COMMERCE COMMISSION
NEW ZEALAND
Te Komihana Tauhokohoko

# Airports IM review
# Profitability Assessment Workshop

## Introduction and Welcome

**1 December 2015**

**John McLaren**

# Introduction and Welcome

# Airports IM Review process

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| Seek views on how airports profitability could be assessed | Seek views on IM issues in the context of the profitability assessment | Draft decisions and reasons published | Submissions/Cross-Submissions on draft decisions and reasons |
|---|---|---|---|
| Pre-Christmas 2015 | February - April 2016 | June 2016 | |

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# Airports IM review
# Profitability Assessment Workshop

## Purpose and Agenda

**1 December 2015**

**Hamish Groves**

# Workshop purpose

- The purpose of the workshop is to seek participants views on how airports profitability assessment could be performed
- The objectives are to understand
  - the purpose and factors that will make the airports profitability assessment successful
  - options for assessing airports profitability
  - how the airports IM can support potential approaches
- The views expressed by our staff or advisors at this workshop are for the purpose of stimulating discussion. Our position will be provided in the draft decision

# Workshop agenda

…. See attached document

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# Airports IM review
# Profitability Assessment Workshop

## Purpose of the airports profitability assessment

1 December 2015

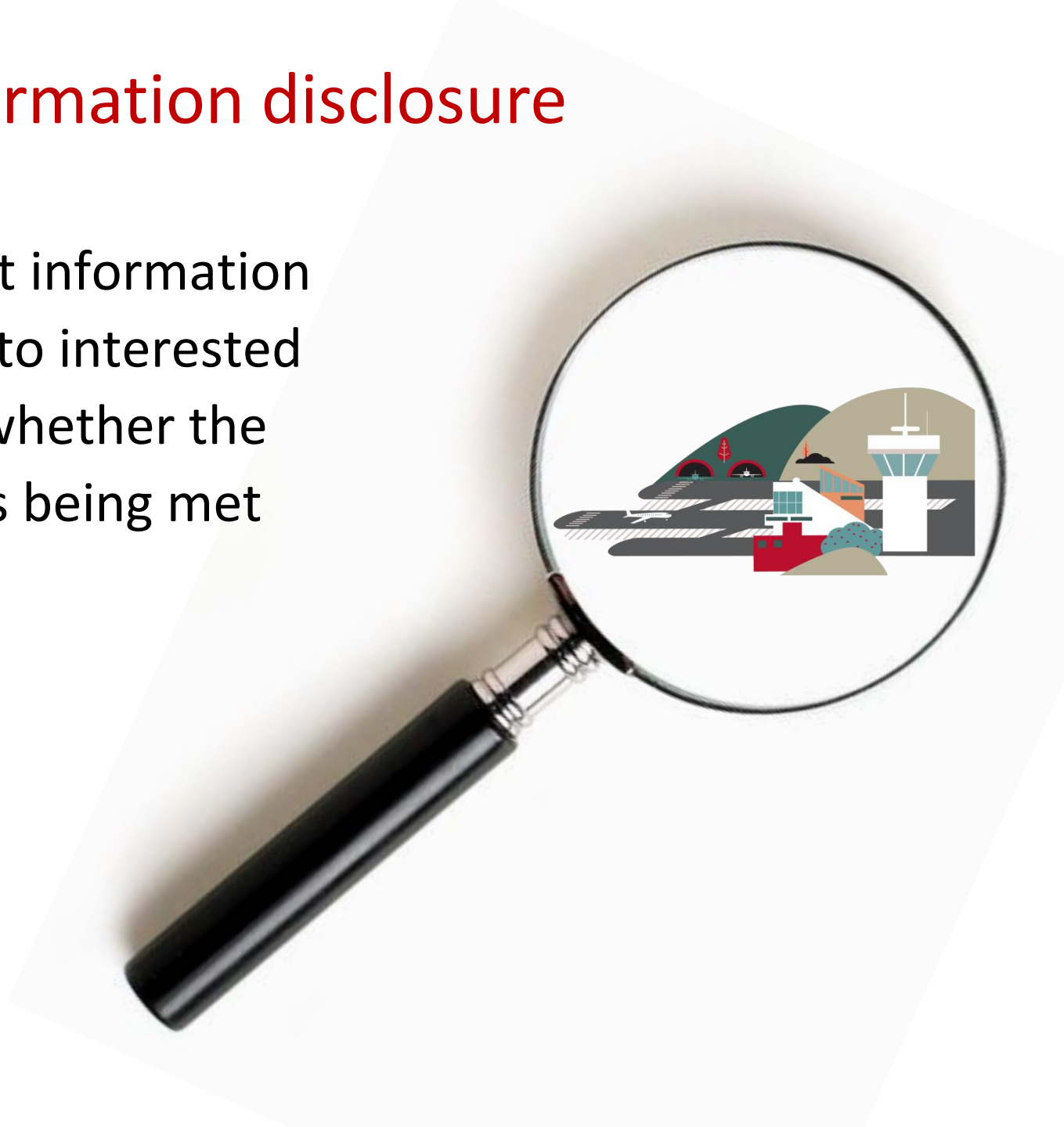
Hamish Groves

# Agenda

- Purpose of information disclosure
- Summary and Analysis
- Purpose of Part 4
- Framework principles
- Other considerations
- IM Forum discussion
- Outcomes of profitability assessment

