COMMERCE COMMISSION NEW ZEALAND
Te Komihana Tauhokohoko

Airports Profitability Assessment Workshop 2

Introduction and Welcome

26 April 2016

John McLaren

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Airports Profitability Assessment Workshop 2

Purpose and Agenda

26 April 2016

Jo Perry

Workshop purpose

- The purpose of this workshop is to present Commission staff's current view on the approach to assessing profitability with a view to discussing the pros and cons of possible solutions to the problems identified in the first workshop with the interested parties.

Topics identified during the problem definition phase

IM or ID issues

- Revaluations
- Depreciation
- Land held for future use
- Opening RAB values
- Application of MVAU (fast track process)
- WACC percentile (WACC projects)

ID only issues

- Unforecast revaluations
- Leased assets
- Under and over recoveries
- Commercial concessions (discounting)

Airports Profitability Assessment process

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Seek views on how airports profitability could be assessed	Seek views on issues in the context of the profitability assessment	IM and ID Draft decisions and reasons published	Submissions/Cross-Submissions on draft decisions and reasons
Pre-Christmas 2015	February - April 2016	June 2016	July – August 2016

Other aspects of the IM review review that could impact on the airport sector

Other aspects of the IM review impacting airports

- Airport WACC percentile
- WACC timing for assessing airport profitability
- Cost allocation
- RAB indexation
- Error corrections and reducing complexity
- Asset lives

Workshop agenda

…. See attached document

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Airports Profitability Assessment Workshop 2

Purpose of the airports profitability assessment

26 April 2016

John McLaren

Agenda

- Purpose of information disclosure
- Summary and Analysis
- Purpose of Part 4
- Framework principles
- Other considerations
- Outcomes of profitability assessment

Purpose of information disclosure

To ensure sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met

Summary and Analysis

- s 56G of the Commerce Act to report on how effectively ID regulation is promoting the Part 4 purpose (transitional provision); and
- s 53B(2)(b) of the Commerce Act to publish a summary and analysis of information provided under ID regulation

Purpose of Part 4

To promote the long-term benefit of consumers … by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated services…..

a) have incentives to innovate and invest …;
b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands;
c) share with consumers the benefits of efficiency gains …; and
d) are limited in their ability to extract excessive profits

Framework principles relevant to airports profitability assessment

- *Real Financial capital maintenance* - (NPV=0) principle underpins our assessment of airport profitability
- *Risk allocation* – in workably competitive markets risks are typically allocated to suppliers or consumers depending on which are best placed to manage them

IM decision making framework

We will only change the IMs where we have identified a problem/opportunity such that changing the IMs would:

- Promote the Part 4 purpose in s 52A more effectively;
- Promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
- Significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).

ID decision making framework

We will only change ID where we have identified a problem/opportunity such that changing ID would:

- Promote the Part 4 purpose in s 52A more effectively;
- Promote the ID purpose in s 53A more effectively (without detrimentally affecting the promotion of the s 52A purpose); or

Other considerations

- *Price setting* - airports are not subject to price quality regulation and can set prices as they see fit
- *Transparency* –
  - required to address information asymmetry
  - provides clarity of decisions made and reasons
- *Flexibility v prescription* – what better promotes the purpose of information disclosure
- *Optional v mandatory* – what better promotes the purpose of information disclosure
- Are there any other matters that should be considered?

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Airports Profitability Workshop 2

Emerging views on the key elements of a forward looking profitability indicator

26 April 2016

Jo Perry

Purpose of this presentation

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- The purpose of this presentation is to provide an overview of our emerging views on the proposed forward looking profitability indicator
- The views expressed by the Commerce Commission staff at this workshop are for the purpose of stimulating discussion about possible solutions.
- The Commerce Commission view will be provided in the draft decision

Structure of this presentation

1. The key elements of a forward looking profitability indicator and how it might work in the light of our emerging views on the ex-post assessment of the allocation of risk

2. Proposed changes to IMs and ID to support the forward looking profitability indicator

The key elements of a forward looking profitability indicator

Purpose of this section

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- This section outlines the key elements we and other interested persons would have to consider when assessing airports forward looking profitability

Forward looking profitability indicator

- At the airports profitability workshop in December 2015, there was general support for:
  - using an ex ante IRR for the 5 year pricing period with a carry forward mechanism between pricing periods;
  - the carry forward to include, at a minimum, those amounts that were agreed to be carried forward in pricing consultations

- This approach can provide for a headline profitability indicator that can be used as a starting point for any subsequent summary and analysis undertaken by us or other interested persons

Forward looking IRR – key elements

- The calculation of an IRR for the 5 year pricing period requires assumptions on the following key elements:
  - Opening investment value (reflecting the initial capital to be recovered)
  - Cash flows (associated with the initial capital to be recovered)
  - Closing investment value (reflecting the remaining capital to be recovered)
- If the closing investment value is a good estimate of the remaining capital to be recovered, then the IRR will provide a better estimate of returns over the remaining lifetime of the assets employed to supply regulated airport services

Ex-ante IRR – key elements

Ex-ante profitability assessment – Key elements of a forward looking IRR calculation

Ex-post assessment of actual values

Opening RAB

−

Opening Carry forward

=

Opening Investment Value

Initial capital to be recovered

Forecast Cash Flow of PSE	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	$$	$$	$$	$$	$$
less opex	$$	$$	$$	$$	$$
less capex	$$	$$	$$	$$	$$
less tax	$$	$$	$$	$$	$$

