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## **Input methodologies review draft decisions**

**Topic paper 5: Airports profitability assessment**

**Date of publication:** 16 June 2016

## Associated documents

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16 June 2016	978-1-869455-08-8	Input methodologies review draft decisions: Summary paper
16 June 2016	978-1-869455-10-1	Input methodologies review draft decisions: Framework for the IM review
16 June 2016	978-1-869455-11-8	Input methodologies review draft decisions: Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower
16 June 2016	978-1-869455-18-7	Input methodologies review draft decisions: Topic paper 2 – CPP requirements
16 June 2016	978-1-869455-12-5	Input methodologies review draft decisions: Topic paper 3 – The future impact of emerging technologies in the energy sector
16 June 2016	978-1-869455-13-2	Input methodologies review draft decisions: Topic paper 4 – Cost of capital issues
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22 June 2016 (expected)	978-1-869455-16-3	Input methodologies review draft decisions: Report on the IM review
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Electricity Distribution Services Input Methodologies Determination 2012</i> [2012] NZCC 26
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Gas Distribution Services Input Methodologies Determination 2012</i> [2012] NZCC 27
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Gas Transmission Services Input Methodologies Determination 2012</i> [2012] NZCC 28
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Commerce Act (Specified Airport Services Input Methodologies) Determination 2010</i> (Decision 709, 22 December 2010)
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Transpower Input Methodologies Determination 2012</i> [2012] NZCC 17
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Commerce Act (Specified Airport Services Information Disclosure) Determination 2010</i> (Decision 715, 22 December 2010)

Commerce Commission  
Wellington, New Zealand

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## **Executive summary**

### **Purpose of this paper**

- X1 The purpose of this paper is to explain in relation to the airports profitability topic:
  - X1.1 the problems we have identified within this topic area;
  - X1.2 our proposed solutions to these problems;
  - X1.3 the reasons for our proposed solutions; and
  - X1.4 how we have taken stakeholders' submissions into account in considering the above.
- X2 This paper relates to regulated suppliers of specified airport services, and will also be of interest to airlines, industry representatives and other interested persons.

### **Overview of the airports profitability topic**

#### *Scope of topic*

- X3 This topic focusses on the forward-looking profitability assessment for airports. We have identified several issues which have made it difficult to carry out this assessment. In considering solutions we took into account the views of interested parties through submissions on our problem definition paper and in the two airports profitability assessment workshops.

#### *Difficulties in conducting forward-looking profitability assessments*

- X4 We have encountered a number of difficulties when conducting forward-looking profitability assessments. There is currently no requirement in the Airports ID Determination for airports to disclose a forward-looking profitability indicator. This means that when we have conducted profitability assessments, we have had to ourselves assess the profitability that each airport was targeting.
- X5 We have also found it difficult to determine the effective returns the airports were targeting because, when setting prices, airports do not have to follow the approaches assumed in our Airport IMs. Airports can use different approaches to those specified in the Airports IMs.
- X6 The different approaches mean that:
  - X6.1 airports may target a different time profile of capital recovery to those implied by the Airport IMs;
  - X6.2 the scope of the asset base used by airports when setting prices can differ to that disclosed under the Airports ID Determination; and
  - X6.3 the profitability assessment may need to take into account multiple pricing periods.

- X7 This makes it difficult to compare forward-looking profitability to the backward-looking profitability indicator included in annual historical disclosures since airports have to apply the Airport IMs Determination to backward-looking disclosures.
- X8 We also identified various problems with the transparency of the information disclosed by airports. This made it difficult for us and other interested persons to understand an airport's pricing intent.
- X9 This topic paper also proposes amendments to the Airport IMs in addition to those amendments which we made to give effect to the High Court's judgment that the initial RAB value for land has to be assessed as at 2010.
- X10 A separate topic paper, on the WACC percentile for airports, sets out our proposals for publishing the benchmark cost of capital against which the proposed forward-looking profitability indicator would be compared.<sup>1</sup>

*We have identified a number of changes to improve our forward-looking profitability assessments*

- X11 Table X1 summarises the areas in this topic where our analysis has led to changes in the Airport IMs Determination, the Airports ID Determination, or both. There are other issues that we have considered in relation to this topic which have not resulted in changes. These issues are discussed later in this paper.

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<sup>1</sup> Commerce Commission "Input methodologies review draft decisions: Topic paper 6 – WACC percentile for airports" (16 June 2016).

**Table X1: Summary of proposed changes in relation to this topic**

<b>Proposed change</b>	<b>Outcomes of the proposed change</b>	<b>Chapter</b>
<p>Require airports to disclose a forward-looking profitability indicator by using an internal rate of return (IRR) calculation that comprises:</p> <ul style="list-style-type: none"> <li>• an opening investment value at the beginning of the pricing period;</li> <li>• a forecast closing investment value; and</li> <li>• forecast cash-flows over the duration of the pricing period.</li> </ul> <p>Supplement the IRR with a carry forward mechanism that can be used to adjust the opening investment value and the closing investment value to better reflect an airport's pricing intent and that can take into account multiple pricing periods.</p>	<p>Greater transparency for interested parties to better understand an airport's approach to pricing and, in particular, whether the airport is limited in its ability to extract excessive profits.</p>	<p>Chapter 4</p>

Proposed change	Outcomes of the proposed change	Chapter
<p>Make the following changes with respect to asset revaluations:</p> <ul style="list-style-type: none"> <li>• require airports to disclose forward and backward-looking costs on a consistent basis to the approaches used when setting prices;</li> <li>• limit airports in their approaches to revaluing assets to the use of either CPI-indexation or an un-indexed approach (except when revaluing land using Market Value Alternative Use (MVAU));</li> <li>• allow airports to make their choice of either CPI-indexation or an un-indexed approach for parts of the asset base separately;</li> <li>• allow airports to apply alternative methodologies with equivalent effect where the application of the asset valuation IMs would prove prohibitively complex or costly. (Alternative methodologies can only be applied if they do not detract from the purpose of Part 4);</li> <li>• allow airports to elect an approach to revaluing assets only at the beginning of the next pricing period, and require airports to use the same approach in the backward-looking disclosures;</li> <li>• include an objective method of forecasting CPI based on the approach to forecasting CPI used in other regulated sectors;</li> <li>• require airports to provide details on the expected treatment of any revaluation gains in the next pricing period arising from a potential change in the approach to revaluing assets; and</li> <li>• require airports to disclose both the forecast of CPI used to set prices and the IM-consistent forecast of CPI, and identify the impact of any differences on the value of forecast revaluations.</li> </ul>	<p>Greater accuracy in the disclosures to better reflect an airport’s pricing intent.</p> <p>Greater clarity about the requirements in the Airport IMs and ID Determinations.</p> <p>Greater transparency for interested parties to better understand an airport’s approach to pricing.</p> <p>Reduce complexity and compliance costs.</p>	Chapter 5

Proposed change	Outcomes of the proposed change	Chapter
<p>Make the following changes with respect to depreciation:</p> <ul style="list-style-type: none"> <li>• require airports to apply specified principles when using alternative depreciation approaches; and</li> <li>• allow airports to apply alternative methodologies with equivalent effect where the application of the asset valuation IMs would prove prohibitively complex or costly. (Alternative methodologies can only be applied if they do not detract from the purpose of Part 4.)</li> </ul>	<p>Greater clarity about the requirements in the Airport IMs and ID Determinations.</p> <p>Reduce complexity and compliance costs.</p>	Chapter 5
<p>Make the following changes with respect to assets held for future use:</p> <ul style="list-style-type: none"> <li>• inclusion of the value of assets held for future use and revenue from, or associated with, assets held for future use on a forecast basis in ID determination (so that airports can offset any revenue from or associated with assets held for future use against the value of assets held for future use); and</li> <li>• amend the definition of “net revenue” to make it clearer that (as intended) revenues derived from, or associated with, assets held for future use are captured by that definition.</li> </ul>	<p>Greater accuracy in the disclosures to better reflect an airport’s pricing intent.</p> <p>Greater clarity about the requirements in the Airport IMs and ID Determinations.</p>	Chapter 8
<p>Make the following changes with respect to pricing assets:</p> <ul style="list-style-type: none"> <li>• addition of a new schedule to the Airports ID Determination reflecting airports’ targeted profitability based on the pricing asset base only; and</li> <li>• require airports to explain any differences in profitability based on the pricing asset base and the profitability based on the total RAB.</li> </ul>	<p>Greater transparency for interested parties to better understand an airport’s approach to pricing.</p>	Chapter 9



Proposed change	Outcomes of the proposed change	Chapter
<p>Make the following changes with respect to the initial RAB value for land:</p> <ul style="list-style-type: none"> <li>• set the initial RAB value for airport land using a pragmatic proxy of land as at 2010 by interpolating 2009 and 2011 MVAU land values (net of any capex or disposals of land that occurred during the years 2009/10 and 2010/11) based on existing MVAU land valuations; and</li> <li>• calculate the proxy by using the average of the 2009 MVAU valuation and 2011 MVAU valuation and add to the calculated proxy the value of any capex and disposals related to land that occurred up to the date of the interpolated value.</li> </ul>	<p>Greater clarity about the requirements in the Airport IMs and ID Determinations.</p> <p>Reduce complexity and compliance costs.</p>	Chapter 12

Proposed change	Outcomes of the proposed change	Chapter
<p>Include in the carry forward mechanism to adjust the opening investment value:</p> <ul style="list-style-type: none"> <li>• un-forecast revaluation gains or losses (in real terms) unless an alternative treatment has been proposed by airports; and</li> <li>• other risk sharing arrangements if these have been proposed in the airport’s price setting event.</li> </ul> <p>Require airports to provide information in the annual ex-post disclosures about variances between forecasts and actuals for the risk allocation arrangements that were included in their price setting event (as these will inform the carry forward adjustment to the opening investment value for the next price setting event).<sup>2</sup></p> <p>Require airports to provide information on the ‘degree of acceptance’ by airlines regarding other risk sharing arrangements and to give interested persons, following the airports disclosures under information disclosure but prior to our summary and analysis, the opportunity to comment on airports’ disclosures on allocation of risks.</p>	<p>Greater transparency for interested parties to better understand an airport’s approach to pricing.</p> <p>Greater clarity about the requirements in the Airport IMs and ID Determinations.</p>	Chapter 6
<p>Include in the carry forward mechanism to adjust the forecast closing investment value forecast over and under-recoveries that are intended by airports to be offset in future pricing events.</p> <p>Require airports to provide information on the ‘degree of acceptance’ by airlines regarding those forecast over and under-recoveries included in the carry forward mechanism.</p> <p>Require airports to provide information on the purpose and the appropriateness of including those forecast over and under-recoveries in the carry forward mechanism.</p>	<p>Greater transparency for interested parties to better understand an airport’s approach to pricing.</p>	Chapter 7

<sup>2</sup> We note that any consequential changes affecting the ex-post Airports ID Determination will be considered as part of a follow-up project that is separate from the IM review and will be subject to a separate consultation process.

Proposed change	Outcomes of the proposed change	Chapter
<p>Make the following changes with respect to other adjustments airports may make to the price path:</p> <ul style="list-style-type: none"> <li>• require airports to provide a high level disclosure of the total value of pricing incentives in the price setting event disclosures.</li> </ul>	<p>Greater transparency for interested parties to better understand an airport's approach to pricing.</p>	<p>Chapter 11</p>
<p>Make the following changes with respect to the timing of cash-flows:</p> <ul style="list-style-type: none"> <li>• ex-post disclosures – to specify mid-year timing assumptions for all revenues and expenditures;<sup>3</sup></li> <li>• price setting event disclosures – to specify mid-year timing assumptions for all revenues and expenditures; and</li> <li>• price setting event disclosures – to provide the flexibility for airports to deviate from the default cash-flow timing assumption if airports provide evidence that the actual cash-flow timing for specific cash-flow items is different from the default cash-flow timing assumption.</li> </ul>	<p>Greater transparency for interested parties to better understand an airport's approach to pricing.</p>	<p>Chapter 10</p>

<sup>3</sup> We note that any consequential changes affecting the ex-post Airports ID Determination will be considered as part of a follow-up project that is separate from the IM review and will be subject to a separate consultation process.

- X12 This topic paper forms part of our package of draft decision papers on the IM review. As part of the package of papers, we have also published:
- X12.1 a summary paper of our draft decisions;
  - X12.2 an introduction and process paper, which provides an explanation of how the papers in our draft decision package fit together; and
  - X12.3 a framework paper, which explains the framework we have applied in reaching our draft decisions on the IM review.

### **Invitation to make submissions**

- X13 We invite submissions on this paper by **5pm on 28 July 2016**. We then invite cross submissions by **5pm on 11 August 2016**.
- X14 In respect of our draft amended IM and ID determinations, which we expect to publish on 22 June 2016, we invite submissions by **5pm on 11 August 2016**.<sup>4</sup>
- X15 Please address submissions and cross submissions to:
- Keston Ruxton  
Manager, Input Methodologies Review  
Regulation Branch  
[im.review@comcom.govt.nz](mailto:im.review@comcom.govt.nz)
- X16 Please clearly indicate within your submission which aspects of this paper it relates to.

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<sup>4</sup> Rather than providing for cross submissions on the draft determinations, we have instead provided an extended period for primary submissions on those drafts.

## Chapter 1: Introduction

### Purpose of this paper

1. The purpose of this paper is to:
  - 1.1 explain how we assess profitability for airports under ID regulation;
  - 1.2 explain our proposed solutions relating to the airport profitability assessment topic by explaining:
    - 1.2.1 the problems we have identified within this topic area;
    - 1.2.2 our assessment of potential solutions to these problems; and
    - 1.2.3 the reasons for our proposed solutions.
  - 1.3 explain how we have taken stakeholders' submissions into account in considering the above and reaching our proposed solutions to problems identified within this topic.

### Where this paper fits into our package of papers on our draft decisions

2. This paper explains our proposed solutions to problems identified within the airports profitability assessment topic.
3. We have identified proposed solutions that could be accommodated through amendments to the Airport Input Methodologies Determination (Airport IMs), the Airports Information Disclosure Determination (Airport ID) or both. In responding to the problems identified in this topic area we considered that a holistic consideration of both the existing Airport IM and ID was required.
4. This topic paper forms part of our package of draft decision papers on the IM review. For an overview of the package of papers and an explanation of how they fit together, see the Introduction and Process Paper published as part of our draft decision package.<sup>5</sup>
5. To the extent our proposed solutions to problems within this topic area involve changes to the Airport IMs, this paper explains how we propose to change our existing Airport IMs decisions. A number of our proposed solutions within this topic involve changes to the Airport ID requirements – this paper also explains how we propose to change the Airport ID requirements.

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<sup>5</sup> Commerce Commission "Input methodologies review draft decisions: Introduction and process paper" (16 June 2016).

6. The Report on the IM review collates our proposed changes to the existing IMs and presents them as draft decisions to change the IMs.<sup>6</sup> Our proposed drafting changes to the Airport IMs and ID requirements, including any resulting from this topic area, are shown in the draft amended Airport IMs and ID Determinations, which we expect to publish on 22 June 2016.
7. The framework we have applied in reaching our draft decisions on the IM review is set out in a separate paper, published alongside this paper.<sup>7</sup> The framework paper explains that we have only proposed changing the current Airport IMs where this appears likely to:
  - 7.1 promote the Part 4 purpose in s 52A more effectively;
  - 7.2 promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
  - 7.3 significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).
8. The framework paper also describes key economic principles that can provide guidance as to how we might best promote the Part 4 purpose.
9. We explain how we have applied this framework in reaching our draft solutions on our review of the Airport IMs and ID Determinations in Chapters 2 and 3.

### **Structure of this paper**

10. Chapters 2 and 3 provide an overview of the context for assessing airport profitability, including:
  - 10.1 how airports are regulated; and
  - 10.2 identifying and explaining, at a high level, the problems with the ex-ante assessment of airports' profitability under the current Airport IMs and ID Determinations.
11. Chapter 3 also provides a summary of all of our proposed solutions to problems identified with the airports profitability topic area.
12. The remainder of the paper is divided into chapters, each addressing a potential problem or problem area within the airport profitability assessment topic. Each of the chapters broadly follows the following structure:
  - 12.1 a description of the problem or problem area;
  - 12.2 an explanation of our proposed solutions and our reason for preferring them; and

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<sup>6</sup> We expect to publish the Report on the IM review on 22 June 2016.

<sup>7</sup> Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016).

- 12.3 an explanation of our assessment of any alternative solutions to the problem.
13. In defining the problems and assessing potential solutions, we have considered stakeholders' submissions and views expressed at two workshops. We have discussed how they have helped to shape our problem definitions and our proposed solutions.
14. Attachment A to this paper explains our proposed transitional arrangements for information disclosures based on the amended Airport IMs and ID Determinations.

### **Introduction to this topic**

15. When we refer to 'airports' in this paper we are only referring the airports that are subject to information disclosure regulation, as specified in s 56 of the Act. These are Auckland, Christchurch and Wellington airports.
16. In our problem definition paper, we identified the assessment of airports profitability topic as one of the key topics for the IM review.<sup>8</sup>
17. This topic is about our assessment of airports' profitability under information disclosure regulation. In particular, it is about how changes to the Airport IMs and ID Determinations would support the assessment.
18. During the problem definition phase we identified several issues that make it difficult to assess the expected profitability of airports when they set their prices. In reaching our views on the problems and proposed solutions discussed in this paper we have been informed by our consultation with stakeholders, which included submissions and two workshops.<sup>9</sup>
19. This topic has focussed on the assessment of airports profitability on a forward-looking basis. We have only proposed amendments to the Airport IMs and ID Determinations relating to the ex-post disclosures made by airports, where they are required to support our forward-looking profitability assessment.
20. This paper does not cover the weighted average cost of capital (WACC) percentile for airports, which is instead discussed in Topic paper 6 – WACC percentile for airports.<sup>10</sup> That topic paper sets out our proposals for publishing the benchmark cost of capital against which the forward-looking profitability indicator proposed in this topic paper would be compared.

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<sup>8</sup> Commerce Commission "Input methodologies review – Invitation to contribute to problem definition" (16 June 2015).

<sup>9</sup> Summaries of the views expressed at the workshops are available at our website.

<sup>10</sup> Commerce Commission "Input methodologies review draft decisions: Topic paper 6 – WACC percentile for airports" (16 June 2016).

21. This paper also does not cover the cost of capital IM for airports more generally. Our approach to calculating the cost of capital, including as it applies to airports, is covered by Topic paper 4: Cost of capital issues.<sup>11</sup>

### Invitation to make submissions

22. We invite submissions on this paper by **5pm on 28 July 2016**. We then invite cross submissions by **5pm on 11 August 2016**.
23. In respect of our draft amended IM and ID determinations, which we expect to publish on 22 June 2016, we invite submissions by **5pm on 11 August 2016**.<sup>12</sup>
24. Please address submissions and cross submissions to:
- Keston Ruxton  
 Manager, Input Methodologies Review  
 Regulation Branch  
[im.review@comcom.govt.nz](mailto:im.review@comcom.govt.nz)
25. Please clearly indicate within your submission which aspects of this paper it relates to.
26. The Introduction and process paper contains further details about the submissions process. This includes:<sup>13</sup>
- 26.1 explaining that material provided outside of the indicated timeframes without an extension might not be considered in reaching our final decisions;
  - 26.2 providing guidance on requesting an extension to the submissions timeframes;
  - 26.3 noting that we prefer submissions on our draft decisions in a file format suitable for word processing, rather than the PDF file format; and
  - 26.4 providing guidance on making confidential submissions.

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<sup>11</sup> Commerce Commission “Input methodologies review draft decisions: Topic paper 4 – Cost of capital issues” (16 June 2016).

<sup>12</sup> Rather than providing for cross submissions on the draft determinations, we have instead provided an extended period for primary submissions on those drafts.

<sup>13</sup> Commerce Commission “Input methodologies review draft decisions: Introduction and process paper” (16 June 2016), Chapter 5.



## Chapter 2: How airports are regulated

### Purpose of this chapter

27. This chapter provides an overview of how airports are regulated, our responsibilities when regulating airports, and the interaction between the Airport IMs Determination and the Airports ID Determination.

### How airports are regulated

28. This chapter focusses on those forms of regulation that we consider are most relevant to how airports set prices for regulated airport services. These are:

28.1 the Airports Authorities Act (**AAA**); and

28.2 Part 4 of the Commerce Act 1986 (the **Act**).

29. Unless otherwise indicated, all statutory references in this paper are to the Act.

#### *The AAA*

30. The AAA sets out statutory obligations on, and powers of, airports. It is administered by the Ministry of Transport. The AAA includes obligations in relation to setting charges for airport services. In particular:

30.1 s 4A(1) of the AAA provides that airports may “set such charges as it from time to time thinks fit for the use of the airport operated or managed by it, or the services or facilities associated therewith”; and

30.2 s 4B of the AAA determines that airports must consult with major consumers (ie, airlines) “in respect of any direct charge payable to the airport company by any passenger in respect of any or all identified airport activities”.

31. In other words, airports are only required to consult (rather than negotiate) on charges and irrespective of airlines’ views, airports are free to set prices as they see fit.
32. Section 4B of the AAA requires that airports must carry out consultation before fixing or altering charges and within at least five years after fixing or altering charges. This means that airports must consult on and set prices at least every five years. It also means that once prices have been set airports cannot change prices without carrying out another consultation.

*Part 4 of the Commerce Act*

33. Part 4 provides for the regulation of the price and quality of goods or services supplied in markets where there is little or no competition, and little or no likelihood of a substantial increase in competition (s 52).

34. The purpose of Part 4 is:<sup>14</sup>

... to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

(d) are limited in their ability to extract excessive profits.

35. As explained in the IM review framework paper, the central purpose of Part 4 of the Act is thus to promote the long-term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition. We promote the interests of consumers of the regulated service by promoting the s 52A(1)(a)-(d) outcomes consistent with what would be produced in workably competitive markets.<sup>15</sup>

36. Auckland Airport, Wellington Airport and Christchurch Airport are subject to information disclosure regulation under subpart 11 of Part 4. Subpart 11 came into force on 14 October 2008 and, among other things, prescribes the scope of regulated services and the definition of ‘specified airport services’ (s 56A). These are defined as:

36.1 aircraft and freight activities;

36.2 airfield activities;

36.3 specified passenger terminal activities; and

36.4 any other services that are determined by the Governor-General, by Order in Council made on the recommendation of the Minister, to be specified airport services.

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<sup>14</sup> Commerce Act 1986, s 52A.

<sup>15</sup> Commerce Commission “Input methodologies review draft decisions: Framework for the IM review” (16 June 2016).

37. Each of the 'specified airport services' set out above is defined in detail in s 2 of the AAA. These definitions are quite broad and include non-exhaustive lists of the types of activity that are considered to fall within each of these categories.
38. Specified airport services are subject to information disclosure regulation under subpart 11 of the Act (s 56C), the purpose of which is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met (s 53A).
39. As further explained in Chapter 3 information disclosure regulation, while being light-handed, is still intended to promote the overall Part 4 purpose as set out in s 52A. As we explained in our s 56G reports, Parliament's intention behind this regime was to introduce regulation that would (among other functions) have an impact on airport's prices.
40. This intention is clear from the structure of Part 4 – all forms of Part 4 regulation including information disclosure regulation, are intended to promote the Part 4 purpose. This includes promoting outcomes such that suppliers are limited in their ability to extract excessive profits.

*The relationship between Section 4A of the AAA and Part 4*

41. While airports can set prices as they see fit, information disclosure is intended to have an impact on those prices. We do not consider that s 4A of the AAA is incompatible with the information disclosure regime as the two operate for distinct purposes. We also do not consider that Part 4 is subordinate to s 4A of the AAA.
42. The AAA establishes that the right of an airport to price as it sees fit needs to co-exist with the Part 4 regime. This is evidenced by s 4A(4) of the AAA which provides that "This section does not limit the application of regulation under Part 4 of the Commerce Act 1986".

**Part 4 regulatory framework for airports**

43. For airports, under Part 4 we are required to (among other requirements):
  - 43.1 set the input methodologies (**IMs**) that apply to airports;
  - 43.2 set the information disclosure requirements for airports; and
  - 43.3 conduct summary and analysis of disclosed information to promote a greater understanding of airport performance.

**The input methodologies that apply to airports**

44. The IMs that apply to airports (**Airport IMs**) are the rules, processes and requirements applying to the regulation of the specified airport services under Part 4. The purpose of the Airport IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to regulation applicable to airports. This purpose is set out in s 52R.

45. IMs must include certain matters, to the extent applicable to the type of regulation (s 52T). Airports are not price-quality regulated and are only subject to information disclosure regulation. In light of the purpose of the information disclosure regulation, and the purpose of Part 4, we have determined IMs for:<sup>16</sup>
- 45.1 allocation of costs to regulated services supplied by the airports;
  - 45.2 valuation of assets that are used to supply airport services;
  - 45.3 treatment of tax costs for regulatory purposes; and
  - 45.4 the cost of capital (which is applied only by us in order to monitor and analyse information disclosed by the airports).
46. Because airports can set prices as they see fit, the Airport IMs only apply to Airport ID for the purposes of assessing whether s 52A is being met and do not apply to the way airports set prices.
47. A brief description of the Airport IMs is set out below. The 2010 Airports IM reason paper provides a more fulsome discussion.<sup>17</sup>

#### *Allocation of costs*

48. The IMs relating to specified airport services must include methodologies for determining the “allocation of common costs, including between activities” (s 52T(1)(a)(iii)). The Airport cost allocation IM applies to the way in which costs incurred in the supply of regulated airport services, or incurred in supplying both unregulated and regulated services together, are reported as part of information disclosure.
49. The Airport cost allocation IM provides the rules that airports must adhere to when disclosing their shared cost data (and other financial information that relies on cost data). These rules are important since the allocation of shared costs, whether operating cost- or asset-related, can have a significant effect on financial results as represented in the regulatory accounts provided under the information disclosure regime.

#### *Valuation of assets*

50. The IMs relating to specified airport services must include methodologies for determining the “valuation of assets, including depreciation and treatment of revaluations” (s 52T(1)(a)(ii)). Matters covered in the Airport IM for the valuation of assets include:
- 50.1 establishment of the initial value of each airport’s regulatory asset base **(RAB)**;

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<sup>16</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010* (Commerce Commission Decision 709, 22 December 2010).

<sup>17</sup> Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010).

- 50.2 revaluation of assets;
- 50.3 calculation of depreciation; and
- 50.4 treatment of asset acquisitions and disposals.

51. The valuation of assets will help determine an appropriate baseline against which profitability can be assessed.

#### *Treatment of tax*

- 52. The Airport IMs relating to specified airport services must include, to the extent applicable to information disclosure regulation, the “treatment of taxation” (s 52T(1)(a)(iv)). The Airport IM for the treatment of taxation sets out the methodology used to calculate the regulatory tax allowance for each airport. This is primarily affected by the depreciation deduction that is used for regulatory tax purposes.
- 53. As airports are only subject to information disclosure regulation, the Airport IM for the treatment of taxation only applies to the way in which profitability is reported. This affects the way in which interested persons can assess airports profitability.

#### *Cost of capital*

- 54. The cost of capital is the financial return that investors require from an investment given its risk. It reflects the estimate of the rate of return that an investor would expect to get from a different investment of similar risk.
- 55. Section 52T(1)(a)(i) requires the IMs relating to a particular good or service to include an IM for the cost of capital. Airports do not have to apply the cost of capital established under the cost of capital IM for Airports (s 53F(1)). However, we can use the cost of capital IM to “monitor and analyse” information made available by regulated suppliers (s 53F(2)(a)).<sup>18</sup> Airports are also required to disclose our annual published WACC in ex-post disclosures of financial information.
- 56. The cost of capital IM is discussed in more detail in Topic paper 4 – Cost of capital.<sup>19</sup>

#### **Information disclosure requirements**

- 57. We are required to make a determination under s 52P that specifies how information disclosure regulation will be applied and what a determination made under s 52P must include. For airports, this determination is underpinned by the Airport IMs.

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<sup>18</sup> This has been confirmed by the High Court in *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, para 1132-1149.

<sup>19</sup> Commerce Commission “Input methodologies review draft decisions: Topic paper 4 – Cost of capital issues” (16 June 2016).

58. In setting the Airports ID Determination, we focussed on the information needed to allow an interested person to assess whether the long-term benefits of consumers are being promoted, through promotion of outcomes consistent with those produced in competitive markets.
59. The Airports ID Determination provides for the disclosure of:
- 59.1 historical financial information;
  - 59.2 quality performance measures and other key statistics;
  - 59.3 forecasts of total revenue requirements; and
  - 59.4 price and pricing methodologies.
60. In addition, the Airports ID Determination sets out publication, certification and audit requirements.
61. A brief description of the Airports ID Determination is set out below. The 2010 Airports ID reason paper provides a more fulsome discussion.<sup>20</sup>

*Historical financial information*

62. For the disclosure of historical financial information, airports are required to apply the Airport IMs for the valuation of assets (including depreciation and treatment of revaluations), the allocation of common costs, and the treatment of taxation.
63. As noted at paragraphs 54-56, we have also set an IM for Airports in relation to deriving the cost of capital. We may apply this when conducting summary and analysis, however airports cannot be required to apply it.

