

Queenstown aerodrome – night operations and building upgrade

Consultation Response Document

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1 Executive Summary

Queenstown (QN) airport is NZ's fourth busiest, and fastest growing international destination. New lights and a building upgrade is a critical infrastructure investment that will facilitate sustainable growth. The investment will move QN aerodrome from a regional low volume airfield to an international airport to meet the needs of our customers.

Airways issued a proposal document on 29 October 2014 detailing the proposed new lights and building upgrade, and the impact on prices at QN aerodrome. Stakeholders were invited to provide feedback on the proposal.

This document represents the final stage in Airways' consultation process and includes a summary of the feedback received and, Airways' response to and decisions made in light of the feedback.

Airways received submissions from Air New Zealand, Board of Airline Representatives of New Zealand (BARNZ), Jetstar, and Qantas which were carefully considered. The key outcomes of the consultation process are:

- **Install new lights to facilitate night operations at QN aerodrome** - Airways will proceed with the lighting equipment upgrade to enable night operations for the 2016 winter season.
- **Proceed with the building upgrade** - Airways carefully considered the merits of delaying the building upgrades and determined that building now provided the best economic and operational outcome. It is estimated that deferring the building upgrades would cost an additional \$1.0m in the long-term.
- **Pricing changes delayed until the 2016 – 2019 pricing round** - The price change required to fund the lights and building upgrade will be delayed until the 2016-2019 pricing period which takes effect on 1 July 2016. The price change to be proposed at that time will be calculated using the actual cost of the new lights and building upgrade. Stakeholders will have a further opportunity to provide feedback on the application of the pricing (including the volume pricing assumptions used in its calculation) as part of the 2016 – 2019 pricing consultation process.

Table 1 lists the key topics raised in the four submissions received, and a summary of changes made to the original proposal. More detail is provided in sections 3.1 – 3.9 of this document.

Table 1: Summary of key submission topics

Submission topic	Airways' proposal	Submitters feedback	Changes ¹ to proposal
Lighting upgrade	Install new lights to increase capacity in time for the 2016 winter season.	All submissions agreed with the proposal.	No change.
Building upgrade	\$4.0m building upgrade required to move QN aerodrome from regional low volume airport to an international airport.	Air NZ and BARNZ agreed that building now presented the best financial and operational outcome. Jetstar and Qantas proposed that the building upgrades be deferred.	No change.
Pricing start date	QN aerodrome prices to be increased from the later of 1 April 2016, or when the lights become operational.	Pricing start date should be delayed until the start of the next pricing round on 1 July 2016.	Prices to change from 1 July 2016. Final prices will be determined as part of the 2016 – 2019 pricing consultation.
Pricing weight	Cost of new lights to be recovered from aircraft over 30 tonnes. Cost of buildings to be recovered from aircraft over 5 tonnes.	Qantas and Jetstar submitted that the cost of new lights should be recovered from all users.	No change. To be reassessed if Air New Zealand's ATR fleet become capable of flying night operations.

¹ To the extent a change to the proposal in relation to pricing related feedback is identified above, the specified change is the approach that will be adopted with regard to the relevant item in developing the pricing proposal for the 2016 – 2019 consultation process.

Submission topic	Airways' proposal	Submitters feedback	Changes ¹ to proposal
Useful life of assets	Lights depreciated over 20 years. Buildings depreciated over 30 years.	Jetstar suggested a useful life of 40 years for both lights and buildings.	No change to lighting useful life as 20 years is the maximum useful life for lighting equipment. Buildings increased to a useful life of 40 years.

Price impact

The investment has been committed and, subject to the outcome of the 2016 – 2019 consultation process, will be recovered by an increase to QN aerodrome prices from 1 July 2016. The final pricing inputs will be finalised during the 2016 – 2019 pricing consultation. For information purposes table 2 shows the indicative price increase from 1 July 2016, using the pricing assumptions² from the proposal document.

Table 2: Indicative QN aerodrome price increase from 1 July 2016

	Consultation document proposal	Revised indicative price increase
5 – 30 tonne aircraft	14%	13%
Over 30 tonne aircraft	29%	28%

² Pricing input assumptions used in the proposal document - Volume growth: 4.9% p.a., Weighted Average Cost of Capital (WACC): 7.8%, Lighting cost: \$2.2m, Building cost: \$4.0m.

2 Introduction

From October 2014 to December 2014 Airways invited feedback on its proposal for night operations and a building upgrade at Queenstown (QN) aerodrome. The proposal document can be found on our website at https://www.airways.co.nz/airways_Services/pricing_consultation.asp.

