CHRISTCHURCH INTERNATIONAL AIRPORT LIMITED

SUBMISSION ON

REVIEW OF CHRISTCHURCH AIRPORT'S REVISED INFORMATION DISCLOSURE FOR ITS SECOND PRICE SETTING EVENT - DRAFT REPORT FOR CONSULTATION

12 JUNE 2015

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Introduction

1 This submission responds to the Commerce Commission's (Commission) consultation paper "Review of Christchurch Airport's revised information disclosure for its second price setting event: Draft report for consultation" dated 22 May 2015 (Draft Report).

2 If there are any questions in relation to this submission please contact:

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Executive summary

3 The genesis for this consultation process is that Christchurch Airport has, with the assistance of Incenta Economic Consulting (Incenta), revised its methodology for disclosing its second price setting event (which occurred in 2012).

4 We have used the revised methodology to reissue disclosure accounts for our price setting event, and the disclosure accounts for 2013 and 2014. We will continue to use the revised disclosure methodology going forward.

5 We revised our disclosure methodology because the transparency of our original price setting event disclosure was criticised in some important respects by the Commission, and we accept those criticisms. We have committed considerable time and resources to address the issues identified by the Commission.

6 Our revised disclosure methodology was developed in an open consultation process that included our customers, BARNZ and the Commission. We circulated a discussion paper on the proposed new methodology, held a workshop, and solicited feedback before finalising our new approach with the expert assistance of Incenta.[1] We appreciated our stakeholders taking the time to participate in this consultation. After our Voluntary Disclosures were published we made ourselves and our expert advisors available to the Commission.

7 We believe our revised disclosure methodology gives good transparency to our return of and return on capital during the pricing period. In particular we have made the key changes identified as necessary by the Commission (and accept the Commission's reasons for requiring these changes):

7.1 use of implied depreciation rather than straight line depreciation;

7.2 we have committed to use a post-tax WACC rather than pre-tax WACC;

7.3 we have committed to use a set 20 year term, rather than a rolling 20 year model.

8 We are committed to providing a full explanation to our stakeholders of the methodology we will use in 2017 to reset prices within the context of the 20 year price path, and as part of that reset provide forecasts of costs, demand and target returns for the remainder of the long term price path.

[1] This process is described in Christchurch International Airport Supplementary Voluntary Disclosures (28 November 2014) (Voluntary Disclosures) paragraph 27 and following

9 We are pleased the Commission has acknowledged the effort made by CIAL and the improvements in our disclosures:[2]

> Christchurch Airport has addressed a number of the concerns we had about the lack of transparency as to its pricing approach. We welcome the effort that Christchurch Airport has made in improving the transparency of its disclosure, and have set out our observations on the revised disclosure in this draft report.

10 We are grateful for the effort the Commission has put into this additional process step and additional analysis.

11 We adopted a non-standard pricing model for our pricing decision in 2012, for reasons endorsed by the Commission. The non-standard approach sets prices for a 5 year period by reference to a 20 year price path, whereas the standard approach simply uses a 5 year model.

12 We have been on a learning curve as to the best form of disclosure of this non-standard pricing approach. Our customers and the Commission have also had to figure this out while the process was underway. As noted above, we believe we have now settled on a robust disclosure methodology that makes transparent our return of and on investment during each pricing period. Standing back, we view this process as demonstrating the effectiveness of the new information disclosure regime.

13 The Draft Report records two remaining concerns and we address those in this submission. The Commission has also released a letter from BARNZ, addressing issues that were raised during our consultation. We respond to BARNZ in the Appendix.

Our revised disclosure methodology

14 It is useful to first highlight the key features of our revised disclosure methodology. Incenta explained the rationale for the approach in its report.

> CIAL, in setting its prices for PSE2, set a levelised price path that was designed to deliver cash flows with NPV=0 over the 20 year period modelled. The rationale for setting the levelised price was to reduce the likelihood of inter-period price shock and, most importantly, to generate a more efficient spreading of the cost of the new terminal over its life.

15 The key features of the revised disclosure methodology include:

15.1 the prices set for the 2012 to 2017 period do not change;

15.2 depreciation is calculated as a residual, after deducting forecast costs and the targeted return;

15.3 a post-tax WACC is used, and forecasts of actual tax paid;

15.4 the full amount of revaluations that occurred prior to the 2012 price decision are treated as revenue in the current pricing period;[3]

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[2] Draft Report at paragraph 14

[3] As described in the Draft Report at paragraphs 57 to 59

15.5 the closing regulatory asset base (RAB) at the end of the period is derived to be consistent with the prices charged during the period, and hence consistent with the revaluations during the period.