# Purpose of information disclosure

To ensure sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met



# Summary and Analysis

- s 56G of the Commerce Act to report on how effectively ID regulation is promoting the Part 4 purpose (transitional provision); and
- s 53B(2)(b) of the Commerce Act to publish a summary and analysis of information provided under ID regulation

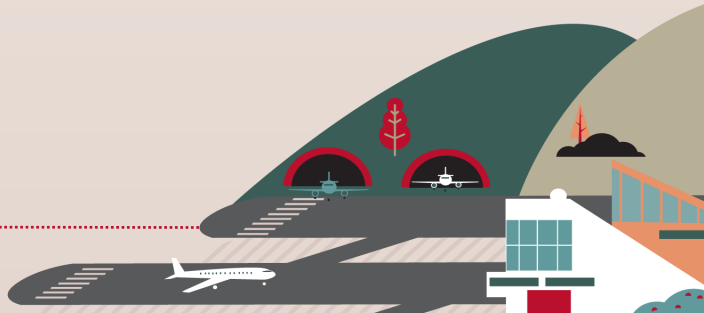
# Purpose of Part 4

To promote the long-term benefit of consumers … by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated services…..

a) have incentives to innovate and invest …;
b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands;
c) share with consumers the benefits of efficiency gains …; and
d) are limited in their ability to extract excessive profits

# Framework principles relevant to airports profitability assessment

- *Financial capital maintenance* - (NPV=0) principle underpins our assessment of airport profitability
- *Risk allocation* – in workably competitive markets risks are typically allocated to suppliers or consumers depending on which are best placed to manage them



# Other considerations

- *Price setting* - airports are not subject to price quality regulation and can set prices as they see fit
- *Transparency* –
  - required to address information asymmetry
  - provides clarity of decisions made and reasons
- *Flexibility v prescription* – what better promotes the purpose of information disclosure
- *Optional v mandatory* – what better promotes the purpose of information disclosure
- Are there any other matters that should be considered?

# IM Forum discussion

At the IM forum we discussed at a high level the following solutions for addressing differences between the profitability assessment assumed in ID and how airports set prices.

1. Non-standard depreciation (workshop 2 topic)
   - Option currently available
   - Not applicable in all scenarios
2. Profitability assessment reflects pricing decision (workshop 2 topic)
   - Consideration of implications required
   - Required to be enduring
3. Disclosed differences (focus of workshop 1)
   - Clarity of difference and reason
   - Tracking under or over recoveries (e.g. Carry forward)

# Outcomes of profitability assessment

- Assessments of profitability could separately identify the various factors affecting profitability
- Disclose profitability indicators with and without the effect of those factors

| | |
|---|---|
| | **Total profits earned** |
| *Excl.* | Returns affected by alternative recovery profiles |
| *Excl.* | Returns affected by incentives and risks |
| | **Profits earned excluding returns earned from incentives, risks and alternative recovery profiles** |

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# Airports IM review
# Profitability Assessment Workshop

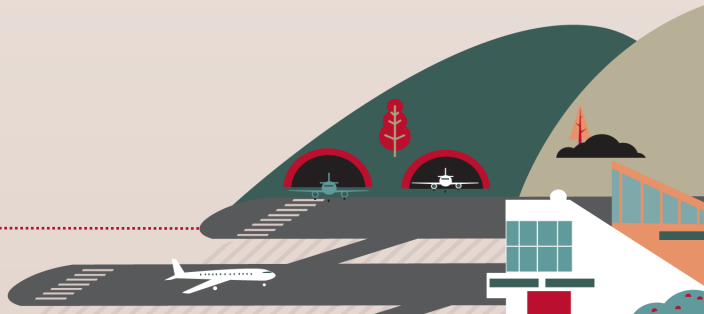
## Lessons learned

**1 December 2015**

**Jo Perry and John McLaren**

# Purpose of session

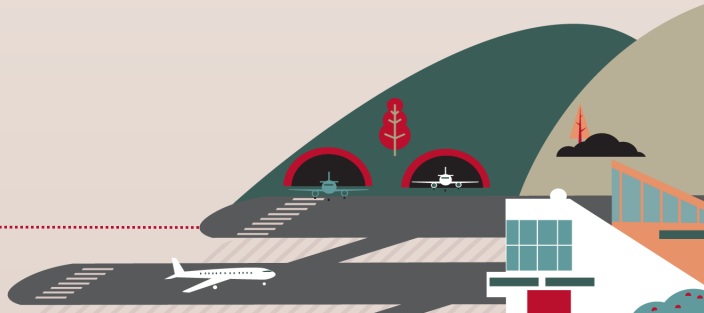
To develop a shared understanding of the issues faced when performing assessments of airport profitability



# Sources

Previous assessments of airport profitability were undertaken in the following contexts

