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Dear Keston

IM REVIEW SUBMISSION

Introduction

- 1 Christchurch International Airport Limited (CIAL) appreciates the opportunity to comment on the Commerce Commission's (Commission) draft decision in the Input Methodologies (IM) review.
- 2 CIAL has assisted the New Zealand Airport's Association (NZ Airports) with its review of the draft decision in the IM Review, and supports the NZ Airports submission. The NZ Airports submission responds comprehensively to the draft decision in the IM Review as it affects airports.
- 3 In this submission we comment briefly on specific topics of particular interest to CIAL. Our perspective is informed by the fact that we are currently preparing our PSE3 pricing proposal, and will begin our consultation with airline customers before the IM Review is finalised. We are therefore acutely aware of the interaction between Information Disclosure (ID) regulation and pricing decisions.

Approach to ID regulation

- 4 In its proposals in the draft decision in the IM Review the Commission is signalling a new approach to ID regulation for airports. Key features of this new approach are:
 - 4.1 an objective of aligning airport disclosures with airport pricing decisions and pricing models;
 - 4.2 in order to achieve that objective, a move away from prescription in the ID requirements that might force a separation between ID and pricing, and an increasing emphasis on flexibility and explanation in the ID requirements in order to allow an airport to align its pricing and ID accounts in a transparent way.
- 5 We endorse that change in focus by the Commission, and appreciate the work that has been done to identify areas where the ID regulation and airport pricing can be better aligned. For our part we have also worked hard to ensure that our PSE3 pricing proposal will be clearly aligned with and reconcilable to our ID accounts so far as we are able.
- 6 The move away from prescription and the focus on flexibility and explanation highlights another important feature of ID regulation.

7 The purpose of Part 4 regulation of airports will be met if consumers are fully informed about the performance of airports. This includes being informed about the limits of available knowledge: what we can know about how an airport is performing will always be imperfect and uncertain, particularly if viewed at a snap shot in time. ID regulation should avoid sending a message of false certainty to consumers. Rather, it should give them good information upon which to form their own judgments.

8 The new approach to ID regulation gives the Commission the platform to fully inform consumers in a way that will advance the purpose of Part 4 regulation. We encourage the Commission to set its specific ID requirements and articulate its commentary in a way that gives consumers good information and informs consumers as to the limits of that information.

Assessing airport returns against the Commission's WACC

9 Our reaction to the Commission's draft decisions paper on WACC percentile for airports is largely positive. In our view, the paper takes a positive step towards implementation of the Yarrow report. It signals a move away from de facto price control and towards an approach to profitability assessment that is much closer to our view of how information disclosure regulation should operate.

10 In particular, CIAL commends the Commission's move away from a precisely defined WACC percentile range and towards a simple IM framework of publishing a WACC mid-point and an indicator of the uncertainty of that estimate. This places the onus on a contextual assessment, with the relevance and weight of any relevant factors to be determined in the context of a pricing decision. This framework is supported by Professor Yarrow who emphasised that there is a clear distinction between setting a WACC IM itself and the application of that WACC IM (in context) when assessing airport profitability.¹

11 We recommend an improvement to the implementation of this approach. The draft reasons paper proposes publishing the standard deviation of the mid-point estimate. This is a consumer-unfriendly measure which is unlikely to be fully understood by many in the intended audience for ID. As a result the focus will be narrowly on the mid-point. The ID regime should produce information that is accessible to non-statisticians. We recommend that the Commission publish regular percentiles as well as the mid-point.

12 We agree that the time for any discussion around the appropriateness of airport returns should be in the context of a pricing decision. We don't anticipate that will make the exercise any easier. There will still be challenges in assessing the market context that the airport is operating in, all facets of airport performance and the value it is delivering to consumers and other stakeholders, and forming an overall view. But that is clearly the correct way to frame the task and we are committed to working with the Commission to fully explain our performance, including pricing.

13 While deciding that airport performance should be viewed in context, the draft decisions paper nevertheless does make a number of comments in the abstract on some key issues. These are addressed in the NZ Airport submission. In brief, we submit:

13.1 there is a strong and direct link between the ID regulation, including Commission commentary or criticism, and pricing decisions by the airports. Any regulatory error will directly impact on pricing decisions by airports;

13.2 there is a strong and direct link between the prices airports can set for regulated services and investment by the airports in the infrastructure to deliver those

¹ Professor George Yarrow, *Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector ("Yarrow Report")*, 19 February 2016, pp 19 – 21.

services. Investors require an appropriate return, and if they cannot expect an appropriate return over the long run then airports will not have the capital to provide the appropriate amount of infrastructure at the appropriate time;

13.3 this link was emphasised by Professor Yarrow, who noted that:²

...investment incentives are clearly related to estimates of the cost of capital in an information disclosure regime both because of their direct effects (they carry implications about the Commission's view of things in the immediate pricing period) and longer-term, indirect effects (they convey signals about the general regulatory approach which may have implications for future decisions, e.g. how the Commission might react to subsequent out-turns).

