

27 February 2015

John McLaren
Manager, Compliance and Performance Analysis Team
Commerce Commission

Dear John,

At the request of BARNZ, in August 2014 I reviewed information provided by Christchurch International Airport Limited (CIAL) and its consultants in relation to CIAL's revised information disclosures for the PSE2 period.¹ BARNZ has asked me to provide this letter to the Commission summarising my views, to assist the Commission in its analysis of CIAL's revised disclosures.

My August 2014 report discussed a number of issues, including:

1. CIAL's proposal to move to an "implied depreciation" methodology, and issues arising from its proposed implementation of that methodology.
2. Whether pre-PSE2 revaluation gains should be rebated only over PSE2 or over a longer period.
3. The treatment of inflation-related revaluation gains and rebating any gains arising from the difference between actual and forecast inflation.
4. The assumption about the timing of the return on capital in the implied depreciation calculations.

Based on a later report from Incenta Economic Consulting,² common ground appears to have been reached on (2) and (4) above, but there are still differing opinions about (1) and (3). Of these, the application and implications of the "implied depreciation" methodology have the largest potential consequences for CIAL's customers, and so I focus on that in this letter.

¹ "Comments on CIAL Revised Disclosures", Covec report for BARNZ, 21 August 2014.

² "Calculating the implied 'return of capital' (non-standard depreciation) for PSE2, Incenta Economic Consulting report for Christchurch International Airport Limited, November 2014.

Implied depreciation

Under CIAL's "implied depreciation" methodology, depreciation is calculated each year as a "residual" after costs, tax, and return on capital are subtracted from its target revenues. CIAL's stated aim for doing so is to produce a depreciation profile that is consistent with CIAL's "constant levelised pricing" methodology. In contrast its earlier information disclosures involved more familiar straight-line depreciation that was predetermined independently of the pricing path.

While implied depreciation can be implemented in a way that is consistent with CIAL's chosen pricing methodology, it introduces additional issues. First, since the amount of depreciation is no longer predetermined, it must be calculated in a step-wise fashion over an asset's life. The fundamental complexity and analytical difficulties created by CIAL's "constant levelised pricing" methodology remain, and the complexity is increased by the nature of the implied depreciation calculations.

Second, the implementation of the implied depreciation approach as proposed by CIAL involves assuming a constant rate of return on capital in each year, equal to CIAL's target rate of return.³ This is a restrictive assumption and appears to be at odds with CIAL's stated approach to price setting, in which it claimed it would earn a relatively low return initially, made up for by higher expected returns in future. Thus while the implied depreciation methodology is theoretically consistent with a "constant levelised pricing path", the way that CIAL has implemented the depreciation calculations does not appear to be consistent with its pricing.

Another implication of all of this is a change in the value of the RAB at the end of PSE2. In particular, CIAL's revised disclosures imply a RAB at the end of PSE2 that is higher than previously expected given its pricing in PSE2, its statements about how it developed its pricing, and its previously disclosed approach to depreciation.

As Incenta Economic Consulting point out in their November 2014 note, this would not matter in a perfect world where prices are fixed for the life of the asset in order to achieve NPV = 0 over its life. In such a case, changing the depreciation methodology causes a shift of cashflows between the return on and return of capital over time, but does not affect the net present value of cashflows (or the annual total cashflow). This was also shown in some simplified examples in my August 2014 report, although the main point of those examples was to demonstrate the effect of changing the depreciation methodology on the value of the closing asset base in each year.

Unlike a theoretical world or stylised examples, the reality is that CIAL's prices are not fixed for the life of its assets – they are only fixed for each price-setting period.

³ In addition, the target rate of return used in these calculations exceeds the WACC range identified by the Commission as appropriate.

As Incenta state in their November 2014 report (page 28), “... the price to customers for PSE3 and beyond will be identical *provided the alternative approaches are applied consistently ...*” (emphasis added). However, in PSE3, CIAL’s prices will be set in a fresh consultation or negotiation process, potentially by different people and potentially using a different pricing methodology, but the end result will depend crucially on the value of the opening asset base at that time.

Therefore in my view it is reasonable for CIAL’s customers to be very concerned about the increase in the value of the asset base at the end of PSE2 that is caused by changing the depreciation methodology from what was previously anticipated based on CIAL’s disclosures and statements about its pricing methodology.

In summary, while the application of “implied depreciation” may assist the Commission in the task of assessing CIAL’s targeted returns in PSE2, it creates additional concerns and risks for CIAL’s customers in future pricing periods.

If you have any questions about these issues I would be happy to discuss them with you. Please call me on (09) 336 1323, or email aaron@schiff.co.nz.

Best regards,

Aaron Schiff