- s 56G reports to Ministers
- s 53B(2)(b) summary and analysis reports



# Lessons learned

1. Importance of forward looking profitability assessment for the s56G reports
2. Scope to improve transparency of disclosed information
3. Airports use pricing approaches that are different from the profitability assessment assumed in ID
4. Importance of being clear on how items have or will be treated

# Lessons learned from our summary and analysis – Part 1

| Lessons learned | How lessons have been learned |
|---|---|
| **1. Importance of forward looking profitability assessment** | • s56G reports excess returns assessment focused on airport behaviour which required analysis of decisions made when setting prices |
| **2. Scope to improve transparency of disclosed information** | • Reconciliation of pricing information with regulatory information (i.e. pricing asset base with RAB)<br>• Airports bundling multiple items in 'Other Factors' of Schedule 18<br>• Airports use of alternative depreciation approaches but rational was not clear to interested persons<br>• No requirement to disclose (dis)agreement on forecasts and risk allocation |

# Lessons learned from our summary and analysis – Part 2

| Lessons learned | How lessons have been learned |
|---|---|
| **3. Airports use pricing approaches that are different from the profitability assessment assumed in ID** | • Auckland revaluing assets differently from the IMs<br>• Christchurch setting prices using a levelised approach and making commercial concessions |
| **4. Importance of being clear on how items have or will be treated** | • It was not clear that we wanted to consider intra-period cash-flows in the profitability assessment<br>• Not clear how profitability assessment deals with commercial concessions, commercial decisions to transfer returns between periods and alternative depreciation profiles |

# Other challenges identified

- Summary and analysis in the future may need to consider two and more consecutive PSEs. Consideration will need to be given to how they link together (e.g. monitoring under or over recoveries between periods).
- Airports may continue to set prices in a manner that is different from the profitability assessment assumed in ID
- Understanding the extent to which profits are due to superior performance (e.g. from managing risks and responding to incentives)
- To provide for an effective ex-post assessment of profitability interested parties will need to consider incentives and risks
- Understanding who is managing risk is an important aspect for understanding the effect of risk allocations on profitability

# Key issues to be considered

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| Key issues | Options for addressing issues and when we will seek participants views on options |
|---|---|
| **Consideration of profitability over multiple years and/or periods** | • an IRR for an enduring period ('enduring IRR')<br>• annual IRR with a carry forward mechanism ('carry forward mechanism')<br>• a hybrid approach such as using IRRs during a price setting period and a carry forward mechanism between periods<br>(Profitability assessment options session) |
| **Time profile of capital recovery used by airports may be different to that assumed in ID** | • Provide further flexibility in IMs - alternative depreciation/revaluations etc (Workshop 2)<br>• Enduring IRR - net effect of accumulated difference on IRR disclosed (Profitability assessment options session)<br>• Carry forward mechanism - value of accumulated net difference identified in carry forward balance (Profitability assessment options session) |
| **Identifying excessive profits– importance of separating profits earned from incentives and risk** | • Disclose the effect of incentives and risks on profitability<br>• Enduring IRR option - effect of incentives and risks on enduring IRR indicator disclosed (Incentives and risks session)<br>• Carry forward mechanism - profits earned from incentives and risks are disclosed in the year they are earned and are generally not carried forward (Incentives and risks session) |

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# Airports IM review
# Profitability Assessment Workshop

## Profitability Assessment Options

**1 December 2015**

**Florian Steinebach & Hamish Groves**

# Purpose of this session

- To present and discuss two options to assessing airports profitability over multiple years/periods:
  - internal rate of return assessment for an enduring period ('enduring IRR' option)
  - annual IRR with a carry forward mechanism ('carry forward mechanism' option)
- To seek feedback on advantages and disadvantages of the presented options
- To seek participants views on other options

# Stylised example - introduction

| | | Price Setting Event -1 | | | | | Price Setting Event 0 | | | | | Price Setting Event +1 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 |
| Building Blocks | Revenue | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 |
| | Opex | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 |
| | Opening RAB | 500 | 485 | 470 | 454 | 438 | 422 | 415 | 409 | 402 | 395 | 488 | 468 | 447 | 426 | 404 |
| | Depreciation | 25 | 25 | 25 | 25 | 25 | 15 | 15 | 15 | 15 | 15 | 30 | 30 | 30 | 30 | 30 |
| | Revaluations | 10 | 10 | 9 | 9 | 9 | 8 | 8 | 8 | 8 | 8 | 10 | 9 | 9 | 9 | 8 |
| | Closing RAB | 485 | 470 | 454 | 438 | 422 | 415 | 409 | 402 | 395 | 488 | 468 | 447 | 426 | 404 | 382 |
| | Tax | 11 | 11 | 11 | 11 | 11 | 13 | 13 | 13 | 13 | 13 | 9 | 9 | 9 | 9 | 9 |
| | | | | | | | | | | | | | | | | |
| Profitability Assessment | WACC (annual) | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| | IRR (annual) | 7.5% | 7.6% | 7.8% | 8.0% | 8.2% | 10.2% | 10.3% | 10.5% | 10.6% | 10.7% | 6.9% | 7.1% | 7.3% | 7.6% | 7.9% |