13.4 we are concerned about that because when infrastructure is delayed or can't get across the line, then entire activities or markets are similarly delayed or lost. The loss for consumers can be significant;

13.5 the effects of prices being set too low cannot be avoided by reference to the dual till or consultation with airline customers, as speculated in the draft decision paper. The regime cannot defy economic gravity: if investors cannot expect an appropriate return over time on the investment in infrastructure to deliver the regulated services then the capital is not available.

14 We would prefer that these issues are discussed in the context of a particular pricing decision. The strength of these effects can be assessed in context. For this reason we would encourage the Commission to keep an open mind on these issues during the IM Review and not prematurely close off aspects of the analysis of airport performance.

15 Related to this, Professor Yarrow advised that it may not be possible (or desirable) to specify upfront all of the circumstances and reasons why a reasonable rate of return for an airport may differ from the mid-point of the Commission's cost of capital estimate.³ Attempting to identify and list all relevant matters in advance risks harming airports' ability to respond appropriately to the real-world challenges and develop reasonable pricing solutions in those circumstances.

Assessing airport returns ex post

16 We do believe it is important to consider *both* forecast and actual returns in order to give consumers and stakeholders a complete analysis of airport performance.

17 Professor Yarrow emphasised the importance of analysing actual returns as well as forecast returns:⁴

The application of great care is therefore required when using the WACC as an indicator of reasonable price levels under an information disclosure regime, particularly when the assessment is made on an ex ante basis. The forecasting information disclosed by businesses is generally focused on a 'central' forecast and, in practice, it can be exceedingly difficult to incorporate regulatory risk into such a forecast in any very explicit way.

18 This rings true to CIAL. We suggest it is impossible to assess our performance since 2012 simply by reference to our pricing and forecasts in December 2012. The market conditions over the last 4 years; the service we have delivered to our customers and travellers; the airline growth, airline competition and connectivity that we have fostered; our increasing experience in operating the new terminal building; and our financial returns are all relevant. To be fully informed, consumers must have good information on all these aspects of our performance.

² Yarrow Report, p 9.

³ Commerce Commission Input methodologies review draft decisions, p 29.

⁴ Yarrow report, p 6.

19 The Commission's focus to date on forecast returns has been a key contributor to the way in which the information disclosure regime has operated in practice as price control. We encourage the Commission to follow Professor Yarrow's lead and place greater weight on actual returns when analysing airport performance. The broader range of information to be provided by the airports to facilitate the contextual analysis will assist the Commission with this.

Non-standard depreciation

20 The Commission proposes to include in the IMs eight principles on when to adopt non-standard depreciation for disclosure and the features of any non-standard depreciation used for disclosure. This will inform airports about what is expected by the Commission when an airport chooses to apply non-standard depreciation.

21 CIAL agrees with this approach, and the principles proposed in Table 5.1 of Topic Paper 5. This approach strikes an appropriate balance, informing all stakeholders about the Commission's expectations and a principled approach to non-standard depreciation, without being so prescriptive as to mandate particular approaches to disclosure that might depart from commercial pricing.

22 We note that one aspect of Principle 5 could be clarified. Principle 5 addresses the expectation that non-standard depreciation relate to expected value or utilisation of the existing asset base. We suggest that the principle be refined to clarify that this principle would authorise a firm to choose a depreciation method that resulted in the combination of the return on capital and return of capital bearing a relationship to the expected value or utilisation of the existing asset base (and thus generating a smoother price path over time).

23 As the Commission is aware this topic is of particular relevance to CIAL. Our approach to depreciation in PSE2 was restated to a non-standard depreciation method (implied depreciation) in order to make transparent the return of capital during PSE2. Looking forward to PSE3 we have committed to consulting with our customers on an approach to non-standard depreciation that is transparent and economically correct. The principles proposed by the Commission assist us in selecting and explaining our depreciation method, and should provide a useful framework for consultation with our customers.

Transitional arrangements

24 In Attachment A to Topic Paper 5 the Commission proposes transitional arrangements that will apply to CIAL and to AIAL. In 2017 CIAL and AIAL will be required to re-issue their FY 2016 disclosures to reflect the updated IM and ID requirements, post this review.

25 We can appreciate the reasons for this proposal – to make the comparison with the PSE3 disclosure meaningful – and we are happy to make the additional disclosures. We anticipate this will include an adjustment to respond to the challenges (and resulting distortions) currently caused by the requirement to allocate implied depreciation at the individual asset level when it was in fact determined at the aggregate asset base level.⁵ We observe that the proposal to allow airports apply "alternative methodologies with equivalent effect" will allow us to ensure that the PSE2 depreciation method is properly reflected in the FY16 disclosure, and without excessive cost, complexity and consequent lack of transparency.