New lights and a building upgrade are required to enable QN to move from a regional low volume airfield, to an international airport that meets the demands of NZ's fourth busiest, and fastest growing international destination. This is a critical initiative to facilitate sustainable growth at QN.

2.1 Document purpose

The purpose of this document is to:

- Summarise the key issues raised by submitters to *Queenstown aerodrome price proposal for night operations and building upgrade*,
- outline Airways' responses and the rationale for those responses,
- describe any changes made to the proposed night operations, building upgrade, and proposals in relation to QN aerodrome prices.

2.2 Consultation process

This document completes the consultation process by providing Airways' responses to the issues raised in submissions, and describing any changes to the proposal.

Table 2: Consultation process

Task or milestone	Planned date	Status
Consultation documents released	29 Oct 2014	✓ Completed
Presentations to key customers	29 Oct 2014 to 7 Nov 2014	✓ Completed
Closing date to request additional information	14 Nov 2014	✓ Completed
Deadline for submissions	28 Nov 2014	✓ Completed (Extended to 3 Dec 2014)
Submissions published on Airways' website	19 Dec 2014	✓ Completed
Airways' decision	25 Feb 2015	✓ Completed
Publication of Consultation Response Document and any price changes	3 Mar 2015	✓ Completed

2.3 Background

During the 2013 – 2016 Air Navigation Services (ANS) pricing consultation process the QN lighting and building upgrade projects were removed from the current price path, to be addressed in a separate consultation. The investments of \$1.8m for the lights and \$2.2m for the building were removed after considering airline feedback that the consultation should be delayed until the Civil Aviation Authority (CAA) approved the safety case for night operations into QN. This safety case was approved by the CAA in July 2013.

The existing equipment room and office at QN was originally built in 1968 as a flight service station when QN Airport operated as a small regional aerodrome. The control tower cab was added in 1993. QN Airport is now the fourth busiest airport in New Zealand by passenger traffic and handles over 50 international movements per week during the peak winter season. Over the past five years total IFR movements at QN have grown on average 5% p.a., including international movement growth of 29% p.a.

Airways now requires 11 air traffic controllers and two technicians to cater for the rapidly increasing volumes. The current buildings at QN are now too small to fit the increased number of staff and the extra equipment that was added when multilateration surveillance and the first phase of the lighting was introduced. Figure 1 below illustrates the airport growth around Airways' tower. The footprint of the tower has changed very little while the airport has grown rapidly around it.

Furthermore, the current buildings have asbestos in the external and internal walls and very steep stairs which are a workplace safety hazard.

The lighting upgrade project will also require additional space in the QN equipment room and within the power centre. The additional power centre requirements needed for the lights will also force the redeployment of the technicians and creates a need for new workshop space for them.

2.4 Submissions received

A total of four written submissions were received from Jetstar, Air New Zealand, BARNZ, and Qantas/Jetconnect (referred to as Qantas in this document).

Customer submissions were published on Airways' website on 15 December 2014 to ensure transparency.

It should be noted that, while all feedback has been considered in making the decisions set out in section 3, and this document provides a summary of the key points made in the submissions, this document is not intended to provide an exhaustive list of all points raised.

For a full list of submissions please refer to our website, at:

https://www.airways.co.nz/airways_Services/pricing_consultation.asp

3 Consideration of submissions

This section provides Airways' response to the topics raised in the four submissions received.

Airways have carefully considered all four submissions received and have revised several of Airways' proposals.

3.1 Lights upgrade

Airways' proposal

Airways proposed to upgrade the lighting equipment to allow night operations and provide building space to house the additional lights. The cost for this is \$2.2m, made up of \$1.4m for the lighting equipment and \$0.8m for building space to accommodate the new equipment.

Summary of submissions

All submissions support this capital expenditure.

Airways' response

Airways will proceed with the lighting equipment upgrade to enable night operations for the winter 2016 season.

The introduction of lights will increase capacity at QN aerodrome by enabling the hours of service during the winter months to be the same as summer. Airways estimates that the increased capacity will provide benefits of over \$22m³ to the airline industry.

The new lights will also facilitate operations throughout the night if required, however this would require resource consent and an increase in air traffic control numbers which is not included in Airways' current pricing.

3.2 Building upgrade

Airways' proposal

Airways proposed to undertake a building upgrade which will replace the existing equipment room and office space with a new purpose-built Importance Level 4 facility containing an equipment room, office space, meeting and training space, and staff facilities. This is expected to cost \$4.0m and will allow the

³ Key assumptions: a) Eight additional international flights per week during the peak winter season of 12 weeks, increasing by 8% p.a. b) 4,400 extra pax in year 1 assuming 80% loading on a mix of A320 & B737-200 aircraft. c) Average fare of \$850, and airline yield of 3.5% d) Maximum additional weekly flights is 30 per week e) NPV calculated over the life of the asset. f) Average inflation of 2.5% g) Discount rate of 7.8%.

move to an international service standard with additional staff accommodation, reduced operational and workplace safety risks and improved service reliability.