Forecast cash flows associated with the initial capital to be recovered

Forecast Closing asset base

−

Forecast Closing Carry forward

=

Forecast Closing Investment Value

Remaining capital to be recovered

Actual Closing RAB = Opening RAB of next PSE

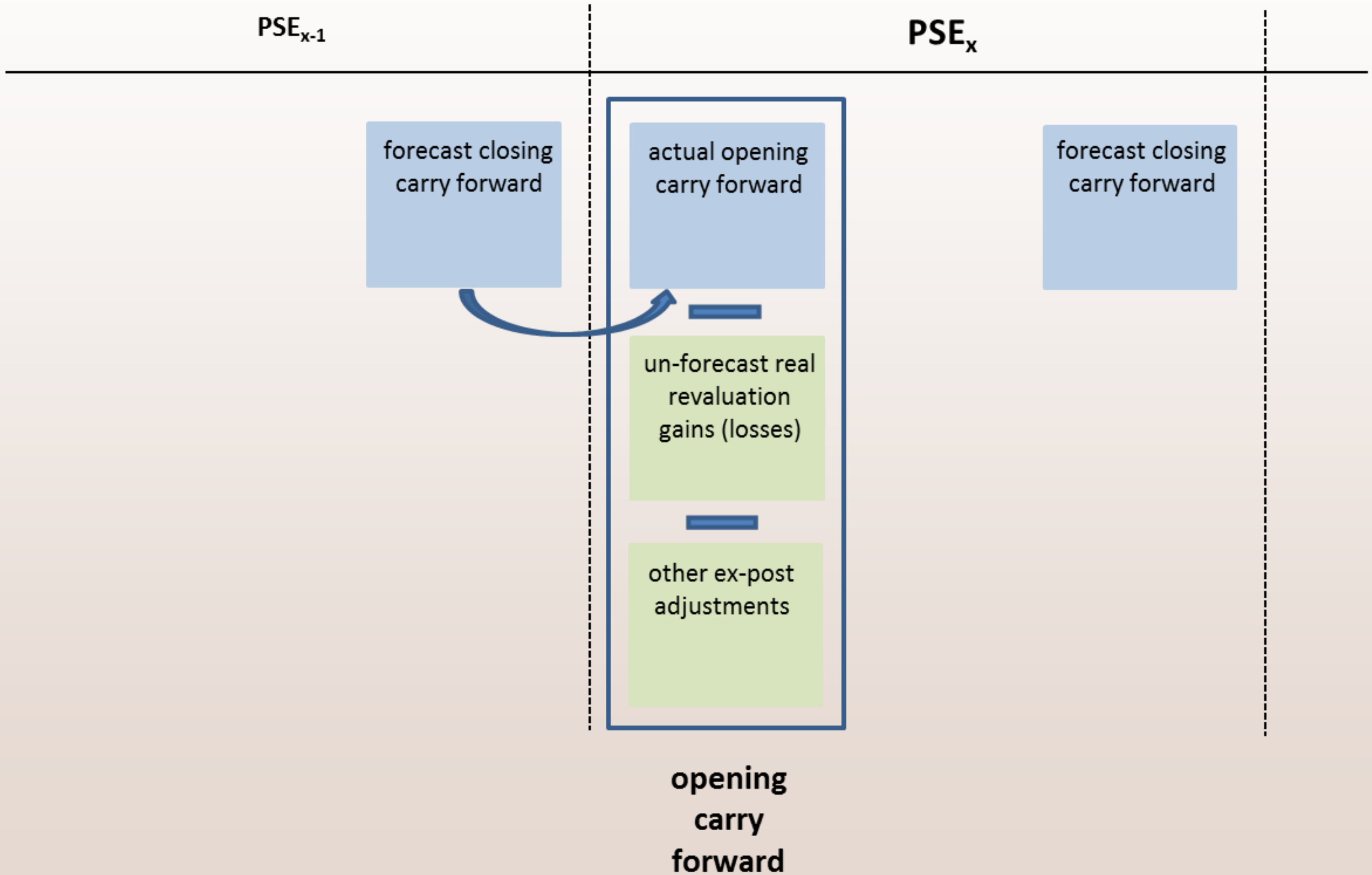
Actual Closing Carry forward = Opening Carry forward of next PSE

Carry forward mechanisms

- In the context of the ex-post assessment of risk allocation our emerging view is
  - **to use the opening carry forward** to carry forward over and under recoveries **between** pricing periods
  - **not to use carry forwards** to carry forward over and under recoveries **within** the pricing period
- Our emerging view is to include a forecast closing carry forward to allow an airport to reflect the impact of any forecast under or over recoveries which the airport has indicated would be taken into account in future PSEs

