

Project no. 17.01 / 15481
18.01 / 15481

Public version

Input methodologies review

Airports profitability assessment – workshop 2

Summary of views expressed

Date of publication: 16 June 2016

Purpose of this paper

1. This paper provides a summary of views expressed by participants of the second of two workshops for the input methodologies review (IM review) in relation to the airports¹ profitability assessment (Airports workshop 2).

Workshop purpose and objectives

2. Airports workshop 2's purpose was to present Commission staff's emerging view on the approach to assessing profitability and to discuss the pros and cons of possible solutions to the problems identified in the first workshop with the interested parties.
3. The proposed solutions included changes to input methodologies (IMs) and information disclosure (ID) Determinations in order to provide a meaningful headline indicator of expected profitability when airports disclose information about price setting events (PSEs).
4. The objectives of Workshop 2 were:
 - 4.1. to provide stakeholders with an overview of the Commission staff's emerging view on how we might assess profitability in future;²
 - 4.2. to provide demonstrations of how proposed solutions for specific issues that have been identified for the IM review in relation to the airports profitability assessment would work;
 - 4.3. to give stakeholders an opportunity to present their views on how profitability should be assessed in future; and
 - 4.4. to identify potential changes to both IM and ID Determinations.
5. The airports profitability assessment discussed at Airports workshop 2 excluded the Market Value Alternative Use (MVAU) land valuation topic which was considered as part of the airports fast track process.³

¹ References to airports in this paper are to those airports regulated under Part 4 of the Commerce Act 1986, being Auckland International Airport Limited, Christchurch International Airport Limited, and Wellington International Airport Limited.

² In developing our view, we have taken into account the views expressed by participants of the IM review forum held in July 2015 and Airports workshop 1. In addition, we took into account the views expressed in submissions made by stakeholders following these two events as well as the submissions on the Problem definition paper (6 June 2016) <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>.

³ Commerce Commission "Input methodologies review – Amendments to input methodologies for airports land valuation – Final reasons paper for the airports fast track review" (24 February 2016).

Workshop format and process

6. Airports workshop 2 used a round table format to allow an open discussion and exchange of information between workshop participants. A full range of views was provided during discussions with workshop participants as well as through presentations from participants.
7. New Zealand Airports Association (NZ Airports) and Auckland International Airport Limited (Auckland Airport) presentations can be found on our website.⁴
8. Any views expressed by our staff at Airports workshop 2 were for the purpose of stimulating discussion, and were not intended to reflect the views of the Commission. The Commission's position is provided in the draft decision.

Role of workshop in the consultation process

9. Airports workshop 2 was a step in our process for considering amendments to the airports IM and ID Determinations to support our proposed approach to airports profitability assessment.⁵
10. Airports Workshop 2 focussed on seeking interested parties' views on the Commission staff's emerging view on the possible solutions to the issues that have been identified for the IM review in relation to the airports profitability assessment through amendments to the airports IM Determination and ID Determination.
11. Views expressed at the workshop informed our proposed solutions to amendments to the IM and ID Determinations.
12. We intend to complete the IM review by December 2016, and will work towards a similar timeframe for final amendments to the ID Determination.

Workshop date and venue

13. Airports workshop 2 was held on 26 April 2016 in the Sunderland room at Wellington Airport Conference Centre.

Outcome of the Airports workshop 2

14. Airports workshop 2 was attended by key airport services stakeholders.⁶

⁴ <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/airport-profitability-assessment/>.

⁵ We also discussed proposed solutions relating to the setting of the initial RAB.

⁶ The list of attendees is attached to this document as Attachment A.

15. Airports workshop 2 generally followed the agenda and the discussions were supported by the workshop papers.⁷ Due to the interrelated nature of the topics, issues were sometimes discussed and addressed in an alternative order to what was outlined in the agenda and workshop papers.
16. Commission staff appreciated the open discussion, and we would like to thank participants for their contribution to the outcome of Airports workshop 2.
17. A summary of views expressed at Airports workshop 2 is included in Attachment C.

⁷ The agenda is attached to this document as Attachment B. The workshop papers can be found on our website at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/airport-profitability-assessment/>