*Quality performance measures and other key statistics*

64. The disclosures of quality and other key statistics include a comprehensive set of measures of passenger satisfaction, reliability, capacity and utilisation, operational improvement, and other statistics.

*Forecasts of total revenue requirements*

65. The disclosures relating to forecast total revenue requirements are intended to align with airports' price setting processes. These disclosures provide key planning assumptions behind the setting of airports' revenue requirements, and include supporting information about proposed capital expenditure, operational expenditure and demand information. The historical financial disclosures also reconcile forecasts with actual annual outcomes.

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<sup>20</sup> Commerce Commission "Information disclosure (Airport Services) reasons paper" (22 December 2010).

66. The Airports ID Determination requires that airports publicly disclose, for a five-year forecast period, the core elements used by the airports for determining the forecast total revenue requirement. There are several components of the forecast revenue requirement:
- 66.1 **Revenue methodology** – this provides an overview of the methodology used to determine the forecast total revenue requirement.
  - 66.2 **Forecast asset base and forecast value of assets employed** – this provides information on the forecast asset base that is rolled forward and the forecast value of assets employed. It includes information on how it is determined, and the extent to which it is used to determine the forecast total revenue requirement.
  - 66.3 **Required return on capital** – this provides information on the forecast cost of capital, a description of the method used to determine it (including assumptions and justifications), and the extent to which it is used to determine the forecast total revenue requirement.
  - 66.4 **Operating costs** – this provides information on the forecast operating costs by cost category, and a description of the extent to which they are used to determine the forecast total revenue requirement.
  - 66.5 **Depreciation on assets** – this provides information on the total forecast depreciation and weighted average depreciation rates for each asset class. It includes a description of the extent to which they are used to determine the forecast total revenue requirement.
  - 66.6 **Taxation** – this provides information on the forecast tax payable, including permanent and temporary differences, tax book value roll forward and reconciliation of tax losses. It includes a description of the extent to which they are used to determine the forecast total revenue requirement.
  - 66.7 **Revaluation gains/losses** – this includes forecast land revaluations, indexed revaluations and any assumptions that have been used. It also includes a description of the extent to which forecast revaluations are used to determine the forecast total revenue requirement.
  - 66.8 **Other income** – this includes information on forecast capital contributions, gains or losses on asset sales, and any other regulated income. It also includes a description of the extent to which they are used to determine the forecast total revenue requirement.

### *Price and pricing methodologies*

67. Disclosure of pricing statistics provides interested persons with information that can assist them to assess the overall financial performance of the regulated business. When used in an appropriate context, pricing statistics are able to provide insight into the overall profitability and efficiency of the regulated business compared to suppliers of comparable services.<sup>21</sup>
68. Pricing methodology disclosures provide information on the process for setting standard prices. They also provide information on how airports relate prices to demand and reflect the cost incurred in providing the services for which prices are set.
69. The pricing methodology allocates the forecast total revenue requirement to each service for which a price is set. Pricing methodology disclosures assist interested persons in understanding the degree to which prices reflect underlying cost and customer demand.

### **Summary and analysis of disclosed information**

70. Section 53B(2)(b) of the Act provides that we:
- ...must, as soon as practicable after any information is publically disclosed, publish a summary and analysis of that information for the purpose of promoting greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time.
71. The requirement to publish a summary and analysis confers an ongoing, active role on us in respect of the information disclosure regime after the information disclosure requirements have been set.
72. We consider that our summary and analysis obligations contribute to ensuring that sufficient information is made available to interested persons to assess whether the Part 4 purpose is being met. It also provides the opportunity for us to consider the wider airport context.
73. We were also required by s 56G to carry out a one-off review of the effectiveness of information disclosure in promoting the Part 4 purpose for airports (the **s 56G reviews**). As part of the s 56G reviews we conducted profitability assessments on the airports. The difficulties and challenges that we faced in doing so helped us to identify many of the problems discussed in this topic paper.
74. Following the review of each airport we provided a report to the Ministers of Commerce and Transport. We refer to these as 's 56G reports'.

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<sup>21</sup> When using pricing statistics for comparative purposes, however, consideration should be given to other factors such as the regional variations in the cost of inputs.



## How the input methodologies interact with the information disclosure requirements

### *Airports must apply IMs when making annual ex-post disclosures*

75. The Airports ID Determination requires airports to publically disclose each year (on an ex-post basis) information relating to their financial position and information relating to the quality of the specified services. This includes providing certain statistics, as outlined in Schedules 16 and 17 of the Airports ID Determination.<sup>22</sup>
76. This ex-post information must be IM-compliant. The parts of the Airport IMs Determination which are applicable to the Airports ID Determination (and so must be applied by airports when disclosing information) are:
- 76.1 valuation of assets;
  - 76.2 allocation of common costs; and
  - 76.3 treatment of taxation.
77. As explained earlier in this chapter, airports are not required to apply IMs relating to cost of capital.<sup>23</sup> We can, however, apply any IM relating to those matters when we monitor and analyse the information disclosed by airports as per our obligations under s 53B. Airports are also required to disclose, but not apply, our annual published WACC in ex-post disclosures of financial information.

### *Airports do not have to apply IMs when making price setting event disclosures*

78. The Airports ID Determination requires an airport to publically disclose, on an ex-ante basis, information relating to its forecast revenue requirement.<sup>24</sup> It must disclose this information following a price setting event (**PSE**), or within five consecutive years of the previous disclosure of this type.<sup>25</sup> This means that airports must disclose price setting information at least every five years.

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<sup>22</sup> *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clauses 2.3 and 2.4.

<sup>23</sup> Commerce Act 1986, s 53F(1).

<sup>24</sup> *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.5.

<sup>25</sup> Price setting event means “the fixing or altering of price by an airport in respect of a specified airport service, pursuant to s 4A and s 4B of the Airport Authorities Act 1966 excluding where the price is: (a) subject to adjustment as a result of a wash-up; or (b) reset or adjusted annually, including without further consultation; or (c) subject to separate negotiation for inclusion in the terms of a lease or licence; or (d) not required to be consulted on by virtue of s 4B(3) of the Airport Authorities Act 1966; A price setting event is deemed to occur on the date that a new price comes into effect” (*Airports Information Disclosure Determination 2010*, (Commerce Commission Decision 715, 22 December 2010), clause 1.4).

79. The forward-looking information disclosed under Airports ID Determination does not have to be IM-compliant. However, at present, airports must publically disclose a description of how the components of the forecast total revenue requirements have been determined.<sup>26</sup> These include:
- 79.1 forecast value of assets employed;
  - 79.2 forecast cost of capital;
  - 79.3 forecast operational expenditure;
  - 79.4 forecast depreciation;
  - 79.5 forecast tax;
  - 79.6 forecast revaluations; and
  - 79.7 any other component of the total revenue requirement.
80. These disclosures must include (where appropriate) an explanation of any differences between how these components have been prepared and the most recent historical financial information (disclosed in accordance with clause 2.3 of the Airports ID Determination).
81. Since the ex-post information disclosed must be IM-compliant, this effectively requires an airport to explain any differences between the approach it has taken during price setting and an IM-compliant approach. This is aimed at assisting interested persons to make meaningful assessments of the appropriateness of prices in light of airports' revenue forecasts.
82. We also require airports to provide the following in their price setting event disclosures:
- 82.1 a summary of its pricing methodology;
  - 82.2 a summary of its proposed prices for charged services; and
  - 82.3 a report on the demand forecasts used when setting prices.
83. This information helps us and other interested persons understand and assess an airport's pricing decision.

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<sup>26</sup> We propose some changes to these disclosure requirements in this topic paper.

## Chapter 3: Summary of problem definition and proposed solutions

### Purpose of this chapter

84. The purpose of this chapter is to provide an overview of the problems we have identified with the ex-ante assessment of airports profitability and to outline our proposed solutions. Further details on these problems and proposed solutions are provided in Chapters 4 – 12.
85. We also identify whether our proposed solutions require amendments to the Airport IMs, Airport ID, or both.

### Problem definition

86. This section explains, at a high level, the problems we identified in respect to the airports profitability topic.
87. The purpose of information disclosure is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met.<sup>27</sup>
88. As explained in Chapter 2, the purpose of Part 4 is stated in s 52A of the Act. Most relevant to the topic of airports profitability are ss 52A(1)(a) and (d) of the Act. In particular, airports:
- 88.1 have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
  - 88.2 are limited in their ability to extract excessive profits.
89. There is currently no requirement in the Airports ID Determination for airports to disclose a forward-looking profitability indicator. As a consequence, when we undertook the analysis required by s 56G of the Act to report on how effectively information disclosure regulation was promoting the Part 4 purpose, we had to assess the profitability that each airport was targeting in the 2012 price setting events ourselves.
90. In assessing targeted returns for each airport as part of the s 56G process:
- 90.1 we found it difficult to determine the effective returns the airports were targeting, because in setting their prices airports did not follow the approaches assumed in our information disclosure requirements; and
  - 90.2 various problems with the transparency of the information disclosed by airports made it difficult for us and other interested persons to understand an airport's pricing intent.

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<sup>27</sup> Commerce Act 1986, s 53A.

91. In the remainder of this section, we explain, at a high level:
- 91.1 the problems created by the lack of a forward-looking profitability indicator in the Airports ID Determination; and
  - 91.2 where the Airports ID Determination lacks transparency which is discussed in the light of the four matters listed below:
    - 91.2.1 airports may target a time profile of capital recovery that is different to that assumed as the default position under the Airport IMs;
    - 91.2.2 the scope of the asset base used by airports when setting prices can be different to that disclosed under the Airports ID Determination;
    - 91.2.3 a profitability assessment should take into account multiple pricing periods;<sup>28</sup> and
    - 91.2.4 other transparency problems exist.
92. We also considered further amendments to the Airport IMs and ID Determinations in addition to those amendments which we made to give effect to the High Court's judgment that the initial RAB value for land has to be assessed as at 2010.<sup>29, 30</sup>

*No forward-looking profitability indicator in Airports ID Determination*

93. To assess whether airports are limited in their ability to extract excessive profits, we compare the effective rate of return targeted by an airport against our mid-point estimate of the cost of capital.
94. When an airport targets a return that is different from our mid-point estimate of the cost of capital, we want to understand the extent of, and rationale for any variance.<sup>31</sup>
95. To facilitate this analysis, we need transparent disclosures of targeted returns and underlying assumptions. In the past, transparency was limited by the fact that:
- 95.1 airports can set prices as they see fit;

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<sup>28</sup> By this we mean that the profitability assessment of the current pricing period must be able to reflect decisions made in previous price setting periods that have an impact on charges for the current pricing period as well as decisions made by airports impacting charges of the current and future price setting events that are not already reflected in the forecast closing asset base of the current pricing period.

<sup>29</sup> For clarification, this issue is different to the other problems we describe in more detail in this chapter, as it does not impact the ex-ante profitability assessment of airports. This is because all airports have revalued their land post 2010 and RAB values have been subsequently updated with these new valuations.

<sup>30</sup> *Wellington International Airport Ltd and others v Commerce Commission* [2013] NZHC 3289, para 892.

<sup>31</sup> For more information on our proposals for the published benchmark against which we assess airport profitability, please see: Commerce Commission "Input methodologies review draft decisions: Topic paper 6 – WACC percentile for airports" (16 June 2016).

- 95.2 airports are not required to apply the Airport IMs Determination in setting prices and making their forward-looking pricing disclosures;
  - 95.3 airports do not have to apply our forecast of cost of capital when setting prices;
  - 95.4 airports may target a return that is different from an airport's estimate of cost of capital; and
  - 95.5 **most importantly, we do not currently require airports to disclose a forward-looking profitability indicator** that reflects the airport's decision on targeted returns.
96. When assessing targeted returns for the s 56G review, we found that determining targeted returns under current disclosure requirements can be onerous and inefficient for all parties involved. The lack of disclosure meant we had to seek additional information from airports to allow us to understand an airport's approach to pricing well enough to calculate targeted returns.
97. The lack of a forward-looking profitability indicator is even more problematic as the effective targeted return inherent in an airport's price setting can be different from the airport's estimate of its cost of capital.<sup>32</sup>
98. The inclusion of a requirement on airports to disclose their targeted returns in the Airports ID Determination would better promote s 53A, because it would allow interested persons to better understand what returns airports were targeting during the price setting events; it would ensure the more timely release of such information; and would reduce our costs in undertaking summary and analysis.

*Insufficient transparency in Airports ID Determination*

99. There is insufficient transparency in Airports ID Determination because the current requirements in the Airports ID Determination do not:
- 99.1 require an airport to accurately and appropriately disclose its approach taken in the price setting event; and
  - 99.2 allow us and other interested persons to understand the approach taken by an airport when it sets prices or to assess the targeted returns inherent in the pricing decision.
100. The matters listed below make it difficult to accurately assess an airport's targeted profitability:
- 100.1 airports may target a time profile of capital recovery that is different to that assumed as the default position under the Airport IMs;

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<sup>32</sup> For example, if an airport has made a commercial decision to under-recover revenue in a pricing period.

- 100.2 the scope of the asset base used by airports when setting prices can be different to that disclosed under the Airports ID Determination;
- 100.3 a profitability assessment should take into account multiple pricing periods;<sup>33</sup> and
- 100.4 other transparency problems exist.

*Airports may target a time profile of capital recovery that is different to that assumed as the default position under the Airport IMs*

- 101. Given that airports can set prices as they see fit, an airport can target a time profile of capital recovery that is different to the default assumption in the Airport IMs Determination.<sup>34</sup>
- 102. There are two main ways an airport may target a different time profile of capital recovery compared to the default position under the Airports IM Determination. These are:
  - 102.1 through its approach to revaluations; and
  - 102.2 by explicitly (or implicitly) using non-standard depreciation (ie, an approach different to the default approach of straight line depreciation).
- 103. When airports use an alternative time profile of capital recovery, we need sufficient information to assess the appropriateness of the choices that the airport has made when setting prices.
- 104. Approach to revaluations: Following a price setting event, airports make forward-looking disclosures reflecting the assumptions and outcomes of the price setting event.<sup>35</sup> The approach to revaluing assets used for disclosure purposes must be the one chosen by the airport in the price setting event.<sup>36</sup> This means that the ex-ante information we receive on asset revaluations may not be consistent with the current Airport IMs.
- 105. In contrast, when making backward-looking disclosures, the revenues and costs disclosed during the relevant regulatory period must be disclosed in accordance with the Airport IMs.

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<sup>33</sup> By this we mean that the profitability assessment of the current pricing period must be able to reflect decisions made in previous price setting periods that have an impact on charges for the current pricing period as well as decisions made by airports impacting charges of the current and future price setting events that are not already reflected in the forecast closing asset base of the current pricing period.

<sup>34</sup> The default position under the Airport IMs involves straight line depreciation and CPI indexation for non-land assets of the RAB (Commerce Act (*Specified Airport Services Input Methodologies*) Determination 2010 (Commerce Commission Decision 709, 22 December 2010), clauses 3.4 (depreciation) and 3.7 (revaluation)).

<sup>35</sup> *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.5 and Schedule 18.

<sup>36</sup> See definition of "forecast revaluations": *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), p. 18.

106. Therefore, if airports do not use an IM-consistent approach to asset revaluation when setting prices, we cannot compare returns assessed on a forward-looking basis with returns assessed on a backward-looking basis. This is because the underlying RAB will diverge between ex-ante and ex-post disclosure purely because the Airport IMs are not flexible enough to reflect the approaches to revaluing assets chosen by airports for price setting purposes.
107. Use of non-standard depreciation: Airports can apply non-standard depreciation in rolling forward the RAB for ex-post disclosures. There are no constraints on how airports apply non-standard depreciation, and airports are not required to make the approach consistent with the approach taken in pricing decisions. In the price setting event disclosures, airports are allowed to apply non-standard depreciation as they see fit, as long as it reflects the pricing decision and they provide an explanation in their disclosures of what they have done.
108. Christchurch Airport was the first airport to disclose a non-standard depreciation methodology when setting prices. Our experience with Christchurch Airport's levelised pricing approach has raised a number of issues which suggest that the current non-standard depreciation requirements are too flexible.<sup>37</sup> These issues relate to the ex-post and price setting event disclosure requirements and include:
- 108.1 **price setting event disclosure** – Christchurch Airport did not initially identify that it was appropriate to use non-standard depreciation rather than straight line depreciation when disclosing price setting information for PSE2;
- 108.2 **price setting event disclosure** – we and other interested parties (in particular, BARNZ) have found it difficult to understand Christchurch Airport's approach to non-standard depreciation; and
- 108.3 **ex-post disclosure** – it is not clear how Christchurch Airport has allocated its total non-standard depreciation to its individual asset classes for information disclosure.

*The scope of the asset base used by airports when setting prices can be different to the scope of the asset base disclosed under the Airports ID Determination*

109. Given that airports can set prices as they see fit, airports may use a different asset base when setting prices compared to the one disclosed for information disclosure purposes.
110. A different asset base for pricing purposes and information disclosure in itself may not be a concern, but reconciling the differences has been problematic. This has impacted on our and other interested persons' ability to accurately assess an airport's targeted return.

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<sup>37</sup> Commerce Commission "Summary and analysis of Christchurch Airport's revised information disclosure for its second price setting event" (9 July 2015), para 48.

111. We have identified the following two instances that may result in different asset bases when setting prices compared to the asset base disclosed for information disclosure purposes:
- 111.1 airports may explicitly or implicitly include a portion of assets held for future use in their asset base used for pricing purposes to collect charges for this portion before it is used in the supply of specified airport services.
- 111.2 In the past, airports have excluded certain assets (mainly comprising leased assets) from their pricing asset base.<sup>38</sup> In contrast, as explained in Chapter 9, we included these assets in our analysis of targeted profitability because they are used in the supply of ‘specified airport services’.<sup>39</sup>
112. Assets held for future use: Under the current Airport IMs, assets held for future use are excluded from the RAB value (and from associated disclosed profitability measures) until they are used in the supply of specified airport services.<sup>40, 41</sup>
113. The current Airport IMs and ID Determinations may not provide adequate transparency for interested persons to assess ex-ante profitability if airports were to include revenues associated with assets held for future use at future price setting events.
114. Pricing assets: Airports have excluded certain asset values and associated revenues from their pricing disclosures. These activities are however included in the definition of ‘specified airports services’ and have therefore been included in our s 56G analysis.<sup>42</sup>
115. Understanding these differences in the underlying asset bases has been difficult in the past and can make the airports profitability assessment of future pricing periods challenging for us and other interested persons.

*Profitability assessment must take into account multiple pricing periods*

116. Consistent with our approach to assessing ex-ante profitability for the s 56G review, in future, as is discussed in Chapter 4, we are proposing to use an internal rate of return (**IRR**) calculation to assess targeted returns over the pricing period.

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<sup>38</sup> More information on what these assets are is provided in Chapter 9.

<sup>39</sup> This problem has previously been referred to as the problem associated with leased assets. Following discussions at the workshop held in April 2016 we have clarified that the problem definition is more accurately described as the treatment of pricing assets in the Airports ID Determination.

<sup>40</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010* (Commerce Commission Decision 709, 22 December 2010), clause 3.1 and definition of “excluded assets”.

<sup>41</sup> Airports can expect to be able to earn a full return on and of the costs of holding and developing this land without profits appearing excessive, provided it is eventually commissioned for use to supply airport services (Commerce Commission “Information disclosure (Airport Services) reasons paper” (22 December 2010), para 4.3.74).

<sup>42</sup> See, for example: Commerce Commission “Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, Section 56G of the Commerce Act 1986” (8 February 2014), p. 105, para F68.3.



117. In order to accurately reflect an airport's pricing intent, an IRR calculation must reflect commitments that an airport makes when setting prices, including the ability to reflect ex-post whether these commitments have been met. By reflecting those commitments, the profitability assessment for the current pricing period effectively links multiple pricing periods together.<sup>43</sup> For the purpose of this topic paper, we describe these commitments as:
- 117.1 ex-post effects of risk allocation (as defined below); and
  - 117.2 forecast over and under-recoveries that an airport intends to offset in future price setting events.
118. Ex-post effects of risk allocation: The Airports ID Determination does not provide sufficient transparency to identify ex-post effects of decisions on risk allocation between airports and airlines made during previous price setting events that have an impact on the current pricing period.
119. In the absence of this transparency, we and other interested persons may find it difficult to appropriately and accurately reflect those effects in the ex-ante assessment of profitability.
120. We provide clarification of what we mean by ex-post effects of risk allocation below:
- 120.1 In this context, given that airports set prices in advance, airports and airlines use the term **risk** as a way to describe that actual out-turns can be different from forecasts. For example, when determining prices of the current pricing event, an airport forecasts demand of the next 5 years. The risk is that the actual demand disclosed ex-post can be higher (lower) from forecast demand resulting in higher (lower) ex-post returns than forecast.
  - 120.2 When we use the term '**ex-post effects of risk allocation**' in this topic paper, we refer to decisions that were made in previous pricing periods by airports on how those risks should be allocated between airports and airlines. This is important in the context of the ex-ante profitability assessment, as the allocation of those risks can affect charges of the current pricing event.
121. Forecast over and under-recoveries: The Airports ID Determination does not provide sufficient transparency to identify forecast over and under-recoveries by airports that are intended to be offset in future pricing events. In the absence of this transparency, we and other interested persons may find it difficult to appropriately and accurately reflect those effects in the ex-ante assessment of profitability.

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<sup>43</sup> For clarification, in the context of this topic paper, we define the current pricing period (also referred to as price setting event) as the upcoming pricing period airports have just consulted on and set prices for in accordance with AAA.

*Other transparency problems*

122. We have identified additional transparency concerns. Given that airports can set prices as they see fit, airports may adjust their price paths in a manner that is not NPV-neutral relative to their targeted return. In the past, we identified the following instances where this was the case:
- 122.1 commercial concessions; and
- 122.2 route incentives.
123. In addition, we have identified the assumptions regarding timing of cash-flows as an area where transparency should be provided. In order to calculate an ex-ante IRR that more accurately reflects targeted returns by airports, we need to establish forecast cash-flow timing assumptions that are reflective of actual cash-flows occurring at the airports.
124. Commercial concessions: Commercial concessions are a commitment by an airport to under-recover revenue in a pricing period.<sup>44, 45</sup>
125. The current Airports ID Determination does not require airports to report on commercial concessions, or to disclose whether it plans for the under-recovery to be permanent or to be offset in future pricing periods.
126. In the absence of such a requirement, we and other interested persons may find it difficult to appropriately reflect commercial concessions in the ex-ante profitability assessment.
127. Route incentives: Route incentives are decisions by an airport to charge an airline less than the standard charge in order to secure new routes or additional passengers from that airline.
128. Currently, the Airports ID Determination only requires airlines to disclose route incentive information (called ‘pricing incentives’ as part of the ‘financial incentives’ in Schedule 2 of the Airports ID Determination) in ex-post disclosures. There is no specific requirement for airports to report in the price setting event disclosures on route incentives.
129. In the absence of such a requirement, we and other interested persons may find it difficult to accurately assess the impact of route incentives on the ex-ante profitability assessment of airports.

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<sup>44</sup> ‘Commercial concessions’ is a term used by airports and is not in our Airport IMs and ID Determinations.

<sup>45</sup> Commercial concessions can be done for a number of reasons. An example we have seen is Christchurch Airport’s commercial concession of a phased implementation of its long-term pricing model in order to support the economic recovery of Canterbury following the 2010 and 2011 earthquakes (Christchurch International Airport Limited, Price Setting Disclosure, 19 December 2012).

130. Timing of cash-flows: In order to calculate an IRR that more accurately reflects returns targeted by airports, we need to establish forecast cash-flow timing assumptions that reflect actual cash-flows occurring at the airports.
131. We consider the current year-end cash-flow timing assumptions implied by the use of a return on investment (**ROI**) in the ex-post disclosure requirements inappropriate, as they consistently and materially underestimate airport returns. This is because the ROI does not reflect actual cash-flows occurring throughout the year.
132. In addition, the current year-end cash-flow timing assumptions do not reflect our latest cross-sector thinking on this matter since we have applied intra-period cash-flow timing assumptions in the regulation of electricity distributors, gas pipeline businesses and Transpower.

### **Proposed solutions and the framework we applied in respect of these problems**

133. This section describes, at a high level, our proposed solutions in respect of the five problems identified above. Further details on our proposed solutions are provided in the Chapters 4 – 12.
134. As explained in Chapter 2 and earlier in this chapter, information disclosure regulation under Part 4 of the Act is, in the first instance, intended to focus on ensuring that interested parties are able to assess whether the Part 4 purpose is being met; in particular, by helping to reflect the extent to which the objectives in s 52A(a) to (d) are being achieved.
135. Given the Part 4 purpose, it is clear that the supply of regulated services is likely to be, and is intended to be, influenced by the relevant type of regulation. In this respect, information disclosure regulation not only contributes to the specific purpose set out in s 53A, but it can also promote the s 52A purpose by improving the sharing of existing information between regulated suppliers and interested persons, as well as in some cases expanding the information available to regulated suppliers themselves.<sup>46</sup>
136. The more effective the disclosure requirements are in meeting the s 53A purpose of information disclosure regulation and making airports' performance transparent, the more likely it is that information disclosure is promoting the overall Part 4 purpose.<sup>47</sup>

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<sup>46</sup> Commerce Commission “Information disclosure (Airport Services) reasons paper” (22 December 2010), para 2.7.3.

<sup>47</sup> 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 – Section 56G of the Commerce Act 1986” (13 February 2014), para 2.15.

137. For instance, if the indicators disclosed in accordance with the information disclosure requirements are not providing a good measure of a particular area of performance, there might be relatively weak incentives for suppliers to change their conduct so that their performance becomes more consistent with the Part 4 purpose.<sup>48</sup>
138. Therefore, we consider that it is important to have a forward-looking profitability indicator in the Airports ID Determination that provides an accurate reflection of an airport's targeted profitability. This indicator is expected to provide better information to interested persons on airports' expected profits, consistent with s 53A, and consequently influence the airports' pricing behaviour to be more consistent with not extracting excessive profits, consistent with s 52A(1)(d).
139. We also propose supplementing the proposed new profitability indicator with a number of 'carry forward' mechanisms. To the extent such mechanisms provide greater transparency around an airport's investment intentions, disclosing that supplementary information may also provide greater incentives for airports to invest efficiently, consistent with promoting s 52A(1)(a) (and (b)) as well.
140. In this regard, our proposals on the inputs to the forward-looking profitability indicator, and to the price setting event disclosures more widely, are intended to achieve the following outcomes:
- 140.1 greater accuracy in the disclosures by allowing airports to better reflect their pricing intent, meaning that the profitability indicator is likely to better reflect the airport's targeted profitability;
  - 140.2 greater clarity about the requirements in the Airport IMs and ID Determinations;
  - 140.3 greater transparency for us and other interested persons to better understand an airport's approach to pricing; and
  - 140.4 ultimately, better ensuring that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met, consistent with s 53A.
141. Table 3.1 outlines the problems as they have been summarised in the problem definition section of this chapter, and provides our proposed solutions. We also indicate in Table 3.1 where we:
- 141.1 propose amendments to the Airport IMs, Airport ID, or both; and
  - 141.2 consider at this stage that no amendments are required to solve the relevant problem.

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<sup>48</sup> 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 - Section 56G of the Commerce Act 1986" (13 February 2014), para 2.16.

