28 November 2017

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**Response to the Process and Issues Paper: Auckland and Christchurch Airports' third price setting events (July 2017-June 2022)**

Dear Jo,

Thank you for the opportunity to respond to the Commission's proposed approach to reviewing prices for Auckland and Christchurch Airports. These two ports are the two largest airports in New Zealand. As a substantial customer of these ports, Air New Zealand is impacted by their pricing and associated operational decisions. We therefore welcome the opportunity to submit to the process.

Information disclosure is designed to limit the ability of regulated airports to extract excessive profits. As the lightest of regulatory tools, information disclosure is not able to restrain such profit taking. Shareholders of regulated airports benefit from significant returns while, in Auckland's case, infrastructure fails.

Both Auckland and Christchurch airports are targeting excess profits. This statement is reinforced by observing the extraordinary total shareholding returns achieved by Auckland Airport over the past fifteen years. The Commission is responsible to respond to this behavior for the long term benefit of consumers.

Auckland and Christchurch airports are both targeting a higher WACC than is necessary. Airports habitually target the upper end of the Commission's WACC range – using any argument to support this that may suit. In PSE3 we see Auckland arguing they need a higher WACC to support a building programme arising from increased passenger numbers. By contrast, Christchurch argues for a higher WACC as they bear more risk as a leisure port. Both arguments cannot be correct.

In setting their WACC, the dual till model allows both airports to ignore their commercial till. The commercial income earned by both airports lowers their commercial risk. In a workably competitive market investors would not ignore this, and nor should the Commission when assessing appropriate cost of capital.

Air New Zealand is also concerned about the capex proposals made by Auckland Airport. While we welcome the building programme, and consider it long overdue, we are aware of the regulatory drivers and how airports can profit by manipulating these.

The current regulatory environment incentivises airports to charge for a capex programme in advance, and then work to deliver it more cheaply and/or more slowly. The capex programme set out by Auckland is still very high level due to the planning stage that AIAL has dwelt on for at least the last five years. Significant further effort will be required to properly assess cost, timing and necessity. We are very concerned to see AIAL's recent advice to investors that they are more likely to under-deliver than over-deliver on planned capex during PSE3. Failure to deliver total capex is a simple over recovery.

Air New Zealand encourages the Commission to take a wider view of the section 53B(2) requirements and consider quality, efficiency, and innovation. These items must be included in the review scope to allow the Commission to determine whether the purpose of Part 4 is being met. There are no other regulated utilities for whom price and quality are not linked. Further, prices are set to provide a service. Service quality, efficiency and innovation in delivering that service are integral to the price being charged. To exclude these things is to weaken the information disclosure regime.

At the conclusion of this review process, the Commission should be able to heighten the regulatory threat for any airport found to be targeting excess profits, swiftly moving them to a different regulatory model. If the Commission is not empowered to do this in the current legislative framework, change must be made. Air New Zealand continues to advocate for the application of negotiate/arbitrate legislation. We believe that negotiation of a contract for service with an airport would bring significant benefits for consumers, both in price and quality of service.

We are happy to discuss any points in our submission with the Commission, both during this process and into the future.

Regards,

Rob McDonald
Chief Financial Officer
**Air New Zealand**

**Scope of the review**

1. The Process and Issues Paper proposes the scope of the Commission's review of Airport pricing under section 53B(2)(b) of the Commerce Act 1986 ("**Act**"), following the transitional review previously completed under section 56G provisions. It is important that this scope is set correctly, as it will serve as the scope for future section 53B reviews the Commission will undertake in future.

2. Air New Zealand is concerned about the Commission's exclusion of quality, innovation and efficiency from the scope of the 53B review, as is proposed in para. 19 of the Process and Issues Paper. The Commission notes that the price setting event disclosures do not include quality, innovation or efficiency, and that these are best considered as part of ex-post analysis of annual information disclosures.

3. Air New Zealand considers that this exclusion is improper, in three ways.

4. First, the exclusion of quality, innovation and efficiency from the section 53B(2) review has the effect of excluding many of the limbs of the purpose of Part 4 as set out at section 52A(1). The purpose of Part 4 should underpin all monitoring actions of the Commission when conducting its review function.

5. Second, it is the responsibility of the Commission under section 53B(2) to *monitor and analyse **all** information disclosed under information disclosure requirements*.[1] This should properly include annual information disclosures in addition to price setting event disclosures, not a subset of these.

6. Finally, the Commission refers to ex-post review of information disclosures as the proper place for analysis of quality, but to date has not published review or analysis of information disclosure data for airports subject to information disclosure. It is not clear that there is, or will be, such ex-post review, and whether substantial customers of airports could submit to such a review, in the same manner as we may during the Commission's review of price setting events. The review of the price setting event is an appropriate time to conduct review of information disclosures, in conjunction with review of proposed prices.

