COMMERCE COMMISSION NEW ZEALAND
CHRISTCHURCH AIRPORT CONFERENCE
HELD ON 24 MAY 2013

[9.59 a.m.]

CHAIR: Good morning everybody and thank you for your attendance today.

This is our third and final conference under 09.59 section 56G of the Commerce Act. This time the hearing relates to Christchurch International Airport.

My name is Mark Berry, I'm the Chair of the Commerce Commission and with me the other members of the Commission today are faces that will be familiar to you from the Auckland hearing we had not long ago. I'll start at the end; we've got Pat Duignan, Sue Begg and Elisabeth Welson. I'll go through the routine background to this conference as well as process issues, and then we can kick off.

10.00 By way of background, we determined information disclosure requirements and input methodologies for airport services supplied at Wellington, Auckland and Christchurch International Airports in December 2010, as required under Part 4 of the Commerce Commission Act.

Under section 56G of that Act we are now required to report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 of the Act.

As you will be aware we have already reported to the 10.00 Ministers in relation to Wellington International Airport and we are currently consulting on our draft report in relation to Auckland International Airport.

The next step in this process is preparing our draft report in relation to Christchurch, and this conference today is an important part of that process.

On the 8th of February we issued a process and issues paper for our section 56G review in relation to the Christchurch Airport. A number of issues were raised in submissions and cross-submissions on this paper. We have found these to be very informative and we thank you all for the time and effort that you have put into these submissions.

It is those submissions and cross-submissions, and our
10.01 analysis to date, that has formed the agenda for today's conference. The objective of the conference today is for us to understand the impact, if any, that Part 4 information disclosure is having on Christchurch Airport's performance, as well as its conduct.

Before we turn to the substance of the conference today, I have a few points on procedure which elaborate on the administrative arrangements set out in our 17th of May notification.

I can say that we have carefully read all submissions
10.02 and cross-submissions. This conference is intended to focus on the areas where we want to test and deepen our understanding of the written submissions made by the parties. We do not usually allow new material to be presented at our conference given that parties would not have an opportunity to consider such information before this conference. However, there is some flexibility and if we find circumstances where this is appropriate and warranted, there is scope for the admission of new evidence, given that we do have cross-submission rounds
10.02 which will enable parties to comment on anything that is new in the course of this conference. But I do urge parties to stay to the evidence that is before us, if that is possible.

The purpose of this conference is to discuss issues relating specific to Christchurch Airport, we will not be visiting our approach to assessing the effectiveness of information disclosure in each area unless there is an issue that is specific to Christchurch Airport. I am assuming that you have all read our final report on the effectiveness of information disclosure at Wellington Airport, as well as our draft report on Auckland, and so are therefore familiar with our approach to the analysis of section 56G reviews.

10.03 As we also notified to you in our e-mail on 17th of May, we have also included time at the beginning of the profitability topic area for Christchurch Airport to explain their pricing approach for us all. Christchurch Airport has adopted a novel and significantly different approach to pricing, to that adopted by Auckland or Wellington Airports. We consider that an introductory briefing by Christchurch Airport will assist us, and also parties contemplating making cross-submissions following this conference, to
10.04 understand their approach to pricing. It is apparent to us in review submissions on our process and issues paper that there is some confusion about the approach taken by Christchurch to profitability.

We have allocated time for parties to introduce themselves to us, and throughout the course of today there will be opportunity for participation through questioning. We have also allocated time later this afternoon for presentations to us, and that's something we've done in both the Auckland and Wellington
10.05 conferences, is to provide closing statement opportunities. I understand that BARNZ, Christchurch Airport and Freightways have already signalled a wish to take up this opportunity. We do ask that you avoid repeating material in those closing

comments. They are not intended as closing submissions,
statements rather, it's simply is an opportunity to make
further comments on points that arise today, and that's
going to better inform all parties before the opportunity
of cross-submissions arise.

The conference has generally been organised around the
areas of performance relevant to the purpose of Part 4.
We appreciate that each of these areas of performance
interrelate. However, for the purpose of this conference
10.06 we have simply arranged them as separate topics and
allocated time according to where we need further
understanding of submissions and cross-submissions. The
timing and order of these topics is of no particular
relevant importance. Further, each topic area may be
relevant to any or all four of the objectives set out in
subsection 1 of section 52A of the Commerce Act, so we'll
move through all of these topics as the day unfolds and
there will be some overlap between them potentially.

As in accordance with previous conferences, Commission
10.06 staff will be invited to follow up with questions on
issues.

While the conference is focused on particular areas we
wish to explore further, the fact we may not refer to
other issues in our questioning does not mean we have
reached a view on any particular matter. The conference
is simply focused on issues where we believe that we will
be assisted by further explanation and discussion. While
this conference provides an opportunity for views to be
discussed, we would like to reiterate that the various
10.07 rounds of written submissions remain the principal avenue
by which we seek and receive interested parties' views
and so, therefore, please do continue with comprehensive
approaches to your written submissions that follow
through.

At the end of this conference parties will be given the opportunity to make cross-submissions. They will be due on the 12th of June, and so everybody is invited to make a cross-submission on any matter discussed at this conference.

There will also be an opportunity to make detailed written submissions on our draft report in due course. So, there are still significant consultation steps to be followed.

10.08 As with previous conferences we intend that there should be as little formality and technicality as is necessary. The conference is not adversarial. No party has a right to ask questions of any other party during these proceedings unless requested to do so by us. During each topic session we will expect the relevant representative of each organisation and experts of them to be present at the table before us and to appear in that capacity. We note that only Dr Layton has today confirmed his capacity as an independent expert, having 10.08 signed the Code of Conduct.

Commissioners and Commission staff will ask questions and we will on most occasions direct questions to specific individuals, so we'll be following through the process that we have done for Auckland and Wellington, and you will all know from having participated in those conferences how they play out.

We appreciate that representatives of the parties may not be able to answer all questions posed. If the timetable permits we may allow other advisors to respond 10.09 to us. Let's just see how that plays out through the course of the day.

We hope to get a transcript of the conference up on our website on Wednesday next week, and if there are further questions that need to be asked, we will also post that on our website. So, there will be both a transcript of today's proceedings as well as any questions that we may raise that parties may or may not have had the chance to answer. So, we'll be posting those hopefully by 29th of May, well in advance of the cross-submissions date, which I've already mentioned is the 12th of June.

The conference proceedings will, as you'll be aware, be recorded. Microphones are available at the table for speakers. You do need to press an on/off button, so before you start speaking if you can make sure to remember to press the button and you'll see a red light coming up, that indicates that you're ready to go. Please speak into the microphone when making your presentation and identify yourself. Speak slowly and carefully so that the stenographer won't have problems with the transcript.

The agenda provides for a morning tea, a lunch break and a break for afternoon tea. The agenda is flexible and let's make changes as we need to throughout the day. Tea and coffee is available at the rear of the conference room at the time of these break-outs.

I should add that the conference room will be open during breaks. The room is not secure so please be careful with valuables and confidential information.

Administrative matters. We are required by Te Papa to make various statements, which makes me feel like, if I can excuse the statement in today's company, an airline steward.

There are bathroom facilities and they can be accessed directly from this room.

We are advised by Te Papa staff that if there should happen to be an earthquake, we are all to get under a table in the first instance and remain until all tremors

have finished. Follow the instructions from the Te Papa
staff or the emergency warden. We are advised that
Te Papa is designed to withstand an 8.5 earthquake, so we
can all sit comfortable in Wellington for those who are
nervous about being in Wellington and on reclaimed land.

In the case of a fire evacuation, Te Papa staff will
ask guests to leave by the main stairwell or by the
nearest fire exit. So, please leave the building. The
assembly point is directly outside Te Papa.

10.12 The final directive is that nobody is allowed to smoke
on the balcony out there, so look out if you engage in
that conduct. So, those are the announcements from
Te Papa.

The Commission's contact person today is, as usual,
Ruth Nichols, and you'll all know Ruth. So, if you've
got any questions, please don't hesitate to ask Ruth
throughout the day. So, she'll be your guide for all of
that stuff.

A matter of some more significance; I understand that
10.12 parties have been asked whether there is a need to
discuss any confidential material in closed sessions
today and the advice we have had is that we have no such
requests. So, look, please do bear that in mind. If
you're about to hit something that you suddenly think
might be confidential, it's not too late. Please
indicate if you are going to walk into something that is
confidential. We don't want to have anything of a lapse
on that front today.

Okay. Well, it's time now to move to the substantive
10.13 parts of today. In order to assist the parties in their
planning of participation at this conference the agenda
has been arranged around key topic areas and we are
exploring whether information disclosure is effective in
limiting Christchurch Airport's ability to extract

excessive profits; whether it's effective in promoting services at the quality consumers demand; and, whether it's effective in promoting incentives to invest efficiently and to improve operating efficiency; and, finally, whether information disclosure is effective in promoting prices that are efficient.

The agenda you'll all know from our e-mail of the 17th of May.

Okay. Well, let's do the routine of appearances and I'll do it the way we've done it previously. We'll just go round the room and if you could identify yourself, name and organisation, and can do it slowly so the stenographer gets to know who you are. So do your microphones as a trial run, so can we go around starting with -

ADRIENNE DARLING: Adrienne Darling, Auckland Airport.

CHARLES SPILLANE: Charles Spillane, Auckland Airport.

CRAIG SHRIVE: Craig Shrive Russell McVeagh on behalf of New Zealand Airport.

KEVIN WARD: Kevin Ward, New Zealand Airports Association.

MIKE BASHER: Mike Basher for Wellington Airport.

MARTIN HARRINGTON: Martin Harrington, Wellington Airport.

NEIL COCHRANE: Neil Cochrane, Christchurch Airport, and I'm supported on my left by Alex Sundokov from Castalia as our commercial advisor, not as an expert witness, and Simon Thompson on the right. I would note, however, that Jeff Balchin, our independent WACC expert, isn't in attendance today as a consequence of no confirmation of any positions or strict questions on WACC, but we would respond in cross-submission should there be any issues arise.

CHAIR: Thank you.

BRENT LAYTON: Brent Layton at the request of BARNZ.

KRISTINA COOPER: Kristina Cooper for BARNZ.

JOHN BECKETT: John Beckett, BARNZ.

NICK McDONNELL: Nick McDonnell, Air New Zealand.

SEAN FORD: Sean Ford from Air New Zealand.

JOHN WHITTAKER: John Whittaker from Air New Zealand.

PHIL de JOUX: And Phil de Joux from Air New Zealand.

CHAIR: Right, thank you. Are there any other appearances that we need to note for the record in terms of attendees in the audience?

KRISTINA COOPER: Sorry, I'd just like to put for the regard that BARNZ is here today representing the international only airlines operating into Christchurch Airport; namely Emirates, Singapore Air, Virgin Australia and Air Pacific soon to be renamed Fiji Airways. In addition, we are also representing several freight operators; namely Airwork which provides air cargo services for Express Couriers Limited and Fieldair Holdings which provides air cargo services for Air Freight, who will also be present later today.

CHAIR: Okay. So, some of those aren't actually members of BARNZ as such?

KRISTINA COOPER: Airwork and Fieldair Holdings are the members of BARNZ and they provide services for Express Couriers Limited and Air Freight respectively.

CHAIR: Right, thank you. I just want to avoid the situation of, you know, having evidence or questions answered on behalf of non-parties. So, we'll just face that when we come to it. Okay. Well, look, if there's nothing else we have to do for housekeeping let's make a start on the topic of profitability, and the questioning of that today is going to be shared by Sue and Pat. But before we get there, of course, we have the presentation to be made by Christchurch Airport.

So, look, I'll hand over to you and the floor is yours for the next 45 minutes Christchurch Airport.

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NEIL COCHRANE: Thank you, Chairman. At the outset what I would like to do is express my sincere thanks to the Commission for this opportunity to present our approach. From the comments received, and also with some discussion with the Commission staff, we felt by providing this presentation it enables us to give you the rationale and the logic applied in terms of the end conclusion reached.

What I would like to do today is just, as you can see, 10.17 outline why we wish to move to a medium-term pricing methodology; the key properties of the pricing model we've developed and how it works, and also the areas of disagreement; how one should interpret the results; how CIAL has used the pricing model in making pricing decisions; and also some comments on the implications for PSE3 and beyond. Then at the close of play is really any points of clarification that the Commission may seek.

What I would like to do here first is to put into context of why we have taken the approach we have. As 10.18 the Commission is aware, we've just completed a major - integrated terminal with approximate value of $237 million - such infrastructure investment really only occurs every 40 to 50 years following our previous domestic terminal reaching the end of its useful life. That was actually designed and built in 1960 and at that time there was only 200,000 domestic passengers flowing through that. In the recent times, the maximum has been about 4.3 million. So, it basically required a replacement.

10.19 The ITP has been designed as an efficient increment in terminal capacity, allowing for changes in passenger facilitation process, both currently as being practised by the airlines but also more particularly likely to occur in the future. And, as we know, technology and the use of smart tools such as iPhones is playing a significant part in how passengers will be processed through terminals. But we also have done as part of that, is included a path for future expansion for the terminal when it's required, now with the objective of basically being ensuring we make a sufficient investment at this time and avoid significant investment upfront while utilisation may grow in the future. However, in approving this investment, our board, our shareholders, 10.19 have a requirement that we will ensure we sufficiently recover this investment and achieve the required rate of return over the asset life-cycle, namely NPV=0.

In considering our pricing strategy we had to consider a commercial point of view, and one of the critical things we have sought to do is to minimise the effects of what we see as demand distortions and inter-period price shocks that get driven by a major investment cycle and the related costs of services. The approach we have taken endeavours to avoid such price shocks and provide 10.20 more stable cash flows for both CIAL and the airlines. But also what we want to ensure is we don't make an inefficient short-term investment which will be to the detriment of all parties.

We considered several options in terms of how we would recover our necessary revenues to achieve this return which was a result of our significantly increased asset base and particularly the total cost of service using the building block approach across specific periods, however, there are two different options and two different 10.21 consequences.

The first could be to take a short-term pricing approach based on the total costs of service in the building blocks in specific pricing periods, but it is felt that applying this building block approach for a

long-life infrastructure asset basically is inherently
inefficient. It would force users during the early life
of the asset to pay more per unit of use than future
customers, and we will provide some more detail
throughout this presentation to explain the consequences
and how this works; or, and in fact the approach we have
taken, is to take a medium-term approach, which basically
considers the life-cycle of the asset, and to meet this
end we've developed a levelised constant wheel price for
10.21 our varied services, and that covers airfield services
and the various terminal services to determine the target
revenue path that well over the 20 year period ensures we
will receive the necessary revenue to give us the
required return.

I have noted that CIAL doesn't want to exceed NPV=0,
but that principle doesn't necessarily mean that revenues
through applying this medium-term approach will mean that
in any one year or any five year period, that we will
match the costs of service. Again, we'll cover this off
10.22 shortly. However, when we set the prices it's not just a
mechanical process. There is a need to take a commercial
perspective which we need to take in consideration,
because this will affect our judgements. Such judgements
are really on how quickly we believe we are going to be
able to achieve the price path that will achieve such
required revenues. In reaching the final price path, the
pricing decision we have made for the next five years
seeks to achieve a balance between targeting the required
return and responding to the current market conditions,
10.23 and this includes having considered, firstly, a stepped
change in price that's required from such major
investment, the airlines have a position that they're not
willing to pay for utilisation of assets until the asset
is completed and in use and therefore you will have

stepped change as a consequence of infrastructure; we're also seeing the residual effects of the GFC and the impacts on business; and, unfortunately in our situation, we have the impact of the Canterbury earthquakes which has had a particular impact on demand.

If I can illustrate this through, if we looked at 2010 our total passenger volumes were approximately 6 million; 2011 they were 5.5 million; and, in 2013, the current year, that is dropping to 5.4 million. The earthquakes 10.24 are having significant impacts on demand and the uncertainty.

And so, in making this final decision, we recognise that we are exposed to a competitive market. If I can use some examples on that.

CIAL is in competition with Auckland Airport, particularly for direct services into New Zealand from overseas services, including the United States, Asia and the like, and more so, more particularly on the trans-Tasman, and if I could note that the trans-Tasman 10.24 passenger volume represents 84% of our total international travellers. We are seeing particularly with carriers such as Jetstar, they predominantly fly point to point, and what we are seeing now is a substitution or a move towards direct travel into airports in the South Island apart from Christchurch, particularly Queenstown, and one thing we have seen, or Queenstown has experienced, is double-digit growth in terms of their international passengers. But also, more particularly, in New Zealand there has been an overflying 10.25 by other airports over Christchurch through to Queenstown and, in fact, what has actually happened, because of this change in practice we've seen withdrawal of services from Queenstown to Christchurch by Jetstar.

So, accordingly, in considering our pricing approach I

would urge the Commission to give full consideration to
how do airports ensure that over the lifetime, and the
risks and returns required from major investment
decisions, that we reflect the trend over a series of
periods, not just one individual period in isolation.
What I would like to do now is to pass over to Alex
who will cover in more detail how we've defined the
problem I've outlined and the pricing model we've
developed in response to that.
10.26 **ALEX SUNDOKOV:** Thanks very much. So, what I would like to do
first is start by clarifying some terminology that I'm
going to use, because I think some of the confusion that
Mr Chairman referred to perhaps arises out of the
proliferation of tools and models that have been
presented, both during the pricing consultations and at
the various stages in the submissions to the Commission.
So, there are three separate models that we will refer
to. The first is the pricing model, which I will
explain. Secondly, we have developed what we call a
10.26 check model and that model was developed after it became
quite obvious that there was a controversy around the
issue of tax in the way that the pricing model works, and
so in order to clarify the implications of the pricing
model we developed a check model where the objective was
to use all the other elements of the pricing model but
bring in the more direct treatment of tax in line with
the input methodologies in order to provide a check on
how the pricing model deals with the tax issue. And then
third there is the IRR model, which is the model of the
10.27 type the Commission has developed which provides a
further check and a further way of thinking about this.
And all of these models I mean are fundamentally
obviously based on exactly the same information but they
provide slightly different insights into what's going on,

and it's kind of useful to keep that in perspective.

So, let me start by focusing on the pricing model, and the pricing model is really a tool to support the pricing approach rather than a mechanical device to calculate prices. As you know, the fundamental issue with any long-term infrastructure is that the cost of service for such infrastructure is the highest during the early years, you still have an under-appreciated asset and so you have very high cost of service. The utilisation of that infrastructure is the lowest during its early years. It's built for expansion over a period of time. So, inevitably, if you're going to try and recover the full cost of service in every year of the life of the asset, you're going to have a problem creating a seesaw of prices where the prices will be highest during the early years, then they will decline until the next increment of capacity is built and then the price may jump again. And I think that's one of the things that motivated Christchurch Airport to really think very seriously about avoiding this in the future, is obviously a fairly painful experience of having to go through the seesaw right now. I mean, the price rises for the domestic terminal are very substantial, there's no hiding that fact, and while they're necessary, it's quite difficult to implement them given the market conditions. And so the desire is to use this opportunity to move towards a pricing approach that as much as possible eliminates these kinds of shocks.