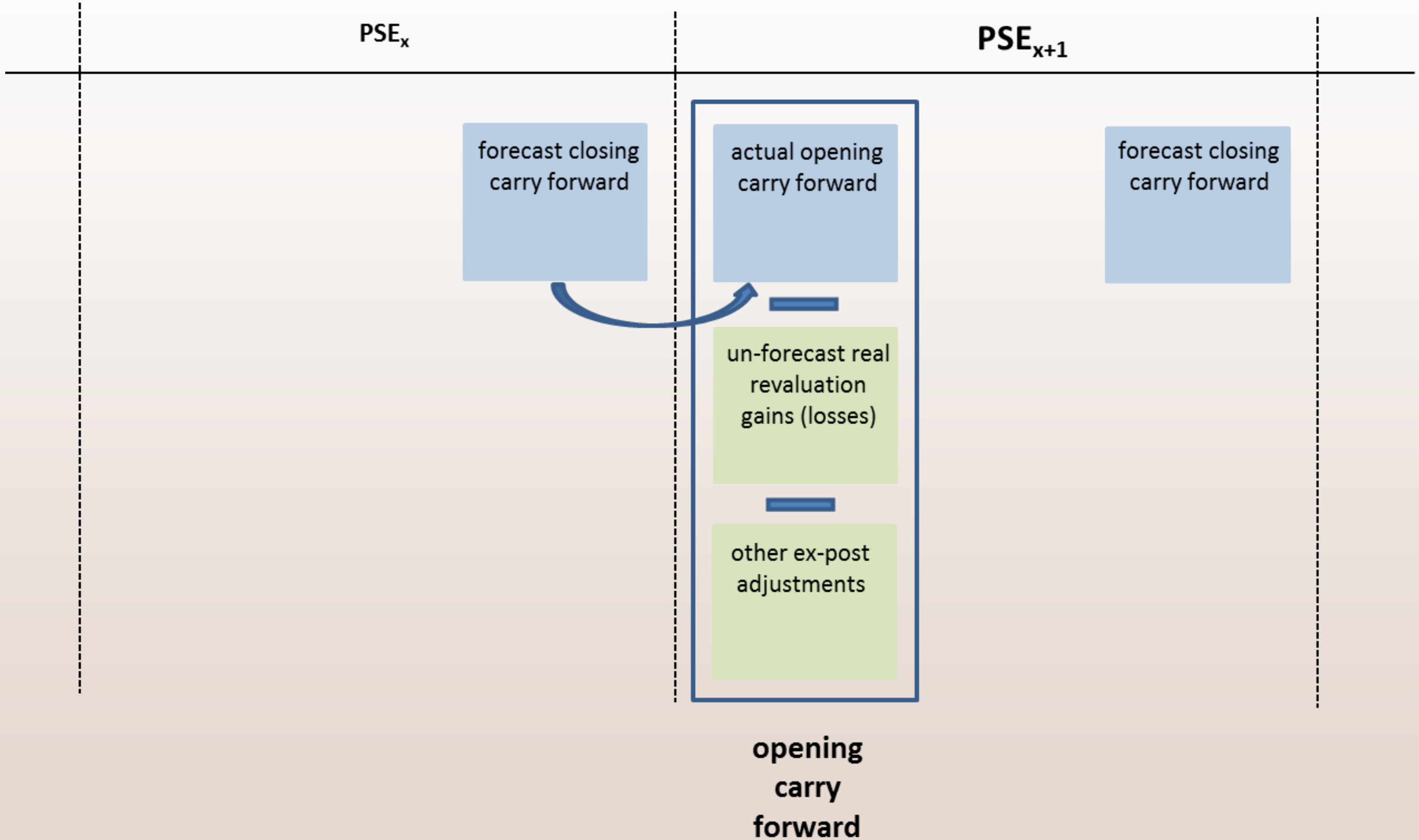
When calculating the forward looking IRR for PSE_x

The following diagram indicates the information we would take into account



When calculating the forward looking IRR for PSE_{x+1}

The following diagram indicates the information we would take into account in a subsequent PSE



Opening investment value

- The **opening RAB value** is the IM-compliant closing RAB value from the ex-post disclosure of the year preceding the start of the current PSE (or the best estimate)

- The **opening carry forward** can be used to reflect
  - un-forecast revaluation gains (losses) in real terms from the previous pricing period
  - other arrangements proposed by airports at the previous PSE to adjust for differences between forecasts and actuals (eg capex wash up)
  - any forecast closing carry forward included in the previous PSE (eg remaining revaluation gain to be returned)

Forecast cash flows

- The forecast cash flows comprise airports’ forecast of
  - revenues
  - opex
  - capex
  - tax
- We use the cash flow items in our forward looking IRR calculation as they are provided by airports
- Cash flows and the opening investment value should be consistent (eg. if leased assets are included in the RAB we would expect the associated revenues and costs to be reflected in the cash flows)

Forecast closing investment value

- The **forecast closing RAB value** is the forecast asset base used by airports when setting prices
  - Airports are required to provide sufficient information to provide transparency if they choose to use non IM-compliant approaches in determining this value

- The **forecast closing carry forward** can be used to capture in the forward looking IRR calculation the impact of any forecast under or over recoveries which the airport has indicated would be taken into account in future PSEs

How is this different to how we assessed profitability during s56G?

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- During the s56G review, we generally took the disclosed RAB as the starting point for the opening investment value with very few adjustments
- We made adjustments to an airport’s forecast cash flows where we considered airports had included within their revenue forecasts the return of over and under recoveries that had occurred in previous price setting periods(eg wash-ups for un-forecast revaluation gains)
- This was to ensure that the cash flows used in our IRR calculation were consistent with any implicit assumptions in the opening investment value and that the resulting IRR provided a good indication of the airport’s target return

Consideration of risk allocation

Purpose of this section

- To discuss our emerging view on risk allocation in light of the discussions at and submissions on airport profitability workshop 1

- To consider how the opening carry forward adjustment can be used to reflect risk allocation decisions

Problem definition - risk allocation

- Where an airport has not identified any specific risk sharing arrangements, the risk that actual outturns are different from forecasts is assumed wholly by the airport for the duration of the pricing period.
  - That is, if actual outcomes are better than forecast (eg, higher demand, lower costs) an airport's ex-post returns will be higher than expected. Similarly if actual outcomes are worse than forecast, an airport's ex-post returns will be lower.

- If airports assume all the risks and rewards associated with actual outturns being different from forecasts, the outcomes (with regards to airport profitability) may not reflect the risk sharing arrangements that would occur in workably competitive market.