7. Air New Zealand considers that the inclusion of quality, innovation and efficiency in the Commission's section 53B(2) review is critical. Each of these components is intrinsically linked to the price paid. Air New Zealand notes that there are no other regulated utilities for whom price and quality is not linked within their form of regulation. This is for good reason; in general, the price you should pay is directly correlated to:

[1] Emphasis added

- the quality of service or goods you receive
- the innovation the firm can deliver to reduce that price or improve that experience
- the operational efficiency that can be delivered.

8. Examples of efficiencies at airports generally arise from economies of scale and/or scope. Under a dual till, economies of scope that would arise from a competitive market are excluded.

9. To exclude quality, innovation and efficiency from the section 53B(2) review is to disconnect these things from the price paid, which is in conflict with and a disservice to Part 4 of the Act.

10. This exclusion would have the effect of a permanent exclusion from section 53(B) reviews. We appreciate that the Commission may want to limit the scope of the review to set an achievable work plan, but argue that weakens an already light handed regulatory regime, permanently.

**Response to Auckland questions**

***Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Auckland Airport?***

11. In December 2016 the Commission published Determinations amending both the Input Methodologies and Information Disclosure provisions applicable to airports subject to information disclosure requirements under the Act. These amendments were intended to address deficiencies in the regime highlighted during the section 56G reviews.

12. The major amendment relating to the transparency of target profitability was to require the airports, as part of a price setting event disclosure, to disclose a forward-looking profitability indicator in the form of an internal rate of return calculation. This amendment also provided for a carry-forward mechanism enabling adjustments to be made to open and closing investment values where this is consistent with an airport's pricing approach.

13. Auckland International Airport Limited ("**AIAL**") has identified two carry-forward adjustments, relating to:

    - treatment of under-recovery of costs associated with the Pier B connector during previous pricing periods; and
    - adjustment of asset values to align with AA's moratorium on asset revaluations adopted in 2007.

14. A further key amendment to the disclosure requirements was the determination that airports must disclose targeted profitability in respect of both the total identified airport activities asset base, and the specific assets associated with the pricing event.

15. Disclosure of this information in a granular form, and the accompanying commentary now required from the airports, has increased the transparency of AIAL's target profitability for interested persons not party to the consultation process.

16. It is abundantly clear that AIAL's target 6.99% return on pricing assets, coupled with the Commission's calculation of a target return of 7.93% on non-pricing assets within the RAB, is aimed at achieving a return well in excess of what is reasonable in a workably competitive market.

***Is Auckland Airport's targeted return appropriate and why?***

***Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Auckland Airport's price setting event?***

17. AIAL is targeting a return in excess of what is appropriate. AIAL claims that an appropriate target return is in a range from 6.85%-7.55% and its target of 6.99% for pricing activities is materially below the mid-point estimate generated by NERA.

18. As noted in AIAL's disclosure there are two key departures from the Commission's WACC IM:
    - use of a "total-business" asset beta, rather than adjusting this downwards to reflect the difference in systematic risk between aeronautical and non-aeronautical activities; and
    - use of a TAMRP of 7.25%.

19. Air New Zealand notes that these approaches were advocated by airports during the IM Review process but were dismissed by the Commission. This highlights the inherent conflict between the Commerce Act information disclosure regime and airports' ability under the Airports Authorities Act 1966 ("**AAA**") to set their own return and price accordingly. No other business can do this.

20. As the Commission notes, airports can earn significant revenue from unregulated complementary activities, and this should be recognised when determining an appropriate return from aeronautical activities. Considering aeronautical returns in isolation from overall airport returns is an artificial construct and does not reflect the practice of markets which will be assessing airport performance on the basis of total returns, and making investment decisions accordingly.

21. The ability of airports to operate a dual till, setting commercial profits aside when setting aeronautical prices, is noted internationally as a model which delivers poor outcomes for consumers. The International Air Transport Association (**IATA**) note in their policy document:

22. *Under a single till approach, airport charges are … likely to lead towards more economically efficient outcomes than a dual till, because it enables the sharing of profits generated by complementary commercial activities. As dual till leads to higher charges, it is not in the interests of users and passengers.*[2]

23. In assessing WACC under a dual till model, AIAL is necessarily blind to commercial returns in the second till. However, the market is not blind to this. Rather, the market will observe the sustained and significant shareholder returns achieved by AIAL over the past fifteen years.

***Do the asset values used by Auckland Airport provide an appropriate basis for assessing expected returns and why?***

24. Air New Zealand remains of the view that the approach it advocated during the High Court Merits Review of the Input Methodologies would result in a truer assessment of expected returns in line with airports' actual (money spent) investment in its infrastructure and facilities.

***Did Auckland Airport make effective use of risk allocation adjustments?***

***In particular, were any risk allocation adjustments proposed by stakeholders during Auckland Airport's consultation but not implemented and what was the rationale for the proposed adjustments?***

25. In our response to the Draft Pricing Proposal in February 2017, Air New Zealand proposed exploring a mechanism for risk sharing in respect of passenger forecasts. This was proposed in response to AIAL's stated concerns that the DKMA forecast contained significant down-side risk to the airport. The intention of the proposed risk sharing mechanism was to limit AIAL's exposure to this down-side risk as well as allow airlines to benefit from any up-side were that to eventuate.