Now, clearly there is almost an infinite variety of ways in which this can be done. One can move to a tilted price where you start with a low price and then delay revenue recovery until later years, or can be a levelised price or, you know, a number of choices can be made here. It seems to us that kind of a reasonable logical approach to use as a benchmark is to aim for levelised price, which effectively means that per unit of use, the users of the airport pay the same today as they will pay in the future. That's really the kind of underlying logic of the levelised price. At the same time, I think as Neil said, it's also important to remember that the model is not a mechanical device. The model provides a ceiling against which CIAL can judge whether, how far it's approaching its required cost recovery of a time. But there are very important competitive constraints that Neil has mentioned, and these constraints are not theoretical, they're very real, and these constraints have translated into the fact that the actual prices, as they have been set for PSE2, are not calculated from the model, they are actually substantially below the levelised constant real price, and the constant real price forms a target and then the set of commercial judgements is applied to try to reach that target over a period of time. Of course, given the competitive pressures there's no sense of a guarantee that that target can always be reached.

So, let me go into slightly more detail specifically on the pricing model. The pricing model has many of the usual attributes of a building blocks model, where we aim to estimate the cost of service. The cost of service in this case is a somewhat simplified version which consists of a pre-tax return on capital, return off capital and opex, and it's this pre-tax return on capital that I think has caused controversy, and I'll come back to that in a bit more detail to explain why we think that's a completely reasonable way of doing it.

But why did we do it in the first place and then having to go through quite a lot of analysis to justify it, is that we were looking for a very transparent and a kind of simplified way of setting that long-term levelised price target. I think it's important to emphasise that clearly it is impossible to fix prices for an infrastructure asset for the duration of its economic life. I do a lot of work on long-term concession contracts around the world and I've never come across a concession contract that fixes prices for the life of the contract. Typically what you find is that there is a levelised price and then there are reopeners and then 10.32 price reviews to deal with it, with the reality that the world changes all the time and prices have to adjust.

So, the best way I think to think about a levelised price in this context is it's kind of like a rolling average. Its purpose is to dampen the fluctuations, but to allow for the regular reviews of factors that clearly need to be reviewed. So, in this particular case the model is a 20 year model, the life of the assets is much more than 20 years, and the intention is to run the model so that at every five year price reset, another 10.32 five years of life gets added to the model, and there's a look through to 20 years forward. The reason for that is that, of course you can take any model and you can roll forward 20, 30, 50 years, you know, it's a copy and paste columns going ahead, but we all know that the quality of that analysis deteriorates very very quickly. So, it seemed to us that a 20 year look forward is kind of a reasonable and a practical compromise.

Also, because this model has to function within the five year consultation process as required by the Airport 10.33 Authorities Act, there's quite a deliberate choice made to include only capex for PSE2 into the model, so only the next five years incorporates expected capex. The remaining 15 years do not have new capex at the moment and the idea is that that obviously will have to be consulted. So, clearly the model in a sense understates the 20 year average because there will need to be additional capex, but that will be incorporated at the roll-overs as consultation takes place on the five year capex required for each pricing period.

In that context, there are I think clearly a number of factors that are reasonable to review at the five year roll-over points. Demand forecasts which play a very important role in the calculation of the levelised price
10.34 will obviously need to be updated, and the logic of five year reset is that under normal circumstances the airport takes, once the price is set the airport takes volume risk within the five year pricing period, but at a five year period, at a reset, there's a review of the reality of the forecast.

One of the disagreements, I think, that obviously has come through in the submissions between CIAL and - between CIAL and the airlines and to some extent perhaps CIAL and the Commission, is the analysis of WACC. Now,
10.35 the disagreement, as I think has been explained in the submissions, is fundamentally a disagreement about the effects of the global financial crisis. It's about very specifically dealing with the issue of the impact of the global financial crisis on the cost of equity and whether the standard implication of capex asset pricing model, where you have long-run calculation of the market risk premium, continues to make sense during what I think many people in the market see as a disequilibrium period while the risk free rate is at an unusually low level as money
10.35 flows out of commercial activities and into Government Bonds. But whether that agreement -

COMMISSIONER DUIGNAN: Just to clarify, you're indicating that your view is that the CAPM model is not applicable following the global financial crisis?

ALEX SUNDOKOV: Right. As we've said in the submissions, we think that it is - I mean CAPM model is always an estimate rather than obviously, necessarily a true description of reality but we think that during periods of global market disequilibria, the estimates produced by the CAPM are going to be further from reality than they normally are. The point I wanted to emphasise is that that disagreement is also more than likely a temporary issue. That disagreement is almost most likely a temporary issue. That the expectation I think is that eventually financial markets will return to the equilibrium, and so, again, it's completely reasonable to review the WACC at the next price reset and to see whether the adjustment that has been made in order to deal with what we perceive as being disequilibrium financial market conditions still is needed in five years time.

So, this is all just simply to say that this is, the model does not attempt to fix prices forever. The model attempts to provide a framework for estimating a levelised target price, as well as a framework for reviewing that within a context of dampening fluctuations.

COMMISSIONER DUIGNAN: I can't resist commenting, I'm sure we would all like to be able to take the global financial crisis out of our own life experience.

COMMISSIONER BEGG: Could I just ask, what things won't change next time round? I mean, you've said nearly all the inputs to the model will be reviewed and consulted on in the next five year period, but in what sense is there continuity?

ALEX SUNDOKOV: I think that there are probably two key elements of continuity. One is that the asset value, obviously it's not fixed, it's rolled over, but it's rolled over within a slightly predictable structure. And secondly, there is a continuity to the way that the model will bring all that information together into the next 20 year forward look.

So, the way the model works in the mechanical sense is really very simple. It calculates the present value of the cost of service, and then draws a line through using the demand forecast to obtain a starting price, or starting set of prices, because clearly these are 10.38 different prices for different services, in a way that gives you NPV=0 over a 20 year time. So, it's fairly easy to see from this that two things really matter; the present value matters, so the timing is somewhat less important, the timing of the cost of service becomes less important, and I'll explain that when I come to the issue of tax; and secondly, what really matters is the tilt of the demand curve. So, if you think that volume will grow faster, then obviously that will change the starting price.

10.39 So, I think it's important to just kind of quickly run through, therefore, how that pricing model should be interpreted. First, the total cost of service in any one year is an approximation, a particular approximation that relates to the tax allowance. Secondly, the model, as I said, isn't really used mechanically to set prices. Having set the levelised price, the model is then used to calculate revenues from the actual prices and to compare those actual prices to the revenues that would have been obtained had the levelised constant price been set, and 10.40 so what the model really allows you to do is to understand what's going on against that benchmark, against that medium term benchmark.

The levelised constant price is seen as a ceiling, and what that means is that kind of by definition the way the model is set up, any time the actual price is below the constant levelised price it's a permanent under-recovery, because there's no mechanism then in this approach to recover that in the future. So, I think that's kind of important, to draw a distinction here between the fact that the model may not be fully recovering the cost of service in any one year. Clearly the tilt of the revenue curve means that, while the model isn't recovering fully the cost of service during early years, it will need to recover more than the cost of service, the pricing will need to recover more than the cost of service during future years. That's just the nature of the levelised constant price. But when the price is below the levelised constant price, that under-recovery becomes permanent. And, if I can just move on and to illustrate that with a picture.

So, if you now think of this as being a revenue curve. So, the bars represent - and this is very stylised because obviously the bars of the cost of service should be declining and they'll differ from year to year. With the levelised constant price, since demand is low during early years and expected to be higher during later years, you would expect that the revenue in the model would not recover the cost of service during early years but would need to earn more than the cost of service during outer years of the life of the asset. But to the extent that during the first five year period prices are below that revenue curve, that would have been obtained, if the levelised constant price had been applied from day one, then that under-recovery becomes permanent. So, there are various numbers sort of floating around, 16 million, 20 million, and so let me just be quite precise what these numbers mean.

20 million is our estimate, approximate estimate of

the revenue of the cost of service in PSE2 that will need
to be recovered in future periods. 16 million is the
estimate of the permanent under-recovery, that's the gap
between the revenue at actual prices, and the gap that
would have occurred had the levelised constant price been
applied from day one, and I realise that that distinction
had caused some confusion. So, let me now come -

COMMISSIONER BEGG: Just before you go on, can I just check
how you're intending to deal with demand risk. Am I
10.43 hearing you say that once you've set demand for the
five year period, then that's, Christchurch wears the
risk; there's going to be no attempt in the future if
demand is much lower than expected, say for this
five year period, there's no intention that you would try
and recover that in the future?

NEIL COCHRANE: We are certainly not looking to recover that
in future periods but one of the issues we have at
present and is a particular point of concern, is that
when the demand forecast was actually made approximately
10.43 15-18 months ago, it was based on the best information
available, and unfortunately going through natural
disasters, there's no model you can say, look at what
happened in a certain event. We looked at what happened
in Kobe, for example, when the earthquake happened there;
we looked at what happened in Phuket when the tsunami was
there, and that demonstrated that the recovery post an
event such as that was relatively short, possibly
two-three years. Unfortunately we've had one further
issue that nobody else has ever had. We've had a number
10.44 of after shocks, in excess of 11,000 since the
earthquakes have occurred in 2010 and 2011, and one of
the concern we have is the demand risk.

If I look at the current position at present, the
demand forecast for even 2013, we are seeing, while

passenger numbers aren't too much of a distortion, we are
certainly seeing significant difference in aircraft
movements and also capacity, you know, particularly in
terms of the various in total Macto, we're about just
under 9% under what was forecast. So, I'm not saying no,
but if the position was that if we had another major
disaster, then we would need to give consideration about
whether we needed to reconsult with our airline customers
earlier. But at this stage there is no intention to but
10.44 this is an area of uncertainty.

ALEX SUNDOKOV: So, I think -

COMMISSIONER DUIGNAN: Could I just ask, I mean under the
five year price setting it's normal for you to bear the
demand risk. I mean there's no precedent, is there, for
you having reopened negotiations part-way through a
period because of that?

NEIL COCHRANE: You're correct in that respect. The issue we
have, though, is that we believe these are unknown times.
Nobody else has had a situation like this and the
10.45 question and was one of them - and as you can see from
that chart that Alex just talked about earlier, that
16 million, that was - you know, Christchurch recognises
it should carry a fair share of the burden of
Christchurch earthquake; it's impacted airlines, it's
impacted Christchurch, it's impacted the South Island.
That was a commercial judgement, it wasn't a mechanically
derived figure. However, if through an extension of the
impact on the market, particularly the Christchurch
development programme, we're saying, is that fair, that
10.46 CIAL and its shareholders carries that significant extra
cost? What we're saying is that there may be abnormal
circumstances, in which case an earlier consideration of
price reset may need to occur.

ALEX SUNDOKOV: But I think just to come back to that.

Clearly I think in this regard we draw the distinction between kind of normal commercial risk within the price period and extreme circumstances, and so there's no expectation of reopening the price within the context of normal commercial risk, but the circumstances just, it's very difficult to know whether they'll be extreme or not.

Let me now come to the question of tax, which has caused a lot of consternation and I think, unfortunately, has been somewhat confused.

10.46 The way that our pricing model works, kind of really kind of abstracts from the issue of the tax allowance by using a pre-tax WACC to calculate the return on capital. So, clearly, in that you can say, well, there's an implied calculation of the tax expense, and that implied calculation is the difference between multiplying the asset base by the pre-tax WACC versus multiplying it by the post-tax WACC, and the difference is the implied tax expense. And I think it's blindingly obvious, and we completely agree with the criticism or statements, that
10.47 this does not represent a true estimate of the tax payable in that year. I think that that's just not a question that we think is at all in dispute, that's an absolutely correct observation. The problem is it's not a relevant observation. It's not relevant because the way that the tax allowance enters into the calculation of the levelised constant price is only through the present value of the tax allowance. So, there is a valid question to ask, is there anything about the way that we have a simplified tax treatment that could possibly
10.48 increase the present value of the tax allowance?

So, again, let me just emphasise that again. It is completely correct that if you calculated the implied tax expense from our pricing model, particularly for PSE2, by looking at the difference between pre-tax WACC and post-tax WACC and multiplying them by the asset base, and then compared that to the expected tax payable using the IMs in the same five year period, or in any one year of that five year period, you will get a disparity. So, it does not attempt to be a forecast of price payable in that year.

The question is, does it matter in any way for the setting of the levelised constant price, and our answer is no, it doesn't. The only thing that matters is the 10.48 present value of the total tax allowance. And so, the question is, the relevant question is, is there any risk that our simplified treatment leads to a higher present value of the tax allowance than would have been obtained if you went through a more detailed exercise of calculating the estimated tax payable for every year for the next 20 years, assuming you can do that, and then bringing it back to the present value.

So, this is the reason why we developed what we call the check model, which is precisely to answer that 10.49 question and to see whether, you know, is there risk that we got it wrong.

This is where it gets quite tricky analytically because clearly the question is, well, what is the discount. When you have pre-tax cash flows, it is obvious that you apply a pre-tax WACC, discount rates are discounted. When you have post-tax cash flows, you apply a post-tax discount rate to discount them. But when you calculate tax payable in any one year, you actually don't know which discount rate to apply because the discount rate depends on what is the effective tax rate that's consistent for that tax payable, and you would expect that the effective tax rate is probably somewhat less than the statutory tax rate because of the benefits of tax deferrals. So - sorry.

COMMISSIONER DUIGNAN: Could I just ask, isn't it sort of
entirely predictable going into the exercise that there's
going to be a disagreement about the discount rate,
because there always is, because it's always going to be
WACC and one can sort of predict in 99% of the cases.
Therefore, even leaving aside the complication that
you've spoken of, that in going for this piece, that it
just inevitably will generate controversy?

ALEX SUNDOKOV: I don't think so because I think analytically
10.51 one should separate the disagreement about the WACC and
the disagreement about how you go - so, if you like,
there's - the disagreement about the WACC to me is
fundamentally a disagreement about the post-tax WACC, and
so yes, you would expect that to be, a level of
controversy about that. But if you agree, or if you
agree to disagree about what the post-tax WACC should be,
the formula of moving from the post-tax to pre-tax is
relatively a mechanical process. So, that to me
shouldn't be part of the debate about what the level of
10.51 WACC should be. Yeah, so hopefully that made sense.

So, we think that - I mean, I think what you're saying
is that I think that some of the emotion that has been
generated about the tax issue probably comes from a kind
of, a reaction to the total level of WACC rather than
saying it has anything to do with the tax treatment, I
think that's probably right but I think that's
analytically wrong because it confuses two separate
issues to my mind.

So, what we've done with the check model is we wanted
10.52 to satisfy ourselves, and obviously satisfy the major
customers, that the present value of the tax allowance is
reasonable because that's really the only thing that
matters for the levelised constant real price, and the
way we did that was to say, okay, if you were - so we

know what the present value of the total pre-tax cash flows is in the pricing model, it's $650 million, and that's discounted at our estimate of the pre-tax WACC. So, then we said, okay, if we now take our check model, which calculates the tax payable for every year over the next 20 years, what would the discount rate have to be in order to arrive at the same present value as is in our pricing model, and what does that tell us about the implied effective tax rate that enters the
10.53 calculation, and as the check model shows very clearly, the discount rate that equalizes present values is 12.74% compared to the, our estimate of the pre-tax WACC of 13.67%, which is another way of saying that the implied effective tax rate that's underpinning the tax allowance and the levelised constant real price is about 24% - 23.4%.

COMMISSIONER BEGG: Can I just ask, the nominal cost over 20 years you say for tax expense and tax payable is the same amount. Is that because you're not taking into
10.53 account the time factors? Because that seems surprising if you were to take into account where the, what period, through that 20 years when you paid the tax.

ALEX SUNDOKOV: Well, that's exactly what the nominal is. The nominal is just simply adding up -

COMMISSIONER BEGG: So that's just adding up the totals over the years.

ALEX SUNDOKOV: Exactly. So, what it says is that, I mean the benefit of tax deferral is that the same nominal amount is paid later, and that's precisely why you would expect that the effective tax rate would be somewhat lower than statutory tax rate.

COMMISSIONER BEGG: Then you're saying, bearing in mind that you've got different paths of tax payment, to make those different paths the same you've used these different discount rates?

ALEX SUNDOKOV: Well, exactly except - I mean, that's exactly right except what we do is we goal seek. So, we say, we know what the present value is for, deriving from the pricing model, so then we ask what the discount rate, and we goal seek the discount rate that would give you exactly the same present value using the tax payable timing.

COMMISSIONER DUIGNAN: Well, I mean, you start with the 2.797, 10.55 you then apply your discount rate of 13.67, end up with the 650, then you switch to the tax payable and say, well, what would give the same answer but that's - I mean, in a sense the controversy is partly about, well what would the answer actually be under the tax payable if it was done fully in that way, and you take comfort from the fact that you can get equality at 23.4% but, I mean, you're going to get equality at some number. You haven't actually done the tax payable approach and considered what it would give, have you?

10.55 **ALEX SUNDOKOV:** No, we have. No, I think that's a wrong interpretation of what the model does. So, the model calculates the tax payable approach for every year over the next 20 years, and the reason why the nominals are the same is because the difference between the tax payable and tax expense is the timing, so you would expect the nominals to be about the same.

The question then becomes, well, once you've got that stream of tax payables, how do you turn that into present value? What discount rate do you use? Now, for example, 10.56 the Commission, when you raise these, consider these issues in relation, for example, to the electricity sector, you discount the tax allowance by the post-tax WACC. So, one option could have been to apply the post-tax WACC to discount this new stream of tax payable

payments, which would be exactly the implication of the Commission's methodology. The problem is that we know that's an approximation but it's not conceptually right. It's an approximation that probably works okay within a 5 year timeframe, but once you extend it to a 20 year timeframe it actually, the error mounts. So, if we did that, if we took the tax payable stream and applied post-tax WACC to that as a discount rate, the present value would be much higher and so the levelised price
10.57 will have to be much higher. We think that's not necessarily a reasonable approach. So, that's why we goal seek to identify a discount rate which equalizes present values, and then ask ourselves, does that discount rate appear to be sensible.

COMMISSIONER DUIGNAN: I mean, my interpretation is that if the effective tax rate is 23.4, then you get this equality because, and you come back to saying the PV is 650, but the issue in some ways is, is the PV -

ALEX SUNDOKOV: Precisely and that's how you - there's no kind
10.57 of scientific way to answer, is this exactly right.

COMMISSIONER DUIGNAN: But you agree with the observation I just made, yep.

ALEX SUNDOKOV: No, that's exactly right. So, if the effective tax rate is 23.4, then you get this equality. So, another way of saying it is that if the effective rate is higher than that, if the effective rate actually trends closer to the statutory rate, then we have too little and the price needs to be higher. If the effective tax rate is less than that, then we have too
10.58 much. Then the question is, what's the balance of risks? I mean, we did a number of checks on this, as we report, for example, the airport's corporate effective tax rate is around 24%, so that seemed to us to be quite reasonable. But, I guess, the key point I want to do,

the reason why we did this is we felt it wasn't proper to simply apply the standard methodology of discounting this tax payable flow by the post-tax WACC because that would give you much higher present value number, nicely higher prices but wouldn't be justified.

COMMISSIONER DUIGNAN: I mean, we will need to talk about this more and we will want to give our staff the opportunity to engage on it. We can either do that now or if we probably - shouldn't interrupt your process, but if we could just register that we will do that.

ALEX SUNDOKOV: Thanks very much. And by the way, also I would like to thank the staff because we had an opportunity to meet with the staff and go through our models in some detail, so I would like to thank them for their attention on that.

So, let me just conclude my element of the presentation.

Now we come to our third model, which is the IRR model, and our analysis of profitability in PSE2. So, I guess a couple of things that come out of that, that I would like to highlight.