**Table 3.1: Summary of proposed solutions**

<b>Problem</b>	<b>Sub-problem</b>	<b>Proposed outcome</b>	<b>Proposed solution</b>	<b>IMs or ID</b>	<b>Chapter</b>
There is no forward-looking profitability indicator	-	Greater transparency for interested parties to better understand an airport's approach to pricing and, in particular, whether the airport is limited in its ability to extract excessive profits	<p>Require airports to disclose a forward-looking profitability indicator, by using an IRR calculation that comprises: an opening investment value at the beginning of the pricing period, a forecast closing investment value and forecast cash-flows over the duration of the pricing period.</p> <p>Supplement the IRR with a carry forward mechanism that can be used to adjust the opening investment value and the closing investment value to better reflect an airport's pricing intent and that can take into account multiple pricing periods.</p>	ID	4
Airports may target a different time profile of capital recovery to those implied by the Airport IMs	Asset revaluations	Greater accuracy in the disclosures to better reflect an airport's pricing intent	<p>Require airports to disclose forward and backward-looking costs on a consistent basis to the approaches used when setting prices.</p> <p>Limit airports in their approaches to revaluing assets to the use of either CPI-indexation or an un-indexed approach (except when revaluing land using MVAU).</p> <p>Allow airports to make their choice of either CPI-indexation or an un-indexed approach for parts of the asset base separately.</p> <p>Allow airports to apply alternative methodologies with equivalent effect where the application of the asset valuation IMs would prove prohibitively complex or costly. Alternative methodologies can only be applied if they do not detract from the purpose of Part 4.</p>	IM	5

Problem	Sub-problem	Proposed outcome	Proposed solution	IMs or ID	Chapter
Airports may target a different time profile of capital recovery to those implied by the Airport IMs (cont)	Asset revaluations (cont)	Greater clarity about the requirements in the Airport IMs and ID Determinations	<p>Allow airports to elect an approach to revaluing assets only at the beginning of the next pricing period, and require airports to use the same approach in the backward-looking disclosures.</p> <p>Include an objective method of forecasting CPI based on the approach to forecasting CPI used in other regulated sectors.</p>	IM	5
		Greater clarity about the requirements in the Airport IMs and ID Determinations	<p>Require airports to provide details on the expected treatment of any revaluation gains in the next pricing period arising from a potential change in the approach to revaluing assets.</p> <p>Require airports to disclose both the forecast of CPI used to set prices and the IM-consistent forecast of CPI, and identify the impact of any differences on the value of forecast revaluations.</p>	IM	5
	Non-standard depreciation	Greater clarity about the requirements in the Airport IMs and ID Determinations	<p>Require airports to apply principles when using alternative depreciation approaches.</p> <p>Allow airports to apply alternative methodologies with equivalent effect where the application of the asset valuation IMs would prove prohibitively complex or costly. Alternative methodologies can only be applied if they do not detract from the purpose of Part 4.</p>	IM	5

Problem	Sub-problem	Proposed outcome	Proposed solution	IMs or ID	Chapter
The scope of the asset base used by airports when setting prices can be different to that disclosed under the Airports ID Determination	Assets held for future use	No change	Assets held for future use remain outside the RAB until it is used to provide specified airport services (IMs are not amended).	N/A	8
		Greater clarity about the requirements in the Airport IMs and ID Determinations	Amend the definition of “net revenue” to make it clearer that (as intended) revenues derived from, or associated with, assets held for future use are captured by that definition.	IM	8
		Greater accuracy in the disclosures to better reflect an airport’s pricing intent	Inclusion of the value of assets held for future use and revenue from or associated with assets held for future use on a forecast basis in ID determination (so that airports can offset any revenue from or associated with assets held for future use against the value of assets held for future use).	ID	8
	Pricing assets	Greater transparency for interested parties to better understand an airport’s approach to pricing	Addition of a new schedule to the ID determination reflecting airports’ targeted profitability based on the pricing asset base only.  Require airports to explain any differences in profitability based on the pricing asset base and the profitability based on the total RAB .	ID	9

Problem	Sub-problem	Proposed outcome	Proposed solution	IMs or ID	Chapter
The scope of the asset base used by airports when setting prices can be different to that disclosed under the Airports ID Determination (cont)	Initial RAB value for land	Greater clarity about the requirements in the Airport IMs and ID Determinations	<p>Set the initial RAB value for airport land using a pragmatic proxy of land as at 2010 by interpolating 2009 and 2011 MVAU land values (net of any capex or disposals of land that occurred during the years 2009/10 and 2010/11) based on existing MVAU land valuations.</p> <p>Calculate the proxy by using the average of the 2009 MVAU valuation and 2011 MVAU valuation and add to the calculated proxy the value of any capex and disposals related to land that occurred up to the date of the interpolated value.</p>	IM	12



Problem	Sub-problem	Proposed outcome	Proposed solution	IMs or ID	Chapter
A profitability assessment should take into account multiple pricing periods	Ex-post allocation of risk	Greater transparency for interested parties to better understand an airport's approach to pricing	<p>Include in the carry forward mechanism to adjust the opening investment value:</p> <ul style="list-style-type: none"> <li>• un-forecast revaluation gains or losses (in real terms) unless an alternative treatment has been proposed by airports; and</li> <li>• other risk sharing arrangements if these have been proposed in the airport's price setting event.</li> </ul> <p>Require airports to provide information in the annual ex-post disclosures about variances between forecasts and actuals for the risk allocation arrangements that were included in their price setting event (as these will inform the carry forward adjustment to the opening investment value for the next price setting event).<sup>49</sup></p> <p>Require airports to provide information on the 'degree of acceptance' by airlines regarding other risk sharing arrangements and to give interested persons, following the airports disclosures under information disclosure but prior to our summary and analysis, the opportunity to comment on airports' disclosures on allocation of risks.</p>	ID	6

<sup>49</sup> We note that any consequential changes affecting the ex-post Airports ID Determination will be considered as part of a follow-up project that is separate from the IM review and will be subject to a separate consultation process.

Problem	Sub-problem	Proposed outcome	Proposed solution	IMs or ID	Chapter
A profitability assessment should take into account multiple pricing periods (cont)	Forecast under or over-recoveries	Greater transparency for interested parties to better understand an airport's approach to pricing	<p>Include in the carry forward mechanism to adjust the forecast closing investment value forecast over and under-recoveries that are intended by airports to be offset in future pricing events.</p> <p>Require airports to provide information on the 'degree of acceptance' by airlines regarding those forecast over and under-recoveries included in the carry forward mechanism.</p> <p>Require airports to provide information on the purpose and the appropriateness of including those forecast over and under-recoveries in the carry forward mechanism.</p>	ID	7
Other transparency problems	Other adjustments to the price path	Greater transparency for interested parties to better understand an airport's approach to pricing	<p>Require airports to provide a high level disclosure of the total value of pricing incentives in the price setting event disclosures.</p> <p>Not to make any changes to the information disclosure requirements with regards to commercial concessions because we consider that the introduction of a forecast carry forward mechanism could be used to make the expectations regarding commercial concessions sufficiently transparent.</p>	ID	11

Problem	Sub-problem	Proposed outcome	Proposed solution	IMs or ID	Chapter
Other transparency problems (cont)	Timing of cash-flows	Greater transparency for interested parties to better understand an airport's approach to pricing	<p>Ex-post disclosures – to specify mid-year timing assumptions for all revenues and expenditures.<sup>50</sup></p> <p>Price setting event disclosures – to specify mid-year timing assumptions for all revenues and expenditures.</p> <p>Price setting event disclosures – to provide the flexibility for airports to deviate from the default cash-flow timing assumption if airports provide evidence that the actual cash-flow timing for specific cash-flow items is different from the default cash-flow timing assumption.</p>	ID	10

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<sup>50</sup> We note that any consequential changes affecting the ex-post Airports ID Determination will be considered as part of a follow-up project that is separate from the IM review and will be subject to a separate consultation process.

## Chapter 4: Forward-looking profitability indicator

### Purpose of this chapter

142. The purpose of this chapter is to explain our proposed solution to the problem associated with the lack of a forward-looking profitability indicator under the Airports ID Determination.
143. We discussed our proposed solution at the airports workshop held in April 2016 that was attended by key airports stakeholders. The slides we presented at the workshop contained information on how we propose to assess ex-ante profitability in future (including some graphics) that may be useful to read alongside this chapter.<sup>51</sup>

### Structure of this chapter

144. This chapter begins with a section on the problem definition, before going on to explain our proposed solution to this problem. The chapter finishes with a discussion of an alternative solution that we considered.

### Problem definition

145. This section explains the problem definition, including how it evolved through consultations, which included submissions and workshops.

#### *Summary of problem definition*

146. There is currently no forward-looking profitability indicator in the Airports ID Determination to assist us and other interested persons in assessing whether airports are targeting excessive profits when they set prices.
147. There might be relatively weak incentives for suppliers to change their conduct so that their performance becomes more consistent with the Part 4 purpose if the information disclosure requirements:
- 147.1 do not provide for indicators that are a good measure of a particular area of performance; or
  - 147.2 more importantly, do not provide for any indicators at all (as is the case with targeted profitability).
148. In this case, the key concern is whether the existing information disclosed following a price setting event sufficiently influences airports' conduct such that they are limited in their ability to extract excessive profits.
149. In this chapter, we discuss how the Airports ID Determination should be amended in order to provide for a headline profitability indicator that can be used as a starting point for any subsequent summary and analysis undertaken by us and other interested persons concerning the profits targeted by airports.

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<sup>51</sup> Commerce Commission "Airports profitability assessment – Workshop 2 – Workshop papers" (19 April 2016).

*Understanding targeted returns by airports is important*

150. Understanding the returns targeted by airports is important in assessing whether airports are limited in their ability to extract excessive profits.
151. For this assessment we consider it appropriate to compare these targeted returns against our mid-point estimate of cost of capital. When an airport targets a return that is different from our mid-point estimate of the cost of capital, we want to understand the extent of the difference and the rationale underpinning this variance in targeted return.
152. Our analysis of airports' profitability relies on transparent and reasonably accurate disclosures of targeted returns, including the assumptions underpinning the disclosures. In the past, transparency was limited by the fact that:
- 152.1 airports can set prices as they see fit;
  - 152.2 airports are not required to apply the Airport IMs Determination in making their forward-looking pricing disclosures;
  - 152.3 airports do not have to apply our forecast of cost of capital when setting prices;
  - 152.4 airports may target a return that is different from an airport's estimate of cost of capital; and
  - 152.5 most importantly, airports currently are not required to disclose a forward-looking profitability indicator at all.
153. In particular, if a forward-looking profitability indicator can provide a good reflection of an airport's target returns, consistent with s 53A, then airports are less likely to target profits that are excessive, consistent with s 52A(1)(d).

*Undertaking an ex-ante profitability assessment for each airport can be challenging*

154. As there was no forward-looking profitability indicator in the Airports ID Determination when we undertook the s 56G review of the effectiveness of airport information disclosure, we performed an ex-ante profitability assessment for each airport relating to the price setting events which occurred in 2012.<sup>52</sup>

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<sup>52</sup> For more information on the approach that we took, see, for example: Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport, Section 56G of the Commerce Act 1986" (31 July 2013), para F3 – F12.

155. When assessing the returns targeted during the price setting event for the s 56G review, we calculated an IRR forecast, which required information on:<sup>53</sup>
- 155.1 the opening investment value;
  - 155.2 the forecast cash-flows over the duration of the pricing period; and
  - 155.3 the forecast closing investment value.
156. In a forward-looking IRR calculation, the **opening investment value** reflects the initial capital to be recovered. We consider the opening investment value should comprise:
- 156.1 the IM-compliant closing RAB value from the ex-post disclosure of the year preceding the start of the current price setting event; and
  - 156.2 any adjustments reflecting decisions made in previous price setting periods that have an impact on charges for the current pricing period.<sup>54</sup> This is important in order to achieve consistency between the opening investment value and the forecast cash-flows that are used in a forward-looking IRR calculation.<sup>55</sup>
157. The **forecast cash-flows** over the duration of the pricing period comprise:<sup>56</sup>
- 157.1 revenues;
  - 157.2 opex;
  - 157.3 capex; and
  - 157.4 tax.
158. We consider it is appropriate to assume that the airport's forecast cash-flows are the starting point for the cash-flows used in our IRR calculation. However, during the s 56G reviews we made adjustments to the forecast cash-flows provided by airports but we found it difficult to accurately and appropriately determine those adjustments in advance.<sup>57</sup>

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<sup>53</sup> We used the IRR, rather than estimating returns on investment (which would have been consistent with information disclosure), as the concept of an IRR avoids problems with the short-term variability in returns. This is discussed in more detail under the section in this chapter on our proposed solution.

<sup>54</sup> For the purpose of this topic paper, we refer to these decisions as the 'ex-post effects of risk allocation'.

<sup>55</sup> For more information on the concept of matching the cash-flows to the opening investment value see Chapter 6.

<sup>56</sup> We note that the cash-flows are those required to determine an IRR comparable with the vanilla WACC. To determine an IRR comparable with a post-tax WACC the cash-flows would also include the value of the notional interest tax shield.

<sup>57</sup> For more information on the adjustments that we made see Chapter 6.

159. In a forward-looking IRR calculation, the **forecast closing investment value** reflects the remaining capital to be recovered. We consider it should comprise:
- 159.1 the forecast closing asset base used by airports when setting prices, reflecting an airport's assumed time profile of capital recovery; and
  - 159.2 any adjustments reflecting decisions made by airports that affect charges of the current and future price setting events that are not already reflected in the forecast closing asset base. This is important in order to derive a forecast closing investment value that is a good reflection of the remaining capital to be recovered.<sup>58</sup>
160. Provided that the opening and forecast closing investment values are determined in a manner as discussed above, the forward-looking IRR of the current pricing event effectively links past and future pricing periods together. This allows for a profitability assessment that is a good reflection of an airport's pricing intent.
161. In undertaking our profitability analysis for the s 56G review, we used our judgement to determine the appropriate value of the inputs to the IRR calculation. We had to determine the investment values and cash-flows that best reflected the airport's pricing intent and risk allocation arrangements. We also ensured that the forecast cash-flows used in our profitability assessment were consistent with the assumptions implicit in the opening and forecast closing investment values.
162. In our view, and based on the experience from the s 56G review, the process under the current Airports ID Determination to establish those input values can be onerous and inefficient for all parties involved.
163. For example, when undertaking the s 56G reviews, additional consultations with airports were necessary to enable us to establish those input values in a way that reflected the airports' pricing intent. In the case of Christchurch Airport, this resulted in Christchurch Airport choosing to re-disclose information relating to its second price setting event using a non-standard depreciation approach in order to provide additional transparency with regards to its forecast closing investment value.

*Stakeholders are open to exploring the introduction of a forward-looking profitability indicator*

164. BARNZ supports our view that the lack of a forward-looking profitability indicator under ID can be problematic. In particular, BARNZ submitted that:<sup>59</sup>

The level of returns being targeted is a key element in assessing the degree to which the purpose of s52A is being achieved or successfully promoted, and in comparing the performance of regulated suppliers, and most members of the general public will not be able to undertake such assessments themselves. The experience during the s56G review process

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<sup>58</sup> For more information on the forecast closing investment value and the adjustments that we consider appropriate, see Chapter 7.

<sup>59</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015), p. 6.

demonstrated not only how important an assessment of the level of profitability being targeted is to reaching any judgment on the degree to which the purpose of Part 4 is being achieved, but also how complex the assessment is as a result of the different approaches taken by each of the airports.

165. NZAA is open to exploring the introduction of a forward-looking profitability indicator in the Airports ID Determination. However, NZAA is not convinced that “a new ex-ante mechanism can remove the inevitable degree of complexity involved in profitability assessment” and considers that the “summary and analysis process plays an important role in providing sufficient information to ensure that the purpose of information disclosure is met”. NZAA is of the view that:<sup>60</sup>

Summary and analysis by the Commission provides an opportunity for:

- (a) the Commission to contextualise the ex-ante price setting disclosures, and consider price setting against outcomes over time; and
- (b) the airports to explain in further detail the reasons for any complexities, if and when they arise.

### **Our proposed solution in respect of this problem**

166. This section explains our proposed solution in respect of this problem.

#### *Our proposed solution*

167. We propose amendments to the Airports ID Determination under s 52Q to increase the transparency relating to targeted returns. In particular, our proposed solution in respect of this problem is:

167.1 to include a requirement on airports to disclose an ex-ante IRR for the current pricing period in the price setting event disclosure requirements. This should include an opening investment value, a forecast closing investment value and forecast cash-flows over the duration of the pricing period; and

167.2 to supplement the requirement to disclose an ex-ante IRR with a carry forward mechanism in the ID requirements that can be used to adjust the opening investment value and the forecast closing investment value used in an IRR calculation.

168. Our proposed solution overcomes the problem caused by no requirement to disclose a forward-looking profitability indicator under information disclosure. In particular, requiring airports to disclose an IRR that measures expected profitability during the current pricing period, and supplementing it with a carry forward mechanism can:

168.1 provide for a headline indicator that can be used as a starting point for any subsequent summary and analysis undertaken by us and other interested persons, and (in doing so);

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<sup>60</sup> NZ Airports “Airport profitability assessment post-workshop submission” (22 December 2015), para 10 and 13.



- 168.2 assist in determining if airports are targeting excessive profits; and
- 168.3 to the extent that the indicator provides a good reflection of an airport's targeted returns, influence price setting such that the returns targeted are not excessive.
169. In addition, our proposed solution focusses on disclosure of the profitability expected in the current pricing period which is consistent with the preferences expressed by participants at the airports workshop held in December 2015.<sup>61</sup>
170. In assessing the expected profitability of the current pricing period, the benefits of using an IRR as opposed to using a ROI (as it is currently implied by the ex-post disclosure requirements) are that an IRR:
- 170.1 avoids the problems associated with the short-term variability in returns that are inherent in a ROI calculation;
- 170.2 allows us to better take into account the time value of money by reflecting that cash-flows during a pricing period occur at different points in time; and
- 170.3 allows us to reflect specific cash-flow timing assumptions as discussed in Chapter 10.
171. Supplementing the forward-looking IRR with a carry forward mechanism is important as it enables us and other interested persons to assess airports' profitability across pricing periods. It also allows us and other interested persons to assess whether prices are being set consistent with the financial capital maintenance (**FCM**) principle over the longer term. Where prices are set consistent with the FCM principle, airports should expect to receive at least a normal return on their investments, consistent with both ss 52A(1)(a) and (d).<sup>62</sup>
172. Our proposed solution allows the reflection of historic and future pricing periods in the profitability assessment of the current pricing period and to assess if the FCM principle is being followed in the longer term. This can be achieved because:
- 172.1 firstly, the carry forward mechanism can be used to adjust the opening investment value in the IRR calculation to reflect decisions made in previous price setting periods that have an effect on charges for the current pricing period. This is important in order to achieve consistency between the opening investment value and the forecast cash-flows that are used in a forward-looking IRR calculation; and<sup>63</sup>

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<sup>61</sup> Commerce Commission "Input methodologies review – airports profitability assessment – Workshop 1 – Summary of views expressed" (18 December 2015), Attachment C, para 4.

<sup>62</sup> For more information on the FCM principle, see Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016).

<sup>63</sup> For more information on the concept of matching the cash-flows to the opening investment value see Chapter 6 on the ex-post effects of risk allocation.

- 172.2 secondly, the carry forward mechanism can also be used to adjust the forecast closing investment value in an IRR calculation to reflect decisions made by airports impacting charges of the current and future price setting events that are not already reflected in the forecast closing asset base. This is important in order to derive a forecast closing investment value that is a good reflection of the remaining capital to be recovered.
173. For more information on what we consider should be captured in the carry forward adjustment to the opening investment value see Chapter 6 on the ex-post effects of risk allocation. For more information on what we consider should be captured in the carry forward adjustment to the forecast closing investment value, see Chapter 7 on the treatment of forecast over and under-recoveries.
174. We consider our proposed solution would better enable us and other interested persons to assess whether airports are targeting excessive profits as it would create transparency in Airport ID with regards to targeted returns inherent in an airport's pricing decision.
175. In the remainder of this section, we provide more detail on:
- 175.1 why our proposed solution can provide for a headline indicator that can be used as a starting point for any subsequent summary and analysis;
  - 175.2 why an IRR avoids the problems associated with the short-term variability in returns; and
  - 175.3 the views expressed by stakeholders on this problem in submissions and at workshops.

*Proposed solution can provide for a headline indicator*

176. Our proposed solution can provide for a headline indicator that can be used as a starting point for any subsequent summary and analysis undertaken by us and other interested persons.
177. We consider the ex-ante IRR that will be disclosed under information disclosure is likely to be a good reflection of an airport's pricing intent. However, because airports can set prices as they see fit, there may be circumstances where the price setting event disclosures do not fully capture the approaches taken by an airport in respect of its pricing decision.<sup>64</sup>
178. We therefore consider that the ex-ante IRR disclosed under information disclosure can only be a starting point in the profitability analysis of airports. We would expect an airport to comment in its disclosures on the extent to which the IRR disclosed is a good reflection of its pricing intent.

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<sup>64</sup> For example, if an airport revalues its asset base inconsistently with our proposed solution for asset revaluations as discussed in Chapter 5, the price setting event disclosure would not be able to fully reflect this airport's pricing decision.

179. In any subsequent summary and analysis we may need to adjust the IRR provided under information disclosure in a way that is more consistent with targeted returns inherent in an airport's pricing decision. However, it is our intent to try and make the proposed new indicator as good as possible in the first instance.

*IRR avoids the problems associated with the short-term variability in returns*

180. As we discussed in the s 56G review for Wellington Airport, an IRR avoids the problems associated with the short-term variability in returns that are inherent in an ROI calculation. In particular, we noted:<sup>65</sup>

(F4) Our analysis of Wellington Airport's returns is based on its internal rate of return (IRR). We have used the IRR, rather than estimating its return on investment (ROI) which would be consistent with information disclosure, as it avoids problems associated with the short-term variability in returns.

(F5) Information Disclosure regulation under Part 4 requires airports to disclose an ROI. The ROI is an annual, single period profitability indicator which measures the airport's net income against its regulatory asset values at the end of each prior disclosure year. The ROI is intended to be comparable to the Commission's estimated weighted average cost of capital (WACC).

(F6) Analysis of returns using the ROI for Wellington Airport could be distorted by the revaluation of assets at Wellington Airport. The ROI reflects any revaluation gain (or loss) that occurs in the year prior to the change in the asset value. This can result in a 'spike' in the ROI, which signals an expectation of higher (or lower) profits in the future.<sup>66</sup> However, whether the reported returns actually eventuate depends on the extent to which the change in the asset value flows through into prices and revenues.<sup>67</sup>

(F7) Unlike an ROI calculation, an IRR calculation does not rely on asset values in each year. Instead, it is based on the initial capital outlay, and the net cash-flows associated with that investment. It therefore avoids the 'spikes' that can occur in the ROI.

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<sup>65</sup> Commerce Commission "Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is Promoting the purpose of Part 4 for Wellington Airport – Section 56G of the Commerce Act 1986" (8 February 2013), para F4-F7.

<sup>66</sup> A 'spike' in the ROI above the cost of capital as a result of a revaluation of assets indicates an expectation of higher profits in the future—but those higher profits have not yet occurred. Such a spike would also indicate that consumers have not yet received any compensation, through lower prices, to offset those expected higher profits. However, that expected level of profits will only fully eventuate if prices rise to the level implied by receiving a normal return on the revalued asset base (eg, Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd Decisions Paper" 30 October 2008, paragraph F.9). For example, during consultation on the asset valuation input methodology, Professor George Yarrow observed that a revaluation corresponds to a capitalisation of *future* cash-flows (G. Yarrow, M. Cave, M. Pollitt and J. Small, *Review of Submissions on Asset Valuation in Workably Competitive Markets, a Report to the New Zealand Commission, Annex 2: George Yarrow – Response to Submissions on Individual Expert Reviews*, November 2010, paragraph 2.11).

<sup>67</sup> If prices following the revaluation do not rise to the level implied by the revalued assets, the ROI measured at the point of revaluation may give a misleading view of returns. See Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decisions Paper" 30 October 2008, Appendix F.

*There is general support for our proposed solution*

181. At the first airports profitability workshop in December 2015, there was general support for using an ex-ante IRR for the five-year pricing period with a carry forward mechanism between pricing periods.<sup>68</sup>
182. In their submissions on this workshop, NZAA and BARNZ confirmed their support for our proposed solution. In particular:
- 182.1 NZAA stated that it “could support the inclusion of an ex-ante forecast IRR (using both pricing and IM inputs), disclosed at the start of a pricing period, indicating returns targeted for the five-year pricing period”. NZAA is also of the view that “transparency would need to be enabled within the information disclosure regime to reflect the carry forward or wash-up outcome”;<sup>69</sup> and
- 182.2 BARNZ reiterated its support for “using a five-year IRR, with a limited set of items carried forward to the next period, and considers that this methodology would best promote the purpose of 52A, and represents the most appropriate balance between the various competing objectives contained in the purpose statement”.<sup>70</sup>
183. Both parties elaborated further in their respective submissions on items that should be carried forward between pricing periods. More information on what these are and our respective proposed solutions are in Chapters 6 and 7.

**Assessment of an alternative solution to this problem**

184. This section explains our assessment of an alternative solution that we considered, namely requiring airports to disclose an enduring IRR under information disclosure.

*Alternative solution – requiring airports to disclose an enduring IRR under information disclosure*

185. At the first airports workshop in December 2015, we also presented on the concept of an enduring IRR that could be introduced in information disclosure.<sup>71</sup> This concept would require:
- 185.1 to fix the starting point of an IRR calculation (eg, the start of Part 4, beginning of PSE2 or PSE3); and
- 185.2 always to begin the IRR calculation from that point in time.

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<sup>68</sup> Commerce Commission “Input methodologies review – airports profitability assessment – Workshop 1 – Summary of views expressed” (18 December 2015), para 12.

<sup>69</sup> NZ Airports “Airport profitability assessment post-workshop submission” (22 December 2015), para 13 and 45.

<sup>70</sup> BARNZ’s post workshop submission on airports profitability assessment workshop 1 “Post profitability workshop comments” (21 December 2015), p. 1.

<sup>71</sup> Commerce Commission “Input methodologies review – airports profitability assessment – Workshop 1 – workshop papers” (18 December 2015), slides 27 and 28.

186. Similar to our proposed ex-ante IRR supplemented by a carry forward mechanism, an enduring IRR would provide for a headline indicator that can:
- 186.1 be used as a starting point for any subsequent summary and analysis undertaken by us and other interested persons; and (in this function)
  - 186.2 assist in determining if airports are targeting excessive profits.
187. As an enduring IRR could span multiple pricing periods, an enduring IRR would also reflect decisions that were made in the past allowing for an assessment of whether the FCM principle is being followed in the longer term.
188. However, although an enduring IRR would provide additional transparency, participants at the airports workshop in December 2015 dismissed this option early in the process given that:
- 188.1 airports and airlines focus in their profitability assessment largely on targeted returns of the current pricing period; and
  - 188.2 the impact of an individual pricing period on the enduring IRR becomes increasingly less important over the longer term.<sup>72</sup>
189. NZAA reiterated its position in its post-workshop submission and noted another argument against an enduring IRR. In assessing whether the FCM principle is being followed in the longer term, an enduring IRR would have to be measured against a comparable WACC for the same time frame. NZAA acknowledged in its submission the complexity involved in the development of such a corresponding WACC.<sup>73</sup>
190. Requiring airports to disclose an enduring IRR under information disclosure is not our preferred solution because:
- 190.1 of the support by airports and airlines for using an ex-ante IRR that is supplemented by a carry forward mechanism in order to assess airports' profitability; and
  - 190.2 of some possible complexities involved in the development of a corresponding WACC.
191. In any event, we can calculate a multi-period IRR under summary and analysis if we considered that doing so would assist interested persons in better understanding airport profitability performance over time.

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<sup>72</sup> Commerce Commission "Input methodologies review – Airports profitability assessment – Workshop 1 – Summary of views expressed" (18 December 2015), Attachment C, para 15.

<sup>73</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 18.

## Chapter 5: Time profile of capital recovery

### Purpose of chapter

192. This chapter discusses the problems and potential solutions we have identified in relation to an airport's time profile of capital recovery due to its treatment of revaluations and depreciation.

### Structure of chapter

193. This chapter begins with an introduction to the two main mechanisms through which an airport may end up with a different time profile of capital recovery than that implied by the Airport IMs Determination. These are through its approach to asset revaluations and depreciation. We then discuss each mechanism in turn. Discussion on each mechanism covers:
- 193.1 the problem definition and the context in which we considered the problem, including an explanation of how the problem definition evolved through consultation, which included submissions and workshops;
  - 193.2 our proposed solutions and the respective reasons associated with this solution; and
  - 193.3 a discussion of any alternative solutions that we considered.
194. We conclude the chapter with a discussion of an additional problem, and our proposed solution to that problem, that is unique to Auckland Airport. This problem arises from our proposed solution with respect to asset revaluation.

### Introduction to the mechanisms which can adjust time profile of capital recovery

195. An airport can target a time profile of capital recovery that is different to the default position assumed under the Airport IMs Determination through two main mechanisms. These are:
- 195.1 through its approach to the revaluation of its asset base; and
  - 195.2 by explicitly (or implicitly) using non-standard depreciation.
196. The default positions under the current Airport IMs Determination assumes that:<sup>74</sup>
- 196.1 revaluations of land assets must be calculated by applying the consumers price index (**CPI**), although airports have the option of undertaking valuations at periodic intervals based on a MVAU methodology;
  - 196.2 revaluations of non-land assets must be calculated by applying CPI-indexation; and

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<sup>74</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010* (Commerce Commission Decision 709, 22 December 2010), clauses 3.4 (depreciation) and 3.7 (revaluation).

