SECTION 56G DRAFT REPORT ON CHRISTCHURCH AIRPORT

SUBMISSION BY CHRISTCHURCH INTERNATIONAL AIRPORT LIMITED

12 November 2013

PUBLIC VERSION

TABLE OF CONTENTS

EXECUTIVE SUMMARY

1 Christchurch International Airport Limited (*CIAL*) appreciates the opportunity to respond to the Commerce Commission's (*Commission*) Draft Report on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch Airport (*Draft Report*).

2 We were surprised at the draft conclusion that the new information disclosure regime has had a "minimal influence" on CIAL. We were also taken aback at how the Commission has interpreted our pricing decision and information disclosure report, and the assumptions about how we will behave in the future. In this submission we explain how we will respond to the Commission's concerns.

3 There is common ground on the starting point for our pricing decision. CIAL opted to use a long-run pricing model to inform its PSE2 prices. This was a change from what we had done in the past, and different to the approach taken by Auckland International Airport Limited (*AIAL*) and Wellington International Airport Limited (*WIAL*). The reason for doing so is that a long-run levelised price path is the most efficient way to price our new Integrated Terminal facility.

4 We took the view that this was the approach that best advanced the efficiency objectives of the new regulatory regime, and the long-term interests of the travelling public and our shareholders. In the Draft Report the Commission agrees with the approach taken by CIAL.

5 The Draft Report raises a concern that our price setting event disclosure report and our annual disclosure reports will only provide sufficient transparency of our performance if they present a non-standard depreciation view of our long-run price path. We are happy to produce reports which present a non-standard depreciation view, and will do so.

6 We do want to be clear about what has led to the difference in approach to depreciation in our disclosure reports. The price setting event disclosure requires CIAL to disclose the depreciation method used in its pricing decision. The depreciation method we used in our model was straight line, and it would have been incorrect and misleading to purport in our price setting event disclosure anything different. We are disappointed with the implication in the Draft Report that we went out of our way to present a non-transparent view in our disclosure reports. We disclosed on the basis of the method we used. However, as noted above, moving forward we will produce reports on the basis suggested in the Draft Report.

7 The Draft Report also identifies four areas where the implementation of the long-term approach in our model does not deliver the transparency the Commission considers appropriate. We propose to make those changes to our model. This won't change our current prices. But it will mean that the next time we use the long-term model we will have addressed the Commission's transparency concerns.

8 We also want to be clear about what has led to these differences in approach. The Commission has identified areas where we made simplifying assumptions to make our model less complicated and more tractable, without affecting the commercial objective of identifying the appropriate long-run price path. The Commission has indicated it would prefer significantly greater detail and complexity in the modelling forecasts, particularly forecasts of expenditure for each of years 11 to 20, as it believes this will enhance transparency.

9 This is a choice between two approaches to promoting an understanding of what drives the long term price path and its implications for the PSE2 pricing decision. We are happy to change to the Commission's preferred approach, but we are disappointed with the implication in the Draft Report that our desire for a simplified, tractable model was in fact intended to be non-transparent. That was not the case.

10 As noted above, the Commission prefers a non-standard depreciation approach to setting a long-run levelised price. We will make this change to the model we used for PSE3 and subsequently.

11 Standing back, we are concerned that CIAL is being penalised for trying something new (and something the Commission agrees was the right thing to do). No New Zealand airport has built and used a long-term, multi-period levelised price path model before. We understand that we made some judgments about what our airline customers would want to see in price consultation and what the Commission would want to see in a regulatory context, which the Commission disagrees with. We were clear in our price setting event disclosure about how our model differs from the standard building blocks approach and where that required differences in our disclosure. The Commission's analysis has identified a number of ways that transparency can be improved. This is a learning process and we are happy to follow the Commission's recommendations.

12 The Commission's concerns about the transparency of our model and price setting event disclosure appear to have spilled over into a more general judgment that the new information disclosure regime has been ignored by CIAL and had minimal influence on our behaviour in each of the areas considered by the Commission. In this submission we explain why that is not an accurate interpretation of the way we made our pricing decision and the way we operate as an airport, and it is not an accurate interpretation of the material we have put in front of the Commission.

13 Across our operations, the transparency delivered by the new information disclosure regulation creates positive incentives that operate on CIAL in the areas scrutinised by the Commission: innovation, quality, pricing efficiency, profitability, operating efficiency, capital expenditure and sharing efficiency gains with our customers.

14 In some of these areas CIAL is demonstrably performing to a high standard and has been for some time, an assessment endorsed by our customers. We are disappointed that in these areas the Commission has, for that reason, suggested CIAL is not influenced by the incentives created by information disclosure regulation. This suggests we are heedless of the additional transparency in these areas, which is incorrect. We have informed the Commission that in these areas where we have a track record of good performance, we nevertheless expect the new transparency to be a further discipline going forward. In other areas, we acknowledge the Commission's view that it is too early to assess the impact of information disclosure regulation, but again note the incentives created by the new transparency do and will continue to operate on the airports.

15 As CIAL explained in its submissions, the new information disclosure regulation framed every step of our pricing process. We had careful regard to the input methodologies, and adopted all but two of them, because we knew our pricing decision would be measured against the input methodologies in our information disclosure reports.

16 This drove our pricing behaviour. As we developed our pricing proposal, Board papers measured options against the input methodologies. Our model used all but two input methodologies. The consultation process with our customers was framed around the input methodologies. Where we departed from the input methodologies we provided detailed explanation and expert reports to our customers on that difference. All of this responded to the fact that future information disclosure reports would measure our pricing against the input methodologies, and none of this transparency and discipline would have happened but for the new information disclosure regime.

17 Some of these changes had a direct impact on our prices. We took a different approach to asset valuation, timing of revaluations, and common cost allocation than we would otherwise have done. These changes directly impacted our revenue requirement, and therefore prices.

18 On the question of whether our pricing is excessive, one aspect of the Commission's assessment is that we did not use the Commission's WACC input methodology. There were a number of good faith reasons for this. We disagree with the Commission's decision not to respond to the fact that risk free rates in 2012 were historically anomalously low. These rates present a distorted view of the returns required by investors (as our underlying risk has not changed). We also used a beta that reflects the above average systematic risk of CIAL, a matter upon which our customers and two independent experts agreed. While we did not agree with the Commission, the information disclosure regulation has increased the level of analysis and rigour in these areas.

19 More generally, on the important issue of WACC it is fair for all parties to reserve judgement until the results of the merits appeal are known. It is reasonable to expect this feature of information disclosure to be more influential once the appeal is settled.

20 However, despite those differences on the WACC calculation, CIAL's pricing decision targets a reasonable return. CIAL agrees with the conclusion in the Draft Report that PSE2 target returns are reasonable, and we confirm the Commission has approached this analysis in the way we expected when considering our PSE2 price path. We also note that outturn demand to date is significantly below forecast, materially lowering our PSE2 returns below forecast.

21 When assessing our target returns over a twenty year period, the key issue is the appropriate benchmark WACC to use. The Draft Report uses a WACC based on the historically anomalously low five year risk free rate in October 2012 to assess returns estimated to be targeted in 2017, 2022, and 2027. However, as a starting point, the input methodologies are clear that the term of the WACC parameters must match the term over which cash flows are being evaluated.

22 We understand that it is difficult to forecast appropriate five-year risk free rates for each of the four pricing periods over which our long-term model operates, or, as an alternative, to observe a 20 year risk-free rate in New Zealand. However this difficulty does not justify evaluating a 20 year price path against the five-year WACC that prevailed in October 2012. We suggest there are a number of better approaches that can be taken to the selection of the correct benchmark risk free rate. In this submission, we show that an approach that implements the Commission's view that the term of the risk-free rate should match the period over which the cash-flows are assessed markedly reduces the difference between our

WACC and the benchmark WACC used by the Commission. As the risk free rate returns to normal levels, we have not ruled out using the approach in the input methodology to the risk free rate in 2017.

23 A second important WACC issue is the asset beta. We are surprised the Draft Report does not address the fact that CIAL and its customers agree that an increment to the asset beta is appropriate, based on expert advice provided to both CIAL and to our customers. This should be seen as the incentives created by information disclosure operating effectively. By insisting on an alternative beta the Draft Report goes further than promoting information disclosure incentives and insists on a price outcome.

24 Looking forward, we are concerned to ensure that we have identified and addressed all of the Commission's transparency concerns with our information disclosure reports and our model. If the changes proposed in this submission will not fully address the Commission's concerns we request that the Commission notify us of any remaining transparency concerns before finalising its report. We also look forward to any comments from our customers on our proposed changes.

OUR INFORMATION DISCLOSURE REPORTS

Key points

25 One of the important conclusions in the Draft Report is that CIAL's price setting event disclosure report does not contain the information interested parties need to assess the annual impact of our long-term levelised price path on our asset base. For this reason CIAL's expected profitability performance in PSE2 and subsequent periods is not as transparent as it otherwise could have been.[1] The Commission notes that if CIAL takes the same approach to its annual disclosures then the same concerns will arise.

26 The central issue here is that the CIAL long-run levelised price model used straight line depreciation. This was for simplicity in constructing the building blocks and communicating the model. The model had two steps – the construction of our long-run costs using standard building blocks, and then a levelised price path. However, while the input methodologies allow a choice of depreciation approach, the Commission considers the non-standard depreciation approach would improve the transparency of the CIAL model and our approach.

27 The Draft Report presents this issue as if CIAL had a choice of method to use when preparing its price setting event information disclosure report, and chose the less transparent method. This misunderstands the information disclosure regulation we face.

28 When it came to preparing our price setting event information disclosure report, the regulatory requirement was to disclose the depreciation method we used in our pricing decision. This was straight line depreciation. Any other description in our price setting event information disclosure report would have been a misleading characterisation of the methodology used to make our pricing decision.

29 In other words, when it came to preparing our disclosure we did not have the choice that the Draft Report describes, and did not want to present a misleading picture of the model we had used.

30 However we do want to respond to the Commission's transparency concerns. We will provide a supplementary price setting event disclosure report for PSE2 that uses a non-standard depreciation approach. We will also provide annual disclosure reports on a non-standard depreciation basis. We cannot make that change in time for our 2013 annual disclosure report due on 30 November 2013, but we will follow that disclosure with a supplementary report for 2013 that uses a non-standard depreciation approach.

31 In Appendix A we describe how we propose to implement a non-standard depreciation approach. This will require making some assumptions and we want to be transparent about those. We are interested to receive comments from our customers and the Commission on our proposal.

The choice of depreciation approach

32 The Draft Report states that CIAL had a choice as to the depreciation approach it used in its price setting event disclosure report, between straight line depreciation

[1] CIAL Draft Report at para E53.

and a non-standard depreciation profile. The Draft Report describes the issues in the following way:[2]

> For its disclosures following the PSE2 pricing event, [CIAL] disclosed its forecast regulatory asset base (RAB) applying a standard straight-line depreciation approach, and indexing the asset base for inflation. It chose not to use an approach equivalent to the mechanism in the input methodologies that provides for an alternative 'non-standard' depreciation approach (ie, an approach other than straight-line depreciation). [CIAL] could have derived and disclosed forecast depreciated values of its RAB that are consistent with its levelised price path (ie, reflecting relatively low capacity utilisation in the short term, as well as an expectation of higher cash flows in the future). Doing so would have allowed interested persons to better assess the impact of its levelised pricing approach on expected returns. However, [CIAL] stated that it "felt that the complexities of that were greater than the approach we've taken."
>
> [CIAL] was entitled not to apply a non-standard depreciation approach, because under the information disclosure regime airports are not required to apply the input methodologies in disclosing their forward-looking pricing methodologies. Nevertheless, as a result of doing so, [CIAL's] expected profitability performance for PSE2 and subsequent pricing periods is not as transparent as it otherwise could have been.

33 This passage mixes together the decisions we made when constructing our long-run levelised price model and the decisions we made when producing our price setting event disclosure report.

34 When constructing our long-run levelised price model we had a choice to make between straight line depreciation and a non-standard depreciation profile. This is discussed in more detail in the next section of this submission (Concerns With Our Model). In brief, we elected to use straight line depreciation in the model because it is simple, and the choice did not impact on the long-run price path produced by the model (i.e. it was financially neutral). This modelling choice is what is referred to in the quote in paragraph E52.[3]

35 When it came to preparing our price setting event information disclosure report, the regulatory requirement was to disclose the depreciation method we used in our pricing decision. We disagree with the suggestion that we had a choice at this stage.

36 Clause 2.5 of the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010 establishes the price setting event disclosure requirements. In relation to forecast depreciation the requirement in clause 2.5 is to disclose "a description of *how [forecast depreciation] has been determined*, including an explanation of … the rationale for the basis of preparing these components, and any related assumptions".[4] In turn, forecast depreciation is defined as "the *forecast depreciation used by an airport* in determining the forecast total revenue requirement *incorporating the values used for the purposes of consultation* undertaken as part of a price setting event".[5]

---

2 CIAL Draft Report at paras E52 and E53; see also paras E20–E21, F28–F35.

3 CIAL Conference Transcript at pg 50.

4 (Emphasis added).

5 (Emphasis added).

37 In other words, the requirement is to disclose the approach used when making the price decision. This makes sense given the nature of the disclosure. For our price setting event, this was straight line depreciation. Any other description in our price setting event information disclosure would have been a misleading characterisation of the methodology used to make our pricing decision.

38 However we do want to respond to the Commission's transparency concerns. We will provide a supplementary price setting event disclosure report for PSE2 that uses a non-standard depreciation approach.

39 We do agree with the statement in the Draft Report that when it comes to our annual disclosures we have a choice of depreciation method. We must use the Commission's input methodology, but this allows for a choice between straight line and non-standard approaches.[6]

40 To respond to the Commission's transparency concerns we will provide annual disclosure reports on a non-standard depreciation basis. However our next annual disclosure is due on 30 November 2013. This does not allow enough time to prepare our disclosure on a new depreciation basis. We will provide an annual disclosure on 30 November 2013 on a straight line basis, and a supplementary 2013 report at a later date on a non-standard depreciation basis. All subsequent annual disclosure reports will be on a non-standard depreciation approach.

The non-standard depreciation approach

41 In Appendix A we describe how we propose to implement a non-standard depreciation approach. This will require making some assumptions and we want to be transparent about those. We are interested to receive comments from our customers and the Commission on our proposal.

[6] CIAL Draft Report at para E54.

CONCERNS WITH OUR MODEL

Key points

42 CIAL agrees with the Commission that the choice of a long-term pricing model, rather than a standard 5 year building blocks approach, was the most efficient decision in CIAL's circumstances. This is a change from our previous approach to pricing. In making the change to a long-term pricing model we were influenced by the fact that this approach better promotes the purpose of the new information disclosure regime. Moving to a long-run price path better promotes efficiency, to the benefit of our customers and shareholders.

43 The model we used included a number of simplifying assumptions which, from a commercial perspective, do not materially influence the result but were intended to make the key features of the model easier to build and understand.

44 In the Draft Report the Commission concludes these simplifications do not provide sufficient transparency for stakeholders wanting a more detailed development of our price path, and in parts the Commission disagrees with our assessment that the simplifying assumptions do not materially influence the output of the model.

45 The areas where the Draft Report indicates more detail should have been included in the model are (i) expanding the treatment of the second ten year period, (ii) expanding the treatment of inflation during that ten year period, (iii) a desire to include capital expenditure assumptions after year five, and (iv) calculation of estimated actual tax expense for each year of the model. For the first three issues, a more detailed treatment is either neutral or implies higher prices for our customers. On the fourth, tax, the Commission disagrees with our assessment that the two alternative treatments are equivalent over a twenty year period.

46 We propose to make those changes to our model. This won't change our current prices. But it will mean that the next time we use the long-term model we will have addressed the Commission's transparency concerns.

47 We do want to be clear about what has led to these differences in approach, however. We included these simplifying assumptions to make our model less complicated and more tractable without affecting the commercial objective of identifying the appropriate long run price path. This is a legitimate transparency objective. The Commission has indicated it would prefer significantly greater detail and complexity in the modelling forecasts, particularly annual forecasts of expenditure in each of years 11 to 20, as it believes this will enhance transparency. This is a choice between two approaches to promoting an understanding of what drives the long term price path and its implications for the 5 year pricing decision being made. We are happy to change to the Commission's preferred approach.

48 The Commission has also expressed a preference for a non-standard depreciation approach to calculating the long-term price path. The Commission prefers this approach because it allows our customers to better track the recovery of our investment and our asset base each year. We will make this change to our model, and our PSE3 pricing proposal will use this approach.

The long-term pricing approach

49 We agree with the Commission that in the circumstances CIAL faced when making its pricing decision, implementing a long-run levelised price path was the right thing to do. The Draft Report states:[7]

> The AAA allows [CIAL] to set prices as it sees fit, and [CIAL's] reason for wanting to establish a 'levelised constant real price' over multiple five-year price setting periods is understandable. The commissioning of the new integrated terminal will result in a significant increase in the value of [CIAL's] asset base, at a time when the expected utilisation of the terminal will be relatively low. [CIAL] has stated the approach it has taken endeavours to avoid price shocks and provide more stable cash flows for both [CIAL] and the airlines.
>
> …
>
> [CIAL's] levelised pricing approach reflects efficient pricing principles because, all other things being equal (eg consumer preferences do not change), constant real prices are consistent with allocative efficiency in workably competitive markets. Furthermore, the approach is conceptually easy to understand. However, we have some issues with how the approach has been implemented in practice, and about the extent the implementation of the approach is transparent to interested persons in disclosures (as well as during consultation on PSE2 and during the current s 56G review consultation process).

50 We explained this in our price setting event disclosure:[8]

> Schedule 18 requires CIAL to provide an overview of the methodology used to determine its "revenue requirements" for specified airport services. The revenue requirement is an estimate of the total efficient cost of service—including return on and of capital—in providing the required services during the pricing period. An airport's actual pricing proposal may exceed or fall below the revenue requirement during any one period, depending on decisions made about the timing of cost recovery over the life of the assets. In general, for long-lived assets serving a growing volume of customers, it would be efficient for pricing to recover less than the total cost of service during the early years of the economic life of the assets and more than the total cost of service during the later years of the economic life.
>
> … in the circumstances facing CIAL, where it had made a significant infrastructure investment in the new integrated terminal, the pricing methodology CIAL developed was to recover the ITP investment over the expected life of the facility in line with growth in volumes. This involved the setting of prices by reference to a calculation of long-run levelised prices that was designed to minimise demand distortions, provide a cost efficient outcome and minimise price shock distortion between price reset periods. The long term model looks at the overall cost using the building block accumulation process, over the economic life of the assets (20 years plus a terminal value), including projections for additional forecast capital expenditure (for the pricing period) and long term volume growth. As a result, the target revenue for the current pricing period differs from an assessment of maximum allowed revenue which does not take the growth in volumes into account.
>
> …
>
> The levelised constant real price minimises future price shocks and ensures that the total cost of investment is allocated fairly between current and future users. Our revenue will grow with utilisation, ensuring that per unit charges for all users are not differentiated by

[7] CIAL Draft Report at paras E45–E46; see also paras E9–E10.

[8] CIAL Price Setting Disclosure (19 December 2012) at pgs 14, 50.

> whether the use occurs during the relatively low utilisation early period in the life of the asset or the relatively high utilisation late period in the life of the asset …

51 We made this change because it better promoted the economic efficiency objectives of the new information disclosure regulation, to the benefit of our customers and shareholders.

The Commission's transparency concerns

52 The Draft Report identifies a number of features of our model that, in the Commission's view, impede the transparency of the model.

53 We propose to make changes to our model to address the Commission's transparency concerns. We explain the changes below.

54 This won't change our current prices. But it will mean that the next time we use the long-term model we will have addressed the Commission's transparency concerns.

The second ten year period

55 The Draft Report notes that our model used composite terminal values for years 11 to 20. These terminal values were calculated to represent forecast revenues and costs over the second ten year period. The model then treated this second ten year period as a single economic period.[9]

56 This simplifying assumption reflected the fact that our cost and revenue forecasts for the second ten year period were straight forward projections from the tenth year.

57 The Draft Report suggests that the simplified treatment of years 11 to 20 means the model is not a 20 year model and we have not accurately described our model (see paragraph 3.22). We want to be clear that this is incorrect. Years 11 to 20 do influence the results of the model. This is demonstrated by the fact that if the model is amended to cover only years 1 to 10, it produces a different levelised price path.

58 However, the Draft Report also flags the use of terminal values as a transparency concern, and to address that concern we have changed our model to explicitly model years 11 to 20. The updated model was provided to the Commission. This change does not in itself alter the real price path produced by the model but does present the more detailed view suggested in the Draft Report.[10]

---

[9] See CIAL Draft Report at paras E12, E49, F20, F49–F50.

[10] The CIAL Draft Report suggests that we refused to provide to the Commission the modelling of years 11 to 20. This is not a fair characterisation of our exchange. As we explained to Commission staff, our difficulty was the source model on which the simplified model was developed was originally linked to several large and more complex spreadsheets that contained a lot of information unnecessary for the commercial model. We did not think it would be helpful to dump a nest of spreadsheets on the Commission containing a large amount of irrelevant (and therefore confusing) information. The commercial model was designed to be a simple compilation that could stand alone on its own right. Instead of providing the detailed spreadsheets we took a Commission staff member through the spreadsheets explaining the full details. In addition we later provided an update of the pricing model that included the breakdown of the period 11–20 on an individual year by year basis reconciled to the pricing model.

Inflation in the second ten year period

59 The Draft Report identifies that a consequence of treating the second ten year period as a single economic period was that the model assumed prices over the second ten year period would only increase by a single period worth of inflation.[11]

60 The result was that the model produced a lower price path than if inflation had been fully incorporated into the modelling of the second ten year period (and so operates in our customers' favour).

61 We have changed the model to address this concern that inflation be modelled fully. This is related to the issue discussed above about explicitly modelling years 11 to 20.

Capital expenditure forecasts after year five

62 The Draft Report notes that our model did not include any forecast capital expenditure beyond 2017.[12] As the Commission identifies, our approach reflected the fact that capital expenditure beyond 2017 would be the subject of consultation at 2017. We considered that, on balance, it was preferable to defer discussion of that capital expenditure until 2017 rather than consult on long range forecasts now.

63 This approach was identified in our initial pricing proposal (which we provided to the Commission):[13]

> Table 8 below summarises CIAL's forecast capital expenditure for the pricing period. Expenditure for the financial years 2013-2014 are from CIAL's current business plan, and expenditure for the financial years 2015-2017 are our best estimates of future capital expenditure...
>
> …
>
> As part of our longer term asset management planning we have also forecast the likely level of investment for the five years following 30 June 2017. This reflects our assessment of likely investment needs to ensure the effective and efficient provision of airport services to meet airline customers and the travelling public's needs over the medium term.
>
> This expenditure is detailed below. It illustrates that major investment on infrastructure such as ITP is lumpy and intermittent, with significant periods in between requiring expenditure for the provision of on-going service delivery and progressive changes to meet the changing needs of the airlines. **This expenditure forecast is for information purposes only and is not included in the current pricing consultation proposal**.
>
> (Emphasis added)

64 In our revised pricing proposal we said:[14]

> In preparing its initial pricing proposal, CIAL compiled a comprehensive assessment of the forecast capital expenditure for the 2013 – 2017 periods. These forecasts were developed

---

[11] See CIAL Draft Report at paras F21, F51.

[12] CIAL Draft Report at para F23.

[13] CIAL "Decision on the Reset of Aeronautical Charges for the period ending 30 June 2017" (12 March 2012) at pgs 23, 25.

[14] CIAL "Proposal for the Reset of Aeronautical Charges for the period ending 30 June 2017" (31 July 2012) at pg 21.

> having also considered the forecast passenger and aircraft movement growth and the resulting developments necessary for [CIAL] over the subsequent 5 years to 2022.

65 In our price setting event disclosure we stated:[15]

> The long term model looks at the overall cost using the building block accumulation process, over the economic life of the assets (20 years plus a terminal value), including projections for additional forecast capital expenditure (for the pricing period) and long term volume growth.

