SECTION 56G DRAFT REPORT ON CHRISTCHURCH AIRPORT

CROSS-SUBMISSION BY CHRISTCHURCH INTERNATIONAL AIRPORT LIMITED

26 November 2013

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INTRODUCTION AND SUMMARY

1 CIAL appreciates the Commission allowing an opportunity to respond to issues raised in submissions on the Draft Report.

2 In the event, there is a narrow range of issues for us to respond to. Only the BARNZ submission raises substantive issues that call for a response from CIAL, and the BARNZ submission is focused almost entirely on the question of how to assess the returns targeted by CIAL.

3 Most of the issues raised by BARNZ have been overtaken by our 12 November 2013 submission. In that submission we explained that we will make changes to our disclosure reports and our model to address the transparency issues highlighted by the Draft Report, some of which were also highlighted by the BARNZ submission.

4 A new matter in the BARNZ submission is a concern that BARNZ has with the Commission's treatment of unforecast PSE1 revaluations. BARNZ has no objection to how these revaluations were treated in the CIAL pricing model, but it argues the Commission should also include the revaluations in its assessment of CIAL's implicit post-tax return.

5 As we discuss below this misunderstands how the Commission has assessed target returns. To assess the target returns on WIAL, AIAL and CIAL the Commission has used its IRR model. The IRR model explicitly and for good reason excludes revaluations. For this reason the change proposed by BARNZ will not change the Commission's assessment of target returns.

6 Outside of the question of how to assess target returns the BARNZ submission says very little. Nothing substantive was provided by BARNZ to support the conclusions proposed in other areas of the Draft Report. Given the tight focus of the BARNZ submission, we wish to record the possibility that we may want to respond to any substantive new matters raised in cross-submissions.

7 As we said in our 12 November 2013 submission, our view – and our experience – is that the new information disclosure regime has put in place new and effective incentives to maintain good performance in all areas of our business. We are very aware of the new transparency and publication of information on key performance measures. The fact that we have been performing well until now does not change the fact that this additional scrutiny will keep the pressure on CIAL to perform well in the future.

8 At this stage of the process, we also wish to emphasise our intention and preparedness to address any transparency concerns with our disclosure reports and our model. As we said in our 12 November 2013 submission we have responded to all of the issues raised in the Draft Report (to the best of our understanding) and welcome feedback from the Commission and our customers.

ASSESSING CHRISTCHURCH AIRPORT'S TARGETTED RETURNS

9 BARNZ submits that the Commission has under-estimated the level of returns targeted by CIAL. BARNZ raises a number of specific issues, and for most of these issues suggests changes to the Commission's model. We discuss each issue raised by BARNZ below.

Treatment of unforecast revaluations from PSE1

Revaluations from PSE1

10 The CIAL pricing model used to set PSE2 prices uses an Opening RAB that is consistent with the Commission's input methodology. That Opening RAB represented a revaluation when compared to the asset base we used to set prices for PSE1.

11 There were two components to the revaluation:[1]

11.1 The input methodology-consistent 2009 land valuation resulted in a $10.7 million revaluation compared to our previous land valuation; and

11.2 Between 2009 and 2012 land and specialised asset values were indexed at CPI.

12 When setting our prices for PSE1 we (explicitly) did not include a forecast of revaluation gains. For this reason, we treated these pre-PSE2 revaluations as a "windfall gain" that had not been paid for through lower prices in PSE1 and therefore refunded that gain to customers in our pricing model, even although this was a departure from the input methodologies.

13 BARNZ has not objected to the treatment of PSE1 revaluations in our commercial pricing model. This was transparent and the treatment that our customers preferred.

14 However, BARNZ has objected to the treatment of these revaluations in the Commission's modelling. BARNZ argues that the exclusion of PSE1 revaluations in the Commission's model is understating the level of returns that CIAL is targeting.

15 We believe that BARNZ's submission misunderstands the Commission's modelling. To see why this is so it is necessary to briefly re-cap the various modelling exercises performed by the Commission.

The Commission's 20 year model performs three main calculations

16 As we understand it, the Commission's model performs three different calculations to assess three different things. The model:

16.1 provides a check of the CIAL pre-tax model;

16.2 estimates post tax cash flows from the pre-tax cash flows contained in the CIAL model; and

16.3 calculates the implied post tax return on assets in the form of an IRR, which the Commission then compares to its estimate of the post-tax WACC.

17 The first section of the model checks the pre-tax CIAL model. It shows that the CIAL levelised price is NPV neutral by comparing forecast revenue with required revenue under our building blocks model. Revaluations prior to PSE1 are included in the building blocks model and the forecast revenue model.

