TREATMENT OF UNFORECAST LAND REVALUATIONS

Presentation by BARNZ to the Commerce Commission
Input Methodologies Forum

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ISSUE

HOW AND WHEN DO YOU TREAT UNFORECAST LAND REVALUATIONS AS INCOME IN ROI PROFITABILITY ASSESSMENTS?

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THE PRINCIPLE

… if a nominal cost of capital is applied to an inflated/indexed asset base, any revaluations of the asset, such as an upward revaluation for inflation, must be treated as income in the ROI for profits to be monitored effectively.

The same principle applies … even where a revaluation occurs for reasons other than economy-wide inflation, and where the extent of the revaluation differs from the change in the CPI. Because the use of a nominal WACC with a non-revalued asset base is consistent with FCM, any revaluation gain must be treated as income in the ROI.

CC Airport Reasons Paper para 2.8.14-15

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CURRENT ID REQUIREMENTS

- Unforecast revaluations are disclosed as income in the year in which they occur
- The closing asset base in any year includes any revaluations undertaken during that year
- There is no requirement on how often or when in the pricing cycle land revaluations should be undertaken
- No practical effect as the disclosure of unforecast revaluations is historic only

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UNFORECAST LAND REVALUATIONS HAVE HISTORICALLY BEEN VERY LARGE

Airport	Consultation date	Level of unforecast land revaluations
Auckland Airport	2007	Circa $200 million
Wellington Airport	2007	$112 million for all assets
Christchurch Airport	2008	$154 million for all assets
Christchurch Airport	2012	$33 million

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HOUSE VALUES ARE CONTINUING TO RISE IN EXCESS OF CPI

Over the last four years from Q2 2011 to Q2 2015:

- CPI increased by 3.5%
- Manukau City house prices increased by 56%
- Southwest Christchurch house prices increased by 37%
- Central and southern Wellington City house prices increased by 8%

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PROBLEM DEFINITION

- Airports set prices on a forward looking basis
- Unforecast revaluations are unknown when prices are set therefore can only be treated as income for pricing purposes after they crystalise
- If unforecast revaluations used in the asset base to set charges are not treated as income as prices are reset, then this breaches the NPV = 0 or FCM principle

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PROBLEM DEFINITION CONT'D

- In the CC's forward looking ROI calculations only forecast revaluations were treated as income
- Unforecast revaluations were not taken into account in the forward looking assessments, instead being treated as income in the prior pricing period on a historic basis
- This significantly understates the level of targeted returns

PROBLEM DEFINITION CONT'D

- Unforecast land revaluations only affect prices paid by consumers when prices are reset using an RAB which includes those unforecast revaluations.
- While the CC's approach includes actual revaluations in historical annual disclosures, it does not treat actual revaluations as income in forward looking assessments of targeted profitability based on the prices set — which is what actually affects customers and consumers.

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THE OUTCOME

- Profitability in the first period when the unforecast revaluation occurred exceeds what was targeted
- The incentives on controlling opex and capex become dampened by the increased profitability
- The unforecast revaluation is not ever taken into account in assessing targeted profitability
- The unforecast revaluation becomes less likely to be taken into account as income by the supplier when resetting prices
- The unforecast revaluation becomes a windfall profit to the supplier

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OUTCOME INCONSISTENT WITH PART 4

- Reduced limitations on suppliers extracting excessive returns
- Windfall gains to suppliers
- NPV = 0 or FCM principle not achieved
- Weakens efficiency incentives created by the *ex ante* approach to setting operating expenditure and capital expenditure forecasts

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CC APPROACH DIFFERS TO HOW CIAL TREATED UNFORECAST REVALUATIONS

- CIAL treated all of the $33m of unforecast land revaluations from PSE1 as income in PSE2 when it reset prices.
- The CC did not count any part of those unforecast revaluations as income in its forward looking profitability assessment for CIAL.
- CIAL committed to treat any future unforecast land revaluations as income as it resets prices.
- BARNZ agrees with CIAL's approach.

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CC APPROACH DIFFERS TO AIAL'S COMMITMENT OVER UNFORECAST REVALUATIONS

- AIAL committed that if it revalued its assets for pricing purposes at the end of its current moratorium it would treat those revaluations as income in the following pricing period (ie PSE3).
- BARNZ agrees that if any part of the moratorium on asset revaluations for pricing purposes finishes then those revaluations need to be treated as income in pricing.
- However, the CC's current approach to forward looking profitability assessments would not treat such revaluations as income.

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FIRST POTENTIAL SOLUTION

- Amend ID requirements to require a forward looking profitability assessment to be disclosed when prices are reset; and
- As part of the forward looking profitability assessment require any unforecast land revaluations which occurred during the previous pricing period to be treated as income in the ROI for new pricing period.

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SECOND POTENTIAL SOLUTION

- Amend ID requirements so that unforecast land revaluations are only permitted to enter the RAB at the start of the first year of a new pricing period.

THIRD POTENTIAL SOLUTION

- Amend the IMs to align land valuation movements with indexing of specialised assets so that land is only indexed by CPI going forward with no unforecast land revaluations.
- This may trigger merits review applications as it significantly differs from the current land valuation IM.

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