- Stylised example illustrates an airport under-recovering in PSE-1 followed by a PSE of over-recovering and another PSE of under-recovering (reflected in differences in annual WACC vs IRR)
- The over-recovery in PSE 0 is driven by a drop in depreciation resulting from an asset being fully recovered
- The under-recovery in PSE+1 is triggered by an asset acquisition at the end of PSE 0
- The profitability assessment uses an annual IRR instead of an ROI as currently specified in ID (to be discussed at workshop 2)

PSE 0 = current PSE; PSE -1 = previous PSE; PSE +1 = next PSE

# Enduring IRR

| Option 1 | | Price Setting Event -1 | | | | | Price Setting Event 0 | | | | | Price Setting Event +1 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| IRR for an enduring period | | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 |
| Building Blocks | Revenue | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 |
| | Opex | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 |
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| | Tax | 11 | 11 | 11 | 11 | 11 | 13 | 13 | 13 | 13 | 13 | 9 | 9 | 9 | 9 | 9 |
| | | | | | | | | | | | | | | | | |
| Profitability Assessment | WACC (annual) | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| | IRR (annual) | 7.5% | 7.6% | 7.8% | 8.0% | 8.2% | 10.2% | 10.3% | 10.5% | 10.6% | 10.7% | 6.9% | 7.1% | 7.3% | 7.6% | 7.9% |
| | | | | | | | | | | | | | | | | |
| IRR for enduring period | WACC (across periods) | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| | IRR (enduring) | 7.5% | 7.6% | 7.6% | 7.7% | 7.8% | 8.1% | 8.3% | 8.5% | 8.6% | 8.8% | 8.6% | 8.6% | 8.5% | 8.5% | 8.5% |

- Accumulated net under/over recoveries are tracked as the difference between the enduring IRR and corresponding WACC
- Considerations of incentives, risk allocation and accumulated net effect of alternative recovery profiles are not presented (to be discussed in incentives and risks session)
- The WACC across periods was determined from the geometric mean in CIALs Final s56 G report – the future approach needs to be confirmed

# Enduring IRR - discussion

| Advantages | Challenges |
| --- | --- |
| • Provides for an assessment of profitability over multiple years and periods, including whether the FCM principle is being followed<br>• Includes the ability to assess profits when airports time profile of capital recovery is different from the profitability assessment assumed in ID<br>• Disclosed primary output is relative (difference between IRR and WACC) | • Requires an IRR to date (enduring IRR) and a comparable WACC<br>• Consideration of how to determine the comparable WACC required<br>• Identifying and quantifying the returns affected by incentives and risk so that they can be accumulated over time to determine the effect on the enduring IRR<br>• The accumulated net effect on the IRR of different time profiles of capital recovery will need to be determined for each disclosure |

# Carry forward mechanism

| Option 2 | | Price Setting Event -1 | | | | | Price Setting Event 0 | | | | | Price Setting Event +1 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Carry forward mechanism | | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 |
| Building Blocks | Revenue | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 |
| | Opex | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 |
| | Opening RAB | 500 | 485 | 470 | 454 | 438 | 422 | 415 | 409 | 402 | 395 | 488 | 468 | 447 | 426 | 404 |
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| | Tax | 11 | 11 | 11 | 11 | 11 | 13 | 13 | 13 | 13 | 13 | 9 | 9 | 9 | 9 | 9 |
| | | | | | | | | | | | | | | | | |
| Profitability Assessment | WACC (annual) | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| | IRR (annual) | 7.5% | 7.6% | 7.8% | 8.0% | 8.2% | 10.2% | 10.3% | 10.5% | 10.6% | 10.7% | 6.9% | 7.1% | 7.3% | 7.6% | 7.9% |
| | | | | | | | | | | | | | | | | |
| Carry Forward | Annual Movement | -3 | -2 | -1 | 0 | 1 | 9 | 10 | 10 | 10 | 11 | -6 | -4 | -3 | -2 | -1 |
| | Time value of money | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 2 | 3 | 4 | 4 | 4 | 4 | 4 | 4 |
| | Closing Balance | -3 | -5 | -6 | -7 | -6 | 4 | 14 | 26 | 40 | 54 | 53 | 52 | 53 | 56 | 60 |

- The cumulative under/over recoveries are tracked in a carry forward position
- The time value of money is also captured in the carry forward position
- Considerations of incentives, risk allocation and accumulated net effect of alternative recovery profiles are not presented (to be discussed in incentives and risks session)
- The carry forward mechanism could also be used in hybrid approaches such as using an IRR for a price setting period and a carry forward mechanism between periods

# Carry forward mechanism - discussion

| Advantages | Challenges |
|---|---|
| • Provides for an assessment of profitability over multiple years and periods, including whether the FCM principle is being followed<br>• Includes the ability to assess profits when airports time profile of capital recovery is different from the profitability assessment assumed in ID<br>• The accumulated net effect of different time profiles of capital recovery will accumulate in the carry forward balance | • Profits earned from incentives and risks are required to be identified so that they are not carried forward*<br>• Disclosed primary output is not relative but instead absolute (carry forward balance)<br>• A mechanism for rolling-forward the carry forward balance is required and will need to include a time value of money aspect |

* Profits from incentives and risks will generally not be carried forward unless there are mechanisms, such as commercial agreements, to carry them forward

# Separating profits earned

- Both profitability assessment options presented require the separation of profits
- The enduring IRR requires profits that reflect superior performance (e.g. from managing risks and responding to incentives) and profits from alternative recovery profiles to be identified and quantified
- The carry forward mechanism requires ‘profits to be netted off against future profits’ to be identified and quantified
- Identifying and quantifying profits to be separated will be challenging

# Separating profits earned – carry forward mechanism example

The carry forward mechanism requires the separation of profits to be carried forward – profits that are to be netted off against future profitability

Examples

Carried forward?