66 The Draft Report records that this under-states the long-run levelised price (and so acts in our customers' favour).[16]

67 The Draft Report suggests that our model includes an implicit capital expenditure allowance beyond 2017, as depreciation in each year appears to be a constant ratio of the RAB.[17] Our model does not have an implicit capital allowance beyond 2017. The trend noted by the Commission occurs because annual revaluation increases and depreciation decreases are approximately equal. For this reason the RAB remains roughly constant post 2017.

68 The suggestion in the Draft Report is that our 20 year model is incomplete if it only includes capital expenditure forecasts for the first five years. In response to the Commission's concern, we can change the model to include longer run forecasts of capital expenditure, similar to the approach used for operating expenditure. This would be done by including a forecast of normal "stay in business" capital expenditure as well as replacing assets when they are fully depreciated.

69 As noted above, there is a trade-off here. Including longer range forecasts of capital expenditure does give a more complete picture of our 20 year cost profile (without wanting to over-state the accuracy of long-run cost forecasts). However it also requires consultation on those long-run forecasts at each price reset. We are interested to hear from our customers as to their preference for how this trade-off is resolved.

70 As noted by the Commission, at each price reset the forecasts of capex, opex, appropriate cost of capital and demand will be the subject of consultation.

Tax

71 Our treatment of tax raised the most concerns about transparency from the Commission and our customers.

72 Our model used a pre tax WACC to estimate the 20 year levelised real price path. In our view this was an appropriate approach as it avoided the requirement of a post tax approach to forecast actual tax paid in each year and, over a period of 20 years, gave materially the same cost of tax.

73 We were transparent about our approach, responded to the concerns of our customers and the Commission, and provided a calculation to demonstrate there was no material NPV difference between the two approaches.

---

[15] CIAL Price Setting Disclosure (19 December 2012) at pg 14.

[16] CIAL Draft Report at footnote 157.

[17] CIAL Draft Report at footnote 158.

74 This was not accepted by the Commission or our customers. We think that this was for three reasons:

74.1 A focus on the annual differences between the tax expense and the regulatory tax allowance rather than the overall impact;

74.2 The view that revaluations gains aren't taxed. They are - not in the period in which they occur, but over future periods where the capital charge is based on the higher revalued RAB; and

74.3 Our use of a standard unlevelised building block model to establish the PV of the revenue needed from levelised prices. This model, of course has a different tax expense profile to that of the levelised model.

75 We note however that the Commission's modelling supports our view that there is no material financial difference between the pre and post tax approached. The Commission's modelling shows that our levelised price path equates to a 9.75 per cent post tax return—almost identical to the 9.76 per cent post tax return derived from the application of a conversion formula to our pre tax WACC of 13.55 per cent.

76 However we accept that we have not convinced our customers nor the Commission that our approach is equivalent to the post tax approach, and that both parties believe the post tax approach is more transparent.[18] We will change our pricing model to use a post tax WACC and include forecasts of the regulatory tax allowance (calculated using the Commission's input methodology) in each year of the model.

Tax depreciation

77 In response to Commission questions at the Section 56G Conference, CIAL provided a model including forecast tax depreciation to the Commission and customers. That data was used by the Commission in its post tax modelling for this report. The Commission noted that this was different to the tax depreciation data provided by CIAL to comply with Schedule 18 of the information disclosure requirements.

78 The tax depreciation information for information disclosure was required in December 2012. At that time CIAL had not calculated the implied tax depreciation and tax payable as part of the pricing model. However to comply with the information disclosure requirements we used a methodology provided by BARNZ during the consultation process. We did this because we did not want any disagreement over the level of tax depreciation and tax payable. This was explained in our price setting event information disclosure report:[19]

> Schedule 18 requires an estimate of how much tax contributes each year to the forecast total revenue requirement. As explained above, our approach of calculating a long term levelised price to recover our new terminal investment means we did not calculate tax, nor our revenue requirement, in that way. For that reason we have included in Schedule 18 the tax payable estimate based on the BARNZ methodology that was used as a reasonableness cross-check. This is the best proxy for the input required by Schedule 18 that was used during the consultation.

79 For the tax depreciation information supplied in response to the questions raised at conference we applied IRD rates to our best estimate of RAB following the

[18] CIAL Draft Report at paras E13, E14, E50, E51, F41, F42, F43, F47.

[19] CIAL Price Setting Disclosure (19 December 2012) at pg 35.

completion of the new Integrated Terminal. This included adjusting for revaluations and non-tax depreciable building assets.

Comment

80 These are areas where we made simplifying assumptions, on the basis that simplifications would not materially influence the results from the model but would make the model more tractable. We were identifying a 20 year price path and our intention was to focus on the primary drivers of that price path.

81 This was a bona fide approach to engagement with our customers on what influences the long-run price path and its implications for the 5 year pricing decision being made. However we accept that the Commission prefers more detailed forecasts, particularly in years 11 to 20, and we will change our model in the ways discussed above.

The depreciation approach

82 Our model used straight line depreciation when developing the picture of costs over the 20 year period. This is identified in the Draft Report at paragraph 3.30 and elsewhere.

83 In our initial pricing proposal we said:[20]

> In this proposal, CIAL has adopted the standard accounting practice of depreciating fixed assets on a straight line basis, across the normal economic lives of the assets concerned.

84 We also described this in our price setting event disclosure:[21]

> CIAL has adopted the standard accounting practice of depreciating fixed assets on a straight line basis, under which the depreciation charges are evenly spread throughout the normal economic life of the asset.

85 The Draft Report notes that when setting up the model to produce a long-run levelised price path we had a choice between straight line depreciation and a non-standard depreciation profile that better reflected utilisation of our new Integrated Terminal. Our reasons for using the straight line depreciation approach were that it was simpler, and given the two-step nature of our model (first calculate allowable revenue over the 20 year period, then calculate the levelised price path), the choice did not impact on the long-run levelised price path produced by the model.

86 However, the Draft Report states a clear preference for a non-standard deprecation approach:[22]

> For its disclosures following the PSE2 pricing event, [CIAL] disclosed its forecast regulatory asset base (RAB) applying a standard straight-line depreciation approach, and indexing the asset base for inflation. It chose not to use an approach equivalent to the mechanism in the input methodologies that provides for an alternative 'non-standard' depreciation approach (ie, an approach other than straight-line depreciation). [CIAL] could have derived and disclosed forecast depreciated values of its RAB that are consistent with its levelised price path (ie, reflecting relatively low capacity utilisation in the short term, as well as an

[20] CIAL "Proposal for the Reset of Aeronautical Charges for the period ending 30 June 2017" (31 July 2012) at pg 26.

[21] CIAL Price Setting Disclosure (19 December 2012) at pg 33.

[22] CIAL Draft Report at para E52.

> expectation of higher cash flows in the future). Doing so would have allowed interested persons to better assess the impact of its levelised pricing approach on expected returns. However, [CIAL] stated that it "felt that the complexities of that were greater than the approach we've taken."

87 This is presented in the Draft Report as the clearly preferable approach. We note that while we have been discussing this issue with the Commission for some time, the Draft Report is the first time the Commission has expressed a definitive view.

88 Our initial pricing proposal was put to our major customers on 12 March 2012. CIAL's model had to be built well before that. At the time we made our modelling choices the Commission had not started this section 56G process (the initial Process and Issues Paper was released on 31 May 2012).

89 At the conference on WIAL's pricing decision on 7 August 2012, CIAL's representative stated:[23]

> So to this end I'm really seeking direction from the Commission, and particularly considering large lumpy investments such as our terminal we're seeking an articulation from the Commission that how it sets out effectively information disclosure is promoting the purpose of Part 4 particularly when we have long life investment, it's over a number of regulatory control periods and what shall that outcome look like, so we're really seeking conclusions to that so we know how, particularly in terms of framing our pricing proposal, it will enable us to ensure we meet the requirements. Thank you.

90 No guidance was received from the Commission following that conference. The first Draft Report from the Commission, discussing WIAL's pricing decision, was released after our pricing decision was made.

91 All of this emphasises to us that the development of a long-term pricing model has involved working through new issues and a process of learning.

92 We will change our model to use a non-standard depreciation approach. In Appendix A we describe how this will be done. We would appreciate comments from the Commission and our customers on our proposed implementation.

[23] WIAL Conference Transcript at pgs 148–149.

EFFECTIVENESS OF INFORMATION DISCLOSURE

Key points

93 We disagree with the Commission's draft conclusion that information disclosure has had "minimal influence" on CIAL's conduct or performance.[24] That statement does not reflect the information we have put before the Commission, nor does it fairly reflect the way we made our pricing decision and the way we operate as an airport.

94 The incentives created by the new information disclosure regime operate across our business. In the area of innovation, our performance has been good for some time. This has been confirmed by our customers and the Commission. The Commission concludes that information disclosure has been effective in promoting incentives to innovate. However the Draft Report goes on to note that information disclosure "does not appear to have had an additional impact" on CIAL beyond commercial considerations.[25] This is an unnecessary caveat on the Commission's conclusion, and not one made in relation to WIAL and AIAL.[26] The information disclosure regime provides a new discipline on innovation in the way that it promotes transparency.

95 There are some areas where our performance is high, and at this point in time commercial considerations are a material influence. An example is quality. As our customers have confirmed, our quality of service is high.[27] At this point in time our new Integrated Terminal (stage 1 commissioned in May 2011) is a material driver of our high quality standards.

96 A further example is our PSE2 prices. As the Commission has determined, our PSE2 prices are not excessive.[28] A material consideration in setting these prices was the post-earthquake market conditions which we and our airline customers faced.

97 It is incorrect to observe the influence of commercial considerations in these areas and conclude that the incentives created by information disclosure do not operate, and our performance is wholly attributable to incentives other than information disclosure.[29] We are alert to the additional transparency delivered by the new information disclosure regime, and these incentives operate on CIAL and will be a continuing influence.

98 In these areas where there is consensus that CIAL is performing well, the Commission's focus on identifying behaviour change is too narrow and its caveats unnecessary and not supported by evidence. We have informed the Commission that we expect the additional transparency under the new information disclosure regime to be a discipline going forward.[30]

99 There are other areas where the Commission has said – for all airports – it is too early to be able to assess the effectiveness of information disclosure. These are

[24] CIAL Draft Report at para 3.2.

[25] CIAL Draft Report at para 3.5.1.

[26] See WIAL Final Report at para 3.5.1; AIAL Final Reports at para 3.5.1.

[27] CIAL Draft Report at para C4.

[28] CIAL Draft Report at para 3.14.

[29] See for instance CIAL Draft Report at para C7.

[30] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pgs 6–7; CIAL "Cross Submission on Section 56G Reports: Process and Issues Paper" (20 July 2012) at para 5; CIAL Price Setting Disclosure (19 December 2012) at pg 8; CIAL "CIAL Cross Submission Following Wellington Airport Conference" (17 August 2012) at pgs 1–2.

operating expenditure efficiency, efficient investment and sharing efficiency gains. We acknowledge the Commission's position here, but observe again that the incentives created by information disclosure will operate on the airports.

100 In relation to the efficiency of our new pricing structure, the Commission agrees that the changes we have made improve the efficiency of our pricing.[31] We have explained to the Commission that we made these changes to better reflect the economic principles of the new regulatory regime. New regulation was introduced requiring disclosure of our pricing methodology and the reasons for it, and new input methodologies were published to support information disclosure that emphasise economic efficiency. In response, CIAL, in its first post–regulation pricing decision, changed its pricing methodology to better reflect economic principles. We don't understand the argument in the Draft Report that this is not evidence of CIAL responding to the incentives created by the new information disclosure regulation.

101 We disagree with the suggestion in the Draft Report that our engagement with our customers on our pricing methodology was lacking, at the expense of an even more efficient pricing methodology.[32] We respond to the criticisms of our consultation and engagement in this submission.

102 More generally, as CIAL explained in its submissions, the new information disclosure regulation framed every step of our pricing process. We had careful regard to the input methodologies, and adopted all but two of them, because we knew our pricing decision would be measured against the input methodologies in our information disclosure reports.

103 This drove our pricing behaviour. As we developed our pricing proposal, Board papers measured options against the input methodologies. Our model used all but two input methodologies. The consultation process with our customers was framed around the input methodologies. Where we departed from the input methodologies we provided detailed explanation and expert reports to our customers on the difference. All of this responded to the fact that we knew information disclosure reports would measure our pricing against the input methodologies. None of this transparency and discipline would have happened but for the new information disclosure regime.

104 Some of these changes had a direct impact on our prices. We took a different approach to asset valuation, timing of revaluations, and common cost allocation than we would otherwise have done. These changes directly impacted our revenue requirement, and therefore prices.

105 We did not use the Commission's WACC input methodology. On this important issue it is fair for all parties to reserve judgement until the results of the merits appeal are known. It is reasonable to expect this feature of information disclosure to be more influential once the appeal is settled. However, as discussed in this submission, our target returns are reasonable when compared to an appropriate benchmark.

106 In the previous sections of this submission we discuss the Commission's suggestion of producing information disclosure reports on a non-standard depreciation basis, and confirm that we will produce those disclosures. The publication of the Draft Report is the first time the Commission has expressed its preference for the non-

[31] CIAL Draft Report at para 3.7.

[32] CIAL Draft Report at para 3.7.

standard depreciation approach, and in this submission we explain that we will produce information disclosure reports which address the Commission's concerns. We also identify where the Commission has specific concerns with the transparency or workings of our model, and confirm we will make changes to address each concern.

107 We would like to think this is a further step in the constructive engagement with the Commission on how to implement a long-term pricing model. The Commission agrees that our decision to use a long-term pricing approach was the most efficient one. If there are further transparency concerns we are happy to consider those, too. Our objective is to establish long term prices that efficiently price our facility, and we share the objective of information disclosure that stakeholders understand the implications of the long-term pricing approach for them.

Incentives created by the new information disclosure regulation

108 The new information disclosure regime has created a level of transparency that did not exist previously. We expect this to act as a discipline on all features of our operations going forward.

109 In our submission on the CIAL Process and Issues Paper, we stated:[33]

> Through the input methodologies, information disclosure has established a more disciplined framework, providing guidance for the elements to be included and considered within the price consultation and decision making process.
>
> In addition, information disclosure regarding the assessment of performance for PSE 1 has provided transparency to interested parties. As well as considering the operating performance of the company, it has established a set of key performance indicators to monitor achievement of, and the trend in on-going, business performance. It has also provided a common basis for benchmarking relative performance with other major airports.
>
> A further tangible benefit has been a proper understanding of the basis of how future investment may be viewed under the information disclosure process, and how such returns on investment will be monitored. While CIAL had already made the major decision to invest in the new Integrated Terminal, information disclosure has provided a useful framework to guide future investment decisions, particularly with respect to their impact on charges and how returns will be portrayed.
>
> CIAL believes that this understanding of our performance will have improved from PSE1 into PSE2. Information disclosure has provided us with a basis for better articulation of our pricing methodology, creating greater transparency of the framework on which pricing decisions will be made, the input elements into the pricing methodology, and the final pricing decision made.

110 In our cross submission on the Section 56G Process and Issues Paper, we stated:[34]

> Information disclosure makes transparent the performance of airports. Combined with the threat of heavier handed regulation, the possibility of adverse publicity, and pressure from customers armed with information, that transparency creates incentives for airports to behave consistently with the Part 4 Purpose.

[33] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pgs 6–7.

[34] CIAL "Cross Submission on Section 56G Reports: Process and Issues Paper" (20 July 2012) at para 5.

111 In our price setting event disclosure we stated:[35]

> Questions about the legal relevance of the IMs have not been a pressing issue for CIAL in this decision. Instead, our starting point has been that the IMs are an important benchmark, representing as they do the Commission's view as to the most appropriate way to calculate the efficient cost of service for airports under Part 4 information disclosure.
>
> CIAL followed the logic of the IMs in calculating its cost of service using the building blocks methodology, and setting its charges so as to recover reasonably efficient costs.
>
> Where it was appropriate, CIAL directly adopted the IMs to identify its costs. However, CIAL also exercised its duty to shareholders to make its own assessment of the reasonable costs of owning and operating Christchurch International Airport. A key part of that assessment has been to consider the way the IMs calculate costs and the reasoning behind the IMs, and to form our view as to the true costs of owning and operating the airport. Because the IMs were deliberated over a long period with input from a number of parties and experts, CIAL was able to use the IMs as the point of reference for its own analysis, and to focus on the aspects of the IMs which CIAL believed were not appropriate for CIAL's circumstances.

112 In our cross submission following the WIAL conference, we stated:[36]

> … we can say that the IMs have been front and centre in our pricing process considerations. They have framed our pricing proposals, been considered by management and our board, and provided a framework for our discussions with airline customers. This has provided a discipline to ensure that we are sure we are presenting an accurate picture of our business and our costs, appropriately investing for the future, aiming for a reasonable return, and sharing gains with our customers.

Innovation

113 As our customers have confirmed, CIAL is engaging in appropriate levels of innovation.[37] Further, the Commission concludes that information disclosure has been effective in promoting incentives to innovate.[38]

114 However, the Commission caveats its conclusion by suggesting that information disclosure "does not appear to have had an additional impact on incentives to innovate" beyond CIAL's commercial considerations.[39] This is an unnecessary caveat on the Commission's conclusion.

115 The starting point here is that the Draft Report concludes our innovation behaviour was good both before and after the introduction of information disclosure regulation. The same conclusion was made in relation to WIAL and AIAL. In these circumstances, as the Commission pointed out in the Draft Report:[40]

> … where a supplier is already innovating appropriately, we would not expect information disclosure to have any material impact on innovation.

---

35 CIAL Price Setting Disclosure (19 December 2012) at pg 8.

36 CIAL "CIAL Cross Submission Following Wellington Airport Conference" (17 August 2012) at pgs 1–2.

37 CIAL Draft Report at para B11.

38 CIAL Draft Report at para B3.

39 CIAL Draft Report at para 3.5.1.

40 CIAL Draft Report at para B3 (also stated in the WIAL Final Report at para B3 and the AIAL Final Report at para B3).

116 As that passage from the Draft Report indicates, *behaviour change* is not expected from CIAL. But this is not evidence for the suggestion that our *incentives* to innovate have not been strengthened by information disclosure.

117 Nevertheless the Draft Report includes a caveat in relation to CIAL that the Commission did not include in its overview sections for WIAL and AIAL,[41] that information disclosure "does not appear to have had an additional impact on [CIAL's] incentives to innovate".[42] The only support given in the Draft Report for this caveat is a footnote reference to a CIAL submission.[43]

118 The full text of that submission is informative. The material referred to responds to the question in the Commission's Process and Issues Paper for CIAL "How does the level of innovation at [CIAL] compare now to prior to the introduction of information disclosure regulation?" In our response to that question we said:[44]

> As the drive for innovation has been a continuing ethos of the company for many years there has been no change in such activity post information disclosure, however the introduction of information disclosure regulation has improved transparency of the level of innovation. This has communicated our initiatives and outcomes to a wide range of customers and stakeholders.
>
> CIAL considers its level of innovation is appropriate for its location and its position as the gateway to Canterbury and the South Island. We believe this is demonstrated through strong performance driven by a focus on ensuring that all staff and participants across the airport focus on service excellence and the identification and development of innovative and leading practices to continually improve the airport experience. CIAL has gained recognition for its innovative approach to sustainability, and was the first airport to be awarded carbon zero certification in the Southern Hemisphere (CIAL has continued to be accredited since that initial achievement).

119 That submission does not support the caveat in the Draft Report. In response to the Commission's question we noted innovation behaviour has remained appropriate but our incentives have improved. The information disclosure regime will influence innovation in the way that it materially increases transparency.[45] For example, customers are able to scrutinise the effect that major capex has on price. The information disclosure regime has also operated to inform market participants of tangible positive airport behaviour and innovative developments which otherwise might not have been widely known.

120 The way that the information disclosure regime informs market participants of innovative developments was noted in the AIAL Final Report as follows:[46]

> [AIAL] has suggested that its innovation activities are driven by core business drivers rather than information disclosure regulation under Part 4. It has however noted that information disclosure has resulted in greater transparency around the outcomes of its innovations.

---

[41] AIAL Final Report at para 3.5.1; WIAL Final Report at para 3.5.1.

[42] CIAL Draft Report at para 3.5.1.

[43] CIAL Draft Report at para B5.

[44] CIAL Draft Report at footnote 42, referring to CIAL"Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 47.

[45] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 47.

[46] AIAL Final Report at para B5.

121 The question of "additional impact on incentives to innovate" was not raised in the overview sections of the reports on AIAL or WIAL,[47] despite the same substantive finding in each of the reports that levels of innovation at the airport were good and therefore that a material change was not expected.[48]

122 Following the Commission's approach for AIAL and WIAL, a consistent treatment for CIAL would be as follows:

122.1 CIAL is already innovating appropriately;

122.2 no material impact on innovation behaviour is expected;

122.3 information disclosure has strengthened incentives to innovate;

122.4 information disclosure is effectively promoting incentives to innovate at CIAL.

Service quality

123 The same analysis applies to service quality — that is, where an airport is already providing a high quality of service, we would not expect information disclosure to have any material or discernible impact on *behaviour* as to quality. This is not evidence that information disclosure *incentives* are ineffective.

124 As CIAL's customers have confirmed, our quality of service is high.[49] No material change in the quality of service should be expected. As the Commission points out:[50]

> … the evidence available indicates [CIAL's] conduct in relation to service quality is appropriate, and that quality reflects consumer demands.

125 As noted in the Draft Report[51] and in our submissions, at this time a material driver of the quality outcomes is the commissioning of our new Integrated Terminal. The commissioning of this facility in May 2011 led to a noted improvement in service quality for our domestic customers and this has continued to be reinforced by our customers through the quarterly Airport Service Quality (*ASQ*) surveys.

126 Our good quality track record cannot be attributed solely to the new Integrated Terminal, however. By way of illustration, WIAL's improvements to its customer satisfaction surveys (a change partially attributed to the introduction of information disclosure)[52] were already present in CIAL's surveys. In the same way that no material impact is expected where suppliers are already innovating appropriately, the same can be said for suppliers who are already providing an appropriate and responsive quality of service.

---

47 AIAL Final Report at para 3.5.1; WIAL Final Report at para 3.5.1.

48 AIAL Final Report at para B3; WIAL Final Report at para B3; CIAL Draft Report at para B3.

49 CIAL Draft Report at para C4.

50 CIAL Draft Report at para C6.

51 CIAL Draft Report at para C7.

52 WIAL Final Report at para C4.3.

127 The incentives created by the information disclosure regime operate despite CIAL not being able to point to specific instances of behaviour change at this time. For instance, as we explained in a previous submission:[53]

> The information disclosure regime has benefited CIAL and its customers by establishing a defined set of key performance indicators that are reported on to interested parties, and which motivates staff to achieve the required quality outcomes and to seek improvement across all business processes.

128 We were clear that immediate discussions of quality with our customers were primarily driven by the commissioning of the new terminal, but information disclosure nevertheless influenced and improved transparency:[54]

> … discussion during the PSE2 consultation was not directly influenced by information disclosure, but as with the overall information disclosure programme, it provided a framework on which information was disclosed.

129 For these reasons we agree with the following conclusion in the Draft Report:[55]

> [CIAL's] overall conduct in this area indicates it seeks to ensure quality reflects consumer demands and, based on the available information, the quality of service provided to passengers and airlines does generally reflect their demands. Given this, and that no concerns have been raised about the transparency of information about quality at [CIAL], our draft conclusion is that information disclosure is effective at [CIAL] at this time.

130 However the Draft Report goes on to caveat that conclusion in a number of ways. First, the Draft Report states that while there are no concerns about the transparency of information on service quality at CIAL, "it is not clear that this is a result of information disclosure".[56] The Draft Report includes this caveat despite recording that:[57]

> BARNZ anticipates the quality measures disclosed will inform regular engagement on service quality at [CIAL] …

131 The response in the Draft Report to this supportive feedback from our customers is "[i]t is not clear what information was previously provided to airlines and other consumers on service quality at [CIAL]".[58] However, as noted above, in a previous submission we informed the Commission:[59]

> Information disclosure has benefited CIAL and its customers by establishing a defined set of key performance indicators that are reported on to interested parties, and which motivates staff to achieve the required quality outcomes and to seek improvement across all business processes.

---

[53] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 48.

[54] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 51.

[55] CIAL Draft Report at para C3.

