



BARNZ
VOICE OF THE AIRLINE INDUSTRY

Submission

Draft Report on Christchurch Airport's PSE3 pricing – cross-submission

To the Commerce
Commission

6 September 2018

INTRODUCTION

1. BARNZ welcomes the opportunity to make this cross-submission in response to submissions published on the Commission's consultation paper *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, dated 19 July 2018.
2. This cross-submission is made on behalf of the airlines¹ which BARNZ has written authority under s2A of the Airport Authorities Act 1966 to represent during consultation over charges with New Zealand Airports.
3. BARNZ's contact person for this submission is:

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STATUS OF THE DRAFT REPORT'S CONCLUSIONS ON CHRISTCHURCH AIRPORT'S ASSET BETA

4. In its Draft Report, the Commission put forward compelling analysis to demonstrate that the 0.05 asset beta adjustment within the WACC used by Christchurch Airport for pricing setting purposes (6.82%) was not justified. BARNZ agrees with the Commission's analysis.
5. Christchurch Airport has not responded to or tried to rebut the Commission's analysis, or defended its asset beta adjustment in any way. Instead it has framed the Commission's analysis as "further guidance" that it "will consider and reflect on" when setting prices for PSE4.²
6. This highlights a shortcoming in the regulatory settings for airports. Christchurch Airport has set prices based on an asset beta adjustment that the Commission has concluded is unjustified and which the airport is not seeking to defend. Had the asset beta adjustment not been made, prices would have been lower – so consumers are paying prices that were set based on a WACC that all parties now appear to accept is too high (while the airport's overall target return of 6.44% is reasonable, this return was only reached because CIAL included incentive costs in its disclosed aeronautical opex, despite making a commitment to exclude these costs from pricing and despite these costs being non-transparent and being unevenly spread across airlines).
7. We find it troubling that under the current regulatory settings, the airport can respond to a finding that a key input used to set prices was not justified by simply keeping the prices

¹ Air Calin, Air China, Air Tahiti Nui, Air Vanuatu, Airwork, American Airlines, Cathay Pacific Airlines, China Airlines, China Eastern, China Southern, Emirates, Fiji Airways, Hong Kong Airlines, Korean Air, LATAM Airlines, Malaysia Airlines, Philippine Airlines, Qatar Airways, Singapore Airlines, Tasman Cargo Airlines, Tianjin Airlines, Thai Airways International, United Airlines, Virgin Australia.

² Christchurch Airport submission on Christchurch Airport Draft Report, paragraph 46.

unchanged (thus keeping the money) and saying it will consider the issue again next time prices are set. Ideally the airport would reduce its prices to reflect what they would have been had a justifiable asset beta been used in the WACC input to the pricing model.

However, there does not appear to be any scope in the regulatory settings to drive this outcome – which is not good enough in terms of protecting consumers.

COST OF CAPITAL ASSESSMENT

8. The submissions by Auckland Airport and NZ Airports' Association argue that the mid-point WACC estimate should not be a "bright-line test" and the Commission should publish information about the standard error of the WACC estimate.³ Auckland Airport states that the Commission "misleadingly conveys that determining a 'sufficiently justified' airport-specific WACC is a task capable of precision. The reality is that significant judgement is required, and, as conveyed by the standard error for the WACC IM, this judgement is inherently prone to error."⁴
9. The airports are correct that WACC estimates are uncertain. But they are seeking to use that uncertainty to create an environment where excessive profits become easier to extract. Auckland Airport and NZ Airports' Association appear to want to see the reintroduction of a WACC range. The effect of this, of course, would be that all of the regulated airports would then set prices based on a WACC set at the top of whatever range the Commission determines. This would mean consumers would consistently pay prices above the best estimate of the cost of capital. This consumer harm is why the previous WACC range was criticised by the High Court and then removed by the Commission.
10. Alternatively, if the Commission were to publish statements relating to the degree of uncertainty regarding the WACC estimates, then the airports would use these statements to deflect any criticism that their target returns are too high and thus be emboldened to set prices that are based on high WACCs and earn excessive profits at the expense of consumers.
11. In the light of these consequences, we consider the Commission's approach to be optimal. The Commission considers a range of evidence and determines a WACC estimate for regulated airport services. If an airport can demonstrate that the estimate is inappropriate for a particular airport then a different WACC can be used. However, given the consumer impact of increased prices, the evidence for using a different WACC needs to be clear. Additional costs to consumers cannot be justified simply on claims of 'judgement' and 'uncertainty'.

³ Auckland Airport submission on Christchurch Airport Draft Report, paragraph 17. NZAA submission on Christchurch Airport Draft Report, paragraph 7(c).

⁴ Auckland Airport submission on Christchurch Airport Draft Report, paragraph 16.

12. Auckland Airport and New Zealand Airports' Association also continue to argue for the use of an airport's own beta estimate. This would not be sensible, for the reasons explained by TDB Advisors in their report on Auckland Airport's cost of capital:⁵

Estimates of beta for a single company have a lot of variability. Noise in the returns data can obscure the true beta for a company. As companies in the same industry face similar cyclicity in their revenue and have similar cost structures there are good theoretical reasons why they would have the same underlying asset beta. Taking a large sample of comparable companies reduces the statistical error in the estimation.