- Carry forwards that have been agreed between airports and airlines (e.g. returns affected by risks that were agreed to be allocated to consumers)
- The effect on assessed profitability of airports using an alternative time profile of capital recovery

Not carried forward?

- Returns earned by airports as incentives (e.g. efficiency gains) or for managing risks (e.g. demand risk) unless there are mechanisms
  - to reallocate risk
  - for amending incentives or
  - to share efficiency gains
- Returns foregone where they were agreed not to be recovered in future years

# Alternative options to assessing airports profitability

- The purpose of this session is to seek participant's views on alternative options to assessing airports profitability
- Other options include using an IRR for the price setting period and a carry forward mechanism between periods (as noted in the lessons learned session)

# Summary of options

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<table>
<tr><th>Key issues to be considered</th><th>Current disclosures provided for in ID</th><th>Enduring internal rate of return</th><th>Carry forward mechanism</th></tr>
<tr><td>Consideration of profitability over multiple years and/or periods</td><td>Interested persons to consider the issue during review of disclosures</td><td>Airports disclose enduring IRR</td><td>Airports disclose net accumulated profits earned that are different to the ID assessment of profits</td></tr>
<tr><td rowspan="2">Time profile of capital recovery used by airports may be different to that assumed in ID</td><td rowspan="2">Interested persons to consider the issue during review of disclosures – disclosures are insufficient to understand effect</td><td colspan="2">The effect of using different time profiles of capital recovery are netted off</td></tr>
<tr><td>Airports separately disclose the accumulated net effect on the enduring IRR</td><td>Airports disclose accumulated net profits earned from using a different time profile of capital recovery</td></tr>
<tr><td>Identifying excessive profits– importance of separating profits earned from incentives and risk</td><td>There is insufficient information to assess excessive returns</td><td colspan="2">Refer incentives and risks session</td></tr>
</table>

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# Airports IM review
# Profitability Assessment Workshop

## Incentives and risks

**1 December 2015**

**Hamish Groves and John McLaren**

# Agenda

- Purpose of Part 4 and current airport incentives
- Other Part 4 regulated industries
- Opportunity to disclose incentives
- Overview of risk allocation
- Regulatory approach to risk allocation
- Risk allocations – practical application
- Opportunity to disclose risk allocations
- Stylised examples and updated summary of options
- Next steps

# Purpose of Part 4

To promote the long-term benefit of consumers … by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated services…..

a) have **incentives to innovate and invest** …;
b) have **incentives to improve efficiency and provide services at a quality that reflects consumer demands**;
**c) share with consumers the benefits of efficiency gains** …; and
d) are limited in their ability to extract excessive profits.

# Current airport regulatory incentives

- Current airport incentives include:
  - transparency of decisions and outcomes (all required incentives)
  - ex-ante profitability assessment provides an opportunity to assess whether airports are targeting a normal return (incentives to invest)
  - ex-post higher returns are able to be earned e.g. cost efficiencies (incentive to improve efficiency)
  - Consultation obligation under the AAA
- There is no explicit mechanism in ID for separating returns earned from incentives and from excessive returns

# Other Part 4 regulated industries

- Industries subject to price quality regulation include ID mechanisms that recognise:
  - quality incentives
  - mechanism for sharing efficiency gains
- Is there anything we can learn from the disclosed effect of incentive mechanisms used in other industries?
- Airports have the ability to and have in the past set prices with implicit incentives mechanisms
- There is/are no mechanism(s) in airports ID to identify how incentives have affected profitability

# Opportunity to disclose the effect of incentives

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Flexibility
Options

Prescription
Mandatory

- No change to profitability assessment or disclosures
- Require the effect of incentives to be disclosed
- Require the effect of incentives to be disclosed and specify how it should be treated in profitability disclosures
- Specify how the effect of incentives should be treated in profitability disclosures and use principles to guide airports in what incentives to include and how they should be quantified
- Specify how the effect of incentives should be treated in profitability disclosures and how they should be quantified

# Overview of risk allocation

- When setting prices airports expose themselves and/or their consumers to risk
- Additional or reduced profits are earned when actual results differ from forecasts
- Under or over recovery of revenue relative to normal returns can result
- Separation of profits earned/ lost from risk allocation is required to make an assessment of excessive returns
- The airport profitability assessment assumed in ID does not currently provide for this separation
- How can ID make transparent the way risks have been allocated?