Emerging view on risk allocation

- We consider that risks should be allocated to the party best placed to manage the risk.

- Consideration of who is best placed to manage risks includes the ability to:

  - control the probability of the occurrence

  - mitigate costs of occurrence and

  - absorb costs where they cannot be mitigated

Emerging view on risk allocation

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- Our emerging view is that:
  - Any gains (or losses) that arise as a result of asset revaluations are to be treated as income (or losses) this includes un-forecast revaluation gains (or losses)
  - Where an airport has made a commitment in a previous price setting event, the expectation that this commitment will be met should be included in the subsequent pricing period
  - Otherwise airports are best placed to manage the risks of actual outturns being different to forecast (but can propose alternative risk sharing arrangements)

What should be included in the opening carry forward?

- Differences between actual and forecast revaluations (in real terms) must be taken into consideration in the opening carry forward adjustment for the next price setting event in order to be consistent with the Commission's expectation that revaluations will be treated as income

- Where an airport has made a commitment in a previous price setting event and has reflected this commitment in its target return for that period (by including an adjustment in the forecast closing carry forward), the expectation that the commitment will be met must be recognised in the target return at the next price setting event (by including the adjustment in the opening carry forward)

What should be included in the opening carry forward?

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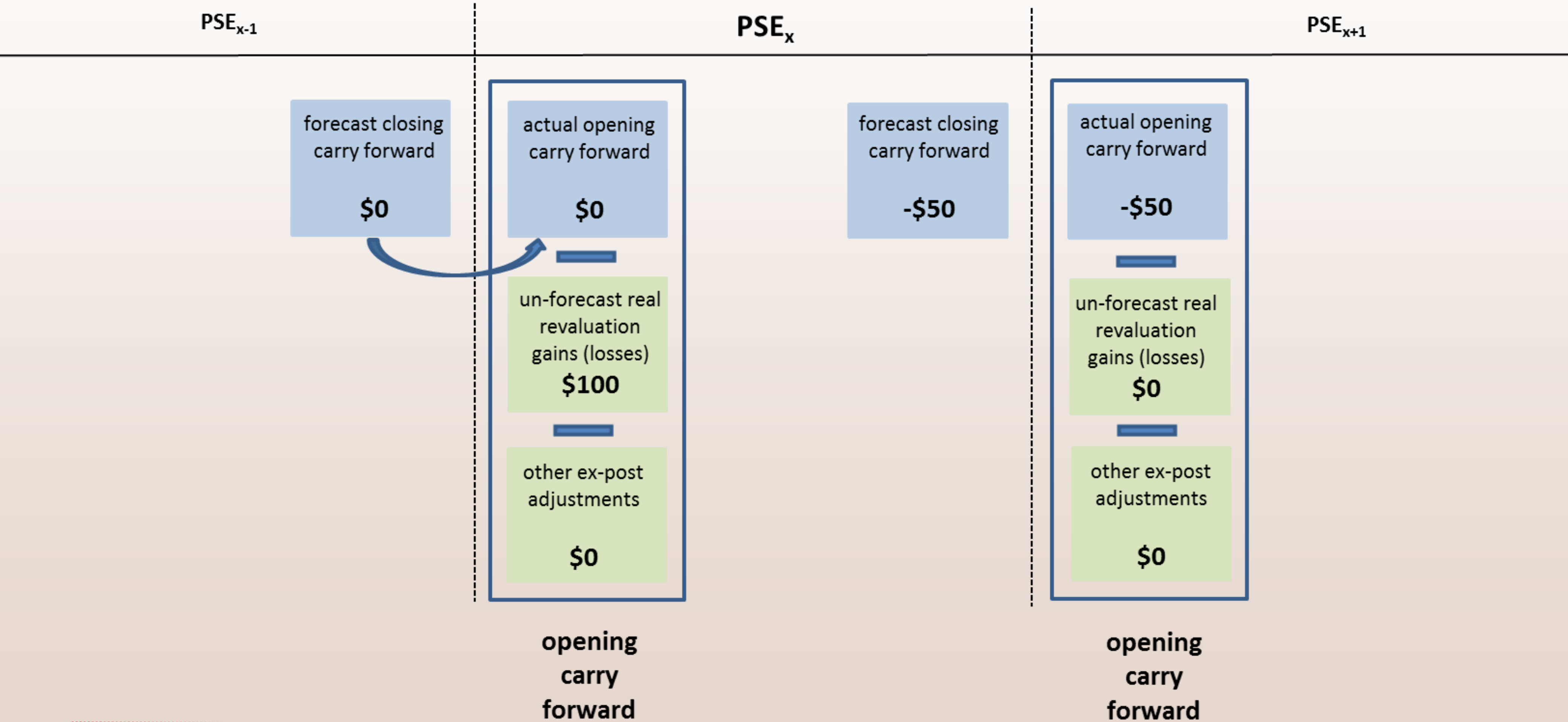
- If an airport has identified an alternate risk allocation adjustment (eg a wash up) during its previous price setting event, this can be captured in the opening carry forward adjustment

- However, we want to be able to understand the views of all parties on the reasonableness of these risk allocation adjustments at the time they were proposed

Practical Example 1

When setting prices for PSE_x there is a $100 real un-forecast revaluation gain, the airport proposes to return $50 in the current PSE and $50 in the next PSE