- 196.3 depreciation of non-land assets must be calculated by applying straight line depreciation.
197. When airports use an alternative time profile of capital recovery, our profitability assessments must be able to take into account and assess the appropriateness of the choices that an airport has made when setting prices. This is important to ensure that airport pricing decisions are transparent enough for us and other interested persons to be able to assess whether the airport has been limited in its ability to earn excessive profits (consistent with s 52A(1)(d)).
198. We have previously said that non-standard approaches might be appropriate. In our s 56G report for Auckland Airport we indicated that while the Airport IMs Determination provides an appropriate benchmark for assessing performance it was not the only legitimate benchmark for assessing performance in terms of the Part 4 purpose.<sup>75</sup>
199. The remainder of this chapter focusses on the problems and proposed solutions associated with these mechanisms for adjusting the time profile of capital recovery.

### **Asset revaluations – problem definition**

#### *Targeted profitability could be assessed on a different basis from actual profitability*

200. When they set prices, airports can apply different asset revaluation approaches to those specified in the Airport IMs Determination, which currently means that targeted profitability may be assessed on a different basis from ex-post profitability. This is because:
- 200.1 the information disclosed by an airport about its price setting event must be consistent with the approaches the airport applied to forecast costs when determining prices;<sup>76</sup> whereas
- 200.2 the information disclosed by an airport on an annual basis about its actual costs must be consistent with the revaluation approaches set out in the Airport IMs Determination.
201. The current Airport IMs Determination on asset revaluation does not allow the pricing decisions that differ from the Airport IMs to be reflected in the RAB value that is disclosed. This means the value of the asset base can differ between ex-ante and ex-post disclosure purely due to the different treatment of the revaluations in each situation.

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<sup>75</sup> Commerce Commission “Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport” (31 July 2013), Chapter 2, p. 20, para 2.41.

<sup>76</sup> *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.5 and Schedule 18. See also definition of “forecast revaluations”: *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), p. 18.

202. These differences mean that, all else equal, the returns that we assess under ex-post information disclosure may not be consistent with the airports expected returns when setting prices. This is because the airports may have treated revaluations differently than assumed under the IMs.

*How stakeholders see the problem*

203. During the IM review consultation process stakeholders expressed views on the subject of asset revaluations. BARNZ acknowledged that airports can use different asset revaluation approaches relative to the Airport IMs Determination but considered:<sup>77</sup>

That it is vitally important that the IMs provide a clear lode-stone against which the reasonableness of the airport's approach can be compared in order to judge its reasonableness.

204. We agree with BARNZ that it is important to be able to assess whether or not the airport's approach is reasonable. This is important in our and other interested persons assessment of profitability.
205. NZAA is of the view that there is sufficient information already provided under information disclosure regulation for interested persons to understand airport profitability.<sup>78</sup> We disagree with this view and consider the requirements could be more transparent to help us and other interested persons understand the implication when an airport has used an alternative approach to asset revaluations.

*The problem was first identified in the s 56G review of Auckland Airport*

206. The problem associated with asset revaluations was first identified in our s 56G review of the effectiveness of the information disclosure regime for Auckland Airport. Auckland Airport introduced a moratorium on asset valuations which meant revaluations were not included in the value of the asset base used to set prices.<sup>79</sup> This moratorium was first applied during PSE1 (2007 – 2012) and will continue in effect until at least the end of PSE2 (2012 – 2017).
207. An airport's choice of an indexed or un-indexed approach to revaluations changes the implied time profile of capital recovery. All other things being equal, the use of an un-indexed approach justifies higher revenues in the short- to medium-term from pricing than are required if CPI-indexation is applied. However, either approach can be NPV-neutral over time.

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<sup>77</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015), p. 10-11.

<sup>78</sup> NZ Airports "Submission on IM review problem definition" (21 August 2015), para 216.

<sup>79</sup> Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), Attachment F, p. 91, para F31.



*Under s 56G profitability assessed consistent with Auckland Airport's pricing approach*

208. In our assessment of Auckland Airport's targeted profitability under s 56G, we reached our conclusions on the effectiveness of information disclosure on the basis of an assessment that was consistent with the approach to revaluations applied by Auckland Airport in pricing.
209. As discussed in the s 56G report, Auckland Airport indicated if a revalued asset base were to be used in pricing in the future, the cumulative revaluation impact will be treated as an offset to the future revenue target.<sup>80</sup>
210. If prices were to be set in future on the basis of the asset value rolled forward using CPI-indexation (without treating the revaluation as an offset to income), then Auckland Airport would be expected to earn excessive profits. This is because prices would reflect CPI-indexed revaluations that have not yet been appropriately treated as income in pricing.
211. Therefore, unless Auckland Airport restates the disclosed asset value consistent with the revaluation moratorium, then future profitability assessments will be more complex. This is because the asset value that has been disclosed on an annual basis is higher than the asset value that would be consistent with Auckland Airport's past pricing approaches and previously indicated intentions.
212. Consequently, a related but separate problem has been created because in the past Auckland Airport has applied an alternative approach to revaluations. This separate problem is discussed later in this chapter. In particular, the restatement of Auckland Airport's asset values is discussed in paragraphs 302 to 318.
213. The remainder of this section focusses on the extent to which input methodologies can be amended to reflect alternative revaluation approaches that may be applied by airports at future price setting events. The solution to this problem is intended to avoid the need to restate past asset values if airports change their approach in future.

**Asset revaluations – our proposed solution in respect to the problem**

*Proposed changes to the Airport IMs Determination*

214. Our proposed solution is to amend the Airport IMs Determination such that airports are required to apply either CPI-indexation or an un-indexed approach when rolling forward the value of individual assets, depending on the approach applied in pricing. This change applies to both land and non-land assets.
215. We consider that this solution will allow us and other interested persons to better assess if airports are targeting excessive profits.

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<sup>80</sup> Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), Attachment F, p. 85, para F13.

216. We have proposed this solution because:
- 216.1 although the two approaches imply different time profiles of capital recovery, both are consistent with allowing interested persons to assess whether airports are limited in their ability to earn excessive profits (consistent with s 52A(1)(d));
  - 216.2 the benefit of ensuring that the approach reflects the pricing approach is that it improves the transparency of returns and reduces the risk that airports will have to restate asset values in future; and
  - 216.3 it provides additional flexibility to airports to disclose costs on a consistent basis to the approaches used by airports when setting prices.
217. When an indexed approach is applied in pricing, it can be shown that ex-post returns will comprise:
- 217.1 a performance-related real return, through cash-flows during the period; and
  - 217.2 compensation for inflation, through inflation indexed asset revaluations.
218. The practical effect of indexing asset values to actual inflation is therefore to ensure that the real return achieved in practice is consistent with the real return embedded in the cost of capital.
219. The primary impact of applying an un-indexed approach is to increase justifiable revenue in the short term. However, a consequence of this approach is that an airport may also increase the extent to which its real return is exposed to inflation risk. The real return is the return the airport earns over and above compensation for actual inflation.<sup>81</sup>
220. The decision between an indexed and an un-indexed approach can affect both the time profile of capital recovery, and the implied exposure of real returns to inflation risk. However, we have proposed additional changes to the information disclosure requirements in Chapter 6 which allows an airport to manage exposure to inflation risk.
221. To give effect to this, we propose to introduce a definition of 'Forecast CPI' which can be used to calculate the returns airports require by way of compensation for inflation risk. This definition is required if an airport chooses to manage its exposure to inflation risk when using an un-indexed approach to revalue assets because it allows an objective calculation of the difference in returns that airports would have recovered ex-post, when an indexed approach has been applied.

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<sup>81</sup> Dr Lally's expert advice on the cost of debt, asset beta adjustments for GPBs, RAB indexation and inflation risk, and TAMRP "Review of further WACC issues" (report to the Commerce Commission, 22 May 2016), p. 41.

222. The reasons for our proposed approach to the definition of 'Forecast CPI' are explained in Electricity Distribution Services IMs relating to the setting of default price-quality paths.<sup>82</sup> We encourage you to provide your views on the approach and reasons set out in that paper.

*Proposed changes to information disclosure requirements*

223. We propose that an airport be required to provide information on the approach used by it to revalue assets (ie, indexation or non-indexation) and the forecast value of revaluations at an asset category level. We also propose that airports be required to disclose the IM-consistent forecast of CPI and the forecast value of revaluations that would have been projected had this methodology been applied at an asset category level.
224. This will provide us and interested persons with sufficient information to understand the airport's approach to forecasting revaluations. It also allows us to understand the forecast value of the assets had the CPI calculated under the Airport IMs been applied.
225. In our view, it would be appropriate for the proposed changes to the input methodologies to be accompanied by a new requirement in the Airports ID Determination. This new requirement would require airports to:
- 225.1 disclose information about the forecast revaluation rate that the airport has applied at an asset category level; and
- 225.2 provide information on the level of revaluations at an asset category level had the airport applied the IM-consistent approach to forecast CPI.
226. This information would make the airport's approach to revaluations transparent. It would also assist in the management of inflation risk, where required, and provide supporting information to summary and analysis.
227. We also encourage views on the level of justification and additional information that airports should be required to provide in support of applying an un-indexed approach. For example, we could require information about the reasons for requiring advanced cash-flows. Such a discussion might sensibly refer to the approach taken to depreciation given that it also affects the implied time profile of capital recovery.

*Specific implications for Auckland Airport's existing valuations*

228. One implication of our proposed approach would be that Auckland Airport would be required to restate its historic disclosed asset values consistent with the approaches it adopted in pricing. This would be required in order to:
- 228.1 ensure that our forward-looking and backward-looking profitability assessments are consistent; and

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<sup>82</sup> Commerce Commission "Input methodologies (Electricity Distribution and Gas Pipeline Services) reasons paper" (22 December 2010), para E12.5 – E12.11.

- 228.2 provide enough transparency for us and interested parties to assess whether Auckland Airport is limited in its ability to earn excessive profits.
229. At our April 2016 workshop, Auckland Airport indicated that restating asset values would be complicated and create significant additional compliance costs.<sup>83</sup> This is because the airport would have to reconcile its un-indexed approach to each of its individual assets in order to be compliant with the asset valuation IM.
230. We consider that Auckland Airport's concern could be addressed through the use of an alternative approach with an equivalent effect. In paragraphs 306 to 309 we discuss how such an alternative approach might be accommodated under the Airports ID Determination.
231. We also note that the approach discussed in paragraph 306 to 309 might provide a mechanism for addressing similar issues if they arise in future. For example, it could be used if airports adopt a non-standard depreciation methodology that is determined at the aggregate asset base level rather than by individual assets.

*Our proposed solution reflects past stakeholder views*

232. In reaching our proposed solution on the treatment of asset revaluations, we have taken into account past stakeholder views on the matter. For example, in its submission to the IM review problem definition paper, BARNZ indicated that it would support an approach like our proposed solution to this problem.<sup>84</sup>
233. BARNZ supports the addition of specified options in the IMs for airports on the degree of revaluations to apply (ie, none, CPI indexing only or Schedule A land revaluations) when rolling forward the RAB (but does not support the introduction of complete or unconstrained flexibility).
234. BARNZ also requested clarity on:
- 234.1 when an airport can make an election of the approach to revaluing assets;
  - 234.2 whether the election can be subsequently changed; and
  - 234.3 how an election by the airport is to be disclosed.

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<sup>83</sup> Commerce Commission "Input methodologies review – airports profitability assessment – Workshop 2 – Summary of views expressed" (16 June 2016), Attachment C, para 8.

<sup>84</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review", (21 August 2015), p. 2.

235. Theoretically, in the context of an airport's profitability assessment, an airport can make these elections any time provided revaluations are treated in a NPV-neutral manner, ie, ensuring the real FCM principle is being followed. However, our proposed solution provides clarity which addresses the points raised by BARNZ because:
- 235.1 the Airport IMs and ID Determinations will be amended so that an airport can only elect its approach to revaluing assets when setting prices, and it must use the same approach in its forward-looking and backward-looking disclosures (this will address the points in paragraphs 234.1 and 234.2).
- 235.2 an airport will be required to provide details on the treatment of any revaluation gains in the next pricing period arising from a change in the approach to revaluing assets (this will address the point in paragraph 234.3).
236. NZAA recently indicated that it would support the inclusion of further flexibility in the Airport IMs Determination in order to allow pricing revaluation approaches to be aligned with the information disclosure requirements. However, NZAA also argued for any non CPI-based revaluations approach to be included in the Airport IMs Determination, noting that:<sup>85</sup>
- Providing this flexibility in the IM would not reduce the effectiveness of the information disclosure regime because the fundamental principle will remain that all revaluations included in the RAB must also be included in disclosed income. However, it would improve the ability of all parties to evaluate airport outcomes because RAB revaluation forecasts and actual outcomes will be presented on a more consistent basis.
237. In addition, NZAA sees benefit in creating greater flexibility in the Airport IM treatment of revaluations if it was decided to capture non-forecast revaluation gains in a carry forward mechanism. We address this point in the section that follows.

*We also considered an alternative solution of using a carry forward mechanism*

238. Another option for resolving the problem associated with asset revaluations without changing the Airport IMs Determination would be to use the proposed carry forward mechanism as we describe it in Chapter 4 of this paper.
239. Under this approach, airports would disclose information about costs on the basis of approaches that are consistent with the Airport IMs Determination. The impact arising from airports using alternative revaluation approaches when setting prices would then be captured in the carry forward mechanism, ie, the impact of applying an alternative to CPI-indexation would be calculated and taken into account when assessing profitability in future.<sup>86</sup>

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<sup>85</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 39.

<sup>86</sup> Further information about the proposed calculation of carry forward amounts can be found in Chapters 6 and 7.

240. This approach would allow us and other interested persons to more easily identify the impact on profitability of airports applying alternative approaches to revaluing assets. We could then comment on how appropriate the airports' approach was through summary and analysis.
241. This is not our preferred approach as we are concerned that any carry forward amount may be perceived by the airport and interested parties as a temporary adjustment whereas our proposed solution makes it clear that the airports' approach to revaluations is a permanent adjustment to the asset values. However, we do note that this alternative approach would not require Auckland Airport to restate past disclosures. We therefore encourage submitters (in particular Auckland Airport) to submit on our recommended solution, noting our concerns about transparency.

*Our consideration of other alternative approaches to revaluations*

242. In reaching our proposed solution, we also considered the alternative approach of allowing airports full flexibility in terms of the alternative approaches they may apply to revaluations. However, this is not our preferred solution, primarily for pragmatic reasons:
- 242.1 other than periodic land valuations, airports have not used anything other than an indexed or un-indexed approach to asset revaluation for pricing purposes since the information disclosure regime was introduced in 2010; and
- 242.2 airports have not indicated that they are likely to apply alternative indexation approaches in future.
243. In addition, we consider the method proposed in paragraphs 306 to 309 (ie, allowing alternative methodologies with equivalent effect) to ensure sufficient flexibility. This is because if airports apply an alternative approach to revaluations in future, it allows for the possibility that asset values can be restated to reflect the pricing approach.

## Depreciation – problem definition

244. The Airport IMs and ID Determinations allow airports to use non-standard depreciation (also known as alternative, implied or economic depreciation) when disclosing information under information disclosure regulation.<sup>87, 88</sup> Airports are allowed to apply non-standard depreciation as they see fit, but they must provide an explanation in their disclosures of what they have done. This is required so that interested persons can assess how it meets the Part 4 purpose.<sup>89</sup>
245. During its second price setting event (**PSE2**) Christchurch Airport set prices based on a 20-year levelised price path but did not disclose a depreciation profile consistent with this pricing decision (ie, it disclosed straight line depreciation). Our s 56G report identified that it would have been more transparent to disclose a non-standard depreciation methodology.
246. Christchurch Airport subsequently made a voluntary re-disclosure of its pricing disclosure using a non-standard depreciation methodology, intended to be consistent with its levelised pricing approach.<sup>90</sup> This made Christchurch Airport the first airport to disclose a non-standard depreciation methodology.
247. Having reviewed the approach applied by Christchurch Airport, we considered that it was an improvement on the previously disclosed information because it:
- 247.1 provides a relatively straightforward way to calculate depreciation that was intended to better reflect the assumptions inherent in Christchurch Airport’s pricing approach; and
- 247.2 is consistent with us and interested persons being able to more readily assess whether Christchurch Airport is limited in its ability to earn excessive profits over time (consistent with s 52A(1)(d)).

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<sup>87</sup> Non-standard depreciation is any methodology other than straight line depreciation as set out in the Airport IMs Determination. *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 (Commerce Commission Decision 709, 22 December 2010)*.

<sup>88</sup> Depreciation is not applied to land and easements (other than fixed life easements) and therefore non-standard depreciation can only be applied to an airport’s non-land assets. *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 (Commerce Commission Decision 709, 22 December 2010)*.

<sup>89</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 (Commerce Commission Decision 709, 22 December 2010)*, clause 3.4; *Airports Information Disclosure Determination 2010 (Commerce Commission Decision 715, 22 December 2010)*, clauses 2.5 and 2.3, Schedules 18 and 4.

<sup>90</sup> Our s 56G report on CIAL found that, among other things, the use of a 20-year levelised price path and straight line depreciation made it difficult for us and other interested parties to assess profitability as it broke the link between target returns and the RAB. 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 – Section 56G of the Commerce Act 1986” (13 February 2014).

248. Nevertheless, our experience with Christchurch Airport’s use of a non-standard depreciation methodology has raised a number of problems:
- 248.1 Christchurch Airport did not initially identify that it was appropriate to use non-standard depreciation rather than straight line depreciation when disclosing price setting information for PSE2; and
- 248.2 in addition, airlines found it difficult to engage with Christchurch Airport’s approach to non-standard depreciation. This may in part be due to the fact that the non-standard approach adopted by Christchurch was intended to better reflect the lower current utilisation of assets, but (counterintuitively) was associated with an increase in disclosed depreciation.
249. This suggests that there is scope to improve the current requirements for non-standard depreciation to ensure that:
- 249.1 an airport discloses a depreciation methodology that is consistent with its pricing decisions; and
- 249.2 there is sufficient information disclosed to allow us and interested persons assess the depreciation methodology an airport has disclosed.
250. In addition, we note that different approaches to depreciation may imply changes to the incentives facing airports. For example, a consequence of the approach applied by Christchurch Airport is that the business is exposed to a lower proportion of any overspend in capital expenditure (and, conversely, retains a lower proportion of any benefits associated with an underspend in capital expenditure).
251. Our consideration of each of these matters is explored in greater detail below.

*Identification and application of non-standard depreciation approach*

252. As part of our review under s 56G for Christchurch Airport, we expressed concerns about the transparency of returns, because (amongst other reasons) Christchurch Airport did not identify that given its pricing methodology it would be appropriate to apply a non-standard approach to depreciation. In our view, such an approach would have better reflected the assumptions inherent in Christchurch Airport’s 20-year levelised price path.<sup>91</sup>

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<sup>91</sup> 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 – Section 56G of the Commerce Act 1986” (13 February 2014).



253. As a result of the s 56G report, Christchurch Airport voluntarily restated its price setting event disclosure to incorporate a non-standard depreciation methodology that better reflected Christchurch Airport's pricing intent.<sup>92</sup> As noted earlier, our view is that these changes have resulted in improvements in the transparency of Christchurch Airport's pricing approach.
254. As a consequence of this experience, we are interested in receiving views on ways in which we can assist airports to identify the situations in which non-standard depreciation approaches might be appropriate in future.

*Stakeholders have found it difficult to engage with the approach to non-standard depreciation*

255. Stakeholders found it difficult to engage with the approach to non-standard depreciation in Christchurch Airport's revised disclosure.<sup>93</sup> For various reasons, the disclosed value of non-standard depreciation was higher than the disclosed value of standard depreciation. This was counter-intuitive given the justification for using a non-standard depreciation approach. We consider that the provision of additional information about the approach may have assisted stakeholder understanding.

*Impact of non-standard approach to depreciation on incentives*

256. By disclosing information about the non-standard approach to depreciation, interested persons have been able to assess the extent to which Christchurch Airport has had incentives to improve efficiency (consistent with s 52A(1)(b)).
257. As noted previously, the impact of the approach applied by Christchurch Airport is that the business is exposed to a lower proportion of any overspend in capital expenditure (and, conversely, retains a lower proportion of any benefits associated with an underspend in capital expenditure).
258. This is because the depreciation applied to the RAB ex-post was fixed in advance (set equal to forecast depreciation), and there was consequently no impact on ex-post depreciation as a result of the capital expenditure undertaken during the period.
259. In his paper on updating the regulatory asset base, Biggar discusses the impact using forecast or actual depreciation has on the incentives faced by regulated suppliers. Biggar also provides a number of examples to demonstrate these incentives.<sup>94</sup>

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<sup>92</sup> Christchurch Airport "Supplementary voluntary disclosures" (28 November 2014).

<sup>93</sup> Letter from Aaron Schiff (Schiff Consulting, on behalf of BARNZ) to John McLaren (Manager, Commerce Commission) summarising views on Christchurch Airport's revised information disclosure for PSE2, (9 July 2010).

<sup>94</sup> Darryl Biggar "Updating the regulatory asset base: revaluation roll forward and incentive regulation" (1 April 2004).

260. The following example (from Biggar) demonstrates the impact of an airport rolling forward the RAB using actual capital expenditure and forecast depreciation:<sup>95</sup>

suppose that a firm initially has a RAB equal to zero. Suppose that the capex target for the next five-year regulatory period is \$100 million for a project which lasts 20 years. The forecast depreciation for the next five-year regulatory period is therefore \$25 million. Suppose that the capex out-turn is \$80 million. The closing RAB is then set equal to the opening asset base plus the actual capex less the forecast depreciation, which is \$55 million. Note that the present value of the revenue stream in this example is just \$80 million – the firm neither gains nor loses financially from under-spending in this example. The firm also does not benefit from inflating the capex target.

261. The next example demonstrates the impact of an airport rolling forward the RAB using actual capital expenditure and actual depreciation:<sup>96</sup>

suppose that the opening RAB is zero. The capex target for the next regulatory period is \$100 million for a project which lasts 20 years. The straight line depreciation allowance on this project for the next five-year regulatory period is  $X/4$  where  $X$  is the level of spending on the project, so the forecast depreciation is \$25 million. If the capex out-turn is, say, \$80 million, the “actual” depreciation is therefore \$20 million, so the rolled forward asset base is equal to \$60 million. Under this approach the firm is allowed to keep the \$25 million depreciation it earned during the regulatory period, instead of the \$20 million depreciation associated with the lower actual capex. The extra \$5 million is the benefit to the firm from this strategy. This benefit to the firm can be increased by both inflating the capex target (which increases the forecast depreciation allowance) and reducing the actual capital spending of the firm.

262. The examples above highlight that, in applying a non-standard approach to depreciation, it is important to consider the impact that such an approach might have on an airport’s incentives to improve efficiency. The specific impact will also depend on other approaches adopted by the airport; for example, whether or not there is a capex wash-up.
263. Airports can set prices as they see fit, and the approaches they apply to depreciation may create different incentives to improve efficiency. However, once prices have been set, they cannot be changed unless there is another price setting consultation (which must occur at least every five years), so the incentives are locked in.
264. We recognise that different incentives may be suitable in different situations. For this reason, we encourage views on what additional information (if any) airports should provide in order to assess whether the incentives to improve efficiency are appropriate.

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<sup>95</sup> Darryl Biggar “Updating the regulatory asset base: revaluation roll forward and incentive regulation” (1 April 2004), para 13.

<sup>96</sup> Darryl Biggar “Updating the regulatory asset base: revaluation roll forward and incentive regulation” (1 April 2004), para 17.

**Depreciation – proposed solution in respect of this problem**

265. To help improve interested persons understanding about non-standard approaches to depreciation, our proposed solution is to amend the Airport IMs Determination and the Airports ID Determination to include a set of high level principles that airports must apply when disclosing non-standard depreciation profiles.
266. Table 5.1 outlines the principles we consider should apply and whether the principles will result in a change to the Airports IM and ID Determinations.

**Table 5.1: Proposed principles and whether these are IM or ID Determination changes**

	<b>Principle</b>	<b>Airport IM or ID</b>
1	An airport must disclose the expected time profile of capital recovery implied by its price setting methodology and demonstrate how this is NPV-neutral given its targeted return.	ID
2	The depreciation profile applied and disclosed by an airport must be consistent with the time profile of capital recovery implied by the airport's price setting methodology and its choice of RAB indexation.	IM
3	Despite principle 2, an airport can only apply or disclose a non-standard depreciation profile if it is able to justify or explain why the time profile of capital recovery implied in its price setting is appropriate.	IM
4	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.	IM/ID
5	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.	ID
6	The standard straight line depreciation profile must be disclosed alongside the non-standard profile on an ex-ante basis for the pricing period when an airport first introduces a non-standard depreciation methodology.	ID
7	If using a non-standard depreciation methodology that is determined using an aggregated asset base, the airport must provide supporting documentation to demonstrate how the non-standard depreciation has been allocated to asset classes.	ID
8	Where an airport has disclosed straight line depreciation but has changed the expected asset lives in order to reflect a different time profile of capital recovery, this must be transparently disclosed and include appropriate explanations or justifications for the change.	ID

*Reasons for preferring this solution*

267. We consider that this solution will improve interested persons understanding about non-standard approaches to depreciation. In doing so, it will more clearly allow interested persons to assess whether airports are targeting or extracting excessive profits (consistent with s 52A(1)(d)).
268. Our proposed solution seeks to balance flexibility with prescription. By providing principles we can provide clarity on what we expect and the evidence we need to support transparency when an airport chooses to apply non-standard depreciation. By keeping these principles high level we can do so without risking unintended consequences that can come from being overly prescriptive.
269. We consider that this level of flexibility is important because airports are not required to use Airport IMs when they set prices. If the principles were too prescriptive it could discourage airports from taking them into account when setting prices. This would create transparency issues between pricing (when airports do not have to apply the Airport IMs) and information disclosure requirements (when airports do have to apply the Airport IMs).
270. We discuss the reason for each of the principles below.

*Principle one: an airport must disclose the expected time profile of capital recovery implied by its price setting methodology and demonstrate how this is NPV-neutral given its targeted return*

271. This principle seeks to ensure that an airport's decisions about its time profile of capital recovery are transparent to interested persons. It also seeks to ensure that, where an airport has targeted a different time profile of capital recovery, the impact is NPV-neutral at the airport's targeted return.
272. In the absence of this principle, it is possible that airports could disclose price setting information in a manner that did not explicitly address the airport's expected time profile of capital recovery or allow interested parties to understand the airport's pricing intent.
273. We would also be concerned that without this principle, an airport could use a time profile of capital recovery that was not NPV-neutral at its targeted return. That is, that an airport could expect a higher expected return using its adjusted time profile of capital recovery than would be expected using the time profile of capital expected using straight line depreciation (given its stated targeted return).

*Principle two: the depreciation profile applied and disclosed by an airport must be consistent with the time profile of capital recovery implied by the airport's price setting methodology and its choice of RAB indexation*

274. This principle seeks to ensure that the use of non-standard depreciation by an airport improves the transparency of its time profile of capital recovery rather than further obscuring the airport's pricing decisions. It is important as the purpose of allowing non-standard depreciation is to improve the transparency of pricing decisions. It also seeks to ensure that the airport's depreciation profile is consistent with its decision about the indexation of the RAB.
275. Without this principle an airport could use a non-standard depreciation profile that is inconsistent with the time profile of capital recovery that would be implied by its pricing methodology. This would mean that the forecast closing asset base in our IRR calculation would not provide a good indicator of the remaining capital to be recovered. This would have the effect of making the disclosure less transparent, making it more difficult for us and other interested parties to assess profitability over time.

*Principle three: despite principle 2, an airport can only apply or disclose a non-standard depreciation profile if it is able to justify or explain why the time profile of capital recovery implied in its price setting is appropriate*

276. This principle seeks to prevent an airport from using non-standard depreciation in its disclosure where an airport cannot adequately explain or justify the time profile of capital recovery used to set prices. That is, we are seeking to ensure that non-standard depreciation is only used in appropriate situations.
277. In the absence of this principle, we are concerned that an airport could use non-standard depreciation to explain any time profile of capital recovery, even those that would not be considered reasonable given the airport's particular circumstances. For example, if an airport used a non-standard depreciation profile to increase depreciation on the RAB due to increased utilisation, supporting evidence (such as passenger numbers) should demonstrate that there has been an increase in utilisation.

*Principle four: 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*

278. Airports can price as they see fit. This includes being able to choose to explicitly (or implicitly) switch between using straight line and non-standard depreciation from one price setting event to the next. This principle seeks to prevent airports from being able to switch between depreciation approaches *during* a pricing period.
279. Without this principle, airports could set prices using straight line depreciation then partway through the pricing period begin to disclose using non-standard depreciation (or vice versa). This would make it difficult for us and other interested parties to assess profitability.