First we ran, again as a check, we see the price path as coming below the levelised constant price, simply because of the commercial constraints, just the reality that it's impossible to, in current market conditions, to move to the levelised price levels as fast as obviously would be desired by the shareholders. We check that against the calculation of the cost of service in PSE2 that would have been derived if we applied the Commission's IM, including the Commission's WACC, as well as the calculation of the cost of service that was produced by BARNZ, and in both cases the actual expected revenue for PSE2 is somewhat below those estimates, and that is just simply, it's not because

Christchurch Airport thinks that those models are better, it's simply because the commercial reality means that that's what the revenue is going to be.

We've also calculated the IRR model using the methodology that you have developed for Auckland and Wellington Airports, and that gives us a 5 year IRR estimate of around 7%, and the reason why I say "around" is that we had a very helpful engagement with the Commission staff where the staff have indicated that, you 11.01 know, there's a valid kind of intellectual question of what is the right terminal value to use in the IRR model; is it the closing asset base, or is it the closing asset base plus that $20 million that needs to be recovered in the future. And so if you use just the closing asset base, the IRR is slightly below 7%. If you add $20 million to the terminal value, the IRR is slightly above 7%. But the variation isn't that great.

COMMISSIONER DUIGNAN: I mean, the asset base that you will use is a topic that we are interested to - sorry, I 11.02 shouldn't say "will use" that you would say will be on offer, because it is a negotiation; that's one issue. Another issue is the treatment of the wash-up that is built into these numbers and where that should be assigned. So, I just think that you've given us this presentation. To me it needs an annex to it that perhaps ought to be supplied, which shows the key assumptions to make it something that, kind of, for the record is properly documented. So, could we perhaps suggest that you might like to provide such an annex so that when in 11.02 the future one looks at this, we have the assumptions.

ALEX SUNDOKOV: Very happy to do that but just like to emphasise that all of that detail, including the assumptions, has already been included in the previous submissions.

COMMISSIONER DUIGNAN: I understand that but with a
presentation that's going on the record, it's rather
helpful to have that.

ALEX SUNDOKOV: Understood.

COMMISSIONER DUIGNAN: Obviously those topics I've just
outlined we need to talk about but we can proceed on this
and then come back to them.

CHAIR: Can I just check, Mr Cochrane, how long -

NEIL COCHRANE: This is the last slide, Chairman.

CHAIR: That's fine. I understand we have interrupted -

NEIL COCHRANE: I want to keep to the timetable. Really, in
conclusion, in considering Commissioner Duignan's
comments we're fully aware from previous conferences and
discussions with the Commission staff that view to draw
conclusions, you're seeking some insight as to what is
likely to happen for PSE3. At the outset I'd confirm we
intend to take a consistent approach as applied in PSE2.
Namely, if you look at valuation methodologies, we will
apply land at MVAU, that is, we're proposing to continue
11.03 with that. However, we do note that expected actual
prices will converge with long-run levelised constant
prices, the question is where, and I'll cover that
shortly. But where future revenues need to exceed in
cost in each year, and that will happen in the future
period as demonstrated by the chart earlier. However, as
we have noted, such future prices can't be prejudged or
fixed in advance. We have an obligation to consult with
our customers. We've already talked about the need to
consider the change in costs, and if there was cost
11.04 efficiencies in PSE2 these will be included in the reset
for PSE3 where we would pass that efficiency gain through
to our airline customers. What is our future capex, what
is the demand volume likely to look at, particularly post
removal of the earthquake influences currently being

experienced in Canterbury, and also the benefits that will come from the Christchurch redevelopment programme.

In addition, while that model sets our target revenue path, our pricing that we will set are constrained by marketing competitor's factors, and this has been clearly demonstrated through our pricing results in both PSE1 and PSE2, and if I could just make one point particularly with PSE2 in terms of those competitive prices and the need to stimulate and grow future volumes, we have held 11.05 the international terminal prices constant at the level that was set 13 years ago, and the reason for that is that there will be an under-recovery but we've done that purely and simply to provide a stimulation to our customers to grow long-haul international travel. This is where those type of factors come into force.

So, in conclusion I would like to thank the Commission again for this opportunity and are happy to provide any points of clarification, including that information asked for by Commissioner Duignan.

11.05 **CHAIR:** Right. Well, thank you, Mr Cochrane. We'll take a break of 15 minutes or so. We've run a little over but that's largely due to our intervention, not the overrun by Christchurch. So, we'll reconvene at 11.20, if that suits everybody. So we'll see you back here at 11.20.

(Conference adjourned from 11.06 a.m. until 11.25 a.m.)

CHAIR: Let's make a start for the next session and Sue and Pat are going to lead the questions for profitability.

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COMMISSIONER BEGG: Thanks, Mark. I just thought I'd ask a 11.25 couple more questions of Christchurch just trying to clarify in my own mind what's going on, and then we will perhaps ask the airlines whether your explanation has helped them or whether they still have concerns about the approach that's been taken.

One thing I wanted to just ask about was the revaluation wash-ups from the previous period that you are treating as income in PSE2, and that is a significant sum as I understand it. I just wanted to check whether the revaluation wash-ups, those ones from the past, are being completely dealt with in that PSE2, or whether there is some carry-over into following years, either directly or through the effect on the levelised prices. When I looked at your model, it looked to me like you 11.26 were treating them in this five year period but then I wasn't sure whether it also had some impact on the levelising. So, I'd just be interested in your response on that.

NEIL COCHRANE: I'll make some opening comments, thank you Commissioner. In terms of revaluations, one of the things why we've treated it in the way we have is that in PSE1 we gave a commitment we wouldn't revalue our assets but one of the things that we determined moving to PSE2 was to ensure that we didn't get too much divergence 11.27 between our financial statements and also what the asset base for pricing. So, what we have done is we've applied the Commission's IMs, and this includes the adjustment made for, the opening adjustment to our regulated asset base in the terms of the treatment of land. So, all of those revaluations have been compiled and carried forward and off-set against the total cost of service as derived by the building blocks model in the five years. So they are there. However, you are correct in one respect. When we looked at the constant long-run levelised price, 11.27 what we have done is they are included in the total costs of service and they've been present valued over it. So, because of that levelising, in the benchmark that Alex talked about there is an element included in there which is spread over the 20 years.

COMMISSIONER BEGG: Okay, thank you.

ALEX SUNDOKOV: I think that answers the question. I have nothing to add.

COMMISSIONER BEGG: Just also in your explanation of the tax effect, one of the concerns of the airlines was the revaluation gains and the treatment of tax. The explanation you were giving us was focusing on the tax expense versus the tax payable and I just wanted, wondered if you had any particular comments that you wanted to make about that, how you've treated the revaluation gains?

ALEX SUNDOKOV: Yeah, so let me just again be clear about which model to refer to. So, in the check model, which is the model that we use to check tax payables, we very carefully make sure that there is low tax on revaluations in the calculation of tax payable. So, while you could argue that it's slightly confused in the pricing model, because it doesn't take account of that, although there it is just a question of timing really, in the check model we certainly treat that very carefully.

NEIL COCHRANE: If I could just add one further point, Commissioner. In our discussion with Commission staff last week we advised them that the, for example the tax depreciation that will be chargeable, that will be accessible, we have full details of that and we will be providing it to the Commission.

COMMISSIONER BEGG: Okay, thanks. Just then my final question. You've tried to reassure us that there's not much difference between the approach that you've used and the approach that you would, the outcome you would have got if you'd used our approach, but I just wonder if you could put a number on the difference that, you know, perhaps an NPV difference, because when I looked in your model I thought I saw that the difference between the approach that you'd used and a post-tax approach was in the order of $30 million for the total tax amount, but I might not have interpreted that correctly.

ALEX SUNDOKOV: I think again the question is difference for what period? You know, is it difference for the implied tax calculation for PSE2? I think that's probably right, 30 million sounds about right, but that of course doesn't affect the price. So, in terms of the impact on price, I guess the question there is when you say "used our 11.30 approach" the question is, what is the Commission's approach? So, if we took the tax pay - if the Commission's approach, as done in other cases, is to take tax payable and present value using the post-tax WACC, then we have done a calculation, sorry, I don't have it in front of me but the present value ends up being quite a bit higher and so the price ends up being higher.

COMMISSIONER BEGG: I'll just check whether Pat's got any points of clarification before we ask the airlines to speak on the matters.

11.31 **COMMISSIONER DUIGNAN:** Well, just first on the point that's been covered about this tax payable, or rather the treatment of tax. As I indicated, I mean it's in the nature of the beast that in a negotiation the things that are very clear, such as the fact that you estimate WACC higher than the Commission does under the IMs, or that the airlines do, sort of something that's quite clear to people and people agree to differ. I just don't quite understand, though, why you thought it - it was in the hope of avoiding complications that you went for this 11.32 simplified approach to tax which then has the consequence of a great deal of debate, but also has this - and I speak from having negotiated matters - this aggravation factor that then you've got the higher WACC, aggravates everybody because there is a piece to which it has to be applied. So, is there anything, other than the fact that you just thought it was simpler going into it?

ALEX SUNDOKOV: Oh, look, I mean with the benefit of hindsight, you're probably right, that what we thought was blindingly obvious turned out to be a lot more difficult to explain. But let me just I think again emphasise, that we really do see the disagreements over the level of WACC as being quite fundamentally different to the question of tax.

COMMISSIONER DUIGNAN: Mmm.

ALEX SUNDOKOV: You can argue whether the WACC is 7% or 9%, but then having decided on one or the other, the calculation from there to the - this is the post-tax WACC - the calculation from there to pre-tax would be exactly formula driven. So, that's why we saw that as being quite different. I think you're absolutely right, with the benefit of hindsight the two got somewhat confused somewhat and, as a result, hasn't been helpful.

But I do think also, the reason why we thought it was easier to do it the way we did was that precisely this question of figuring out what is the discount rate to use for a 20 year stream of tax payable payments? So, you know, we've calculated - apart from any kind of question of what kind of precision can you get trying to calculate tax payable 20 years from now, but having done that, having got that stream of nominals, how do you bring that back to present value, what is the proper discount rate, and that's just not easy whereas I think the way we used it is kind of obvious, you know, you bring it back by the pre-tax WACC.

COMMISSIONER DUIGNAN: Right.

COMMISSIONER BEGG: I just had a couple of questions for the airlines and the first one is, just leaving aside your concerns about these issues that we've just been discussing, I just wanted to get a feel for how transparent you found Christchurch's model and how obvious it was to you what it was that they were proposing. So, I just wondered if you'd mind giving us a bit of a view on that.

KRISTINA COOPER: The model was certainly a lot more complex than that used by Auckland, for example. It took a lot of working through. We were able to understand how it was intended to be used. I think it was good that the 11.35 airport had broken up the activities into the four cost centres, because that provided transparency. It certainly then took a lot of work then to understand what they were doing back at the front end when they were comparing the three different streams.

COMMISSIONER BEGG: Thank you. Air New Zealand?

JOHN WHITTAKER: I think the same but I think we also made representations to have that model simplified and to have some of these things addressed, and that those weren't ever picked up. You know, once Christchurch had gone 11.35 down this path it kept going down this path and, you know, I don't think it listened to much that we had to say about these things.

COMMISSIONER BEGG: Thanks. Then I'd ask you to respond to what you've heard about the tax treatment which has been one of your major issues in your submissions, and whether you still have concerns or whether you've been reassured by what Christchurch has said today?

KRISTINA COOPER: Thank you. Not reassured at all. I think Christchurch has completely missed the key concern we 11.36 have and it's unfortunate the presentation is not there any more but there's a slide called tax expense versus tax payable over 20 years, and the concern we have is that at the very first point on that slide where the tax is calculated, the nominal tax is calculated for 20 years or, as we were working through it in consultation for five years, the airport has overstated that tax payable simply because it is not deducting income from revaluations from its taxable income when it calculates the tax, and in so doing it is inflating its required revenue by requiring airlines and passengers to pay tax on income that's not taxable.

COMMISSIONER BEGG: Can I just check with Christchurch, because when I looked at their model when they model tax 11.37 payable, my understanding was that they did treat the revaluation gains as income but didn't really in the tax expense, so I just -

ALEX SUNDOKOV: Indeed, we think that statement is wrong. I'm not quite sure what we need to do to demonstrate that it is wrong but it certainly is wrong.

COMMISSIONER BEGG: But that was in the cross-check model, I thought that they did treat it appropriately, but that doesn't necessarily overcome the problem that in the tax expense approach they've used the statutory tax rate and 11.37 haven't explicitly addressed the revaluations I don't think, so that might be what you're concerned about.

KRISTINA COOPER: I think it is. When we go into Christchurch Airport's pricing model, there's four spreadsheets, one for each of the airfield and the various terminals and there's, you know, a summary at the end where it sets out the full cost of service calculation and it shows quite clearly that when Christchurch Airport has calculated its tax there, you know, it has not made any deduction for income from 11.38 revaluations when it calculates it. And so a concern is that the overall, you know, total cost of service is therefore overstated, so therefore when the airport comes back to calculate its levelised price, it's calculating a levelised price to reimburse it for more costs than it is actually incurring.

COMMISSIONER BEGG: I think our modelling suggested that there is a difference, that's why I was asking Christchurch before whether there's a difference, but I hear from them that it does depend a bit upon the assumptions you make about discount rates and so on. I will just check whether staff had any follow-up or clarification they wanted to make on that?

CALUM GUNN: Calum Gunn, Commerce Commission. I think part of
11.38 the questions that are in our minds from looking at the models, we've raised this earlier as well, is that part of it is to do with the transformation from post-tax to pre-tax WACC, and I think you were mentioning before, it's a fairly mesonistic process. Although it's mesonistic, one of the difficulties in doing the mesonistic calculation is the assumptions that are implicit in that as to whether the effective tax rate's taken into account appropriately and whether the revaluation rate or inflation rate is taken into account.
11.39 So, I think when - we looked at the check model our sort of first question was well, we understand the questions raised around what the appropriate discount rate is on a pre-tax basis but it would perhaps be just more straightforward just to recognise that both those revenue streams, one based on the Christchurch approach, and one based on a more traditional Commerce Commission tax payable approach, those two revenue streams over time, the 20 year period, both generate post-tax returns, and you can compare those by discounting on post-tax WACC
11.39 basis. That was probably a more straightforward way of doing the comparison, recognising that there is quite a lot of, I guess, controversy in the literature about the appropriate transformation at post-tax to pre-tax. Generally the recommendation is you're on safer ground

when you're doing a using post-tax discount rates.

ALEX SUNDOKOV: Well, I think that that's right, and if you did that, if you discounted the tax payable - there's always obviously a problem with discounting pre-tax flows by post-tax WACC but let's kind of strike from that, but if you discounted the check model which is the tax payable pre-tax cash flows, in other words, cash flow incorporating the tax allowance, by the post-tax WACC - is that what you're saying?

11.40 **CALUM GUNN:** Well no, we're suggesting that you've got your pre-tax revenues effectively.

ALEX SUNDOKOV: Yep.

CALUM GUNN: Those generate post-tax cash flows and you model your construct with what those post-tax flows are and you can discount the post-tax cash flows associated with the two revenue profiles based on a post-tax WACC and compare those.

ALEX SUNDOKOV: Sure.

CALUM GUNN: And that gets away from the controversy of when 11.41 you're generating what's the implicit effective tax rate, does your pre-tax discount rate, the transformation, is it correct or not.

ALEX SUNDOKOV: I agree and I think that is what the third model, the IRR model, effectively tries to do and you've seen the results of that.

CALUM GUNN: So sorry, that's quite a technical - that's sort of at the heart of some of the ways we're approaching it.

ALEX SUNDOKOV: Sure.

CALUM GUNN: And we're interested in anything in the 11.41 cross-submissions, any clarifications and thoughts you might have about how that check could be made more transparent and reveal I think some of the concerns the airlines have, is that on the one hand the airlines are somewhat more focused on PSE2 when in fact the levelised price is less relevant, and your concern is more in the long run but it's really joining the dots between those two approaches and getting to some view on how material is the difference in the approach over the 20 years.

ALEX SUNDOKOV: Yep.

NEIL COCHRANE: Thank you, Commissioner. That was certainly the crux of the discussion we had with the Commission staff last week. We haven't calculated that way but we will give consideration to that.

11.42 **COMMISSIONER BEGG:** Thank you. I'll just check whether Air New Zealand had any comments they wished to make on this matter?

JOHN WHITTAKER: I think only that clearly in the consultation the tax, the rate - the revaluations were grossed up for tax and that was used then to calculate the cost of service, and the claim from Christchurch is that their actual prices are less than the cost of service and when they've made that calculation they've compared a cost of service which clearly has a tax component on revaluations
11.42 which does not exist and then claim to be underneath it, and so there's been a lot of, sounds like a lot of post-consultation undertaken that we're not familiar with at all but in what was presented to us there was a clear error or anomaly which affected the judgements that Christchurch must have been making at that time about what was acceptable pricing, and despite repeated submissions in that regard to them, they chose to proceed down that path.

COMMISSIONER BEGG: Thank you.

11.43 **ALEX SUNDOKOV:** I just wanted to clarify, the check model was supplied during the consultation process, not after the consultation process.

JOHN WHITTAKER: Sorry, at the end of the consultation process.

ALEX SUNDOKOV: Well, if I recall correctly it went with the draft proposal but not with the final proposal.

COMMISSIONER BEGG: Perhaps you can clarify that in cross-submissions if that's important.

BRENT LAYTON: I was asked by BARNZ to have a look at this and I'd have to say my head went round and round in circles with all the explanations I got, so I wasn't at all convinced that there wasn't something going on here even in the first model that should be raised. My advice to BARNZ was that they should continue to raise this issue and that they should continue to raise this issue with the Commission. It has the ability, I think, to get numbers and expositions that hopefully can clarify it, but it certainly wasn't clarified in my mind that it was exactly right, and I would note this morning that there wasn't actually this element of the discussion at the presentation, that it was levelised yet. This was from my feedback from what was engaged in the consultation, I didn't attend apart from one session. The feedback was that this was an important issue that was discussed.

COMMISSIONER BEGG: Can I just check whether staff had any questions on this - oh John, sorry.

JOHN BECKETT: Just make a comment if I could, just adding on to what Brent Layton has said. It just seems to me that if revaluations are not treated as being taxed when they are treated as income, so that there isn't tax with them when they're treated as income, that part of the income should not be grossed up for tax, up to calculate the tax that has to be added. It's just a matter of - it just seems like a mathematical matter, not a complicated, sophisticated tax matter that needs to be discounted out 20 years. It's just plain simple, if you don't take it off when you go downwards you shouldn't put it in when you go upwards.

COMMISSIONER BEGG: Okay, that sounds fair enough. What's your response to that, Alex?

ALEX SUNDOKOV: I mean, I think I just want to emphasise again that we completely agree, that's exactly right if you're trying to get the tax payable right in that year, it's just it doesn't matter for the levelised model, that's the only thing.

NEIL COCHRANE: If I could add one final point, Commissioner, is that the discussion we're having here on tax relates 11.46 to the constant long-run levelised price and what is that profile over the life of the asset. If we look at PSE2, as we've identified, and particularly through the IRR model, our actual charges are less than all of those and, therefore, this is why the IRR, in fact depending whichever way you go, is either slightly below 7% or just above it. So, in terms of PSE2, this isn't an issue that is saying we are overcharging, we are not.