Attachment A: Workshop attendees

No.	Representing	Name	Role
1	Auckland Airport	Adrienne Darling	Head of Economic Regulation and Pricing
2	Auckland Airport	Phil Neutze	Chief Financial Officer
3	Auckland Airport	Natalia Plamadeala	Corporate Analyst
4	Auckland Airport	Emma Rae	Senior Advisor Economic Regulation and Pricing
5	Air New Zealand	Sean Ford	Manager Aeronautical Suppliers
6	BARNZ	John Beckett	Executive Director
7	BARNZ	Kristina Cooper	Legal and Regulatory Counsel
8	Commerce Commission	Hazel Burns	Senior Analyst
9	Commerce Commission	Luana D'Appollonio	Senior legal counsel
10	Commerce Commission	Kimberley Foo	Assistant Analyst
11	Commerce Commission	Calum Gunn	Principal Advisor
12	Commerce Commission	James Marshall	Senior Economist
13	Commerce Commission	John McLaren	Manager, Compliance and Performance Analysis
14	Commerce Commission	Jo Perry	Senior Analyst
15	Commerce Commission	Leigh Rafferty	Senior Analyst
16	Commerce Commission	Florian Steinebach	Senior Analyst
17	Christchurch Airport	Tim May	Chief Financial Officer
18	Christchurch Airport	Michael Singleton	General Manager Legal and Corporate Affairs
19	MEUG	Garth Ireland	Director, Ireland, Wallace & Associates (IWA)
20	NZ Airports	Kevin Ward	Chief Executive
21	NZ Airports	Christopher Graf	Senior Associate, Russell McVeagh
22	NZ Airports	Craig Shrive	Partner, Russell McVeagh
23	NZ Airports	Mike Basher	Director, Kooba Limited

No.	Representing	Name	Role
24	NZ Airports	Kieran Murray	Managing Director, Sapere Research Group
25	Wellington Airport	Martin Harrington	Chief Financial Officer
26	Wellington Airport	Meena Parbhu	Legal Counsel

Attachment B: Workshop agenda

Ref	Start	Session topic and discussion points	Duration
1	9.00	Introduction and welcome	10 min
2	9.10	Purpose and agenda <ul style="list-style-type: none"> • Purpose of the workshop • Overview of the agenda 	20 min
3	9.30	NZ Airports – Principles that inform profitability assessment under information disclosure	10 min
4	9.40	Overview – Approach to profitability assessment <ul style="list-style-type: none"> • Key elements of a forward-looking profitability indicator • Illustrative examples 	50 min
	10.30	Morning tea	15 min
5	10.45	Auckland Airport – Enabling transparency for Auckland Airport pricing and returns	15 min
6	11.00	Overview of proposed amendments to IMs and ID	75 min
	12.15	Lunch	60 min
7	1.15	Stylised examples <ul style="list-style-type: none"> • Un-forecast revaluation gains or losses • Risk allocation adjustments (eg, wash-ups) • Indexation of RAB • Non-standard depreciation 	25 min 20 min 30 min 30 min
	3.00	Afternoon tea	15 min
8	3.15	Stylised examples continued <ul style="list-style-type: none"> • Land held for future use 	30 min
9	3.45	Cost of capital	35 min
10	4.20	Wrap-up <ul style="list-style-type: none"> • Key issues covered • Next steps 	10 min

Attachment C: Summary of views

Introduction

1. This attachment is a summary of the views expressed at the Airports workshop 2. The summary of views has been grouped as per the chapters in the associated airports topic paper. However, due to the interrelationship of the problems identified in this topic, the views as outlined below may have been covered off in an alternative order during the workshop.

Forward-looking profitability indicator

2. The proposed forward-looking profitability indicator was discussed in slides 21 – 32 and 43 - 47 of the workshop papers.⁸
3. Clarification was sought as to whether the forecast closing asset base was IM-compliant or reflected an airports pricing event. Workshop participants discussed whether, given the proposed amendments, there would continue to be differences between the airports roll-forward of its assets for pricing purposes and the approaches prescribed in the IMs.
4. Wellington Airport noted that the five-year IRR can distort the view of profitability and therefore our analysis should include caveats and context to reflect this. Similarly, NZ Airports emphasised that no matter how good, effective and robust our rules are, it will always be appropriate to take a holistic approach with contextual analysis.
5. Commission staff expressed their view that the IRR would not be a replacement for Summary and Analysis and would simply be an additional tool for explaining airport profitability. It was also noted that the carry-forward could be used between pricing periods, with no tracking within the period, to ensure that the commitments made in one pricing period are reflected in the next.

Time profile of capital recovery

6. The proposed solutions regarding the issue of the time profile of capital recovery were discussed in slides 58 - 68 of the workshop papers.⁹

⁸ Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).

⁹ Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).