Some technical points

26 Our current work on preparing for PSE3, and aligning our pricing methodology and model with disclosure requirements as far as possible, has uncovered two technical improvements that could be made. We submit that alignment and transparency would be improved if the requirements of the IMs were changed so that:

⁵ As noted at paragraph 231 of Topic paper 5.

- 26.1 Depreciation – a year of inflation was added to the depreciation component (i.e., it was established in end of year terms). This would permit the calculations of depreciation and the RAB where inflation indexation is applied to be calculated and presented in constant price terms. This would be a much easier calculation for customers and consumers to understand. It also permits substantial simplification with respect to the calculation of straight line depreciation (this simplification is particularly useful where an airport is keen to inform customers about the expected trend in prices out over a longer period than a single price setting period);
- 26.2 Revaluation gains – a full year of revaluation gains is required to be recorded for assets in the last year of their service life (currently, the standard approach is for no revaluation gain in an asset’s last year of service). This change would mean that the revaluation gain that is calculated at an aggregate level (i.e., as the revaluation rate multiplied by the opening RAB) would align precisely with the revaluation gain that is calculated at an individual asset level, and so make it much easier to explain the calculation of revaluation gains to customers. Under the current requirements, the revaluation gain calculated at an aggregate level will inevitably differ to the sum of the revaluation gains calculated at an individual asset level, which in turn means that high-level demonstrations of the roll-forward of the RAB will never match up precisely with the sum of the calculations at the individual asset level.⁶
- 26.3 Options for asset revaluations – we suggest that the Commission leave open the option of permitting an airport to apply a fixed increment to the revaluation gain to either all assets (or just to land assets). This would take the firm of having assets revalued at $CPI + Z\%$, where the $Z\%$ was locked in in advance for a price setting period (and treated as income in price setting). Applying an increment to the revaluation gain in this manner is an alternative means of adjusting the recovery of cost over time to the choice of a different depreciation method, and may be particularly appropriate in some circumstances (e.g., where the desire is to smooth out the recovery of land over time, which cannot be influenced by the choice of depreciation method).
- 27 In addition, we are advised that an improvement could be made to the change proposed in the draft decision in the IM Review to the treatment of cash flow timing. The key points are:
- 27.1 The payment terms in the airport sector are the same as those in the energy sector (billing is monthly in arrears, with revenue received on the 20th of the following month);
- 27.2 To reflect this cash flow timing, in its regulation of the energy sector the Commission has not used a midyear timing assumption for revenue (but has retained this for the other cash flow items). Instead, it assumes that revenue is received monthly in arrears on the 20th of the following month, which is equivalent to receiving all revenue 148 days prior to the end of the year;
- 27.3 To be consistent with principle, reflect actual cash flow timing,⁷ and regulation across the sectors,⁸ the IMs and ID regulation should establish the same position as used in the energy sector;

⁶ We note that this change would require an offsetting change to depreciation. If the suggestion of adding a year of inflation to depreciation (the point above) was adopted, then no further adjustment would be required. If the change to depreciation was not accepted, then it would be necessary to increase depreciation in the final year of an asset’s life to offset the revaluation gain (and so ensure that the asset becomes fully depreciated).

⁷ An objective stated in paragraph 541 of Topic Paper 5

⁸ An objective stated in paragraph 537 of Topic Paper 5

27.4 In the airport ID context, specify that the default timing assumption is the same as that in the energy sector (i.e. 148 days prior to the end of the year for revenue and midyear for other items). This would be specified in PSE and annual disclosures, with the flexibility in PSE disclosures to justify and use a different timing assumption;⁹

27.5 The current proposal to set mid-year timing as the default risks misleading consumers, and creating confusion and complexity. The default disclosure will have an authority in practice that misleads stakeholders; particularly in annual disclosures where there is no alternative option; the dynamic of all airports departing from the default when making PSE disclosures will be misread; and the fact that the Commission has two different regulatory treatments in two sectors for the same actual cash flows will confuse stakeholders.

28 We would be happy to make our external and internal experts available to discuss these points with the Commission staff if that would be helpful.

Conclusion

29 CIAL appreciate the work done to date by the Commission on the IM Review. The set of changes proposed improve the quality of the ID regulation, and the possibility of disclosure empowering stakeholders to make informed judgments about the performance of airports. CIAL is committed to playing its part in providing the necessary information and commentary to assist the Commission and consumers.

30 If there are any questions about this submission, or CIAL's position on any aspect of the IM Review, please contact us.

Yours sincerely



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⁹ This is the scheme proposed in paragraph 545 of Topic paper 5