COMMISSIONER DUIGNAN: Just, I mean, given what we are doing with the 56G reports, is answering the question how 11.46 effective has information disclosure been, and there's a number of aspects to that but I just would like to give Christchurch the opportunity to address the issue that, doesn't what's been discussed indicate that while you are able to point to an end result, that in terms of the actual process, the fact that you didn't kind of address the tax payable, which was a piece of the information disclosure, has kind of caused the problem, if I put it as bluntly as that.

NEIL COCHRANE: Thank you, Commissioner. I think if 11.47 we - hindsight is a great thing. If we look at the situation now, I believe that, yes, this has been - if we understood the issues at present, that is one area we could have done better. But I believe that the information disclosure has provided us with a basis on

the wider sense of things to provide a better
articulation of our pricing methodology. Yes, we
appreciate, and a lot of the discussion this morning has
reflected that we didn't get that message through as
effectively as we could but I believe in terms of which
of the decisions that were made, our input elements, how
they were determined and the final decision being made,
the information disclosure regime I did believe was
robust, provided greater transparency.

11.48 **COMMISSIONER DUIGNAN:** Right. I would now like to just move
on to the, to first of all to just in some sense a
technical question. The pricing period is for 4 years
7 months, and this complicates life for all concerned,
just as a practical matter, no reflection, but the
question that I particularly want to ask was that in our
IRR analysis there are two ways of responding to this
difference in the pricing period compared to the
five years that we had sort of envisaged. So,
particularly in terms of the asset values, there are
11.49 two options that we're aware of, and there may be others;
to use the asset value disclosed in the ID for 2012,
which would mean our analysis is based on a five year
period and we would have to introduce cash flows for the
immediate five months period, including substantial capex
and make the adjustment that way, or alternatively to
estimate the asset values at the 30 November 2012 which
would mean that it was based on 4 years 7 months but we
would have to then decide the appropriate way to
introduce the asset values, or to calculate them for this
11.49 date that's not a disclosure date.

So, we would wish to hear the views on the two, well,
the various parties on that choice, thank you.

NEIL COCHRANE: Thank you, Commissioner -

COMMISSIONER DUIGNAN: It's appropriate to start with

Christchurch and then -

NEIL COCHRANE: We agree and this was one of the concerns that in consultation with the airlines there was a concern that because our prices only came into force on 1 December 2012, that we should exclude costs for the five months through to November to ensure that future prices that were being set wouldn't recover any potential under-recover in prior periods. However, in terms of our disclosure and the calculations we've done is we've 11.50 complied with the Commission's requirements there. We can do either way but one point I would make is by using ID as at 30th of June 2012 we would need to make one slight adjustment. The ID for 2012 assumed an asset base for land particularly at 2009 and was then indexed by CPI through to 2012. Within pricing, and we actually completed an MVAU revaluation in years 2012, that adjustment would need to be made I believe to give the correct opening asset base for the pricing period going forward. However, either period can be - we can provide 11.51 that.

ALEX SUNDOKOV: But just to add, in terms of the two possible approaches that you mention, Commissioner. We tried both and it produces very little difference. So, to be honest, we came to the view that we couldn't tell which one is right and which one is wrong, but the outcome is almost the same.

COMMISSIONER DUIGNAN: Thanks. If I could hear the other parties' views, please.

KRISTINA COOPER: BARNZ's preference is for the 30 November 11.51 2012 date because that reflects when consultation was to reset prices. The airport had not completed consultation as at 1 July. The 30 November date also reflects when charges increased. Otherwise, if one took an earlier date, you are effectively backdating and washing up the losses. And finally, the 30 November date means a large portion of the terminal was in use by then. If one took the 1 July date, then there was significant sections of the terminal, passenger circulation areas, that weren't yet in use, so one would have to adjust the asset base.

COMMISSIONER DUIGNAN: Just before, to make it more efficient, so the issue then becomes, based on that point, and we'll come to Air New Zealand's view, but is there thought to be agreement about the appropriate asset base calculation for November, because that's the implication, that we would need that? We've heard Christchurch feel they can supply us, supply - indeed they have already, with a view on that. I just wondered if there's a consensus on that number?

KRISTINA COOPER: I would need to check, I think, with the operational staff as to exactly when those portions of the terminal came into use, so if could come back in cross-submissions.

SEAN FORD: Air New Zealand would agree with the position as set out by BARNZ. 30 November is the appropriate starting time, given that that was when the prices came into effect and that's when the building was effectively in operation.

COMMISSIONER DUIGNAN: Thanks. Just on the sort of subsidiary issue of whether there's an agreed view on the asset valuation at November, would Christchurch like to give us -

NEIL COCHRANE: In terms of the total value estimate that's in the current price reset, we've provided the basis to the airlines as part of our consultation. The question, if we are taking what was the actual expenditure as at 30 November, the Commissioner is correct, we would need to add as part of the assets commissioned in expenditure at the balance of the year. However, again, it makes relatively small difference. I don't believe there's going to be a discrepancy on value.

COMMISSIONER DUIGNAN: Thanks. The staff, or Christchurch have indicated you will be ensuring we have the information, to the extent it was feasible to quickly sort of ensure that there is consistency of view on, with the airlines, on that number, it would be helpful because then we would have that sorted. So, perhaps that could be borne in mind in the cross-submissions.

So, I think the next set of questions, in the first place I would like to just have an opportunity to hear views regarding the closing asset base to be used in the IRR analysis given that Christchurch has indicated that it expects to be earning above the levelised price in the - sorry, not above the levelised price, but above the WACC essentially, in periods beyond PSE2 so - or rather more generally, given the approach you are taking, what is the appropriate way to take that into account in our closing asset base for the purposes of the IRR calculation? So, I should word it generally. Thank you.

ALEX SUNDOKOV: So, first of all I do want to re-emphasise that there's no intention to charge above the levelised price, and I think, as you've indicated, we agree that a logical way of dealing with the, kind of the tilt in revenue path that's introduced by the levelised price is to include in the terminal value the closing asset base plus the amount of the cost of service that is to be recovered in the future. So, that's that area between the cost of service and the revenue curve. We estimate that to be about $20 million.

NEIL COCHRANE: Nothing further, Commissioner.

COMMISSIONER DUIGNAN: Well, if I could hear the airlines, BARNZ's view on this, please.

BRENT LAYTON: The future recovery of that will represent an asset at the end of the period, so we agree it should be added on.

COMMISSIONER DUIGNAN: Air New Zealand?

SEAN FORD: Similar view here, yep.

COMMISSIONER DUIGNAN: Staff, would you wish to ask any follow-up questions?

CALUM GUNN: Yes, I think one of the interesting responses in the first session was Commissioner Begg asked what things will change between PSE2 and PSE3, and I think the first area where there was continuity was in the asset value, and I guess that's in a context of thinking about the assets changing in accordance with the default approach and the input methodologies just being straight line depreciation and CPI indexation, you're going to have that, well, say a $20 million difference at the end. But the input methodologies allow for an alternative depreciation approach that was really intended to deal with the kind of situation that Christchurch is facing to try and levelise prices where volumes are taken into account in the price. Just wondered if you've given any thoughts that information disclosure will allow you to track that difference over time and effectively you could disclose a closing value consistent with the input methodologies as Dr Layton said, with that extra asset value effectively disclosed. Is that something you've given any thought to and that would mean the ongoing assessment of returns would be somewhat more straightforward for all interested parties because the disclosed regulatory asset base would then be even more in accordance with the pricing approach that you're taking?

NEIL COCHRANE: Thank you. Yes, we have given some consideration to that. One of the critical determinants in considering this deferred appreciation is, in fact, what is your future demand going to be? That requires a forecasting to be made on future demand going out 20 to 30 years, and one of the things that we identified firstly was that we are having significant difficulties at this point in time as to what will that demand forecast look like, particularly because of the earthquake, and we didn't want to add an extra element of risk because of that forward demand forecast.

Secondly, in doing so, what it would mean as you go 11.59 forward, because when you look at differences in demand every five year reset, it would basically mean you would have to reset every five years. It's not going to be reset just at the end of this five years and that's going forward. As you relook at demand in subsequent pricing periods, basically it would mean you're going to have a continuing and ongoing rolling of what's that forward, deferred depreciation going to look like because of the variation in demand. We felt that the complexities of that were greater than the approach we've taken, and this 12.00 is why we believe the developing the constant levelised long-run price overcome a number of those risks and inconsistencies.

ALEX SUNDOKOV: So, obviously under certain assumptions the two approaches converge. The reason why I think we sort of came to the view that on balance what we were doing made more sense in this setting, is that the two approaches are identical in a natural monopoly situation where you are recovering the cost of service. The issue we're dealing with is the fact that in quite a 12.01 competitive setting that Christchurch finds itself at, the levelised price is a target, it's not a reality, and so the approach that we're using enables us to understand the consequences of commercial choices and commercial impacts much more clearly than a deferred depreciation

approach would.
CALUM GUNN: I think it's just that you recognise that there
will be an addition to the asset value at the end of the
period, so the question is how has that kept track of
transparently so that at the time you get to the
beginning of the PSE3, the airlines are on an
understanding of what is the asset base you are going to
be setting the prices off, or at least they have some
indication of what that might be. The mere fact that
12.01 you've created a levelised price, that will have an
implicit depreciation profile associated with it. So,
recognising the difficulties in forecasts in coming up
with the levelised price, but once you've done that, that
implies a depreciation profile that you keep track
against.
ALEX SUNDOKOV: But you're comparing the levelised price with
the deferred depreciation approach. What I'm saying is
that there is a third consideration that we think is
quite important here and that's the fact that CIAL is
12.02 actually struggling to reach the levelised price, and
it's important to understand the implication of that gap.
CALUM GUNN: Thanks.
COMMISSIONER DUIGNAN: Well, I want to ask the airlines' view
but just to give it, a specific characteristic to it,
again I come back to the purpose of this which is the
role that ID has played potentially in your
considerations and, as indicated, the virtue of the
depreciation approach is that it gets translated into
something that one can more easily keep track of than the
12.03 levelised price approach being reset every five years.
So, I just would like as we go round to hear views upon
that point. I do understand there are counter arguments.
I'll give Christchurch an opportunity to respond to that,
and then it's more efficient that the airlines can then

respond to the full sweep of matters.

ALEX SUNDOKOV: I'm not sure there's much more we can add, sir, to what we've just said. I think the key point is that the deferred depreciation approach allows you to keep track of deferral relative to the cost of service.

COMMISSIONER DUIGNAN: Yes.

ALEX SUNDOKOV: It doesn't allow you to keep track of under-recovery because the price path is set below the target level, and that's really probably the key
12.03 difference. And we also think the deferred depreciation approach is actually a bit more information rich, more information demanding than what we're doing.

KRISTINA COOPER: BARNZ does not accept that there's any loss that needs to be carried forward. I mean, as far as we can tell, the prices, the levelised prices that have been set by Christchurch Airport result in an over-recovery. So, there's nothing that needs to be disclosed. If there was a situation where an airport was setting a long-run price at a reasonable WACC level which did result in an
12.04 under-recovery, then I think BARNZ would certainly support transparency in disclosing that.

There is one other matter I just wish to briefly go back to in that this whole discussion started with the Commission asking, should this perceived $20 million loss be added to the closing asset base, but it begged the question of what is the closing asset base? I note that when BARNZ was in consultation with Christchurch Airport we sought assurance on what was Auckland committing to in this long-run approach, the answer was nothing. That was
12.05 repeated in Christchurch Airport's submissions on the Commission's issues paper, and I've got the exact page here. On page 30 the airport says, "No valuation basis can be predetermined before the next pricing reset". What we appear to be hearing today is possibly a change

in approach, I'm not sure, with the airports saying it is committing to MVAU but I'm not sure so I think we would appreciate clarification of that, and, if possible, before cross-submissions, if that's all right.

COMMISSIONER DUIGNAN: I think the airport's made the point, quite validly, that they can't commit given it's a negotiation but we, in the case of Auckland, that was dealt with quite simply in the obvious manner, that the commitment is not that it will do something but it will 12.05 offer something that will then be the subject of negotiations.

NEIL COCHRANE: Thank you, Commissioner. No, I agree with that, but we are committing to apply a consistent approach and, as we said, we couldn't commit to that in the cross-submission but we are committing to be consistent and that's consistent with the approach we've taken in PSE2.

COMMISSIONER DUIGNAN: So, shall we continue with the airports, please.

12.06 **JOHN BECKETT:** It's kind of in a way like the airlines and aircraft measure their altitude not from the stratosphere but from the ground.

COMMISSIONER DUIGNAN: If we carry on. Colourful -

JOHN WHITTAKER: We've got nothing else to add, thank you.

COMMISSIONER DUIGNAN: Well, just go back to Christchurch briefly but I'm not inviting you to comment, but I'll move on unless you have some other point to register on this matter.

NEIL COCHRANE: No, thank you.

12.07 **COMMISSIONER DUIGNAN:** Okay, thank you. Well, what I would like to now just briefly cover is the revaluation wash-up matter. We did touch on this during the presentation. So, we have a wash-up, it's how it's described, it's been therefore built into the prices. The question is, the revaluations actually occurred during PSE1 so should the amount be attributed to, really, PSE1 in accounting terms, in other words that it's a repayment of an amount that was over-charged in some sense in PSE1, or is it appropriate to treat it, as I think has been suggested, as a concession and therefore to be attributed to PSE2 given there was no agreement in existence which required such a wash-up.

So, those are the two points. I would like to ask brief comments on them, and I think we should deal with the subsidiary matter, which is that there is a possibility that part of it should be attributed to PSE1, or rather if we're going to attribute any to PSE1, should we distinguish between the revaluations that occurred prior to ID versus the ones that occurred after the introduction of ID. So, if I can ask for Christchurch's comments on that.

NEIL COCHRANE: I would first reflect that when we were doing PSE1, we gave a commitment that we wouldn't revalue. However, in coming into an information disclosure we wanted to ensure a synergy between asset values going forward and what we carried in our financial statements. Accordingly, we have carried it as revaluations and we have always said one thing, if we have revaluations and we include those revaluations in the asset base on an ex ante basis, then we will include them as a revenue offset. Because we didn't include them in period 1, we carried them forward to 2, and to really as a commitment that we are complying with the information disclosure regime and are treating them appropriately.

There is a question, further question, Commissioner, you made a comment about whether the revaluations, which is particularly for 2009 and 2010, which is prior to the information disclosure regime, you could do that, and we understand what those values are, but as part of this commitment that we gave to the airlines, we believe it was a concession provided as part of setting our prices going forward.

KRISTINA COOPER: I think we'd have a similar approach if I've understood it correctly. They should be treated as revenue attributable to PSE2. When the airport set its charges in PSE1, it elected not to forecast any revaluations. It committed to no revaluations for
12.10 two pricing periods, said it was doing that to preserve its cash position. BARNZ raised this question, well, there's a real risk if you revalue in the future that they won't be treated as income, and the response that was provided by Christchurch Airport's valuer, I'm sorry, advisor, Jeff Balchin at the time was that the risk that BARNZ has identified is a risk that should not exist, and he said the revaluation has not been foreshadowed. Consistency requires that the assets must not be revalued at the end of the period. So we'd see there is a clear
12.11 commitment by Christchurch Airport not to revalue, it did, and so accordingly the revaluations need to be treated as income.

There's a distinction here between the situation which faced the Commission with Wellington Airport where the revaluation wash-up related to an MVEU revaluation which the Commission did not include in its opening asset base. So, therefore, for consistency with Wellington, because the MVEU uplift was not in the opening asset base, nor was the wash-up treated as income in PSE2. Now, with
12.11 Christchurch the revaluation was an MVAU revaluation, it is in the opening asset base, therefore the revenue should be treated as income in PSE2.

SEAN FORD: For all the reasons articulated by both Neil and Kristina, they should be treated in PSE2 and I think from our perspective we would see all the revaluations being treated in that manner given, as Neil was saying, the commitment that the airport made at the time around the moratorium and the fact that they then changed their approach, did a 180 degree u-turn effectively.

COMMISSIONER DUIGNAN: Staff, do you have any supplementary on this?

CALUM GUNN: Just to clarify, I think BARNZ's distinction between Wellington and Christchurch is helpful there. So, just to clarify, in the Wellington case, because the asset base from the Commission's analysis hadn't been revalued to MVEU, the Commission left the wash-ups where they fell in PSE2. The distinction being made here, though, is that in Christchurch's case the revaluation is being effectively allowed because if you're setting on a revalued MVAU value at the beginning of PSE2, using the same logic as Wellington that would actually suggest we should take the wash-ups from PSE2 and recognise the revenue set off that revalued higher MVAU asset base without the wash-up is potentially the approach we should take for consistency with the logic used in Wellington's case.

So, that maybe something to think about in cross-submissions. It's a complicated issue but perhaps it would be useful for parties to come through in cross-submissions and think about what the logic for Wellington implies for the Christchurch situation.

COMMISSIONER DUIGNAN: Thanks, I'll move on unless there's - the point that was just registered is important and we look forward to cross-submissions. I'll move on though unless you've got - right. Okay, the next question was that the timing of the WACC determination, the point being that our previous - well, the decision was made in October-November 2012, our previous WACC

determination for airports was in July. Leaving aside
the parameters, which I will come to briefly in a moment,
should we use the July WACC or a later estimate, perhaps
from October, when assessing Christchurch Airport's
return?

ALEX SUNDOKOV: We happen to think that both would be wrong,
so.

COMMISSIONER DUIGNAN: Well, it's the dates rather than
the - I mean, you know, the disagreement is over I think
12.14 parameters, not - but within that there is the question
of the dates. So, that's what I'm inviting you to offer
your view on.

COMMISSIONER BEGG: Another way of raising the question is
when did you fix on the cost of capital, what was the
date that you fixed on your cost of capital that you
used?

NEIL COCHRANE: That is probably the most appropriate way to
do that. Even though the final decision was made on
24 October, the settling on WACC was at an earlier date,
12.15 I don't have the exact date, I can confirm that in
cross-submission, but I believe that would be the more
appropriate date.

KRISTINA COOPER: BARNZ believes there's a key matter of
principle here and we feel that the Commission's
decision, or draft decision in relation to
Auckland Airport has actually created regulatory
uncertainty here. We believe that as a matter of
principle, whether the cost of debt is moving up, down,
or staying still, the cost of debt input for the WACC
12.15 calculation should be calculated as reasonably
practicable - as soon as reasonably practicable prior to
the setting of charges. Now, for Auckland Airport it's
said that it updated its financial model on 21 May and I
think it published its charges about 7-8 June, so that

was approximately 17 days which they said was their reasonably practicable approach. For Christchurch, BARNZ put its last written submission in on 17 September and Futures Consultants updated the cost of debt for BARNZ as at 1 September. Now, that actually results in the 0.28 basis point movement upwards from the Commission's 1 July date, but we believe it's very important to have a point of principle here that can be relied upon by all parties and applied going forward.

12.16 **SEAN FORD:** From Air New Zealand's perspective, again, as a point of principle we believe that it's appropriate to set as close as practicable to the time when the pricing decision was actually made. I think everyone has a very clear understanding of how the framework works and it's not a particularly complex matter to do that updating.

COMMISSIONER DUIGNAN: Well, I appreciate the points. I'm actually a little surprised in the sense that it implies that the parties think that it's appropriate to sort of actually make possibly quite significant changes in the 12.17 outcome very close to the final decision, but I think, then that, you know, to the extent that's a settled view and in this case BARNZ is indicating it actually goes against their sort of superficial interest, that we would find it useful to have that confirmed in the cross-submissions. It possibly has implications for the way the Commission thinks about WACC updates, if you see what I mean, because it implies that we ought to be considering putting them out at a timetable that fits, which is an interesting observation that we'll take - I 12.18 mean, if we've - it seems clear so I'll move on if that's okay.