26. Air New Zealand is aware that BARNZ also proposed a risk-sharing mechanism in respect of capital expenditure.

27. AIAL declined to adopt either of these suggested approaches. In another regulatory model, such as negotiate/arbitrate, such risk sharing would be a natural inclusion in a regulated contract.

[2] https://www.iata.org/policy/Documents/single-till.pdf

28. Little incentive exists for airports to share risk. In participating in a risk sharing mechanism, airports effectively agree to lower their asset beta, and therefore their rate of return. To the extent that any risk sharing was entered into, that risk would be reallocated every year. Under the current settings, it is unlikely that airports will adopt any mechanism to share risk as available in the Input Methodologies.

***To what extent does the demand forecast, presented by Auckland Airport as part of PSE3, reasonably reflect expectations of future demand and why?***

29. AIAL commissioned DKMA to develop traffic forecasts for both facility planning (i.e. busy day assessments) and overall throughput purposes. Air New Zealand had the opportunity to review the DKMA forecast throughout the consultation process and provided its own forecasts to AIAL.

30. While Air New Zealand considered the DKMA methodology to be sound, we did note that our own forecasts were slightly higher than those developed by DKMA, with the DKMA forecast having growth tapering off (back towards longer-term averages) faster than we considered appropriate. It was noted that we did not have access to other airline's forecasts so were unable to determine whether that difference was appropriate or not.

31. As noted above, our preferred approach to dealing with uncertainty around forecasts – which AIAL claimed presented it with material risk (both upside and downside) – was to introduce a risk-sharing mechanism, which AIAL did not support.

***Are there any concerns that Auckland Airport's capital or operating expenditure projections are not reasonable?***

32. The capital programme proposed by AIAL is generally welcomed by Air New Zealand. We have been in consultation with AIAL since prior to the commencement of the previous pricing period (circa 2011) on a new terminal building, and we are pleased to see projects proposed finally promise progress on building works.

33. The question of whether the capex is reasonable is difficult to answer. Despite the terminal rebuild having been long planned for, the projects in the price setting event remain at a very high level, and are lacking in sufficient detail for customers to be able to assess whether the projects are costed accurately, or can be delivered in the timeframes indicated.

34. To maximise returns under the current regulatory settings, the airport is incentivised to price above its true expected capex, and then either deliver that capex more cheaply, or more slowly, or both. Capex planned for but not spent would represent

an over-recovery in any other regulatory regime. AIAL is certainly engaged in this monopoly behaviour. In recent advice to its investors, Forsyth Barr report:

> *Capex assumptions used for AIA's recent aeronautical repricing were at the ceiling of its needs for the next 5–10 years. The company suggested that there was some flexibility to the programme, albeit any change would be lower rather than higher capex.*[3]

35. The current regulatory regime allows AIAL to use the regulatory settings to achieve excessive returns for shareholders, rather than driving them to act as a good steward of monopoly infrastructure. Their behaviour suggests that they see little regulatory threat to such behaviour.

36. Operational costs per passenger have remained flat over the past five years, and are forecast to marginally increase, despite a forecast increase in total passenger numbers. It is difficult from information disclosed to tell precisely why this is. In any other business, particularly one with high fixed costs such as an airport, marginal costs would decrease with increased scale. Operational efficiencies are being captured rather than shared with consumers.

***Questions relating to the runway land charge***

37. Air NZ accepts that a second runway at AIAL will become necessary at some stage. However, Air NZ has concerns regarding the proposed runway land charge ("**RLC**") in relation to both the ability of AIAL to implement the RLC and the reasonableness of the charge itself.

**AIAL does not have the ability to set a RLC**

38. The implementation of the RLC is not within AIAL's power under section 4A(1) of the AAA. Section 4A(1) of the AAA empowers an airport company to set charges "*for the use of the airport operated or managed by it, or the services and facilities associated therewith*." Section 4A(2) provides that any charges may be charged to "*persons owning or operating aircraft, or to persons or to classes of persons using or otherwise enjoying the benefit of the airport, services, or facilities, or to any other persons*". This subsection thus provides for the concept of "*enjoying a benefit*" in addition to use.

39. The plain meaning of section 4A of the AAA requires present "use" of the matter giving rise to the charge. This can be "the airport" or "services or facilities", and charges are permitted where there is use or where those charged currently "enjoy the benefit" of the airport, services or facilities. The RLC does not relate to the use of the airport, or any associated services and facilities. A new runway will not provide

[3] Forsyth Barr: NZ Equity Research 20 November 2017: Published following AIAL Investor Day, November 2017.

utility or benefit until 2028 at the very earliest. Hence, the charge is not permitted by section 4A.