Summary of submissions

Air New Zealand support the capital expenditure, and wrote in their submission:

“We appreciate that Airways has investigated alternative options to undertake this investment, but has determined that these deliver an inferior operational and financial outcome over the longer term. Air New Zealand agrees with this conclusion”

Jetstar and Qantas both stated a preference to defer the building works. They also requested more information about the breakdown of costs for the building upgrade to enable them to make a more informed decision.

BARNZ engaged with Air NZ, Qantas, Jetstar and Virgin Australia before writing their submission which supports the new building. They wrote “The intermediate option of only refurbishing the existing equipment room would be taking a very short term view of the expenditure.”

Airways’ response

Delaying the building upgrade would require a temporary building or a temporary lease. Airways estimates that the additional costs of deferring the building for a five year period would be in the order of \$1.0m.

Airways will proceed with the proposal to upgrade the building as over the longer term the proposed building provides the best operational and financial outcome.

Airways also notes that the building cost of \$4.0m provided in the proposal document was based on estimates provided by an independent quantity surveyor. When new prices are set from 1 July 2016, they will be based on the actual costs of the buildings and lights. If the final building cost is less than the estimate of \$4.0m then the savings will be passed to customers via a lower QN aerodrome price.

Airways believes sufficient detail was provided in the consultation document to make an informed decision. The customer meetings and formal period for further information requests provided the opportunity for customers to ask for further explanation if it was required.

3.3 Pricing start date

Airways’ proposal

Airways proposed that the start date for the price increase will be from the later of 1 April 2016, or when night operations begin. The changes would then be subject to subsequent adjustments in line with Airways’ general three-yearly price reviews. The next price review will take effect from 1 July 2016.

Summary of submissions

Air New Zealand, BARNZ, and Qantas submitted that the new price should come into effect from 1 July 2016, when the 2016 - 2019 pricing period begins. Air NZ expanded further to state that "...the forecast shortfall associated with the first part year of operation of approximately \$0.2m would be offset by a positive EVA outcome for Queenstown Aerodrome and Approach Services."

Airways' response

Airways has considered the unique set of circumstances at QN. After considering the rapid growth at QN over the past five years, and given that the proposed pricing start date is only three months before the next pricing round Airways will defer the start date to 1 July 2016.

A deferral of the pricing start date to 1 July 2016 will allow prices to be set more accurately. Airways will have a more current volume forecast, and the capital cost will be based on the actual cost of the lights and building rather than the current project estimate. Deferring the pricing start date to 1 July 2016 is also more efficient and less complex for Airways to administer as the changes will be made as part of the 2016 – 2019 pricing process.

The proposed price increase for the lights and building upgrade will be consulted upon as part of the 2016 – 2019 pricing consultation and will:

1. Be based on updated volume forecasts for QN aerodrome;
2. be calculated using the Weighted Average Cost of Capital (WACC) applicable for the 2016 – 2019 period; and
3. reflect the actual capital costs of the lighting and building upgrades,

Stakeholders will have an opportunity to provide feedback on these items as part of the 2016 – 2019 pricing consultation process.

In response to Air New Zealand's comments about the EVA position at QN it is important to note that the EVA results included in the annual BARNZ disclosure do not include an allocation of corporate overheads, so looking at the QN aerodrome and approach EVA in isolation may present a misleading view of the true EVA result.

3.4 Pricing weight

Airways' proposal

Airways proposed to recover the cost of the lighting upgrade by increasing the Aerodrome Service price for aircraft over 30 tonnes. This excludes the ATR 600 aircraft which we understand are currently not equipped to be able to use the lights.

Airways proposed that the weights the new prices are applied to, and the volume assumptions would be reassessed during the 2016 – 2019 pricing consultation. Prices will be adjusted from 1 July 2016 if aircraft lighter than 30 tonnes are able to use the lights.

The cost of the building replacement will be recovered by increasing the Aerodrome Service price for all aircraft over five tonnes. En-route and Approach Service charges are not affected by this proposal.

