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Dear Keston

Introduction and summary

1 Christchurch International Airport Limited (*CIAL*) welcomes the opportunity to comment on the input methodologies review problem definition paper (the *Problem Definition Paper*). We appreciate the Commission seeking stakeholder views on the scope of the input methodologies review (the *Review*) at this early stage.

2 CIAL supports the submission made by the New Zealand Airports Association (the *NZAA*). The NZAA submission canvasses the full range of issues raised by the Commission's Problem Definition Paper relevant to airports. In particular we support the high level messages in the NZAA submission that the current uncertainty over WACC is important to resolve, and forward looking profitability indicators that are too prescriptive are unlikely to deliver the intended benefits. We appreciate the Commission will be picking up these issues in greater detail in subsequent processes and look forward to engaging on the best approach for the airport sector at that time. Rather than repeating the NZAA submissions we focus in this submission on issues of particular relevance to CIAL.

3 The discussion at the IM Forum of the use of alternative depreciation in the information disclosure accounts was constructive. There was agreement that the IMs and the ID determination do not prevent the adoption of alternative depreciation methods.

4 There was also a desire by stakeholders to explore methods for CIAL setting alternative depreciation in PSE3 that are more simple than the implied depreciation methodology we are using for PSE2. As discussed at the IM Forum we will work with our expert advisor (Jeff Balchin) to explore whether there are options for a more simple approach and consult with our customers once some options are identified.

5 As we have noted previously, the implied depreciation methodology used for PSE2 results in a closing RAB that fully reflects the pricing decision made in PSE2. We will use that RAB for both ID and pricing purposes, including for identifying the opening RAB for PSE3. This means changes to methodology for PSE3 can be made without creating windfall gains or losses.

6 On a separate matter, we agree with the point made by BARNZ at the IM Forum that using CPI indexation is not a forecast of revaluation gains. The CPI indexation serves a different purpose, that of an inflation hedge. In the context of that approach, we agree that unforecast revaluation gains and losses should be booked as revenue, although we think it is valid to apply this principle only to the *real* (i.e., after CPI inflation) component of the unforecast revaluation gain or loss.

The IM Review

7 We appreciate the IMs need to be regularly reviewed and we also appreciate the collaborative way the Commission is going about the current Review.

8 Our starting point for this Review is that we are looking for regulatory stability, in the sense of a stable rule book. At an operational level we hope the level of change that results from this Review is modest.

9 The Commission started the Review process appropriately by publishing its problem definition paper and holding the IM Forum to gather industry views. This allowed the range of potential issues to be aired. Now is a good time in the Review process to apply a filter and identify the material issues that the Commission will take forward in the Review.

10 Consistent with our desire for regulatory stability, we do not have any material changes to the IMs to suggest. As discussed at the IM Forum, the IMs and the ID determination are sufficiently flexible to permit high quality disclosures.

11 As a related point, at the end of this year we will start work on our pricing consultation for PSE3. We will have to develop our pricing model and our price proposal, and consult with our airline customers, before the end of this IM Review. There are clearly some potential process risks for us and our customers in that timing. We will work with the Commission staff to manage those risks but this is another reason for us favouring a limited number of IM changes where they are truly required.

Alternative depreciation

12 A key issue of relevance to CIAL in this Review is the use of alternative depreciation methods.

13 As is well known, CIAL set its aeronautical charges for PSE2 by reference to a 20 year smoothed price path. This was an efficient and commercially appropriate way to set prices after our investment in our new integrated terminal.[1]

14 Our initial disclosure of our PSE2 prices was criticised as insufficiently transparent, which we have accepted. A key problem identified by the Commission with our initial disclosure was use of straight line depreciation, which meant that our regulatory accounts did not transparently disclose how much of our investment was intended to be recovered by our PSE2 prices, and our target returns for the period.[2]

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[1] Commerce Commission "Summary and analysis of Christchurch Airport's revised information disclosure for its second price setting event" (9 July 2015) (*s53B Report*) at [27]. See also Commerce Commission "Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch Airport" (13 February 2014) (*s56G Report*) at [3.9].

[2] Commerce Commission, s56G Report at [F35].

15 We responded by revising our disclosure methodology to show the depreciation implied by our PSE2 prices. Our implied depreciation methodology was the subject of consultation with our stakeholders and has been described a number of times.[3] The implied depreciation approach makes transparent the returns targeted in PSE2 and the recovery of investment implied by PSE2 prices.[4]

16 The use of alternative depreciation in the information disclosure accounts was discussed at the IM Forum. In our view the discussion at the IM Forum was constructive. Some points that we took from the discussion at the IM Forum include:

16.1 the IMs and the ID determination do not prevent the adoption of alternative depreciation methods;

16.2 support in principle for a longer term smoothed price path in circumstances like those facing CIAL where there has been a significant new capital investment;

16.3 support for alternative depreciation as the way to smooth the price path;

16.4 a desire by stakeholders to explore methods for setting alternative depreciation in PSE3 that are more simple than the implied depreciation methodology we are using for PSE2.

17 As we have noted previously, the implied depreciation methodology used for PSE2 results in a closing RAB that fully reflects the pricing decision made in PSE2.[5] We will use that RAB for both ID and pricing purposes, including for identifying the opening RAB for PSE3. This means changes to methodology for PSE3 can be made without creating windfall gains or losses.