# Allocating risks

- The approach to assessing profitability assumes certain risk allocations
- Pricing structures can also allocate risks between airports and their consumers (i.e. price setting v. revenue setting)
- Suppliers may choose to reallocate the costs and rewards from managing risk to or from suppliers e.g. previous airport pricing decisions to wash-up the effect of capital expenditure risk
- Regulators can establish other mechanisms to reallocate risks between suppliers and consumers
- Regulatory mechanisms used for reallocating risks in other industries include:
  - Transpower economic value mechanism
  - EDB pass-through and recoverable costs

# Approaches to risk allocation

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Where there is commercial agreement

- The airport profitability assessment approach could reflect commercial agreements relating to risk allocation

Where there is no commercial agreement

- Where commercial agreements do not exist or are not transparent how should the allocation of risks be determined (e.g. unforecast revaluations)?
- Should we assume a similar approach used for allocating risks in other regulated industries?
- When allocating risks for price quality regulated industries we seek to allocate risks to those best placed to manage them. This includes:
  - Control over probability of occurrence
  - Ability to mitigate costs of occurrence
  - Ability to absorb costs where they cannot be mitigated

# Risk allocation – practical application

| Risk examples | Considerations for allocating the risk, disclosure and treatment in the profitability assessment |
|---|---|
| **Capital expenditure risk** | • In setting prices airports bear the risk and rewards of capital expenditure being under or over spent<br>• Airports have previously used mechanisms to reallocate the risks and rewards back to consumers – the profitability assessment does not currently provide for this<br>• The capital expenditure forecast is set by airports and reviewed by airlines |
| **Demand risk** | • In setting prices airports bear the risk and rewards of demand risk<br>• The demand forecast is set by airports, and reviewed by airlines<br>• Are airports best placed to bear the risk and rewards? Is there agreement that airports should manage this risk? |
| **Unforecast revaluations risk** | • In setting prices airports bear the risk and rewards of unforecast revaluations<br>• Airports have previously set up mechanisms to reallocate the risks and rewards back to consumers – the profitability assessment does not currently provide for this<br>• The revaluation forecast is set by airports and reviewed by airlines<br>• Airports have control over whether MVAU revaluations are included in the current profitability assessment and whether the effect of higher asset values are used in the assessment of future profits |

Should (dis)agreement on risk allocation and forecasts be disclosed?

# Opportunity to disclose risk allocations

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Flexibility
Options

Prescription
Mandatory

- No change to profitability assessment or disclosures
- Require separate disclosure of profits affected by risk allocations
- Require separate disclosure of profits affected by risk allocations and specify how it should be treated in profitability disclosures
- Specify how profits affected by risk allocations should be treated in profitability disclosures and use principles to guide airports in what risks to include and how they should quantified
- Specify how profits affected by risk allocations should be treated in profitability disclosures and how they should be quantified

# Stylised examples – Enduring IRR

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| Option 1<br>IRR for an enduring period | | Price Setting Event -1 | | | | | Price Setting Event 0 | | | | | Price Setting Event +1 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 |
| Building Blocks | Revenue | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 |
| | Opex | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 |
| | Opening RAB | 500 | 485 | 470 | 454 | 438 | 422 | 415 | 409 | 402 | 395 | 488 | 468 | 447 | 426 | 404 |
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| | Revaluations | 10 | 10 | 9 | 9 | 9 | 8 | 8 | 8 | 8 | 8 | 10 | 9 | 9 | 9 | 8 |
| | Closing RAB | 485 | 470 | 454 | 438 | 422 | 415 | 409 | 402 | 395 | 488 | 468 | 447 | 426 | 404 | 382 |
| | Tax | 11 | 11 | 11 | 11 | 11 | 13 | 13 | 13 | 13 | 13 | 9 | 9 | 9 | 9 | 9 |
| | | | | | | | | | | | | | | | | |
| Profitability Assessment | WACC (annual) | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| | IRR (annual) | 7.5% | 7.6% | 7.8% | 8.0% | 8.2% | 10.2% | 10.3% | 10.5% | 10.6% | 10.7% | 6.9% | 7.1% | 7.3% | 7.6% | 7.9% |
| | | | | | | | | | | | | | | | | |
| IRR for enduring period | WACC (across periods) | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| | IRR (enduring) | 7.5% | 7.6% | 7.6% | 7.7% | 7.8% | 8.1% | 8.3% | 8.5% | 8.6% | 8.8% | 8.6% | 8.6% | 8.5% | 8.5% | 8.5% |
| | | | | | | | | | | | | | | | | |
| Analysis of IRR | Enduring IRR | 7.5% | 7.6% | 7.6% | 7.7% | 7.8% | 8.1% | 8.3% | 8.5% | 8.6% | 8.8% | 8.6% | 8.6% | 8.5% | 8.5% | 8.5% |
| | excl. effect of Incentives and Risk | 0.2% | 0.2% | 0.1% | 0.1% | 0.1% | 0.1% | 0.2% | 0.2% | 0.2% | 0.2% | 0.2% | 0.1% | 0.1% | 0.1% | 0.1% |
| | excl. effect of Alternative Recovery Profiles | 0.0% | 0.0% | 0.1% | 0.1% | 0.1% | 0.0% | -0.1% | -0.2% | -0.2% | -0.3% | -0.2% | -0.2% | -0.2% | -0.2% | -0.2% |
| | = Enduring IRR (net of Other Profits) | 7.7% | 7.8% | 7.9% | 8.0% | 8.1% | 8.2% | 8.4% | 8.5% | 8.6% | 8.6% | 8.6% | 8.5% | 8.4% | 8.4% | 8.4% |