16 The effect of the implied depreciation approach was explained by Incenta:[4]

> In broad terms, the "implied return of capital" or "implied depreciation" or "non-standard depreciation" spreadsheet model (these terms are used interchangeably) is endeavouring to work out the return of capital that was expected to be achieved during the PSE2 period under the levelised price path. The implied return of capital that is calculated in this manner will be used to update the RAB over PSE2 and so derive an opening RAB for PSE3.

17 This advice from Incenta, that we address the transparency concerns with the disclosure of the levelised price path by calculating depreciation as a residual, is the solution suggested by the Commission in its Final Section 56G report on Christchurch Airport's price setting event disclosure.[5]

18 The Draft Report explains:[6]

> We suggested that Christchurch Airport's use of a standard straight-line depreciation approach in its disclosures, in conjunction with its levelised pricing approach may have meant that its pricing disclosures were less transparent than they could have been. We indicated that Christchurch Airport could have derived and disclosed forecast depreciated values of its RAB that were consistent with its levelised price path (i.e., reflecting relatively low capacity utilisation in the short term, as well as an expectation of higher cash flows in the future). Doing so would have allowed interested persons to better assess the impact of its levelised pricing approach on expected returns.

19 Applying this methodology means that our stakeholders will be able to identify from our disclosures:

19.1 how much of our investment we recover during the pricing period; and

19.2 a closing RAB at the end of the pricing period (30 June 2017) that is consistent with our pricing decision and that shows how much of our investment has been recovered during the pricing period, and how much remains to be recovered in future.

20 In addition, it will be a simple exercise to derive from this closing RAB the opening asset base on which prices will be reset from July 2017.[7]

Remaining transparency concern

21 The Draft Report records that the Commission has some areas where it believes the transparency of our disclosures could be further improved. The Draft Report states:[8]

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[4] Calculating the implied "return of capital" (non-standard depreciation) for PSE2: Christchurch International Airport Limited (November 2014) (Incenta Report), page 2

[5] Paragraph E90 and footnote 178

[6] Paragraph 32

[7] Described in Voluntary Disclosures paragraph 38 and following

[8] Paragraph 66.5

> the main area in which an Christchurch Airport could further improve the transparency of its disclosure is by providing improved information about the 20-year period that is referred to when setting prices for any particular PSE pricing period.

22 We accept that we have not provided fully detailed forecasts of costs and demand for the 20 year period from 2012. In our 2012 pricing model detailed information was provided for the 4 year 7 month pricing period, and less detailed information was supplied for a 10 year view.

23 We are committed to providing the Commission and our other stakeholders the information they need to understand our long term price path and the implications for return of and return on capital in any pricing period. There are several aspects to this.

24 The first is that when resetting the price path in 2017 we will address the modelling gaps identified in the Section 56G Report. We recorded in our Voluntary Disclosures:[9]

> The Commission's Final section 56G Report raised some questions as to gaps in our 20 year pricing model (specifically, forecast capital expenditure after 30 June 2017 and inflation after 2022, and detailed forecasts after 2022), which we will address when consulting on our prices to apply from 1 July 2017.

25 Second, in the lead up to our price consultation for the 2017 reset we intend to take our stakeholders through the process for resetting the long-term price path. Incenta will provide expert advice on a methodology for resetting the price path that is transparent and internally consistent.

26 Third, as part of that process we will be re-forecasting opex, capex, demand and WACC for the new pricing period and the period to 2032. While prices are set by reference to a 20 year price path, at each 5 year pricing reset the model will include new forecasts of demand, operating and capital expenditure and the cost of capital. The model does not lock in 20 year forecasts of costs and demand. For the first five years from 2017 the forecasts will be as detailed as they would be if prices were set under the standard methodology. For the remaining 10 of the 15 years, the forecasts will be as detailed as is possible for forecasts of that duration.

27 Finally, it is important that the Incenta methodology for calculating implied depreciation allows an analysis of our current prices to be made independently of forecasts for the remaining 15 years of the price path.

28 As noted above, and explained in our Voluntary Disclosures[10] and the Incenta Report,[11] the implied depreciation methodology means that our stakeholders can identify from our disclosures:

28.1 how much of our investment we recover for the pricing period from 2012 to 2017; and

[9] Voluntary Disclosures paragraph 41

[10] Paragraphs 34 to 41

[11] Pages 1-2; 27-29

28.2 a closing RAB at the end of the pricing period (30 June 2017) that is consistent with our pricing decision and that shows how much of our investment has been recovered during the pricing period, and how much remains to be recovered in future.

29 This assessment of the implications of our 2012 pricing decision can be made without having to make assumptions about costs, target returns and demand over the 2017 to 2032 period.