[1] Described in our Revised Pricing proposal (1 August 2012) at pages 18 to 20

18 The Commission's second modelling exercise identifies CIAL's implied post tax return. The Commission's model determines this in three steps:

18.1 it calculates the revenue that would be earned from applying the CIAL price path and calculates post tax return in each year (lines 326 to 362 and 421 to 449);

18.2 it sets up a conventional post tax IM compatible building block model using CIAL's inputs (lines 366 to 414 and 453 to 501);

18.3 it goal seeks a discount rate such that the return on capital in the building block model and the post-tax return calculated from applying CIAL prices amount to the same present value.

19 The discount rate produced by the goal-seek is the estimated post-tax return implied by CIAL's levelised price path.

20 The Commission's third modelling exercise determines the IRR for CIAL on an input methodology compatible basis. The IRR is the Commission's measure when determining if an airport is targeting excessive returns. This is described by the Commission as:[2]

> The IRR is the discount rate that results in the sum of net cash flows, discounted using that IRR, equalling the initial capital outlay.

21 The Commission explained in the WIAL Final Report why it uses the IRR measure to assess excess returns:[3]

> The regulatory asset value provides an appropriate baseline against which profits can be assessed...
>
> We have used the IRR, rather than estimating its return on investment (ROI) which would be consistent with information disclosure, as it avoids problems associated with the short-term variability in returns…
>
> Analysis of returns using the ROI for Wellington Airport could be distorted by the revaluation of assets at Wellington Airport. The ROI reflects any revaluation gain (or loss) that occurs in the year prior to the change in the asset value. This can result in a 'spike' in the ROI, which signals an expectation of higher (or lower) profits in the future.

22 The same approach was taken in the AIAL Final Report.

Assessment of BARNZ inclusion of PSE1 revaluations

23 The inclusion of PSE1 revaluations proposed by BARNZ affects the second modelling exercise undertaken by the Commission — the estimate of the implied post-tax return — but does not affect the calculation of the IRR. Depending on the question being asked, there could be arguments for and against inclusion of PSE1 revaluation in the calculation of the implied post-tax return. The key point is that however one treats PSE1 revaluations in a model that calculates the implied post-tax return from pre-tax cashflows, it would not, in any way, affect the Commission's assessment of "excess returns".

[2] Wellington International Airport Limited Final s56G Report

[3] Wellington International Airport Limited Final s56G Report

24 The divergence between the implied post-tax return and the IRR is a reflection of the problems associated with short-term variability of returns identified by the Commission. This is why the Commission has adopted an approach which is only dependant on the opening RAB and cash flows throughout the period. No change in the IRR means there is no change in the assessment of profitability.

25 The fact that BARNZ is drawing a conclusion on profitability from changes to an aspect of Commission's modelling which is not designed to measure profitability highlights the care that needs to be taken in interpreting various concepts used in the Commission's analysis. When assessing the returns of all three airports the Commission has used its IRR calculation. This is the approach that all parties expected the Commission to take when CIAL was setting its prices in October 2012.

26 With respect to the estimation of the implied post-tax return, we confirm the change proposed in our 12 November 2013 submission. We understand the Commission's concerns about transparency and CIAL will in future use and report on the basis of post-tax modelling.

CPI escalation of prices post 2022

27 BARNZ has proposed adjusting the CPI escalation in the Commission's model post 2022 from 0.25% per year to 2.5% per year.

28 We have no objection to this adjustment. In our 12 November 2013 submission we committed to using an annual inflation adjustment in our future pricing models.

Price path after PSE2

29 As discussed in our 12 November 2013 submission, some of our prices exceed the long run levelised price path at the end of PSE2 (however, our revenue for the PSE2 period is comfortably below the long run levelised path). In our response to the Commission during this section 56G process, including our 12 November 2013 submission, we confirmed that at the price reset in 2017 we will ensure all future prices do not exceed the levelised price path.

30 BARNZ notes that the Commission's model uses CIAL's actual price path for PSE2 then reverts to the long run levelised price path for the remaining years of the model. The Commission's treatment is correct – it reflects what we intend to do in 2017.

31 BARNZ assumes we will not do this and so proposes using a price path beyond PSE2 that assumes prices will stay permanently above the long-run levelised price path. This assumption is incorrect.

Use of mid-year cash flows

32 BARNZ notes that the Commission's model uses end of year cash flows and the CIAL model uses mid-year cash flows. BARNZ argues that the Commission's model should use mid-year cash flows.