40. Air NZ acknowledges that the legality (or otherwise) of the RLC is not part of the scope of the current review, and we have not set out our position in detail in this submission. However, the fact that AIAL is willing to implement a charge that does not relate to the use or enjoyment of a benefit of the airport, services or facilities, and for which airlines and their passengers will receive any utility or benefit until at least 2028, shows that information disclosure is not limiting AIAL's ability to extract excessive profits.

**The RLC is unreasonable, arbitrary and inconsistent with a competitive market**

41. The RLC proports to allow AIAL to achieve funding of its second runway through an arbitrary mechanism that could not be achieved in a competitive market, and unreasonably moves the cost and risk of funding onto airlines (and their passengers).

42. AIAL consistently claims that that the RLC is in the best interests of airlines and their passengers. This is despite unanimous opposition from airlines and airline groups that it was not in their best interests, and little consideration of alternative financing options put forward by third parties. In particular, AIAL summarily dismisses the option of mitigating the anticipated price shock of the RLC by way of smoothing prices from the time the second runway is commission, which is the broad outcome that would be seen in a competitive market.

43. AIAL claims that the RLC is NPV neutral. This may be true for AIAL, but is still pre-funding of a regulated asset, it is not cash neutral, and it is not NPV neutral for the customers of the airport. The analysis of NPV by AIAL is AIAL-centric, and fails to take user-interests into account. In its Response, Air NZ cited a paper by First Economics[4] (in the context of London airports) which identifies two potential detriments for airlines and their customers from pre-funding arrangements such as the RLC:

44. *Today's users may not use or be very infrequent users of the airport in the future.* Provided triggers are met, from July 2020 at the latest AIAL will be charging airlines and their customers for the second runway. Some of these customers may not still be operating (or may be operating at a different level) in 2028 or whenever the runway is commissioned. Comparing the airlines operating to Auckland with those operating eight years ago gives a stark example of how different the airline profile will be between the imposition of the RLC and the contemplated completion of the airport the last eight years. This will enable some airlines to obtain the use and benefit of the

[4] *An Assessment of the use of Pre-Funding for Airport Capacity Expansion Schemes*. First Economics, January 2015.

second runway, and the lower land value, without fully paying for the benefit, to the detriment of those airlines currently operating at AIAL.

45. *Other users may place a high value on money they spend today and attach a low value to benefits or savings that might accrue to them in the future.* It is generally accepted that airline discount rates are higher than airport rates. Consequently, it is self-evident that airlines and their customers will be worse off, in NPV terms, if forced to pay now for use of a not-in-service asset. The pre-funding of the RLC therefore results in a less efficient outcome than if it was funded in a manner which is consistent with a competitive market

46. AIAL provides no mechanism to account for delays or abandonment of the second runway. Nor is there any guarantee that the second runway will be completed as contemplated in 2028, or a review or rebate mechanism to ensure that charges can be recovered in the event of delay or abandonment, despite the high possibility that external factors cause demand for the second runway to drop (e.g. fuel price increases, disruptive technologies). AIAL could, if it wishes, charge and collect the RLC for some years, but later put the development on hold, or even cancel the development. Once in effect, the RLC provides no incentive against delay or cancellation by transferring the risk of cancellation and delay to airport users and their customers.

47. AIAL does not need the RLC to obtain a return under the current information disclosure regime. Instead, it states that the aim of the RLC is necessary to prevent a 'price shock' for airlines, which would occur if AIAL only commenced charging for the runway once it was in use. The RLC will not achieve this aim. Extrapolating out the forecast assets held for future use value (Table (o) of AIAL's disclosure) to 2028 indicates that the reduced value resulting from the RLC amounts to only ~$0.75 per passenger at that time. Airlines were also clear during the consultation process that they could handle any "price shock" without an RLC. AIAL summarily dismissed mechanisms airlines and other interested parties provided to AIAL as an alternative to pre-funding, and which would have achieved AIAL's stated aim of lessening the passenger impact of the RLC.

48. Air NZ notes that while development charges have been introduced for both Heathrow and Hong Kong airports to bring forward revenues associated with significant infrastructure developments prior to those assets being in use, these examples are not comparable with AIAL's introduction of the RLC. The Heathrow Economic permit was set by the regulatory authority, rather than the airport itself, after two rounds of public consultation, was subject to strict review and restrictions to ensure no over recovery, and related only to actual (rather than theoretical) costs incurred. There are no substantially similar mechanisms imposed on the RLC. Hong Kong Airport, the beneficiary of the Airport Construction Fee, is a government owned entity, not a publicly listed company with access to the funding options available to

AIAL. AIAL's recent bond issue is an example of its ability to raise capital on its own terms.

49. While information disclosure provides greater transparency regarding AIAL's proposed approach to the RLC, it provides no protection against AIAL earning excessive profit through the unnecessary pre-funding of capital expenditure, and transfers significant cost and risk to airlines and their customers. This is exacerbated by the fact that AIAL has undertaken limited consultation on the timing of the second runway, and options for investment that might delay the need for the second runway.

