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

22 March 2013

The responses by Christchurch Airport and BARNZ to the Commerce Commission's Issues Paper highlight a number of common themes for the Commission to consider as it undertakes its review of how effectively information disclosure under the Commerce Act has been able to promote the purpose of Part 4.

There appears to be unanimity among both airlines and the Airport that Christchurch Airport:

- Is innovating where appropriate
- Is providing services at quality levels that reflect consumer demands
- Is responsive to airline concerns or initiatives in relation to quality and innovation
- Has a capital expenditure profile that is by and large appropriate.

It also seems to be acknowledged by all parties that the context in which prices for PSE 2 were set, namely in the aftermath of serious earthquake events and as construction of a significant new terminal was being completed, were such that there simply were not operating efficiency gains available to be shared.[1]

There is also unanimity over which issues are controversial.

At a high level these issues relate to whether the prices set by Christchurch Airport result in an appropriate return and promote efficiency – in the phraseology of section 52A(1)(d), is Christchurch Airport limited in its ability to extract excessive returns? BARNZ strongly considers that in this respect information disclosure regulation has proved ineffective at promoting the purpose of Part 4.

The submissions made by both the Airport and BARNZ devote considerable attention to the questions of what level of WACC represents a reasonable return reflecting the risks faced by Christchurch Airport and whether the Airport's calculation of the tax element in its pricing model is appropriate.

[1] BARNZ does however note that one area where savings have occurred, which the Airport could have shared but declined to do so, was in relation to the cost of debt, which is at lower levels than existed in PSE 1. However, the Airport elected to apply a historical average of the cost of debt over the previous ten years, rather than the lower current forward looking debt rates.

In addition, the Airport emphasises the levelised constant real prices it claims its long run marginal cost pricing model has produced.

This cross-submission by BARNZ addresses these three issues as well as the view expressed by Christchurch Airport that information disclosure enabled the consultation process in PSE 2 to be considerably shorter than that of PSE 1.

WACC

The first point BARNZ wishes to make with respect to WACC in this cross-submission is to reiterate overall unreasonableness of Christchurch Airport's WACC.

Christchurch Airport's financial model utilises a 13.6% pre-tax WACC, converted from a 9.8% post tax nominal WACC. This is some 50% greater than the Commerce Commission's July 2012 mid-point post-tax WACC for specified airport services of 6.49%.

BARNZ firmly considers that Christchurch Airport's 9.8% post tax WACC (and its 13.6% pre-tax WACC) is excessive and will result in the Airport earning excess returns.

The prices set by Christchurch Airport for PSE 2 do not result in any under-recovery, as claimed by the Airport, but , in fact, will result in the Airport earning excess returns of $37m over the second pricing period compared to the Commerce Commission mid-point WACC estimate, individualised for Christchurch Airport with a higher asset beta. This represents additional revenue which will be paid by airlines and passengers of $64m over and above the revenue derived by adopting the Commission's input methodologies.

BARNZ requested Dr Brent Layton of Futures Consultants Ltd to review the responses provided by Christchurch Airport on WACC as well as the supporting report provided by PWC on behalf of the Airport. The response by Futures Consultants is attached, which discusses:

- The use by Christchurch Airport of the 10 year historical average cost of debt rather than the current forward looking debt rates.
- Evidence of long term PTMRP.
- Recent evidence of current equity premia.

Futures Consultants concludes that the core argument of Christchurch Airport that using the current government stock rate as the proxy for the risk free rate will result in significant understatement of the Airport's true cost of equity and WACC is not supported by the evidence.

The second point which BARNZ wishes to address is Christchurch Airport's attempt to divert attention away from the high level of its adopted WACC rate.

In its Response to the Issues Paper, Christchurch Airport has sought to draw a distinction between its 'estimated cost of capital' and 'the actual returns targeted in [its] posted prices', claiming that its IRR is well below the Commission's estimate of WACC.

However, the levelised constant real price which Christchurch Airport's pricing structure reaches by the end of PSE 2 is one that is designed to earn the Airport its 9.8% post tax cost of capital over the medium term (using its flawed financial model which seeks to charge airlines for tax on income attributable to revaluations despite the fact no such tax is payable). The Airport has clearly signalled its intention that under-recovery from the so-called 'transition pricing path' in PSE 2 will be recouped through higher returns in later pricing periods (PSE 4 and PSE 5) exceeding its WACC.[2]

In its Price Setting Disclosures Christchurch Airport described its starting point as 'the economic principle that it will achieve an NPV = 0 outcome over the life of the assets', noting that 'any under-recovery in revenue over the next five years will require an over-recovery in the subsequent pricing periods'.[3]

Christchurch Airport's 9.8% post tax 'estimated cost of capital' therefore is its 'actual targeted return'. There is no distinction between the two.