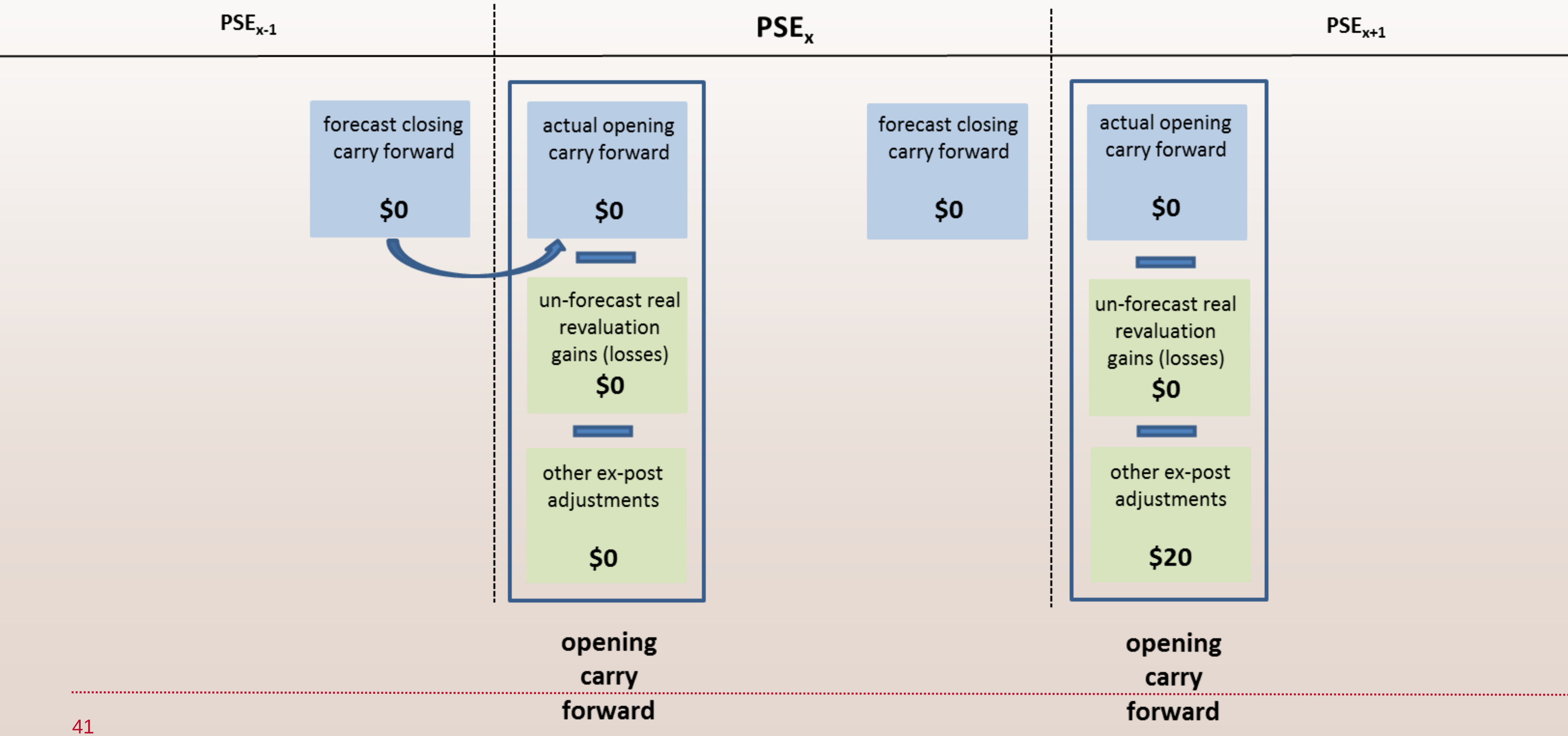
There are no un-forecast revaluations gains at the end of PSE_x to be reflected in PSE_{x+1}



Practical Example 2

When setting prices for PSE_x the airport forecast capex of $100 but it commits to a capex wash up if actual expenditure is less than forecast expenditure

The airports actual expenditure in PSEx is less than $100 and result in an over recovery of $20. There have been no un-forecast revaluation gains



Proposed changes to ID to reflect carry forward mechanism

Forward looking profitability indicator – proposed amendments to ID

- Include an IRR to provide an indicator of the airports effective target return

- IRR to be calculation over the pricing period (ie 5 years)

Carry forward adjustments – proposed amendments to ID

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- Include a forecast closing carry forward adjustment to reflect any decisions made by airport to bring returns forward from or delay returns until a future pricing period in an NPV neutral manner

- Include an opening carry forward adjustment to reflect
    - Any closing carry forward adjustment proposed by an airport at the previous pricing period
    - Any adjustment to risk allocation related to difference between forecasts and actuals proposed by an airport at the previous pricing period
    - Any differences between forecast and actual revaluations (in real terms) over the previous pricing period

Proposed changes to ID - carry forward adjustments

- To require the disclosure the differences between forecast and actuals that an airport has committed to reflecting in future price setting events and track the build up of the opening carry forward adjustment over time

- To require additional disclosure of consultation material in order to under the airlines view of the airport's proposed risk allocation adjustment and time profile of capital recovery at the time of price setting

Other considerations

- We are currently considering the date any carry forwards should start from (ie how far back should an airport look when establishing the opening carry forward for PSE3?)
  - Does the Commission need to determine this date or should individual airports be able to establish and justify their own approach?
  - Should any proposed date be consistently applied for all airports?
- We are interested in understanding the views of stakeholders as to the appropriate starting date for each airport

Questions for stakeholders

- Do our proposed solutions provide the flexibility airports require in order to demonstrate their target returns when setting prices?
- Do parties have any concerns about the difficulty of populating the carry forward adjustments?
- Do the parities consider that our proposed solutions will provide transparency to interested parties?
- What level of information should be required to be disclosed by an airport in order to provide interested parties the opportunity to understand the level of acceptance by airlines of an airport's pricing proposals?
- Does our proposed tracking mechanism allow airlines to engage on the value of the opening carry forward during consultation?