50. The practical statutory accounting outcome for AIAL's income from the runway is that it is taxable, it is not held in trust, and that it allows for increased returns to shareholders. The benefits for AIAL arising from pre-funding a regulated asset should not be ignored by the Commission.

**Response to the Commission's questions**

***Are there concerns relating to Auckland Airport's introduction of a contingent 'runway land charge'?***

51. Yes, Air NZ has significant concerns relating AIAL's introduction of the RLC. The RLC is an arbitrary charge that is not NPV-neutral for airlines or their customers, provides no incentives on AIAL to implement the second runway on schedule, and does not meet the purpose of smoothing any price spike when the runway is commissioned into use. Air NZ's view, shared by other airlines, is that the RLC is the least best option for smoothing passenger charges following the introduction of the second runway, and is not consistent with a competitive market outcome.

***In particular, is the proposed timing of Auckland Airport's returns on its assets held for future use appropriate?***

52. No, Air NZ does not consider that the proposed timing of AIAL's returns on the second runway is appropriate. AIAL proposes to pre-fund the second runway by charging airlines and their customers an arbitrary charge for an asset that it will not have the use or benefit of until 2028 at the earliest.

***Has information disclosure assisted in promoting stakeholder understanding of Auckland Airport's proposed approach to the 'runway land charge'?***

53. Information disclosure has assisted Air NZ in understanding the proposed approach the RLC. However, this only serves to confirm Air NZ's views above on the unreasonableness of the charge. We note that airlines views were largely ignored by

AIAL in its final decision to implement the RLC, with the changes made to the RLC following consultation insufficient to address Air NZ's concerns.

***Does Auckland Airport's pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?***

54. The pricing structure for the second runway is proposed to be levied as a flat charge. Congestion charging, or peak pricing, was discussed during consultation, but Air New Zealand's feedback was, and remains, that congestion charging is not a price mechanism that airlines are able to respond to, and therefore would not be able to be implemented in such a way as would change usage patterns. Airline schedules are influenced by a number of elements, overriding any ability airlines might have to respond to congestion charging.

55. Domestically, Air NZ's network is driven by the demands of the business day. As much as we might want to smooth peaks of runway use, we are not able to sell something our customers do not want to buy. In the same way as electricity networks must negotiate peaks in network planning, so must airports.

56. Internationally, our network is influenced by availability of arrival and departure slots at congested international ports. We are wholly unable to influence slot times at these ports, which has a direct impact on our schedule in New Zealand.

57. Air New Zealand believes that congestion concerns are better resolved through the introduction of, and adherence to, policy options such as slot management. The most likely influencer of timing for the second runway is frequency of landings, and type of aircraft. In general, airlines add capacity through a combination of up-gauge and frequency.

58. The runway charge, levied as a flat per passenger charge after the introductory triggers are met, is not the only way to price for the second runway. Air New Zealand remains interested in working with AIAL on an appropriate pricing model for the second runway, which relies on a business case of *use* of the asset.

***Is AIAL's forecast investment sufficient to meet expected demand and desired service quality over PSE3?***

***How appropriate is Auckland Airport's approach to cost allocation when determining its capital expenditure projections?***

***Are there concerns that Auckland Airport will not be able to achieve its capital expenditure forecasts over PSE3?***

59. Air New Zealand supports AIAL's capital expenditure programme for PSE3 and considers it vital that these works proceed, in order to address the significant infrastructure deficit which has developed in recent years as a result of a lack of investment by AIAL. This lack of investment has resulted in significantly degraded service quality, particularly in respect of domestic terminal facilities and airport access. Any failure or delay in delivering the forecast investment programme will mean further significant degradation in service quality during PSE4.

60. The degraded state of AIAL's terminal infrastructure causes operational challenges for substantial customers, as well as significant challenge, and unavoidable cost, to consumers as they attempt to navigate the airport land holding. The contrast between new commercial buildings and degraded and inadequate terminal buildings is stark. The impact this has on arriving and transiting visitors and tourists is significant. Tourism is New Zealand's highest income earner: we should be striving to unlock the value in this income stream for New Zealand and New Zealanders; a high quality, or at least an efficient airport is a necessity if we are to deliver this value to the New Zealand economy.

61. As highlighted in AIAL's disclosure, a significant portion of the forecast investment relates to large projects which will not be delivered until the end of PSE3 or during PSE4. As such, and as a result of the ongoing construction work, combined with the need for significant enabling works to facilitate construction of the new facilities, maintenance of appropriate service quality will be a challenge during PSE3.

62. Significant further consultation will be required (and is underway) regarding the concept and detailed design of much of the planned capital expenditure. A key part of this consultation will be ensuring an appropriate level of service is in place for the design life of the facilities. This will include the need for detailed costings enabling appropriate trade-offs to be made between level of service and cost.

63. In terms of allocations, the current plans may be appropriate, though because the plans remain very high level it is difficult to make a proper assessment. The final allocations will depend on what is actually built and the functions carried out within those facilities.