13. Auckland Airport also states that it cannot be right that Auckland and Christchurch Airports both have the same systematic risk for PSE3 and that they are both equivalent to the comparator sample.⁶ However, as TDB notes, there are good reasons to believe that companies in the same industry would have the same underlying beta. The aim is to develop a reliable estimate that can be used for pricing purposes and the statistical error is much reduced when a sample of companies is used.

OTHER REGULATED SERVICES (LEASED SERVICES)

14. Christchurch Airport's submission contains some helpful information about its 'other regulated services' – ie services that are within the definition of the regulated specified airport services but outside of the standard aeronautical pricing decision. Auckland Airport and the New Zealand Airports' Association also comment on how the Commission should assess returns on these services.
15. We agree with Auckland Airport that the question to focus on is what is the "best method to assess whether these prices [for other regulated services]"⁷ are meeting the Purpose of Part 4. The information provided through this consultation process has been helpful but there is more work to be done and the Commission is likely to need additional data. BARNZ at this stage has no fixed view of the best approach for the Commission to take when regulating these services. However, we offer some comments on pertinent points raised in the airports' submissions.
16. It seems from the information provided by Christchurch Airport that its prices for other regulated services are set based on 'market rates' (perhaps an assessment of comparable property rentals at the time a lease was entered into). This means there is no reason to expect current airport practice to deliver a return on other regulated services that reflects an aeronautical services WACC – this seems likely to be true across any time period the Commission could consider. This is acknowledged by Christchurch Airport in paragraph 39.3 of its submission.
17. This creates some problems for the Commission's review of information disclosures relating to other regulated services. If we are to accept the view that rates for leased services are set on market rentals that are not related to an aeronautical WACC then there

⁵ TDB Advisory, Review of Aspects of AIAL's Beta for the PSE3 Pricing Decision, 26 June 2018, page 5.

⁶ Auckland Airport submission on Christchurch Airport Draft Report, paragraph 24b.

⁷ Auckland Airport submission on Christchurch Airport Draft Report, paragraph 9.

is no benchmark to which we can compare the rents that are being charged and the Commission may need to develop a new comparable standard.

18. However, there are grounds to think that a linkage to a regulatory airport WACC estimate would be reasonable – this is because the airport companies in the Commission’s comparator sample will all offer similar services to the other regulated services provided by New Zealand airports. Therefore, the returns on these services from the other airports should be incorporated into the asset beta average used by the Commission to determine its mid-point WACC estimate. In other words, it is not obvious that an aeronautical WACC estimate (over an appropriate time period) is an inappropriate benchmark for other regulated services.
19. A theme in the airport submissions is that airports have limited market power in at least some of the other regulated services.⁸ Auckland Airport quotes an Australian Productivity Commission statement that some leased services are only subject to limited market power.⁹ However, the services referred to by the Productivity Commission are not a complete set of other regulated services, include some services that are not regulated under Part 4 and exclude those services that we are particularly concerned about.
20. As noted in our previous submission, airlines, ground handlers and the aviation security service all require leased space at airports and have no option to locate elsewhere – in most cases they will have no choice but to procure the lease. The airports will have market power in these instances and regulatory oversight is required. It follows from this that we do not agree with NZ Airports’ Association’s statement that the process for setting prices for other regulated services “reflects a competitive market process”¹⁰ – if this was the case there would be no need for these services to be regulated.
21. BARNZ looks forward to working with the Commission as it considers the best approach for assessing the returns earned by airports on their other regulated services.

CHRISTCHURCH AIRPORT’S CONSULTATION PROCESS

22. Christchurch Airport’s submission states that BARNZ had commented favourably on the airport’s price setting consultation process.¹¹ We think it would be helpful to clarify this. We have previously stated that we thought Christchurch Airport’s consultation process was transparent and we found their pricing model helpful.¹² While this is still mainly correct, we note that our previous favourable comments were made before we were fully aware of the differences between the airport’s pricing consultation material and the airport’s pricing

⁸ For example, NZAA submission on Christchurch Airport Draft Report, paragraph 34.

⁹ These were: aircraft heavy maintenance facilities, flight catering, freight and ground equipment storage sites and commercial and retail activities. Auckland Airport submission on Christchurch Airport Draft Report, paragraph 11c.

¹⁰ NZAA submission on Christchurch Airport Draft Report, paragraph 29.

¹¹ Christchurch Airport submission on Christchurch Airport Draft Report, paragraphs 10.3 and 68.1.

¹² BARNZ Assessment of CIAL PSE3 pricing decision against Part 4 criteria, page 10.

disclosures in relation to the target return, which we discussed in our submission on the Christchurch Airport PSE3 Draft Report.¹³

¹³ BARNZ submission on Christchurch Airport Draft Report, 16 August 2018, page 3.