KRISTINA COOPER: Just very quickly, there's just one little piece of factual history, when charges were reset by Auckland and Wellington approximately five years ago the

cost of debt was going in the opposite direction, sky
high, and those airports were regulating right until the
last minute. So, it has worked against the airlines, so
we just think it's very important to have the principle
enshrined whatever's happening with the market.

COMMISSIONER DUIGNAN: Okay, thank you. I'd now just like to
move on to a brief discussion on some of the parameters
of WACC. So, we'll start with the beta and I'll address
my comments to BARNZ but also invite Christchurch
12.19 obviously.

BARNZ has indicated that in this case they could see a
case for an asset beta of, that allows for the
international travel - well, really, tourism intensive
demand for this particular airport. Given the
Commission's derivation of beta was from a wide range of
airports, I was wondering whether the comparison had been
made with that as opposed to simply the Auckland,
Wellington, Christchurch, which is - I mean we didn't
actually use that set of airports in order to derive our
12.19 beta, we moved outside New Zealand and got a range of
airports. So, I really was interested to hear BARNZ's
comments about that particular aspect.

BRENT LAYTON: You're quite correct, it was from a comparison
of the business mixes of the other airports in
New Zealand, not from the consideration of the wide pool
of 20 odd airports that you used.

COMMISSIONER DUIGNAN: Thanks. Could I ask Christchurch just
whether you've got anything to add? You've indicated you
believe the number should be 0.7. Is that essentially
12.20 also based upon the tourism intensive demand aspect, or
do you see it as based upon other considerations?

NEIL COCHRANE: Basically when we set our asset beta we were
thinking about the relative risk from setting prices, not
from a regulatory regime but what do we require in terms

of the risk that Christchurch Airport is exposed to, and you are correct, it was in terms of the comparative intensity of tourism activity and leisure activity at Christchurch Airport relative to other airports, and we believed comparing all three as one, I think it would underscore the risk that CIAL was exposed to and therefore we shouldn't be just cast with what I call the lowest common denominator.

COMMISSIONER DUIGNAN: I just note, the Commission of course
12.21 to the extent it allowed a 75 percentile, that matter, which on the other hand, you know, there's the question of when you apply it, but that is in some sense intended to cover variations, because clearly each airport will have subtle variations and that is why that sort of exercise is done.

ALEX SUNDOKOV: Unfortunately we don't have our WACC advisor on this. I don't pretend to be a regulatory WACC expert, but it seems to me that there are different ways to skin a cat here. So, one could either say that - obviously
12.22 the Commission's WACC is derived from a wider sample of the airports, so one can either say that that's relative to NZ Airports, Christchurch is the most exposed to leisure travel and that should be recognised in its WACC, or you can say that when you assess Christchurch return against an average New Zealand airport's WACC you would be treating deviations differently. Either way you would probably come to the same conclusions.

COMMISSIONER DUIGNAN: Thank you.

BRENT LAYTON: I've never thought the 75% is a good idea and
12.22 I've consistently argued against and I will consistently do so. I think it should be the mid-point that should be the reference. I think there is as much dangers in the regulatory risk of the charges to the other people effecting investment as there is to the airport. So I

don't - I've never accepted the Commission's argument.

COMMISSIONER DUIGNAN: I just note that the standard deviation that is actually embedded in our 75 percentile calculation is 0.11, in other words, which is equivalent to a beta of 0.71, but we don't just translate it, it's a more complex calculation. I'll move on - sorry.

JOHN WHITTAKER: So we were comfortable with the Commission's original position.

COMMISSIONER DUIGNAN: Thanks.

12.23 **COMMISSIONER BEGG:** So you don't support BARNZ's support for a 0.65?

JOHN WHITTAKER: No.

COMMISSIONER BEGG: You prefer the 0.6?

JOHN WHITTAKER: Correct.

COMMISSIONER DUIGNAN: I'll move on just to note that the Commission obviously looks to the IMs for its basic thinking about WACC and that the matter of the role of the risk free rate is part of a basic thinking as opposed to, on the other hand, the beta that I spoke of, where in
12.24 principle our thinking includes considering adjustments. CIAL is using a WACC of 9.78. The biggest factor that influences the difference between this and the Commission's WACC is your use of the risk free rate. I'd simply note the following, that if the risk free rate is applied in the way that the IMs suggest, then if one asks the question, well, what other variable would need to adjust to get 9.78; our calculations are that the market risk premium would have to be 8.8 to result in that, and so I'd just say to Christchurch that we would invite you
12.25 to acknowledge that, do your own calculation if you wish, and that whether you have anything you would put to us as to why a market risk premium as high as that would be sound given that even in the merits review no-one has proposed market risk premium that high, anything like

that high?
NEIL COCHRANE: Thank you, Commissioner. We will consult with
our independent expert and respond in cross-submission.
COMMISSIONER DUIGNAN: I'll just give BARNZ any comment
briefly that you wanted to make on that, although it's
pretty obvious stuff.
BRENT LAYTON: We made our submissions about the 7%.
COMMISSIONER BEGG: Could I ask Christchurch, just I'm not
sure whether we should debate WACC but I know BARNZ
12.26 raised the paper, they quoted the paper, the Dimson et al
paper which has a specific article on the global
financial crisis. Really, I would be quite interested in
Jeff Balchin's comment on that paper, given that he's
referred to some other papers, but if he had an
opportunity. Although I then hesitate a little bit
because when - you know, the IMs set in place what the
cost of capital should be and so this is really
intellectual curiosity slightly just to get feedback, but
given that you've raised the issue I just wondered if -
12.26 it would be interesting to get your response on that.
COMMISSIONER DUIGNAN: I would note that the CIAL submission
made reference to neither the Commission nor airlines
having to face the pressures from investors. The paper
that has just been referred to, the - it's an updating of
the classic Dimson paper, is as indicated here, published
by Credit Suisse. So, that it's not just a piece of
academic research. It has been put out by a major
investment bank which is essentially offering it to its
investor clients as being an indication as to what they
12.27 should expect by way of return, and I think in that sense
the Commission takes quite a lot of weight upon such a
paper which is how we do link up with the way investors
are looking, plus other things, connections we have.
I'll move on. Shall we go on to Jetstar?

COMMISSIONER BEGG: They're not here. (Commission members confer).

COMMISSIONER DUIGNAN: Okay, I wanted to address this question to BARNZ and Air New Zealand and it is the basic question of, do you believe that there is any change in Christchurch Airport's price setting behaviour between PSE1 and PSE2 that it's appropriate to attribute to ID regulation, particularly in the areas that we've been talking about of profitability, which is what this
12.29 session is about; so, the question is, the extent to which the behaviour in the negotiations, particularly as it relates to profitability, has been influenced by ID?

JOHN BECKETT: (Inaudible).

COMMISSIONER DUIGNAN: Consultations, I agree.

JOHN WHITTAKER: So, my understanding of Part 4 is the desired outcome is the same as would be, or consistent with workably competitive markets, and so just to look at the entire scope of this in relation to that; the fact that Christchurch looked at its long-term investment and
12.29 sought to create a long-term model, we think that that's, we've got no problems with that as a general principle. What we would expect, though, is if they were looking to put in a long-term model but say that they're bound by five year reviews which create lots of uncertainty about what will happen at various stages along that model, that actually they would have sought to get a long-term contract with us consistent with the long-term pricing model, and we made that representation and got no response to that. So, there is probably some creative
12.30 thinking about the model and the appropriateness for the asset, but not a workably competitive response to how that could be implemented.

Secondly, I think that the Commission has already heard some comments here today also on WACC expectations

and about risk, and the way that the airports continued
to behave in relation to that, so - and the
disequilibrium comment that was made earlier, where it
was almost the market, the GFC causes the market to have
a lower expectation but actually maybe that caused
Christchurch to have a higher expectation of their return
because of the risk that was associated with it, and some
comments around extreme circumstances risk, almost in our
view Christchurch made a decision prior to the earthquake
12.31 to make an extensive asset investment and that their WACC
was based on that investment. The fact that there was
then an earthquake and that caused volume to fall
shouldn't be something that they're looking to recover
completely from the customers or users. That was an
investment for which an appropriate WACC was returned.
To then say well, we need a greater amount of revenue or
greater amount of return to make sure we still make the
same return on that asset I think is very questionable.
What if the asset had been completely wiped out, would
12.31 they expect the airlines to keep paying revenue for an
asset which is no longer usable at all because
Christchurch had made that investment and they should get
a return on that WACC? So, I think the volume risk is
being constantly reset on a five year basis. The
question almost is, is there a volume risk which if the
airport's WACC accepts a volume risk, should that volume
risk actually sit through some of these type of events
rather than being recast to the airlines because we have
a series of five year pricing events?

12.32 **COMMISSIONER DUIGNAN:** Thank you, BARNZ and then I'll go to
Christchurch quickly.

KRISTINA COOPER: I mean, the yardstick against which the
effectiveness of information disclosure regulation has to
be judged is a workably competitive market. Has it been

effective in promoting that purpose of achieving a
workably competitive market? So, in terms of the outcome
BARNZ's answer is, no. The prices contain significant
excess returns and the airport has clearly just
completely disregarded the Commerce - some of the
Commerce Commission's input methodologies with respect to
WACC and with respect to, we'd say the calculation of
tax, and in so doing has used its market power to set a
return very high with significant excess returns.
12.33 At the same time we would have to acknowledge that
some of the inputs the airport used were influenced by
the input methodologies. For example, its move to MVAU
to value land, and it moved away from a new ODRC of its
specialised assets and instead it rolled forward the
specialised assets, and it did treat the unforecast
revaluations as income. So, there were changes to the
inputs but there was no significant effect on the output.
So, overall, we would say that information disclosure has
not been effectively able to prevent or limit the
12.33 extraction of excess profits, therefore has not promoted
a workably competitive market outcome.

COMMISSIONER DUIGNAN: Christchurch?

NEIL COCHRANE: Thank you, Commissioner. Several comments I
would make there. In terms of the level of investment
Christchurch has made, it is correct we made an
investment there which we were expecting to get a return
on. Our determination, we believe that our WACC is still
appropriate recognising the risk appropriate for
Christchurch. One thing I would comment on is we're not
12.34 expecting the airlines to carry the burden. In fact,
this was one of the issues in terms of what would be the
implications from this price reset, and as we've
endeavoured to identify is that the actual prices charged
reflect the commercial concession we have given in

reflection of this. So, what we're saying is we don't
believe we should expect airlines to carry it all, but
similarly we don't expect Christchurch to wear it all.
Therefore, what we've endeavoured to do is to get a
reasonable balance there.

If I could correct one point that Air New Zealand has
made in terms of longer term contracts. One thing we did
identify in terms of longer term contracts and
willingness to share risk, whilst it wasn't part of the
12.35 consultation we did provide the offer, we were willing to
look at longer term contracts and we were actually
willing to consider risk sharing mechanisms but we would
look at these post the setting of our published rates.
So, we have created, we have provided the opportunity to
consider this further.

COMMISSIONER DUIGNAN: I think that completes this session. I
think the last point is outside the PSE2 discussion so
it's just to put that -

COMMISSIONER BEGG: Staff?

12.35 **COMMISSIONER DUIGNAN:** Staff, do you have any points?

CHAIR: Okay. Well, that brings this session to a close and
this morning's sessions to a close. So, let's adjourn
for lunch and we'll start back at 1.15.

(Conference adjourned from 12.36 p.m. until 1.17 p.m.)

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CHAIR: Okay. Well, let's make a start for the afternoon
session. First of all I notice a few new faces around
the table so for the benefit of our stenographer can I
ask new participants around the table to identify
13.17 themselves for the record, please.

MARK TROUGHEAR: Mark Troughear from Freightways Limited.

CHARLES GILIAM: And Charles Giliam from Fieldair Holdings, a
subsidiary of Freightways.

CHAIR: Great, thank you. Okay, look there's been a slight

programme change at the request of Christchurch Airport,
and I understand everybody's happy with us going to
pricing efficiency as the next topic for discussion then
once we've done pricing efficiency we'll then go back and
do the other sessions on quality and so on as per the
programme. So, if we could just jump to pricing quality,
which we have an indicative allocation of an hour for.
We'll start that session now and so I'll hand that over
to Sue.

13.18 ***

COMMISSIONER BEGG: Thanks Mark. I would like to start with a
question for the airlines. You have been reasonably
critical in terms of the pricing approach that
Christchurch has adopted in that you've said that you
don't see it as being strongly efficiency based, but I
thought I'd ask you a question about the levelised
pricing which we've heard a lot about this morning and
how Christchurch had put a lot of focus on trying to
smooth prices over time, and they've suggested that this
13.19 could lead to improved certainty and stability, and I
just wanted to ask the airlines whether they considered
that this was an important step that Christchurch was
proposing and that it could be to your benefit in terms
of providing stability over time and, in fact, it could
be an efficient way of pricing over time.

JOHN BECKETT: We can certainly appreciate that for a large
investment at one time, like the new terminal, that there
is a bit of a problem of slightly - slight
under-utilisation at the end - at the beginning, and
13.19 towards the end it could be a bit tight on capacity. But
the simple way to solve that is to deal with the way in
which it is depreciated and not to have a straight line
depreciation. That would be a way of dealing with it
that is just very easy to see from pricing period to

pricing period, could be agreed at the start and away it
goes. Whereas the levelised pricing that is being
suggested is very complex and hard to use.

KRISTINA COOPER: And incorporates significant excess returns.
I think that is the key complaint by the airlines, is
that the levelised price ends up over-recovering.

COMMISSIONER BEGG: Although dealing with the issues through
depreciation is one way of doing it, you're still
accepting that it is efficient to try - I mean that would
13.20 be another way of levelising the prices, just a different
way and perhaps a more straightforward in accounting for
it, but you are accepting that in principle this is a
positive step, is to spread this over time?

JOHN WHITTAKER: So, from our perspective we think the
principle has the - could be an efficient principle.
Your second question was whether it's improved certainty
and I think because of the perceived inability to come to
any agreements beyond the five year period, we don't
think it really has improved certainty at all. So, two
13.21 parts to the question really.

COMMISSIONER BEGG: Just on the certainty question, this was
raised in the earlier session about contracting over a
longer period, it would be interesting to get a little
bit more of your view on to what extent you did explore
the contracting and what would need to happen for that to
work; and just the airlines?

KRISTINA COOPER: From BARNZ's perspective we don't explore
contracting because we're consulting and our authority
under the Airport Authorities Act in terms of
13.21 representing parties is simply in the consultation
process. So, it's up to each individual airline if they
want to explore a contract. I know that Jetstar
mentioned in its submission that it had requested, I
think, a ten year contract and had commented that the

airport had not engaged with them on that.

JOHN WHITTAKER: As Neil mentioned, we had some discussions
about the possibility of a long-term contract and
Christchurch's desire was to set its prices and then
consider the possibility, and I suppose we felt that was
the wrong way round.

COMMISSIONER BEGG: So, are you still willing to engage? Is
that still on the table, that you might -

JOHN WHITTAKER: We have signalled our willingness to engage
13.22 with all airports on that and that long-term contracts
would be our preferred engagement.

COMMISSIONER BEGG: Okay, did Christchurch want to comment?

NEIL COCHRANE: No, all I will do is confirm, we are willing
to look at longer term contracts admittedly there are
mechanisms and I know they are already in place; how you
handle certain issues such as fluctuation or demand, but
for example right now we're already working with the
airlines for a longer term, lower contract for provision
of ground power for jet aircraft. So, it's not an
13.23 unfamiliar concept and we are willing to consider it.

COMMISSIONER BEGG: Thank you. Just moving, then, to some
more specific questions about the pricing approach, the
allocation of charges really over this next period. One
thing that seems to be a bit controversial is the
introduction of the fixed charge for the airfield and so
I would just like to ask Christchurch what their purpose
has been in introducing the fixed charge. In different
places there seems to be a suggestion that it's
reflecting the opportunity cost of using runway capacity
13.23 or else, alternatively, it's suggested that it's better
reflecting fixed costs such as security, lighting and
fire services. So, I just would like to get a feel for
what your main driver was in introducing the fixed
charge?

NEIL COCHRANE: If I could step back one point from there, Commissioner, first. The first consideration is what revenue do we need to recover over the period. The question then is, what is the best mechanism on how we should recover this, and basically we had two objectives when we set this basis. One was we wanted to ensure that our charges were reflective of costs incurred, and as you have mentioned there are costs on the airport which are fixed in nature relative to the variable component of the aircraft. For example, you can only land one aircraft at a time and therefore in terms of the categorisation and things like that, supporting Rescue Fire Service, not necessarily the category but there is a basic requirement. So, what we wanted to do is to ensure that it was more reflective of that capacity. We then have costs which are more variable in nature and depending on the size of the aircraft will depend on the impact it has on the services; heavy aircraft do have a greater propensity to have a greater impact on the surface. Admittedly, though, with current technologies on the landing gear on aircraft, sometimes you can actually see the converse applying.

So, the other point we wanted to get to was we wanted to get to a position where our customers chose the aircraft types for commercial rather than charging basis reasons. In other words, if there was a cost advantage, we wanted to ensure that they picked them for the right reasons.

So, what we did, and if I can just explain this a wee bit further, in terms of setting these charges the first process is derived, what is that fixed charge going to be, and we were, when we addressed this, was to address the concerns around possible cross-subsidy and there was a concern about whether jets paid more share of the

airfield costs, as previously all of our charges
previously were a pure variable Macto basis. But the
question, therefore, becomes one of balance and
reasonableness.

In terms of setting our charges it's not a strict
science. We've spoken to the airlines, we've spoken to
other airports, both domestically and overseas, and there
is no strict mechanical formula as to how you derive
this. So what we did do in terms of deriving it, we had
13.26 both engineering and economic advice and determined a
range of costs, and depending how you allocated it, it
would get very sufficient levels of cost allocation. So
the level we set was a judgement call within that but
which we believe was reasonable. One thing I would note,
in terms of when we set this rate there was varying
responses from our airline customers as some said it
wasn't big enough, it should have been higher and
therefore there should have been less charge to jet
aircraft, and conversely. So, the issue was to try and
13.27 avoid cross-subsidy and reflect that there are costs that
are fixed in nature based on movements, but there are
also costs that are variable in nature and that is what
has, how we've set that on a per Macto charge.

COMMISSIONER BEGG: There's no concern about congestion in
Christchurch, I presume, and so your prices were not
aimed at all at rationing?

NEIL COCHRANE: No, we do not have congestion. We certainly
have peak hours of use at the airport but there is no
congestion on the airfield. We do currently have, but we
13.27 have a potential path to address it, is to do with turbo
prop aircraft parking, not necessarily on the landing but
in terms of the aprons and that, but we have a path
through the demolition of the Air New Zealand pain hanger
which will address those needs in the future. So, where

there is congestion, as I've mentioned, there is paths to
address that.

COMMISSIONER BEGG: You said you were concerned to ensure
there was no cross-subsidisation going forward. Do you
think that the charges that applied previously did
include elements of cross-subsidisation between jets and
smaller planes?