- The stylised example presented in the session on profitability assessment options has been expanded to include an analysis of the enduring IRR showing the effect of incentives, risks and alternative recovery profiles on the enduring IRR (-> red box)
- Enduring IRR (net of other profits) means Enduring IRR excluding the effects of profits due to incentives, risk and alternative recovery profiles

# Stylised examples – Carry forward

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| Option 2 | | Price Setting Event -1 | | | | | Price Setting Event 0 | | | | | Price Setting Event +1 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Carry forward mechanism | | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 | Y 1 | Y 2 | Y 3 | Y 4 | Y 5 |
| Building Blocks | Revenue | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 | 95 |
| | Opex | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 |
| | Opening RAB | 500 | 485 | 470 | 454 | 438 | 422 | 415 | 409 | 402 | 395 | 488 | 468 | 447 | 426 | 404 |
| | Depreciation | 25 | 25 | 25 | 25 | 25 | 15 | 15 | 15 | 15 | 15 | 30 | 30 | 30 | 30 | 30 |
| | Revaluations | 10 | 10 | 9 | 9 | 9 | 8 | 8 | 8 | 8 | 8 | 10 | 9 | 9 | 9 | 8 |
| | Closing RAB | 485 | 470 | 454 | 438 | 422 | 415 | 409 | 402 | 395 | 488 | 468 | 447 | 426 | 404 | 382 |
| | Tax | 11 | 11 | 11 | 11 | 11 | 13 | 13 | 13 | 13 | 13 | 9 | 9 | 9 | 9 | 9 |
| | | | | | | | | | | | | | | | | |
| Profitability Assessment | WACC (annual) | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| | IRR (annual) | 7.5% | 7.6% | 7.8% | 8.0% | 8.2% | 10.2% | 10.3% | 10.5% | 10.6% | 10.7% | 6.9% | 7.1% | 7.3% | 7.6% | 7.9% |
| | | | | | | | | | | | | | | | | |
| Analysis of Profits | Total profits | 37 | 37 | 37 | 36 | 36 | 43 | 43 | 43 | 43 | 42 | 34 | 33 | 33 | 32 | 32 |
| | - due to Incentives and Risk Allocation | -1 | -1 | 0 | 0 | -1 | -1 | -1 | -1 | -1 | 0 | -1 | 1 | 1 | 1 | 0 |
| | - due to Alternative Recovery Profiles | 0 | 0 | -2 | -1 | 0 | 4 | 4 | 4 | 4 | 4 | -2 | -2 | 0 | -1 | -1 |
| | - due to Other Unexplained Profits | -2 | -1 | 1 | 1 | 2 | 6 | 7 | 7 | 7 | 7 | -3 | -3 | -4 | -2 | 0 |
| | | | | | | | | | | | | | | | | |
| Carry Forward | Annual Movement | -2 | -1 | -1 | 0 | 2 | 10 | 11 | 11 | 11 | 11 | -5 | -5 | -4 | -3 | -1 |
| | Time value of money | 0 | 0 | 0 | 0 | 0 | 1 | 1 | 2 | 4 | 5 | 5 | 5 | 5 | 5 | 5 |
| | Closing Balance | -2 | -3 | -5 | -5 | -3 | 7 | 20 | 33 | 48 | 63 | 63 | 63 | 63 | 65 | 69 |

- The stylised example presented in the session on profitability assessment options has been expanded to separate profits from the effect of incentives, risk and alternative recovery profiles (-> red box)
- The carry forward has been amended to only reflect profits due to alternative recovery profiles and other unexplained profits (-> green box)
- "Other Unexplained Profits" comprises profits above or below a WACC consistent return but excluding profits due to the effect of incentives, risk and alternative recovery profiles

# Summary of options

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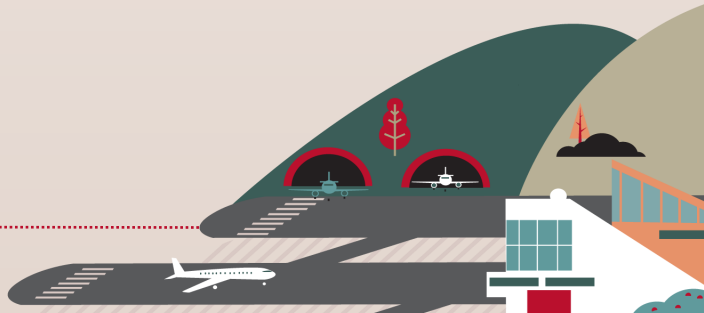
| Key issues to be considered | Current disclosures provided for in ID | Enduring internal rate of return | Carry forward mechanism |
|---|---|---|---|
| **Consideration of profitability over multiple years and/or periods** | Interested persons to consider the issue during review of disclosures | Airports disclose enduring IRR | Airports disclose net accumulated profits earned that are different to the ID assessment of profits |
| **Time profile of capital recovery used by airports may be different to that assumed in ID** | Interested persons to consider the issue during review of disclosures – required disclosures are insufficient to understand the effect | The effect of using different time profiles of capital recovery are netted off | |
| | | Airports separately disclose the accumulated net effect on the IRR | Airports disclose accumulated net profits earned from using a different time profile of capital recovery |
| **Identifying excessive profits– importance of separating profits earned from incentives and risk** | There is insufficient information to assess excessive returns | Airports disclose accumulated effect on the IRR of incentives and risks | Airports disclose profits earned from incentives and risks in the year/period they are earned |