*Principle five: 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*

280. This principle seeks to ensure that non-standard depreciation is being used because it better reflects the expected value or utilisation of the RAB than straight line depreciation. We would expect airports to disclose sufficient evidence to support this position.
281. This is important as the explanation and evidence will help us to assess the reasonableness of the airport's approach. It will also allow us to identify whether we need to conduct any further summary and analysis on the impact of non-standard depreciation compared to standard depreciation on expected returns. Without this information it would be difficult to reach a view on the approach taken.

*Principle six: the standard straight line depreciation profile must be disclosed alongside the non-standard profile on an ex-ante basis for the pricing period when an airport first introduces a non-standard depreciation methodology*

282. This principle seeks to ensure that we are able to understand the consequence, and test the impact of using non-standard depreciation through our summary and analysis. We do not collect the information required to set the non-standard depreciation profile ourselves.
283. Without this principle we would not have enough information to conduct a thorough profitability assessment as we would not be able to compare what the airport has done to what would have occurred had straight line depreciation been applied. In the absence of the disclosure of the roll forward of the RAB under straight line depreciation, we would not have sufficient information to accurately approximate this roll forward ourselves.

*Principle seven: if using a non-standard depreciation methodology that is determined using an aggregated asset base, the airport must provide supporting documentation to demonstrate how the non-standard depreciation has been allocated to asset classes*

284. Under the current ID requirements airports must disclose depreciation information ex-post by individual asset class. Airports may use a non-standard depreciation methodology that is determined at the total RAB level rather than by individual asset classes. If this occurs we want to be able to understand how total non-standard depreciation has been allocated across the three non-land asset classes.
285. If we do not have this principle then airports can allocate total depreciation to the individual assets classes in any manner they choose. Requiring airports to explain any allocation methodology allows us to consider whether the airports approach seems reasonable by considering the asset class's proportion of the total RAB or its proportion of total depreciation under a straight line depreciation approach.

*Principle eight: where an airport has disclosed straight line depreciation but has changed the expected asset lives in order to reflect a different time profile of capital recovery, this must be transparently disclosed and include appropriate explanations or justifications for the change*

286. The purpose of this principle is to ensure that an airport's decisions about changing its time profile of capital recovery are made transparent through information disclosure.
287. An airport may be able to alter its expected time profile of capital recovery by changing the asset lives used to determine the value of depreciation using the straight line methodology. This would not require airports to disclose or explain a non-standard depreciation approach.
288. The current information disclosure requirements do not currently collect sufficient information about the asset lives used to determine the disclosed depreciation using straight line depreciation or how these have changed over time.
289. In the absence of this principle, it may be possible for an airport to alter its time profile of capital recovery, even when using the default straight line depreciation methodology, without making this transparent to ourselves or interested parties.

*We are not proposing any amendments to specify how airports disclose information about the value of non-standard depreciation ex-post*

290. We are not proposing any amendments to the Airport IMs and ID Determinations to specify how airports disclose information about the value of non-standard depreciation ex-post (ie, whether an airport should use forecast or actual depreciation). This is because, while the approach an airport takes to non-standard depreciation will have an impact on the incentives for airports to be efficient in their capital expenditure, it is not the only factor that will have an impact.
291. In practice, incentives to be efficient will be affected by a range of decisions made by airports including:
- 291.1 the approach to the disclosure of depreciation;
  - 291.2 the WACC businesses expect to earn;
  - 291.3 the choice of whether or not to index the RAB;
  - 291.4 the use of the carry forward mechanism; and
  - 291.5 proposed wash ups and other adjustments for forecasts versus actuals.
292. Under information disclosure regulation (ie, where airports can set prices as they see fit), we do not determine the incentives for airports to be efficient in their capital expenditure. However it is possible for us to assess the strength of incentives faced by airports and whether they are consistent with s 52A(1)(b).



293. To assess the efficiency incentives airports face, we need to consider the decisions an airport makes in aggregate rather than individually. Therefore, changes to the way in which we require depreciation to be disclosed would not necessarily affect the strength of a specific efficiency incentive. This is because the strength of the incentive could be adjusted by other decisions made by an airport.
294. It is also not clear that there is an appropriate strength of incentive that should be targeted in all situations. It could be that judgement needs to be applied to assess what incentive strength should be in place for any airport at a particular point in time, similar to our view on cost of capital. For example, we use different mechanisms across Transpower and EDBs when designing incentive schemes. Transpower also has different incentives applied to different classes of capex.

### **Depreciation – assessment of other potential solutions to this problem**

295. The alternative solutions that we have considered include:
- 295.1 allowing airports to use a carry forward approach instead of non-standard depreciation; and
  - 295.2 issuing additional guidance rather than introducing additional requirements.

#### *Use of a carry forward approach instead of non-standard depreciation*

296. Another option for resolving the problem associated with non-standard depreciation would be to use a carry forward mechanism instead of the non-standard depreciation methodology provided for in the existing Airport IMs. The carry forward mechanisms are described in more detail in Chapter 4 of this paper.
297. The airport could use straight line depreciation in disclosing its asset base and the impact of the change to the airport's time profile of capital recovery when setting prices would be captured in a carry forward mechanism rather than a non-standard depreciation methodology.
298. This is not our preferred solution as we are concerned that any carry forward amount may be perceived by the airport and other interested parties to have a different status to an adjustment to asset values.

#### *Issuing guidance around the existing Airport IMs Determination*

299. We also considered maintaining the status quo by not making changes to the Airport IMs and ID Determinations but issuing guidance around it to help steer airports when applying non-standard depreciation. In this solution, the principles we outline above would form the guidance rather than being amendments to the Airport IMs Determination.
300. We did not progress this alternative or consider in detail how practical and effective it would be. However during our April 2016 airports profitability workshop some stakeholders suggested that guidance may be more appropriate than amending the existing Airport IMs and ID Determinations on non-standard depreciation.

301. One rationale provided for this view is that our current proposed solution potentially creates a layer of complexity that would act as a deterrent against airports applying non-standard depreciation. We are keen to hear stakeholder's views on this.

**Restatement of asset values for Auckland Airport and other airports affected in future**

302. This section outlines Auckland Airport's concern with our proposed approach, and our proposed solution to that concern.
303. As identified in paragraph 228 to 231, under our proposed solution for asset revaluations, Auckland Airport would have to adjust past disclosures to reflect the moratorium. This will result in write-downs relative to the values that have been disclosed under information disclosure regulation.
304. Auckland Airport expressed some concern with the complexity and cost associated with re-disclosing historic RABs to reflect an un-indexed approach to revaluations. In particular, rather than a concern with the proposed solution in principle, the concern appeared to be around the practical implications of implementing our solution given the requirement under the Airport IMs to roll forward each asset individually. This would require a significant amount of effort from Auckland Airport to reconcile and roll forward over 60,000 assets using the revised approach.<sup>97</sup>
305. More generally, the issue arises because input methodologies require asset values to be rolled forward on an individual asset basis, rather than in aggregate.

*Proposed solution*

306. We propose to allow alternative methodologies with equivalent effect within the Airport IMs and ID Determinations. These alternative methodologies could only be applied in place of the current requirements to roll forward the asset base under the Airport Asset Valuation IMs.
307. The alternative methodology could be used when an airport makes a disclosure (either forward-looking or backward-looking) so long as it results in an equivalent overall valuation outcome to the application of the Airport Asset Valuation IMs and it does not detract from the purpose of Part 4.
308. In applying an alternative methodology, an airport would also have to comply with additional information disclosure requirements that would require an airport to:
- 308.1 identify any alternative methodology applied;
  - 308.2 identify where the alternative methodology has been applied in the disclosure;
  - 308.3 discuss the reasons for the alternative methodology;

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<sup>97</sup> Commerce Commission "Input methodologies review – Airports profitability assessment – Workshop 2 – Summary of views expressed" (16 June 2016), Attachment C, para 9.

308.4 provide evidence the methodology has equivalent effect (and does not detract from the part 4 purpose); and

308.5 provide appropriate certification (eg, senior management).

309. Airports would still be required under the Airports ID Determination to break down the RAB into the four asset categories of land; sealed surfaces; infrastructure and buildings; and vehicles, plant and equipment.

*Reasons for preferring this solution*

310. Consistent with our decision-making framework, we consider that the inclusion of alternative methodologies with equivalent effect could result in a reduction in complexity and compliance costs while still promoting the purpose of Part 4.

311. In addition, we do not require individual asset values when assessing airport profitability. When assessing airport profitability, on either a forward or backward-looking basis, we do not use any information beyond the RAB reported at an asset category level. We consider that the four asset categories provide sufficient transparency for the disaggregation of the RAB for interested persons.

312. We have considered whether this amendment could cause future problems due to insufficient transparency regarding the value of individual assets. While it has been useful to have this level of information in other sectors in order to easily account for the sale and purchase of regulated assets, such sales have not been material in the airport's sector. We invite you to provide your views on whether the lack of transparency of the value of individual assets could present concerns in the future.

*Other potential solutions to this problem*

313. An alternative solution to the problem facing Auckland Airport would be to provide a mechanism for a one-off adjustment to Auckland Airport's asset value. Such a mechanism would be more targeted towards the specific issue facing Auckland Airport, as opposed to the more general alternative methodologies with equivalent effect mechanism included in our proposed solution.
314. The specific mechanism that we could introduce would be a 'pseudo-asset' with a negative value, defined as being equal in value terms to the impact of unwinding the moratorium at Auckland Airport. The pseudo-asset could be depreciable or non-depreciable depending on the views of interested persons.<sup>98</sup>
315. One benefit of this approach is that the mechanism would be provided for by the Commission, rather than Airports having to consider and justify their own approach. However, we have favoured the proposed solution on the basis that it provides greater flexibility to Airports.
316. We therefore invite views on whether the proposed solution would result in more or less compliance and complexity costs for Auckland Airport than the introduction of a pseudo-asset.
317. The solution above would only allow for the aggregation of the asset base for revaluations. If we also wanted to allow for aggregation of the asset base for an airport applying a non-standard depreciation approach, we would also have to amend the Airport IMs Determination to allow for non-standard depreciation to be applied either on individual assets or on collections of assets.
318. These combined amendments are potentially more complex than allowing for flexibility through the use of alternative methodologies with equivalent effect. As such it is not our preferred solution at this time.

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<sup>98</sup> We have previously used pseudo assets in the asset valuation input methodologies for Transpower. How, pseudo assets work in the Transpower context is discussed in Commerce Commission "Input methodologies (Transpower) reasons paper" (22 December 2010), para 4.4.25 – 4.4.30.

## Chapter 6: Ex-post effects of risk allocation

### Purpose of this chapter

319. The purpose of this chapter is to explain our proposed solutions to the problem associated with the ex-post effects of risk allocation in the context of the profitability assessment of airports.
320. In this chapter we consider to what extent the opening investment value should be adjusted in order to appropriately reflect the ex-post effects of risk allocation.<sup>99</sup>
321. In the context of this chapter:
- 321.1 given that airports set prices in advance, airports and airlines use the term **risk** as a way to describe that actual out-turns can be different from forecasts. For example, when determining prices of the current pricing event, an airport forecasts demand of the next 5 years. The risk is that the actual demand disclosed ex-post can be higher (lower) from forecast demand resulting in higher (lower) ex-post returns than forecast; and
- 321.2 the term '**ex-post effects of risk allocation**' refers to decisions that were made in previous pricing periods by airports on how those risks should be allocated between airports and airlines. This is important in the context of the ex-ante profitability assessment, as the allocation of those risks can affect charges of the current pricing event.

### Structure of this chapter

322. This chapter begins with a section on the problem definition. We also use this section to explain the relevant context that we considered in determining our proposed solutions.
323. We then explain our proposed solutions and the reasons for our proposed solutions.

### Problem definition

324. This section explains the problem definition, including how it evolved through consultation, which included submissions and workshops. In this section we also explain the relevant context for our proposed solutions.

#### *Summary of problem definition*

325. The Airports ID Determination does not provide sufficient transparency for us and other interested persons to identify ex-post effects of risk allocation between airports and airlines made during previous price setting events.
326. This is problematic as it impacts our and other interested persons' ability to accurately assess if an airport is targeting excessive profits.

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<sup>99</sup> As discussed in Chapter 4, the opening investment value comprises the opening RAB and a carry forward mechanism to adjust the opening investment value.

*A forward-looking profitability indicator requires assumptions on the opening investment value*

327. As discussed in Chapter 4, we propose to include a forward-looking profitability indicator (**IRR**) in the Airports ID Determination for future price setting events. We consider the IRR to comprise:
- 327.1 forecast cash-flows over the duration of the pricing period;
  - 327.2 the opening investment value; and
  - 327.3 the forecast closing investment value.
328. We need to determine, in advance, the most appropriate assumptions regarding the opening investment value such that the IRR is the best reflection of an airport's pricing intent.
329. As explained in Chapter 4, in order to establish an **opening investment value** that is a good reflection of an airports' pricing intent and the initial capital to be recovered, we consider it should comprise:
- 329.1 the IM-compliant **closing RAB** from the ex-post disclosure of the year preceding the start of the current price setting event; and
  - 329.2 any **adjustments reflecting decisions made by airports** in previous price setting periods that have an impact on charges for the current pricing period. This is important in order to achieve consistency between the opening investment value and the forecast cash-flows that are used in a forward-looking IRR calculation.

*Ex-post effects of risk allocation are better addressed through adjustments to the opening investment value*

330. When undertaking the s 56G review, our default assumption for the opening investment value for our IRR calculation was the RAB disclosed in the previous historic annual disclosures. We then considered whether there were any adjustments that needed to be made to the RAB to reflect a specific airport's pricing intent.<sup>100</sup>
331. The starting point for the cash-flows in the IRR was the airport's estimate of future revenues and costs. In order to ensure that the cash-flows used in our IRR calculation were consistent with the implicit assumptions in the opening investment value we made adjustments to the airport's forecast cash-flows:
- 331.1 where we considered an airport had included within their revenue forecasts the return of over and under-recoveries that had occurred in previous price setting events; and

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<sup>100</sup> For example, we adjusted Auckland Airport's opening RAB in the IRR calculation to reflect the fact that it had not revalued its pricing assets since 2007.

- 331.2 where over and under-recoveries that had occurred in previous price setting events were already reflected in the opening RAB.
332. In the s 56G report for Wellington Airport, we discussed the concept of matching the cash-flows (or revenues) to the opening investment value.<sup>101</sup> If we recognised an un-forecast land revaluation gain in the opening investment value (ie, we assumed that the revaluation gain occurred in the previous pricing period), then any repayments of the gain throughout the PSE would have been backed out of target revenue.<sup>102</sup> However, if we used unadjusted target revenue to inform our cash-flows, we should back the revaluation gain out of the opening investment value.
333. We consider it is appropriate to assume that the airport's forecast cash-flows are the starting point for the cash-flows used in our IRR calculation. This is because we cannot predict the adjustments we may need to make to an airport's cash-flows in advance of prices being set.<sup>103</sup>
334. Consequently, for transparency reasons, we consider that ex-post effects of risk allocation are better addressed through adjustments to the opening investment value instead of changes to the forecast cash-flows.

*Risk allocation determines the impact of ex-post effects on the ex-ante profitability assessment of the current pricing period*

335. As discussed in the topic paper on the framework for the IM review, ideally, risks should be allocated to suppliers or consumers depending on who is best placed to manage the risk, unless doing so would be inconsistent with s 52A.<sup>104</sup> We refer to this approach as “default risk allocation” for the purposes of this chapter. NZAA and BARNZ agree with our approach regarding risk allocation.<sup>105, 106</sup>

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<sup>101</sup> Commerce Commission “Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport” (8 February 2013), paras F55 – F59.

<sup>102</sup> If an airport repays the value of any un-forecast revaluation gains to airlines, this results in a reduction in the total forecast revenue requirement for the relevant price setting event. By backing out the repayments, we increased the forecast revenue requirement to reflect the expected revenues that would have been required in the absence of any repayment of past un-forecast revaluation gains.

<sup>103</sup> For example, an airport's total forecast revenue can be made up of a number of adjustments for different reasons. We may not be able to identify what proportion of an un-forecast revaluation gain an airport intends to return over the current pricing period. Therefore we may not understand how an airport's cash-flows need to be adjusted in order to ensure that the cash-flows match the assumptions about the timing of revaluation gains implied by the opening investment value.

<sup>104</sup> Commerce Commission “Input methodologies review draft decisions: Framework for the IM review” (16 June 2016).

<sup>105</sup> NZ Airports “Airport profitability assessment post-workshop submission” (22 December 2015), para 21.

<sup>106</sup> BARNZ's post workshop submission on airports profitability assessment workshop 1 “Post profitability workshop comments” (21 December 2015), p. 2.

336. As also explained in the topic paper on the framework for the IM review, consideration of who is best placed to manage risks includes the ability to:<sup>107</sup>
- 336.1 control the probability of the occurrence;
  - 336.2 mitigate costs of occurrence; and
  - 336.3 absorb costs where they cannot be mitigated.
337. Where an airport has not identified any alternative risk allocations, the risk that actual out-turns are different from forecasts is assumed wholly by the airport.<sup>108</sup> That is, if actual out-turns are in favour of airports (eg, higher demand, lower costs) an airport's ex-post return will be higher than expected. Similarly, if actual out-turns disadvantage airports, an airport's ex-post return will be lower.
338. Accordingly, we consider that in those circumstances (ie, where the risk is wholly assumed by the airport), there is no reason to carry forward the impact of actual out-turns of the prior period being different to forecasts into the ex-ante profitability assessment of the current pricing period.
339. If airports assume all the risks and rewards associated with actuals being different from forecasts, the outcomes (with regards to airport profitability) may differ from those if markets were actually workably competitive (in particular, if actual revaluations are greater than forecast). However, sometimes outcomes different to those in a workably competitive market are the result of alternative risk allocations proposed by an airport as part of the consultation process.
340. At the airports profitability assessment workshop held on 1 December 2015, we discussed how the disclosure requirements could make the way risks have been allocated when airports set prices more transparent. We also discussed the possibility of including a carry forward mechanism between pricing periods within our IRR calculation in order to reflect decisions about risk allocation.<sup>109, 110</sup>

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<sup>107</sup> Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016).

<sup>108</sup> As explained further below, the exception to the above statement is any differences in forecast and actual inflation, where objective inflation forecasts have been used in setting prices.

<sup>109</sup> Commerce Commission "Airport profitability assessment workshop 1 – workshop papers" (18 December 2015), slide 30.

<sup>110</sup> In Chapter 4, we are proposing to include a carry forward mechanism in the Airports ID Determination. As we discuss in more detail in Chapter 4, the general purpose of this mechanism is to carry forward between pricing periods any over or under-recoveries that relate to past or future decision. In doing so, this mechanism will create further transparency in ID as it allows an airport to more accurately reflect its pricing decision.



341. NZAA submitted that there are sound reasons for expecting airports to be better placed than airlines and passengers to manage, mitigate or absorb the risk of unexpected variations in airport forecasts. For example, NZAA considered that airports are better placed to anticipate the extent of any variation in values and to take mitigating action as they are likely to have better information in relation to changes in resource costs.<sup>111</sup>
342. NZAA also noted that in rare occasions, pricing may be set on a basis that reflects a risk allocation that differs from the default risk allocation. NZAA's view is that it is only in those circumstances a carry forward between pricing periods reflecting over and under-recoveries may be appropriate.<sup>112</sup>
343. BARNZ argued that differences between forecasts and actuals should be carried forward into the next pricing period to the extent they reflect:<sup>113</sup>
- 343.1 un-forecast revaluation gains;
  - 343.2 timing differences of major capital expenditure;<sup>114</sup>
  - 343.3 any undertaking by an airport to wash-up a risk as recorded in the price setting event disclosures; and
  - 343.4 any risk where there was a material disagreement by a substantial volume of the airport's customers over the airport's adopted approach, where we consider it is appropriate to carry forward the difference.
344. We agree with NZAA that carry forward adjustments to the opening investment value should only be made where an approach to allocating risk is different to the default risk allocation. We took this principle into account when we determined our proposed solutions regarding the elements that should be captured in a carry forward adjustment.
345. For clarification, we do not immediately assume that any carry forward adjustment to the opening investment value will be reflected in the carry forward adjustment to the forecast closing investment value. The carry forward adjustment to the closing investment value will be based on the airport's stated intentions as described in the current price setting event. This is discussed further in Chapter 7.

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<sup>111</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 22.

<sup>112</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 24.

<sup>113</sup> BARNZ's post workshop submission on airports profitability assessment workshop 1 "Post profitability workshop comments" (21 December 2015), p. 2

<sup>114</sup> BARNZ suggests major capex should be defined as projects costing \$30 million or more.

### **Our proposed solution in respect of this problem**

346. This section explains our proposed solution in respect of this problem.

#### *Our proposed solution*

347. We do not propose any change to the Airport IMs Determination to address this problem. Instead, we propose amendments to the Airports ID Determination.
348. Our proposed solution in respect of the problem associated with the ex-post effects of risk allocation is to amend the Airports ID Determination in order to:
- 348.1 include un-forecast revaluation gains or losses (in real terms) in the carry forward adjustment to the opening investment value unless an alternative treatment has been proposed by airports;
  - 348.2 include other risk sharing arrangements in the carry forward adjustment to the opening investment value if these have been proposed in the airport's price setting event disclosure;
  - 348.3 require airports to provide information on the 'degree of acceptance' by airlines regarding those other risk sharing arrangements and to give interested persons, following the airports disclosures under information disclosure but prior to our summary and analysis, the opportunity to comment on airports' disclosures on allocation of risks; and
  - 348.4 require airports to provide information in the annual ex-post disclosures about variances between forecasts and actuals for the risk allocation arrangements that were included in their price setting event (as these will inform the carry forward adjustment to the opening investment value for the next price setting event).<sup>115</sup>
349. Our proposed solution will allow us and other interested persons to better assess if an airport is targeting excessive profits by creating transparency in information disclosure with regards to the ex-post effects of risk allocation on the current pricing event.
350. We explain our reasons in more detail in the remainder of this section.

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<sup>115</sup> We note any consequential changes affecting the ex-post Airports ID Determination will be considered as part of a follow-up project that is separate from the IM review and will be subject to a separate consultation process.

*Our proposal to include un-forecast revaluation gains or losses (in real terms) in the carry forward adjustment to the opening investment value*

351. As explained in Chapter 5, our proposed solution regarding asset revaluations requires airports to disclose forward and backward-looking costs on a consistent basis to the approaches used when setting prices. However, it limits airports in their approaches to revaluing assets to the use of either CPI-indexation or an un-indexed approach with the exception of land. Regarding land we continue to hold the view that airports can revalue it using an MVAU valuation methodology.<sup>116</sup>
352. Our Airport IM reasons paper states that any gains (or losses) that arise as a result of asset revaluations are to be treated as income (or losses) when we monitor prices.<sup>117</sup> This is important because actual revaluations may differ from forecast asset values assumed in the price setting event disclosures. We have considered how these differences should be reflected in the carry forward adjustment to the opening investment value.
353. The risk is that actual revaluations may vary from forecast to the degree that actual values increase at a rate greater to that assumed in the price setting event disclosures.
354. In determining whether un-forecast revaluation gains or losses (in real terms) should be included in the carry forward adjustment to the opening investment value of the current pricing period, we discuss the following three scenarios:
- 354.1 **Scenario 1:** An airport forecasts asset revaluations using CPI-indexation. During the previous pricing period, the airport did not revalue its land using a periodic MVAU valuation.<sup>118</sup>
- 354.2 **Scenario 2:** As above, but the airport revalued its land in the previous pricing period using a periodic MVAU valuation.
- 354.3 **Scenario 3:** An airport does not revalue its asset base at all.
355. In discussing these scenarios, we assumed that airports treat revaluation gains (or losses) as income for price setting purposes.<sup>119</sup>

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<sup>116</sup> Airports Information Disclosure Determination 2010 (Commerce Commission Decision 715, 22 December 2010), clause 3.7.

<sup>117</sup> Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010), para X21.

<sup>118</sup> As discussed in Chapter 5, we intend to include in the Airport IMs an approach to determining an unbiased CPI forecast. If an airport uses a CPI forecast that is different from our proposed approach to determining a CPI forecast, we would consider the implications in our summary and analysis.

<sup>119</sup> This is to ensure the FCM principle (NPV=0), as outlined in the topic paper on the framework for the IM review, is being met which means that suppliers have an opportunity to maintain financial capital maintenance in real terms. Christchurch Airport acknowledges the issue. Christchurch Airport argued that “un-forecast revaluation gains and losses should be booked as revenue, although we consider it is valid to apply this principle only to the real (ie, after CPI inflation) component of the revaluation gain or loss”. See Christchurch Airport, Untitled submission on the problem definition paper (21 August 2015), para 6.

*Our proposed solution in terms of scenario 1*

356. When an airport forecasts asset revaluations using CPI-indexation and did not revalue its land using a periodic MVAU valuation in the previous pricing period, we consider that no adjustment to the opening investment value of the current pricing period is required.
357. This is because when actual inflation is lower (higher) than forecast:
- 357.1 an airport's nominal revenues are unchanged, while its real revenues are higher (lower); but
- 357.2 this is offset by actual RAB revaluations being lower (higher) by an equal amount but in the opposite direction to the change in real revenues.

*Our proposed solution in terms of scenario 2*

358. When an airport forecasts asset revaluations using CPI-indexation and revalued its land using a periodic MVAU valuation in the previous pricing period, we consider that the opening investment value of the current pricing period should be adjusted for the un-forecast revaluation gain (or loss) that occurred in the previous pricing period as a result of the MVAU valuation.
359. In particular, we propose to adjust it for the amount calculated as the difference of actual land revaluations based on a periodic MVAU valuation and actual land revaluations based on actual CPI. For the same reasons as outlined under scenario 1, we do not consider that an adjustment for variances arising from actual CPI being different to forecast CPI is required.
360. In practice, provided the un-forecast revaluation (in real terms) is a gain, the un-forecast revaluation gain would be included as a negative amount in the carry forward adjustment to the opening investment value. This approach effectively reduces the opening investment value in order to offset the un-forecast revaluation gain that is already reflected in the opening RAB value of the current pricing event (comprising the closing RAB disclosed in the previous historic annual disclosures).

*Our proposed solution in terms of scenario 3*

361. When an airport does not revalue its asset base at all, we consider that the opening investment value of the current pricing period should be adjusted for the un-forecast revaluation gain (or loss) that has occurred as a result of actual revaluations. However, this adjustment would only apply if an airport:
- 361.1 decides for the current pricing period to move from an un-indexed approach to asset revaluations to an approach based on CPI-indexation; and
- 361.2 revalues its land using a periodic MVAU valuation.

362. We note that an airport that does not revalue its asset base exposes itself and its customers to inflation risk.<sup>120</sup> In order to protect itself and its customers from that risk, an airport can include variances arising from actual CPI being different to forecast CPI in the carry forward adjustment to the opening investment value in a way as explained under scenario 2.<sup>121, 122</sup>

*Reasons for including un-forecast revaluation gains or losses (in real terms) in the carry forward adjustment to the opening investment value*

363. Un-forecast revaluation gains would be reflected:
- 363.1 in our ex-post assessment of actual returns for the prior price setting event; and
  - 363.2 in our assessment of returns of the current price setting event if our assessment included prior price setting events or started from the initial RAB in 2010.
364. While an ex-post assessment of returns would always identify actual revaluation gains at the time when they are reflected in the disclosed RAB, airport stakeholders are of the view that the focus should be on the ex-ante assessment of profitability of the current pricing period, because they want to understand how these targeted returns compare to our estimate of cost of capital.<sup>123</sup>
365. The RAB at the start of the price setting period will already reflect any revaluation gains (or losses) that occurred during the previous pricing period. Including un-forecast revaluation gains (or losses) in the carry forward adjustment to the opening investment value in a way as explained above is aimed at ensuring that the impact of any un-forecast revaluation gains (or losses) that occurred during the previous pricing period:
- 365.1 is taken into account in the ex-ante profitability assessment of the current pricing period; and
  - 365.2 is appropriately treated as income.

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<sup>120</sup> Dr Lally's expert advice on the cost of debt, asset beta adjustments for GPBs, RAB indexation and inflation risk, and TAMRP "Review of further WACC issues" (report to the Commerce Commission, 22 May 2016), p. 41.

<sup>121</sup> We are seeking submissions on whether we should put in place a mechanism to adjust for Transpower's exposure to inflation risk because it does not index its RAB for inflation. However, we think in the context of the airport's information disclosure regime, a similar default adjustment to deal with Auckland Airport's asset moratorium is likely to be an unnecessary complication for our proposed solution. For more information on the mechanism considered for Transpower, please refer to: Commerce Commission "Input methodologies review draft decisions: Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016).

<sup>122</sup> As discussed in Chapter 5, we intend to include in the Airport IMs an approach to determining an unbiased CPI forecast. We would expect an airport to use this approach when determining the amount to be included in the carry forward adjustment to the opening investment value.