64. Air New Zealand has very real concerns regarding the deliverability of AIAL's capital expenditure programme during PSE3. These concerns result from the significant step-up required within AIAL itself over historical performance, the complexities associated with building in an operating airport environment and the significant interdependencies between projects required to stage the construction, and the current market for construction services in New Zealand.

**Christchurch International Airport Questions**

***Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Christchurch Airport?***

65. The Commission, in December 2016, published Determinations amending both the Input Methodologies and Information Disclosure provisions applicable to airports subject to information disclosure requirements under the Commerce Act. These amendments were intended to address deficiencies in the regime highlighted during the section 56G reviews.

66. The major amendment relating to the transparency of target profitability was to require the airports, as part of a price setting event disclosure, to disclose a forward-looking profitability indicator in the form of an internal rate of return calculation. This amendment also provided for a carry-forward mechanism enabling adjustments to be made to open and closing investment values where this is consistent with an airport's pricing approach.

67. CIAL identified a carry-forward adjustment to the RAB relating to the impact of its implied depreciation approach implemented during PSE2 on asset values.

68. A further key amendment to the disclosure requirements was the determination that airports must disclose targeted profitability in respect of both the total identified airport activities asset base, and the specific assets associated with the pricing event. While CIAL's disclosure does comply with this approach, as noted below in regard to asset values, CIAL has changed its approach to allocation of its land asset to include within the pricing asset class, areas that were previously excluded from the pricing asset. CIAL claims that its changed approach is consistent with the IM/ID regime, notwithstanding that assets for which it is not otherwise receiving revenue are not required for pricing activities.

***Is Christchurch Airport's targeted return appropriate and why?***

***Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Christchurch Airport's price setting event?***

69. CIAL is targeting a return in excess of what is appropriate.

70. CIAL's approach to calculating WACC differs from the WACC IM in respect of two parameters:
    a. a 0.05 uplift to the asset beta to reflect the supposedly increased systematic risk arising from a higher proportion of leisure travellers than other New Zealand airports; and
    b. use of a BBB+ credit rating to determine the debt risk premium.

71. CIAL's uplift to WACC has been rejected previously by the Commission.

72. In respect of the debt premium, CIAL is proposing to use a credit rating of BBB+ to derive the debt premium rather than the A- rating used by the Commission. CIAL justifies this approach on the basis that:

    a. BBB+ is consistent with CIAL's standalone credit profile (i.e. removing the effect of government ownership)
    b. CIAL faces greater risk than its peers due to size, traffic mix, and a concentration of international destinations in Australia.

73. Air New Zealand does not agree that CIAL should look to adopt a credit rating which does not reflect its ownership structure. CIAL is arguing in respect of the asset beta that its specific circumstances warrant adoption of parameters which differ from those defined in the IMs. In this case those specific circumstances create a situation where consumers will benefit from lower costs than would otherwise be the case. CIAL noted the potential for its overall credit rating to be raised to A-. Air New Zealand considers that this is the level which should be adopted.

74. Air New Zealand questions the relevance of CIAL's size, traffic mix and market concentration to the debt premium. As CIAL itself noted, its current credit rating metrics support a BBB+ rating, with the potential for that to be raised to A-. There does not, therefore, appear to be any empirical evidence to support CIAL's position.

***Do the asset values used by Christchurch Airport provide an appropriate basis for assessing expected returns and why?***

75. CIAL has adopted asset values for pricing purposes which are consistent with the Input Methodologies and the implied depreciation approach adopted during PSE2.

76. Air New Zealand is concerned however that CIAL has exploited the changes to the IM's which sought to better align disclosure asset base with the pricing asset base to include assets which are not required for provision of pricing activities within the pricing asset base. This has resulted in a change to the allocation approach adopted during PSE2 to increase the airfield asset base, include the "Antarctic apron" and include new freighter stands which should be allocated to the aircraft and freight activity – which is not part of the pricing asset.

77. As a result, land which is included in the disclosure RAB, which does not generate revenue from other means, is automatically included in the pricing RAB, regardless of whether it is required for pricing activities or not. Air New Zealand considers this is inappropriate and masks the return CIAL is targeting on required pricing assets.

78. Air New Zealand also disagrees with CIAL's allocation of the first floor landside terminal assets to the pricing asset base. Allocation of 100% of this area to aeronautical ignores the actual use of the area by passengers for retail of goods and food, and is a significant departure from the approach adopted during PSE2.

79. As a matter of principle, Air New Zealand remains of the view that the approach it advocated during the High Court Merits Review of the Input Methodologies would result in a truer assessment of expected returns in line with an airport's actual investment in its infrastructure and facilities.

***Did Christchurch Airport make effective use of risk allocation adjustments?***

***In particular, were any risk allocation adjustments proposed by stakeholders during Christchurch Airport's consultation but not implemented and what was the rationale for the proposed adjustments?***

80. CIAL included carry forward adjustments to the opening and closing RAB values to reflect the impact on values of its implied depreciation approach during PSE2.

81. Air New Zealand proposed a risk-sharing mechanism to address concerns regarding the accuracy of passenger forecasts. CIAL rejected this approach.