[56] CIAL Draft Report at para C6.

[57] CIAL Draft Report at footnote 49.

[58] CIAL Draft Report at footnote 49.

[59] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 48.

132 We can confirm the point made in that submission, that the information disclosure quality measures are new and do constructively add to the transparency and incentives around quality of service at CIAL. We also observe the different language adopted for AIAL where, despite the questions raised about the extent to which information disclosure impacted upon service quality at AIAL, the Commission determined that information disclosure *may* have had an impact on AIAL's conduct.[60]

133 The second caveat in the Draft Report is that our good conduct and performance in relation to quality of service is "attributable to incentives other than information disclosure".[61] The Draft Report references submissions from our customers that, correctly, note the material impact of our new Integrated Terminal on recent quality levels.

134 However just because there is an identifiable commercial driver for our good performance doesn't mean that information disclosure incentives aren't operating as well. The Draft Report correctly highlights the way that information disclosure incentives will operate on quality levels over time:[62]

> The public disclosure of information through information disclosure regulation can strengthen the incentives to provide services at a quality that reflects consumer demands, for example by requiring [CIAL] to disclose the process it has put in place for undertaking operational improvement forums.
>
> We expect it may take some time for information disclosure regulation to be as effective as it can be in promoting the provision of services at a quality that reflects consumer demands. Significant quality improvements highlighted as necessary by consumers through information disclosure regulation may require a long lead time to implement if investment is required. The availability of a longer time series of information on quality may improve its effectiveness, including during consultation at price setting events. Only limited information on quality was available through information disclosure at the time of consultation for PSE2.

135 CIAL supports this view. While commercial considerations are in play when assessing our recent behaviour, as we have noted in previous submissions and again above, information disclosure has added to the incentives to provide a high quality of service, and will continue to do so.

136 The third caveat in the Draft Report is a reference to a CIAL submission discussing the PSE2 consultation.[63] In response to the Commission's question as to the role that information disclosure played in consultations on quality in our PSE2 consultation, the Draft Report notes CIAL's observation that the quality discussion during the PSE2 consultation "was not directly influenced by information disclosure".[64]

137 However, the Draft Report does not record the context for this point, which is that quality of service is not separately consulted on during price setting events. For this

---

60 AIAL Final Report at para C5; see also CIAL Draft Report at para C7.

61 CIAL Draft Report at para C7; see also para C18.

62 CIAL Draft Report at paras C10–C11.

63 CIAL Draft Report at para C32.

64 CIAL Draft Report at para C32, referring to CIAL's 22 March 2013 submission on the CIAL Process and Issues Paper at pg 51.

reason, quality issues only arise indirectly. As we stated in our immediately preceding answer in the same submission:[65]

> Quality of service is not separately consulted on during price setting events and arises only to the extent it is relevant to the consultation process, particularly with respect to the development of the relative inputs into the building block revenue determination. This includes asset management, operating cost efficiency, and improvements in demand.

138 In that regard, the Draft Report records that CIAL's consultation on quality is appropriate:[66]

> [CIAL's] consultation on quality appears appropriate.
>
> 30.1 [CIAL] engages with airlines on quality issues through a number of forums. These include the Airlines Working Group, Airside Safety Group, Facilitation Group and the Airlines Operating Committee.
>
> 30.2 Although quality is not explicitly consulted on as part of price setting events, [CIAL] did appear to engage effectively with airlines on the service requirements for the new terminal during PSE1. As a result, it agreed significant improvements to services in the new terminal with airlines. Air New Zealand notes that [CIAL] did not reflect all customer requirements in its design for the new terminal, and that this may result in some levels of services not being as requested by airlines. Airlines have not raised any major concerns with the resulting quality of service provided by the new terminal.

139 With that context, we think the full quote from our submission is more informative than the partial sentence quoted in the Draft Report. In response to the question regarding consultation on quality during the PSE2 consultations, having earlier made the point that quality is not separately consulted on, we stated:[67]

> Ensuring service quality is an on-going process, involving considerable interaction between CIAL, the airlines, and other parties that are dependent on [CIAL] (including airways, Customs, and MAF). CIAL management regularly reviews service performance and customer service standards and there are bodies through which such items are discussed with the airlines on an on-going basis – as explained in our information disclosure reports in 2011 and 2012.
>
> **Accordingly, discussion during the PSE2 consultation was not directly influenced by information disclosure, but as with the overall information disclosure programme, it provided a framework on which information was disclosed.** This included the provision of capital investment forecasts and passenger and aircraft demand forecasts for the 10 year period to 2022 – identifying the levels of investment required by category and the rationale and benefit behind such capital investment together with the 10 year profile of the type and number of passenger and aircraft movements.
>
> (Emphasis added)

---

65 CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 50.

66 CIAL Draft Report at para C30.

67 CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 51.

140 This makes the point we have made consistently in our submissions to the Commission, that while our quality of service is good and acknowledged by our customers to be so, maintaining good quality is a process and we expect the transparency and framework provided by information disclosure to improve incentives going forward.

141 Following the Commission's approach for AIAL and WIAL, a consistent treatment for CIAL would be as follows:

141.1 CIAL is already providing services at a quality that reflects our consumer demands;

141.2 no material impact on service quality behaviour is expected;

141.3 information disclosure has added to the incentives to maintain appropriate quality standards;

141.4 information disclosure is effectively promoting incentives to provide services at a quality that reflects CIAL's consumer demands.

Our changes to price structure

142 CIAL made a number of changes to its price structure when making its PSE2 price decision. These changes were:

142.1 mapping of prices against our long run levelised path, to ensure economic return over the lifecycle of the new Integrated Terminal and to avoid inter-period price shocks;

142.2 implementation of a transitional price in PSE2 rather than increasing our prices to the long-run levelised path straight away;

142.3 introduction of a fixed and variable airfield charge, in replacement of the single MCTOW charging structure;

142.4 implementation of a differential terminal services charge to reflect different aircraft types; and

142.5 adjustment of our passenger services charge to account for children.

143 These changes to our price structure were significant. The introduction of a fixed and variable airfield charge was particularly significant, replacing a single MCTOW charging structure that had been in place for at least 12 years. The move to a fixed and variable pricing structure for the airfield charges was opposed by some of our airline customers and supported by others. The Draft Report concludes that our changes to our pricing structure are "likely to promote efficiency".[68] We agree with that conclusion.

144 However the Draft Report includes two caveats to the conclusion that our changes are likely to promote efficiency. For this reason the Draft Report concludes that

[68] CIAL Draft Report at para 3.7.

information disclosure regulation was not "as effective as [the Commission] would have expected it to be".[69]

145 The first caveat is that the Commission summarises one of CIAL's submissions as saying that information disclosure only had an impact on CIAL's decision-making to the extent that it provided a "cross-check" on the changes to pricing methodology.[70] In fact, our submission was that we developed our pricing methodology knowing that in the new environment it would be scrutinised and its efficiency made transparent and tested. This shows the incentives created by information disclosure working effectively.

146 The full quote of CIAL's submission referred to in the Draft Report is as follows:[71]

> The Price Setting Event Disclosure has provided interested parties – including the Commission in its Sec 56G review – with detailed information about our pricing decisions. **Because we knew that this scrutiny would happen, we knew our decisions had to be credible.** The questions at conference on CIAL's pricing efficiency showed that the scrutiny was real, and we demonstrated that we had sound reasons supporting the efficiency of our pricing decisions. **ID made us double-check our reasoning.**
>
> (Emphases added)

147 This makes clear that we developed our proposal knowing scrutiny would happen and our decisions had to be credible in the new environment where efficiency principles are emphasised.

148 We have explained to the Commission that we made these changes to our pricing methodology to better reflect the economic principles of the new regulatory regime.[72] New regulation was introduced requiring disclosure of our pricing methodology and the reasons for it, and new input methodologies that emphasise economic efficiency were developed and published to support information disclosure. In response CIAL, in its first post-regulation pricing decision, changed its pricing methodology to better reflect economic principles. This included a change to the pricing structure for airfield charges that we had used for at least 12 years. We don't understand the argument in the Draft Report that this is not evidence of CIAL responding to the incentives created by the new information disclosure regulation.[73]

149 We submit the key points are as follows:

149.1 CIAL changed its pricing methodology from PSE1 to PSE2;

149.2 the change to the pricing methodology promoted efficiency;

149.3 the incentives to price efficiently were clearly operating at the time pricing decisions were made, and will continue to operate going forward;

---

69 CIAL Draft Report at para D7; see also para 3.7.

70 CIAL Draft Report at para D8.

71 CIAL "CIAL Post-Conference Submission" (19 June 2013) at para 22.9.

72 CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 60.

73 We refer to the Commission's statements at CIAL Draft Report at para 3.7.

149.4 the change to the pricing methodology was influenced by the information disclosure regime.

150 The second caveat to the conclusion in the Draft Report that our changes to our pricing structure promote efficiency is that with more constructive engagement with our customers even better changes may have been identified.[74] The Draft Report argues that information disclosure regulation creates incentives for constructive engagement, and this suggested shortfall is evidence that the incentives are not operating on CIAL.

151 To support this suggestion the Draft Report refers to residual points of disagreement raised by some of our substantial customers, and a concern raised by one of our air freight customers at the time of the conference. We address this issue in Appendix D. In summary, in relation to the consultation with our substantial customers we demonstrate the following:

151.1 The consultation with our substantial customers on this issue was lengthy and involved several iterations.

151.2 Our proposal and the purpose of the proposed change was transparent and clear.

151.3 Because the change created winners and losers amongst our customers, the feedback was contradictory and a consensus position was not possible.

151.4 Nevertheless changes were made to our pricing methodology proposal in response to the feedback we received from our customers.

151.5 As the Commission noted, some of the continuing feedback from airlines was directed more at the level of returns than the price structure.

152 This was a credible and good faith consultation process with our substantial customers, where our proposal was clearly described and our customers engaged consistent with self-interest and their assessment as to whether this part of our pricing proposal was a point of focus for them. The final result was a set of changes that promoted economic efficiency. There were limits to our ability to get a consensus among the airlines, including competition law. In this environment some of our customers consider that further changes could have been made, while others would oppose those very changes.

153 In relation to our air freight customers we explain, that for good reasons, our engagement with air freight customers was sequenced after our consultation with substantial customers. Commercial negotiations have resulted in interim arrangements agreeable to all parties, and further developments are being explored.

154 Against that backdrop, we suggest that to support the argument made in the Draft Report the Commission needs to identify the further engagement it considers to have been lacking and explain why, despite the conflicting positions of our customers, the Commission can be sufficiently confident that further engagement would have resulted in a more efficient pricing structure at this stage.

[74] CIAL Draft Report at para 3.7.

155 We also note that AIAL was in a similar position to us. As the Commission noted at paragraphs 3.21 and 3.22 of AIAL's Final Report:

> 3.21 Information disclosure has had a positive impact on this outcome. [AIAL] has indicated that the requirement to transparently outline its pricing methodology in Part 4 information disclosure prompted discussions with airlines about its pricing methodology. These discussions led to a number of changes to its pricing structure, with the intention of improving the efficiency of prices.
>
> 3.22 **Additional changes** to [AIAL's] pricing methodology may further improve the efficiency of its prices (for example, further consideration of maximum certified take-off weight (MCTOW) charges for smaller aircraft).
>
> (Emphasis added)

156 Despite the acknowledgement that additional changes to AIAL's methodology may result in further improvements, the Commission concluded that information disclosure had a positive impact on AIAL's pricing efficiency.[75]

157 CIAL's position is similar, except that in our case the Commission has not identified specific improvements that could be made in the future. The Commission has found that CIAL's PSE2 pricing methodology is likely to better promote efficiency than its PSE1 methodology.[76] However, the Draft Report speculates that further (unspecified) improvements may have been possible, and so CIAL's PSE2 pricing methodology "may have *better* promoted efficiency if information disclosure had been more effective".[77] For that reason the Draft Report concludes information disclosure incentives are not effective.

158 We also note that in WIAL's Final Report the Commission concluded that WIAL's PSE2 price setting conduct indicated that it sought to improve the efficiency of its prices, despite the fact that after the pricing was finalised the airlines raised with the Commission a number of concerns with WIAL's pricing methodology. The WIAL Final Report stated:[78]

> Overall, we consider that [WIAL's] conduct in setting the pricing methodology for PSE2 shows that it seeks to improve the efficiency of its prices. [WIAL's] pricing methodology for PSE2 shows greater consideration of efficient pricing principles than previously. [WIAL] also commissioned economic experts to advise them on efficient pricing principles during consultation for PSE2 and adopted many, although not all, of their recommendations. However, submissions received as part of this s 56G review and discussed above indicate that the airlines have expressed a number of concerns with [WIAL's] pricing methodology.

159 Importantly, the WIAL Final Report did not conclude that WIAL has failed to constructively engage with its customers, and therefore information disclosure incentives were not operating effectively, simply because there was not complete agreement among all airline customers on WIAL's (improved) pricing methodology. A consistent approach should be taken to the initiatives we took in PSE2 to improve our pricing methodology. The introduction of a fixed / variable pricing structure was

---

[75] AIAL Final Report at para 3.5.3.

[76] CIAL Draft Report at para D5.

[77] CIAL Draft Report at para D7 (emphasis added).

[78] WIAL Final Report at para D44.

a significant change and a significant step forward in the efficiency of our pricing structure, in circumstances where some customers opposed the change per se, others supported it, and there was disagreement on the detail. It was inevitable that we couldn't satisfy all our customers and we of course don't rule out the potential for improvement in the future. But that does not support the suggestion that our engagement with our substantial customers was anything less than fulsome and constructive.

160 We submit that the more appropriate and consistent conclusion is the same as that drawn in the AIAL Report: that improvements in pricing methodology support the conclusion that information disclosure incentives are operating effectively, and the potential for further improvements in the future does not detract from that conclusion.

Our price setting process

161 As CIAL explained in its submissions, the new information disclosure regulation framed every step of our price setting process. The new regime places an on-going discipline on CIAL's conduct.[79] While we have maintained that competitive market constraints have influenced our price setting decisions, we have also pointed out that:[80]

> Information disclosure has provided us with a basis for better articulation of our pricing methodology, creating greater transparency of the framework on which pricing decisions will be made, the input elements into the pricing methodology, and the final pricing decision made.

162 Board papers measured pricing proposals against the input methodologies. Our model used all but two input methodologies. In our cross submission following the WIAL conference, we stated:[81]

> … we can say that the IMs have been front and centre in our pricing process considerations. They have framed our pricing proposals, been considered by management and our board, and provided a framework for our discussions with airline customers. This has provided a discipline to ensure that we are sure we are presenting an accurate picture of our business and our costs, appropriately investing for the future, aiming for a reasonable return, and sharing gains with our customers.

163 The consultation process with our customers was framed around the input methodologies. Where we departed from the input methodologies we provided detailed explanation and expert reports to our customers on the difference. Copies of all of our consultation documents were provide to the Commission during the consultation process.

164 All of this responded to the fact that we knew information disclosure reports would measure our pricing against the input methodologies.[82] None of this transparency and discipline would have happened but for the new information disclosure regime. BARNZ advised CIAL at a briefing in Auckland that they felt we had responded

[79] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 5–6.

[80] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 5.

[81] CIAL "CIAL Cross Submission Following Wellington Airport Conference" (17 August 2012) at pgs 1–2.

[82] CIAL "CIAL Post-Conference Submission" (19 June 2013) at pg 7.

positively to disclosure of information in line with input methodologies, and that we recognised areas where there were differences and explained why.

165 As we stated in a previous submission:[83]

> Information disclosure is having a positive impact on the AAA processes (i.e. consultation and price setting) by arming airline customers with more detailed information and compelling airports to robustly consider the IMs in pricing decisions. In turn, the outcomes of the AAA processes are made transparent through price setting event disclosures.

Our use of the input methodologies

166 Information disclosure has had a clear impact on CIAL's pricing. As we identified in a previous submission:[84]

> CIAL adopted an asset valuation consistent with the input methodologies, and this meant that an issue which has historically been contentious was not a significant part of the consultation process.

167 In fact, we had careful regard to the input methodologies, and adopted all but two of them, because we knew our pricing decision would be measured against the input methodologies in our information disclosure reports.

168 Some of these changes had a direct impact on our prices. We took a different approach to asset valuation, timing of revaluations, and common cost allocation than we would otherwise have done. These changes directly impacted our revenue requirement, and therefore prices.

169 We did not use the Commission's WACC input methodology. On this important issue it is fair for all parties to reserve judgement until the results of the merits appeal are known. It is reasonable to expect this feature of information disclosure to be more influential once the appeal is settled. However as discussed in this submission our target returns are reasonable when compared to an appropriate benchmark.

Our prices are not excessive

170 The Draft Report concludes that CIAL's PSE2 prices are not excessive. We agree with that assessment.

171 However, the Draft Report attributes this outcome solely to CIAL reacting to the demand conditions it faced for PSE2. The Draft Report concludes that the good outcome of CIAL's PSE2 prices not targeting excessive returns cannot be attributed to information disclosure incentives in any way.[85]

172 We disagree with that assessment. It is inaccurate to say that our pricing decision was unaffected by the incentives created by the new information disclosure regime. Throughout the pricing process CIAL considered a number of price paths for PSE2. When doing so we assessed proposed PSE2 price paths against the Commission's likely analysis. Whether a price path was consistent with the likely analysis to be conducted by the Commission was an important consideration when deciding on our prices for PSE2.

---

83 CIAL "CIAL Cross Submission Following Wellington Airport Conference" (17 August 2012) at para 44.

84 CIAL "Cross Submission on the Section 56G Review – Christchurch International Airport – Process and Issues Paper" (5 April 2013) at para 41.

85 CIAL Draft Report at para 3.3.

173 We can confirm that the Draft Report presents an analysis of our PSE2 price path that is consistent with what we assumed the Commission would do.

174 Further, as noted above we used all but two of the input methodologies in our pricing model. In places this involved a change from what we had done in the past. Those changes flowed directly through to the revenue requirement identified by our model.

175 The Draft Report does conclude that our prices after 2017 are likely to be targeting excessive returns. We explain in Appendices E and F why that conclusion is incorrect. There is no reason to conclude that the incentives created by the new information disclosure regime will be ineffective in the future.

Our model and information disclosure reports

176 The Draft Report identifies areas where the Commission is concerned that our model and our information disclosure reports (both price setting event disclosure and annual disclosure) are not sufficiently transparent. We agree with the Commission that transparency is an important part of the information disclosure regime and we share the Commission's objective of making our performance and the implications of our long-run price path transparent to all stakeholders.

177 In previous sections we confirm we will make changes to address all of the Commission's concerns, and explain how we will do so.

Areas where it is too early to assess the effectiveness of information disclosure

178 For all airports, the Commission has said that it is too early to be able to assess the effectiveness of information disclosure for particular elements of section 52A. These are operating expenditure efficiency, efficient investment and sharing efficiency gains. In the Commission's view, to make a fair assessment of these outcomes, more information is needed over a longer period of time. We acknowledge the Commission's position, but note that the incentives created by information disclosure do, and will continue to, operate on the airports.

APPENDIX A – IMPLEMENTING A NON-STANDARD DEPRECIATION APPROACH

Introduction

179 One of the important conclusions in the Draft Report is that CIAL's price setting event disclosure report does not contain the information interested parties need to assess the annual impact of our long-term levelised price path on our asset base. For this reason CIAL's expected profitability performance in PSE2 and subsequent periods is not as transparent as it otherwise could have been.[86] The Commission notes that if CIAL takes the same approach to its annual disclosures then the same concerns will arise.

180 CIAL accepts the Commission's comments that there would be a mismatch between annual depreciation values calculated using a straight line depreciation method and the implicit "return of capital" that CIAL expects to receive under the long-run levelised price in each year. In response to the Commission's transparency concerns CIAL will report in its disclosures the "return of capital" (depreciation) values that are consistent with its price path. CIAL will calculate these values in a manner that is consistent with the use of a post tax WACC and application of the tax payable approach, consistent with the Commission's preference. CIAL also confirms that the annual "return of capital" (depreciation) values that it proposes to include in the annual disclosures will be used to update the RAB for pricing purposes when reviewing prices for the PSE3 and subsequent periods. The method that CIAL will apply to derive these annual "return of capital" values is described further below.

181 The assumption implicit in CIAL's proposed enhancement to its disclosures is that what the Commission considers is required for our disclosure accounts to be sufficiently transparent is the "return of capital" that is implicit in a long term price path to be reported as "depreciation" in the disclosure accounts. To this end, CIAL takes comfort in the Commission's statement that it what it seeks is the "implicit alternative depreciation profile" consistent with CIAL's levelised price path to be disclosed:[87]

> More importantly, we consider that not reflecting the implicit alternative depreciation profile associated with [CIAL's] levelised price path in its disclosures will mean that interested parties will experience difficulties in trying to assess whether the airport's ability to extract excessive profits is being limited. This is because the disclosed value of the RAB will bear little or no relationship to the net present value of [CIAL's] expected future cash flows, and the usefulness of the disclosed RAB value will become more and more limited at future price setting events.

182 CIAL accepts that this change to its disclosure will improve transparency of its pricing method. Moreover, it is a reasonably straightforward calculation to derive the "return of capital" that is implied by CIAL's long term price path.[88] Under this

---

[86] CIAL Draft Report at para E53.

[87] CIAL Draft Report at para F35.

[88] The Commission correctly describes the calculation of these dollar-values in its footnote 140. As the formula the Commission spelled out suggests, the "return of capital" that is appropriate is the amount that was forecast over the relevant period – the use of forecasts in the calculation of "return of capital" amounts (albeit with adjustments to take account of the difference between forecast and actual inflation) results in the same allocation of demand and cost risk as the use of conventional depreciation methods (aside from a small change to the gains or losses where capex is lower or higher than forecast as this will now comprise only the avoided/additional return on assets and exclude any depreciation element). In turn, as the "return of capital" amounts are to be based upon

approach, CIAL's non-standard depreciation method could be summarised as follows:

182.1 First, derive from the long-term price path identified when setting PSE2 prices the (post tax) cash flows consistent with NPV=0 (CIAL's further proposals in this regard are outlined below).

182.2 Secondly, derive the implied annual "return of capital" that is consistent with that long term price path, and report these values (subject only to adjustment for differences between forecast and actual CPI) in the annual disclosures and use the same values to derive the opening RAB at the next review of prices.

182.3 Thirdly, as a cross-check on the above method, CIAL will demonstrate that if the implied return of capital values derived using this method are inserted as the depreciation component in a conventional building block calculation, building block revenue requirement amounts will be calculated that are identical to the revenue stream targeted by the long term price path. This step is not necessary for the calculation but will be undertaken to reinforce the transparency the Commission is looking for.

183 In this Appendix we describe how we will implement this depreciation approach in our disclosure reports and our model. We want to be transparent about the assumptions that need to be made when implementing such an approach, and to receive comments from our customers and the Commission on our proposal.

184 We cannot make that change in time for our 2013 annual disclosure report due on 30 November 2013, but we will follow that disclosure with a supplementary report for 2013 that uses a non-standard depreciation approach, having considered the feedback from our customers in cross submission and the Commission either prior to or as part of the Final Report.

Derivation of the annual implied return of capital (economic depreciation) amounts for disclosure in PSE2

Basic method

185 CIAL will apply the basic method that the Commission has described in words in footnote 140 to derive the "return of capital" (economic depreciation) values for PSE2 (as well as in future pricing periods). The "return of capital" will be calculated as:

Return of capital = revenue – opex – tax payable – return on assets

186 Simultaneously with this, the RAB will be updated annually as follows:

Closing RAB = opening RAB + capex – return of capital

187 The annual "return of capital" values for PSE2 will be calculated using the forecasts of all of the inputs set out above that were used to derive the PSE2 prices, except where modifications are required to implement the post tax WACC and tax payable approach. These annual "return of capital" values will then be "locked in" for the relevant pricing period, subject only being changed to reflect the difference between

forecasts, they can be derived and "locked in" when prices are determined for the pricing period in question.

forecasts and actual CPI inflation. These "locked in" "return of capital" values will then be:

187.1 Reported annually as "depreciation" in the annual disclosures, and

187.2 Used to update the RAB at the commencement of PSE3 (and subsequent pricing periods).[89]

188 Consistent with the Commission's preferences, these calculations will make the following assumptions about the timing of cash flows within each year:[90]

188.1 Revenue is received at the end of each year

188.2 Operating expenditure and taxation are paid at the end of each year, and

188.3 Capital expenditure is incurred at the midpoint of each year (except for the first year – which is a period of 7 months – in which it will be assumed that the expenditure is incurred at the end of the year).