Summary of submissions

Air New Zealand supports Airways' proposal to allocate the costs of the lighting upgrade to aircraft over 30 tonnes, as these are the only aircraft equipped for night operations at this time. Jetstar and Qantas are opposed to this. Both believe that costs should be recovered from all aircraft over 5 tonnes. Furthermore, Qantas stated that "it is imperative that the costs associated with this proposal are recovered from all airport users whether they chose to have night operations or not at this point in time. To disadvantage one group of Airport users through a costs recovery mechanism is in contrast to the philosophy of a fair and equitable user pays model and potentially could facilitate unfair competitive advantage."

Airways' response

When setting prices Airways is guided by the Pricing Principles outlined in the Pricing Framework. In practice this often involves finding a balance between the Principles. In this instance, the Principles specifically considered included taking account of the difference in value customers derive, reflecting costs, and be transparent and practicable to implement.

The approved safety case for night operations at QN includes a mandatory requirement for aircraft flying at night to be capable of flying RNP-AR⁴ procedures. Generally, only aircraft over 30 tonnes that fly into Queenstown are RNP-AR capable and therefore capable of using the lights. Airways understands that there are currently no ATR aircraft that are RNP-AR capable.

As noted in section 3.3, any final decisions with regard to pricing will be made following the 2016 – 2019 pricing consultation. However, Airways proposes to only apply the charge for lights to aircraft over 30 tonnes. Airways' pricing proposal for the 2016 – 2019 pricing consultation will reflect this approach. However, if any of the ATR fleet subsequently become RNP-AR capable Airways will review the pricing weights.

3.5 Price smoothing

Airways' proposal

Airways' proposed prices were calculated using the Economic Value Added (EVA) framework which is consistent with Airways' Pricing Framework and a form of the cost building block method that is commonly used to set prices in regulated industries. Airways' prices are set at EVA = 0, meaning that revenue is equal to the cost of delivering services (including operating costs, depreciation and tax), while providing a fair return to the shareholder.

⁴ RNP-AR (Required Navigation Performance – Authorisation Required) procedures require users to meet specified performance criteria and be authorised to use the procedures.

Summary of submissions

Air New Zealand questions Airways' focus on achieving EVA = 0 from day one of the lives of the assets, particularly in the case of long-lived assets such as these. They suggest an alternative approach could be to consider mechanisms to achieve EVA = 0 over a longer time period, rather than in every single annual period, and to achieve a flatter profile of charges through capitalising on activity growth.

Qantas presented a similar opinion to Air New Zealand in their submission:

"Another element that is important is the timing of the pricing increases related to lumpy infrastructure builds that materially increase charges. It is not an efficient or equitable process to calculate the charges only over a short 3 year recovery period, rather pricing should be smoothed over a much longer period of time to avoid a pricing shock to the industry. This is particularly relevant at Queenstown, being a leisure and seasonal destination, whereby substantial cost increases reduces demand, lowering the revenue and increases the charges again, thus creating a negative cost recovery cycle for all parties involved."

Airways' response

Setting prices at a level to achieve EVA = 0 is part of the price setting methodology outlined in Airways' Pricing Framework and is used to calculate prices for the Queenstown Aerodrome Service which the new lights and building upgrade will form part of. The key reasons Airways uses EVA = 0 to set prices are:

- (1) Prices should reflect the cost of delivering services (meeting the "Reflect Cost" Pricing Principle"⁵). Pricing at EVA = 0 means that customers are paying for the cost of a service in the year that they use the service. The alternative of smoothing prices over the life of the asset means that a concession given in the early years of an assets life would need to be offset with higher prices in subsequent years. This could mean that some customers fund more of the asset than they actually use – e.g. customers using the asset in the early stages of an assets life would be paying less of the asset cost than those using the asset later in the assets life. If the mix of customers using a service over time changes, customers using the assets in later years would be subsidising those using the asset initially.
- (2) To provide Airways' shareholder with an appropriate return (as required by the "Be commercially sustainable" Pricing Principle). Airways sets prices at EVA = 0 so it can provide its shareholder a fair return each year. If Airways smoothed its prices for this service then Airways would provide a fair return to its shareholders over the life of an asset, but not in each year – early years would provide a less than fair return and later years greater than the fair return.

⁵ The Pricing Principles are the principles that Airways used to guide the development and implementation of its Pricing Framework and resulting prices. The Pricing Principles are provided in Airways Pricing Framework which can be found at http://www.airways.co.nz/airways_Services/service_and_pricing_review.asp

Most customers use a mix of Airways services, each being priced using EVA = 0. This means that a price 'spike' in one service caused by a new asset, will be smoothed by other services that have assets of different ages. While individual service prices change as new assets are added and existing assets age, over all of Airways services prices are smoothed.