NEIL COCHRANE: I believe there was. One of the things we
have at this stage is those charges were set 13 years ago
13.28 and what actually happened, there was significant review
of what is the impact of a certain type of aircraft based
on its weight, wheels configuration et cetera. But
aircraft technology has changed dramatically since then
and this is why we endeavoured to try and find an
alternate mechanism but there was no consensus, and even
when we looked at some of the airports in the UK and one
of the comments made was what the market will bear. We
didn't do that, it was really trying to look at what was
a reasonable balance between a fixed cost for a pure jet
13.28 aircraft versus a turbo prop aircraft, and we believe it
was a reasonable balance set there into.

COMMISSIONER BEGG: Can I just clarify there, efficient
pricing sometimes leads to taking into account the
sensitivity to prices, so the demand sensitivity that I
hear you say that you didn't take into account the
difference in jet and turbo prop sensitivities.

NEIL COCHRANE: We didn't in terms of jet to turbo prop
per se, but there was a response come back from our
airline customers, particularly where you have smaller
13.29 turbo prop aircraft, particularly like Beach 1900
aircraft in that setting a standard charge, fixed charge
was economically inefficient, and accordingly what we did
do for aircraft less than 20 tonnes, we actually reduced
that fixed charge by 50% to reflect the different nature

of aircraft types. So, that was taken into account following a response from our airlines.

COMMISSIONER BEGG: Okay, thanks for that. So, Air New Zealand, just on that point about the small aircraft. You did raise a concern that the fixed charge might result in a reduction in usage because the small operators might choose to no longer fly to Christchurch, or they might reduce their demand, and I just would be interested in your views as to whether the adjustments 13.30 that it sounds like Christchurch made addressed your concerns, or do you still think that the fixed charges for the smaller aircraft are sufficiently high that they might have an impact on demand of your own services or perhaps feeder services that you're aware of?

JOHN WHITTAKER: So, I think we believe that it remains a risk and that the rationale for fixed charges exists where there is congestion, and Christchurch doesn't have congestion. So, we acknowledge the risk has been reduced by the actions that Christchurch took but I think there 13.31 is still a risk and time will tell over the next few years as to whether that risk materialises.

COMMISSIONER BEGG: Just then turning to the concerns of the freight operators. There's been suggestions, BARNZ for example have suggested that the airfield is subsidising the terminal activities; Air New Zealand suggests there's a significant cross-subsidy of the terminal by airfield users; and the freight users are concerned also that they are cross-subsidising, or paying too much, cross-subsidising terminal activities. I would just be 13.31 interested to get your feedback on whether you think it's an actual cross-subsidy or you just think it's unfair that you're paying more than you think you ought to?

MARK TROUGHEAR: I think it's probably the latter to a large degree. The improvements, the benefits, the extra

services we gain from the airport as a freight operator,
operating in the middle of the night, non-peak periods,
no contact with the terminal, negligible, so we don't see
how we have benefitted from any advances, any
innovations, any extra services. What we do see is a
significant price increase, though, which has affected us
not only in this period but in the previous period, and
that to us is out of line with what (a) we receive as a
customer and (b) what we've seen from other airports that
13.32 we operate out of. So, I guess that's our frame of
reference for the increases that we've seen and natural
supposition is that maybe that is cross-subsidising a
terminal which seems to be the only material change on
that airport.

COMMISSIONER BEGG: Thank you. I would be interested in BARNZ
or Air New Zealand, if they had comments?

KRISTINA COOPER: From BARNZ's perspective the analysis we did
showed that the airfield charges were significantly too
high. I mean 98% or 99% of the excess returns that we
13.33 identified the airport earning, related to the airfield.
We see it as being a situation of excess prices and that
the charges for the airfield have just been set so as to
earn monopoly returns. The charges for the terminal are
by in large about right; slightly too high for the
domestic terminal come 2010, slightly too low for the
international terminal, but there or thereabouts. But
the airfield is significantly over-priced.

COMMISSIONER BEGG: So over-priced but not cross-subsidising
is your view?

13.33 **KRISTINA COOPER:** Yes, it's been over-priced so as to extract
monopoly profits.

JOHN WHITTAKER: Same. Same view.

COMMISSIONER BEGG: So, Christchurch, did you want to respond
to that?

NEIL COCHRANE: What I would like to comment on here is the
contention that we're achieving excess returns, we
believe is to be incorrect. In terms of setting our
appropriate weighted average cost of capital, and we've
discussed this in significant depth and made submissions
on, allowing for that level of return and considering the
period for the next five years under PSE 2, the level of
return is less than the required recovery. So, we
believe based on our WACC, and I think largely the
13.34 discussions that are coming here are in terms of our
difference of opinion as to the rate of return.

One thing I would say is there is no
cross-subsidisation. The costs involved in the airfield
services reflect not only the work that has been done
recently as part of the terminal development, but also
that each year we spend in the order of 4-5 million and
in one of our cross-submissions I noted that our payment
maintenance programme for the airfield is in the order of
100-120 million over the next 20 years. So, what we have
13.35 in short is we are continuing to invest to ensure that
that airfield is of the appropriate quality and
integrity, and if we look at our price increase which we
had in 2009, that was the first for nine years. There
was to be a review in 2005, those prices were held
constant. Again, the issue is a question not of
over-recovering but in light of what we believe is the
appropriate return on capital, we are actually
under-recovering.

COMMISSIONER DUIGNAN: I mean, you've said that you're aiming
13.35 to earn a return which is projected into the future, but
that relates to the terminal. So, it's quite
conceivable - let's put it this way, do you think you are
getting something like you're 9.76 on the airfield? I
mean, you're clearly - you've identified, all the

discussion has identified that it is the terminal cost that is being recovered and the return on it that you're looking to get in the future. So, I don't think you can just sort of say that that piece - I mean there's been no reference to some reason to be getting some of the return relating to the airfield in the future, and if - just on the literal interpretation, that would imply that you think you probably are getting something like your 9.76 on the airfield and you're getting a lot less on the
13.37 terminal.

NEIL COCHRANE: In total, over the period we don't believe we are. In setting a transition of our price path, which is in place for both the airfield and the terminal, the price path is progressive. At the beginning of the period we don't believe we are achieving the right return. When we look towards the end of the period, we believe we're getting close to where it should be to achieve that return in the long-term.

COMMISSIONER DUIGNAN: So, but I mean the logic of what you've
13.37 said to us is that all the movement between today and the future is about the terminal. You're saying that some of it is about the airfield?

NEIL COCHRANE: Certainly. In terms of the total cost of service Alex covered earlier on, that's determined for each of the different areas; that's airfield, turbo prop aircraft in the domestic terminal, domestic jets and international services. Each of those cost of service are relative to that service provision.

Looking at the airfield in isolation, we believe that
13.38 at the beginning of the period we weren't achieving the appropriate return and that's why you've - the transition price path that we put into place and the step changes over the period was designed to overcome that gap.

ALEX SUNDOKOV: So, perhaps if I can just add, the pricing model sets the target levelised price in a way that would provide NPV=0 for each service separately. So, it aims for NPV=0 for airfield, just as it aims for NPV=0 for the terminals. Now, clearly because of the different profile of investments and perhaps also possibly different profile of demands, that could result in different levelised prices for each of the services, but each levelised price aims at achieving NPV=0. Let's just put the argument about the WACC aside because I think that's a separate issue.

I think it's probably useful to comment that it is - as we mentioned before, for commercial reasons there is, the actual prices are below our estimate of the target levelised constant real price, but the rate, I guess, at which the actual price is moving towards that target does differ between different services, for commercial reasons. And I think it's true to say that the price for the airfield is moving towards that target faster and will get there by the end of the PSE2.

COMMISSIONER DUIGNAN: Yes, well perhaps you can clarify it. If you've got the model that disaggregates it, then, you know, I mean it would be rather surprising if you've sort of imposed a build-up on the airfield as much as on the terminal, because the airfield's been there for some time and I know you're maintaining it but it's not like it's got some big lump that's just arrived. So, could we hear your, you know, see the numbers?

ALEX SUNDOKOV: You have them, Commissioner. All the segregated numbers have already been submitted. The only thing I just want to emphasise, that may not be clear from the model that has been submitted, is the point I made earlier, that the 20 year model only incorporates capex for the next five years, and I think as Neil just said, the expectation is that actually probably most of

the future capex will come in the airfield in the next 15
to 20 years rather than the terminals, means that if
anything the models somewhat underestimate the long-run
cost of the airfield service.

COMMISSIONER BEGG: Just before we move on I'll just check
that the airlines, including the freight people for whom
this is probably the most important issue, whether you
had any more comments that you wanted to make?

MARK TROUGHEAR: I think in relation to those long run
13.41 pricing, that's another of our concerns I guess, and it
touched on a point you raised earlier, that the increases
beyond this period are pretty pertinent, and those are
things that should feed into our long-term decisions
about how and where we operate from. So, there's a whole
lot of costs coming onto airfield which relates
specifically to us in that wider period, then we would be
very interested in the impact on cost in that longer
period as it relates to our decisions for shifting and
moving our infrastructure.

13.41 **COMMISSIONER BEGG:** Have you changed your behaviour at all in
response to these prices? Have you reduced your use of
the airport or tried to do other things?

MARK TROUGHEAR: You know, ironically our usage of the airport
increased in September last year so we increased our
volume coming in through a commercial arrangement that we
had with another provider of freight. So that increased
our landings and activity in Christchurch by 17%. So we
would argue that we're making a pretty good contribution
to what we see is a fixed cost without an additional
13.42 price increase on top of that. Now, these charges here
we have yet to flow through and I guess what we're hoping
is we don't have anywhere near this kind of charge that
we have to impose on our customers. But it's a very
price sensitive game. Overnight airfreight is a very

expensive commodity, and as we saw through the GFC, as soon as you hit a bit of economic pressure or as soon as you have price increase, it absolutely affects demand and people make a decision to rail their freight on a two day basis rather than fly it overnight. So, it's extremely price sensitive. We haven't flowed that through yet so no, there is no impact to date.

COMMISSIONER BEGG: Thank you.

MARK TROUGHEAR: The other point is I guess just explaining the way an express rate network works. Christchurch geographically is basically the one place you can come into to run your overline haul. So you come into the middle of the South Island, you arrive around about the middle of the night and you run trucks from that point to every other point around the South Island, which takes around six hours. That gets your freight into depots to be delivered into hospitals and auto part stores et cetera, et cetera. So, you know, the decisions around what we do long-term almost rests on saying do we revert to a road-based network where you're not going to suffer these kind of price increases, and the demand will probably flow to that area because you haven't had the same degree of input cost increase.

COMMISSIONER BEGG: Okay. Any other thoughts?

KRISTINA COOPER: BARNZ's understanding of Christchurch's pricing model, if it's correct, is that for the airfield the airport is going to be earning its 9.76% sought after WACC in the five years. So, it is pricing right up to that level straight away and the question becomes, well, if the 9.76% WACC is not justified, then the airport is simply utilising its monopoly power to extract excessive returns.

COMMISSIONER BEGG: Thank you. I just now turn to some concerns expressed by the different airlines about the charging for jet aircraft versus turbo prop, and we get different views from the different airlines, I suppose which is not surprising. But one of the suggestions is that jet aircraft are subsidising turbo prop aircraft. This was a comment made by Jetstar, who I don't think are here, but also BARNZ made a comment that the increase in charges for PSE2 were disproportionately large for jet aircraft relative to turbo prop aircraft, but what I heard from Christchurch was that there had been a rebalancing of charges towards turbo prop aircraft because they were concerned about cross-subsidies in the past. So, I just invite airlines to comment on whether they are concerned that jet aircraft are paying too much, whether there is any cross-subsidy element left, or whether you just think it's not fair?

KRISTINA COOPER: So, this comment is made specifically on behalf of the international airlines that BARNZ is representing that operate the heavy aircraft. And I think the fair word to use is that they are spiflicating over the price increases. The heavy 777 aircraft got a $2,000 increase in charges under Christchurch Airport's proposal, sorry, decision, and that's as a result of the 49% increase to Macto rates. So, the airport says it has rebalanced and it has introduced a fixed per movement charge, but then it seems to have completely negated that by imposing different levels of increase to the Macto rates on turbo props which have had a 27% increase as opposed to the jets that have had a 49% increase. So, the overall increase over the five years to those large operators is around 40%, 40% per landing which is $2,000 per aircraft, and it's enormous and it - yep.

COMMISSIONER BEGG: So, can Christchurch respond to that, please?

NEIL COCHRANE: If I could just clarify the position. I'm assuming we're talking about the airfield here and not terminal.

COMMISSIONER BEGG: Mmm.

NEIL COCHRANE: In terms of the airfield, it comes back to the point I made earlier on; what is the balance of the recovery revenue required? We have determined what the level of revenue that is required, and determined firstly what is that fixed revenue going to be and therefore what should the variable revenue recovery should be.

13.47 That value in terms of the variable revenue has been applied on the same basis of - that has been applied for the last 12 years and it's been, went back to that year of 2000 which I referred to, that says a certain amount comes from turbo prop aircraft and a certain amount from jet. What we have seen is that in terms of turbo prop aircraft there has been a substitution by Air New Zealand, particularly, on a number of routes from jet to turbo prop aircraft. Therefore, when we look at how are those charges going to be recovered, assuming that we 13.47 have an amount that has to be recovered by way of turbo prop aircraft, an amount by jet, and really it is one into the other. If you have a greater level of Macto, variable Macto for turbo prop aircraft, the rate will be lower. If you have a higher amount for jet, it will be higher, and vice-versa. So, it's really a consequence of what is the revenue to be recovered and what is the level of volume, either in terms of aircraft and Macto, that those charges need to be set over, and that is purely as a consequence of that relationship.

13.48 **COMMISSIONER BEGG:** Just one question, then. Why is - can you just explain why your Macto rate is different for the jets versus the turbo prop, why is it - it's significantly lower per tonne, I guess, for the smaller planes?

NEIL COCHRANE: The reason what you have is, in effect, the idea of a Macto charge, in effect, is actually to reflect the damage that each aircraft, and I'm using "damage" in inverted commas, to the surface and therefore what repairs and maintenance will be required. A lighter aircraft such as a turbo prop aircraft will do less damage than a jet aircraft, and it's really a reflection of the weight of each aircraft and the consequential impact it will have on the surfaces.

13.49 **COMMISSIONER BEGG:** So, you're saying it's not a linear relationship presumably?

NEIL COCHRANE: No.

ALEX SUNDOKOV: Yeah, so I think just to expand, just exploring, the tonne of maximum take-off weight imposes different levels of cost, whether it's a jet aircraft or a turbo prop aircraft, and one way just to see it in a very simple way, for example when the jet aircraft is landing it's taking much further to travel on the runway than a turbo prop aircraft.

13.49 **COMMISSIONER BEGG:** Just before I go to Pat, did Air New Zealand have something to say?

JOHN WHITTAKER: So, certainly, just to answer your last question as well, the size of the runway for a smaller aircraft would be significantly smaller, so you would expect the last bit of the runway is just for the jet aircraft. In terms of is there a cross-subsidy or not, you've heard Christchurch say that they balanced towards the turbo prop and the international airlines are saying that it balanced towards the jet. Our view is it 13.50 probably hasn't moved materially, it's similar to what it was in the end result.

COMMISSIONER BEGG: Okay.

COMMISSIONER DUIGNAN: I thought I heard Christchurch saying that you actually just took the amount being raised from

turbo and the amount being raised from jet, that the
relationship that you previously had, and you just ran
with that. Have I misunderstood that? Because you then
also said that actually Air New Zealand had, was using
more turbo than in the past which would - they were
substituting turbo for jet, so the net result of those
two would mean that the turbo one is depressed compared,
you know, in a relative sense. So, have I misunderstood
the first point, that you've kept the ratios constant?
13.51 **NEIL COCHRANE:** If I could clarify. The ratio is based on the
comparative weight proportion between jet and turbo prop
aircraft. What we have - so, what has also been
occurring is that, and BARNZ - sorry, Air New Zealand
refer to it in their comments on the forecast demand, we
are seeing in Christchurch a move away from 737s to A320s
and what you actually have is that whilst you have one
aircraft, the A320s has a higher seat capacity and a
higher weight. So, in effect, what you're seeing is
necessarily lower movements but in terms of the Macto in
13.51 which that charge is levied, it's based on that.

So, the initial proportion is based on the relative
proportion between jet and turbo prop aircraft, and then
based on the Macto for each of those types of aircraft.
COMMISSIONER DUIGNAN: You say the weight, you mean the total
global aggregate weight of aircraft?
NEIL COCHRANE: Correct, correct.
COMMISSIONER DUIGNAN: That doesn't sound particularly
efficient, I have to say, because I mean if that ratio is
changing I would have thought that there's no reason why
13.52 you should raise the same amount of money as in the past,
but.
NEIL COCHRANE: Correct, and this, as I mentioned earlier, one
of the issues was trying to identify what is the most
appropriate way to do it. When we looked at the ratio

for the five years for PSE2 versus the relative proportion previously, they were similar, so therefore as a consequence we elected not to make a change in PSE2 because that relative proportion was the same as is being experienced for the five years prior to that.

ALEX SUNDOKOV: And, of course, just to add, in thinking about the total landing charges, they consist of variable and fixed, and so in understanding the, for example the incentive effects on the utilisation of aircraft, you 13.52 have to look at the total charge, not just the Macto.

COMMISSIONER BEGG: Just then turning to the airlines, I would just be interested in your feedback on the process of consultation through, particularly on prices. The issues that you, concerns that you raised with Christchurch, did you find Christchurch was reasonably responsive; did they take a position that you could see was based on principle and therefore was reasonable? Just what your experience was through the period would be interesting.

KRISTINA COOPER: I think in respect to its prices, no, the 13.53 airport didn't have any sort of flexibility or interest in debating that. I mean they were going to be having a fixed charge and that was that, and they were putting up sort of the Macto rate which effectively seemed to negate the introduction of the fixed charge, and that was that. So, no, in terms of pricing structure I don't think there was a great deal of willingness to listen.

COMMISSIONER BEGG: Any of the other airlines like to comment?

SEAN FORD: Yes. From our perspective I guess the pricing structure as it ended up is pretty much how it started 13.54 out. We thought, I guess the exception within that is that with the fixed charge, Christchurch Airport did through the process adopt the 50% discount for the smaller turbo prop aircraft. We do still have some questions or scratching our head as to why the ATR is considered differently to the Beach and Q300 given it's only about 2 tonnes more than the Q but getting the $450 per movement versus the 75.

COMMISSIONER BEGG: And Freight?

MARK TROUGHEAR: Yeah, look, from our point of view I think we'd make the same comment, that from the initial position to what we ended up with, in quantum it wasn't a great deal of difference. The consultation that we made didn't seem to have any impact. And what we really try to do is get in front of customers or suppliers, if you're dealing with price increases of this magnitude, and discuss it, and that was pretty difficult as well. So, I wouldn't say the consultation period gave us a great deal of insight into how and why those charges had ended up the way they did.

COMMISSIONER BEGG: My final question is for Christchurch. With Auckland and Wellington, they both said that the information disclosure regime had had a significant impact on the way they went about setting their prices; they got expert advice on how prices should be set officially and so on. And other than for your levelised pricing approach, I don't get the impression that you've thought very hard about your prices in an efficiency framework or that the information disclosure has really had a big impact. So, really that's a question rather than a statement, so I would be interested in your feedback.

NEIL COCHRANE: I think the major issue with information disclosure in setting of prices is that, as we've mentioned a number of times, is transparency. One of the critical things, as we've reiterated through this whole process, is that our objective it so ensure that our shareholders have the appropriate incentive to invest, and that we achieve the appropriate returns. As part of this process and the comments have been made that we relatively end up, what we end up with is what we started with.