82. Air New Zealand also proposed adopting an approach whereby prices could be adjusted during PSE3 if capital expenditure not agreed during consultation was subsequently agreed and carried out. CIAL rejected this approach but included the unagreed capital expenditure in its pricing forecasts.

83. As noted above with respect to AIAL, Air New Zealand considers that airports are unlikely to take up risk sharing mechanisms under the current regulatory regime. Such mechanisms would be a natural consequence of negotiate/arbitrate regulation.

***To what extent does the demand forecast, presented by Christchurch Airport as part of PSE3, reasonably reflect expectations of future demand and why?***

84. Air New Zealand considered CIAL's initial domestic demand forecasts were unduly conservative, particularly in the latter years of PSE3, given CIAL's consultant highlighting the link between passenger growth and GDP. These forecasts were revisited and amended in the revised proposal to more closely align with GDP forecasts.

85. In our response to the initial proposal Air New Zealand noted that growth will invariably differ from forecasts and proposed further discussion on a risk-sharing mechanism to mitigate this. CIAL indicated its preference was to establish headline prices and then deal with airlines individually to develop bespoke arrangements. This

strategy demonstrates CIAL using the regulatory pricing regime to disguise a 'divide and conquer' strategy, in play to benefit the airport.

***Are there any concerns that Christchurch Airport's capital or operating expenditure projections are not reasonable?***

86. BARNZ has highlighted a number of areas of concern in relation to CIAL's operating expenditure. Air New Zealand shares these concerns.

87. In response to feedback questioning the cost-benefit of CIAL's proposed runway extension, the airport removed that expenditure from pricing and indicated an intention to consult further with airlines over the course of PSE3.

88. CIAL has included ~$10 million in relation to unspecified "terminal reconfiguration". Air New Zealand is concerned at the lack of specificity attached to this expenditure. Air New Zealand suggested that CIAL engage in more detailed consultation in relation to this expenditure, including with government agencies, and was willing to consider a mechanism which would adjust prices during PSE3 if this expenditure was incurred. Notwithstanding this, CIAL set prices for PSE3 which included this expenditure.

89. Pricing in capital expenditure, then failing to deliver this, or delivering it more cheaply, is how airports are incentivised to make additional returns for shareholders at the expense of consumers under the current regulatory regime. Inclusion of high value projects which lack clear detail at the outset of the pricing period is an example of CIAL responding to regulatory settings.

***Does the pricing structure at Christchurch Airport for PSE3 reflect efficient pricing principles?***

***What impact do you expect Christchurch Airport's proposed pricing structure and associated incentives to have on demand and revenues?***

90. Air New Zealand has major concerns with the pricing structure adopted by CIAL for PSE3 and considers it represents a fundamental departure from efficient pricing principles.

91. CIAL justifies its new approach on the basis that it better reflects the forward-looking costs of its facilities. Such an approach ignores the significant sunk costs in infrastructure and results in some user groups paying for infrastructure they neither require nor use. represents resulting in different user groups.

**Airfield Charges**

92. Charges for airfield use have traditionally been based on weight due to the close relationship between the size of the aircraft and the resulting infrastructure requirement.

93. Airfield dimensions – the base strength of runways, taxiways and apron areas - as well as the dimensions - runway length and width, taxiway width, and pavement/overlay thickness – are affected by the size and weight of the aircraft assumed to be using those facilities as well as whether those aircraft are operating internationally. As such, the investment required for larger, heavier aircraft significantly exceeds that required for smaller aircraft. For example, CIAL, in its FY16 Annual Disclosure, notes that it spent $15.3 million during FY2016 on upgrading runway shoulders to enhance airfield productivity and future proof it for the next 20 years. This investment is not required for use by turbo-prop aircraft.

94. On this basis ICAO policies[5] recommend the use of weight-based methodologies for landing charges as these "reflect how wear and use of airport-provided facilities tend to increase as the weight of aircraft increases"

95. ICAO policies also require that:

*"The proportion of costs allocable to various categories of users, including State aircraft, should be determined on an equitable basis, so that no users shall be burdened with costs nor properly allocable to them according to sound accounting principles."*[6]

96. It should also be noted that being available for international operations results in additional complexity and cost for the airport operator due to the requirement to comply strictly with international standards.

97. CIAL accepted this rationale when it last set prices in 2012, noting that in setting airfield charges at that time, it "sought to ensure that the resulting allocation of total costs between various classes of users is both efficient and commercially reasonable"7

98. Advice to CIAL from BECA indicated that the standalone cost of an airfield configured solely for turboprop aircraft would have a cost of 33 per cent of the then current configuration, due to shorter and narrower runways with less pavement thickness as well as less taxiways and parking areas. That same BECA advice also indicated that the annual maintenance costs associated with a turboprop only operation would be in the order of $4 million less per annum.