Implications for the treatment of taxation

189 CIAL will undertake the calculations above using a post tax WACC and using "tax payable" as the cost of tax that is assumed in the analysis. An implication of this is that any additional compensation for taxation above tax payable that was implicit in CIAL's use of a pre tax WACC in developing the levelised price path will be treated as additional economic depreciation, and thereby deducted from the opening RAB at the commencement of PSE3.

190 The treatment of taxation in this manner has the effect of applying a post tax WACC (and tax payable) approach to PSE2. We have considered the possibility of transition issues and believe our approach will be appropriate and fair to all parties. In particular:

190.1 Under a pre tax WACC, there is an implicit over-compensation for taxation in the levelised price path for the early years of an asset's life that is offset by under-compensation for taxation later in the asset's life (although it is acknowledged that views differ between CIAL and the Commission as to whether this offsetting is perfect).

190.2 However, in view of CIAL's proposal to switch to a post tax WACC (and tax payable) approach for future pricing periods, it is inappropriate for CIAL to retain any over-compensation for taxation in PSE2.

190.3 Indeed, if we are correct that our treatment of taxation would compensate CIAL fairly in NPV terms, then including the over-compensation for taxation in PSE2 implicit in a move from pre tax to post tax part way through a long-run price path as additional "return of capital" will offset the additional taxation liabilities that CIAL will be entitled to recover through prices in future periods on a post tax basis. Alternatively, if the Commission is correct that a pre tax WACC would overcompensate for taxation over the life of the asset, then

[89] For the avoidance of doubt, the RAB will be updated to reflect actual capital expenditure, and thereby factor in any difference between what was forecast and the capital expenditure that actually occurred.

[90] CIAL Draft Report at para F68.

including this over-recovery of tax payable in PSE2 in the calculated "return of capital" should resolve the Commission's concerns in relation to tax.

How will the RAB be determined at the commencement of PSE3?

191 As noted above, the RAB at the commencement of PSE3 and future pricing periods (with the formulae appropriately amended) will be calculated as:

$$\text{Opening RAB}_{PSE2} + \text{Capex}_{PSE2} - \text{Return of capital}_{PSE2}$$

192 The "Opening RAB" will be the figure that was disclosed in the previous pricing decision, and the "Return of capital" values will be those that in the future will be disclosed in a pricing decision (but will be disclosed through this process). The "Capex" values will reflect actual capital expenditure over the course of PSE2.

Treatment of the under-recovery that is forecast for PSE2

193 CIAL has set prices for the first part of PSE2 that are below the long term levelised price, and has said that it will bear this under-recovery. CIAL reaffirms its commitment to bear this amount as a permanent under-recovery.

194 In terms of the calculations described in this Appendix, CIAL will give effect to this commitment by calculating the "return of capital" values by using the forecast of revenue that assumed that the long term levelised prices were charged, rather than the actual prices. This will imply that the shortfall in revenue recovered will show up as additional return of capital (compared to the return of capital that would have been calculated using actual prices), with this additional return of capital resulting in a lower RAB at the end of PSE2 than otherwise. The effect of this is that the under-recovery would be borne permanently by CIAL.

Resetting of the price path for PSE3

195 CIAL also appreciates the Commission's concern for greater transparency as to how CIAL intends to reset the long term price path for PSE3 and subsequent periods. We are keen to discuss this with our customers, and appreciate the opportunity for feedback that the current process will provide.

196 The method that CIAL applied to generate the long term levelised price path applicable to PSE2, in broad terms, was to find a series of levelised price paths that were forecast to generate cash flows with an NPV=0 outcome over the 20 year period. Operating expenses and demand was forecast over the period, and capital expenditure forecast for PSE2 was included in the calculation, and the forecast RAB at the end of year 20 (calculated using conventional straight line depreciation with inflation indexation) was the effective residual value. CIAL undertook and presented its calculations by first calculating the conventional "building block" revenue requirement and then smoothed this revenue stream (in NPV terms) given the familiarity of users with building block calculations.

197 When resetting the price path in PSE3, CIAL will first update the RAB to reflect actual capital expenditure in PSE2 and the implied "return of capital" that is calculated using the method described above. Thus, the method for deriving the opening RAB is transparent. CIAL will then produce updated forecasts of future expenditure as well as a revised estimate of the WACC (or WACCs) and use these updated assumptions to revise the long term price path as necessary. However, in order to calculate that new long term price path, a number of methodological choices need to be made, namely:

197.1 the term of the new long term price path, how the residual value of assets at the end of the long term price path will be calculated and, as a subset of this, the period over which the under-recovery element of the RAB at the end of PSE2 should be recovered;

197.2 how the WACC should be determined for the purpose of both setting the long term price path and for determining the implied "return of capital" for PSE3; and

197.3 how CIAL's computations should be amended in order to implement fully a post tax WACC and tax payable approach.

198 While CIAL has considered these matters already and reached preliminary conclusions, it appreciates the opportunity provided by the Commission's current process to receive early feedback on these matters (CIAL's intention was to consult fully with customers on these matters when reviewing prices for PSE3; however, earlier dialogue is welcomed).

Term of the new long term price path

199 When CIAL resets the long term price path for PSE3 it proposes to do so by again undertaking calculations of costs and revenue over a 20 year period. In this manner, as we progress from price reset to price reset the long term price path will be the outcome of a series of overlapping 20 year periods.

Calculation of the residual value at the end of the 20 year modelling period

200 The residual values at the end of year 20 that were adopted when setting prices for PSE2 were, in effect, the projected straight line inflation indexed values as at that date. This recognised that many assets would have a remaining life after that date. CIAL intends again to calculate the residual values of its assets at the end of the 20 year price path with reference to a conventional straight line depreciation calculation.

201 An implication of the discussion in the previous paragraph is that CIAL will maintain a conventional calculation of straight line inflation indexed depreciation of its assets in order to facilitate calculation of the residual values for those assets at the end of the 20 year period. Clearly, however, the written down value of the assets that will be calculated at the end of PSE2 using this method will not comprise the whole of the RAB – rather, there will be a further component that reflects the difference in the return of capital that is assumed under a straight line depreciation calculation and the return of capital that CIAL actually received under its long term price path. This residual is referred to here as the "PSE2 residual RAB". As the "return of capital" for PSE2 – and hence the magnitude of the "PSE2 residual RAB" – was the product of an NPV calculation over 20 years, the "PSE2 residual RAB" will be recovered over the remaining period of that 20 years (i.e., 15 years at the start of PSE3, 10 years at the start of PSE4, etc.).

202 As a technical matter, CIAL will compute the "straight line depreciation RAB" and "PSE2 residual RAB" for each of its service categories in order to facilitate the current segmentation of costs that is undertaken for pricing purposes.

WACC applied to determine the long term price and to calculate the implied return of capital

203 Under the method described in this appendix for the setting and resetting of the long term price path, estimates of the WACC are used for two different roles that may require different values, namely:

203.1 *To set the level of the long run price path* – which requires a WACC assumption that is representative of the whole of the 20 year period over which the long term price path is determined, and

203.2 *To derive the implied "return of capital" for the immediately forthcoming pricing period (which is then used to determine the closing RAB at the end of the period)* – which requires the use of the best estimate of the WACC for that forthcoming pricing period.

204 Of these WACC estimates, the second should be of the most importance to the Commission and customers. That is, if the WACC estimate for the forthcoming period is overstated and CIAL sets prices at the corresponding level, then CIAL will make excess returns. In contrast, the role of the long term WACC, in effect, is just to derive the implied "return of capital" for the forthcoming pricing period. To the extent that estimate of the long term WACC proves to be too high then the implied "return of capital" would be higher than necessary in the forthcoming pricing period to achieve levelised prices. Thus, pricing in that period would have been higher than necessary to achieve levelised prices, but correspondingly lower (with interest) in later periods.

205 As discussed more fully in Appendix F, the WACC that CIAL used in its pricing decision, in its view, achieved both of these objectives. That is, CIAL argued (and in our continuing view, correctly) that at the time we were consulting on our pricing proposal the best estimate of the WACC for PSE2 would be obtained by using a risk free rate that reflects normal market conditions, rather than using the then abnormally low yields on government bonds. A consequence of using a "normal market WACC" for PSE2, however, was that this figure was also considered to be representative of the 20 year period.

206 In contrast, the Commission has argued that the best estimate of the WACC for PSE2 would have been obtained by using an estimate of the risk free spot rate (with no compensating adjustments to any other parameter) with a term to maturity that matched the term of the pricing period. However, the Commission has also applied the same WACC estimate for PSE3, 4 and 5 (that is, the full 20 year period).

207 During its consultations on the price review for PSE3 CIAL will reconsider its views on whether the use of a risk free spot rate at the time would be likely to produce an accurate estimate of the WACC for PSE3. As addressed more fully in Appendix F, however, if CIAL does use the risk free spot rate when estimating the WACC for PSE3, it may not be appropriate to also apply the PSE3 WACC to the future periods (as discussed in Appendix F, the PSE2 WACC clearly is <u>not</u> an appropriate assumption for future periods). Rather, what is required is a forecast of the WACC (and, most importantly, the risk free rate element) that is appropriate for those future periods. This outcome, in turn, could be achieved by either:

207.1 Estimating any 20-year NPV using an estimate of the risk free "spot" rate for a term to maturity of 20 years, or

207.2 Using a different WACC assumption for each pricing period, namely a forecast of the WACC estimate that would be derived for the pricing period in question. If the WACC is to be set with reference to risk free spot rates, this would require a forecast of the risk free spot rate at the commencement of each pricing period.

208 In relation to the review of prices for PSE3, if we revert to using spot rates then CIAL's current preference would be the latter method (i.e. an estimate for each pricing period during the 20 year term) because of the comparative difficulties of deriving a WACC estimate for a full 20 year period (the longest dated NZ Government Security at the time CIAL finalised its pricing proposal was approximately 11 years).

209 While forecasting a series of five year government interest rates out to 20 years also is not a straightforward activity, a reasonable assumption may be that government interest rates move over the long term up or down to their historical long term average values. In addition, long term forecasts of government interest rates are prepared by the NZ Treasury as guidance for accounting valuation purposes that could be referred to. As observed in Appendix F, both of these sources were consistent with an assumed long term forecast for NZ Government bond rates of 6 per cent at the time that CIAL finalised its pricing proposal.

Calculation of the new long price path: fully implementing a post tax / tax payable approach

210 On the question of how we will model the long-term price path at the 2017 reset, and the resets thereafter, we need to make changes to reflect the move to a post tax WACC and the use of non-standard depreciation. The key issue is that as revenue is smoothed out, the NPV of tax payments will also change, for which a correction is required.

211 One means of ensuring that the tax implications of revenue smoothing are properly incorporated while preserving the two step nature of our current modelling approach (namely, first do a building block calculation to derive allowed revenue and then to smooth the revenue in NPV terms) is to alter the smoothing equation. Rather than finding the smoothed prices that will preserve the NPV of the *revenue*, the smoothed prices instead would be selected to deliver the same NPV of *after tax cash flows*. The taxation payments would be recalculated to reflect the changed profile of revenue, but other elements of cash flow would remain unchanged.[91] In practice, a goal seek will need to be undertaken to find the starting prices satisfy the NPV objective. This is the same algorithm that has been used by at least one Australian regulator when fitting a smoothed price cap to a series of building block annual revenue requirements.

212 An alternative approach would be to dispense with the initial application of a building block calculation and instead to calculate the smoothed price paths directly in a present value framework. Under this calculation, the opening and closing RABs for the 20 year period would be the opening and closing RAB as discussed above, and the forecasts of cash flows and demand would be the same as would be assumed under CIAL's current approach. A "goal seek" would then be undertaken to find the series of starting prices that are level in real terms and result in an NPV=0. Provided that the same assumptions were adopted about the quantum and timing of

[91] If a post tax WACC is used, then no other inputs into the calculations would need to change. If the vanilla WACC was used, the assumed interest deduction would also change in line with the change to the implied RAB at any point in time as revenue is smoothed.

cash flow, this alternative calculation would deliver identical results to the modification to CIAL's current approach discussed above.

213 We are interested in the views of our customers and the Commission on each of the approaches outlined above.

APPENDIX B - IS INFORMATION DISCLOSURE PROMOTING APPROPRIATE INNOVATION AT CHRISTCHURCH AIRPORT?

Key points

215 We agree with the Commission's draft conclusion that CIAL is delivering and facilitating an appropriate level of innovation. This view is endorsed by our airline customers and reflects our motivation to continuously improve the airport for the benefit of our various stakeholders.

216 We also agree that information disclosure is effectively promoting incentives to innovate at CIAL and we think that the Final Report should acknowledge the effect that transparency of innovation levels will have on incentives to innovate going forward.

Innovation levels are appropriate

Levels of innovation

217 We agree with the Commission's draft conclusion that CIAL has innovated appropriately in the past and continues to innovate appropriately.[92]

218 In support of this conclusion, the Draft Report states that the airlines have not raised any concerns with the level of innovation at CIAL and acknowledges BARNZ's view that CIAL is more innovative than other New Zealand airports, with the exception of AIAL.[93]

219 Submissions on the Commission's Process and Issues Paper for CIAL made a number of positive endorsements of CIAL's levels of innovation. For example:

219.1 BARNZ recognised CIAL's modern construction techniques, automatic security doors, modern swing gates, modern baggage handling system, and our forecast innovation activities (including the installation of ground power units and pre-conditioned air at the departure gates, and the installation of a MARS gate);[94] and

219.2 we documented a broad range of innovation activities at CIAL, relating to our Integrated Terminal infrastructure (such as our common use check-in hall) and our general airport operations. We also noted the fact that we are the first airport to be awarded carbon zero certification in the Southern Hemisphere. [95]

Facilitation of innovation

220 We agree with the Commission's draft conclusion that CIAL has facilitated innovation.[96]

221 In support of this conclusion, the Draft Report states that the airlines consider that CIAL is "receptive to airline-led innovation".[97] While this is a positive

---

[92] CIAL Draft Report at para B11.

[93] CIAL Draft Report at para B11.

[94] BARNZ "Responses to Commerce Commission Section 56G Issues Paper relating to Christchurch Airport" (22 March 2013) at pg 24.

[95] See CIAL "Commerce Commission Section 56G Review Process and Issues Paper" (22 March 2013) at pgs 43 – 46.

[96] CIAL Draft Report at para B12.

[97] CIAL Draft Report at para B12.

acknowledgement, the Final Report should reflect the particularly strong endorsement CIAL received about its receptivity to airline-led innovation. For example:

221.1 BARNZ described CIAL as:[98]

> … very responsive and receptive to airline led innovation. Airport management were described as being solutions focussed and flexible. Unsolicited positive comment was made of [CIAL's] willingness to engage when compared with other airports which [operational] staff had dealings with.

221.2 Air New Zealand specifically referenced CIAL's willingness to facilitate the introduction of ground power units.[99]

Information disclosure is effective

222 As the submissions from our customers show, CIAL has a very good track record in delivering and facilitating innovation. From this starting point, the role of information disclosure is to provide increased transparency, and so a greater incentive, to maintain good standards. As we noted in our submission on the Process and Issues Paper for CIAL:[100]

> As the drive for innovation has been a continuing ethos of the company for many years there has been no change in such activity post information disclosure, however the introduction of information disclosure regulation has improved transparency of the level of innovation. This has communicated our initiatives and outcomes to a wide range of customers and stakeholders.

223 We disagree with the Commission's view that information disclosure places "relatively weak" incentives on CIAL to innovate appropriately[101] and that information disclosure is not expected to have a "material impact" on innovation.[102]

224 Similarly, by suggesting that information disclosure "does not appear to have had an additional impact on incentives to innovate" beyond CIAL's commercial considerations,[103] we think that the Commission has placed an unnecessary caveat on its conclusion that information disclosure regulation is effectively promoting innovation at CIAL.

225 The starting point here is that the Draft Report concludes our innovation behaviour was good both before and after the introduction of information disclosure regulation. The same conclusion was made in relation to WIAL and AIAL. In these circumstances, as the Commission pointed out in the Draft Report:[104]

---

98 BARNZ "Responses to Commerce Commission Section 56G Issues Paper relating to Christchurch Airport" (22 March 2013) at pg 25.

99 Air New Zealand "Submission to the Commerce Commission – Section 56G Review of Christchurch International Airport" (22 March 2013).

100 CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 47.

101 CIAL Draft Report at para B7.

102 CIAL Draft Report at para B3.

103 CIAL Draft Report at para 3.5.1.

104 CIAL Draft Report at para B3 (also stated in the WIAL Final Report at para B3 and the AIAL Final Report at para B3).

> … where a supplier is already innovating appropriately, we would not expect information disclosure to have any material impact on innovation.

226 As that passage from the Draft Report indicates, *behaviour change* is not expected from CIAL. But this is not evidence for the suggestion that our *incentives* to innovate have not been strengthened by information disclosure.

227 Nevertheless the Draft Report includes a caveat in relation to CIAL that the Commission did not include in its overview sections for WIAL and AIAL,[105] that information disclosure "does not appear to have had an additional impact on [CIAL's] incentives to innovate".[106] The only support given in the Draft Report for this caveat is a footnote reference to a CIAL submission.[107]

228 The full text of that submission is informative. The material referred to responds to the question in the Commission's Process and Issues Paper for CIAL "How does the level of innovation at [CIAL] compare now to prior to the introduction of information disclosure regulation?" In our response to that question we said:[108]

> As the drive for innovation has been a continuing ethos of the company for many years there has been no change in such activity post information disclosure, however the introduction of information disclosure regulation has improved transparency of the level of innovation. This has communicated our initiatives and outcomes to a wide range of customers and stakeholders.
>
> CIAL considers its level of innovation is appropriate for its location and its position as the gateway to Canterbury and the South Island. We believe this is demonstrated through strong performance driven by a focus on ensuring that all staff and participants across the airport focus on service excellence and the identification and development of innovative and leading practices to continually improve the airport experience. CIAL has gained recognition for its innovative approach to sustainability, and was the first airport to be awarded carbon zero certification in the Southern Hemisphere (CIAL has continued to be accredited since that initial achievement).

229 That submission does not support the caveat in the Draft Report. In response to the Commission's question we noted innovation behaviour has remained appropriate but our incentives have improved. As suggested above, the information disclosure regime will influence innovation in the way that it materially increases transparency. For example, customers are able to scrutinise the effect that major capex has on price. The information disclosure regime has also operated to inform market participants of tangible positive airport behaviour and innovative developments which otherwise might not have been widely known.

230 The way that the information disclosure regime informs market participants of innovative developments was noted in the AIAL Final Report as follows:[109]

---

[105] AIAL Final Report at para 3.5.1; WIAL Final Report at para 3.5.1.

[106] CIAL Draft Report at para 3.5.1.

[107] CIAL Draft Report at footnote 42, referring to CIAL"Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 47.

[108] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 47.

[109] AIAL Final Report at para B5.

> [AIAL] has suggested that its innovation activities are driven by core business drivers rather than information disclosure regulation under Part 4. It has however noted that information disclosure has resulted in greater transparency around the outcomes of its innovations.

231 The question of "additional impact on incentives to innovate" was not raised in the overview sections of the reports on AIAL or WIAL,[110] despite the same substantive finding in each of the reports that levels of innovation at the airport were good and therefore that a material change was not expected.[111]

232 Following the Commission's approach for AIAL and WIAL, a consistent treatment for CIAL would be as follows:

232.1 CIAL is already innovating appropriately;

232.2 no material impact on innovation behaviour is expected;

232.3 information disclosure has strengthened incentives to innovate;

232.4 information disclosure is effectively promoting incentives to innovate at CIAL.

233 Transparency as to both our levels of innovation over time, and the innovation activities of other airports, will be a powerful incentive for CIAL to continue to innovate at competitive levels.

---

[110] AIAL Final Report at para 3.5.1; WIAL Final Report at para 3.5.1.

[111] AIAL Final Report at para B3; WIAL Final Report at para B3; CIAL Draft Report at para B3.

APPENDIX C –IS INFORMATION DISCLOSURE PROMOTING SERVICES AT THE QUALITY CONSUMERS DEMAND AT CHRISTCHURCH AIRPORT?

Key points

234 We agree with the Commission's draft conclusion that quality standards at CIAL are high and reflect consumer demands. This includes the Commission's positive endorsements of:[112]

234.1 passengers' levels of satisfaction with CIAL;

234.2 the quality of service experienced by our customers;

234.3 our facilitation of service improvements for services provided by our customers; and

234.4 our endeavours to ensure that quality levels appropriately reflect consumer demands.

235 We agree with the Commission's draft conclusion that information disclosure regulation is effective at incentivising airports to provide services at a quality that reflects consumer demand, including the Commission's observations that:

235.1 these incentives will have an observable impact over time, as information disclosure highlights areas for improvement and investment, and operational changes are made in response;

235.2 there are no issues with the CIAL's transparency regarding its service quality levels; and

235.3 given the recent commissioning of CIAL's new Integrated Terminal, which has resulted in a step change in the quality of service, the Commission would not expect information disclosure regulation to have an additional impact on quality at CIAL at this time.

236 We think that is a fair assessment. But we disagree with several of the Commission's caveats regarding the effectiveness of information disclosure on service quality at Christchurch Airport. The transparency provided by information disclosure about our quality levels and our processes has imposed, and will continue to impose, a discipline on quality issues that did not exist prior to information disclosure regulation.

Service quality levels are appropriate

Passenger satisfaction

237 The Draft Report acknowledges that CIAL scores highly on the ASQ quarterly passenger survey, which shows amongst other things that passenger satisfaction at CIAL has increased in recent years as a result of the new terminal and ranks very positively when compared with the range of Australasian airports.[113] CIAL has used the ASQ survey to assess passenger satisfaction levels since 2007, prior to the introduction of the information disclosure regime.

---

[112] CIAL Draft Report at para C4.

[113] CIAL Draft Report at para C20.

238 In addition to doing the ASQ survey (and often on the basis of the survey results), CIAL also undertakes a range of further detailed studies that involve benchmarking and monitoring of particular services. These studies determine where operational improvements are required and ensure that our passenger service levels are consistently high. [114] The positive and practical results of these studies are reflected in the number of awards that CIAL has received for its passenger service performance in recent years, including the following:[115]

238.1 Travel Digest Industry Awards 2012 – "The International Airport of the Year"

238.2 Future Travel Experience Awards 2011 – "Best Arrivals Experience"

238.3 New Zealand Airports Association Airport of the Year Award for 2010

Consumer demands

239 We support the Commission's findings that CIAL:

239.1 has a low number and duration of interruptions for many services, relative to AIAL and WIAL.[116] We note that the interruptions to our baggage handling services in 2011 were mitigated by the new integrated baggage handling system which has reduced the number of baggage handling faults and will ensure the number of faults remains low;

239.2 utilises capacity in a way that reflects consumer demands;[117]

239.3 facilitates improvements in quality and efficiency for services provided by its consumers;[118] and

239.4 seeks to ensure that its service quality reflects consumer demands. [119]

240 Regarding the uncertainty expressed in the Draft Report about the impact of information disclosure regulation in this particular area, we note that CIAL has always sought to ensure its service quality reflects consumer demands through a range of forums, but we believe that that the transparency and structured framework provided by the information disclosure regime (whereby issues are disclosed, discussed and resolved) will ensure that CIAL will face strengthened incentives to provide services at the quality consumers demand.

Information disclosure is effective

241 We agree with the Commission's view that information disclosure regulation incentivises airports to provide services at a quality reflecting consumer demand, by providing transparency around the extent to which an airport engages with its consumers and implements consumer-driven operational improvements.[120]

---

[114] See CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 49.

[115] See CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 50.

[116] CIAL Draft Report at para C22.

[117] CIAL Draft Report at para C25.

[118] CIAL Draft Report at para C27.

[119] CIAL Draft Report at para C28.

[120] CIAL Draft Report at para C10.

