BARNZ
BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND INC

SUBMISSION ON THE COMMERCE COMMISSION'S DRAFT REVIEW OF CHRISTCHURCH AIRPORT'S REVISED INFORMATION DISCLOSURE FOR THE SECOND PRICE SETTING EVENT

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On 22 May the Commerce Commission released its draft report on Christchurch Airport's revised information disclosure for the second price setting event. The Commission said, in summary, that:

- Although there are still some areas for improvement, Christchurch Airport's efforts to improve the transparency of its disclosure following the Commission's review of its original disclosure are welcomed

- The most significant improvement is the move from disclosure of information on a pre-tax basis to a post-tax basis

- The introduction of an implied depreciation approach by Christchurch Airport is an improvement in that it better reflects the demand considerations that are implicit in the 20 year pricing approach

- The main area in which 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 pricing period

- Information disclosure has not been effective in limiting Christchurch Airport's ability to extract excessive profits. The revised information disclosure shows that the airport is still targeting a return of 8.9% over the 20 year period, which is above the Commission's 75th percentile (8.5%).

Transparency

The Commission says that Christchurch Airport has addressed most of the concerns the Commission had about the lack of transparency as to its price setting approach. BARNZ welcomes the improvements, particularly the correction of the tax treatment of revaluations, but considers that there are still major deficiencies. It is still not completely clear how the airport applies the implied depreciation approach over the 20 year period. Anything that is less than full disclosure means that the disclosure is not transparent. As the airport's revised information disclosure has still left the pricing methodology partly obscure, it demonstrates very clearly the inadequacies of relying on information disclosure regulation when airports are free to set prices as they see fit.

While the revised information disclosure has drawn the airport to correct its tax treatment of revaluations, providing a revised information disclosure a full two years after the airport board

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determined the charges is hardly an explanation of the rationale that the airport board had in its mind when it set the charges for PSE2 in 2012. At that time it sought, not just an excessive WACC, but also the gain from the incorrect treatment of tax on revaluations. BARNZ believes the Commission's final report should recognise the airport board's intentions as they were at the time at which prices were set. They remain opaque.

Movement from Pre-tax to a Post-tax WACC Basis

In its draft report the Commission says that the airport's use of a pre-tax WACC resulted in a higher level of returns because of the method the airport used to convert its post-tax WACC to a pre-tax WACC (para 61.1). In BARNZ's view, it was not the method used to convert from a post-tax to a pre-tax WACC itself, it was the faulty methodology adopted in applying the pre-tax WACC whereby the revaluation gains were grossed up for tax when calculating the allowable revenue, but the revaluations were not grossed up for tax when they were "rebated". That lifted the airport's calculation of allowable revenue.

BARNZ agrees with the Commission that it was an improvement in moving from a gross WACC to a net WACC — but the improvement was not just in transparency. It was also substantive — a difference of $36m over the pricing period.

Introduction of "Implied Depreciation"

In its summary the Commission is saying that the introduction of an "implied depreciation" approach by the airport is an improvement in that it better reflects the demand considerations that are implicit in the 20-year pricing approach.

The link between demand considerations and the profile of implied depreciation over the 20 years remains obscure. The implied depreciation is the result of back-solving. As the Commission says, any areas of contention between the airport and airlines remain embedded in the RAB (para 53). BARNZ remains sceptical that the method can be improved so that interested persons can possibly regard the method as being transparent. What is more, interested persons should not need a PhD in mathematics to understand the price setting methodology and intentions.

In paragraphs 61-63 the Commission says the pricing asset base is lower than that resulting from straight line depreciation. That has occurred because the error in the application of the gross WACC has been corrected and because of the proper treatment of revaluations gains prior to PSE2 — both of which BARNZ supports. Had all else been equal, the implied depreciation approach would have reduced depreciation in PSE2 relative to straight line depreciation, which would have caused asset values to be higher going into PSE3, resulting in higher prices in PSE3 than would have been the case with straight line depreciation. This gratuitous increase in the asset base would be repeated into each of the following three pricing periods.

The implied depreciation approach treats the airport's excessive WACC as immutable, with "implied depreciation" being used to raise the pricing asset base from pricing period to pricing period compared with straight line depreciation. These increases in the pricing asset base are not rebated as income and, in addition, they generate an excessive return at the airport's chosen WACC.

Moving from Rolling 20 Years to Fixed 20-Year Period

The Commission says that the transparency is improved by moving from a rolling 20-year period to a fixed 20-year period. BARNZ agrees that is better, but believes that there is still a lack of clarity about how the price setting would be done in each subsequent period. Many factors will change from one pricing period to the next — for example, the WACC could be lowered following the Commission's review of the WACC percentiles.

Effectiveness of Information Disclosure

Despite the difficulties embodied in the methodology chosen by the airport for price setting, it remains perfectly apparent that it is unilaterally applying a net WACC of at least 8.9%, which is above the Commission's 75th percentile (8.5%). The Commission's approach has been generally conservative in the airport's favour, which strongly suggests the target return is indeed well above 8.9%. The revised information disclosure has at least revealed that, but it is patently obvious that it cannot prevent it. BARNZ supports the Commission's conclusion on this important substantive point.

Finally, BARNZ remains greatly disappointed that — after the Commission said so clearly when setting the input methodologies that revaluation gains should be treated as income, whether the revaluation gains are forecast or not, and after the High Court clearly endorsed that principle — the Commission has not treated the unforecast revaluations at the beginning of PSE2 as income. Had it done so, it would have found the return sought by the airport significantly higher than 8.9%.

BARNZ thanks the Commission for the opportunity to make these comments on its draft report and trusts they will assist the Commission in finalising its report.

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