One of the concerns we had when we were setting this transition price path which I've referred to, having taken account of those market forces that have come into play, is the level of risk, and the level of risk is a major concern to us, as to how do we ensure that if we're providing what we believe is a concessionary price path through the transition, that we're not carrying all the risk in future periods? As the Commission is aware, we did offer a concept called a deferred value account which was to try and ensure that because of the offering of a transition price path, that there was some degree of certainty through a risk mechanism of how we could ensure that over the lifetime we would still achieve that return. That wasn't accepted by the airlines and, as a consequence, when we looked at the prices we set we had to make a judgement call on risk, and in terms of setting our final prices, it was actually an assessment of that risk versus the return we were willing to accept, and more particularly what was the level of burden we were going to share with our airline customers, and that's the 16 million we've talked about. So what we actually have is a balancing of risk and minimal returns. Alex, do you want to add anything further to that?

ALEX SUNDOKOV: As an advisor who was intimately involved in this entire process I would disagree with the observation that efficiency considerations weren't taken into account, and I think that the main thing here is not to conflate the pricing model with the actual price setting process. I mean clearly in thinking about prices, the kinds of issues that have been raised by the airlines, about changes in behaviour and impossible responses to prices, were very much taken into account and that's precisely what efficiency pricing is about, it's about not inducing inefficiency behaviours, and that's why for example the price movements towards the long run levelised price level are different for different services as a result of these considerations. I think the same applies to kind of carefully thinking about the relative burdens between turbo props and jets.

So, to the extent that the efficiency is - and in this regard the efficiency is about not inducing inefficient behaviour by the users, that was very much taken into consideration. Now, clearly in Christchurch's case congestion is not an issue so the congestion type issues were not considered.

COMMISSIONER BEGG: Thank you. Pat?

COMMISSIONER DUIGNAN: We have representatives of the freight business here and just following on from the comment that's been made, I mean, what has happened between PSE1 and PSE2 is that there's a large terminal development
13.59 project which one imagines has very little relevance to the freight business. So, my question is, on the point of the thought that went into the efficiency of prices, I would have thought that it called for quite a study of the relative ways that money was being raised from freight versus from the bulk of the business, which is passengers; was that done?

ALEX SUNDOKOV: Can I just clarify before answering the question, the new terminal investment and the additional assets that have gone into terminal do not in any way
14.00 affect airfield pricing.

COMMISSIONER DUIGNAN: You say "do not in any way"?

ALEX SUNDOKOV: Affect airfield pricing.

COMMISSIONER DUIGNAN: No, but - so that they are completely excluded, and so that they've had no impact in that regard; right?

ALEX SUNDOKOV: That's right.

COMMISSIONER DUIGNAN: Okay. Nevertheless, if you see what I'm saying, that's sort of saying that you've just added them as increments somewhere else. Did you reappraise the amounts that you have actually been getting from freight in the circumstance?

NEIL COCHRANE: If I could comment and just firstly a point of clarification. Yes, the major investment did include
14.01 approximately just under $20 million of capital
investment, primarily for the aprons. Admittedly, yes, it's not an impact on the freight aircraft. Our major focus through this process was to look at what is the major impact on the commercial airlines who are the major users, and if we talk about consultation, consultation was on what is it our published rates. We are aware, and the freight market in Christchurch, as Mark has mentioned, it is growing but it is still a relatively small proportion of the total. We didn't in setting
14.01 these prices make a specific determination between one
and the other, so in terms of setting those published rates. However, one of the things we are very aware of, you know, freight in the South Island is growing. We want to ensure that that still continues through Christchurch, and if commercial pressures come to force in terms of how do we ensure that we're not going to compromise that in the future, then we would need to give consideration to that.

COMMISSIONER DUIGNAN: Well, can I just ask, then, I mean the
14.02 increase in the cost of freight, the charges that are
being paid by people bringing freight by, from what I'm hearing, are in the high percentages, so why would that be if the thing that has changed between PSE1 and PSE2 is not relevant to this, namely the main thing that's

changed, which is the building of a terminal? So, in
what - I mean, just in a very simple sense, where has the
reason for the reasonably large increases, the freight
people could probably tell me exactly the numbers, I
don't, haven't got them in front of me, that they are
experiencing, what's the origins of it please?

NEIL COCHRANE: If I could clarify it in one sense, is that it
is Christchurch's opinion that prices previously did not
reflect the costs of the assets employed. What we have
14.03 done through this reset is to take account of what is the
actual cost of service delivery, the additional increased
investment that we have made, and what we have done is,
you could say there is a catch-up there. It is not
purely related to this period, it is ensuring that we
move towards achieving that required return. It is our
position that in the past this had not occurred. As I
mentioned, prices have been held fixed for nine years for
our airfield services. When we did the increase in 2009
it was near the GFC, so again it comes back to,
14.03 commercial pressures came into force, we weren't able to
achieve the level of return that would give us the
appropriate required return, so therefore it was what we
were able to achieve within the condition of the market
at that time.

COMMISSIONER DUIGNAN: I must say, then, what is interesting
to me is that, you know, much of the way we've been
thinking about this is that we've got this dominant
levelising of prices because we're going to be picking up
things in the future rather than the present, which sort
14.04 of makes you think that that's all related to the
terminal, but actually there's a different process going
on that hasn't actually had much air time, I would have
to say, and naturally enough, in either conversations or
analysis, which is that in regard to the freight business

you're doing something different, you're seeing yourselves as increasing the prices because of lower recovery in the past; right?

ALEX SUNDOKOV: Not quite, no, I think it's probably useful to just clarify some concepts here. So, the pricing model uses the actual costs of delivering each service to calculate the levelised price for that service. So that the levelised price for delivering the airfield service is calculated in exactly the same logical basis as the terminals. Of course because there hasn't been the same increase in the value of the assets of the airfield, you have different results as a result of that. The model sets the levelised price. The question about the price change, which I think is a somewhat different question, is about what is the gap between the prices inherited from PSE1, and these levelised prices? And so where I think some of the issue around the airfield comes, is that while in relation to, for example, the domestic terminal, the jump in the levelised price occurs because of new investment. In relation to the airfield, the levelised price doesn't really jump very well, very much, but the fact is that the historic prices were so far behind having been frozen for many years and haven't taken account of the investment that had gone on, that the gap looks much larger and therefore the rate of increase is much larger than would have occurred otherwise.

COMMISSIONER DUIGNAN: I'll just see whether anyone else has any comments?

MARK TROUGHEAR: Yes, we do. So, I guess it begs the question how the airport was running prior to these increases, that 66% and then another proposed 94%, and then an indicated increase which looks 25% or more on top of all of that, looks to be a massive reset, presuming that the

airport was making some money in the first place. It also seems to be a massive increase in cost when we compare it to the other airports in which we land and operate out of so we would wonder what Christchurch is doing that's different to perhaps other operators, are there some efficiencies that they can find, what have they done as a commercial entity to lower their costs of operation to benchmark themselves against other airports that we would use that have a far far lower rate than the
14.07 proposed rates.

COMMISSIONER DUIGNAN: Any comment from others?

SEAN FORD: I guess without wanting to delve too far back into history I guess the perceived under-recovery in the previous period which has driven the supposed need to increase in this period I guess is, you need to go back and look at revaluations that were brought into the asset base in 2009 and how they were treated, and sort of that's just flowing on into the so-called required revenues this time round.

14.07 **KRISTINA COOPER:** I was going to make the same comment. I believe the significant uplift in the airfield is because of revaluations which totalled around $150 million which were not treated as income in 2009, and it's an uplift because of inappropriate treatment in the past.

COMMISSIONER DUIGNAN: Thanks. I suppose that we would to the extent that time permits just like a little more information in the cross-submissions regarding the distinctions that have been drawn here between freight and passengers. I must note that, you know, the biggest
14.08 thing that, or the other thing that's changed is that Christchurch Airport has increased the WACC compared to the WACC you had earlier, and that, I mean one interpretation of that is that, whereas papers like this are sort of saying that the global financial crisis had

an ongoing effect in reducing returns, essentially you dispute that, and that that is one of the factors that are resulting in an increase being applied now to restore your return to what you thought was appropriate pre the global financial crisis.

ALEX SUNDOKOV: I'm reluctant to reopen the debate on WACC but I think that, I guess we take a - first of all, the change in WACC actually isn't that big. I think it's correct that if you kind of think about the way the model works, it is the revaluation, which is completely legitimate, it's fully in compliance with the IMs. But I think in relation to the target return, I mean there's no doubt that the global financial crisis is putting business returns under pressure. That is precisely why we're saying that the market risk premium is likely going up. The difference between a workably competitive market and an infrastructure asset like this is that in a workably competitive market businesses have long periods of earning well above that cost of capital. You can't have it kind of both ways and say well, no, you can never earn above your cost of capital but you should also not recover the cost of capital at all times. You know, it's kind of - it seems to me that in a workably competitive market clearly you have differential periods of performance. The impact of the global financial crisis on many competitive firms is that it's reducing their profitability and increasing the market risk premium which is driving their share prices down, and that clearly is a temporary phenomenon, or people hope it's a temporary phenomenon. From the point of view of an infrastructure business like CIAL, it knows that it will not have a period of being able to earn above its cost of capital in the future, and so therefore it needs to target something that is much more consistent with the real underlying cost of capital.

COMMISSIONER DUIGNAN: Thanks, so we can leave it there.

ALEX SUNDOKOV: Yeah.

COMMISSIONER BEGG: Can I just check; staff?

ISOBEL OXLEY: Isobel Oxley for the Commerce Commission. I've got a question for BARNZ. I would be interested in knowing for the airlines that you represent, whether they expect their demand to change as a result of the new pricing structure at Christchurch Airport?

14.11 **KRISTINA COOPER:** I can't comment on their internal confidential views, which we're not aware of, but I would just observe that four of the main airlines in New Zealand now are subject to conditions that they cannot reduce activity levels because of alliance approvals having been given. So, I think Air New Zealand, Virgin Australia, Emirates and Qantas all now have to keep their activity levels at the same level that approval was given for their various alliances. Now, that's really going to mean that those airlines can't 14.12 reduce a large portion of their capacity because of the trans-Tasman conditions.

JOHN BECKETT: And that's what's led them to be spiflicated, as Kristina said before.

KRISTINA COOPER: Well no, it's the price increases that -

ISOBEL OXLEY: I think we'd find it very useful in cross-submissions if the airlines could provide perhaps more information, some examples of how they expect their demand to change as a result of the new prices and pricing structure.

14.12 **CHAIR:** Okay, well that brings to an end the session on pricing efficiency and we still have good time before the scheduled break of 2.45 and so we'll now move to the last of the topic sessions in the agenda, starting with quality, and I'll hand over to Elizabeth for that.

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COMMISSIONER WELSON: Thank you. So, change of topic, moving on to quality. In the submissions there wasn't a lot of comment, certainly nothing to suggest that Christchurch was not providing services at a quality that reflected consumer demands. But there are just one or two areas where I would be quite interested to explore, get a little bit of further information and my first question is directed at Christchurch.

14.13 I noticed in your information disclosure for 2011 there obviously were a lot of number and duration of interruptions for a number of services; your runway services, baggage sortation, and baggage claims were quite high. I think you explained in your disclosure document that the runway services was as a result of the earthquake, I think you might have mentioned contact stands as well. In 2012 baggage claim number and duration of interruptions continued also to be quite high. So, I was just wondering if you could give us an
14.14 explanation around the reasons for those service levels?

NEIL COCHRANE: If I could comment. If we look at the period over 2011 through 2012 it's probably unprecedented in terms of natural disasters; we've had earthquakes, we've had snow, we've had some ash cloud from Chile and so on, so that's led to a number of disruptions there. Yes, they have been disruptions and one thing I believe can be demonstrated is that probably we have - how we have managed them has been very efficient in terms of our emergency management and so on. They have been natural
14.15 disasters, they are significantly above what was there.

In terms of the baggage handling, what we have is moving through the processes, transitioning from one system which is in stage 1 of our ITP development, the new integrated baggage handling system came into play, and that did itself have some, I'll call it teething issues. I don't have the full detail in front of me but I am happy to provide further detail in cross-submission should that be required.

COMMISSIONER WELSON: I think it's just understanding the reasons behind those numbers, would be helpful. I'll move on to the next question unless anyone else has a comment?

CHARLES SPILLANE: I'm Charles Spillane from Auckland Airport. Neil made reference to the efficient emergency management approach that Christchurch took through the earthquake events, and I'd just like to note that that is something that they have been generous enough to share with the rest of the industry so that we've all been able to learn from their crisis management with a view to making our own practices better, and I think that's something that's important for the whole industry.

COMMISSIONER WELSON: Okay, thank you, and certainly there was no suggestion not to acknowledge the impact of the earthquake. It was more just understanding for the record what was the reason for those interruptions, but do appreciate your comment. Thank you.

So, moving on. Understand that the service quality really discussions didn't feature too much in the consultation and discussions around PSE2 but it was part of the consultation for the capex around the integrated terminal. I think, BARNZ, in your submission, there was the reference to some discourse going on during that consultation and I think Air New Zealand also made some comments around the outcomes. So, I suppose, a couple of questions initially for BARNZ and Air New Zealand in relation to that consultation. The discourse, the disagreements that are referenced, just wanting to understand, was that between the different airlines as to the type of quality, service qualities that you were looking for, or was it between airlines and with the Christchurch Airport? So BARNZ first perhaps, and then Air New Zealand.

KRISTINA COOPER: It was between the airlines and the airport.
There was, from memory, significant amount of debate as
to whether the baggage make-up area downstairs would be
big enough. I mean the previous area was extremely
congested and the new proposed area was going to be very
14.18 very tight. It was doubted so much that the airport
basically knocked up an outline outside to try and prove
that it would work and the answer was, just. In the
actual outcome, when Air New Zealand and
Christchurch Airport agreed to build a regional lounge,
that enabled a fifth carousel to be added downstairs and
we've been told that that's what has made the baggage
area downstairs be workable. There were other debates
over whether corridor widths were wide enough with
airlines being worried about passenger flows. I think
14.19 they ended up being widened in the plan. There was
significant debate about whether Avsec had enough space.
I think in the end the airport added extra space at the
Avsec throat so that it is future proofed. So, yeah, it
was effectively trying to, airlines trying to ensure that
the building would be large number. It was an unusual
situation. It wasn't a case of airlines thinking that
there was a planned over-build, it was actually airlines
being very worried that there was this brand new terminal
being built and it wasn't going to be big enough,
14.19 certainly with the check-in hall, you know, there is
still sort of doubt as to whether it is large enough. It
is at capacity today I understand, but it is hoped that
it's technology that's going to be the saving grace
there.

COMMISSIONER WELSON: So just to recap, my understanding is
there were a number of issues raised but by in large the
concerns were taken on board and the airport responded?

KRISTINA COOPER: There was a two-stage consultation. In the
second stage, your answer is correct. The first stage
was an absolute - I don't know if I'm allowed to say the
word "shambles" - you know, in all my time you very
rarely see a consultation process which would be able to
be successfully challenged for lack of process and a
14.20 closed mind. That first consultation in my process was
100% certain to be overturned by the Courts. Air New
Zealand brought a Judicial Review proceeding,
Christchurch Airport decided to reset the process and
start again, quite rightly in my view. And so in the
second process, yes, we worked through.

COMMISSIONER WELSON: Thank you. Air New Zealand, did you
want to add anything?

SEAN FORD: No, I think that covers it all off quite nicely.

COMMISSIONER WELSON: Christchurch, would you like to comment?

14.20 **NEIL COCHRANE:** If I could make a comment there. I agree with
Kristina, the first stage of that could have been better
but I think what we had at the same time as we were
developing the new terminal was a significant change in
business model. We had the coming in of new low-cost
carriers and therefore how do we ensure that we provide
the necessary service for them, and Kristina is correct,
that in terms of the initial stuff, it didn't necessarily
meet what the airlines required. What we were trying to
do is particularly respond to concerns that the future
14.21 for travel is different for what it was in the past. If
I can use an example, and Kristina has referred to the
check-in counters, if we had carried on with the existing
model we would have had to have about 74 counters. We
have under the integrated terminal only 60 and they are

able to check in both domestic and international. So what we've responded to in terms of the submissions by the airlines, what were their functional requirements, what were the service level requirements, and the standard of service they require, whilst at the same time trying to ensure that we weren't going to have an investment that could be changed through subsequent change in airline processes in the future. And Kristina refers to the check-in counters at present. We know that the check-in counter process will change. You know, we'll see greater technology through web check-in and so on. So, it's going to change the way passengers travel. We believe that the way the final consultation came out, the use of dynamic modelling to demonstrate to all of the airlines, remembering that we have to deal with six different airlines who may have six different types; we have the premium service carriers, we have the low cost carriers and the question was, how do we get that balance, and I believe at the end of the day, yes, there were some issues that we had to overcome but I believe at the end of the day the final service delivery met the airlines requirements and it's certainly been shown through the ASQ results that we're actually receiving now from passengers and travellers who use our airport.

COMMISSIONER WELSON: Thank you.

SEAN FORD: Just one point on that. I guess one issue that we would see as being a problem was relating to the way in which that design, or that process happened, in terms of basically the build was put out to tender before the design had actually been properly, to our mind properly finalised, and as a result there has been sort of significant costs which we as tenants have had to bear in terms of getting the building right simply because of the way that that tender process happened. So, I think in that sense there's a, yeah, from our perspective it wasn't necessarily done in a particularly good way.

COMMISSIONER WELSON: All right.

NEIL COCHRANE: Could I make a comment on that, please. If we look at the capital costs of ITP, there has been a number of comments made about cost of it. The terminal was forecast in 2009 under a fixed price contract. That contract is just now being completed after major earthquakes, finding of asbestos and the like, and a significant delay because of the earthquakes, and it has come in at 0.9% over budget. We think that's a tremendous outcome.

COMMISSIONER WELSON: All right. I think if we could move on to the next question. It's my last question on quality; directed to Christchurch.

I think the submissions are all fairly uniform and suggesting that the improvements in quality that have been experienced at Christchurch come as a result of the new terminal rather than information disclosure, and what we're looking at here is impacts of, or effectiveness of information disclosure. So, my question to you is, has information disclosure had an impact on your processes around ensuring quality meets consumer demand?

NEIL COCHRANE: I believe the major impact of information disclosure has been one of transparency. If I could step back and think about the point you've made, Commissioner, is that the terminal was first thought about being developed back in the late 1990s. It was then revisited in 2003 and as we've just heard it's taken significant time starting back from 2005 through to 2013 to meet those functional requirements. Information disclosure wasn't even thought of then. So, the functional requirements, the service delivery standards required have been provided through that, and this is why service quality wasn't such a major issue.

What I believe the benefit of information disclosure is, it is providing transparency of what is actually happening through ASQ surveys, the key performance indicators, and the expansion of the indicators that have been developed for information disclosure is providing a benefit to us, I believe; one is to understand our business; secondly, that through the integration of the working groups with the various airlines, the border
14.26 agencies and airways, that we're actually getting a better understanding of what's going on, and through that we're able to address how do we improve service overall.

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COMMISSIONER WELSON: Thank you, I'll just check with staff if there was any question on quality before we move on to the next one? No. If I could just now move on to operational efficiencies.

Analysis shows that the unit opex at Christchurch is forecast to decline over PSE2, although it is at higher
14.26 levels than in the period prior to the earthquakes.