# Next steps for incentives and risk allocation

- We intend considering whether the airports profitability assessment should be amended to account for incentives and risk
- Any amendments to the profitability assessment will likely occur in the ID determination
- ID determination amendments will be considered as part of a separate process



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# Airports IM review
# Profitability Assessment Workshop

## Wrap-up

**1 December 2015**

**John McLaren**

# Key issues covered

- Consideration of profitability over multiple years and/or periods
- Time profile of capital recovery
- Identifying excessive profits– importance and challenges of separating profits
- Options for addressing the above issues
- Implications for IM review amendments

# Next steps

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| Seek views on how airports profitability could be assessed | Seek views on IM issues in the context of the profitability assessment | Draft decisions and reasons published | Submissions/Cross-Submissions on draft decisions and reasons |
|---|---|---|---|
| Pre-Christmas 2015 | February - April 2016 | June 2016 | |

# Post Workshop Decision - intro

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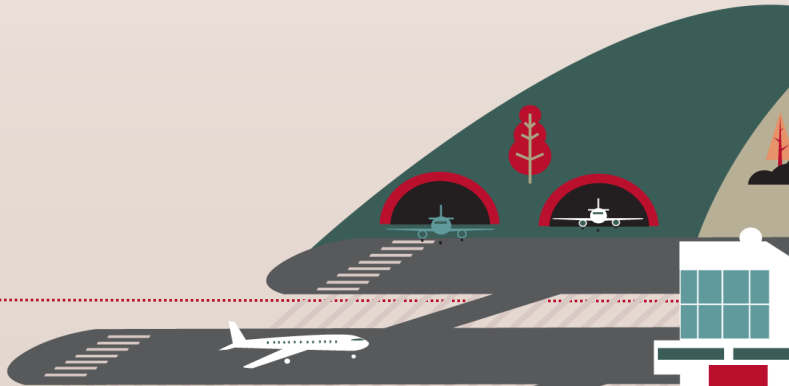
- Following the workshop, we intend to make an indicative decision on the approach to airports profitability assessment
- The decision may influence how issues identified during the problem definition phase are resolved
- We invite participants to comment on specific issues that will assist us with the indicative decision
- Comments are due by **5pm, Tuesday 22 December 2015**



# Question for indicative decision

- **Will the profitability assessment include a mechanism for tracking over or under recoveries between periods?** This could either be an enduring IRR mechanism, a carry forward mechanism between years/periods, a hybrid or an alternative
- In making this indicative decision we will consider whether such a mechanism is beneficial for tracking:
  - Forecast under or over recoveries – when airports decide to have a different time profile of capital recovery to what is assumed in the ID profitability assessment, such as:
    - → Recovering costs relating to land held for future use
    - → Applying alternative approaches to revaluations
    - → Commercial agreements for under or over recovery in one period to be offset against under or over recoveries in another period
    - → Other currently unforeseen circumstances
  - Under or over recoveries from managing risks, including:
    - → where there are commercial agreements to pass the benefits or costs of risks between periods (i.e. unforecast revaluations and capital expenditure)
    - → potentially those risks where commercial agreements do not exist
  - Incentives – to allow airports to manage incentives between periods

# Post Workshop Decision - continued

- Whether the IMs or ID should be amended to address the secondary issues identified during the problem definition phase
- Whether the mechanism for tracking over or under recoveries for airports will be an enduring IRR, carry forward mechanism or a hybrid or how either of these mechanisms would work
- What the mechanism for tracking over or under recoveries will be used for – the indicative decision is whether there is likely to be one
- Whether the ID determination is amended to require the disclosure of the approach for tracking over or under recoveries or whether the tracking is done by the Commission in its summary and analysis

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# Airports IM review
# Profitability Assessment Workshop

## IM review issues and workshop 2

**1 December 2015**

**John McLaren**

# Purpose of session

- To seek participants initial views on how issues identified during the IM review problem definition phase could be addressed through amendments to the IMs, taking into consideration the options for assessing profitability
- To facilitate a discussion about the purpose and scope of workshop 2 to be scheduled between February – April 2016

# Topics identified during the problem definition phase

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**IM or ID issues**

- Revaluations
- Depreciation
- Land held for future use
- Opening RAB values
- Application of MVAU (fast track process)
- WACC percentile (WACC projects)

**ID only issues**

- Unforecast revaluations
- Leased assets
- Under and over recoveries
- Discounting