BARNZ notes that if the error in Christchurch Airport's financial model regarding the calculation of tax on income earned from revaluations is corrected, then the Airport will already be very close to earning its 9.8% WACC over the four year seven month pricing period in PSE 1, assuming all other forecasted inputs remain constant.

Calculation of tax on return earned from asset revaluations

Christchurch Airport's submission on the Issues Paper discusses its use of a pre-tax WACC over four pages. However, not once in those four pages does the Airport acknowledge or address BARNZ's fundamental concern with Christchurch Airport's calculation of tax, which is that:

> Christchurch Airport's financial model increases its required revenue for tax on revaluation gains – when income from revaluation gains **is not taxable**.

The approach by the Airport results in its required revenue being over-stated. This is not just a problem confined to the four years and seven months of PSE 2. Christchurch Airport's financial model embeds this fundamental error in its calculations over the next 20 years.

The error in the Airport's approach can be plainly seen in the Airport's submission, where at page 33 Christchurch Airport outlines its understanding of the tax calculation steps prescribed by the input methodologies. The Airport states *'start with EBIT, deduct tax depreciation and notional interest expenses to give profit before tax, apply the tax rate to profit before tax to calculate tax payable …'.*

The Airport has omitted the fundamental step of *'deduct revenue attributable to revaluations'* which is necessary before applying the tax rate in order to ensure a NPV = 0 result is achieved. Without this step the tax element to the building block model will be overstated – because income from revaluation gains **is not taxable**.

[2] Christchurch Airport Response to Issues Paper, page 11.
[3] Christchurch Airport Price Setting Disclosures, 19 December 2012, pages 8 – 9, reproduced at pages 63 to 67 of Christchurch Airport Response to Issues Paper.

The input methodologies specified by the Commerce Commission deduct revaluations from income before calculating tax. This is clearly set out in paragraph 5.1.5 of the Airport Services Reasons Paper as well as in the formula for calculating Regulatory Taxable Income at page 31 of the Airport Services Information Disclosure Determination. In the Commission's language, the reason revaluation gains need to be deducted before calculating tax is because that revenue is not assessable under tax legislation.

BARNZ continues to consider that Christchurch Airport has over-stated its required revenue because of this fundamental error in calculating the tax element when building up its required revenue. Christchurch Airport's submission on this topic demonstrates the Airport's wilful blindness to the basic underlying concept that when calculating tax payable it is necessary to first deduct income from revaluation gains – because income from revaluation gains **is not taxable**.

BARNZ calculates that over the four years and seven months of PSE 2, this mistake has resulted in the Airport over-stating its required revenue by $34.8m. In addition, the same mistake has not surprisingly flowed into the next 15 years of the Airport's calculation of its levelised constant real price.

The underlying calculations behind the $34.8m impact of this error, and further detailed discussion of this issue, were set out on pages 15 to 18 of BARNZ's Response to the Issues Paper dated 22 March.

Levelised constant real pricing?

A recurring theme throughout Christchurch Airport's submission is that it has adopted a 'long term pricing model' which will result in 'largely constant prices' once the 'long-run marginal cost level is reached'.[4]

However, another constant refrain in the Airport's submission is that it cannot make any commitments as to the future because of its obligation to consult under the Airport Authorities Act. Thus, the Airport states that, come, PSE 3, it will need to update or reconsider with an open mind:[5]

- The long run pricing approach;
- WACC;
- Asset valuation methodologies;
- Demand forecasts;
- Opex; and
- Capex.

In short – virtually every aspect of the so called long run levelised pricing approach is able to be reopened by the Airport. Clearly there is no long term commitment by the Airport.

[4] Christchurch Airport Response to Issues Paper, pages 5 and 9.
[5] Christchurch Airport Response to Issues Paper, pages 5, 11, 13 and 30.

The airlines represented by BARNZ would be willing to consider a long term contractual arrangement aimed at producing a long run constant real price – however the arrangement would have to be a commercial one reflecting reasonable inputs.