<sup>123</sup> Commerce Commission "Input methodologies review – Airports profitability assessment – Workshop 1 – Summary of views expressed" (18 December 2015), Attachment C, para 3 and 4.

366. In addition, this approach enhances transparency in the ex-ante profitability assessment by ensuring consistency with the concept of matching the forecast cash-flows with the opening investment value. No further adjustments to the forecast cash-flows are required as the impact of any revaluation gains or losses has already been accounted for in the opening investment value.
367. For clarification, not including the un-forecast revaluation gains (or losses) in the carry forward adjustment to the opening investment value would:
- 367.1 allow airports to justify cash-flows in future that do not recognise the un-forecast revaluation gain as income when setting prices;
- 367.2 would only recognise un-forecast revaluation gains (or losses) in the ex-post assessment of airport profitability; and
- 367.3 result in forecast cash-flows that may not be consistent with the opening investment value of the current pricing period.

*Alternative risk sharing arrangements proposed by the airports*

368. In the past, airports have included alternative risk allocation arrangements when setting prices and have provided details of these arrangements in their price setting event disclosures.<sup>124</sup> BARNZ submitted that any undertaking by an airport to wash-up a risk as recorded in a previous price setting event disclosure should also be included in the carry forward adjustment to the opening investment value.<sup>125</sup> We agree with BARNZ.
369. However, airlines might not agree with an airport's approach to risk allocation and no agreement between the parties is required before airports set prices.<sup>126</sup>
370. Also, as submitted by NZAA, airlines cannot enter into a contract, arrangement or arrive at an understanding with other airlines over the price at which they would acquire airport services.<sup>127</sup>
371. We consider that the proposed risk allocation arrangements identified in an airport's previous price setting event disclosure are the appropriate starting point when identifying other adjustments to include in the carry forward adjustment to the opening investment value.

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<sup>124</sup> For example, Wellington Airport proposed a 'wash-up' when setting prices in PSE1 that would return any over-recoveries associated with a delay in any capital expenditure associated with their new international terminal 'the Rock'.

<sup>125</sup> BARNZ's post workshop submission on airports profitability assessment workshop 1 "Post profitability workshop comments" (21 December 2015), p. 2.

<sup>126</sup> Airports are able to set prices as they see fit. Airports are required to consult with airlines when setting prices. The purpose of consultation is to ensure the views of interested persons are provided to airports so that those views can be taken into account as part of good decision making. For more information on how airports set prices see Chapter 2.

<sup>127</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 26 and 27.

372. Given that airports are not obliged to reach agreement with airlines when setting prices, we also consider it appropriate to understand the airlines' view of any proposed risk allocation arrangements. For the purpose of this chapter we use the term 'degree of acceptance' to reflect the extent to which airlines either objected to or accepted the proposed risk sharing arrangements during consultation.
373. We would want to collect additional information regarding the 'degree of acceptance' that existed between airports and airlines at the time of price setting.
374. During the s 56G review, the consultation material provided a clear indication of the 'degree of acceptance' of airlines on risk allocation issues. We do not currently require airports to disclose the consultation documents associated with price setting events. For the s 56G review, we requested these documents as additional information to support our analysis.
375. BARNZ submitted that the consultation documents provide a good record of the 'degree of acceptance' from airlines on an airport's approach regarding risk allocation.<sup>128</sup>
376. As the information on the 'degree of acceptance' is only relevant in the context of proposed alternative risk allocations, we do not consider it appropriate to require airports to provide all consultation documents under ID. However, we propose to require airports to provide information under ID on the 'degree of acceptance' from airlines on an airport's approach regarding risk allocation (but only in the event an airport has included a carry forward adjustment to the opening investment value reflecting alternate risk allocations under ID).
377. Interested persons will have the opportunity to comment on an airport's disclosures on allocation of risks following the airports disclosures under information disclosure, but prior to our summary and analysis.
378. This is important so that we can assess the 'degree of acceptance' of any proposed risk sharing arrangements by airlines. This approach would allow us to consider through summary and analysis whether there was any objection by a substantial volume of the airport's customers over the airport's adopted approach that could impact on our assessment of an airport's profitability.

*No requirement to adjust for timing differences of major capex expenditure*

379. We do not consider that we need to adjust the opening investment value for any timing differences of major capex expenditure from what was forecast unless it is proposed by airports at the time of their previous price setting event disclosure.
380. This is consistent with our approach for other regulated industries were we generally do not require making adjustments for differences in actual capex compared to forecast capex.

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<sup>128</sup> BARNZ's post workshop submission on airports profitability assessment workshop 1 "Post profitability workshop comments" (21 December 2015), p. 3.

381. We would still be able to discuss the impact and implications of any timing differences relating to major capital expenditure as part of summary and analysis.

*Summary and analysis*

382. The amount to be carried forward as an adjustment to the opening investment value is needed to inform the airport's next pricing decision.
383. Airports will determine the value of the carry forward at the time of price setting, but airlines might have a different view on whether the carry forward appropriately reflects the risk allocation arrangements set by the airports at the previous price setting event.
384. The determination of the appropriate carry forward is complicated by the need to calculate the amount before the pricing period ends, despite not having received all of the information required to inform this calculation. This is because airports are required to provide the annual ex-post disclosure for the last year of the previous pricing period 5 months after the new prices have come into effect.
385. We do not consider it appropriate for us to determine the value of the carry forward adjustment to the opening investment value to be used by airports in the next price setting event. Airports can set prices as they see fit and would not be obliged to use any carry forward calculated by us.
386. However, we consider we should comment on the appropriateness of the airport's method for calculating the carry forward adjustment in our summary and analysis.
387. We therefore propose to require airports to disclose in their annual historic information disclosure the variance between forecast and actuals to date for the risk allocation arrangements that were included in their price setting event (as these will inform the carry forward adjustment to the opening investment value for the next price setting event).
388. For example, if an airport had included a wash-up arrangement relating to a particular capex project when setting prices at the previous price setting event, the airport would be required:
- 388.1 to disclose the variances between forecast and actual expenditure for that project in its ex-post disclosures for each year of the pricing period; and
  - 388.2 to identify the outstanding value of the over recovery.
389. We can use these disclosed variances to consider whether the airports have determined the appropriate carry forward adjustment to the opening investment value when setting prices at the next price setting event. We can also take into account the disclosed variances when undertaking summary and analysis on the ex-post profitability assessment for airports.



390. With the relevant variances disclosed, we would be able to perform summary and analysis on these variances and consider whether the airport's disclosures appropriately reflect the risk allocation arrangements that were in place for the pricing period.
391. We would also be able to comment on the appropriateness of the disclosed variances being included in the carry forward adjustment to the opening investment value for the next price setting event. This would allow airports the opportunity to reflect our comments when determining the carry forward adjustment to the opening investment value used to set prices.

## Chapter 7: Treatment of forecast over and under-recoveries

### Purpose of this chapter

392. The purpose of this chapter is to explain our proposed solution to the problem associated with the treatment of forecast over and under-recoveries in the context of the profitability assessment of airports.
393. In this chapter we consider to what extent the forecast closing investment value as discussed in Chapter 4 should be adjusted in order to appropriately reflect forecast over and under-recoveries.<sup>129</sup>

### Structure of this chapter

394. This chapter begins with a section on the problem definition, before going on to explain our proposed solution to this problem.

### Problem definition

395. This section explains the problem definition, including how it evolved through consultation, which included submissions and workshops.

#### *Summary of problem definition*

396. There are insufficient transparency requirements in the Airports ID Determination for us and other interested persons to identify forecast over and under-recoveries resulting from an airport's pricing event that are intended to be offset in future pricing events.
397. This is problematic as it impacts our and other interested persons' ability to accurately assess if an airport is targeting excessive profits.

#### *A forward-looking profitability indicator requires assumptions on the forecast closing investment value*

398. As discussed in Chapter 4, we propose to include a forward-looking profitability indicator (IRR) in the Airports ID Determination for future price setting events. We consider the IRR to comprise:
- 398.1 forecast cash-flows over the duration of the pricing period;
  - 398.2 the opening investment value; and
  - 398.3 the forecast closing investment value.
399. We need to determine, in advance, the most appropriate assumptions regarding the forecast closing investment value such that the IRR is the best reflection of an airport's pricing intent.

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<sup>129</sup> As discussed in Chapter 4, the forecast closing investment value comprises the forecast closing asset base and a carry forward mechanism to adjust the forecast closing investment value.

400. As explained in Chapter 4, in order to establish a **forecast closing investment value** that is a good reflection of an airports' pricing intent and the remaining capital to be recovered, we consider it should comprise:

400.1 the **forecast closing asset base** used by airports when setting prices reflecting an airport's assumed time profile of capital recovery; and

400.2 any **adjustments reflecting decisions made by airports** that affect charges of the current and future price setting events that are not already reflected in the forecast closing asset base. This is important in order to derive a forecast closing investment value that is a good reflection of the remaining capital to be recovered.

*The forecast closing investment value should reflect the airport's expectation of the remaining capital to be recovered*

401. The forecast closing investment value is an important input assumption for the calculation of a forward-looking profitability indicator of the current pricing event as it should reflect an airport's expectation of the remaining capital to be recovered at the end of the current pricing period.

402. In this function, the forecast closing investment value should link the current pricing event together with subsequent pricing events enabling a profitability assessment across pricing events.

403. When assessing airports' targeted profitability for the s 56G review, we used our judgement to determine the appropriate value of the inputs to the IRR calculation.<sup>130</sup> We had to determine the forecast closing investment value in a way that it best reflected the airports' pricing intent and the remaining capital to be recovered.

404. For example, in order to assess targeted returns for Auckland Airport, we used forecast closing asset values reflecting Auckland Airport's non IM-compliant moratorium on asset valuations used when setting prices. This approach better reflected Auckland Airport's future pricing behaviour (ie, the remaining capital to be recovered) as Auckland Airport had stated it had no intention of revaluing its asset base for the following pricing event.<sup>131</sup>

405. However, Auckland Airport also indicated it may unwind the moratorium in a future pricing event and inquired about IM-consistent approaches to addressing this intention.<sup>132</sup>

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<sup>130</sup> In our assessment of how effectively information disclosure is promoting the Part 4 purpose we examined the performance and conduct of airports. See, for example: Commerce Commission "Final 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), para 2.52.

<sup>131</sup> Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), Attachment F, para F29-31.

<sup>132</sup> Commerce Commission "Input methodologies review – Airports profitability assessment – Workshop 2 – Summary of views expressed" (16 June 2016), Attachment C, para 10.

406. If Auckland Airport expected to unwind the asset moratorium in a subsequent pricing event, the forecast closing investment value for the calculation of an IRR of the current pricing event should be based on asset values reflecting Auckland Airport's likely future pricing behaviour.
407. This approach would result in assessed targeted returns of the current pricing event being higher due to an increased forecast closing investment value reflecting higher asset values unless it is adjusted for Auckland Airport's intention to also pass on the revaluation gain to airlines.
408. This is of importance as Auckland Airport has noted several times that if the moratorium is unwound in the future, and a revalued asset base is used in pricing, the cumulative impact will be treated as an offset to the future revenue requirements to make sure the FCM principle is being followed.<sup>133</sup>
409. The current Airports ID Determination does not provide sufficient transparency for us and interested persons to identify such expected or intended over- (and under) recoveries of airports that are intended to be offset in future pricing events.
410. We consider this problematic as it impacts us and other interested persons to accurately assess if an airport is targeting excessive profits.

#### **Our proposed solution in respect of this problem**

411. This section explains our proposed solution in respect of this problem.

#### *Our proposed solution*

412. We do not propose any amendment to the Airport IMs Determination at this stage. Instead, we propose that airports can use the carry forward mechanism proposed in Chapter 4 to adjust the forecast closing investment value in a way that it reflects forecast over and under-recoveries that are intended by airports to be offset in future pricing events.
413. In addition, we propose the following amendments to the Airports ID Determination.<sup>134</sup>
- 413.1 Require airports to provide information on the 'degree of acceptance' by airlines regarding those forecast over and under-recoveries included in the carry forward mechanism. We would give interested persons, following the airports disclosures under information disclosure but prior to our summary and analysis, the opportunity to comment on the airports' disclosures; and

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<sup>133</sup> See, for example: Auckland Airport "Problem definition for input methodologies review: submission to Commerce Commission" (21 August 2015), para 72.

<sup>134</sup> Under s 52Q of the Act.

- 413.2 Require airports to provide information on the purpose and the appropriateness of including those forecast over and under-recoveries in the carry forward mechanism. This must comprise an explanation of why the resulting forecast closing investment value is a good indicator of the remaining capital to be recovered at the end of the current pricing period.
414. This is our proposed solution because it creates transparency around targeted profitability of airports and improves our and other interested persons' ability to assess if airports are targeting excessive profits. This is achieved by:
- 414.1 better reflecting an airport's pricing intent in information disclosure; and
- 414.2 being able to take into account multiple pricing periods in the profitability assessment (ie, the carry forward mechanism to adjust the forecast closing investment value links the current pricing event together with subsequent pricing events).
415. In addition, our proposed solution:
- 415.1 clearly identifies where airports have decided to under or over-recover in a pricing event (but with the intent to offset this over or under-recovery in future pricing events). This enables us to comment on the reasonableness of the proposed carry forward in our summary and analysis (eg, if the FCM principle is being met in the longer term); and
- 415.2 does not impact on airports' ability to set prices as they see fit, as it only creates greater transparency around decisions made by airports when setting prices.
416. We have identified a few circumstances where forecast over or under-recoveries that are intended to be offset by airports in future pricing events can be included in the carry forward mechanism. Further guidance on what these circumstances are is provided later in this chapter.
417. However, an additional benefit of using the carry forward mechanism to adjust the forecast closing investment value is that it removes the requirement for us to determine up front how other yet un-identified issues are to be considered. We expect this contributes to future-proofing the Airports ID Determination further.

*A carry forward to adjust the forecast closing investment value forms the basis of the carry forward adjustment to the opening investment value of the next pricing event*

418. We would expect the carry forward adjustment to the opening investment value for the next pricing period (discussed in the previous chapter) to include adjustments made by an airport at the previous price setting event that effect the airport's expected recovery in future price setting events.

419. Our proposed solution would allow us and other interested persons to identify whether this has been done. This is because an adjustment to the forecast closing investment value of the previous pricing event would be the starting point when determining any adjustments to the opening investment value of the current pricing event.
420. For clarification, when the carry forward to adjust the forecast closing investment value is used as an input to the opening carry forward of the next pricing event, our view is that it should not be adjusted for any differences between forecast assumptions and actuals that have occurred in previous pricing periods unless such adjustments were signalled at the time the forecast carry forward was set.

*Stakeholders consider a carry forward should only occur in limited and pre-defined circumstances*

421. The purpose of the airports workshop in December 2015 was to seek key stakeholders' views on how airports profitability assessments could be performed. One of the objectives was to understand key stakeholders' views on the options for assessing airports profitability.<sup>135</sup>
422. At the workshop, there was general support to include some form of carry forward mechanism between the pricing periods and for the carry forward to include, at a minimum, those amounts that were agreed to be carried forward by parties during consultation of the pricing event.<sup>136</sup>
423. In submissions to the workshop, NZAA and BARNZ were still supportive of the introduction of a carry forward mechanism and both parties similarly considered that carry forwards between pricing events should only occur in limited and pre-defined circumstances.<sup>137, 138</sup>

*Circumstances where a carry forward mechanism to adjust the forecast closing investment value can be used*

424. We have discussed with stakeholders at the workshop held in April 2016 circumstances where the proposed carry forward mechanism as an adjustment to the forecast closing investment value can be used. In particular, we consider that a carry forward can be used to address the discrete issues listed below.
425. **Auckland Airport unwinding its asset moratorium:** As discussed earlier in this chapter, a carry forward mechanism could be used to reflect a situation where Auckland Airport intends to unwind its asset moratorium over more than one pricing period.

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<sup>135</sup> Commerce Commission "Input methodologies review – airports profitability assessment – Workshop 1 – Summary of views expressed" (18 December 2015), para 2 and 3.

<sup>136</sup> Commerce Commission "Input methodologies review – airports profitability assessment – Workshop 1 – Summary of views expressed" (18 December 2015), Attachment C, para 11 - 13.

<sup>137</sup> BARNZ's post workshop submission on airports profitability assessment workshop 1 "Post profitability workshop comments" (21 December 2015), p. 1.

<sup>138</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 17.

426. **Commercial concessions:** As discussed in Chapter 11, commercial concessions are commercial decisions made by the airport to under-recover revenue. Airports could include a commercial concession in the carry forward mechanism to adjust the forecast closing investment value if airports specifically state in their price setting event disclosures that they intend to recover the concession in future pricing events.
427. **Assets held for future use:** As explained in Chapter 8, assets held for future use are excluded from the RAB value (and from associated disclosed profitability measures) until they are used in the supply of specified airport services as specified in the Airport IMs.<sup>139</sup> Airports can expect to be able to earn a full return on and of the costs of holding and developing these assets, without profits appearing excessive, provided they are eventually commissioned for use to supply airport services.<sup>140</sup>
428. An airport may include revenues associated with assets held for future use at a future price setting event. If this happens, in order to create transparency around these early over-recoveries, an airport could use the proposed carry forward mechanism to adjust the forecast closing investment value provided that it intends to offset these over-recoveries in a later period.
429. In order to avoid double counting of revenues associated with assets held for future use in the profitability assessment, we would expect an airport not to include it in the carry forward mechanism if it has already been captured by the other solution proposed in Chapter 8 (ie, as an offset to the value of the assets held for future use balance).
430. This is of particular importance for Auckland Airport, as Auckland Airport might include additional revenues associated with the planned second runway for its third price setting event in 2017. This would result in the assessment of higher returns in the short term unless Auckland Airport adjusts the forecast closing investment value by an amount reflecting these additional revenues (but taking into account the time value of money).<sup>141</sup> This approach would signal Auckland Airport's intention to return the value of any identified over-recoveries in future pricing events.

*'Degree of acceptance' by airlines on proposed carry forwards by airports*

431. Consistent with our proposed solution regarding the ex-post assessment of risk, we propose to include a requirement in the Airports ID Determination for airports to disclose their understanding of the 'degree of acceptance' that was achieved between airlines and airports during pricing consultations on proposals made by airports.<sup>142</sup>

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<sup>139</sup> Commerce Act (*Specified Airport Services Input Methodologies*) Determination 2010 (Commerce Commission Decision 709, 22 December 2010), clause 3.1.

<sup>140</sup> Commerce Commission "Input methodologies (Airport Services) reasons paper" (22 December 2010), para 4.3.74.

<sup>141</sup> For clarification, this would only result in the assessment of excessive profits if Auckland Airport chooses not to offset those additional revenues against its land held for future use balance.

<sup>142</sup> In Chapter 6, we use the term 'degree of acceptance' to reflect the extent to which airlines either objected to or accepted the proposed risk sharing arrangements during consultation. We are using the

432. This disclosure requirement regarding the 'degree of acceptance' would apply in the event airports include carry forwards as adjustments to the forecast closing investment value in their price setting event disclosures.
433. This is important so that we can assess the 'degree of acceptance' of any proposed carry forwards that are aimed at adjusting the forecast closing investment value. This approach would allow us to consider through summary and analysis whether there was any objection by a substantial volume of the airport's customers over the airport's adopted approach that might impact on our assessment of an airport's profitability.
434. We intend giving interested persons the opportunity, after the airports' price setting disclosures under information disclosure, but prior to our summary and analysis, to comment on these disclosures.
435. In our view, the benefits arising from enhanced transparency in the price setting event disclosures outweigh the cost of the increased disclosure requirements particularly in the light of airports intent that carry forwards "will be the exception rather than the norm".<sup>143</sup>

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same expression for the purpose of this chapter. We provide more information on this matter in the Chapter 6.

<sup>143</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 45.



## Chapter 8: Assets held for future use

### Purpose of this chapter

436. The purpose of this chapter is to explain our proposed solution to the problem associated with the treatment of assets held for future use in the context of the profitability assessment of airports.

### Structure of this chapter

437. This chapter begins with a section on the problem definition, before going on to explain our proposed solution to this problem. The chapter finishes with a discussion of alternative solutions that we considered.

### Problem definition

438. This section explains the problem definition, including how it evolved through consultation, which included submissions and workshops.

### *Summary of problem definition*

439. Our current Airport IMs and ID Determinations requirements mean that it may become difficult to assess the impact revenues associated with assets held for future use have on the expected profitability of regulated airport services. The current Airport IMs and ID Determinations may not provide adequate transparency if airports were to include revenues associated with assets held for future use at a future price setting event. This, in turn, can make it difficult for interested persons to assess airports profitability.

### *Current requirements for assets held for future use in information disclosure*

440. Assets held for future use (also referred to as excluded assets, land held for future use, and future development land) are excluded from the RAB value (and from associated disclosed profitability measures) until they are used in the supply of specified airport services as specified in the Airport IMs.<sup>144, 145</sup>

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<sup>144</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010* (Commerce Commission Decision 709, 22 December 2010), clause 3.1 and definition of “excluded assets”.

<sup>145</sup> Airports can expect to be able to earn a full return on and of the costs of holding and developing this land without profits appearing excessive, provided it is eventually commissioned for use to supply airport services (Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010), para 4.3.74).

441. The treatment in the IMs of assets held for future use, in particular future development land, recognises the indirect incentives that the treatment might create under information disclosure regulation. Airports should not have an incentive to acquire land imprudently, nor to hold land indefinitely without developing it. Requiring that land is being used before it enters the RAB places the risk of ultimate non-development on the airports (ie, profits will appear excessive if airports attempt to earn a return on the value of the land before it is developed in order to supply specified airport services).<sup>146</sup>
442. Given that airports are best placed to manage this risk, it is reasonable that they are the ones that are required to bear it. Under this treatment there is a possibility that airports might attempt to commission new capacity imprudently or in advance of the time that they otherwise would have.<sup>147</sup> Information disclosure is intended to limit the incentives to attempt this, because interested persons should have sufficient information to be able to assess whether or not such an attempt has been made.
443. The Airports ID Determination requires that the value of assets held for future use is tracked over time on an ex-post basis.<sup>148</sup> The Airport IMs establish that the value of assets held for future use comprises the base value, accumulated holding costs and revaluations, but is net of net revenue generated from the assets not otherwise reported under ID.<sup>149</sup> The relevant value will enter the RAB when the assets become used in the supply of specified airport services.
444. As we explain later in this section however, the current requirements and the information currently disclosed by airports to us may be insufficient for interested persons to understand the impact on profitability if an airport includes charges for assets held for future use in its price setting event and respective disclosures.

*Charging for assets held for future use before they are used to supply regulated services*

445. The treatment of assets held for future use is of particular concern for Auckland Airport as the airport currently holds a significant amount of land for its planned second runway.<sup>150</sup> Auckland Airport has indicated a concern that there are likely to be price shocks at the time when the second runway is completed and is included in the RAB.<sup>151</sup>

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<sup>146</sup> That said, the risks are modest under an information disclosure regime, not least because land could potentially be sold—given that it has a value in an alternative use— and any residual risk relates to holding and development cost.

<sup>147</sup> Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010), para 4.3.77.

<sup>148</sup> This information is disclosed to us under section 2.3 (Annual Disclosure Relating to Financial Information) and Schedule 4 (Report on Regulatory Asset Base Roll Forward) of the ID Determination.

<sup>149</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010* (Commerce Commission Decision 709, 22 December 2010), clause 3.11.

<sup>150</sup> Auckland submitted that the “northern runway capex has not yet been costed, but could conceivably be in the order of \$600m” (Auckland Airport “Problem definition for input methodologies review: submission to Commerce Commission” (21 August 2015), para 44(b).

<sup>151</sup> Auckland Airport “Problem definition for input methodologies review: submission to Commerce Commission” (21 August 2015), para 44 and 45.

446. When setting prices for the price setting event in 2007, which came into effect prior to the Part 4 regime, Auckland Airport included charges associated with assets held for its second runway. However, for its second price setting event (2012), Auckland Airport set prices in a manner consistent with the Airport IMs by excluding its assets held for future use from the asset base used to set prices and from airport charges.
447. When setting prices for its third price setting event in 2017, Auckland Airport is considering including additional revenues associated with the planned second runway. This would result in higher revenues in the short term with the expectation of lower revenues at the time the assets held for future use are included in the RAB.<sup>152</sup> In particular, Auckland Airport submitted that:

Although the current IM and ID regimes provide transparency regarding the costs of land for future use, the problem is there is no clarity today on how transparency should be enabled and profitability assessed in the event that an airport were to smooth prices in advance of commissioning an asset held for future use. One potential price-smoothing alternative has been considered by Auckland Airport and is summarised briefly as follows: (a) Auckland Airport believes that the value of land held for future use could be monitored through ID showing the holding costs and net income attributed to that land. (b) An interim levy could be introduced and the net income attributable to the land held for future use would be deducted from the original value of, and the holding costs associated with, that land.<sup>153</sup>

448. Airports can set prices as they see fit, and therefore future prices might include revenues related to assets held for future use. We consider that there are two likely scenarios that an airport might consider when including charges associated with assets held for future use in future airport price settings, which affects the understanding of interested persons:
- 448.1 **Scenario 1:** An airport sets prices so that the additional revenues associated with assets held for future use can be identified and offset against the value of assets held for future use (eg, through a special levy).
- 448.2 **Scenario 2:** An airport increases prices in a way that does not distinguish between revenues on the RAB and revenues relating to assets held for future use.

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<sup>152</sup> In this instance, higher or lower revenues refers to revenues being different from those revenues that are required by an airport to support its target revenue excluding charges for land held for future use.

<sup>153</sup> Auckland Airport "Problem definition for input methodologies review: submission to Commerce Commission" (21 August 2015), para 50 and 51.

## Our proposed solution in respect of this problem

449. This section explains our proposed solution in respect of this problem.

### *Our proposed solution*

450. Our proposed solution involves both IM and ID amendments.

#### IM amendments

451. We do not propose any change regarding the treatment of assets held for future use. We consider that assets held for future use should remain outside of the RAB until they are used to provide specified airport services.<sup>154</sup> This is further explained under “Assessment of alternative solutions to this problem”.

452. However, consistent with our framework for the IM review, we propose an amendment to the definition of “net revenue” in the IMs, to make it clearer that (as intended) revenues derived from, or associated with, assets held for future use are captured by that definition.

#### ID amendments

453. We propose amendments to the Airports ID Determination to increase the transparency relating to revenues associated with assets held for future use. In this regard, our proposed solution to the problem associated with assets held for future use addresses the two scenarios discussed earlier.

454. **To address scenario 1** (ie, where an airport chooses to price in a way that revenues associated with assets held for future use **can be separated** from revenues associated with the RAB), we propose amending the ID requirements to include the revenue from, or associated with, assets held for future use on a forecast basis (eg, the special levy) and the value of assets held for future use on a forecast basis in the disclosure requirements under clause 2.5 of the Airports ID Determination.

455. Under this scenario:

455.1 we would expect that airports offset these forecast revenues against the forecast value of the assets held for future use according to the formula described in clause 3.11(2) of the Airport IMs;<sup>155</sup> and

455.2 airports would be required to provide information on the rationale for including revenues associated with assets held for future use for the price setting event.

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<sup>154</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010*, clause 3.1.

<sup>155</sup> In order to minimise complexity and compliance costs for airports, we would expect an airport to only provide the value of assets held for future use on a forecast basis in ID in the event it has included revenues associated with assets held for future use in the price setting event and wants to make use of the formula described in clause 3.11(2) of the Airport IMs.

456. **To address scenario 2** (ie, where an airport chooses to set prices in a way that revenues associated with assets held for future use **cannot be separated** from revenues associated with the RAB), we propose:
- 456.1 that airports use the carry forward mechanism as described in Chapter 7 to identify the value of upfront recoveries associated with assets held for future use that an airport intends to return to airlines in future; and
- 456.2 consistent with the information disclosure requirements under scenario 1, airports would be required to provide information on the rationale for including revenues associated with assets held for future use for the price setting event.
457. In order to ensure consistency between the price setting event and ex-post disclosures, we would expect an airport to use in its ex-post disclosures the approach to treating revenues associated with assets held for future use selected in its price setting event disclosures.<sup>156</sup> However, any consequential changes affecting the ex-post Airports ID Determination will be considered as part of a follow-up project that is separate from the IM review and will be subject to a separate consultation process.

### Summary

458. In summary, our proposed solution will allow us and other interested persons to better assess if airports are targeting excessive profits.
459. We explain the reasons for our proposed solutions in more detail in the remainder of this section.

### *Revenues derived from assets held for future use*

460. As explained in the Airport IMs Reasons paper:<sup>157</sup>

Even though holding future development land forms part of the regulated services, it does not follow that the Commission must set an IM for the valuation of assets that treats future development land in the same manner as land currently in use.