30 Or to put that another way, by using implied depreciation to calculate the PSE2 closing RAB at the end of this pricing period, and using that closing RAB to calculate the opening RAB for 2017, we can consult with our customers on the pricing model, forecast costs, demand and target returns on a forward-looking basis. No windfall gains or losses are created by changes in forecasts, or the model.

31 For present purposes, this is important to bear in mind when considering whether our disclosures are complete and useful. As noted above we are committed to providing in 2017 longer term forecasts that are of better quality than the ones we used in 2012. However that information isn't needed to assess the return of investment (and thereby the return on investment) implied by our current prices.

32 The Commission has also released a letter from BARNZ, addressing issues that were raised during our consultation. We respond to BARNZ in the Appendix.

Target returns

33 The Draft Report repeats the Commission's findings in its Final Section 56G Report that CIAL is targeting excess returns after 2017. This is a direct function of the WACC used by CIAL.

34 The Final Section 56G Report advised Ministers that returns we are targeting in this pricing period fall within an acceptable range. For this reason there has been no suggestion that CIAL reset its prices for the current period (as was done by Wellington International Airport Ltd).

35 Our experience this pricing period is that actual returns are lower than target returns. The following summary was included in our 2014 disclosure:

	$'000			
Item	2011	2012	2013	2014
Regulatory Profit	18,884	7,517	7,213	14,591
Adjusted Regulatory Profit	17,873	6,385	6,247	13,497
Regulatory Investment value	315,378	404,058	428,960	489,229
ROI - comparable to post tax WACC	***5.67%***	***1.58%***	***1.46%***	***2.76%***
Post Tax WACC *:	*8.06%*	*7.56%*	*6.49%*	*6.77%*

36 As noted above we have committed to continue using a post-tax WACC. In 2017 we will ensure this method (together with a calculation of actual taxation liabilities) is used in all calculations, and make transparent any implications for forecast returns.

37 In relation to the returns we might target in 2017, we appreciate the Commission's clearly expressed concerns and intend to respond to them. CIAL will reset

aeronautical prices in 2017 for a five year period, following a normal and extensive consultation process with airline customers. CIAL is confident the Commission will be comfortable with this process and the targeted returns, and be able to identify changes that are a direct result of the information disclosure regulation. However we appreciate the Commission cannot assess this until 2017.

Conclusion

38 CIAL is committed to making the information disclosure regime effective. We have put a lot of effort into revising our disclosure methodology to more transparently report the return of capital implied by our current prices, and we appreciate the time and effort that the Commission and our other stakeholders have put into this process.

39 We acknowledge the Commission's suggestion for more information about the remainder of our 20 year price path, and its concerns as to the returns we target after 2017. We will respond to those concerns in the lead up to, and during our pricing consultation for the 2017 price reset.

Appendix A – response to BARNZ

40 BARNZ has provided a report from Schiff Consulting. Mr Schiff repeats opinions that he expressed during our consultation on the methodology for calculating implied depreciation and revising our disclosures (when working with Covec).

41 The first is that the implied depreciation methodology is more complex than the standard building blocks approach. We acknowledge that is the case. However the context here is:

41.1 a levelised price path is appropriate in a context where we have made a large terminal investment. The Commission has endorsed this choice of approach;

41.2 when disclosing the implications of the levelised price path, it is more transparent to use implied depreciation than straight line depreciation. This was the point made by the Commission in our section 56G report, and why we have revised our disclosure methodology.

42 The second is that the change to calculating and using implied depreciation is at odds with CIAL's statements when proposing the long run price path that it would earn low returns in the early part of the 20 year period and higher returns toward the end of that period.

43 The Incenta Report considered this point and responded as follows:[12]

A.1 Response to Covec's principal comment

A.1.1 Introduction

As noted above, Covec's principal comment on our earlier report and other material was that the concept of implied depreciation is inappropriate and will generate windfall gains and should not be applied at all. It advocated instead that CIAL should continue to report a RAB value that is based upon straight line depreciation as it foreshadowed and that to do otherwise would be inconsistent with CIAL's previous statements.

We disagree with the suggestion that windfall gains may be made from the application of implied depreciation (they cannot) and note that Covec comments appeared to miss the reason that CIAL is restating its disclosures to be based upon implied depreciation, which is to provide the Commission and airlines with the additional transparency over returns that both have sought.