242 We also agree that the effectiveness of information disclosure regulation in incentivising appropriate levels of service quality may improve over time, when service quality trends are more readily observable, and any necessary investments to improve identified service quality issues can be made.[121]

243 As the Commission has observed, the circumstances at CIAL include a good level of engagement with our customers on quality issues, a track record of responding to customer feedback, and high levels of quality, in part as a result of the new Integrated Terminal.

244 Where an airport is already providing a high quality of service, we would not expect information disclosure to have any material or discernible impact on *behaviour* as to quality. This is not evidence that information disclosure *incentives* are ineffective.

245 As CIAL's customers have confirmed, our quality of service is high.[122] No material change in the quality of service should be expected. As the Commission points out:[123]

> … the evidence available indicates [CIAL's] conduct in relation to service quality is appropriate, and that quality reflects consumer demands.

246 As noted in the Draft Report[124] and in our submissions, at this time a material driver of the quality outcomes is the commissioning of our new Integrated Terminal. The commissioning of this facility in May 2011 led to a noted improvement in service quality for our domestic customers and this has continued to be reinforced by our customers through the quarterly ASQ surveys.

247 Our good quality track record cannot be attributed solely to the new Integrated Terminal, however. By way of illustration, WIAL's improvements to its customer satisfaction surveys (a change partially attributed to the introduction of information disclosure)[125] were already present in CIAL's surveys. In the same way that no material impact is expected where suppliers are already innovating appropriately, the same can be said for suppliers who are already providing an appropriate and responsive quality of service.

248 The incentives created by the information disclosure regime operate despite CIAL not being able to point to specific instances of behaviour change at this time. For instance, as we explained in a previous submission:[126]

> The information disclosure regime has benefited CIAL and its customers by establishing a defined set of key performance indicators that are reported on to interested parties, and which motivates staff to achieve the required quality outcomes and to seek improvement across all business processes.

---

121 CIAL Draft Report at para C11.

122 CIAL Draft Report at para C4.

123 CIAL Draft Report at para C6.

124 CIAL Draft Report at para C7.

125 WIAL Final Report at para C4.3.

126 CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 48.

249 We were clear that immediate discussions of quality with our customers were primarily driven by the commissioning of the new terminal, but information disclosure nevertheless influenced and improved transparency:[127]

> … discussion during the PSE2 consultation was not directly influenced by information disclosure, but as with the overall information disclosure programme, it provided a framework on which information was disclosed.

250 For these reasons we agree with the following conclusion in the Draft Report:[128]

> [CIAL's] overall conduct in this area indicates it seeks to ensure quality reflects consumer demands and, based on the available information, the quality of service provided to passengers and airlines does generally reflect their demands. Given this, and that no concerns have been raised about the transparency of information about quality at [CIAL], our draft conclusion is that information disclosure is effective at [CIAL] at this time.

251 However the Draft Report goes on to caveat that conclusion in a number of ways. First, the Draft Report states that while there are no concerns about the transparency of information on service quality at CIAL, "it is not clear that this is a result of information disclosure".[129] The Draft Report includes this caveat despite recording that:[130]

> BARNZ anticipates the quality measures disclosed will inform regular engagement on service quality at [CIAL] …

252 The response in the Draft Report to this supportive feedback from our customers is "[i]t is not clear what information was previously provided to airlines and other consumers on service quality at [CIAL]".[131] However, as noted above, in a previous submission we informed the Commission:[132]

> Information disclosure has benefited CIAL and its customers by establishing a defined set of key performance indicators that are reported on to interested parties, and which motivates staff to achieve the required quality outcomes and to seek improvement across all business processes.

253 We can confirm the point made in that submission, that the information disclosure quality measures are new and do constructively add to the transparency and incentives around quality of service at CIAL. We also observe the different language adopted for AIAL where, despite the questions raised about the extent to which information disclosure impacted upon service quality at AIAL, the Commission determined that information disclosure *may* have had an impact on AIAL's conduct.[133]

---

[127] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 51.

[128] CIAL Draft Report at para C3.

[129] CIAL Draft Report at para C6.

[130] CIAL Draft Report at footnote 49.

[131] CIAL Draft Report at footnote 49.

[132] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 48.

[133] AIAL Final Report at para C5; see also CIAL Draft Report at para C7.

254 The second caveat in the Draft Report is that our good conduct and performance in relation to quality of service is "attributable to incentives other than information disclosure".[134] The Draft Report references submissions from our customers that, correctly, note the material impact of our new Integrated Terminal on recent quality levels.

255 However, just because there is an identifiable commercial driver for our good performance doesn't mean that information disclosure incentives aren't operating as well. The Draft Report correctly highlights the way that information disclosure incentives will operate on quality levels over time:[135]

> The public disclosure of information through information disclosure regulation can strengthen the incentives to provide services at a quality that reflects consumer demands, for example by requiring [CIAL] to disclose the process it has put in place for undertaking operational improvement forums.
>
> We expect it may take some time for information disclosure regulation to be as effective as it can be in promoting the provision of services at a quality that reflects consumer demands. Significant quality improvements highlighted as necessary by consumers through information disclosure regulation may require a long lead time to implement if investment is required. The availability of a longer time series of information on quality may improve its effectiveness, including during consultation at price setting events. Only limited information on quality was available through information disclosure at the time of consultation for PSE2."

256 CIAL supports this view. While commercial considerations are in play when assessing our recent behaviour, as we have noted in previous submissions and again above, information disclosure has added to the incentives to provide a high quality of service, and will continue to do so.

257 The third caveat in the Draft Report is a reference to a CIAL submission discussing the PSE2 consultation.[136] In response to the Commission's question as to the role that information disclosure played in consultations on quality in our PSE2 consultation, the Draft Report notes CIAL's observation that the quality discussion during the PSE2 consultation "was not directly influenced by information disclosure".[137]

258 However, the Draft Report does not record the context for this point, which is that quality of service is not separately consulted on during price setting events. For this reason, quality issues only arise indirectly. As we stated in our immediately preceding answer in the same submission:[138]

> Quality of service is not separately consulted on during price setting events and arises only to the extent it is relevant to the consultation process, particularly with respect to the development of the relative inputs into the building block revenue determination. This includes asset management, operating cost efficiency, and improvements in demand.

---

134 CIAL Draft Report at para C7; see also para C18.

135 CIAL Draft Report at paras C10–C11.

136 CIAL Draft Report at para C32.

137 CIAL Draft Report at para C32, referring to CIAL"Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 51.

138 CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 50.

259 In that regard, the Draft Report records that CIAL's consultation on quality is appropriate:[139]

> [CIAL's] consultation on quality appears appropriate.
>
> 30.1 [CIAL] engages with airlines on quality issues through a number of forums. These include the Airlines Working Group, Airside Safety Group, Facilitation Group and the Airlines Operating Committee.
>
> 30.2 Although quality is not explicitly consulted on as part of price setting events, [CIAL] did appear to engage effectively with airlines on the service requirements for the new terminal during PSE1. As a result, it agreed significant improvements to services in the new terminal with airlines. Air New Zealand notes that [CIAL] did not reflect all customer requirements in its design for the new terminal, and that this may result in some levels of services not being as requested by airlines. Airlines have not raised any major concerns with the resulting quality of service provided by the new terminal.

260 With that context, we think the full quote from our submission is more informative than the partial sentence quoted in the Draft Report. In response to the question regarding consultation on quality during the PSE2 consultations, having earlier made the point that quality is not separately consulted on, we stated:[140]

> Ensuring service quality is an on-going process, involving considerable interaction between CIAL, the airlines, and other parties that are dependent on [CIAL] (including airways, Customs, and MAF). CIAL management regularly reviews service performance and customer service standards and there are bodies through which such items are discussed with the airlines on an on-going basis – as explained in our information disclosure reports in 2011 and 2012.
>
> **Accordingly, discussion during the PSE2 consultation was not directly influenced by information disclosure, but as with the overall information disclosure programme, it provided a framework on which information was disclosed.** This included the provision of capital investment forecasts and passenger and aircraft demand forecasts for the 10 year period to 2022 – identifying the levels of investment required by category and the rationale and benefit behind such capital investment together with the 10 year profile of the type and number of passenger and aircraft movements.
>
> (Emphasis added)

261 This makes the point we have made consistently in our submissions to the Commission, that while our quality of service is good and acknowledged by our customers to be so, maintaining good quality is a process and we expect the transparency and framework provided by information disclosure to improve incentives going forward.

262 Following the Commission's approach for AIAL and WIAL, a consistent treatment for CIAL would be as follows:

[139] CIAL Draft Report at para C30.

[140] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2012) at pg 51.

262.1 CIAL is already providing services at a quality that reflects our consumer demands;

262.2 no material impact on service quality behaviour is expected;

262.3 information disclosure has added to the incentives to maintain appropriate quality standards;

262.4 information disclosure is effectively promoting incentives to provide services at a quality that reflects CIAL's consumer demands.

263 Information disclosure regulation will play a material role in keeping our performance and conduct standards up, as it has introduced a new level of transparency and discipline on quality issues.

APPENDIX D – IS INFORMATION DISCLOSURE PROMOTING PRICES THAT ARE EFFICIENT AT CHRISTCHURCH AIRPORT?

Key points

264 We agree with the Commission's draft conclusion that our new pricing methodology is likely to promote efficiency in PSE2. We also agree that our new pricing methodology is an improvement over the methodology we used in PSE1 and "likely to promote efficiency".[141]

265 We disagree with the Commission's draft conclusion that information disclosure has not been fully effective in promoting efficient pricing at CIAL, and in particular we disagree with:

265.1 the finding that our decision to change our pricing methodology in PSE2 was not influenced by the introduction of the information disclosure regime;[142] and

265.2 the characterisation of our engagement with our customers on the pricing methodology.[143]

CIAL's new pricing methodology promotes efficiency

266 We agree with the Commission's draft conclusion that our new pricing methodology promotes efficient pricing.[144] The following efficiency enhancing measures were included in our PSE2 pricing methodology:

266.1 mapping of prices against our long run levelised path, to ensure economic return over the lifecycle of the new Integrated Terminal and to avoid inter-period price shocks;

266.2 implementation of a transitional price in PSE2 rather than increasing our prices to the long-run levelised path straight away;

266.3 introduction of a fixed and variable airfield charge, in replacement of the single MCTOW charging structure;

266.4 implementation of a differential terminal services charge to reflect different aircraft types; and

266.5 adjustment of our passenger services charge to account for children.

267 We endorse the Commission's assessment of our pricing methodology in relation to the following efficient pricing principles:

267.1 Our prices are subsidy-free. Our PSE2 pricing methodology is unlikely to result in cross-subsidisation due to aspects such as the fixed departure charge per aircraft and the charges for children. We also agree that our PSE2 methodology is an improvement in terms of being subsidy free, relative to our PSE1 methodology.[145]

---

[141] CIAL Draft Report at para 3.7.

[142] CIAL Draft Report at para D8.

[143] CIAL Draft Report at para D6.

[144] CIAL Draft Report at paras D4–D5.

[145] CIAL Draft Report at paras D18–D19.

267.2 Any capacity constraints (such as at the gates for regional aircraft) will be managed by us through investment and operational changes, and our airline customers have not indicated that they would prefer these constraints to be addressed through our pricing structure.[146]

267.3 The price-quality trade-offs in our pricing methodology are appropriate, notably through our use of commercial arrangements with our airline customers.[147]

267.4 The development of our prices promotes appropriate price stability and certainty for stakeholders, in particular through our use of a levelised price (which is designed to avoid inter-period price shocks) and our openness to entering into longer term contracts with our customers, where possible. [148] We do, however, disagree with the Commission's criticism of the transparency with which our pricing methodology was developed,[149] which we address fully below in the section regarding our PSE2 consultation.

267.5 We have considered our consumers' demand responsiveness (e.g. by pricing below our levelised constant price (during PSE2), and by reducing our fixed turboprop aircraft charge per departure for smaller aircraft in response to Air NZ concerns). However, we disagree with the Commission's view that it is unclear whether our regard to consumer demand responsiveness has improved relative to PSE1.[150] We address this fully below in the section regarding our PSE2 consultation.

The caveats in the Draft Report

268 Despite the range of efficiency-enhancing measures that we introduced in our PSE2 pricing methodology, the Commission's draft conclusion is that information disclosure regulation "does not appear to have been as effective as we would have expected it to be at this point in time" in promoting efficient pricing at CIAL.[151]

269 This draft conclusion is based on the following two caveats regarding the effectiveness of information disclosure on our pricing efficiency:

269.1 the positive changes we made for PSE2 were not influenced by the incentives created by information disclosure.[152] The Draft Report states that the only indication we have provided that information disclosure has impacted on our pricing efficiency decisions is that information disclosure has provided a "cross-check" on our reasons; [153] and

269.2 with more constructive engagement with our customers even better changes may have been identified. [154] The Draft Report argues that information

[146] CIAL Draft Report at para D21.

[147] CIAL Draft Report at para D27.

[148] CIAL Draft Report at paras D30, D32.

[149] CIAL Draft Report at paras D30, D33.

[150] CIAL Draft Report at para D23.

[151] CIAL Draft Report at para D4.

[152] CIAL Draft Report at para 3.7.

[153] CIAL Draft Report at para D8.

[154] CIAL Draft Report at para 3.7.

disclosure regulation creates incentives for constructive engagement, and this suggested shortfall in constructive engagement is evidence that the incentives are not operating on CIAL.[155]

270 We address below why both of these caveats are incorrect and lacking in foundation.

The influence of information disclosure

271 We disagree with the Commission's following statement in the Draft Report:[156]

> [CIAL] has not indicated that the requirement to outline its pricing methodology in information disclosure had an impact on its decisions in this area [regarding pricing efficiency], other than to provide a cross-check on its reasons supporting the efficiency of its pricing decision.

272 This statement from the Draft Report references (in a footnote) a paragraph from our post-conference submission. The full text of the paragraph is informative:[157]

> *Price Setting Event Disclosure*: The Price Setting Event Disclosure has provided interested parties – including the Commission in its Sec 56G review – with detailed information about our pricing decisions. **Because we knew that this scrutiny would happen, we knew our decisions had to be credible.** The questions at conference on CIAL's pricing efficiency showed that the scrutiny was real, and we demonstrated that we had sound reasons supporting the efficiency of our pricing decisions. **ID made us double-check our reasoning**.
>
> (Emphases added)

273 By stating "[b]ecause we knew that this scrutiny would happen, we knew our decisions had to be credible", we were reiterating a point we've made repeatedly – that CIAL had the disciplines of information disclosure in mind when we made our pricing decision.

274 By stating that "ID made us double-check our reasoning", we were making a short-hand reference to the fact that information disclosure prompted us to revisit and reconsider the efficiency of our pricing methodology. This partial quote is not a basis for the Commission to conclude that information disclosure has been less effective than the Commission would have expected at this point in time.

275 We emphasised to our customers the influence of information disclosure in our final pricing decision for PSE2 (a copy of which was provided to the Commission). As noted in our final pricing decision:[158]

> The Commerce Commission's input methodologies (IMs) and the purpose of Part 4 of the Commerce Act have been an integral part of CIAL's deliberations for this pricing reset.
>
> … our starting point has been that the IMs are an important benchmark, representing as they do the Commission's view as to the most appropriate way to calculate a significant part of the costs of service for airports under Part 4 information disclosure.

155 CIAL Draft Report at para D6.

156 CIAL Draft Report at para D8; see also para 3.7.

157 CIAL "Post Conference Submission Section 56G Review" (19 June 2013) at para 22.9.

158 CIAL "Decision on the Reset of Aeronautical Charges for the period ending 30 June 2017" (24 October 2012) at pgs 5–9.

However, we would fail in our duty to our shareholders if we did not make our own assessment of the reasonable costs of owning and operating Christchurch International Airport. A key part of that assessment has been to consider the way the IMs calculate costs and the reasoning behind the IMs, and to form our view as to the true costs of owning and operating the airport. Because the IMs were deliberated over a long period with input from a number of parties and experts, CIAL considered them to be important element in assessing its efficient costs.

The table below shows a comparison of the way CIAL assessed costs against the input methodologies…

Our overall assessment is that our cost inputs are consistent with the asset valuation, tax and cost allocation IMs. Although we use the pre-tax WACC to estimate the benchmark levelised constant real price, we show later in this document that our revenue over the pricing period does not exceed the maximum allowable revenue based on the tax payable approach. Our analysis presented to the airlines as part of the Revised Pricing Proposal shows that there is no material difference between (i) our approach of using the pre-tax WACC to calculate the levelised constant real price and (ii) the calculation of the levelised constant real prices using the present value of tax payable over the life of the assets. For this reason, we consider our method of using the pre-tax WACC to estimate the levelised constant real price over the life of the assets is consistent with the tax IM.

In the one area where we have materially diverged from the IMs – WACC – we have explained in our Initial and Revised Pricing Proposal and later in this document our reasons for doing so.

One area where the IMs have clearly influenced our decision is in the valuation of CIAL's assets. CIAL has applied the asset valuation IM except for one particular departure in favour of the airlines. Although the IM does not require revaluations from the change in methodology to the 2009 RAB MVAU valuation to be treated as income, CIAL has decided to treat the revaluation gain as income. This is a $10.5m benefit to airlines.

CIAL believes that its charges will achieve outcomes consistent with the purpose of Part 4

CIAL believes that the charges it has set are consistent with the purpose of Part 4. As we noted above, the IMs are an important benchmark for a significant part of the costs of service for airports, but there is much more to setting prices than the costs represented by the input methodologies. CIAL needs to ensure that its forecasts of opex, capex and demand are accurate and take into account efficiencies, and also that the charges we set promote the efficient use of the airport, and reflect the requirement to achieve the required return on major infrastructure investment over the life of the asset.

Overall, CIAL believes that its charges will achieve outcomes consistent with the purpose of Part 4. While it is always CIAL's objective to provide airport services to its customers and the travelling public in a way that balances the needs of all stakeholders (with or without the incentives provided for by regulation), the circumstances produced by the Canterbury earthquakes have given this objective an added importance.

The table below explains how CIAL's pricing decision will achieve the outcomes in the purpose of Part 4.

(Emphasis added)

276 Further, throughout the section 56G process we have emphasised that the advent of information disclosure, including the input methodologies, was a key prompt for us in implementing a transparent efficiency basis for our pricing methodology. As noted in our submission on the Process and Issues Paper for CIAL: [159]

> For PSE2, CIAL applied a new and more efficient charging structure designed to ensure economic return over the lifecycle of the asset and to avoid price shocks between reset periods. New fixed and variable charges, which recognise that some of the costs of aeronautical services are fixed and independent of the weight of the aircraft (e.g. emergency fire services), were used. Our thinking was informed by the economic disciplines emphasised during the development of the input methodologies.

277 We took the view that the new Part 4 regime was going to require a more sophisticated approach to our pricing methodology. The development of input methodologies raised the expectations of our stakeholders that pricing would be more efficient, and the information disclosure regulations introduced the transparency that stakeholders could use to hold us to account in this area.

278 The change in pricing methodology was a direct response to this new regulatory environment and the incentives it created. Prior to this change, CIAL had used a single MCTOW charge for 12 years. In our first pricing decision under the new regulatory regime we changed our pricing methodology to better reflect well-known economic principles.

279 The Final Report should acknowledge the extent to which CIAL has indicated throughout its price consultation and the section 56G process that the advent of information disclosure has influenced the efficiency basis of our PSE2 pricing methodology. It is concerning that a statement to the contrary was included the Draft Report.

280 We have explained to the Commission that we made these changes to our pricing methodology to better reflect the economic principles of the new regulatory regime.[160] New regulation was introduced requiring disclosure of our pricing methodology and the reasons for it, and new input methodologies that emphasise economic efficiency were developed and published to support information disclosure. In response CIAL, in its first post-regulation pricing decision, changed its pricing methodology to better reflect economic principles. This included a change to the pricing structure for airfield charges that we had used for at least 12 years. We don't understand the argument in the Draft Report that this is not evidence of CIAL responding to the incentives created by the new information disclosure regulation.[161]

281 As we note in the section of this submission discussing the effectiveness of information disclosure, CIAL's position with respect to the impact of information disclosure on its pricing efficiency is effectively the same as that described in WIAL and AIAL's respective Final Reports.[162]

---

[159] CIAL "Commerce Commission Section 56G Review Process and Issues Paper" (22 March 2013) at pg 60.

[160] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pg 60.

[161] We refer to the Commission's statements at CIAL Draft Report at para 3.7.

[162] WIAL Final Report at para D6; AIAL Final Report at para D6.

282 We submit the key points are as follows:

282.1 CIAL changed its pricing methodology from PSE1 to PSE2;

282.2 the change to the pricing methodology promoted efficiency;

282.3 the incentives to price efficiently were clearly operating at the time pricing decisions were made, and will continue to operate going forward;

282.4 the change to the pricing methodology was influenced by the information disclosure regime.

Our customer engagement

283 We disagree with the Commission's draft assessment that our engagement with our customers fell short of what would be expected in an effective information disclosure environment.[163]

284 We also disagree with the corresponding conclusion in the Draft Report that there is "no evidence to suggest that [CIAL's] conduct in this area has improved since PSE1".[164]

285 The Draft Report suggests that with more constructive engagement with our customers, even better changes to our pricing methodology may have been identified.[165] The Draft Report argues that information disclosure regulation creates incentives for constructive engagement, and the suggested shortfall in constructive engagement at CIAL is evidence that the incentives are not operating on CIAL.[166]

286 This draft assessment appears to be based on statements by our customers to the Commission that we did not engage with them on specific issues when finalising our pricing structure. We discuss these concerns below, including by providing evidence that we did constructively engage with our customers and that this was an improvement on PSE1 conduct.

Our consultation process

287 We began the PSE2 pricing consultation with the release of our proposed consultation process on 12 March 2012, and concluded the consultation with the release of our final pricing decision on 24 October 2012.

288 The first phase of the pricing consultation involved the release of our initial pricing proposal - with subsequent consultation, and the second phase involved the release of our revised pricing proposal - with subsequent consultation.

289 Below is a summary of our pricing consultation process in its entirety, illustrating the generous consultation period that we provided to our substantial customers, and the thorough consultation process that we undertook with those customers:

---

[163] CIAL Draft Report at paras D6–D7, D34.

[164] CIAL Draft Report at para D38.

[165] CIAL Draft Report at para 3.7.

[166] CIAL Draft Report at para D6.

Summary of Pricing Consultation Process		
Item	**Description**	**Date**
1.	Letter to Airlines outlining the proposed Consultation Process	2 March 2012
2.	Submission of Pricing Proposal and Supporting Information to Airlines	12 March 2012
3.	Briefing session to Airline representatives and BARNZ in Christchurch	20 March 2012
4.	Receipt of summary of questions and points of clarification from BARNZ	22 March 2012
5.	Circulation of the summary of questions received to all airlines/BARNZ for information	23 March 2012
6.	Summary of all questions received and responses to the questions and updated pricing model circulated to airlines/BARNZ	16 April 2012
7.	Further update on questions received and responses circulated to airlines/BARNZ	24 April 2012
8.	Circulation of 20 March briefing to airline/BARNZ representatives circulated to all airlines	24 April 2012
9.	Circulation of Summary of Asset movements and relevant categories for the 2008-2012 Period circulated to airlines/BARNZ	10 May 2012
10.	Circulation of the Deferred Value Account Concept to airlines/BARNZ for their consideration	11 May 2012
11.	Circulation of an updated copy of the pricing model, having taken account of the points raised/queried by Airlines and BARNZ	17 May 2012
12.	Receipt of Response from Qantas on its assessment of CIAL's Initial Pricing proposal	17 May 2012
13.	In support of the DVA concept paper a more specific example was circulated to airlines/BARNZ outlining the concepts in response to a request from one airline	23 May 2012
14.	Receipt of Response from BARNZ on its assessment of CIAL's Initial Pricing proposal and on behalf of the airlines it represents	25 May 2012
15.	Receipt of Response from Jetstar on its assessment of CIAL's Initial Pricing proposal	27 May 2012
16.	Receipt of Response from BARNZ on CIAL's Land Valuation reports	29 May 2012
17.	Receipt of Response from BARNZ (and on behalf of the airlines it represents) on CIAL's Proposed DVA Concept	31 May 2012
18.	Submission of Revised Pricing Proposal and Supporting Information to Airlines, following detailed consideration of their initial responses	1 August 2012
19.	Briefing session to airline representatives and BARNZ in Auckland on the revised pricing proposal	23 August 2012
20.	Submission from Air NZ on the Revised Pricing proposal	4 September 2012
21.	Receipt of Response from BARNZ on its assessment of CIAL's Revised Pricing proposal	7 September 2012
22.	Receipt of BARNZ assessment of the worked example of the tax treatment of revaluations with a gross WACC	11 September 2012
23.	Receipt of Response from BARNZ on its assessment of CIAL's Revised Pricing proposal on behalf of the airlines it represents	12 September 2009
24.	Receipt of Response from Jetstar on behalf of the Qantas Group on its assessment of CIAL's Revised Pricing proposal	21 September 2012
25.	Final Pricing Decision	24 October 2012
Note – This summary excludes verbal communication and discrete letters between CIAL and Airlines/BARNZ on a range of issues over the consultation process		

The quality of our consultation process

290 Where our customers raised points that related to the proposed new price structure, we engaged with those concerns. Indeed, the quality of our PSE2 pricing consultation is reflected in the positive endorsements that we've received from our customers, and in the marked departure of our final pricing decision from our initial pricing proposal in several, key respects.