18 So when responding to requests from our customers for a more simple alternative depreciation approach the question is not whether changes are possible, but what the more simple approach looks like. As discussed at the IM Forum we will work with our expert advisor (Jeff Balchin) to explore whether there are options for a more simple approach and consult with our customers once some options are identified.

19 In that context, however, we do wish to respond to two queries that have been raised in relation to our PSE2 depreciation.

20 The first is a query raised by BARNZ at the IM Forum as to whether implied depreciation is really depreciation because it is not explicitly linked to use of the asset.

21 Depreciation is the return of investment, in contrast to the return on investment, and in the regulatory context, it is a financial concept – the return of the *funds* invested. As explained in our publications, the implied depreciation is the return of our investment implied by the PSE2 prices. If the implied depreciation method was used consistently over the life of the assets it would result in the return of the PV of the investment.

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[3] This process is described in CIAL "Supplementary Voluntary Disclosures" (28 November 2014) (*Voluntary Disclosures*) at [27] – [31].

[4] CIAL, Voluntary Disclosures at [37] – [38]; Incenta Economic Consulting "Calculating the implied "return of capital" (non-standard depreciation) for PSE2" (November 2014) (*Incenta Report*) at pages 1-2; and CIAL "Submission on review of Christchurch Airport's revised information disclosure for its second price setting event – draft report for consultation" (12 June 2015) (*s53B Submission*) at [14] – [20].

[5] CIAL, Voluntary Disclosures at [37] – [38]; Incenta, Incenta Report at pages 1-2; and CIAL, s53B Submission at [14] – [20].

22 A different amount of depreciation could have been used, but to do so would have had one of two consequences. First, a different amount of depreciation would have implied a different price path, and we were explicit that we were not re-opening PSE2 prices. Or second, if PSE2 prices were held constant and a different depreciation amount used this would have obscured target returns, which was the transparency concern we were addressing.

23 We are satisfied that the implied depreciation method accurately identifies the return of our investment implied by the PSE2 prices. However, as noted above, we appreciate that our stakeholders would prefer a more simple method for identifying alternative depreciation in PSE3 and we have committed to engaging on that.

24 The second query was raised in the Commission's section 53B report. In a footnote the Commission asked whether the IM WACC should be used to calculate the implied depreciation.[6] In our view the implied depreciation should be calculated using the same WACC as was used to set prices. There are a number of reasons for this:

24.1 if one WACC is used to calculated a levelised price path and another to derive the implied depreciation, then the sum of depreciation over the life of the asset will not equal its original cost. If the WACC used to calculate the implied depreciation is lower, then over the life of the asset more than the original cost will be recovered. In this scenario the stream of costs identified stop having the character of depreciation and become something else;

24.2 the effect of substituting the IM WACC when calculating implied depreciation would be to adjust the closing RAB in each period so that the IRR for the period always equalled the IM WACC. This would obscure target returns (the criticism we were responding to), and claw back any over or under recovery during the period in a way that would be contrary to the purpose of information disclosure. Moreover, this claw back would only apply in the case of the particular form of implied depreciation applied by CIAL – it would not be applied, for example, where an airport had applied the standard depreciation method and used a different WACC to the IM WACC when setting prices;

24.3 this approach would "cherry pick" the circumstances in which the IMs are substituted into the implied depreciation calculation. For example, in our situation a consistent approach would be to also make changes to reverse out our decisions to set our actual prices lower the levelised price path for much of PSE2 and to treat pre-PSE2 revaluations as income.

25 For these reasons we believe the implied depreciation methodology has been correctly specified and applied for PSE2. Looking forward, as noted above we will engage with our stakeholders to explore more simple methods for identifying alternative depreciation for PSE3.

26 CIAL has encountered one issue with the detailed implementation of implied depreciation for ID purposes. The ID regulations require implied depreciation to be allocated to classes of assets, a requirement which CIAL's auditors have interpreted as requiring an allocation against individual assets.

[6] Commerce Commission, s53B Report at footnote 19.

27 Both of these allocations are somewhat arbitrary given that the implied depreciation CIAL calculated for PSE2 reflected a global (financial) return of capital across the totality of assets for each service. We are still working through whether the requirement to allocate implied depreciation in this manner imposes a real constraint to flexibility or is more a matter of form. Accordingly, depending on the outcome of that analysis, we may raise this issue further with the Commission in the future.

Land revaluations

28 At the IM Forum BARNZ asked that the Review consider the treatment of unforecast revaluation gains of land assets. We agree that this issue should be considered in the Review. Our views in brief are:

28.1 we agree with BARNZ that using CPI indexation is not a forecast of revaluation gains. The CPI indexation serves a different purpose, that of an inflation hedge;

28.2 in the context of that approach, we agree that unforecast revaluation gains and losses should be booked as revenue, although we think it is valid to apply this principle only to the *real* (i.e., after CPI inflation) component of the unforecast revaluation gain or loss (as the CPI-related component of revaluation gains or losses is part of the inflation hedge referred to above);

28.3 we also agree that the timing required by the IMs for the consequences of revaluation gains to be reported for disclosure purposes should be addressed, so that the revaluation gain or loss is booked in the relevant price period about to begin, not the one that has just ended. This might also avoid the need for separate revaluations for pricing and disclosure, and in so doing remove a source of difference between the two models.

29 We look forward to discussing these issues with the Commission as it moves from problem definition to identifying potential solutions.

Kind regards

Yours sincerely

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