Asset revaluations

7. Auckland Airport noted that changing the way the RAB is disclosed creates challenges in the context of a moratorium. Although Auckland Airport thought that we should not suggest a preferred disclosure approach, and instead provide flexibility for transparent disclosure of the outcome of the price setting consultation, it expressed a preference to use of a carry-forward adjustment to opening and closing RABs.
8. Auckland Airport expressed a preference for using a carry-forward mechanism as this avoids re-stating the RAB and results in lower compliance and complexity costs. Auckland Airport indicated that re-stating the RAB is possible but backing out revaluations would take several months, would require engagement with third parties, and there is a risk of getting it wrong.
9. Auckland Airport noted that it would not be able to restate the RAB before the next PSE. It noted that the aggregate value of revaluations would be easier to determine than at an individual asset level. This is because Auckland Airport has approximately 60,000 asset lines.
10. Auckland Airport also noted that the effort required was disproportionately high given the moratorium may be unwound in future. It suggested having a separate carry-forward mechanism that was only used for revaluations. It also noted that it has not been applying zero revaluations to all assets in pricing, and that having a carry-forward would mean the moratorium could be unwound in the future.
11. BARNZ supported having two options to asset revaluations with airports able to select and explain their choice, and with the airport having to adopt the option that best reflects its approach at the pricing setting event.

Principles relating to non-standard depreciation

12. BARNZ supported the principles relating to non-standard depreciation and proposed rules in the IMs and the supporting explanatory level in ID. NZ Airports noted the proposed approach was a great example of prescription vs flexibility with lots of ins and outs. However NZ Airports noted there is a risk if we translate these principles into rules that it may be a deterrent to use these. It was suggested by NZ Airports that there may be scope for us to provide guidance on airports' using non-standard depreciation rather than having prescriptive rules about the use of those principles.
13. All parties agreed that disclosing straight line depreciation alongside non-standard depreciation is only useful in the first year following a non-standard depreciation methodology being used. Workshop participants were concerned that continually disclosing both straight line and non-standard depreciation beyond that first pricing period could create confusion and complexity.

“Principle 2”

14. Christchurch International Airport Limited (Christchurch Airport) asked for clarification on what was meant by ‘appropriate’ in principle two (ie an airport cannot disclose a non-standard depreciation profile if it is unable to justify or explain the time profile of capital recovery implied in its price setting is appropriate) and whether it would be a threshold test or something that the airport can decide.

“Principle 3”

15. In relation to principle three, Auckland Airport suggested that there might be circumstances where there is a need to switch from a standard to non-standard depreciation approach during a pricing period, for example if an asset had to be written off before planned.¹⁰

“Principle 5”

16. Auckland Airport further asked whether linking non-standard depreciation to the utilisation of the existing RAB was supposed to be a deliberate limitation to the airport’s ability to use non-standard depreciation.
17. Commission staff explained that linking non-standard depreciation to the utilisation or value of the existing RAB was more about ensuring that non-standard depreciation related to the existing RAB and how that is being utilised by airports. Commission staff further explained that this principle is intended to encourage airports to use, where appropriate, other more transparent options to appropriately account for assets outside the RAB (eg assets held for future use (AHFU)).

Ex-post effects of risk allocation

18. The proposed solutions regarding the issue of ex-post effects of risk allocation were discussed in slides 25 – 41 and 44 – 47 of the workshop papers.¹¹
19. There was a discussion on the purpose of the carry-forward mechanism. Auckland Airport and Wellington Airport expressed interest in how it would work and NZ Airports asked whether it would capture alternative risk sharing arrangements that were not set in advance (ie at the prior PSE).

¹⁰ Principle three is that the decision to use non-standard depreciation can only be made ex-ante, at the time when prices are set and the same methodology must be applied ex-post over the period the price setting event is in effect.

¹¹ Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).

20. Clarification was also sought on what happens if airports and airlines generally supported risk allocations different to the default assumption during the PSE. Clarification was also sought by BARNZ on whether the information provided by airports on the reasonableness of the risk sharing arrangements should include information on situations where no such risk-sharing arrangements have been put in place. NZ Airports' position was that the scope should be confined to adoption of alternative arrangements and the airlines should not have the ability to comment on Airports not adopting alternative approaches.
21. BARNZ expressed the view that details on the calculation of opening carry-forward needs to be provided under ID. BARNZ also made the point that if airports (instead of the Commission) determine the value of the carry-forward, airlines should be able to bring their views forward on what should be included in that value.
22. NZ Airports asked for clarification on the rationale for including un-forecast revaluation gains or losses in the carry-forward.
23. Commission staff explained why they think there is a natural hedge such that there does not need to be adjustments for un-forecast inflation gains or losses resulting from actual CPI being different from forecast. Staff also noted that this is the approach adopted for other sectors, so the question is whether there is anything unique about land and/or airports that requires a different approach.
24. BARNZ questioned why airports were not well placed to manage inflation risk. Commission staff expressed the view that there is no reason to assume that airports should always be best placed to control, manage and bear inflation risk and indicated that they would direct stakeholders to materials elaborating on this view.
25. BARNZ stated that it has been generally agreed among stakeholders that revaluations should be treated as income for ID purposes.
26. BARNZ expressed its view that an inflation wash-up was completely unnecessary.
27. BARNZ had concerns that real and nominal terms were being mixed. Commission staff explained how ex-post and ex-ante work together with the carry-forward – ie nothing would be backed out or adjusted for specialised assets.
28. BARNZ asked if any opening carry-forward adjustment could be split into two lines for revaluation gains and "other adjustments". This is because there could be many items that make up the carry-forward and the breakdown should be explained. Commission staff agreed there should be an explanation of the breakdown.