291 Both Qantas and Jetstar acknowledged the level of transparency that we provided throughout the consultation,[167] and Qantas specifically endorsed the detail that we provided in our pricing model.[168]

292 Further, the following changes were all incorporated into our final pricing decision as a direct result of feedback we received from our airline customers during PSE2 consultation:

292.1 removal of Deferred Value Account (DVA) concept in response to opposition from the airlines. Our initial pricing proposal was predicated on a slow start to the required price adjustment, with the under-recovery to be carried over for recovery in subsequent periods through the DVA concept. This approach involved risks for CIAL, and required an acknowledgement by the airlines of the DVA concept before CIAL was willing to provide this beneficial transition price path. We engaged comprehensively with the airlines on the DVA concept, including by providing an explanatory report, but we ultimately abandoned the concept after strong opposition from the airlines;

292.2 reduced the fixed airfield charge for aircraft under 20 tonnes by 50%, in response to concerns raised by Air New Zealand;

292.3 updated our demand forecasts, based on revised information from Air New Zealand and incorporation of the actual results for the year ending 30 June 2012; and

292.4 indicated our willingness going forward to consider a volume-risk-sharing mechanism with the airlines, where prices would be revised annually based on updated volume forecasts, in response to a suggestion by Air New Zealand.

293 In PSE1 we simply increased the overall airfield charge by a straight percentage. In addition to the changes identified above, all directly resulting from our engagement with customers throughout the PSE2 pricing consultation, our conduct in relation to the PSE2 methodology is an improvement on PSE1 in the following respects:

293.1 we addressed airline concerns on aircraft reconfiguration data used to compile pricing – an issue raised by the airlines in PSE1;

---

167 Letter from Fiona Leishman (Senior Procurement Executive – Aviation Charges, Qantas) to Neil Cochrane (General Manager Business Services, CIAL) regarding CIAL's proposed reset of aeronautical charges for the period ending 30 June 2017 (17 May 2012); Letter from Tim Castine (Manager Aviation Charges, Jetstar) to Neil Cochrane (General Manager Business Services, CIAL) regarding CIAL proposal for the Reset of Aeronautical Charges for the period ending 30 June 2017 (27 May 2012) at pg 1.

168 Letter from Fiona Leishman (Senior Procurement Executive – Aviation Charges, Qantas) to Neil Cochrane (General Manager Business Services, CIAL) regarding CIAL's proposed reset of aeronautical charges for the period ending 30 June 2017 (17 May 2012).

293.2 we offered airlines the option to move to a per passenger (versus the present per seat basis) on aircraft capacity – the status quo was endorsed by Air NZ particularly;

293.3 we implemented a differential basis for domestic terminal revenue recovery (Jet v Turbo) recognising that Air New Zealand had a separate commercial arrangement for the Regional lounge to support Turboprop services; and

293.4 we implemented a passenger service charge on children, a revenue source to mitigate costs on the airlines.

294 It follows that we disagree with the Commission's draft conclusion that there is no evidence to suggest that our conduct in seeking to improve our pricing efficiency has improved since PSE1.[169]

295 Following consultation, a residual area of disagreement remaining between us and our substantial customers concerned the details of the fixed/variable airfield charge. Our substantial customers had conflicting views regarding the application of the charge. In addition, Freightways expressed concern at conference about the application of airfield charges to freight operators.

296 The Commission acknowledges that our price setting process is "not intended to address the concerns of all its consumers".[170] However the Draft Report refers to the residual disagreement, largely expressed at conference, regarding the airfield charges as evidence that information disclosure could have been more effective at CIAL. To the contrary, comprehensive engagement with airlines and freight operators has been undertaken on the airfield charge, which we illustrate below.

Engagement with substantial customers on fixed/variable airfield charges

297 The Commission acknowledges that the introduction of the fixed/variable charge was an efficiency-enhancing step taken by CIAL in PSE2,[171] but in support of its draft conclusion that information disclosure could have been more effective in relation to our pricing efficiency, the Commission references the airlines' apparent "confusion" around the purpose for the fixed charge, and the airlines' concerns about our engagement in relation to the new fixed/variable charge.

298 We take this opportunity to:

298.1 demonstrate that the purpose of the fixed/variable charge was made very clear to the airlines throughout PSE2 consultation, and in particular it was clear that the purpose was never grounded in addressing congestion issues; and

298.2 illustrate that our engagement with the airlines around the fixed/variable charge was comprehensive and constructive.

We were clear about the purpose of the fixed/variable charge

299 The Draft Report states that:

[169] CIAL Draft Report at para D38.

[170] CIAL Draft Report at para D37.

[171] CIAL Draft Report at paras D18–D19.

> … there appears to be some confusion from airlines on the purpose of specific changes to the pricing methodology (even during consultation on this section 56G review)..

300 We assume that the supposed confusion from airlines relates to the purpose underlying the fixed/variable charge. This is because, in support of the statement above, the Draft Report references a section of a BARNZ submission specifically questioning the purpose of the fixed/variable charge.

301 The purpose of the fixed/variable charge is to ensure that airfield costs are reflective of airfield use. As noted in our initial pricing proposal:[172]

> Introducing fixed and variable charges allows airfield costs to better reflect causation:
>
> - Many of the costs of landing an aircraft are independent of weight:, airport security, lighting and fire fighting services are provided to all aircraft. This is the basis for a fixed charge per aircraft movement.
> - Some of the costs of landing a plane stem from the wear and tear impact to the runway. The level of wear and tear caused by landing on the runway varies according to the weight of the landing aircraft. This is the basis for variable charges based on maximum certified take-off weight (MCTOW)
>
> Fixed charges are a standard tool, as demonstrated by a study by Airports International, 2007, which found that:
>
> - 30% of airports in Europe and 45% of airports in Asia had landing charges comprising of fixed and variable charge
> - The vast majority of airports levy a parking charge, with about 30% of airports around the world imposing a parking fee related to time rather than aircraft type of weight
> - 23% of airports in Europe and 15% of airports in Asia charge separately for airfield lighting and other ground equipment, which in effect comprises a fixed charge per aircraft movement.

302 We repeated our explanation of the purpose of the change to a fixed / variable charging structure in our price setting event disclosure:[173]

> To improve the efficiency of charging, we propose the introduction of the fixed and variable charges for the airfield. The split of the total airfield charge into the fixed and variable components is based on the fact that the impact of each use on the airfield has two elements:
>
> - By occupying the airfield, taxiways and apron for a period of time, and aircraft imposes a cost which is related to the fact of utilisation, rather than the size of the aircraft. This cost is recovered through a fixed charge.
> - Different aircraft impose maintenance and other variable costs in proportion to their Maximum Take-off Weight (MCTOW). This cost is recovered through a variable charge.

[172] CIAL "Proposal for the Rest of Aeronautical Charges for the period ending 30 June 2017" (12 March 2012) at pgs 59–60.

[173] CIAL Price Setting Disclosure (19 December 2012) at pg 51.

> We recognise that there is no single, perfect way to allocate airfield cost between utilisation and variable impact components. We have tested our proposed fixed and variable charges on the basis of professional advice about maintenance impact of different aircraft types and of the investment required to accommodate different aircraft types. The split of the airfield charges into the fixed and variable components, compared to the previous MCTOW charge, increases the proportion of the airfield cost recovered from the turbo-prop planes. We estimate that the proportion to be recovered from all types of aircraft is a reasonable approximation of the incremental cost of each type.

303 We also emphasised to our customers that this pricing methodology created appropriate commercial incentives. On 16 April 2012, in response to a request by Air New Zealand for more details regarding the charge, we drew their attention to the economic rationale above and further noted that the fixed/variable charge ensured cost recovery from the least price-elastic customers:[174]

> Aiming to recover costs from least price-elastic customers is a standard feature of infrastructure pricing. Different routes have different degrees of competition. Aircraft servicing more competitive routes tend to have greater price elasticity. 27% of European, 14% of American and 32% of Asian airports relate their landing fees to flight origin (e.g. international, domestic or regional). The proposed two-part tariff results in the allocation of the burden of cost recovery for the airfield shifting slightly from international to domestic services. There is strong market evidence that domestic routes are more profitable and less competitive, than international services.

304 We explained the incentives as follows:[175]

> It is appropriate for CIAL to ensure that its airfield charges do not distort the incentives for the airlines to use different aircraft to avoid specific charges and thereby create additional risk of under recovery by airports who have minimal ability, apart through pricing structures, to mitigate such risk. CIAL believe this two tier approach to be commercial appropriate
>
> Airports, like any other business, are entitled to use policies and financial incentives to appeal to a certain market niche and clientele as per their commercial strategy. According to Airports International, numerous airports have preferential fees for cargo vs passenger flights (15% Europe, 9% America, 23% broader Asia & Africa), scheduled vs charter (5% America, 5% Australasia. In our view, the proposed structure provides a benefit to trans-Tasman and long haul services.

305 The Draft Report is wrong to say that the airline's confusion about the purpose of the fixed charge indicates that we could have been more transparent.[176] These excerpts from our communications with our customers show we were clear about the purpose and basis of the new charge. In particular, the Draft Report is wrong to rely on statements by the airlines that there was confusion about whether the purpose of the charge was to address congestion.[177] The Commission has copies of all of the relevant consultation documents.

---

[174] CIAL "Detailed Response to Questions" (12 April 2012) at pgs 4–5 – attached to email from Neil Cochrane to Substantial Customers 'Response to Questions' (16 April 2012).

[175] CIAL "Detailed Response to Questions" (12 April 2012) at pg 5 – attached to email from Neil Cochrane to Substantial Customers 'Response to Questions' (16 April 2012).

[176] CIAL Draft Report at para D33.

[177] CIAL Draft Report at footnote 109.

306 Despite us being very clear about the purpose of the charge, the airlines attempted to dispute the new fixed charge on the basis that there were no congestion issues to address at CIAL. [178] This is different from saying that CIAL's objectives were unclear. While the Commission correctly observes that the purpose of the fixed charge is in fact to reflect fixed airfield costs, the Commission should take care to distinguish tactical behaviour by the airlines during the consultation process.

We engaged constructively on customers' conflicting views

307 In response to both our initial and revised pricing proposals, the airlines expressed a range of conflicting views about our fixed/variable charge. Views on the fixed/variable charge following our initial pricing proposal included the following:

307.1 BARNZ argued that our fixed charge should not be introduced as it was an "unjustified impost" on airlines, and (based on the BARNZ's alternative pricing model) would result in an over recovery on the returns for the airfield. They also claimed that the fixed charge would significantly cross subsidise terminal activities.[179]

307.2 In contrast, Qantas and Jetstar both supported the fixed charge on the basis that many of the costs associated with operating an airfield are fixed. Their concern was that the fixed charge was too small - both expressed concern that only 18% of the total airfield costs were allocated to the fixed charge component.[180]

307.3 Jetstar was concerned that, in determining the allocation of variable charges between Jet and Turboprop aircraft, only 16% of the variable cost was being allocated to recovery from Turboprop aircraft. Instead, Jetstar believed "a uniform variable airfield charge should be applied to all aircraft landings on an MTOW basis."[181]

308 During consultations it was not possible for us to reconcile our customers' conflicting views on the fixed/variable charge. But, we did reduce the fixed airfield charge for aircraft under 20 tonnes by 50%, in response to concerns raised by Air New Zealand.

309 We then went on in the revised pricing proposal to provide graphs, illustrating the extent to which our proposed cost recovery from jet and turboprop aircraft did not result in a cross-subsidy.[182] And following the release of our revised pricing proposal, we held a briefing session for the airlines where we showed how our

---

[178] BARNZ "Assessment by BARNZ of CIAL's Initial Pricing Proposal" (25 May 2012) at pg 29 – attached to email from John Beckett (Executive Director, BARNZ) to Neil Cochrane (General Manager Business Services, CIAL) regarding BARNZ assessment of initial pricing proposal (25 May 2012).

[179] BARNZ "Assessment by BARNZ of CIAL's Initial Pricing Proposal" (25 May 2012) at pg 29 – attached to email from John Beckett (Executive Director, BARNZ) to Neil Cochrane (General Manager Business Services, CIAL) regarding BARNZ assessment of initial pricing proposal (25 May 2012).

[180] Letter from Fiona Leishman (Senior Procurement Executive – Aviation Charges, Qantas) to Neil Cochrane (General Manager Business Services, CIAL) regarding CIAL's proposed reset of aeronautical charges for the period ending 30 June 2017 (17 May 2012) at pg 4; Letter from Tim Castine (Manager Aviation Charges, Jetstar) to Neil Cochrane (General Manager Business Services, CIAL) regarding CIAL's proposed reset of aeronautical charges for the period ending 30 June 2017 (27 May 2012) at pg 1.

[181] Letter from Tim Castine (Manager Aviation Charges, Jetstar) to Neil Cochrane (General Manager Business Services, CIAL) regarding CIAL's proposed reset of aeronautical charges for the period ending 30 June 2017 (27 May 2012) at pg 1.

[182] CIAL "Proposal for the Reset of Aeronautical Charges for the period ending 30 June 2017" (31 July 2012) at pgs 15–16.

airfield charges compared reasonably with both WIAL's and AIAL's new airfield charges.[183] The graphs showing this comparison were also provided in our final pricing decision.[184]

310 Airline views on the fixed/variable charge following the revised pricing proposal included the following:

310.1 Air New Zealand was opposed to the fixed charge due to the resulting increases in airfield charges for the B1900 fleet. Air New Zealand also disagreed with the weight break for application of the higher fixed charge being 20 tonnes, as this meant the ATR fell into the higher fixed charge bracket. [185]

310.2 BARNZ (representing Emirates, Singapore Airlines, Virgin Australia and Air Pacific) disagreed with the fixed/variable charging structure largely on the basis that BARNZ considered that the structure would result in CIAL having an inappropriate revenue target. BARNZ also believed that it resulted in a disproportionately large increase in charges for jet aircraft. [186]

310.3 The Qantas Group (including Qantas and Jetstar) reinforced its support of the fixed airfield charge on the basis that it "helps to ensure fixed costs are recovered in a more appropriate manner and reduces the current cross subsidisation of turboprops by jet aircraft". [187] However, the Qantas Group was concerned that the lower fixed charge for aircraft under 20 tonnes resulted in jet aircraft bearing a disproportionate share of airfield costs. [188]

311 Ultimately, in our final pricing decision we implemented the fixed/variable charge in a way that we considered appropriately balanced our customers' conflicting views on an equitable allocation of cost recovery across the range of aircraft at issue, reflecting both the economic "use" of airfield resources and a reasonable spread of revenue required from different aircraft weight categories.

312 Standing back, at paragraph D37 the Draft Report states:

> We understand that [CIAL's] price setting process is not intended to address the needs of all its consumers, and that it is open to negotiating variations to its standard charges following the price setting event… We are not necessarily concerned that the price setting event does not address the concerns of all customers regarding the efficiency of the pricing structure provided that these are all addressed appropriately following the price setting event. It is not clear that this has occurred at [CIAL].

[183] CIAL "Pricing Consultation - Briefing to Airlines" (23 August 2012) at slide 22.

[184] CIAL "Decision on the Reset of Aeronautical Charges for the period ending 30 June 2017" (24 October 2012) at pg 5.

[185] Letter from Sean Ford (Manager Aeronautical Suppliers, Air New Zealand) to Neil Cochrane (General Manager Business Services, CIAL) regarding consultation on the reset of CIAL's aeronautical charges from 1 Dec 2012 (4 September 2012) at pg 3.

[186] BARNZ "Submission by BARNZ on CIAL Initial Pricing Proposal on behalf of the Airlines it has Authority to Fully Represent" (10 September 2012) at pg 2.

[187] Letter from Jim Castine (Manager Aviation Charges, Jetstar) to Neil Cochrane regarding CIAL's revised pricing proposal for the rest of aeronautical charges (21 September 2012) at pg 2.

[188] Letter from Jim Castine (Manager Aviation Charges, Jetstar) to Neil Cochrane regarding CIAL's revised pricing proposal for the rest of aeronautical charges (21 September 2012) at pg 2.

313 We agree with the assessment that not all customer needs must be addressed in the price setting event, and as we have illustrated that is not always possible. But it leaves us unclear about what the Commission is saying we should have done differently. After some statements that we did not engage constructively with our customers, the Commission acknowledges that the price setting event cannot address the concerns of all customers regarding the price structure.

314 The suggestion in the Draft Report that we did not engage constructively with our substantial customers rests solely on references to statements that some of our customers made to the Commission. As illustrated above, these statements repeated areas of residual disagreement from some customers, against a background of detailed consultation where we made adjustments to our proposals and received conflicting feedback on the points the Draft Report refers to.

315 Against that backdrop, we suggest that to support the argument made in the Draft Report the Commission needs to identify the further engagement it considers to have been lacking and explain why, despite the conflicting positions of our customers, the Commission can be sufficiently confident that further engagement would have resulted in a more efficient pricing structure.

316 We also note that AIAL was in a similar position to us. As the Commission noted at paragraphs 3.21 and 3.22 of AIAL's report:

> 3.21 Information disclosure has had a positive impact on this outcome. [AIAL] has indicated that the requirement to transparently outline its pricing methodology in Part 4 information disclosure prompted discussions with airlines about its pricing methodology. These discussions led to a number of changes to its pricing structure, with the intention of improving the efficiency of prices.
>
> 3.22 **Additional changes** to [AIAL's] pricing methodology may further improve the efficiency of its prices (for example, further consideration of maximum certified take-off weight (MCTOW) charges for smaller aircraft).
>
> (Emphasis added)

317 Despite the acknowledgement that additional changes to AIAL's methodology may result in further improvements, the Commission concluded that information disclosure had a positive impact on AIAL's pricing efficiency.[189]

318 CIAL's position is similar, except that in our case the Commission has not identified specific improvements that could be made in the future. The Commission has found that CIAL's PSE2 pricing methodology is likely to better promote efficiency than its PSE1 methodology.[190] However, the Draft Report speculates that further (unspecified) improvements may have been possible, and so CIAL's PSE2 pricing methodology "may have *better* promoted efficiency if information disclosure had been more effective".[191]

319 We also note that in WIAL's Final Report the Commission concluded that WIAL's PSE2 price setting conduct indicated that it sought to improve the efficiency of its prices, despite the fact that after the pricing was finalised the airlines raised with the

[189] AIAL Final Report at para 3.5.3.

[190] CIAL Draft Report at para D5.

[191] CIAL Draft Report at para D7 (emphasis added).

Commission a number of concerns with WIAL's pricing methodology. The WIAL Final Report stated:[192]

> Overall, we consider that [WIAL's] conduct in setting the pricing methodology for PSE2 shows that it seeks to improve the efficiency of its prices. [WIAL's] pricing methodology for PSE2 shows greater consideration of efficient pricing principles than previously. [WIAL] also commissioned economic experts to advise them on efficient pricing principles during consultation for PSE2 and adopted many, although not all, of their recommendations. However, submissions received as part of this s 56G review and discussed above indicate that the airlines have expressed a number of concerns with [WIAL's] pricing methodology.

320 Importantly, the WIAL Final Report did not conclude that WIAL has failed to constructively engage with its customers, and therefore information disclosure incentives were not operating effectively, simply because there was not complete agreement among all airline customers on WIAL's (improved) pricing methodology. A consistent approach should be taken to initiatives we took in PSE2 to improve our pricing methodology. The introduction of a fixed / variable pricing structure was a significant change and a significant step forward in the efficiency of our pricing structure, in circumstances where some customers opposed the change per se, others supported it, and there was disagreement on the detail. It was inevitable that we couldn't satisfy all our customers and we of course don't rule out the potential for improvement in the future. But that does not support the suggestion that our engagement with our substantial customers was anything less than fulsome and constructive.

321 We submit that the more appropriate and consistent conclusion is the same as that drawn in the AIAL Report: that improvements in pricing methodology support the conclusion that information disclosure incentives are operating effectively, and the potential for further improvements in the future does not detract from that conclusion.

Engagement with freight operators on airfield charges

322 The Commission has referenced Freightways' dissatisfaction with our engagement, in support of the Commission's draft conclusion that information disclosure hasn't been as effective as it would have expected in influencing our pricing efficiency.[193]

323 But the Draft Report does not recognise the important fact, highlighted in our cross-submission on the CIAL conference,[194] that we engage with freight operators through confidential commercial negotiations after our PSE consultations are completed. These commercial negotiations have regard to the freight operators' unique commercial circumstances and cost sensitivity.

324 The negotiations with freight operators and our other smaller customers are sequenced to occur after our consultation with 'substantial customers' under the AAA because such sequencing:

324.1 ensures that our posted prices (from which most of our revenues are derived) are efficient, by enabling us to fully engage with our substantial customers on the methodology underlying those prices. Domestic freight services only account for approximately 5-6% of domestic aircraft movements by weight

---

[192] WIAL Final Report at para D44.

[193] CIAL Draft Report at para D24 and footnote 111.

[194] CIAL "CIAL Post-Conference Submission" (19 June 2013) at paras 104–106.

and only 1.2% of total aeronautical revenues, and so it made sense for us to prioritise engagement with our airline customers during consultation on our posted prices; and

324.2 enables us to more thoroughly take account of freight operator-specific considerations, including the need to minimise leakage of freight being taken by road, through negotiation with freight operators.

325 While we sequenced our negotiations with freight operators to happen after our consultation with substantial customers, the volume of freight movements (number of aircraft movements and aircraft weight) were taken into account as an item in the demand forecast used to set airfield prices.

APPENDIX E - IS INFORMATION DISCLOSURE LIMITING CHRISTCHURCH AIRPORT'S ABILITY TO EXTRACT EXCESSIVE PROFITS?

Key Points

326 We agree with the Commission that CIAL will not earn excessive returns during PSE2.

327 However, we disagree with the Commission's draft conclusions that information disclosure regulation has not materially influenced our price setting.

328 The input methodologies and the picture that would be presented under information disclosure was a constant reference point in our pricing considerations. CIAL changed its approach in places to adopt specific input methodologies, which had a direct effect on the revenue requirement estimated by our model and our pricing.

329 We assessed possible price paths for PSE2 against the picture that would be presented by information disclosure. When doing so, we confirm that for PSE2 we assumed the Commission would use its standard building blocks approach.

330 We disagree with the draft conclusion that CIAL will earn excessive returns once post-2017 returns are factored in.

331 The Commission has estimated that on current settings CIAL will target returns of 8.9% over the 20 year period covered by our model. CIAL has reviewed the Commission's modelling and does not materially disagree with the Commission's estimate. The Commission's modelling confirms our 13.55% pre-tax WACC converts to a 9.75% after-tax return. The 8.9 per cent is derived after adjusting for the lower return on leased assets.

332 The Draft Report then assesses whether target returns are appropriate. It is a unique feature of the analysis of CIAL's pricing that the only analytical difference between CIAL and the Commission in the assessment of target returns after 2017 is the appropriate benchmark WACC. There are no disagreements or questions about the asset base or asset valuation, CIAL has committed to using all other input methodologies (including, in this submission, the regulatory tax allowance), and our track record in forecasting operating and capital expenditure and demand is good.