More specifically, Covec observed that the outcome of the implied depreciation calculation is that the RAB is structured such that the expected return is equal in all years. Covec observed that:

- the equal expected return was not consistent with how CIAL described its expected return during the consultation for PSE2 prices (CIAL had described the levelised price path as generating a return that starts low and increases over time),[13] and

[12] Page 27

[13] Covec, p.2

- would result in a higher closing RAB for PSE2 than would straight line depreciation and so imply higher prices for customers in PSE3 and beyond, describing the method as resulting in upwards revaluations that are not being rebated to customers.[14]

Covec advocated an alternative approach to setting prices in which:

- the RAB is carried forward using straight line depreciation, and
- the return on assets would vary over time – in the stylised example provided by Covec (20 year asset life, WACC of 10 per cent and a level cash flow), the annual return would increase over time from 8.0 per cent to 15.7 per cent.[15]

A.1.2 Will there be a windfall gain?

First, with respect to future prices, Covec is incorrect in its assertion that carrying forward the RAB using implied depreciation will generate a higher price to customers in PSE3 and beyond than under Covec's alternative approach. Rather, the price to customers for PSE3 and beyond will be identical provided the alternative approaches are applied consistently and so a fair comparison is being made. Indeed, this is the outcome under the stylised example that Covec provided in its report.[16]

This follows because under Covec's preferred approach, whereas the RAB would be lower than if implied depreciation is applied, the annual return that is required to achieve NPV=0 will increase over time to levels substantially in excess of the WACC. In the stylised example in Covec's report, a margin over the WACC of 0.02 percentage points would be required for year 6, rising to a margin over the WACC of 1.64 percentage points by the final year of the second pricing period (year 10). As Covec's stylised example demonstrates, while the RAB would be lower under its preferred approach, the rate of return provided would be higher by a precisely offsetting amount (this is clear from the fact that the "annual cash flow" under the two methods is identical at 117,460 in all years).

A.1.3 Should CIAL depart from how it described the effect of the levelised price path?

Covec is clearly correct that CIAL did make a number of statements suggesting that it expected its rate of return (on a straight line depreciated RAB) to commence low and then to escalate over time. However, this was the very aspect of how CIAL had presented the outcomes of the levelised price path that caused valid concerns with the Commission about the transparency of CIAL's returns over time.

More specifically, if the RAB is carried forward on a straight line depreciated basis, then as Covec's own analysis makes clear, the "appropriate" rate of return (i.e., the rate of return that is necessary to achieve NPV=0) will vary

[14] Covec, p.2

[15] This stylised example assumed, in effect, a constant demand. With demand growth and levelised prices, an even greater variation in the expected return over the period occurs.

[16] Covec, p.10. Note that both approaches

> over time, with the "appropriate" return starting well below the WACC and then increasing to levels substantially higher. In turn, if the "appropriate" return varies in this manner, then it is difficult to compare CIAL's expected or measured return in any year with an estimate of the appropriate WACC and draw any meaningful inference about the appropriateness of those expected or measured returns. The whole purpose of deriving the depreciation that was implied for PSE2 under the levelised price path and using this to update the RAB is to convert a framework in which returns are varying returns into an equivalent framework in which the expected return in each year is the assumed WACC so that the transparency sought by the Commission is achieved.[17]

44 The third is that the revised methodology results in a higher closing RAB than the result when using straight line depreciation. Schiff does not contest the correctness of this result (and the Draft Report records the Incenta methodology is correct). The argument made by Schiff is that the Incenta methodology must be applied consistently at each price reset in order to avoid windfall gains or losses.

45 However as the Incenta Report explained, this is a feature of the methodology being proposed by Mr Schiff (when at Covec), and a concern that is avoided by using the Incenta methodology: [18]

> In addition, if the RAB were derived in the manner advocated by Covec, then it would be necessary to again apply the levelised price approach for PSE3 and beyond. This is because, as Covec's stylised model shows, using the straight line depreciated RAB would only be consistent with an NPV=0 outcome over the life of the asset if the rate of return provided in future periods increases above the WACC as anticipated under the levelised price path. In contrast, if the RAB is updated to the end of PSE2 using implied depreciation (as recommended in this report), then the flexibility is provided to reapply a levelised price path for PSE3 or to switch to a more conventional application of the building block approach.

46 As can be seen from the discussion above, the arguments from Schiff Consulting do not go to the correctness or transparency of Incenta's methodology but rather are made in support of BARNZ's stance that CIAL should not adopt a long-term price path approach. As recorded in the Draft Report, BARNZ position is that CIAL should have used a standard 5 year building block model. However for reasons explained by CIAL and endorsed by the Commission we adopted a 20 year price path.

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[17] As noted in several places, the two frameworks are not precisely equivalent because a change has also been made from using a pre-tax approach to a post-tax approach, which is to the benefit of the airlines (that is, this change is likely to lead to prices for PSE3 and beyond being lower than would otherwise have been the case)

[18] Page 29