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Key issues: Proposed amendments to IMs and ID

26 April 2016

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Proposed changes to IMs and ID to support the forward looking profitability indicator

Purpose of this section

- This section outlines the proposed amendments to IMs and ID to support the forward looking profitability indicator and the rationale tor these changes

- The amendments are aimed at resolving issues raised during the problem definition phase including:
  - Setting the initial RAB for land as at 2010
  - Indexation of the RAB
  - Time profile of capital recovery
  - Land held for future use
  - Other transparency concerns

Rationale for the amendments

- Our proposed amendments have been driven by the goal of providing greater transparency around airport pricing decisions so that interest parties are able to assess whether airports are limited in their ability to extract excessive profits and have incentives to innovate and invest

- We seek to strike an appropriate balance between flexibility and prescription

- We aim to reduce compliance costs and complexity where appropriate

Rationale for the amendments

- In the case of:
  - land held for future use and RAB indexation, to provide greater flexibility in how airports disclose information on an ex-ante basis
  - non-standard depreciation, to provide additional requirements where the current requirements are too broad and where additional guidance can support interested parties' understanding
  - cash flow timing, to provide new requirements where existing requirements do not reflect current Commission thinking
  - setting the initial 2010 RAB value (consistent with the high court decision), to determine the value in a pragmatic and cost effective manner

Setting the initial RAB value for land as at 2010

Initial RAB for land – Problem definition

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- The High Court-determined amendments to the IMs in the merits review require that the initial RAB value for land has to be assessed as at 2010
- Airports currently do not have MVAU valuations for land undertaken as at 2010

Initial RAB - Proposed amendments

- To amend the IMs to set a proxy for the initial RAB value for land as at 2010 based on interpolating 2009 and 2011 RAB land values based on existing Market Value Alternative Use (MVAU) valuations rather than requiring airports to undertake a new MVAU valuation for 2010.

- Calculated as the average of the 2009 MVAU valuation and 2011 MVAU valuation (net of any capex or disposals related to land that occurred during the years 2009/10 and 2010/11) plus capex and disposals related to land that occurred in 2009/10

Purpose of the proposed amendments

- To reflect the High Court decision to change the date of the initial RAB value for land from 2009 and 2010 in a pragmatic and cost effective way

Questions for stakeholders

- Do parties agree on our emerging view on how the initial RAB value reflects a pragmatic and cost effective solution?
- Are there any concerns with implementing our solution as proposed?

Indexation of the RAB

Indexation of RAB – Problem definition

- The IMs require annual CPI indexation for all assets (or periodic MVAU valuations for land), but airports may choose alternative approaches in their pricing decisions

- This may result in our forward looking profitability indicator not providing a reasonable estimate of the airports effective target return if the opening and closing investment values do not reflect the airport's indexation approach

- This may also result in assessed ex-ante returns not being comparable to ex-post returns disclosed

Indexation of RAB - Proposed amendments

- To amend the IMs to allow airports to either index the RAB at CPI or to not index the RAB
- This flexibility can be applied differently to asset classes (eg could CPI-index infrastructure and buildings but not index sealed surfaces)
- This solution may require airports to restate their previously disclosed RAB in order to reflect the indexation approach adopted at the previous price setting event

Purpose of the proposed amendments

- To allow airports the flexibility to disclose the RAB in a manner that reflects the expectation of the time profile of capital recover that the airport has used to set prices
- To provide greater transparency when disclosing returns both on an ex-ante and an ex-post basis

Questions for stakeholders

- Do parties agree that our proposed solution would provide greater transparency of an airport's price setting event?
- Do parties have any concerns about allowing this additional flexibility when disclosing the RAB?
- Do parties have concerns about the ability to disclose the RAB (or re-disclose historic RABs) based on the indexation approach used during price setting?

Non-standard depreciation

Non-standard depreciation – problem definition

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- Airports may set prices using a different time profile of capital recovery than that implied by straight-line depreciation
- The IMs include a mechanism that provides for a ‘non-standard’ depreciation approach other than straight-line depreciation and airports must provide explanations where this is used
- Interested parties have raised transparency concerns associated with the approach to depreciation taken by CIAL (eg CIAL’s application of non-standard depreciation resulting in higher depreciation than under straight-line was counter-intuitive)

Non-standard depreciation – proposed changes

- To include in the IMs the following principles to guide the use of non-standard depreciation:
  - The depreciation profile disclosed by an airport must be consistent with the time profile of capital recovery implied by the airport's pricing setting methodology and its choice of RAB indexation
  - An airport cannot disclose a non-standard depreciation profile if it is unable to justify or explain why the time profile of capital recovery implied in its price setting is appropriate
  - The decision to use non-standard depreciation can only be made ex-ante, at the time when prices are set and the same methodology must be applied ex-post over the period the price setting event is in effect.

Non-standard depreciation – proposed changes

- To include the following information disclosure requirements to supplement the use of non-standard depreciation:
  - An airport must disclose the expected time profile of capital recovery implied by its pricing setting methodology and demonstrate how this is NPV neutral given its target return
  - It should be clearly explained and evidenced how the non-standard depreciation profile reflects the airport's expected value or utilisation of the existing RAB
  - The standard straight-line depreciation profile must be disclosed alongside the non-standard profile on both an ex-ante and ex-post basis.
  - the airport must provide supporting documentation to demonstrate how the non-standard depreciation has been allocated to asset classes.
  - if an airport has disclosed straight-line depreciation but has changed the expected asset lives this must be transparently disclosed and include appropriate explanations or justifications for the change.