[5] ICAO Doc9562 Airport Economics Manual, para 4.144
[6] ICAO Doc9082 ICAO's Policies on Charges for Airports and Air Navigation Services, p. II-1
[7] CIAL Response to Queries from Airlines following the briefing 23 August 2012, p.11

99. Given established international practice and previous approaches accepted by CIAL, movement to a standard per passenger charge for airfield services, for which there is no direct casual or cost driver, is not appropriate. Moreover, CIAL's approach results in a cost per landed tonne in FY2018 for turbo-prop aircraft in the order of $20 per tonne versus a cost per landed tonne for wide-body aircraft in the order of $9. This is grossly inappropriate given the operational requirements of the smaller aircraft.

100. Non-passenger aircraft are levied charges on a weight basis at $8.22 per tonne per movement. Air New Zealand considers that the same methodology should be applied to passenger aircraft. Contrary to CIAL's assertion that MCTOW cost-reflective pricing adds significant complexity to its price structure, Air New Zealand considers that it is a well-understood and accepted feature of airport pricing globally, including in respect of CIAL's previous structure.

101. Air New Zealand also disagrees with CIAL's position that a per passenger pricing approach aligns CIAL's interests with those of its airline customers, and leaves airlines free to innovate in choosing and changing their fleets.

102. CIAL's approach fails to recognise that airline interests vary across the different market segments and that by moving to this per passenger structure, it is favouring larger wide-body operators at the expense of smaller operators. Turbo-prop aircraft are used to service markets which cannot be served (either physically or sustainably) by larger aircraft. Airline fleet choices are made based on the best aircraft type to serve the markets it operates in. Different aircraft configurations can allow airlines to achieve economic efficiencies in the market and CIAL's approach simply undermines this competitive dynamic.

**Terminal Charges**

103. Notwithstanding CIAL's last-minute adjustment to a transitional path for international and regional passengers' terminal charges, the pricing structure reverts over time to a situation where international and domestic (non-regional) passengers are charged at the same level.

104. Air New Zealand disagrees with CIAL's approach on the basis that there are currently, and for the foreseeable future, significant barriers to operating a completely "swing" operation across the entirety of CIAL's airside terminal asset. Different aviation security requirements, along with the application of immigration, customs and quarantine standards to international passengers result in the continuing need to maintain different areas for domestic and international passengers. The nature of international operations, including the security aspects, also impact on terminal facility requirements to accommodate increased dwell time

for passengers, as well as areas for emigration, immigration and quarantine processing and queueing space associated with these.

105. CIAL's own disclosures highlight the areas which are associated solely with the international terminal, as well as the relative productivity of the international and terminal assets. What this highlights is the significantly higher productivity of the domestic terminal facility versus the international terminal. CIAL's new pricing structure undermines the productivity of the domestic terminal and results in domestic passengers not receiving any benefit from the efficiency gains (via lower prices) achieved.

106. CIAL, during consultation, purported to demonstrate the "fairness" of its approach by calculating a stand-alone cost for international passengers of $7.72 versus the proposed terminal price of $6.74 per passenger. This is not a valid comparison as the proposed $6.74 includes all the other shared components of the terminal cost whereas the $7.72 relates to the dedicated international area only.

107. Including these additional elements results in a price per international passenger of $10.61. This compares with a cost per domestic passenger, for the dedicated and shared services they use, of $4.90 (note this includes all Wellington passengers). This $5.71 differential represents the domestic efficiency benefit which should be passed onto domestic consumers.

108. CIAL's pricing structure is nothing less than an effort to attract international operators through loading costs associated with serving international operations onto domestic passengers. If Christchurch Airport is concerned about the level of charges impacting international operations, it should bear any shortfall in international revenue itself.

109. CIAL's false belief that it can influence international jet movements via its pricing structure penalises New Zealand consumers. Landing charges are a small proportion of international ticket prices, but represent a large portion of regional fares. CIAL's price structure adds an unwarranted distortion to the regional economy.

**Non-jet CHC -WLG passengers**

110. CIAL's new pricing structure also differentiates terminal prices between passengers travelling to/from Auckland, Wellington and any international point, and all other points. This creates a price differential between passengers using the integrated terminal and those using the "regional lounge" – with the exception of passengers travelling to/from Wellington but not using the integrated terminal.

111. CIAL justifies this distinction on the grounds of the Regional Lounge arrangements agreed between the Airport and Air New Zealand.

112. Air New Zealand disagrees with CIAL's characterisation of the arrangements and considers it is deliberately targeting Air New Zealand's strategy to serve the Christchurch-Wellington market in a sustainable and responsive manner through increasing the number of turbo-prop services which are better suited to the operating conditions and allow us to provide greater frequency.

113. CIAL has stated that it is its intention that pricing is fair and transparent, and that passengers pay for services they use. CIAL's price structure does not meet this standard. Passengers travelling to/from Wellington but using the Regional Lounge will attract significant charges for areas of the terminal and services they are not using. This restricts the opportunity for airlines to take innovative approaches to serving a market through the use of different aircraft, better suited to that market. This is not in the long term interests of consumers.