333 In these circumstances, the Commission should take particular care to select the correct benchmark WACC. As we explain in Appendix F, a comparison of the Commission's estimate of CIAL's target returns against an appropriate benchmark confirms CIAL is not targeting excess returns.

334 Even using the benchmark WACC range in the Draft Report of 6.6% to 7.6%, the Commission needs to take care before proceeding straight from a conclusion that (on that measure) target returns are excessive, to a further conclusion that information disclosure incentives are ineffective in this area. To begin with, the Commission's WACC range reflects the historical low risk free rates post GFC and is thus not an appropriate reflection of likely returns post 2017. We took a different approach to selecting the appropriate term of the risk free rate in these circumstances, but have been clear that we are not prejudging the market conditions that will exist in 2017 and therefore the appropriate approach to take then.

335 Further, as the Commission is aware, the WACC input methodology is under appeal. It is reasonable to expect that the incentive effect of the WACC input methodology would be reduced for this price setting event, but this is only temporary.[195]

336 We acknowledge that for all three airports the Commission has expressed a view as to likely behaviour at the next price reset, and the reasonableness of likely target returns. We are concerned at the Commission advising the Minister on potential outcomes four years away, and emphasise the Commission must have sufficiently solid evidence before drawing any firm conclusions.

337 The Draft Report records the Commission's concern that our information disclosure reports will not deliver the appropriate degree of transparency unless a non-standard depreciation view is presented. As discussed in the section Our Information Disclosure Reports above, CIAL commits to publishing reports for both price setting event disclosure and annual disclosure that show a non-standard depreciation view. We describe in Appendix A how this will be implemented and the assumptions required to do so.

338 The Draft Report also records the Commission's concerns with the transparency of our pricing model. As discussed above in the section on our model, the features identified by the Commission are areas where we believed simplification made the model more tractable without materially affected the commercial result. However we appreciate the Commission considers more detailed forecasts will assist transparency, and we commit to making those changes to the model when we next use it to reset prices. The Commission has also expressed the view that the model would give our customers more information if it used an economic depreciation approach. We commit to making that change also.

Influence of information disclosure on price setting

339 As CIAL explained in its submissions, and summarised in the section above on the Effectiveness of Information Disclosure, the new information disclosure regulation framed every step of our pricing process. We had careful regard to the input methodologies, and adopted all but two of them, because we knew our pricing decision would be measured against the input methodologies in our information disclosure reports.

340 This drove our pricing behaviour. Board papers measured pricing proposals against the input methodologies. Our model used all but two input methodologies.[196] The consultation process with our customers was framed around the input methodologies. Where we departed from the input methodologies we provided detailed explanation and expert reports to our customers on the difference. All of this responded to the fact that future information disclosure reports would measure our pricing against the input methodologies, and none of this transparency and discipline would have happened but for the new information disclosure regime.

341 Some of these changes had a direct impact on our prices. We took a different approach to asset valuation, timing of revaluations, and common cost allocation than we would otherwise have done. These changes directly impacted our revenue requirement, and therefore prices.

[195] Note this is a different point to the commitment the Commission makes in its Final Report that it will update its report where necessary once the outcome of the merits review is known. The point here is that the WACC input methodology can be expected to have less of an incentive effect during the course of the merit review process.

[196] This is acknowledged in the CIAL Draft Report at paras F14 and F26.

Pricing in PSE2

342 The Draft Report concludes that CIAL's PSE2 prices are not excessive. We agree with that assessment.

343 However, the Draft Report attributes this outcome solely to CIAL reacting to the demand conditions it faced for PSE2. The Draft Report concludes that the good outcome of CIAL's PSE2 prices not targeting excessive returns cannot be attributed to information disclosure incentives in any way.[197]

344 We disagree with that assessment. When commercial considerations are also in play, as they usually will be, the Commission cannot for that reason conclude the information disclosure incentives were of no effect.

345 It is simply inaccurate to say that our pricing decision was unaffected by the incentives created by the new information disclosure regime. Throughout the pricing process CIAL considered a number of price paths for PSE2. When doing so we assessed proposed PSE2 price paths against the Commission's likely analysis.

346 Whether a price path was consistent with the likely analysis to be conducted by the Commission was an important consideration when deciding on our prices for PSE2. We can confirm that the Draft Report presents an analysis of our PSE2 price path that is consistent with what we assumed the Commission would do.

347 Further, as noted above we used all but two of the input methodologies in our pricing model. In places this involved a change from what we had done in the past. Those changes flowed directly through to the revenue requirement identified by our model.

The Commission's estimation of 20 year returns

348 The Commission has estimated that on current settings CIAL will target returns of 8.9% over the 20 year period covered by our model. CIAL has reviewed the Commission's modelling and does not materially disagree with the Commission's estimate. The 8.9 per cent is close to the post tax conversion of our 13.55 per cent pre tax WACC after adjusting for the lower return on leased assets.

349 The Commission identifies a number of adjustments that could increase its assessment of CIAL's target returns.[198] We have responded in the section on our model earlier in this submission to the concerns in regard to post 2022 inflation and the absence of post 2017 capital expenditure forecasts.

350 We disagree with the Commission on the issue of increased returns that might flow from "more realistic assumptions about cash flow timing".[199] In our view, given the order of accuracy of forecasts and costs over a twenty year period, making intra period assumptions on cash flow timing does not add to value of the model's results.

351 The Draft Report observes that the CIAL actual price path slightly overshoots the levelised price path in 2017. The impact on overall returns in PSE2 is minor, and CIAL again commits to setting prices no higher than the levelised price path in 2017 and beyond.

---

[197] CIAL Draft Report at para 3.3.

[198] CIAL Draft Report at para E85.

[199] CIAL Draft Report at para E85.1.

352 The Draft Report suggests that CIAL's treatment of revaluations that occurred prior to PSE2 would result in higher returns than estimated by the Commission.[200] However our treatment is consistent with the Commission's input methodology, and the desires of our customers. The revaluation that occurred during PSE1 was not booked against prices in PSE1 (our PSE1 pricing decision was explicit that a forecast of revaluations was not included). For that reason the revaluation amount is included in the opening RAB for PSE2, but the PV of that amount is discounted from revenues collected from customers. This approach has been agreed by our customers and we do not understand why the Commission believes our treatment is incorrect, or how it represents potentially higher returns than estimated by the Commission's modelling.

Target twenty year returns are not excessive

353 The Draft Report assesses whether target returns it calculates are appropriate.

354 When assessing target returns post-2017 the only analytical difference between CIAL and the Commission is the appropriate benchmark WACC. There are no disagreements or questions about the asset base or asset valuation, CIAL has committed to using all other input methodologies (including, in this submission, the regulatory tax allowance), and our track record in forecasting operating and capital expenditure and demand is good.

355 In these circumstances, the Commission should take particular care to select the correct benchmark WACC. As we explain in Appendix F, a comparison of the Commission's estimate of CIAL's target returns against an appropriate benchmark confirms CIAL is not targeting excess returns.

356 Even using the benchmark WACC range in the Draft Report of 6.6% to 7.6%, the Commission needs to take care before proceeding straight from a conclusion that (on that measure) target returns are excessive, to a further conclusion that information disclosure incentives are ineffective in this area. To begin with, the Commission's WACC range reflects the historical low risk free rates post GFC and is thus not an appropriate reflection of likely returns post 2017. We took a different approach to selecting the appropriate term of the risk free rate in these circumstances. However at each five year price reset we will be resetting our forecast cost of capital, and we are not prejudging the market conditions that will exist in 2017 and therefore the appropriate approach to take then.

357 Further, as the Commission is aware, the WACC input methodology is under appeal. It is reasonable to expect that the incentive effect of the WACC input methodology would be reduced for this price setting event, but this is only temporary.[201]

Our model and information disclosure reports

358 The Draft Report identifies areas where the Commission is concerned that our model and our information disclosure reports (both price setting event disclosure and annual disclosure) are not sufficiently transparent. We agree with the Commission that transparency is an important part of the information disclosure regime and we share the Commission's objective of making our performance and the implications of our long-run price path transparent to all stakeholders.

[200] CIAL Draft Report at para E85.2 and elsewhere.

[201] Note this is a different point to the commitment the Commission makes in its Draft Report (at para 1.10) that it will update its advice to the Minister where necessary once the outcome of the merits review is known. The point here is that the WACC input methodology can be expected to have less of an incentive effect during the course of the merit review process.

359 In the previous sections of this submission we confirm we will make changes to address all of the Commission's concerns, and explain how we will do so.

APPENDIX F – SUPPLMENTARY MATERIAL ON COMMISSION'S ANALYSIS OF CHRISTCHURCH AIRPORT'S RETURNS

Key points

360 The Commission has estimated that our returns during PSE2 will be 6.8% and on current settings CIAL will target returns of 8.9% over the 20 year period covered by our model. CIAL has reviewed the Commission's modelling and does not materially disagree with the Commission's estimate. The 8.9 per cent is almost identical to the post tax conversion of our 13.55 per cent pre tax WACC after adjusting for the lower return on leased assets.

361 When assessing whether these target returns for PSE2 and the 20 year period are appropriate, we believe the Commission is using an incorrect benchmark WACC. In this section we explain why.

PSE2 target returns

362 Our submission on these matters puts to one side the issues that were well rehearsed with the Commission during the input methodologies process and focusses on two matters that were not properly addressed in that context, namely:

362.1 the implications of the anomalously low risk free rate during 2012 for the estimation of the WACC, and

362.2 the risk of CIAL relative to that of the average airport.

363 In relation to the risk free rate, CIAL remains of the view that its proposal not to mechanically apply spot government bond rates as the risk free rate, but instead to apply a "normal market" risk free rate was appropriate in view of the anomalously low bond rates prevailing in 2012. It is also consistent with a 20 year pricing model rather than a more standard 5 year building blocks model.

364 Turning to the asset beta, CIAL is concerned that the Commission appears to have overlooked the fact that CIAL's proposition that the makeup of its passenger base implied it had a greater systematic risk than the other airports was in fact agreed to by the airlines.

20 year target returns

365 The Commission has assessed the return the Commission anticipates CIAL to target in PSE3, 4 and 5 against the WACC the Commission has derived for PSE2.[202]

366 Significantly, the Commission's analysis has therefore assumed that the current difference in view between CIAL and the Commission in relation to the risk free rate for PSE2 will persist, and be of the same magnitude, for the next three price reviews (i.e., spanning a period of 20 years). This assumption is untenable. A more reasonable assumption would be that the current difference of opinion with respect to the risk free rate would have disappeared by the end of PSE2, either because:

366.1 the period of current anomalously low interest rates had passed, which is consistent with forecasts for short term and long term interest rates in New

202 CIAL's price path was set in the context of a 20 year price path, and employed an assumption about the WACC that would be used in PSE3, 4 and 5. However, CIAL will be reviewing prices prior to the commencement of each new pricing period and will employ an updated estimate of the WACC when setting prices for that period. Under CIAL's pricing model, the role of the WACC assumption for PSE3, 4 and 5 was only to determine the "return of capital" to factor into prices for PSE2.

Zealand, as well as with the movement in interest rates since the October 2012 averaging period; or

366.2 the anomalously low interest rates persist but that a consensus is reached amongst finance practitioners and regulators and regulated entities as to how the WACC should be estimated in that new environment.

367 More generally, the spot rate on five year government bonds as at October 2012 cannot be held out as a reasonable forecast of that interest rate for the next 20 years. The anomalous level of government interest rates in 2012 suggests that that would be a poor starting point for a long term forecast. Moreover, as noted above, such a forecast would be inconsistent with the official long term forecasts of government bond rates and with the movement in interest rates since October 2012.

Midpoint vs 75th percentile WACC

368 CIAL reiterates its earlier view that the Commission should focus only on the 75th percentile WACC when assessing for excess returns. This is necessary in order to ensure that there is a reasonable degree of confidence that excess returns in fact exist in view of the estimation error inherent in deriving the WACC, as well as uncertainty as to whether the CAPM is correct and likelihood that real economic costs are omitted by the analysis (namely asymmetric events).

Cost of capital benchmark

369 The Draft Report assesses its estimate of our target returns against a benchmark WACC range of 6.6% to 7.6%, reflecting the range between the midpoint and 75th percentile cost of capital. This is the result of applying the Commerce Commission's cost of capital input methodology.

370 As the Commission is aware, we disagree with the parameters specified in its cost of capital input methodology. However we do not propose to rehearse all of those differences in this submission. In this analysis, the task is to identify an appropriate benchmark WACC against which to compare an estimate of returns CIAL is targeting over a 20 year period. In that context we focus on two issues – the correct choice of the risk free rate and the asset beta appropriate for CIAL.

Risk free rate

Introduction

371 When calculating the benchmark WACC the Draft Report uses as the risk free rate of return the "spot rate" for the New Zealand Government bond with a five year term to maturity that prevailed in October 2012.

372 First, we disagree with the Commission's use of the October 2012 risk free rate and other market information for testing whether CIAL's prices contain excess returns. The practicalities of undertaking meaningful consultation with customers and the proper consideration by boards of a five year pricing proposal requires key parameters like the assumed cost of capital to be locked in some time in advance of the actual pricing decision. CIAL observes that in the only treatment in the Input Methodologies where a precise timing of sampling of interest rates is prescribed – namely, for firms under default price paths – interest rates are required to be sampled six months prior to the commencement of the new period.

373 Turning to the risk free rate assumptions that have been adopted, there is a material difference of view between CIAL and the Commission in relation to the appropriate risk free rate (and hence WACC) for PSE2, in that CIAL has argued that

the use of the "spot" five year rate for the risk free rate will lead to an understatement of the cost of equity even over a five year period, but particularly over a 20 year period, in view of the anomalously low interest rates that prevailed in 2012. As CIAL has pointed out in its submissions to the Commission, this issue alone was sufficient to account for the difference between the WACC that CIAL used to determine its prices and the WACC that the users advocated be used to test CIAL's proposal. This issue is returned to below.

374 However, the Commission's modelling has also assumed that this material difference in view in relation to the risk free rate will continue into PSE3 to 5 and be the source of material excess returns. We consider this to be unreasonable and address this issue first.

Risk free rate for PSE3 to 5

375 The Commission has also sought to test whether the airports are expected to make excess returns in PSE3 and, in the case of CIAL, also in PSE4 and PSE5.[203] The conclusions the Commission draws about returns in PSE3 to 5 turn upon the Commission's anticipation of how CIAL will determine its WACC for pricing purposes in those future pricing periods and how that anticipated WACC compares to the estimate of the WACC for the relevant pricing periods that the Commission expects to take in the future.

376 Significantly in this regard, the Commission's calculations assume that the current difference in view with CIAL with respect to the risk free rate of return will continue (and continue by the same magnitude) for the full 20 year period that is spanned by PSE2 to 5.[204] Similarly, the Commission's calculations assume that the WACC it has applied for PSE2 is the best estimate of the WACC that is anticipated in PSE3 to 5, whereas CIAL's WACC will continue to incorporate an estimate of the risk free rate that is slightly more than 3 percentage points higher than will be shown to be appropriate at those future price reviews.

377 CIAL's view is that it is unreasonable for the Commission to assume that this source of difference between it and the Commission extends beyond PSE2.

378 First, it is noted that the difference in view with respect to the risk free rate arises from the anomalous interest rates that prevailed in 2012 and what that situation implied for the estimation of a WACC. CIAL's view that the mechanical use of spot rates was inappropriate was not a frolic that it alone embarked upon, but was a view that was consistent with the view taken by many in the finance profession, which CIAL has referred to in its submission. However, clearly, this is not a matter that has been uncontroversial. If the current situation of low interest rates persists as the Commission implicitly assumes, then a more reasonable assumption is that a consensus emerges as to what this will mean for the WACC will emerge, this parameter again becomes uncontroversial and this source of the gap between the Commission and CIAL disappears.

---

203 CIAL notes that there is no justification for it to be treated differently to other airports in this regard. While CIAL has calculated a price path over 20 years, this has only been to determine the extent of "return of capital" to factor into prices in PSE2. As noted in the text, CIAL will be reviewing prices prior to the commencement of each new pricing period and will employ an updated estimate of the WACC when setting prices for that period.

204 It is important to reemphasise here that CIAL has confirmed that it will be reviewing its prices each five years and will be employing an updated estimate of the WACC in each pricing period. Therefore there is nothing "locked in" about the WACC that CIAL will be applying in PSE3, 4 and 5.

379 More importantly, however, the Commission's calculations assume implicitly that its PSE2 WACC is appropriate for all future periods. However, the spot rate in 2012 on five year government bonds is not the correct risk free rate under the Input Methodologies for the WACC in PSE3 and future periods. Rather, what is required is a forecast of the interest rate on 5 year government bonds in 2017 and then in 2022, and so on. The 2012 five year government bond rate contains no information about the interest rates that are expected to prevail after PSE2 – indeed, part of the Commission's rationale for matching the term of the risk free rate to the length of the regulatory or pricing period (five years) was to select a risk free rate measure that included only information pertinent to the regulatory or pricing period in question. The fact that the 2012 risk free rate was an anomalous figure when judged against historical standards means that, even if it was considered to be appropriate for the 2012-17 period, it would be a poor basis for a forecast of the risk free rate for future periods.

380 CIAL contends that a more appropriate assumption when forecasting the risk free rate out to the long term is that those interest rates will revert to the historical average level. To this end, it is noted that:[205]

380.1 the New Zealand Treasury's recent statement on New Zealand's long term fiscal position explicitly assumed that five year government bond rates would increase from the current low levels to 5.5 per cent in the 2020s and to 6 per cent from the 2030s;[206] and

380.2 in the time since the October 2012 averaging period that the Commission adopted, the interest rate on five year bonds has already risen by 1.20 percentage points (i.e., to approximately 4.2 per cent), which approximately halves the gap that existed between CIAL and the Commission. Moreover, the consensus forecasts of New Zealand Government interest rates predict long term government bond rates to increase by a further 50 basis points by the first quarter of 2015.[207]

205 It is noted that there is no requirement or logic for the Commission to try to ascertain what would have been an appropriate forecast for the (five year) risk free rate for PSE3, 4 and 5 as at October 2012. Those risk free rates have not been locked in, but rather will be updated at the commencement of each pricing period, and so it is appropriate for the Commission to use the broadest information set to establish this forecast. However, even if the Commission only looked at information proximate to October 2012, official forecasts at the time were consistent with a long term interest rate of 6 per cent: see NZ Treasury, 2012, Methodology for risk-free discount rates and CPI assumptions for accounting valuation purposes – review of long-term economic assumptions, (May) pg 10.

206 NZ Treasury, 2013, Affording our future – statement on New Zealand's long term fiscal position, July, p.69. An accompanying information paper is more detailed as to the precise forecasts and observes that "[w]e are assuming the bond rate moves up gradually from the present 2.2% to 5.5% in 2022, remains at this level until 2027 and then climbs to its peak 6% in 2032 and stays there. These numbers are used to calculate projections of the debt-financing costs which are added to expenditure" (NZ Treasury, 2013, Long term fiscal projections: reassessing assumptions, testing new perspectives, background paper for the 2013 statement on the long term fiscal position (July) pg 24). It is noted that the starting figure of 2.2 per cent for five year bonds would appear to be an obvious error – given the timing of the report's release, this figure was most likely intended to be 3.2 per cent.

207 The consensus forecasts for the yield on 10 year NZ government bonds (as published on Bloomberg) are for the yield to rise by a further approximately 50 basis points, from the current 4.7 per cent to 5.2 per cent. Forecasts are not provided for 5 year bonds; however, the trajectory in 10 year bonds should be indicative of expectations for 5 year bonds. Indeed, given that the overnight cash rate is forecast to increase by 75 basis points over the period, the yield on 5 year bonds may increase by a greater extent than 10 year bonds.

381 Alternatively, if the Commission nonetheless decided that CIAL should be assumed to use a 6 per cent risk free rate in all future periods irrespective of any emerging consensus as to the appropriate risk free rate when estimating the WACC, these forecasts suggest that the best assumption about the future risk free rates would be approximately **4.5 to 5 per cent for PSE3**,[208] **5.5 per cent for PSE4** and **6 per cent for PSE5** rather than the 2.97 per cent the Commission has assumed for the whole 20 year period.

PSE2 risk free rate

382 Turning now to the issue of the risk free rate for PSE2, CIAL's proposal was driven by the observation that interest rates in 2012 were at historically anomalously low levels, and indeed as shown in the figure below, the risk free rate that was used to test CIAL's prices was almost at the nadir of interest rates (and materially below the rate that was used to test the returns for the other airports). This was a key issue we grappled with in our pricing proposal.

383 In his 12 July 2012 expert report (supplied to our customers and the Commission) Jeff Balchin described the situation this way:[209]

> … we also note that the key issue we addressed in our previous report – namely whether it is appropriate to use the currently extremely low government bond rates as the risk free rate when estimating the cost of equity – arose as a significant matter largely after the Commission's Input Methodology process had been completed.
>
> Indeed, the gap between what we have advised as a reasonable WACC for pricing purposes and the figure that Futures (and the Board of Airline Representatives of New Zealand, BARNZ) would consider reasonable can be explained completely by how the events of the Global Financial Crisis (GFC) and its continuing aftermath are considered to impact upon the required returns for risky assets…
>
> … we remain of the view that use of the current spot government interest rates will lead to a material understatement of the cost of equity and that a risk free rate drawn from "normal market" conditions will result in a materially better estimate of the cost of equity. We note that there is considerable support in the theoretical and empirical finance literature for the proposition that the cost of equity does not move one-for-one with government interest rates. We also note that there is also considerable regulatory precedent in the UK and US for ignoring transitory movements in government interest rates when estimating costs of equity for regulatory purposes. We also remain of the view that a 10 year term should be used when estimating the risk free rate, as this is more indicative of the risk free alternative investment for investors in long lived infrastructure. However, this matter is only material if the cost of equity were to be estimated using current government interest rates as the risk free rate – historically in New Zealand, there has been little difference in interest rates between 5 and 10 year bonds (with the yield curve often slightly inverse).

384 It was for this reason that Jeff Balchin advised that we use a risk free rate figure that is consistent with the "normal" market conditions from which the market risk premium has been derived. It was further noted that not applying the CAPM in a mechanistic manner while interest rates remained anomalously low and making an upward adjustment was consistent with the practice amongst a substantial number

[208] The trajectory for the risk free rate assumed in the NZ Treasury assumptions would suggest a figure that is closer to the lower end of this range; however, the current level of the risk free rate (4.2 per cent) and short term forecasts (increasing by 0.50 percentage points by the first quarter of 2015) would put the risk free rate above the lower bound well before the commencement of PSE3.

[209] At pgs 1, 3.

of valuations professionals, it had been the standard practice of regulators in the UK, it was a practice that had been applied by at least one Australian regulator (IPART) and was also consistent with the corroborating market evidence. CIAL remains of the view that its proposed risk free rate in respect of PSE2 remains appropriate in view of the anomalously low level of interest rates and the evidence outlined above as to how this should impact upon the WACC.

385 CIAL is concerned that the Commission has not properly understood CIAL's proposal or reasons for doing so. The Commission has described our proposal and contrasted it with its view of the application of the input methodologies as follows:[210]

> We do not therefore agree with Christchurch Airport's deviations from the IMs when calculating its cost of capital. For example, Christchurch Airport's estimate of WACC uses a 10 year average of the risk free rate for the cost of equity. This is because it considers using a 10 year average reflects recent market uncertainty. The IMs use a five-year average; reflecting the airport's ability to reset prices over this time and, in doing so, reflect changes in the risk free rate.

386 With respect, this statement does not correctly state the Commission's position in the Input Methodologies and so does not describe our difference of view.

387 The Input Methodologies do not require the use of "5-year average" of the risk free rate, but rather require the use of the "spot" interest rate on NZ Government bond with a term to maturity of 5 years. CIAL's argument is that the use of a "spot" risk free rate to estimate the cost of equity as at March 2012 or July 2012 or October 2012 will lead to a material under-estimate of the cost of equity, irrespective of whether the risk free rate is proxied by the government bond yield with a 5 year term or 10 year term to maturity. Accordingly, the Commission's statement that a bond with a five year term better matches the interest rate risk borne by asset owners when prices are reviewed does not answer the question of whether the use of a spot rate remains appropriate under current market conditions. We argue that a risk free rate that is more reflective of normal market conditions will lead to a materially better estimate of the cost of equity, and have argued that an assumption that is more in line with the historically observed risk free rate would provide a better proxy for that normal market figure. We have also observed that if a normal market risk free rate were applied, then the choice between a 5 year and 10 year term would be unlikely to be material.