461. The reasoning above has been endorsed by the High Court.<sup>158</sup>

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<sup>156</sup> For example, if an airport cannot separate revenues associated with land held for future use in its price setting event disclosures, ex-post profitability assessment would have to take into account all revenues (eg, including revenues associated with land held for future use).

<sup>157</sup> Commerce Commission "Input methodologies (Airport Services) reasons paper" (22 December 2010), para 4.3.79.

<sup>158</sup> *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, para 905 - 908.

462. The value of assets held for future use must be disclosed to us in Schedule 4 of the ID Determination. The value of assets held for future use is determined under clause 3.11 of the Airport IMs as follows:<sup>159</sup>

*base value + holding costs – net revenue<sup>160</sup> – tracking revaluations*

463. As it can be seen, the net revenues derived from assets held for future use must be deducted from the value of those assets for disclosure purposes.

464. As explained in the Airport IMs Reasons paper:<sup>161</sup>

To provide transparency around the value of the future development land, and thus allow interested parties to make assessments as to whether the Part 4 purpose is being met, it is necessary to identify holding costs, and other factors such as net revenue and revaluations, separately from the initial land value. This is provided for in the formula set out in clause 3.11 of the IM Determination. This treatment is supported by submissions received on this topic. (Emphasis added)

465. As explained in the ID reasons paper:<sup>162</sup>

The ID Determination requires that in disclosure periods prior to the earlier of the land's commissioning or the commencement of the associated works under construction, Airports must separately disclose the following information concerning the cost of holding the land:

- the 'initial value' of the land;
- the accumulated value of holding costs;
- any accumulated income generated from the land, net of associated operating costs; and
- accumulated gains or losses from revaluations. (Emphasis added)

466. We continue to hold the view that the net revenues derived from assets held for future use must be deducted from the value of those assets, and we have not received any evidence to suggest otherwise. We are proposing an amendment to the definition of "net revenue" in clause 3.11(6)(c) of the Airport IMs to make our policy intent clearer.

#### *Reasons for including forecast value and revenues of assets held for future use in the Airports ID Determination*

467. As discussed earlier in this chapter, Auckland Airport has indicated that it may consider using a special levy in future price setting events to increase revenue in the short term and reduce possible price shocks in future.

<sup>159</sup> Airports Information Disclosure Determination 2010 (Commerce Commission Decision 715, 22 December 2010), definition of "assets held for future use".

<sup>160</sup> (c) 'net revenue' means the sum of amounts, other than those included in regulatory income under an **ID determination** or preceding regulatory information disclosure requirements, for all **disclosure years** derived from holding the **excluded asset**, where the amount derived from holding the **excluded asset** in the **disclosure year** in question is determined in accordance with the formula-  
revenue derived from the **excluded asset** (other than tracking revaluations) - **operating costs** incurred in relation to the **excluded asset** (*Commerce Act (Specified Airport Services Input Methodologies) Determination 2010*, clause 3.11)

<sup>161</sup> Commerce Commission "Input methodologies (Airport Services) reasons paper" (22 December 2010), para C3.9.

<sup>162</sup> Commerce Commission "Information disclosure (Airport Services) reasons paper" (22 December 2010), para 3.139.

468. Auckland Airport (and other airports) can make use of the existing clause 3.11 of the Airport IMs to offset net revenues associated with a special levy from the value of the assets held for future use.
469. This is our proposed solution because, where an airport chooses to price in a way that revenues associated with assets held for future use can be separated:
- 469.1 it creates transparency as it allows us and other interested persons to assess an airport's profitability taking into account revenues associated with its RAB only;
- 469.2 there would be no immediate expectation of excessive profits resulting from a special levy (assuming an appropriate return is targeted on the assets included in the RAB); and
- 469.3 it provides for a mechanism that can minimise the price shock when the asset enters the RAB upon commissioning (as at that time the carrying value of the assets held for future use would be net of any associated net revenues).
470. However, as discussed earlier in this chapter, information related to assets held for future use is currently only disclosed on an ex-post basis. This information does not allow interested persons to understand the impact on ex-ante profitability if an airport includes charges for assets held for future use in its price setting events.
471. Therefore, we propose amendments to the Airports ID Determination so that airports disclose the value of, and revenue from or associated with, assets held for future use on a forecast basis.

*Reasons for allowing airports to use the carry forward mechanism*

472. Given that airports have the ability to price as they see fit, future prices might be set in a way that does not allow us and other interested persons to identify what portion of revenue relates to the underlying RAB and what portion relates to assets held for future use.
473. If an airport increased revenues but included no other adjustments for assets held for future use, the higher revenues suggests that there may be excessive profits. This is because all revenues would be included within regulatory income if the airport did not separately identify revenues associated with assets held for future use.
474. However, we would expect that if an airport were to increase forecast revenues, it would do so in a way that does not immediately suggest that there may be excessive profits.

475. An airport could use the carry forward mechanism as described in Chapter 7 as an adjustment to reflect the upfront recoveries related to revenues from its assets held for future use. This would signal its intention to return the value of any upfront recoveries related to revenues from its assets held for future use identified at the end of the pricing period to airlines in future pricing periods.<sup>163</sup>
476. If an airport chooses to price in a way that revenues associated with assets held for future use cannot be separated from revenues associated with the RAB, allowing airports to use the carry forward mechanisms is our preferred solution because:
- 476.1 it creates transparency as it allows us and other interested persons to assess an airport's profitability taking into account revenues associated with its RAB only (as the carry forward adjusts for the impact of the revenues associated with assets held for future use from the profitability assessment);
- 476.2 there would be no immediate expectation of excessive profits resulting from upfront recoveries related to revenues from its assets held for future use (assuming an appropriate return is targeted on the assets included in the RAB); and
- 476.3 it provides for a mechanism that can minimise the price shock when the asset enters the RAB upon commissioning (as the value captured in the carry forward would offset the increase in the opening RAB).

#### *Summary and analysis*

477. Although we consider that revenues associated with assets held for future use are not part of regulatory income, in our summary and analysis of the price setting event disclosures, we would test the impact of those revenues on the airports' profitability based on the RAB.
478. Our proposed solution under scenario 1 and 2 ensures that sufficient information is provided for us and other interested persons to undertake such a sensitivity analysis. This is because of the following reasons:
- 478.1 **Scenario 1:** Where an airport chooses to price in a way that revenues associated with assets held for future use **can be separated** from revenues associated with the RAB, us and other interested persons would be able to identify the forecast revenue collected on assets held for future use.
- 478.2 **Scenario 2:** Where an airport chooses to price in a way that revenues associated with assets held for future use **cannot be separated** from revenues associated with the RAB, us and other interested persons would also be able to identify the change in the carry forward balance that is a result of forecast revenue collected on assets held for future use.

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<sup>163</sup> The airports would have to do this in a way that the value included in the carry forward would equate to the present value of future reductions in revenues that would be expected to occur once the land held for future use is commissioned.



479. Given that our proposed solution provides sufficient transparency to test the impact of revenues collected on assets held for future use on the airports' profitability based on the RAB, we do not consider that the Airports ID Determination has to be amended to include a separate IRR for the RAB that would also take into account revenues collected on assets held for future use.<sup>164</sup>
480. We would also be able to comment, through summary and analysis, on the concept of earning revenues on assets excluded from the RAB. In particular, we will be able:
- 480.1 to keep track of these early revenues and to assess the extent to which an airport has returned them to airlines; and
  - 480.2 in the long-term, to assess if an airport's approach to charging for assets held for future use is NPV-neutral.
481. We also want to collect information on the rationale underpinning why an airport has included revenues associated with assets held for future use for the price setting event. Requiring airports to provide this additional information in the price setting event disclosure requirements will allow us to comment on the appropriateness of the approach in our summary and analysis.

#### **Assessment of alternative solutions to this problem**

482. This section explains our assessment of alternative solutions that we considered.
483. Aside from our proposed solutions, the other two options we considered as alternative solutions to this problem were:
- 483.1 amending the Airport IMs in order to allow for assets held for future use to be recognised in the RAB before they are used to provide specified airport services; and
  - 483.2 making use of the provision for non-standard depreciation that is already allowed for by the Airport IMs.

#### *Alternative solution 1 – Amending the Airport IMs in order to allow for assets held for future use to be recognised in the RAB before it is used to provide specified airport services*

484. When we set the Airport IMs in 2010 we decided that assets held for future use should not be included in the RAB.<sup>165</sup>
485. As noted above, at that time we indicated that our decision to exclude assets held for future use from the RAB was based on the incentives that the treatment of assets held for future use would likely create under information disclosure regulation.

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<sup>164</sup> 'Separate' means in addition to the proposed IRR as discussed in Chapter 4 (ie, based on the RAB and taking into account all revenues associated with the RAB).

<sup>165</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010*, clause 3.1.

486. We noted that if assets held for future use were included in the RAB before it was used for specified airport services, there would be little incentive for airports to avoid investment in assets they own but do not use and would provide greater incentive to invest in assets speculatively.<sup>166</sup>
487. In addition, requiring that an asset is used before it enters the RAB was consistent with our general approach to risk allocation as it ensures that the disclosure of returns is consistent with the risk of non-development being managed by airports because they are best placed to manage that particular risk.
488. To date, we have not received any new information that would support a change in the Airport IMs relating to assets held for future use. We consider that our original decision and its reasoning, as outlined in the 2010 reasons paper, is still valid.<sup>167</sup> Furthermore, our approach has been endorsed by the High Court.<sup>168</sup>

*Alternative solution 2 – Making use of the provision for non-standard depreciation that is already allowed for by the Airport IMs*

489. If an airport wanted to include revenues related to assets held for future use, it could potentially make use of the provision for non-standard depreciation that is already allowed for by the Airport IMs, given there are limited restrictions on the current application of this provision.
490. In this case, the airport could accelerate the depreciation on its current RAB with the expectation that the value of the RAB would be increased at a future date by the introduction of assets held for future use once they were commissioned.
491. The Airport IMs specify that a straight line depreciation method must be applied as the standard depreciation profile, but provide for flexibility under certain circumstances by allowing airports to use a non-standard depreciation methodology. In doing so, airports are required to explain the reasoning for their divergence from the default straight line depreciation assumption.<sup>169</sup>
492. By increasing the rate of depreciation on the current RAB, the airport would be able to increase revenues in the short term without necessarily giving rise to an expectation of excessive profits.

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<sup>166</sup> Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010), para 4.3.78.

<sup>167</sup> Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010), para 4.3.77.

<sup>168</sup> *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, para 904 - 921.

<sup>169</sup> The IM Reasons Paper outlines how Airports may use a non-standard depreciation method (Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010), Appendices C11 and C12).

493. Additional information relating to non-standard depreciation is provided in Chapter 5. As discussed in that chapter, we propose to set principles describing when we would consider the use of non-standard depreciation to be appropriate. In particular, we are making clear that “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”.
494. In case of land held for future use, we also note that land is not depreciated under the Airport IMs so using a non-standard depreciation methodology for fixed assets to resolve a land related issue seems to be an artificial justification.<sup>170</sup> We do not consider the use of non-standard depreciation would provide transparency to interested persons about an airport’s pricing intent.

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<sup>170</sup> No depreciation is to be applied to land and easements (other than fixed life easements) (Commerce Commission “Input methodologies (Airport Services) reasons paper” (22 December 2010), Appendix C11.2).

## Chapter 9: Pricing assets

### Purpose of this chapter

495. The purpose of this chapter is to explain our proposed solutions to the problem associated with the treatment of pricing assets in the Airports ID Determination.
496. This problem has previously been referred to by us and submitters in this consultation process as relating to the treatment of leased assets.<sup>171</sup> Following discussions at the workshop held in April 2016, we have clarified that the problem definition is more accurately described as the treatment of pricing assets in the Airports ID Determination.<sup>172</sup>
497. For the purpose of this chapter, we define pricing assets as the asset base airports use to set prices and explain how transparency can be created in information disclosure with regard to targeted returns based on these assets.

### Structure of this chapter

498. This chapter begins with a section on the problem definition, before going on to explain our proposed solution to this problem.

### Problem definition

499. This section explains the problem definition, including how it evolved through consultation, which included submissions and workshops.

#### *Summary of problem definition*

500. Airports have been excluding certain asset values from the pricing assets that are, however, activities that are included in the definition of “specified airport services” in s 56A of the Act. Those activities have therefore been disclosed by airports for ID purposes and have been included in our s 56G analysis.<sup>173</sup>
501. A different asset base for pricing and information disclosure purposes in itself may not be a concern, but reconciling the differences has been problematic.<sup>174</sup> We consider that this has impacted on our and other interested persons’ ability to accurately determine an airport’s targeted return.

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<sup>171</sup> Therefore, we use the term ‘leased assets’ when referring to submissions, as this was the expression used by submitters.

<sup>172</sup> Commerce Commission “Input methodologies review – Airports profitability assessment – Workshop 2 – Summary of views expressed” (16 June 2016), Attachment C, para 43.

<sup>173</sup> See, for example: Commerce Commission “Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, Section 56G of the Commerce Act 1986” (8 February 2014), para F68.3.

<sup>174</sup> See, for example: 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, Section 56G of the Commerce Act 1986” (13 February 2013), para F158 -165.

502. For example, in case of Auckland Airport, the asset base used to set prices comprised airfield and terminal activities but excluded:<sup>175</sup>

502.1 aircraft and freight activities;<sup>176</sup> and

502.2 certain specified passenger terminal activities, namely leased identified tenancies and collection facilities for duty free.

*How the problem evolved*

503. We first identified the problem associated with pricing assets during the s 56G review of airports.

504. All airports have been excluding certain asset values and cash-flows from their pricing decisions which have been included in our analysis of airports targeted returns (as these activities are included in the definition of ‘specified airport services’ in s 56A of the Act).

505. Our s 56G analysis showed that airports were targeting higher returns on pricing assets compared to targeted returns on the RAB. This implies that airports have been targeting lower returns on those assets that are excluded from the pricing asset base but are included for ID purposes.

506. In particular, we estimated that for PSE2, the exclusion of those assets from the pricing asset base increased targeted returns based on pricing assets of:

506.1 ~0.5% for Auckland Airport;<sup>177</sup>

506.2 ~0.6% for Christchurch Airport;<sup>178</sup> and

506.3 ~0.2% for Wellington Airport.<sup>179</sup>

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<sup>175</sup> We do not have visibility on the assets that Wellington Airport and Christchurch Airport exclude from their pricing assets in relation to the activities that are included in the definition of “specified airport services” in section 56A of the Act. However, we understand that they largely comprise ‘leased assets’.

<sup>176</sup> In case of Auckland Airport, for aircraft and freight activities, revenues are driven by contracted rental rates and renegotiated at the end of the term of the lease. Prices are struck through benchmarking to comparative market rentals. For the most part, these revenues relate to leases within the terminal, or hangars (including those for aircraft maintenance), freight facilities within a security area and the joint user fuel hydrant line.

<sup>177</sup> Commerce Commission “Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport, Section 56G of the Commerce Act 1986” (31 July 2013), para E49.

<sup>178</sup> 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, Section 56G of the Commerce Act 1986” (13 February 2013), para E73.

<sup>179</sup> Commerce Commission “Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, Section 56G of the Commerce Act 1986” (8 February 2014), para E42.

507. This analysis indicates that the impact of different asset bases for pricing and ID purposes on the profitability assessment can be material. However, we recognise that we only have a limited historic series to rely on and that airport behaviour can change over time.<sup>180</sup>
508. We discussed the problem associated with different asset bases for pricing and ID purposes in our invitation to contribute to problem definition for the IM review.<sup>181</sup>
509. NZAA submitted that leased assets are appropriately recorded in annual and price setting event disclosures, and considered further analysis as unwarranted.<sup>182</sup>
510. BARNZ submitted that leased assets form part of the definition of “regulated airport services”, and therefore need to be disclosed under the Airports ID Determination.
511. In particular, BARNZ stated the following:<sup>183</sup>

The difficulty we have experienced over the past five years (and indeed under the old AAA disclosures too) is that there is a disconnection between the pricing asset base, on which prices are calculated and set under the AAA and disclosed soon after the price setting event, and the regulatory asset base as a whole. The former is only a subset of the latter, therefore it is impossible to determine the return being achieved on the pricing asset base when the revenues and costs are not subsequently separately disclosed. This means one cannot (from the disclosed information) accurately compare the revenues targeted from the pricing asset base with the returns actually earned on that base.

512. BARNZ reiterated this view at our workshop held in April 2016.<sup>184</sup>

### **Our proposed solution in respect of this problem**

513. This section explains our proposed solution in respect of this problem.

#### *Our proposed solution*

514. We do not propose any amendment to the Airport IMs Determination at this stage. We propose amendments to the Airports ID Determination under s 52Q of the Act to increase the transparency relating to targeted returns on pricing assets. In particular, our proposed solution in respect of this problem is:

514.1 to add a new schedule to the Airports ID Determination reflecting airports targeted returns based on pricing assets; and

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<sup>180</sup> In its PSE3, Wellington Airport targeted the same return on leased as for pricing assets. Commerce Commission “Summary and analysis of Wellington Airport’s third price setting event” (30 June 2015), para 53.

<sup>181</sup> As explained earlier in this chapter, at that stage of our consultation process we referred to this problem as “leased assets”. Commerce Commission “Input methodologies review – Invitation to contribute to problem definition” (16 June 2015), para 318-320.

<sup>182</sup> NZ Airports “Cross-submission on Commerce Commission’s input methodologies review: invitation to contribute to problem definition” (4 September 2015), para 48.

<sup>183</sup> BARNZ “Cross-submission on problem definition submissions” (5 September 2015), p. 3-4.

<sup>184</sup> Commerce Commission “Input methodologies review – airports profitability assessment – Workshop 2 – Summary of views expressed” (16 June 2016), Attachment C, para 44.

- 514.2 to require airports to explain any differences in profitability based on the pricing asset base and the profitability based on the RAB.
515. Following this approach, we and other interested persons would be able to determine the impact of assets that are excluded from pricing assets but included in the RAB on airports' profitability. This can be achieved by simply deducting targeted profitability based on the pricing asset base from targeted profitability based on RAB values.
516. In addition, we and other interested persons would be in a position to:
- 516.1 separately identify targeted returns inherent in the airports' pricing decision; and
- 516.2 understand why those targeted returns might differ from the disclosed IRR associated with the total RAB.
517. Our proposed solution creates transparency in ID by requiring airports to disclose targeted returns based on pricing assets. Our proposed solution would only require airports to provide information based on an aggregated asset level that airports already have determined in their pricing decision.
518. For clarification, it is not our intent:
- 518.1 to specify the pricing asset base that airports would have to provide information on in ID; and
- 518.2 to require airports to determine opening and closing asset values for leased or other assets that are not part of the pricing asset base and tracking those over time. This was a concern raised by Auckland Airport raised at the workshop held in April 2016.
519. We explain our reasons in more detail in the remainder of this section.

*Proposed solution ensures that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 of the Commerce Act is being met*

520. In the Airports ID Determination reasons paper we stated:

3.55 The ID Determination requires Airports to report operating revenue such that revenue from leases, rentals and concessions is separately disclosed and other operating revenue earned in relation to airport activities is reported using categories that correspond to the Airport's specific charges.

3.56 Regulatory income comes from a range of sources. To enable an effective assessment of movements in profitability either between years, or between forecast and actual revenue some level of disaggregated disclosure is required. In determining the appropriate level of disclosure the Commission considered the characteristics of revenue and other income streams that Airports receive.

3.61 Revenue from leases, rentals and concessions has a generally understood meaning in financial reporting and is relevant to all Airport businesses. Having this revenue disclosed in its own pre-defined category will aid comparability.

521. We continue to consider that an adequate disclosure of information related to the pricing assets enables interested persons to understand airports' approach to pricing.
522. This is because the additional information provided enables interested persons to determine the impact of different asset bases for pricing and disclosure purposes on airports profitability; assess the profitability of pricing assets separately in the price setting event disclosures; and consequently assess if airports are targeting excessive profits in particular.
523. This ultimately ensures that sufficient information is readily available to interested persons to assess whether airports are being limited in their ability to extract excessive profits, consistent with s 53A.
524. In our view, the benefits arising from enhanced transparency in the price setting event disclosures outweigh the cost of the increased disclosure requirements, particularly in the light of airports having to populate the new schedule with information they are likely to already have available from meeting their consultation obligations under the AAA in respect of pricing.
525. In this regard, pursuant to the AAA, airports are required to consult with "substantial customers" as part of their process of amending prices for airport activities. These airport activities align with the 'specified airport services' identified in the Act. Further, these consultation obligations require airports to prepare and make available to their substantial customers information relevant to the calculation of prices for airport activities and costs of major investments.<sup>185</sup>

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<sup>185</sup> "Substantial customers" are defined in section 2A of the AAA.



*Proposed solution contributes to future-proofing the Airports ID Determination*

526. We consider that our proposed solution contributes to future-proofing the Airports ID Determination by continuing to provide transparency on airports' targeted returns based on pricing assets even if airports decide to remove (or add) further items from (or to) their pricing asset base that are included in the definition of 'specified airport services'.

*Our proposed solution addresses BARNZ's transparency concern*

527. Our approach addresses BARNZ's transparency concern that "one cannot (from the disclosed information) accurately compare the revenues targeted from the pricing asset base with the returns actually earned on that base".

528. We do not propose following BARNZ's suggestion to separate out leased assets and associated costs and revenues into a separate schedule (or table).<sup>186</sup> We understand that different asset bases for pricing purposes and ID purposes are largely a result of the exclusion of leased assets from the pricing asset base. However, our proposed solution also provides transparency in the event that airports decide to change the items included the pricing assets, but which remain included in the RAB (for ID purposes).

529. Therefore, separating out particular asset bases in the Airports ID Determination seems counter-intuitive and, in our view, the cost associated with populating those schedules in information disclosure outweigh the additional benefit of increased transparency.

*We disagree with NZAA that leased assets are appropriately recorded under the ID disclosures*

530. We agree with NZAA's view that "there is no basis for seeking the Commission to separately identify assets based on the way prices are set for particular customer classes".<sup>187</sup>

531. However, we disagree with NZAA's position that leased assets are appropriately recorded under the ID disclosures and that further analysis is unwarranted. As discussed in the problem definition section of this chapter, both us and BARNZ have encountered significant difficulty in assessing airports targeted returns based on pricing assets and would continue to do so if no further transparency is created under the Airports ID Determination.

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<sup>186</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015), p. 11.

<sup>187</sup> NZ Airports "Cross-submission on Commerce Commission's input methodologies review: invitation to contribute to problem definition" (4 September 2015), para 46.

## Chapter 10: Forecast timing of cash-flows

### Purpose of this chapter

532. The purpose of this chapter is to explain our proposed solution to the problem associated with the forecast timing of cash-flows in the context of the profitability assessment of airports.

### Structure of this chapter

533. This chapter begins with a section on the problem definition, before going on to explain our proposed solutions to this problem.

### Problem definition

534. This section explains the problem definition, including how it evolved through consultation, which included submissions and workshops.

### *Summary of problem definition*

535. The Airports ID Determination currently does not explicitly specify cash-flow timing expectations for airports, but it includes a year-end ROI calculation in the ex-post information disclosure requirements from which year-end cash-flow timings can be inferred.
536. However, these year-end cash-flow timing assumptions consistently and materially underestimate airport returns, because they do not reflect the time value of money of cash-flows occurring throughout the year.
537. In addition, the current year-end cash-flow timing assumptions are not consistent with our latest cross-sector thinking on this matter. We have applied updated intra-period cash-flow timing assumptions in the regulation of electricity distribution businesses (**EDBs**), gas pipeline businesses (**GPBs**) and Transpower (ie, both in the setting of price-quality determinations and in their information disclosure requirements).<sup>188</sup>

### *Year-end cash-flow timing assumptions understate targeted profitability*

538. We used year-end cash-flow timing assumptions in our profitability assessment in the s 56G reviews, as this was the most consistent option with the treatment of cash-flows inferred by the ex-post information disclosure requirements. We also tested the impact of assuming that cash-flows would occur mid-year rather than at the end of the year.

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<sup>188</sup> See, for example: our reasons paper on the ID amendments electricity distributors and gas pipeline businesses: Commerce Commission “Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: Final Reasons Paper” (1 October 2012), para 3.22-3.36 and Attachment E.

539. Our profitability assessment for Auckland Airport and Wellington Airport in the s 56G reviews indicated that the profitability of airports was understated by approximately half a percent using year-end cash-flow timing assumptions as compared to cash-flows occurring mid-year.<sup>189</sup>
540. Although we did not place any weight on our analysis based on mid-year cash-flow timing in drawing our conclusion on the effectiveness of the information disclosure regime, we indicated our intent to consider enhancing the information disclosure requirements to better reflect the actual timing of cash-flows.
541. In our invitation to contribute to problem definition for the IM review, we re-emphasised our intent to include cash-flow timing assumptions that better reflected the actual timing of cash-flows and invited interested persons to submit on this matter.<sup>190</sup>
542. BARNZ supported our intent to update the information disclosure requirements. In particular, BARNZ stated in its submission the following:<sup>191</sup>
- Given that revenues are received (and expenses incurred) throughout the year BARNZ considers that the end-of-year calculations understate the level of returns being targeted. BARNZ considers that the ID requirements in relation to intra-period cash flow timing assumptions should be amended to reflect mid-year cash-flows. Unless there are good reasons otherwise, the same timing assumptions should be applied to airport ID as are applied in the ID for other industries regulated under Part 4.
543. NZAA saw merit in reviewing the cash-flow timing assumptions under the Airports ID Determination further, but did not submit any particular views on this matter.<sup>192</sup>

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<sup>189</sup> For example: Commerce Commission “Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is Promoting the purpose of Part 4 for Wellington Airport – Section 56G of the Commerce Act 1986” (8 February 2013), para E33.2.

<sup>190</sup> Commerce Commission “Input methodologies review – Invitation to contribute to problem definition” (16 June 2015), para 331-333.

<sup>191</sup> BARNZ “Submission by BARNZ on problem definition paper for the input methodologies review” (21 August 2015), p. 13-14.

<sup>192</sup> NZ Airports “Cross-submission on Commerce Commission's input methodologies review: invitation to contribute to problem definition” (4 September 2015), para 56.

## Our proposed solution in respect of this problem

544. This section explains our proposed solution in respect of this problem.

### *Our proposed solution*

545. We do not propose any amendments to the Airport IMs Determination at this stage. Instead, we propose amendments to the Airports ID Determination so that interested persons can better assess if airports are targeting excessive profits by more accurately reflecting actual and expected timing of cash-flows in airports' disclosures. Specifically, we propose to amend the Airports ID determination to:

545.1 specify, in the **price setting event disclosures**, mid-year timing assumptions for all revenues and expenditures; but

545.2 provide, in the **price setting event disclosures**, the flexibility for airports to deviate from the default cash-flow timing assumption if airports provide evidence that the actual cash-flow timing for specific cash-flow items is different from the default cash-flow timing assumption; and

545.3 specify, in the **annual ex-post disclosures**, mid-year timing assumptions for all revenues and expenditures.<sup>193, 194</sup>

546. We note that any consequential changes affecting the ex-post Airports ID Determination will be considered as part of a follow-up project that is separate from the IM review. This project will be subject to a separate consultation process. As part of that consultation process, we will also seek stakeholder's views on alternative solutions regarding cash-flow timing assumptions in the annual ex-post disclosures.<sup>195</sup>

547. We explain our reasons in more detail in the remainder of this section.

### *Better assessment of airports profitability*

548. We consider that our proposed solution is appropriate, because mid-year cash-flow timing assumptions:

548.1 better reflect the actual timing of cash-flows;

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<sup>193</sup> The current Airports ID Determination requires airports to provide an ROI in the ex-post disclosures. *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.3.

<sup>194</sup> The implementation of mid-year cash-flow timing assumptions in the ex-post assessment of airports profitability would require moving to an IRR-based profitability indicator as an ROI-based approach does not allow accounting for specific cash-flow timing assumptions.

<sup>195</sup> For example, as we stated in our reasons paper on the 2012 ID Determination amendments for electricity distributors and gas pipeline businesses, under some circumstances, using monthly cash-flows may result in a significantly better estimation of returns than using mid-year cash-flow timing assumptions. Examples include when capital expenditure during the year is lumpy or revenue is seasonal. See: Commerce Commission "Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: Final Reasons Paper" (1 October 2012), para 3.27-3.28.

- 548.2 result in improved accuracy as compared to assuming cash-flows occur year-end, as they can take into account intra-year effects;
- 548.3 consequently, allow interested persons to better assess if airports were targeting excessive profits; and
- 548.4 only require changes to the profitability indicator calculation under information disclosure requirements, rather than a change to the data used by airports in the calculation of profitability. This is because our proposed solution would still require the same revenue and expenditure amounts to be disclosed each year.
549. In addition, by allowing airports to use different cash-flow timing assumptions than mid-year in their price setting event disclosures, we can take account of airport-specific circumstances which may result in an even better estimate of expected profitability.
550. We consider that under the current year-end cash-flow timing assumptions airports do not have an incentive to comment on the appropriateness of the default assumption, because a year-end assumption is in favour of airports.
551. Our proposed solution could potentially result in an over-estimate of expected returns, if the actual timing of cash-flows lies between mid-year and end-of-year. Our proposed solution incentivises airports to provide evidence on the reason why the new default assumption of mid-year could be inappropriate.
552. If airports choose to use different cash-flow timing assumptions when setting prices, airports would have to provide evidence in their price setting event disclosures underpinning why the assumptions for specific cash-flow items are different from the default assumption. We would then comment on the appropriateness of the mid-year cash-flow assumptions in our summary and analysis.