Christchurch Airport's approach based on a 13.6% pre-tax WACC, carrying forward any under-recoveries compounded at that cost of capital, was not considered reasonable. The financial model provided by Christchurch Airport with its Initial Pricing Proposal[6] indicated that under its long term approach, as well as there being substantial increases in charges in PSE 2, it intended that at the commencement of PSE 3 charges would further substantially increase in the magnitude of:

- A doubling of jet MCTOW rates
- An increase in the vicinity of 50% for turbo-prop MCTOW rates
- Close of tripling of current charges for the departing international passenger terminal seat charge
- An increase in the vicinity of 50% for domestic passenger terminal charges
- A doubling of turbo-prop passenger charges

This approach was soundly rejected by the airlines which BARNZ was representing in consultation as being unreasonable, not sustainable and one which would result in significant over-recovery by the Airport. We are not aware of other airlines supporting the Airport's proposal either.

Impact of information disclosure on consultation process

Christchurch Airport has submitted that information disclosure provided greater clarity around the information required for consultation and, in particular, resulted in an improved timeframe over which the consultation process was carried out. The Airport compared the PSE 2 consultations with the consultation for PSE 1 which they describe as commencing in mid 2007 and concluding in February 2009.[7]

BARNZ does not agree with Christchurch Airport's assessment of the impact of information disclosure on consultation. While BARNZ has acknowledged that the asset valuation and treatment of revaluation input methodologies resulted in a narrowing of the issues in contention during consultation with Christchurch Airport, the Airport did not follow the input methodologies relating to WACC and the calculation of tax, and these issues were just as contentious, if not more contentious, as the issues in PSE 1.

BARNZ has always been clear on the information required for consultation. Airline views on this matter have remained constant for the last decade. Indeed, it was these views that helped shape the information disclosure requirements, rather than the reverse as Christchurch Airport is implying. The information provided by the Airports has also remained largely constant over that time.

The comparison of the length of time consultation encompassed in PSE 2 as compared with PSE 1 is not particularly informative in the case of Christchurch Airport.

[6] CIAL – Pricing Model v 4.8 – release to airlines.
[7] Christchurch Airport Response to Issues Paper, page 7.

While Christchurch Airport issued a very broad draft pricing framework document in July 2007 and draft pricing principles in October 2007, they were akin to discussion documents only. The real heart of the consultation process for PSE 1 did not begin until August 2008, with the release of Christchurch Airport's Initial Pricing Proposal. BARNZ responded to this in October 2008, with airlines providing individual responses in November. The Airport provided a Revised Pricing Proposal in December 2008, which BARNZ and airlines responded to in January 2009. Christchurch Airport released its pricing decision in February 2009. The core consultation process encompassed August 2008 to February 2009, a period of some seven months – remarkably similar to PSE 2.

Consultation for PSE 1 took place in a very unsettled internal environment at Christchurch Airport, which included the unexpected resignation of Christchurch Airport's Chief Executive in January 2009.

Moreover, capital expenditure consultation under section 4C of the Airport Authorities Act on the Integrated Terminal Project was also occurring at the same time. That consultation process was initially fundamentally flawed due to a decision being taken in July 2008 by the Airport's Board to proceed with the project some weeks before consultation, which was still purportedly continuing with the airlines, was concluded. After Air NZ commenced judicial review proceedings alleging failure to consult with an open mind, Christchurch Airport (properly in BARNZ's view) elected to reset that consultation and undertake the process again to remedy the defects. That second capital expenditure consultation process, which occurred from October to December 2008 and which was very intensive, was in BARNZ's view, a constructive and productive process, which resulted in a number of changes and improvements to the final design.

These extraneous events contributed to consultation for PSE 1 progressing slowly at first and to the Airport deferring releasing an Initial Pricing Proposal which was able to be consulted on and responded to by the airlines.

While Christchurch Airport's adoption (for PSE 2) of the input methodologies for asset valuations certainly reduced the effort needed in relation to the level of valuations adopted, there was still considerable effort and time required to understand and follow movements in asset valuations over time.

In any event, any savings in time or money obtaining advice on the level of revaluations, were absorbed by the new issue of how asset revaluations should be treated when calculating tax under a pre-tax WACC. The question of the appropriate WACC was actually more controversial in PSE 2 than PSE 1 with there being a greater difference between the Airport's views and the advice received by BARNZ.

Overall, there was little difference in the time invested or effort required between PSE 1 and PSE 2.