Purpose of the proposed amendments

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- To continue to allow airports the flexibility to disclose the RAB in a manner that reflects the expectation of the time profile of capital recovery that the airport has used to set prices
- To provide additional guidance to ensure that the use of non-standard depreciation results in outcomes that are NPV neutral compared to straight-line depreciation (i.e. when using airports' target return rate)
- To provide greater transparency when disclosing returns both on an ex-ante and an ex-post basis

Questions for stakeholders

- Do parties agree that our proposed principles would provide greater transparency of an airport's price setting event?
- Will the additional information disclosure requirements make more transparent the impact of the non-standard depreciation methodology on airport profitability?
- Do parties have any concerns about the complexity or practicality of the additional information requirements?

Land held for future use

Land held for future use – problem definition

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- LHFU is excluded from the RAB until it is used in the supply of specified airport services
- An airport may include additional revenues associated with the LHFU when setting prices
- We need to ensure that where an airport expects to earn revenues associated with LHFU, this is made transparent as well as the impact on expected profitability

Land held for future use - Proposed amendments

- To include a forecast LHFU charge in the ex-ante disclosure requirements to allow airports to reflect the impact of revenues associated with LHFU in a transparent manner
  - To either report the forecast LHFU balance in the ex-ante disclosure requirements in order to allow airports to reflect the impact of revenues associated with LHFU on the value of this land; or
  - To use the proposed forecast closing carry forward mechanism to allow forecast over-recoveries associated with LHFU to be accounted for in the event that the forecast LHFU balance cannot be used

Purpose of proposed amendments

- To provide greater transparency about the effective return targeted by airports on the underlying RAB
- To make transparent the value of any revenues associated with land held for future use

Questions for stakeholders

- Do our proposed solutions provide enough flexibility for airports to reflect the impact of land held for future use on prices set by airports?
- Do our proposed solutions provide the necessary transparency regarding the airports' proposed treatment of land held for future use?

Cash flow timing

Cash flow timing – problem definition

- ID does not explicitly specify cash flow timing assumptions for airports
- ID does include a year-end ROI calculation from which year-end cash flow timings can be inferred
- In other sectors we have explicitly set cash flow timing assumptions which generally reflect an expectation of mid-period cash flow timings

Cash flow timing – proposed amendments

- To amend information disclosure:
  - To include default cash flow timing expectations in the IRR
  - To allow airports the ability to propose alternative cash flow timings
  - To request evidence to support this alternative cash flow timing proposals

Purpose of proposed amendments

- To provide additional guidance on the Commission's default expectations about cash flow timing for ex-ante and ex-post profitability assessments
- To provide airports with the flexibility to suggest airport specific cash flow timing assumptions where there is evidence to support this

Questions for stakeholders

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- In other sectors we have allowed monthly disclosure of cash flows (for where cash flows are expected to be lumpy or revenues to be seasonal), do stakeholder consider that monthly disclosure of cash flows is required for airports?

Other transparency concerns

Other transparency concerns – problem definition

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- Airports exclude the asset values and revenues from leased assets from their pricing disclosures, whereas ID includes these items
- Some airports target different returns on leased assets than on pricing assets
- Airports may make a number of adjustments to the price path reflecting
  - Commercial concessions
  - New route incentives
- These adjustments typically result in an adjustment to target revenue

Other transparency concerns – proposed amendments

- To require airports to disclose information about target returns on both the pricing asset base and the total RAB in the ex-ante price setting disclosures
- To require airports to explain any differences in expected profitability of the pricing asset base and the total RAB
- To require high level disclosure of the total value of pricing incentives in the ex-ante price setting disclosures

Purpose of proposed amendments

- To improve the transparency of the expected returns on both the pricing asset base and the total RAB
- To allow interested parties the opportunity to understand the impact of leased assets on airport profitability
- To improve the transparency around the impact of pricing incentives on airports' expected revenue requirements

Questions for stakeholders

- Do our recommended solutions:
  - Provide the necessary transparency for airlines to understand the expect returns on the pricing asset base and the impact of pricing incentives?
  - Provide the opportunity for parties to understand the airports expectations about the value of pricing incentives when determining its total revenue requirement?
  - Do airports have concerns about the level of complexity of the proposed disclosure requirements?

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Stylised Examples

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Worked Examples – Un-forecast revaluation gains/losses

Proposed Solution for un-forecast revaluation gains and losses

- Pros
  - Can explicitly take into account un-forecast revaluation gains and losses in the ex-ante profitability analysis
  - Can understand whether airports are treating un-forecast gains or losses as an offset to required revenue
- Cons
  - Need to consider how ex-post disclosures of returns can reflect the carry forward adjustments

Worked Examples – Wash-up for ex-post risk allocation adjustments

Proposed Solution for other ex-post risk allocation adjustments (eg wash-ups)

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- Pros
  - Can explicitly take into account any risk allocation adjustments proposed by airports in the previous price setting event in the ex-ante profitability analysis
  - Can understand whether airports have priced in a manner consistent with proposed risk allocation adjustments from the previous period
- Cons
  - Need to consider how ex-post disclosures of returns can reflect the carry forward adjustments