388 CIAL also disagrees with the Commission's suggestion that the Commission considered the effect of the anomalously low risk free rate during the Input Methodologies consultation. As CIAL has explained previously, this is not a matter that was pressing during the Input Methodologies consultation – while interest rates had dropped in late 2008/early 2009, they had largely recovered to historical levels by the time of the conference on WACC issues in late 2009 and the most intense period of consultation on the Input Methodologies in the first half of 2010. Indeed, the Commission's testing of the WACC implied by the Input Methodologies against the other market evidence employed a risk free rate assumption of 4.96 per cent (and a midpoint post tax WACC of 8.1 per cent).[211]

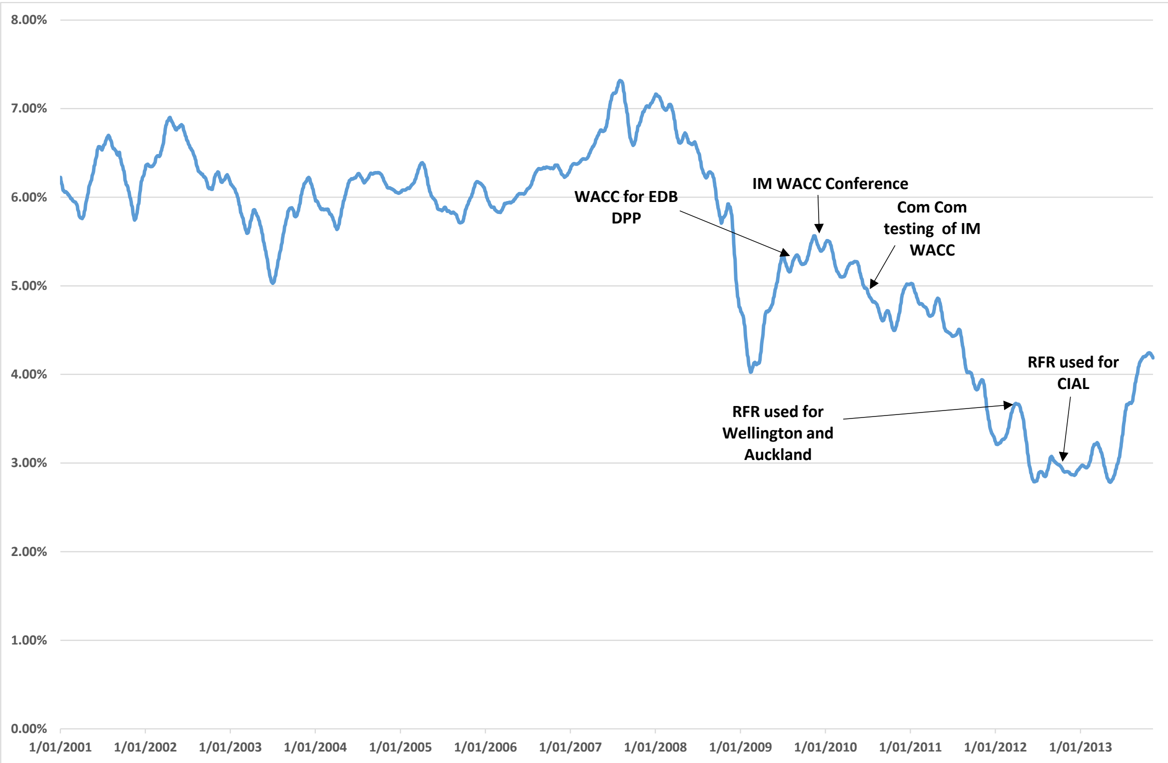
---

210 CIAL Draft Report at para F85.

211 Commerce Commission, 2010, Airport IMs – Reasons at pg 346. It also follows that CIAL disagrees with the Commission's statement that it has "considered a range of analyses used by capital market practitioners to estimate the cost of capital" (para F69). The testing the Commission did of its WACC assumptions was conducted during the Input Methodologies consultation, and was against a post tax

389 We continue to believe this is an appropriate response to unusual market conditions. Indeed, the movements in interest rates since the Commission's October 2012 averaging period largely support CIAL's contention. The figure below shows the time path of the five year risk free rate of return over the period since the start of 2001 and the present time. It demonstrates that if the Commission was to recalculate the WACC as at October 2013, it would employ a risk free rate estimate that was 1.2 percentage points higher, which would translate into an increase in the cost of equity by 0.9 percentage points. Thus, just into the second year of a 5 year pricing period, the Commission analysis assumes that CIAL's equity investors should be happy with returns that are now substantially lower than returns available in alternative investments (and adjusted for relative risk).[212]

Movements in the 5 year risk free rate since 2001



Source: Bloomberg. Each data observation represents the average over the 20 day period ending with the day in question.

Beta

390 The second key issue when constructing an appropriate benchmark WACC is to identify the asset beta appropriate for CIAL.

391 The Commission's input methodology sets an average beta for all three airports of 0.60. However, as the Commission is aware, CIAL has a differing of opinion with the

WACC estimate that is 150 basis points higher than the figure the Commission has calculated for October 2012. The Commission has not tested how market practitioners have responded to the substantial fall in the risk free rate since that time. In contrast, CIAL has presented evidence that demonstrates that the market practitioners have not assumed that the fall in the risk free rate translates into a one-for-one change in the cost of equity.

212 As noted above, the consensus forecasts for the yield on 10 year NZ government bonds (as published on Bloomberg) predict the risk free rate to increase by a further 0.5 percentage points by the first quarter of 2015.

Commission as to the asset beta for the average airports, and has used 0.65 for this figure in its calculations. In addition, CIAL has also received expert advice that the greater proportion of leisure travel at Christchurch Airport means that CIAL has a higher systematic risk than an average airport, with a recommended addition of 0.05 to the "average airport" asset beta. These two factors led to CIAL using an asset beta of 0.70 rather than the value set out in the Input Methodologies of 0.60.

392 The discussion below puts to one side the question of the appropriate asset beta for an average airport and focusses on the question of whether the average asset beta is appropriate for the circumstances of CIAL. We observe as a general proposition that the level of systematic risk of different airports is likely to vary, and in such circumstances the principled practice is to refine the estimate of the asset beta. Indeed, failing to do so will lead to an understatement of the WACC and, in the context of the Commission's current activities, it will lead to "fair return" being inappropriately characterised as "excess return". This issue is noted in the Draft Report at paragraphs F86 and F87. The Draft Report suggests that no evidence has been made available to support CIAL's beta.[213] We disagree.

393 Prior to summarising again the evidence that was submitted, we draw attention to the fact that this is an issue where there was an agreement between CIAL and its customers. We have provided a copy of an expert report from Brent Layton, Future Consulting, commissioned by BARNZ, agreeing with the application of an increment of 0.05 to the average airport asset beta, as proposed by Jeff Balchin, and the reasons for it:[214]

> In my opinion, since leisure based travel is more sensitive to income movements than business travel the higher percentage of leisure travel through CIAL warrants a slightly higher asset beta for aeronautical assets as CIAL's returns are likely to be more strongly correlated with movements in the overall market. An uplift of 0.05 points may be justifiable. If this is applied to the Commission's 0.60, the result is an asset beta for CIAL to 0.65.

394 We acknowledge once more, and as reflected in the quoted text, that the agreement between the experts related to the increment to the asset beta in the context of CIAL, and hence a fair interpretation of Brent Layton's views imply an asset beta of 0.65.

395 We think it is significant that our customers agree with us on this issue, and we are disappointed this fact was not made transparent in the Draft Report. As it stands, the Draft Report proposes to advise the Minister on the acceptability of CIAL's target returns using a general airport asset beta, when our customers and two independent experts agree a higher asset beta should be used.

396 It seems to us the process is misfiring in this respect. There is no reason for the Commission to ignore a consensus from both sides of the market as to the appropriate asset beta for CIAL. It will also create confusion, to the extent that the Minister has to grapple with feedback from customers in the market that the Commission has used the wrong WACC.

397 We understand that for the purposes of the input methodologies the Commission was reluctant to identify airport-specific WACCs given the difficulties of focussing on

213 CIAL Draft Report at pg 119.

214 Brent Layton, 2012, CIAL's weighted average cost of capital: comparison with Commerce Commission information disclosure requirements, report to BARNZ (May) pg 9.

entity specific issues in the context of a pan-industry – not to mention broadly focussed – exercise in which the Commission was engaged. However the concerns that motivated the Commission in that context do not apply here, where the Commission is preparing one-off advice for the Minister on the returns targeted by a specific airport.

398 Turning to the question of the evidence CIAL has provided, CIAL has submitted to the Commission data on the profile of travellers at CIAL, which indicates a materially greater proportion of leisure travellers at CIAL. The table below displays visitor statistics for the major New Zealand airports for the 12 months to 30 June 2011. This table shows that, compared with Auckland and Wellington, Christchurch is significantly more exposed to leisure markets (i.e. 84 per cent, relative to 75 per cent and 73 per cent respectively for Auckland and Wellington), and significantly less exposed to business, conference, education and other purpose of visit.

New Zealand Airports – Purpose of Visit – 12 months ending 30 June 2011

Purpose of visit	Christchurch	Auckland	Wellington
Holiday / Vacation	55%	42%	31%
Visiting Friends and Family	29%	33%	42%
Subtotal leisure	84%	75%	73%
Business	8%	13%	16%
Conference / education / other	8%	12%	11%
Total	100%	100%	100%

Source: Bloomberg

399 We also provided the expert report from Jeff Balchin referred to earlier, as well as the expert report of Brent Layton, which both concluded that this greater proportion of leisure travellers would be expected to increase the systematic risk of CIAL, the former concluding as follows:[215]

> Based on international precedents, and the differences in the mix of passengers at Christchurch relative to Auckland and Wellington, it is reasonable to adopt an asset beta of 0.70 (with zero debt beta) for CIAL, which is higher than the 0.65 asset beta we have recommended for New Zealand airports as a whole. The higher asset beta for Christchurch is supported by the international evidence for airports, and by the analysis of passenger type relative to other New Zealand airports.

400 Again, the intention of the discussion in this section is to draw attention to the recommended differential between the asset beta for an average airport and that of CIAL.

401 A fact relied upon in the report of Jeff Balchin was that a number of international regulatory decisions have applied a higher asset beta to airports that have a higher proportion of leisure travellers. This evidence includes decisions by the Australian Competition and Consumer Commission (ACCC) and two UK regulatory bodies (the UK Civil Aviation Authority (CAA) and the UK Competition Commission (CC)).

[215] PwC (21 March, 2013), *Advice on the weighted average cost of capital of Christchurch International Airport for pricing purposes*, Letter from Mr. Jeff Balchin to Mr. Neil Cochrane, General Manager Business Services, Christchurch International Airport, pg 22.

402 In 2001 the ACCC applied an equity beta (with zero debt beta) of 0.71 to Launceston Airport on the basis of evidence showing that it had a higher proportion of discretionary passengers than other Australian airports, concluding that:[216]

> In relation to the asset beta, APAL submits it has undertaken an analysis of its traffic composition similar to that undertaken by Melbourne Airport. APAL submits that the analysis shows that Launceston Airport's traffic is more correlated with domestic GDP than either Melbourne or Canberra. APAL states this is generally the result of a far greater proportion of discretionary travel either by residents of north eastern Tasmania or tourists from the mainland… It proposes an asset beta of 0.80 as compared with 0.70 for Melbourne Airport and 0.75 for Canberra Airport… In this instance the Commission does not object to the WACC parameters proposed by Launceston airport.

403 In its decisions on UK airports, the CAA has adopted an asset beta for Stansted Airport that is higher by 0.09 and 0.14 than the beta adopted for Gatwick and Heathrow airports, respectively.[217] This higher beta was applied in order to reflect the higher systematic risks borne by Stansted Airport owing to its relatively much higher proportion of charter group travel. Charter group travel represents relatively low cost discretionary leisure travel, and is therefore liable to co-vary with the economic cycle. This was corroborated by the evidence of Europe Economics, which found that passenger growth rates at Stansted were more sensitive to economic shocks than passenger growth at Heathrow or Gatwick.[218] In the course of the current regulatory process the CAA engaged PwC UK to undertake an analysis of relative costs of capital at the UK airports, and once again concluded that the asset beta of Stansted Airport is 0.09 and 0.14 higher than Gatwick and Heathrow respectively.[219]

404 Lastly, as an extension of the above matters, Jeff Balchin also highlighted a number of other distinguishing characteristics of Christchurch relative to Auckland and Wellington airports that are relevant to a consideration of their relative asset betas. These included that Auckland is a major international hub in the South Pacific, which provide it with greater resilience to withstand an economic shock, just as has been observed for Heathrow relative to Stansted Airport in the UK. On the other hand, Wellington Airport is located at the seat of the New Zealand Government, and should therefore be insulated from economic shocks due to a high proportion of government related business travel that is relatively invariant to economic conditions.

Midpoint WACC vs. 75th percentile

405 CIAL observes that the Commission has reported its testing of CIAL's anticipated returns against the range that is spanned by the both the midpoint WACC and the 75th percentile WACC.

406 CIAL supports the Commission's explicit statements that values below the midpoint WACC are not relevant to its analysis. However, CIAL would also reinforce to the

---

216 ACCC (June 2001) *Australia Pacific Airports Launceston Pty Ltd – Proposal to increase aeronautical charges to recover the costs associated with drainage works - Decision*, pg 12.

217 CAA (11 March, 2008), *Economic regulation of Heathrow and Gatwick Airports.*

218 Europe Economics (24 November, 2006), *Cost of Capital – estimating separate costs of capital for Heathrow and Gatwick, Supporting paper XIII, CAA's initial price control proposals for Heathrow, Gatwick and Stansted Airports*, pgs 45-46.

219 PwC UK (April, 2013), *Estimating the cost of capital in Q6 for Heathrow, Gatwick and Stansted*, A report prepared for the Civil Aviation Authority (CAA), pg 4.

Commission that in its advice to the Minister as to whether excess returns are being earned, that – if a case of excess returns is identified – the Commission include a statement about the degree of confidence that can be taken in that finding. The rationale for the Commission deriving a confidence interval for the WACC is that very real estimation error exists in relation to the relevant inputs, not to mention uncertainty about the validity of the CAPM itself and omissions in the economic costs the Commission has taken into account in its estimate of excess returns (namely asymmetric events). CIAL contends that unless the expected return exceeds the 75^{th} percentile of the WACC estimate that there cannot be a reasonable degree of confidence that excess returns are in fact being earned.

APPENDIX G - IS INFORMATION DISCLOSURE PROMOTING IMPROVEMENTS IN OPERATING EFFICIENCY AT CHRISTCHURCH AIRPORT?

Key points

407 We acknowledge that for WIAL, AIAL and CIAL the Commission has concluded that it is too early to be able to assess whether information disclosure is effectively promoting improvements in operating efficiency.[220] However we do note that the transparency of information disclosure is providing, and will continue to provide, an additional discipline on the operation of the airports.

408 We agree with the Commission that:

408.1 the available information suggests CIAL may have improved operating efficiency since the introduction of information disclosure;[221]

408.2 the available information shows CIAL seeks to improve its operating efficiency;[222] and

408.3 our forecasts indicate we are improving our operating efficiency over PSE2.[223]

409 In our annual disclosures we will be providing information on actual operating costs and the reasons for departure from forecast. We expect information disclosure to be effective in showing where we are achieving our improvements in operating efficiency, and highlighting where we are not.

Effectiveness of information disclosure

410 However, the Draft Report inappropriately caveats its discussion of our operating efficiency by stating that while there is evidence that CIAL strives to improve operating efficiency it is unclear whether this is a result of information disclosure regulation. The Draft Report states:[224]

> There is some evidence to indicate that [CIAL] does seek to improve its efficiency based on its conduct. For example, in building the ITP, [CIAL] has included features to improve efficiency such as heating, lighting, and air conditioning. However, it is unclear whether this is a result of information disclosure regulation.

411 We acknowledge the Commission said something similar in the AIAL Final Report, where despite recording that there was some evidence to suggest AIAL seeks to improve its operating efficiency, the report stated it is unclear whether there has been any change in AIAL’s conduct since the introduction of information disclosure.[225]

412 We think the caveat in the Draft Report gives insufficient weight to the incentive effects of information disclosure. The Draft Report states:[226]

---

220 CIAL Draft Report at para 3.8; WIAL Final Report at para 3.9; AIAL Final Report at para 3.6.

221 CIAL Draft Report at para G5.1.

222 CIAL Draft Report at para G36.

223 CIAL Draft Report at para G27.

224 CIAL Draft Report at para G36.

225 AIAL Final Report at para G39.

226 CIAL Draft Report at para G37.

> Transparent consultation provides an opportunity for consumers to identify potential efficiency gains, and for [CIAL] to incorporate these into its expenditure forecast. BARNZ considered that [CIAL] responded to and engaged on issues that were raised during consultation. Airlines also note that, due to [CIAL's] operating circumstances at the time (including the impact of the earthquakes), it was difficult to critique opex during consultation.

413 As our customers have said, we responded to and engaged on operating efficiency issues that were raised during consultation. No concerns as to transparency are recorded in the Draft Report.

414 In our submission on the Process and Issues Paper for CIAL, we said:[227]

> … information disclosure regarding the assessment of PSE1 has provided transparency to interested parties. As well as considering the operating performance of the company, it has established a set of key performance indicators to monitor achievement of, and the trend in on-going, business performance. It has also provided a common basis for benchmarking relative performance with other major airports.
>
> A further tangible benefit has been a proper understanding of the basis of how future investment may be viewed under the information disclosure process, and how such returns on investment will be monitored. While CIAL had already made the major decision to invest in the new Integrated Terminal, information disclosure has provided a useful framework to guide future investment decisions, particularly with respect to their impact on charges and how returns will be portrayed.
>
> … In addition, the provision of a longer term view of the forward demand forecast and of forecast capital investment provides a longer term perspective on the airport's future operational outlook, and on how the airport will ensure the provision of services necessary for continued efficient performance. In contrast, PSE1 was for a discreet period of three years only.

415 As we note above, in our annual disclosures we will be providing information on actual operating costs and the reasons for departure from forecast. We expect information disclosure to be effective in showing where we are achieving our improvements in operating efficiency, and highlighting where we are not.

416 At this point in the process, we submit the key points are as follows:

416.1 the available information suggests CIAL may have improved operating efficiency since the introduction of information disclosure;

416.2 CIAL is seeking to improve its operating efficiency;

416.3 it is too early to see actual performance of opex efficiency;

416.4 the transparency of opex efficiency under the information disclosure regime has strengthened incentives to improve opex efficiency;

[227] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pgs 6–7.

416.5 information disclosure is effectively promoting incentives to improve operating efficiency at CIAL.

APPENDIX H – IS INFORMATION DISCLOSURE PROMOTING INCENTIVES TO INVEST EFFICIENTLY AT CHRISTCHURCH AIRPORT?

Key points

417 We acknowledge that for WIAL, AIAL and CIAL the Commission has concluded that it is too early to be able to assess whether information disclosure is effectively promoting incentives to invest efficiently.[228] However we do note that the transparency of information disclosure is providing, and will continue to provide, an additional discipline on the operation of the airports.

418 We agree with the Commission that the available information shows CIAL's investment plans are generally prudent and occur at the right time.[229] Our customers have confirmed that we consulted appropriately on planned capital expenditure.[230]

419 In our annual disclosures we will be providing information on actual capital expenditure. We expect information disclosure to be effective in showing where we are investing efficiently, and highlighting where we are not.

Effectiveness of information disclosure

420 However, the Draft Report inappropriately caveats its discussion of our investment plans by stating that no party has attributed our good performance to information disclosure regulation.[231]

421 In our submission on the Process and Issues Paper for CIAL, we said:[232]

> … information disclosure regarding the assessment of PSE1 has provided transparency to interested parties. As well as considering the operating performance of the company, it has established a set of key performance indicators to monitor achievement of, and the trend in on-going, business performance. It has also provided a common basis for benchmarking relative performance with other major airports.
>
> A further tangible benefit has been a proper understanding of the basis of how future investment may be viewed under the information disclosure process, and how such returns on investment will be monitored. While CIAL had already made the major decision to invest in the new Integrated Terminal, information disclosure has provided a useful framework to guide future investment decisions, particularly with respect to their impact on charges and how returns will be portrayed.
>
> … In addition, the provision of a longer term view of the forward demand forecast and of forecast capital investment provides a longer term perspective on the airport's future operational outlook, and on how the airport will ensure the provision of services necessary for continued efficient performance. In contrast, PSE1 was for a discreet period of three years only.

---

[228] CIAL Draft Report at para 3.8; WIAL Final Report at para 3.9; AIAL Final Report at para 3.6.

[229] CIAL Draft Report at para H4.2.

[230] CIAL Draft Report at paras H3, H4.4, H23.

[231] CIAL Draft Report at paras H3, H4.4, H22.

[232] CIAL "Section 56G Submission on Process and Issues Paper Christchurch Airport" (22 March 2013) at pgs 6–7.

422 The Commission's caveat is at odds with the Commission's discussion of how information disclosure incentives are expected to operate in this area. The Draft Report states:[233]

> We expect information disclosure regulation will only become as effective as it can be, in terms of promoting efficient investment, over time. That is because the effectiveness of information disclosure is dependent on the availability of data to assess trends, and the opportunity for suppliers and consumers to react to the information disclosed. At the time of consultation for PSE2, only limited information on [CIAL's] capex was available in information disclosure.

423 Here the Commission emphasises its position that it does not expect information disclosure regulation to be effective at this time. It had made that clear in its reports on WIAL and AIAL. The Commission should not expect parties to be attributing our good performance to information disclosure at this time.

424 The AIAL Final Report, however, finds that "information disclosure regulation appears to have promoted an efficient investment plan for PSE2", despite also determining that:[234]

> It is not clear to what extent information disclosure has had an impact on the efficiency of [AIAL's] planned investment and its conduct in this area. [AIAL] considers that information disclosure has provided it with a useful reference point for expenditure forecasts for PSE2. It states that this has resulted in less disagreement between parties in consultation. However, BARNZ and Air New Zealand consider that this improved conduct at [AIAL] may also be due to other factors. This indicates that information disclosure does not appear to have negatively affected existing incentives to plan efficient investment.

425 As we have noted earlier in this submission, in areas where we are performing well the question is not whether behaviour change can be identified. Rather, the issue is whether the additional transparency provided by information disclosure does act, and will continue to act, as an additional incentive to invest efficiently. As our submission on the Process and Issues Paper for CIAL indicates, we think this is so.

426 At this point in the process, we submit the key points are as follows:

426.1 CIAL's investment plans are generally prudent and occur at the right time;

426.2 it is too early to assess actual investment information for PSE2;

426.3 the transparency of historic and planned capex under the information disclosure regime has strengthened incentives to invest efficiently;

426.4 information disclosure is effectively promoting incentives to invest efficiently at CIAL.

[233] CIAL Draft Report at para H8.

[234] AIAL Final Report at paras H3, H4.3.

APPENDIX I – IS INFORMATION DISCLOSURE PROMOTING THE SHARING OF EFFICIENCY GAINS WITH CONSUMERS AT CHRISTCHURCH AIRPORT?

427 We acknowledge that for WIAL, AIAL and CIAL the Commission has concluded that it is too early to be able to assess whether information disclosure is effectively promoting the sharing of efficiency gains with consumers.[235]

428 However we do note that we have provided evidence of information disclosure incentives operating to influence CIAL's behaviour in this area. As a result of the information disclosure regulation we have adopted all but two of the Commission's input methodologies. These include common cost allocation, which results in sharing of scope efficiencies.[236]

[235] CIAL Draft Report at para 3.8; WIAL Final Report at 3.9; AIAL Final Report at para 3.6.

[236] See discussion in CIAL Draft Report at para I7.