33 This issue has been canvassed, and we agree with the response that the Commission provided in its Draft Report:[4]

> For our assessment of Christchurch Airport's conduct, we have assumed cash flows occur at the end of each year, with the exception of capital expenditure. This gives rise to a conservative estimate of the return compared to using assumptions which attempt to better approximate the real timing of cash flows. We do not agree with BARNZ and Air New Zealand's suggestion that

[4] At paragraph F68

> our conclusions should be based on analysis that assumes cash flows occur mid-year. Our conclusion is based on the assumption of year-end cash flows as this is consistent with the treatment of cash flows in information disclosure requirements. The use of mid-year cash flows to assess returns had not been signalled at the time Christchurch Airport set prices. Therefore, we would not expect Christchurch Airport to have had regard to this when setting its prices. We propose to consider enhancing the information disclosure requirements to better reflect the actual timing of cash flows.

Alteration of taxable depreciation for the last eight years of the model

34 When modelling taxable depreciation BARNZ has taken the average of tax depreciation for the 2021, 2022, and 2023 years and applied this average to the 8 years from 2024 to 2032.

35 As we explained in our 12 November 2013 submission,[5] the pre-tax model we used for our price consultation did not explicitly identify annual tax depreciation. During the consultation process we used the annual tax depreciation calculated by BARNZ at the time (which was different from the approach now proposed by BARNZ described above), because we had not at that time done our own calculation and we did not want to get into a debate on this topic.

36 Later, at the Commission's request during this section 56G process, we supplied forecast actual tax depreciation to the Commission. These estimates reflect the estimated remaining asset lives, which have considerably shorter lives than building assets, which are non-depreciable for tax purposes and have been excluded.

37 BARNZ states that the figures provided had not been previously disclosed to airlines during consultation, which is correct. BARNZ also states it does not accept these figures. All we can say in response is that they are our best estimates, supplied to the Commission.

38 We agree with the Commission that the best estimates should be used. In any case, it would be inconsistent for BARNZ to accept higher tax depreciation for early years and to roll that forward to future years, by which time the relevant assets will have been largely depreciated for tax purposes.

39 As explained in our 12 November 2013 submission, we will use a post-tax model for disclosure and pricing purposes going forward.

Allowance for Capital Expenditure

40 As identified in the Commission's Draft Report, our pricing model did not include a forecast of capital expenditure after 2017. BARNZ does not analyse this in its model, but does raise it as an issue:[6]

> Like Christchurch Airport, the Commission's modelling does not include any allowance for capital expenditure in the last 15 years of the 20 year model, namely PSE3, PSE4 or PSE5. If the average capital expenditure levels disclosed for PSE3 are applied, and indexed for CPI, this indicates capital expenditure upwards of $222m has not been taken into account. The difference in return on capital between Christchurch Airport's targeted 9.76% post tax WACC and the 7.58% upper bound of the Commission's acceptable WACC range amounts to $37m over these 15 years, which represents a significant amount of excessive profits which have not been taken into account in the Commission's analysis.

[5] And our Price Setting Event Disclosure.

[6] BARNZ Submission on Commerce Commission Draft s56G Report for CIAL, page 4.

41 In our 12 November 2013 submission we confirmed that in future uses of our model we will include a long run forecast of capital expenditure. The modelling point to be made, of course, is that this will not affect the level of return. Capital expenditure will flow through the model as both an expense (depreciation) and a return. We are aware that BARNZ disagrees with the level of our targeted returns but the inclusion of capital expenditure forecasts will not change that level.

42 We further observe, however, that the additional excess return that BARNZ calculates assumes that the gap between CIAL's estimated post tax WACC and the figure the Commission has calculated for PSE2 remains unchanged throughout PSE3, 4 and 5. As explained in our 21 November submission, this assumption is not realistic.

43 Almost all of the gap between CIAL and the Commission (assuming the Commission applies the 75th percentile figure as we have argued it should) is explained by the use of a different risk free rate assumption. Putting aside the question of which rate should have been used for PSE2, interest rates have already increased such that the gap between CIAL and the Commission on this parameter has almost halved, and the available independent forecasts suggest that interest rates will continue to rise in NZ and so narrow and eventually rise to the level that CIAL has assumed. Moreover, even if interest rates were to remain at very low levels for an extended period (as the Commission's calculations have assumed), CIAL has not ruled out changing how it derives its risk free rate assumption in light of an emerging consensus in the finance community as to what this means for the cost of capital.