Worked Examples – Non-indexation of RAB and AIAL’s moratorium

Preferred Solution for non-indexation of RAB

Disclose asset base in manner consistent with pricing approach

- Pros
  - Disclosed RAB is able to reflect an airports actual time profile of capital recovery.
  - Makes more transparent the airport’s expected return over the pricing period and of the remaining capital to be recovered at the end of the pricing period
  - Does not require any other adjustment to be made
- Cons
  - Airports would need to re-disclose historic RAB roll forward for impact of non-indexation

Alternate solution for non-indexation of RAB

Use of carry forward adjustments to opening and closing RABs

- Pros
  - Makes more transparent the airport's expected target return in current pricing period
  - Most appropriate when unwinding the moratorium
- Cons
  - Not as transparent as disclosing RAB consistent with pricing indexation approach
  - Difficult to make transparent enough if different indexation approaches are being applied to different asset classes

Worked Examples – Changes to time profile of capital recovery (eg CIAL levelised price path)

Preferred solution - Changes to time profile of capital recovery

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Use of non-standard depreciation methodology

- Pros
  - Disclosed RAB is able to reflect an airports actual time profile of capital recovery.
  - Makes more transparent the airport's expected return over the pricing period and of the remaining capital to be recovered at the end of the pricing period
  - Allows ex-post profitability assessment to be more consistent with the ex-ante assessment
- Cons
  - Concerns that the approach to calculating non-standard depreciation is difficult for interested parties to understand (hence additional principles for guidance)

Alternate Solution - Changes to time profile of capital recovery

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Use of forecast carry forward to reflect airports time profile of capital recovery

- Pros
  - Makes more transparent the airport's expected return over pricing period
- Cons
  - Does not build into the RAB the expected future over/under recoveries
  - Need to consider how ex-post disclosures of returns can reflect the carry forward adjustments

Worked Examples – Land held for future use

Proposed Solution 1 – Land held for future use

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Special levy is included in the forecast LHFU balance

- Pros
  - Makes transparent the value of revenues associated with LHFU and can track the value over time
  - Is consistent with ex-post disclosures of LHFU
  - Can separately consider the expected return on the underlying RAB
- Cons
  - Risk if LHFU is not commissioned
  - Doesn't build in the expectation of lower revenues in future pricing periods

Proposed Solution 2 – Land held for future use

Revenues from LHFU included in IRR using a forecast carry forward

- Pros
  - Builds in the expectation of lower revenues in future pricing periods
  - Can easily test the impact of the risk that the LHFU is not commissioned
  - Can still understand the expected return on the underlying RAB
- Cons
  - Doesn’t make transparent the value of revenues associated with LHFU in each year of the pricing period

Alternate solution – Land held for future use

Revenues from LHFU included in IRR using an alternate depreciation profile

- Pros
  - Builds in the expectation of lower revenues in future pricing periods
  - Can still understand the expected return on the underlying RAB
- Cons
  - Concerns about the transparency of the non-standard depreciation methodology
  - Use of non-standard depreciation would need to be justified in the context of the value or utilisation of the existing RAB

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Airports Profitability Assessment Workshop 2

Cost of capital

26 April 2016

Cost of capital in the IM Review

- Problem definition paper – 16 June 2015
  - Topic 5: Issues raised by the High Court on cost of capital
  - Topic 7: Reconsidering the WACC percentile range for airports
- Update paper on the cost of capital topic – 30 November 2015
  - Parameters required to estimate the cost of capital
  - Identified areas of focus
- Professor Yarrow report and emerging views on the airport WACC percentile – 19 February 2016
- Martin Lally advice on airport asset beta adjustment – 29 February 2016

Two distinct areas

1. Review of ('mid-point') WACC methodology for airports
    - Review of methodology (eg, cost of debt)
    - Review of specific parameters (eg, TAMRP, asset beta)
2. Review of the Airport WACC percentile
    - Review of the approach to determining a WACC percentile range for airports

Review of WACC methodology

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- Areas of focus (outlined in WACC update paper)
  - Cost of debt – trailing average/annual updating
  - Debt premium methodology
  - Term credit spread differential (TCSD)
  - Black's simple discounting rule as cross-check

- Review of all parameters
  - Asset beta
  - Tax Adjusted Market Risk Premium (TAMRP)
  - Credit rating
  - Leverage
  - Standard error

Our emerging views on the WACC percentile range have been published

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- Summary of our views described in paper:
  - There may be legitimate reasons why an airport's returns may be above or below our mid-point estimate of the cost of capital
  - The current specification of a WACC percentile range is likely to have placed too much emphasis on the upper limit of the range (75th percentile) when assessing airport profitability
  - The importance of the mid-point as the starting point for assessing airport returns has been confirmed by the High Court and airports should be required to provide justification for any divergence from that mid-point
  - We think that this approach is best applied in the IMs by providing a midpoint estimate together with information on its probability distribution (eg, publication of a standard error term)

Submissions to the process

- Submissions received on the WACC update paper in February 2016
- Submissions on the airport WACC percentile emerging views paper received in March 2016
- Currently considering those submissions in advance of the IM review draft decision published in June 2016

Any questions?

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Airports Profitability Assessment Workshop

Wrap-up

26 April 2016

John McLaren

Key issues covered

- Proposed forward looking profitability indicator
- Providing transparency about airport pricing intent
- Decision making framework for IM and ID amendments
- Options for addressing the issues from the problem definition phase
- Implications for IM review amendments
- Implications for ID amendments

Next steps

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IM and ID Draft decisions and reasons published → Submissions/Cross-Submissions on draft decisions and reasons → Final decision

IM and ID Draft decisions and reasons published	Submissions/Cross-Submissions on draft decisions and reasons	Final decision
June 2016	July – August 2016	December 2016