29. Workshop participants did not express a view on the date that any carry forwards should start from. Workshop participants also noted that there needs to be thought around whether there are already risk sharing arrangements in place. BARNZ suggested letting the airlines comment on what is appropriate, and the Commission giving consideration to these comments.

Treatment of forecast over and under-recoveries

30. The proposed solutions regarding the issue of the treatment of forecast over and under-recoveries were discussed in slides 25 – 32 and 44 – 47 of the workshop papers.¹²
31. BARNZ sought clarification on whether Commission staff expected that time value of money would be taken into account when using the forecast closing carry-forward as an input to determine the opening investment value.
32. BARNZ questioned whether the over and under-recoveries to be included in the closing carry-forward adjustment would reflect when an airport does not make as much money as planned. Commission staff clarified that this mechanism would only be for over and under-recoveries that the airport signalled when forecasting at beginning of the PSE.
33. Wellington Airport expressed concern that a requirement for airports to disclose the level of disagreement between airports and airlines may incentivise airlines not to agree.
34. Auckland Airport sought clarification on what to do about assets that are not revalued. In particular, how would non-IM-compliant values be reflected?
35. Workshop participants expressed the view that once the initial carry-forward was generally supported, profitability assessments should go on from there and not look back. It was also noted that there would need to be consistency between ex-post and ex-ante profitability assessments.

Assets held for future use

36. The proposed solutions regarding the issue of assets held for future use were discussed in slides 69 – 73 of the workshop papers.¹³

¹² Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).

¹³ Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).

37. BARNZ stated that an alternative option of carry-forward instead of AHFU balance is not helpful.
38. Auckland Airport noted that it will address any revenues associated with AHFU in an NPV neutral manner and prefers to have two options available (but prefers to offset AHFU revenues against AHFU balance).
39. Auckland Airport stated its intention to provide transparency hence had a preference for the option of a special levy being included in the forecast AHFU balance.
40. Workshop participants expressed the view that the stylised examples provided for the workshop give more transparency than the current Schedule 6 in the ID Determination.¹⁴

Pricing assets

41. The proposed solutions regarding the issue of leased (pricing) assets were discussed in slides 79 – 83 of the workshop papers.¹⁵
42. Pricing assets were previously referred to as leased assets in the problem definition paper and during Airport workshops 1 and 2.
43. Workshop participants noted that there is a need to be clear on the definition of leased assets and when they are in or out of the RAB, and that there should be consistency about the pricing asset base compared to the RAB and what is included in the asset base that is being disclosed.
44. BARNZ noted that information on pricing assets is necessary and it was missing in previous price setting disclosures. It noted that the information disclosed by airports needed to be useful (ie there should be information on the pricing asset base, the total RAB). NZ Airports questioned whether more transparency would justify increased complexity and compliance costs.
45. Auckland Airport expressed concern that the proposed solution in terms of pricing assets may require airports to determine opening and closing asset values for leased assets separately (including tracking those over time) and may cut across how assets are treated for pricing. Commission staff explained that this is not the intent.

¹⁴ Commerce Commission "Stylised examples – Airports profitability assessment workshop 2" (19 April 2016).

¹⁵ Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).

Forecast timing of cash-flows

46. The proposed solutions regarding the issue of the forecast timing of cash-flows were discussed in slides 74 – 78 of the workshop papers.¹⁶
47. The majority of workshop participants considered it was unnecessary for airports to provide monthly cash flow forecasts.

Initial RAB value of land

48. The proposed solutions regarding the issue of the initial RAB value of land were discussed in slides 53 – 57 of the workshop papers.¹⁷
49. Auckland Airport agreed that the emerging view (interpolation for a 2010 valuation) on the initial RAB value reflects a pragmatic and cost-effective solution. BARNZ also agreed that it was pragmatic solution.

Discussion on the WACC

50. The proposed solutions regarding the issue of the forecast timing of cash-flows were discussed in slides 99 – 105 of the workshop papers.
51. NZ Airports noted that it shared Yarrow's view that ID will not identify problems purely by comparing expected returns to the WACC. It noted the need to understand how the comparison to the WACC will be used.
52. NZ Airports also noted that it did not think it would be effective to use profitability indicator as a single answer. Instead the profitability indicator should just be a starting point or an element of how we assess the performance of an airport, and we need to take into account all of the relevant circumstances, including the fact that each airport will be different.

¹⁶ Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).

¹⁷ Commerce Commission "Workshop papers - Airports profitability assessment - workshop 2" (19 April 2016).