You've indicated that there's a number of factors. I think higher insurance costs, increased operational costs associated with the new terminal contribute to that.

BARNZ have noted in their submission that there's a 50% uplift in opex per passenger in recent years and has expressed some concern, whilst acknowledging the impacts of the earthquake, that the base level is the correct level for use in forecasting opex.

So, my question for you, BARNZ, was whether there was
14.27 any specific example of costs included in that base level which you consider to be inefficient, and if you could just expand on why that might be the case?

KRISTINA COOPER: Given the unique circumstances facing Christchurch Airport of two earthquakes, of insurance

payments not covering all of the related damage, of it moving to a brand new terminal, it was felt that it was too difficult to draw sort of accurate comparisons from the past and to try and sort of flow it through into what was considered to be an appropriate base level of opex. So, therefore, in consultation, BARNZ did not challenge Christchurch Airport's level of forecast operating expenditure beyond observing that, as you note, it had increased from a forecast of a base 17 million opex cost
14.28 in FY11 up to the 24-26 million in PSE2. So, effectively BARNZ is really anticipating or hoping that Christchurch Airport will be able to move to introduce efficiencies once the impacts of the earthquake are over, and that we will see efficiency gains in opex going forward. But in this situation of the circumstances facing Christchurch Airport, we would acknowledge it's really not possible to draw any clear conclusions.

COMMISSIONER WELSON: Christchurch, did you just want to comment at all on that?

14.29 **NEIL COCHRANE:** No, I would concur with the comments Kristina's made. When we went through the costs forecasts for the terminal and recognising that the terminal is actually bigger than what we had previously, it's 26% bigger in footprint, there has been a greater footprint allocation to aeronautical activities, we went through a very rigorous cost determination process and as part of that process there was significant scrutiny by our Board in terms of developing the business plan. There are a number of efficiencies there which, and if I
14.29 can use just as an energy efficiency, that with the methodology applied for heating the new terminal we're receiving, we'll achieve a 25% efficiency per square metre usage there because of the type of initiatives that were put into place. But we believe there will be

efficiencies come through.

The issue is that we've got a bigger terminal. It was very difficult to determine what is going to be ongoing effects. One thing I would say, that we believe there will be efficiency gains through the period and these will be included in our reset of our costs forecasts from the 2017 price reset.

COMMISSIONER WELSON: Thank you. Just a couple more questions. The airlines in their submissions have raised concerns about the uplift in opex for PSE2 so we've talked about the base level forecast. My question is whether there are any other elements of the forecast opex which might relate to, or reflect efficient costs? You're looking a bit perplexed.

So, the question is, do you consider that there are other elements of the forecast opex which reflect efficient costs, so it's probably also building on the comments that have just been made. So, you're comfortable, leaving aside the starting point you're comfortable that the forecast costs are, or reflect efficient costs; there's no concerns there? It's really just confirming what I think I've understood you to say.

KRISTINA COOPER: I mean I think one concern which has been expressed by our operational staff on the ground is whether the head count is getting too high down at Christchurch. But it's really, it was a unique situation of just so many unknowns, so many changed variables that we really have to confess that we didn't put as much scrutiny into the opex as Christchurch Airport reset its prices as we normally would have, simply because of these changed variables. We focused more on the capex, the asset base, the WACC, the tax, and those elements.

COMMISSIONER WELSON: Okay. Is there any other comments?

JOHN WHITTAKER: No, we're not sure what, but that's exactly it, we're just not sure, we don't know.

COMMISSIONER WELSON: Freightways, did you have any comment?

MARK TROUGHEAR: No, again, it's not an area we explored in any great detail, so no.

COMMISSIONER WELSON: And Christchurch, I acknowledge the comments you made in response to the previous question probably addressed this issue as much as the earlier one.

NEIL COCHRANE: Yes, they did.

COMMISSIONER WELSON: So thank you. My last question just goes to the consultation process and just how constructive the parties found the consultation process around opex. I gather from the comments that obviously there wasn't a lot of dialogue around that issue but if I could just have some comments around how effective you found those discussions and that engagement. So really, were there any concerns? I'm getting a sense that there wasn't but I would just appreciate if you could comment.

KRISTINA COOPER: I think that any issues we raised were responded to by Christchurch Airport and engaged upon, so there wasn't any concern about, you know, lack of engagement.

JOHN WHITTAKER: I think often it's perceived that airlines will complain about anything they can possibly complain about in terms of pricing. I think there's an example here of where there has been a 50% uplift, we really were unable to establish whether that was required or not but we're prepared to cut the slack for them to get on with it because of the difficult circumstances.

COMMISSIONER WELSON: Yes, that's understood.

KRISTINA COOPER: I think that sums it up very nicely, so thank you.

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COMMISSIONER WELSON: All right. So staff, just before we move on, any - no. So moving on to the last area for discussion which is around investment efficiency and there's just a couple of issues, I've only got two questions to explore in relation to the capital expenditure.

So, again, resulting from the fact that we've received very little feedback from airlines regarding the capital expenditure, most of which has related to the integrated terminal building, so my question really is just to invite comment, is there anything anybody would like to
14.34 add to the submissions in terms of timing and level of spend on the terminal, whether this was efficient and why. Now, I understand the comments that you made before around the consultation process, so it's really if there's anything additional to add in relation to that. So, Air New Zealand, start with you, and then move to BARNZ.

SEAN FORD: I haven't got anything to add at this time but we can certainly review that and come back to you in cross-submissions, but certainly off the top of my head I
14.35 can't think of anything pressing.

COMMISSIONER WELSON: BARNZ?

KRISTINA COOPER: I have one comment, it's more in the nature of a constructive observation of having been through consultation with the three airports over the last 15, or over the 15 month period, and that is that we made quite positive comment at the Auckland conference about Auckland's capex process where they sat down with airlines very early in the stage and said, here's what we're thinking of, what are your priorities, is there
14.36 anything you want to come forward, is there anything else that should be included that we haven't thought of, and Christchurch Airport didn't do that, and nor did Wellington, and we didn't ask them too, but thinking about it, it worked very very well at Auckland and I

think what it's led to is it led to airlines actually thinking, you know, perhaps not necessarily taking an approach if we don't need something, but more thinking about what do we need. And I know that as I prepared this submission and went and talked to the Airline Operators Committee down at Christchurch Airport they said, we've got a problem with the international baggage reclaim belts, you know, we want bigger belts. Rather than lots of small ones we want several larger ones. And
14.36 I was thinking well, if a process like Auckland Airport followed had been taken at Christchurch Airport, for example, that would have been drawn out. So, I think it's a lesson for the airports and it's a lesson for BARNZ in the future, is really to have a preliminary stage in the capex consultation process of sitting down and talking about, what do airlines need and what are their priorities before the plan is developed.

COMMISSIONER WELSON: Freightways, did you have anything to add? No. Christchurch, did you want to comment?

14.37 **NEIL COCHRANE:** No, I find that comment quite constructive and we have no problem about doing that. I think it would improve the process. So certainly we will take that on board.

COMMISSIONER WELSON: Thank you. My final question, just again largely directed to the airlines, was just a comment around a comparison between consultation on investment for PSE2 compared to PSE1 and the ITP, and it may well be that, I think your comment just made goes to some of that as well but whether there's anything
14.37 additional?

KRISTINA COOPER: No, I mean I think the vast majority of the consultation on capex related to the ITP. So, what we've effectively got forecast going forward in this pricing period really is business as usual capex. It doesn't

sort of require quite the same degree of engagement
probably.

SEAN FORD: Sorry, just having said that, having listened to
that, I think one distinction to make is that the PSE1
pricing outcome did not actually reflect any pricing
associated with the ITP because that was done under a
separate process.

COMMISSIONER WELSON: Yes.

SEAN FORD: So, in that sense the consultation around the
14.38 effectively business as usual investment associated with
the PSE1, and the same process for PSE2 was basically
done in much the same way in terms of the transparency of
information and just engaging on it. I think you'd see
PSE1 as sitting outside - sorry, the ITP as sitting
outside and being quite a different beast, as it were.

COMMISSIONER WELSON: And just a final, any comments from you,
Christchurch?

NEIL COCHRANE: No, we have no further comment to make.

COMMISSIONER WELSON: That was all the questions from me. Do
14.39 you - no, that's fine, thank you.

CHAIR: Right. Well, we've kept very much to the timetable
today and so the only thing left now is for the closing
statements which we'll start at 3 o'clock. Can I just
check that, I mentioned at the start that we understand
three parties, namely BARNZ, Christchurch Airport and
Freightways wish to avail themselves of this opportunity,
so I'm assuming we're still proceeding on that basis.

In terms of the batting order, there's nothing magic
to it but can I perhaps suggest we do it in this order;
14.40 BARNZ first, Freightways second, and Christchurch Airport
last. So, I think we'll have closing statements in that
order, please. Thank you.

(Conference adjourned from 2.40 p.m. until 3.01 p.m.)

CHAIR: Okay, shall we make a start, please, for the closing submissions. I'm told that each of them will be about ten minutes long, or thereabouts, so let's see how we go. First of all, can I call on BARNZ, please.

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KRISTINA COOPER: The airlines which BARNZ is representing today acknowledge that Christchurch Airport has appropriate levels of quality, innovation, service levels and investment. These airlines also acknowledge that due to the unique circumstances facing Christchurch Airport 15.03 of two major earthquake events and the move to a significantly larger new terminal building, means it is not possible to reach any definitive conclusions at this point with respect to efficiency. The key issue which the BARNZ represented airlines have with Christchurch Airport's conduct is with respect to its price setting. Specifically, Christchurch Airport's use of its market power to set charges at which it will earn significant excess returns, both in the present pricing period and at greater levels into future pricing periods.

15.04 The BARNZ represented airlines acknowledge that the input methodologies have had an affect into the inputs used in Christchurch Airport's financial pricing model in this pricing period. Specifically Christchurch Airport moved to follow the Commission's asset valuation input methodology, and has stated that it intends to treat both forecast and actual revaluations as income, and this is welcomed and appreciated by the BARNZ represented airlines. However, there is still come question over the level of commitment which the airport is prepared to 15.04 make. However, despite the change in asset valuation approach for this pricing period, in BARNZ's view information disclosure has not been effective in limiting the ability of the airport to extract excessive profits. Christchurch Airport has set its charges at a level which will result in it earning significant excess returns and at levels which do not replicate outcomes of workably competitive markets.

Applying an updated mid-point WACC of 7.06%, BARNZ assesses that the new charges and the charging structure Christchurch Airport has set, will result in it earning excess returns of $37 million over this current pricing period. This represents additional revenue which has to be paid by airlines and by the travelling public and by
15.05 freight users of $64 million.

Moreover, Christchurch Airport has indicated that it will be further increasing charges in the next three pricing periods to ensure it earns its desired 13.6% pre-tax WACC in full over the next 20 years. There are two key departures which Christchurch Airport has made from the Commission's input methodologies which lead to the significant level of over-recovery.

The first key departure is that the airport is using a 9.8% post-tax cost of capital which it applies in the
15.06 13.6% pre-tax format, and it sets its charges over 20 years so that it will earn this very high level of return. This WACC is approximately 50% higher than the Commerce Commission's mid-point WACC for specified airport services of 6.49% as at 1 July 2012. It is also considerably higher than the adjusted updated mid-point WACC 7.06% which BARNZ estimated in September 2012.

The second key departure from the Commerce Commission input methodologies is that the Airport has treated income from revaluations as being taxable when it
15.07 calculated its base income requirements, and it has increased its required revenue to include tax on income from these revaluations despite the fact that such tax does not exist in New Zealand. This is inconsistent with both commonsense and with the Commerce Commission input

methodologies which clearly deduct revaluation related income from regulatory income before regulatory tax is calculated. The ability of airports to pick and choose which input methodologies they will apply and to adopt different inputs where they so choose in BARNZ's eyes leaves airports unlimited in their ability to extract excessive profits.

Now, Christchurch Airport has chosen to set prices to earn a 9.8% return over the next 20 years. This
15.07 represents significant excess returns, demonstrably demonstrates that information disclosure has not been able to effectively limit the ability of airports to extract excessive profits, that information disclosure alone has not been able to effectively promote the purpose of Part 4 in respect of specified airport services, and that information disclosure alone does not result in an outcome which reflects the workably competitive market. Thank you.

CHAIR: Thank you, BARNZ. I'll now give Freightways the
15.08 opportunity to present.

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MARK TROUGHEAR: Thank you. Just to reiterate a couple of points around the express freight market in which we operate. We operate road and air freight. Air freight is the pointy end of express freight. It's the sector where your pharmaceuticals, your life-support parts in many cases, your just-in-time products are transported overnight between the islands. It is the most marginal sector we operate. It runs on extremely slim margins and
15.09 those margins are being constantly eroded by the pricing increases we experience, be they CAA, airways, landing fees. We service over 30,000 customers around the country, so we service a very broad cross-section of the New Zealand economy and we think we play a pretty

critical part in connecting consumers and suppliers throughout that network.

We've been a customer of Christchurch Airport for over 24 years and we've got many customers that have been with us for over 40 years, and never in that time have we either increased rates to our customers or experienced that level of increase from a supplier that would see us pay 66% over the past three years, projected 94% based on these rates over the next period, and then potentially 15.09 another 25% and above where we have demanded no extra resources from that particular supplier. So, we use nothing more really than we did 24 years ago; we land on that air strip, we have a small freight shed which occupies the edge of the ramp, and we pay rent for that at a commercial rate and they process our freight through that gateway. We don't use the terminal, we don't fly on peak. As I said, I don't think we've placed any extra burden on CIAL over that period.

We don't accept, and I guess we haven't seen evidence 15.10 that airfield cost increases have occurred that would demand that level of increase, and if it's in fact a revaluation, well, we'd love to go back and revalue customers where we might have got the rates wrong 15-20 years ago and get a recovery from them as well. That's simply not the market we operate in and it's not the competitive market.

If we had another choice we'd take it but we don't, so the choice is left to us really to increase rates to those customers that use that particular service and hope 15.11 they accept them, and we absolutely know that an increase in rates in that sector will reduce demand. Okay? We have seen that in the past and there are many examples of where price sensitivity around express air freight, where those rates have gone up the demand has fallen.

So, the options for us are that we push customers to road-based services that we can complete in two days between the islands, or that we make a marginal sector even more marginal. So, those types of increases are a significant impact on our operation, and, as I said, in a commercial, competitive world I've never seen those occur.

So, you know, we object pretty strongly to that. We've tried to have dialogue through the consultation process and then subsequent to that, but the spectre of increases of 94% over what we pay now and then increases further into the future, certainly will have an effect on demand and will cause us to re-evaluate the way we service the interisland sector. Thank you.

CHAIR: Thank you, and if we can now finish the conference with Christchurch Airport, please.

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NEIL COCHRANE: Thank you, Commissioners. I would like to make some closing remarks but in doing so I'm mindful of the Commission's request that such closing remarks don't cover the same ground we've already covered today. And so for that reason I thought I would conclude with some reflections on the process to date for both our pricing consultation process and the Commission's inquiry process.

My first reflection is on how the information regulation has influenced our operating environment. There's no question that the Commission's information disclosure regime is more rigorous than the old disclosure requirements under the AAA. As a business we know there is a lot more transparency on how we run the airport and our performance outcomes, but however our objective is still the same, to run a great airport that delivers service excellence for our airline customers, travellers, exporters, importers and the wider users of Christchurch Airport. But we are conscious of that extra transparency and scrutiny which helps we believe keep our feet to the fire through this awareness.

I believe the information disclosure regime has had a material influence on our pricing consultation process. We believe the Commission's IM and the application of that streamlined our commercial consultation. It was certainly helpful in getting the parties to focus on the 15.13 specific points of difference that have arisen and have then been discussed here today.

Having said that, my second reflection is on how our investment in our new integrated terminal has required everybody to think outside the normal parameters of the building blocks model to ensure that we can achieve the necessary return over the life-cycle of that investment. We've got no secret scheme here, as I hope our presentation today has made clear. You know, we've made a very large investment, $240 million odd, that we need 15.14 to recover over the medium term, and if we had applied the building blocks model it would have certainly sent a very large price shock last year. In fact, if we had applied the building blocks for the total cost of service, this would have been even greater still. The complexity of developing a medium term pricing model we haven't underestimated and particularly, probably reflected through the comments today, communicating that has certainly been a challenge. However, I would hope that our basic objective is clear and that our 15.14 willingness to engage on the details are also clear.

My third reflection would be on the amount of effort that our stakeholders have put into the pricing process. Our airline customers, the Commission as well as ourselves have invested significant time and effort in this process, and I just want to thank parties for that.

My last reflection, however, is on the, after all this on what we call the regulatory science. The commercial environment is still very unpredictable and this has been demonstrated by when we set our prices in 2009 we didn't predict the earthquakes and the impact that would have on our market, and particularly the growth outlook over the next four to five years. Similarly, when the Commission was setting its WACC IM no-one would predict the lengthy 15.15 impact of the GFC on the risk free rate. Again, when we filed the IM appeals the lawyers said one year max, who knows. Also when we set our prices just last year we made our best forecast with the likely demand over the five year period. That forecast is already significantly questionable just one year into the process and it looks like demand will certainly take much longer to come back than our prices had assumed. This is particularly considering the timeframe for, and the influence of the Christchurch redevelopment programme, both on 15.16 Christchurch and on the South Island tourism market as a whole.

So, I must reflect that when considering this unpredictable commercial environment I do get a bit nervous about the weight that is seeming to be put on predicting what will be happening in 2017. However, I can tell the Commission we will be pricing in a way that is consistent with the long run model we used last year; we will continue to take the principled transparent approach we explained to you today. Hopefully by PSE3 15.16 the effects of GFC will have faded away and hopefully again our ability to forecast demand will have improved. Until then our intention is to keep up our track record of operational efficiency, quality and facilitating innovation. We will publish these outcomes as part of

our annual information disclosure report and this will be
something that all our stakeholders can review and check
on.

Thank you again and I would like to express my thanks
to the Commission for giving us the opportunity to make
the presentation at the beginning of this conference.

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CHAIR: Thank you, Mr Cochrane. Look, I've just got a few
final comments to make.

15.17 What next? There's two steps I would like to point
out. First, as I've already mentioned a number of
questions have come up and we've indicated a desire to
get further information in cross-submissions and so we
will be publishing a list of those questions on our
website together with the transcript of today's hearing,
and the target for that is next Wednesday, the 29th of
May. So, keep your eyes on our website for those
two documents.

Following the conference, again, as I've already
15.17 mentioned, all interested parties have the opportunity to
make cross-submissions on any matter discussed at the
conference today, and that's another submission round
before we prepare our draft report. Cross-submissions
are due 12th of June. After we've received the
cross-submissions and looked into that, we will be
putting out our draft report and so that becomes yet
another opportunity for written submissions in response
to our draft report. So, there still are, you know,
ample opportunities for submissions to be made.

15.18 All that's left now is to do the usual thank yous to
all parties involved. I would like to thank my fellow
Commissioners, and the staff, and Ruth and her team for
all of their assistance and background work and interface
with all of you here. Thank you to all of you once again

for your very free and frank participation in what are I think very helpful sessions to enable us to understand the dynamics of what's going on with this new information disclosure regime. Thanks to our stenographer as usual and all others involved in the process.

With those comments, this is the end of our third and final section 56G inquiry, so that brings to an end another step in Part 4 of the Commerce Act regime. So, with those words I'll bring this conference to a close. 15.19 Thank you.

(Conference concluded at 3.19 p.m.)

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