to Auckland Airport. The Commission is referred back to that response, which BARNZ confirms.