*Proposed solution is consistent with our approach to cash-flow timing assumptions in other regulated industries*

553. Our proposed solution is consistent with our approach to cash-flow timing assumptions for the EDBs and GPBs regulated under Part 4.
554. In our 2015 amendments to information disclosure determinations for EDBs and GPBs, we decided to use mid-year cash-flow timing assumptions with the exception of revenues. Suppliers provided evidence that revenues should be recognised as being received on the 20<sup>th</sup> day of each following month, which is equivalent to the aggregate annual revenue being received 148 days before year-end.<sup>196</sup>

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<sup>196</sup> Commerce Commission “Amendments to information disclosure determinations for electricity distribution and gas pipeline services 2015: Final Reasons Paper” (24 March 2015), para 2.30 and Attachment A.

555. Consistent with our decision for the EDBs and GPBs, our proposed solution does also allow to include airport-specific cash-flow timing assumptions instead of applying our default assumption provided airports can give evidence why the alternative assumption is a more accurate reflection of actual cash-flows occurring for the airport.

## Chapter 11: Other adjustments to an airport's price path

### Purpose of this chapter

556. This chapter discusses problems related to the transparency of airports profitability disclosures where an airport adjusts its price path, for example, to allow for a commercial concession or route incentive. This chapter also presents our solution to this problem.

### Structure of this chapter

557. This chapter begins with a section on the problem definition, before going on to explain our proposed solution to this problem. The chapter finishes with a discussion of an alternative solution that we considered.

### Problem definition

558. This section describes the problems that could be created in ex-ante and ex-post profitability assessments of airports due to 'other adjustments' an airport may make to its price path. To date we, and submitters, have identified two types of 'other adjustments' that have taken place:

558.1 commercial concessions; and

558.2 route incentives.

559. However, there may be additional ways that an airport may adjust its price path in the future which could give rise to transparency concerns.

### *Commercial concessions*

560. Commercial concessions are commercial decisions made by an airport to under-recover revenue. 'Commercial concessions' is a descriptive term used in discussions between us, airports, and interested persons. It is not in our Airport IMs or ID requirement definitions. Currently, there is no requirement for airports to report on commercial concessions or whether a planned under-recovery is intended to be permanent.

561. Airports may apply commercial concessions to pricing for a number of reasons. An example we have seen is Christchurch Airport's commercial decision of a phased implementation of its long-term pricing model in order to support the economic recovery of Canterbury following the 2010 and 2011 earthquakes.<sup>197</sup>

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<sup>197</sup> Christchurch International Airport Limited, Price Setting Disclosure, 19 December 2012.

562. When setting prices for 2012 - 2017 (ie, its second price setting event, PSE2), Christchurch Airport set prices at a level that created forecast revenue temporarily lower than its long-term pricing model. This commercial concession had a present value (in 2014 dollars) of \$16 million according to Christchurch Airport.<sup>198</sup> Christchurch Airport stated that it does not intend to recover the concession, however, there could be other instances of commercial concessions that airports may intend to recover in future regulatory periods.
563. The principal problem with commercial concessions is that they are a complication to understanding an airport's pricing intent and may cloud any profitability assessment by interested persons. If commercial concessions are not applied in a clear and transparent way, they could lead to the double counting of the concession in profitability assessments.
564. Double counting may occur if an airport applied a commercial concession during one price setting event, did not signal that it would claim this back in a future price setting event, but subsequently did. In this case, there is the risk that in future price setting events an airport may attempt to claim some sort of a credit for past commercial concessions.
565. The consequence of this would be that the airport would benefit from a lower assessed target profitability in the year that the concession is applied. However, it may later successfully argue for the impact of the commercial concession to be ignored when the amount is claimed back in a future price setting event. This would mean that the airport would again benefit from lower assessed target profitability.

#### *Route incentives*

566. Route incentives are decisions by an airport to charge an airline less than the standard charge in order to secure new routes or additional passengers on an existing route to the airport from that airline. The Airports ID Determination currently only specifies a need to disclose information on financial incentives (which can be route incentive or other incentives) on an ex-post basis. There is no requirement to disclose information on route incentives in price setting event disclosures.
567. While route incentives appear to be simply a lower price for a particular airline, there are benefits to other airlines. The other airlines can benefit in the long run through the fixed (if not constrained) airport costs being spread over more flights once the route incentive is lifted and the new route has established itself at the airport (or during the route incentive period if the remaining charge is greater than the short run incremental cost). This benefit could flow through to consumers in the form of increased competition between airlines and as a result of increased competition, lower prices.

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<sup>198</sup> Christchurch International Airport Limited, Price Setting Disclosure, 19 December 2012.



568. A recent example of route incentives is what Wellington Airport has offered for new routes and increased passenger numbers, as described in its publicly disclosed pricing schedule.<sup>199</sup> Wellington Airport has included consideration of its route incentives in the forecast of demand and revenue in its last price setting event.<sup>200</sup>
569. In contrast to commercial concessions, route incentives are targeted towards specific airlines, so the prices for other airlines may be higher than they would be if there was no route incentives planned, so that the airport can maintain its revenue level. There generally does not appear to be sufficient publicly disclosed information for interested persons to fully understand the forecast impact of route incentives and thus understand whether the charges for other airlines are higher as a result of the incentives.
570. Route incentives are, therefore, another problem of transparency. Interested persons may be prevented from assessing the impact of route incentives on the ex-ante assessment of airport profitability because there is no specific price setting event disclosure requirement for airports to report on route incentives.
571. BARNZ has supported the need to amend the ID requirements to add further detail on route incentives.<sup>201</sup>
- “The disclosures around financial incentives are currently not clear – improved definitions and disclosure lines could provide better clarity over the relationship between the incentives and the disclosed costs and revenues and between the incentives and the published charges”.
572. In contrast, NZAA said in its cross submission that “BARNZ fails to identify and fully explain any problem with the current disclosure of pricing incentives.”<sup>202</sup>

### **Our proposed solution in respect of this problem**

573. This section provides a description of our proposed solution for improving transparency of other adjustments that an airport may make to its price path as well as our reasoning. The solution is framed in terms of the two ‘other adjustments’ that we have seen to date (commercial concessions and route incentives).
574. There may be additional ways in which the price path may be adjusted that are yet to be identified. However, we consider that our proposed solution is flexible enough to also deal with other adjustments to the price path that may arise.

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<sup>199</sup> Wellington International Airport Limited “Schedule of Landing and Terminal Charges Effective 1 June 2014 to 31 March 2019”, p.2 available at: <https://www.wellingtonairport.co.nz/yk-files/48022a68a248d08df0f53c80efce5a86/WIAL%20Schedule%20of%20Charges%20-%201%20June%202014%20to%2031%20March%202019.pdf>.

<sup>200</sup> Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, 8 February 2013, para D40.

<sup>201</sup> BARNZ “Submission by BARNZ on problem definition paper for the input methodologies review” (21 August 2015).

<sup>202</sup> NZ Airports “Cross-submission on Commerce Commission's input methodologies review: invitation to contribute to problem definition” (4 September 2015).

575. In respect of the commercial concessions problem, we do not propose any changes to the Airport IMs or ID Determinations. We consider that the carry forward mechanism to adjust the forecast closing investment value proposed in Chapters 4 and 7 could be used to make the expectations regarding commercial concessions sufficiently transparent. As such we do not propose any changes to the Airport IMs or ID requirements specifically in response to this problem. We explain our reasoning for this in paragraphs 578 to 586.
576. In respect of the route incentive problem, our proposed solution is:
- 576.1 not to make any amendments to the Airport IMs Determination at this stage;  
and
- 576.2 to amend the Airports ID Determination under s 52Q, as explained in paragraph 587.
577. This change is aimed at providing greater transparency to interested persons to better understand an airport's approach to pricing where it provides route incentives. This will ultimately better enable us and interested persons to assess airports' targeted returns. We explain our reasoning for this change in paragraphs 587 to 589.

#### *Commercial concessions*

578. In respect of the commercial concessions problem, we do not propose any changes to the Airport IMs or ID Determinations. This is because we consider that the carry forward mechanism to adjust the forecast closing investment value proposed in Chapters 4 and 7 could be used to make the expectations regarding commercial concessions sufficiently transparent.
579. As discussed in Chapters 4 and 7, we will only accept the inclusion of a commercial concession in the carry forward mechanism to adjust the forecast closing investment value if the airport has specifically indicated in its price setting disclosure that it intends to recover the concession in the future, and the reasons for doing so.
580. Further, we do not consider that the disclosure of commercial concessions is required unless airports intend to recover the amounts in future price setting events.<sup>203</sup> In cases where an airport does not intend to recover the amount, the commercial concession can simply be viewed as relatively lower target revenue, and thus profitability will rightfully be assessed to be relatively lower.
581. In cases where an airport intends to recover a commercial concession it will be in the airport's interest to disclose this intention so that it can be included in the forecast carry forward mechanism. Therefore, our view is that an additional ID requirement would not provide any additional benefit.

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<sup>203</sup> However, airports are always welcome to voluntarily provide additional information in their price setting event disclosures to assist interested persons in understanding their pricing approach.

582. NZAA seems to generally support this approach.<sup>204</sup> NZAA submitted that:
- “discounts and commercial concessions are clearly in the long-term interest of consumers, and the ID regime should not disincentivise this behaviour....This does make a case for changes to the IMs or ID requirements.”
583. However, NZAA also said that “it is not necessary to alter the disclosure regime to introduce a new layer of complexity in “tracking” these concessions over time to ensure they are not clawed back.”<sup>205</sup> This suggests that NZAA may consider that the carry forward mechanism is not required.
584. We agree that when an airport does not intend on recovering the commercial concession in the future, it is not necessary to track it. However, when the airport does intend to recover the commercial concession, it is important for this to be transparent and for interested persons to be able to understand the impact of it. Our proposed solution accommodates this.
585. NZAA also said that “greater clarity is required from the Commission on the principles that will guide the assessment of historical under and over-performance.”<sup>206</sup> This supports our proposed solution, which will provide guidance on how we will treat a specific decision to under-recover due to a commercial concession. However, Chapter 6 provides more specific detail on ex-post risk allocation arrangements when actual outcomes differ from forecast.
586. BARNZ questioned in its submission how the amount of a commercial concession should be calculated.<sup>207</sup> Our proposed solution will make an airport’s expected returns, including commercial concessions which an airport intends to recover at a later date, more transparent.

### *Route incentives*

587. Our proposed solution is to amend the Airports ID Determination under s 52Q of the Act to improve transparency of route incentives. In particular, we propose to require airports to disclose the forecast total annual dollar amount of route incentives in the same manner of the ex-post ID requirement to disclose financial incentives.<sup>208</sup>
588. We consider that this additional information should be relatively simple for airports to calculate. This is because airports already forecast the volume of flights that will meet the requirements for route incentives in order to forecast demand, revenue, and prices.

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<sup>204</sup> NZ Airports “Submission on Commerce Commission’s input methodologies review: Invitation to contribute to problem definition” (21 August 2015), para 238-240.

<sup>205</sup> NZ Airports “Submission on Commerce Commission’s input methodologies review: Invitation to contribute to problem definition” (21 August 2015).

<sup>206</sup> NZ Airports “Submission on Commerce Commission’s input methodologies review: Invitation to contribute to problem definition” (21 August 2015).

<sup>207</sup> BARNZ “Submission by BARNZ on problem definition paper for the input methodologies review” (21 August 2015).

<sup>208</sup> ie, require airports to disclosed the amount of revenue foregone compared to applying standard charges.

589. Requiring airports to disclose the aggregate impact of route incentive forecasts as part of price setting event disclosures will help interested persons understand whether or not the forecast effect of route incentives are included in an airport's target revenue. This will improve transparency and help interested persons assess an airport's profitability with and without any route incentives as a sensitivity test.<sup>209</sup>

#### **Assessment of another potential solution to this problem**

590. This section describes the potential alternative solution we considered to the transparency problems around other adjustments. The alternative solution was considered in the context of commercial concessions.

#### *Alternative solution – add specific ID requirements for commercial concessions*

591. We considered whether to add ID requirements for airports to specifically identify any commercial concessions. As suggested by BARNZ, this could be seen as an improvement to the level of transparency of airport pricing which could potentially provide insight into how commercial concession should be calculated.<sup>210</sup>
592. However, this is not our proposed solution as it is difficult to define what a commercial concession is other than when it is identified by the airport themselves. For example, a price of \$10 per passenger could simply be \$10 per passenger, or it could be a target of \$12, minus a \$2 concession. In cases where it is identified by the airport itself, then additional ID requirements will not provide any benefit.
593. Further, we only consider that the disclosure of commercial concessions is required where airports are specifically intending to recover the amounts in future price setting events. In these cases it is in the airport's interest to disclose this intention, therefore an additional separate ID requirement would not provide any additional benefit.

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<sup>209</sup> We undertook such a sensitivity test in our s 56G report on Wellington Airport to help assess the impact of the incentive scheme on the airports profitability.

<sup>210</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015).

## Chapter 12: Initial RAB value of land

### Purpose of this chapter

594. The purpose of this chapter is to explain our proposed solution to the problem associated with the initial RAB value of land.

### Structure of this chapter

595. This chapter begins with a section on the problem definition, before going on to explain our proposed solution to this problem. The chapter finishes with a discussion of an alternative solution that we considered.

### Problem definition

596. This section explains the problem definition, including how it evolved through consultation, which included submissions and workshops.

597. The original Airport IMs required an initial RAB value for land as at 2009. However, the High Court judgment in the merits appeals requires that the initial RAB value for land has to be assessed as at 2010. We made the Court-ordered amendments to the Airport IMs in late 2014.<sup>211, 212</sup>

598. The problem is that airports currently do not have MVAU land valuations as at 2010. Airports only have MVAU land valuations for the years 2009 and 2011.<sup>213</sup>

599. The problem has been well-canvassed with interested parties since the High Court issued its judgment in December 2013. Various discussions have been ongoing between airports, airlines and us about possible approaches to addressing the problem. Auckland Airport presented on the problem at the IM Forum.<sup>214</sup> NZAA, BARNZ and Auckland Airport also submitted on the problem as per the views presented in this chapter.

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<sup>211</sup> Commerce Commission “Publication of Electricity, Gas, and Airport Input Methodologies Amendments ordered by the High Court” (27 November 2014).

<sup>212</sup> *Wellington International Airport Ltd and others v Commerce Commission* [2013] NZHC 3289, para 892.

<sup>213</sup> The value of land assets in the initial RAB for all airports must be established using the Market Value Alternative Use (MVAU) valuation approach (*Commerce Act (Specified Airport Services Input Methodologies) Determination 2010*, clause 3.2 and Schedule A).

<sup>214</sup> Auckland International Airport Limited “Initial regulatory asset value for land” (30 July 2015), available at <http://www.comcom.govt.nz/dmsdocument/13513>.

### **Our proposed solution in respect of this problem**

600. This section explains our proposed solution in respect of this problem.

#### *Our proposed solution*

601. Our proposed solution in order to be consistent with the High Court judgment is to amend the Airport IMs Determination:
- 601.1 to set the initial RAB value for airport land as at 2010 using a pragmatic proxy by interpolating 2009 and 2011 MVAU land values (net of any capex or disposals of land that occurred during the years 2009 to 2011) based on existing MVAU land valuations; and then
  - 601.2 to add to the calculated proxy the value of any capex and disposals related to land that occurred up to the date of the interpolated value.
602. This is our proposed solution because:
- 602.1 an interpolation of 2009 and 2011 MVAU land valuations would likely result in a similar value to a 2010 MVAU land valuation as the existing MVAU land valuations are from nearby dates; and
  - 602.2 it would be inefficient for each airport to incur the cost of obtaining a 2010 MVAU land valuation considering that we expect using interpolated values would provide similar results.
603. Implementing our proposed solution requires amending the Airport IMs as these currently provide that the “unallocated initial RAB value of land is its value determined as on the last day of the **disclosure year** 2010 in accordance with Schedule A.”<sup>215</sup>

#### *Proposed solution is consistent with the High Court judgment*

604. Given that the 2009 and 2011 land valuations for each airport are consistent with the MVAU approach specified in Schedule A of the Airport IMs, we consider that our proposed amendments are also consistent with the High Court judgment.
605. This is because an interpolated valuation will reflect the value of the land as at 2010, and still be consistent with the MVAU land valuation methodology set out in Schedule A of the Airport IMs.<sup>216</sup>
606. We consider that our proposed approach is a pragmatic and cost-effective way to be consistent with the High Court judgment. Our proposed solution is likely to result in a similar value to a 2010 MVAU land valuation, as the existing MVAU land valuations are from nearby dates without imposing significant costs on airports, with little identifiable benefit.

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<sup>215</sup> *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010*, clause 3.2.

<sup>216</sup> For clarification, this refers to Schedule A of the Airport IMs that was in place at the time, ie, not the amended one we published in February 2016.

*Impact of any capex or disposals of land that occurred after the date of the interpolated value should be removed*

607. Simply interpolating 2009 and 2011 land values would result in any capex or disposals of land that occurred after the date of the interpolated land value being included in the initial RAB value for land as per 2010.
608. Therefore, we propose not to add to the calculated proxy the value of any capex and disposals related to land that occurred after the date of the interpolated value in order to:
- 608.1 most accurately reflect the initial RAB value for land as per 2010; and
- 608.2 not to distort the initial RAB value as per 2010 by any events subsequent to the High Court-determined date of the initial RAB date.

*Proposed solution is widely accepted in industry*

609. Our proposed solution seems to be supported by most submitters.<sup>217, 218</sup> Also, we have recently presented our proposed solution at our workshop held with airports stakeholders in April 2016, and no one raised any concerns.<sup>219</sup>
610. The apparent industry support for pragmatism is also consistent with the support we received from stakeholders on our proposal not to update the analysis undertaken for our s 56G reports for the High Court judgment. In the s 56G reports we concluded updating the MVAU land valuations to 2010 would not change the conclusions presented in our final reports for all airports.<sup>220, 221</sup>
611. Despite the industry-wide support for our proposed solution, BARNZ did not initially support interpolating existing 2009 and 2011 MVAU land valuations in the case of Wellington Airport.<sup>222</sup>
612. BARNZ was of the view that Wellington Airport's 2009 and 2011 MVAU land valuations were not IM-compliant, therefore Wellington Airport needed to provide a 2010 MVAU land valuation.

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<sup>217</sup> NZ Airports "Submission on Commerce Commission's input methodologies review: Invitation to contribute to problem definition" (21 August 2015), para 194.

<sup>218</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015), p. 2.

<sup>219</sup> Commerce Commission "Input methodologies review – airports profitability assessment – Workshop 2 – Summary of views expressed" (16 June 2016), Attachment C, para 49.

<sup>220</sup> Email from Ruth Nichols (Commerce Commission) Consultation on impact of IM judgement on s56G reports for airports regulated under Part 4 of the Commerce Act (6 January 2014), available at <http://www.comcom.govt.nz/dmsdocument/11451>

<sup>221</sup> Letter from John Beckett (Executive Director, BARNZ) to Ruth Nichols (Senior Legal Counsel, Commerce Commission) regarding impact of Merits Review judgement on section 56G reports (24 January 2014), available at <http://www.comcom.govt.nz/dmsdocument/11455>

<sup>222</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015), p. 2.

613. NZAA agreed with BARNZ that 2010 valuations could be required if the MVAU land valuations carried out by airports were found to be non-compliant, but does not consider this to be an issue. This is because NZAA considers all airports' MVAU land valuations to be IM-compliant.
614. We disagree with BARNZ's early concern regarding Wellington Airport's 2009 and 2011 MVAU land valuations. In our summary and analysis of Wellington Airport's third price setting event, we concluded that Wellington Airport's approach to the 2013 MVAU land valuation was not inconsistent with the Airport IMs for land valuation.<sup>223</sup>
615. Given that the approach used in the 2013 MVAU land valuation did not materially differ from the approaches used in the 2009 and 2011 MVAU land valuations, we consider those valuations to be IM-compliant as well.

### **Assessment of an alternative solution to this problem**

616. This section explains our assessment of an alternative solution.
617. Aside from our proposed solution, another option we considered is requiring airports to undertake and disclose a 2010 MVAU land valuation.

#### *Alternative solution – requiring airports to undertake and disclose a 2010 MVAU land valuation*

618. Requiring airports to undertake and disclose a 2010 MVAU land valuation could possibly result in a more accurate initial RAB value as compared to using a pragmatic proxy derived from interpolated existing 2009 and 2011 MVAU land valuations. Therefore, it could possibly increase transparency and better enable interested persons to assess if airports were targeting excessive profits from the beginning of the Part 4 regime.
619. In addition:
- 619.1 this is also consistent with the High Court judgment, which requires that the initial RAB value for land has to be assessed as at 2010;
  - 619.2 an adjustment to the initial RAB value for any capex or disposals of land that occurred during the years 2010 to 2011 would not be required as a 2010 MVAU land valuation would accurately reflect the value of land at that particular point in time; and
  - 619.3 no amendments to the Airport IMs would be required.

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<sup>223</sup> Commerce Commission "Summary and analysis of Wellington Airport's third price setting event" (30 June 2015), para A14.



620. However, this is not our preferred solution because:

- 620.1 the aim to providing an initial RAB for land as at 2010 can be more efficiently, but potentially slightly less accurately, met by using interpolated 2009 and 2011 land values;
- 620.2 a 2010 valuation would have no practical impact on current airport land values, since all airports have revalued their land since 2009;
- 620.3 a 2010 MVAU land valuation would result in airports incurring significant cost; and
- 620.4 in our view, the cost of requiring a 2010 valuation outweighs the benefit of increased accuracy in the initial RAB value.

## Attachment A: Transitional arrangements

### Purpose of this attachment

- A1 The purpose of this attachment is to explain our proposed transitional arrangements for information disclosures based on the amended Airport IMs and ID Determinations.

### Current requirements

#### *Information required in price setting event disclosure*

- A2 Under the current Airports ID Determination the forward-looking disclosure airports make following a price setting event must include:
- A2.1 information relating to each of the components of the airports' forecast total revenue requirement; and
  - A2.2 an explanation of the differences between the preparation of each component and the most recent corresponding historical financial disclosure.
- A3 This allows us and other interested persons to understand the extent to which and the reasons why airports have deviated from the default position in the Airports IM Determination when setting prices. It also allows us and other interested persons to understand the extent to which approaches consistent with the Airport IMs were being applied as part of the pricing decisions.

#### *Timings of the historical financial disclosure and the IM review*

- A4 The current Airports ID Determination requires airports to make their historical financial disclosure within 5 months after the end of each disclosure year.<sup>224</sup> For Auckland and Christchurch airports this means that they must make their annual historical disclosure in November of each year.
- A5 Amendments to the Airport IMs and ID Determinations as a result of the IM review are not expected to be implemented until December 2016. This means that the historical financial disclosures that Auckland and Christchurch airports make in November 2016 will be based on the current Airport IMs and ID Determinations-*ie*, they will not reflect the changes as a result of the IM review.

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<sup>224</sup> *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.3.

*Timings of Auckland Airport's and Christchurch Airport's next price setting disclosure*

- A6 The next price setting disclosure for both Auckland and Christchurch airports are due following their price setting events which are expected to occur in July 2017. Under the current Airports ID Determination they are required to provide the explanation described above by comparing the information relating to their forecast total revenue requirement with the ex-post information disclosed in November 2016.<sup>225</sup>
- A7 As noted above, the November 2016 historical disclosures will not reflect any of the changes proposed as part of the IM review since any consequential amendments to the ex-post ID requirements will only be implemented following the IM review (ie, post 2016). To account for this, Auckland Airport and Christchurch Airport may have to provide significant explanation to us in their price setting event disclosures made following the July 2017 price setting events.<sup>226</sup>
- A8 Therefore the current wording of the Airports ID Determination is likely to result in complex disclosures by Auckland Airport and Christchurch Airport. It may also obscure the differences between their pricing setting methodologies and the amended Airport IMs Determination, which is undesirable since it would reduce transparency making it more difficult for us and other interested persons to assess profitability and it would add to the cost of compliance.

**Our proposed transitional arrangements for Auckland and Christchurch airports next price setting disclosures**

- A9 This section explains our proposed approach for Auckland and Christchurch airports while we transition from the current Airport IMs and ID Determinations to the amended determinations.

*Transitional requirements*

- A10 We are not proposing any amendment to the Airport IMs Determination at this stage. We propose amendments to the Airports ID Determination to introduce transitional requirements in the Airports ID Determination to require Auckland and Christchurch airports to:
- A10.1 restate some of key information provided by in their November 2016 historical financial disclosure, in a manner consistent with the amended Airport IMs and ID Determinations;<sup>227</sup> and

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<sup>225</sup> *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.5.

<sup>226</sup> This is because differences must be explained by comparison to the most recent corresponding historical financial information disclosed rather than information disclosed using the most recent Airports IMs.

<sup>227</sup> ie, asset roll forward, and the costs that are used to make up the components of their revenue requirement.

- A10.2 explain the difference between the preparation of each component for pricing purposes in Auckland and Christchurch airports next price setting event disclosure to be provided considering this transitional schedule. This means that for components where the information has changed since the most recent historical financial disclosure we would expect the comparison to be made to the transitional schedule rather than the most recent historical financial disclosure.<sup>228</sup>
- A11 Auckland and Christchurch airports could provide a re-stated transitional schedule at the same time as they report on their price setting event disclosures in order to reflect the most recent IM and ID determination requirements.
- A12 This would mean that, in the event that historic disclosures do not reflect the most recent IM and ID Determination requirements, the explanations provided would compare the components disclosed in the Schedule 18 of the price setting event disclosure template (Report on the Forecast Total Asset Base Revenue Requirements) and the corresponding information in the new transitional schedule.
- A13 We consider these proposed transitional requirements to be appropriate as they require minimal adjustments to the way information disclosure has operated in the past. We would only request additional information in Auckland and Christchurch airports' next annual disclosures in so far as it is required to reflect the amendments resulting from the IM review.
- A14 The proposed transitional requirements are also consistent with the approach within airport information disclosure requirements we have taken in the past.<sup>229</sup> We have also requested other regulated businesses to restate past disclosures to reflect amendments to IM and ID Determinations requirements.<sup>230</sup>

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<sup>228</sup> For components where the information has not changed since the most recent historical financial disclosure we would expect the comparison to continue to be made to the most recent historical financial disclosure.

<sup>229</sup> For example, we included at transitional provision for disclosure of the initial RAB in a form of a transitional schedule. This schedule was only required to be produced in the first disclosure year in which airports were subject to information disclosure.

<sup>230</sup> For example, EDBs were required to provide restated financial information regarding the roll forward of the RAB and deferred tax balances for the years 2010 – 2012 in the 2013 annual disclosures after IMs came into effect in 2012. In addition, we required EDBs to provide restatements of the previous two years' ROI calculations in 2015 after we amended the ID disclosure requirements for ROIs to better reflect the cash-flow timings used to set prices for the DPP.

### Alternative transitional approach

A15 This section explains our assessment of an alternative approach that we considered.

#### *Alternative approach – require airports to explain differences compared to the most recent IM requirements*

- A16 We considered amending the clause that relates to explanations of differences compared to historic disclosures so that it required the comparison to be made to the most recent Airport IMs Determination.<sup>231</sup> The difficulty with this is that some of the components of airports forecast revenue that would need to be compared are not defined in the Airport IMs Determination but are required under the Airports ID Determination.<sup>232</sup>
- A17 This means that any comparison would have to be made in relation to both the most recent Airport IMs Determination and the most recent Airports ID Determination. However, Auckland and Christchurch airports will have to make their next price setting event disclosure before having made a historical financial disclosure using the amended Airport IMs and ID Determinations. Therefore when making these comparisons they could only provide explanations of how they would expect to disclose historical financial information as opposed to how they have actually disclosed it.
- A18 This is not our preferred approach because we consider that trying to explain pricing setting methodologies against disclosures that have not yet been provided would add an additional layer of complexity compared to our proposed approach. We do not consider this alternative approach would make the explanations provided by airports more transparent or better enable us to make an objective decision about whether the price setting disclosure has met the information disclosure determination requirements.

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<sup>231</sup> *Airports Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.5.

<sup>232</sup> For example, information on cash-flow timing or the carry forward mechanism we have proposed in this topic paper.