Airways will proceed with maintaining EVA = 0 to calculate proposed prices for the lights and building upgrade in its 2016 – 2019 pricing proposal. This methodology is consistent with all of the other assets included in the Queenstown Aerodrome Service and most of Airways' other services.

3.6 Useful life of assets

Airways' proposal

Airways proposed a depreciation period for the lighting equipment and buildings at 20 and 30 years respectively which are the estimated useful lives used by Airways for lighting equipment and control towers.

Summary of submissions

Jetstar submitted that a 40 year asset life is more appropriate.

Airways' response

Airways asset depreciation periods are based on useful life guidelines that are reviewed annually by Airways' subject matter experts and PriceWaterhouseCoopers. Airways' current useful life guidelines use 20 years for lighting equipment, 30 years for control towers, and 40 years for all other buildings.

Upon review, the nature of the building upgrade could reasonably be deemed to not directly relate to the control tower. Therefore we agree with Jetstar that a 40 year useful life is more appropriate for the building upgrade. The lighting component should still be depreciated over a 20 year period to reflect the expected useful life of the equipment. This change will be reflected in Airways' 2016 – 2019 pricing proposal and is expected to reduce the final price increase in respect of this upgrade by approximately 1%.

3.7 Source of funding

Airways' proposal

Airways proposed to fund the investment in lights and the building upgrade by increasing the QN Aerodrome price.

Summary of submissions

- Jetstar suggested "Airways may source funding from unspent capital expenditure budget from other projects, opposed to implementing a significant increase in Queenstown charges."

- Qantas recommended that Airways explore some other key stakeholders who could contribute towards the cost of the lights. They gave examples such as Queenstown Tourism and the associated tourism infrastructure that would directly benefit from an increase in passengers to Queenstown. They also asked if Airways had considered self-funding the lights from its own unallocated or delayed capital expenditure budget.
- Air New Zealand questioned the extent of the increases when Airways' budget for Queenstown aerodrome and approach services suggests that the positive EVA generated by these services in 2015 will be sufficient to fund the lighting and building investment. They also noted that Airways' FY14 result was ahead of forecast and delivered a positive EVA outcome across the "Domestic" business. They believe it is appropriate to re-invest this return into the business in the form of contributing to the proposed investment at Queenstown.

Airways' response

Airways sets location specific prices every three years to achieve an EVA = 0 position (see section 3.5 for more detail). The pricing includes a capital charge and depreciation expense based on the existing capital outlay at each location plus the forecasted capital spend over the next three years. If the actual capital spend during the three year period differs from the forecasted capital spend this is reflected in the following price round. This means that any underspent capital budgets are adjusted for in the next pricing period.

In response to Qantas' suggestion to investigate funding from other stakeholders we note that the introduction of night operations has been driven by requests from airlines, as they are the prime beneficiaries of night operations and are best placed to recover charges from the end users of this service. The wider QN will benefit indirectly but it would be impractical to recoup funds from this source.

Prices are set at a level to achieve EVA = 0, based on the best available information at the time of price setting. Airways bears the risk of the actual EVA results being higher or lower than EVA = 0. Airways do not seek to recoup negative EVA results from customers within a pricing period, nor does Airways return surplus EVA results to customers.

Accordingly, Airways' 2016 – 2019 pricing proposal will still be developed based on relevant costs being recovered by increasing the QN Aerodrome price.

3.8 Consultation process

Airways' proposal

Airways followed a robust consultation process designed to allow engagement with all affected stakeholders directly.

Summary of submissions

Qantas submitted that the timeline and information provided for the consultation for these substantial projects has been insufficient to provide a well-informed response.

Airways' response

The release of this document marks the end of an extensive consultation process, which Airways believes provided customers the time required to request further information and to provide informed input into the final decision. The consultation timetable was consistent with Airways other recent consultation processes.

During the consultation period Airways attempted to meet all affected stakeholders directly to discuss the proposal. Qantas did not respond to Airways' requests to meet. Airways also presented the proposal at the annual BARNZ meeting during the consultation process.

3.9 Cost of capital

Airways' proposal

Airways' proposed prices were calculated using a WACC rate of 7.8%, which was set at the 75th percentile in accordance with the Commerce Commission's input methodologies.

Summary of submissions

Air NZ noted that the "Commerce Commission has recently reviewed its approach to establishing the point estimate of the WACC and concluded for gas pipeline and electricity distribution businesses that the appropriate point estimate is the 67th percentile."

Airways' response

In light of the decision to defer the pricing start date to 1 July 2016 (see section 2.3) Airways will revisit the WACC rate during the 2016 – 2019 pricing consultation process. Airways will consider the Commerce Commission's approach to the point estimate at that time.