BARNZ
BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND INC

14 March 2014

Dr Mark Berry
Chairman
Commerce Commission
By email mark.berry@comcom.govt.nz

Dear Dr Berry

Treatment of un-forecast revaluations in s56G analysis

I am writing to you to set out BARNZ's concerns over the consequential effects of the Commission's treatment of the un-forecast revaluations made by Christchurch Airport to its aeronautical assets, within the modelling undertaken by the Commission of the returns being targeted by the Airport. In short, the Commission did not include the income from those un-forecast revaluations in its modelling of the Airport's targeted returns.

In so doing the Commission under-estimated the levels of return targeted by the Airport, both within the next five years and over the 20 year period the Airport's pricing model related to. That is of great concern to BARNZ members.

Of even greater concern to BARNZ members, is the forward looking impact of the Commission's approach on pricing decisions by Christchurch Airport and the other airports. Already, within a month of the final report, Wellington Airport has moved back from its commitment made in November 2013 to treat actual revaluations as income, and has reverted to its previous position that only forecast revaluations have to be treated as income. As you are aware, Auckland Airport is currently operating under a moratorium on asset revaluations agreed with airlines which expires in 2017. The Commission's approach has opened the opportunity to the Airport to not treat the un-forecast revaluations as income. The amounts are considerable.

BARNZ considers that the Commission's approach to its analysis for Christchurch Airport has significantly reduced the ability of the input methodologies and information disclosure under Part 4 to limit the earning of excessive profits. It has reopened the whole issue of how the un-forecast component of actual revaluations should be treated for the purposes of setting charges, and creates an enormous gap for airports to potentially exploit to the detriment of consumers.

Treatment of un-forecast revaluations historically contentious

One of the most contentious issues around airport pricing since the privatisation of Auckland and Wellington Airports has been the treatment of asset revaluations. All three of New Zealand's large international airports have a history of revaluing aeronautical assets, and setting charges off that higher asset base, without fully treating all the asset revaluations as income when charges are set. This has enabled charges to be increased simply by writing up asset values without any actual corresponding investment by the airports.

Level 12, BDO Tower, 120 Albert St, PO Box 2779, Auckland 1140, NZ
Phone: 09 358 0696 Fax: 09 358 0697 Email: admin@barnz.org.nz **www.barnz.org.nz**

Treating only forecast revaluations as income had left a significant gap open to airports to exploit in order to earn excess returns. Revaluations could be forecast at a relatively low level, with any difference between those low forecasts and the actual higher revaluations (i.e. un-forecast revaluations) being retained by the asset owner to earn excessive profits by setting prices off the new higher valuation, without treating the revaluation gains as income. By the time the input methodologies were being developed by the Commerce Commission in 2010, BARNZ estimated that for the three main airports alone, there were $400m of revaluations not properly accounted for as income in the charge setting process over the previous decade. These revaluations created a stream of excess profits out into the future for as long as those assets continued to be used to provide airport services. In the case of land, this was forever.

Treatment of revaluations was therefore one of the matters listed in s52T as being mandatory for the Commerce Commission to develop input methodologies in relation to.

Commerce Commission general principle is all revaluations must be treated as income

In its reasons paper accompanying the input methodologies for regulated airport services, the Commerce Commission articulated the general principle that, if a nominal WACC is applied to a revalued asset base, then all revaluations, whether undertaken by indexing or as a result of a new valuation, must be treated as income in order to be consistent with the FCM or NPV = 0 principle:[1]

> ... 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, however, 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.

Accordingly, for information disclosure purposes, the Commission required airports to disclose both indexed and un-forecast revaluations of land and specialised assets, and to include these as income in its calculations of return on investment (ROI).

High Court confirmed all revaluations must be treated as income for pricing purposes

In the recent merits review of the input methodologies, the High Court affirmed the general principle articulated by the Commerce Commission that all revaluations must be treated as income, stating:[2]

> The Commission's approach for the future is generally accepted. Consistent with its use of a nominal WACC, which incorporates an allowance for inflation, all revaluation gains are required to be treated as income for pricing purposes.

It thus seemed to BARNZ that the decade long controversy over whether only forecast revaluations had to be treated as income when setting charges, or whether all revaluations (ie forecast as well as un-forecast revaluations) were required to be treated as income when setting charges, had been settled. In the future, all revaluations had to be treated as income in the charge setting process. The High Court, which had heard months of submissions by all of the regulated suppliers, described the principle as being 'generally accepted' by the parties and 'uncontroversial' among them.

---

[1] Refer Commerce Commission, Specified Airport Services Input Methodologies Determination, 22 December 2010, para 2.8.13 – 17, quote in text is para 2.8.14 – 2.8.15.

[2] *Wellington International Airport Ltd v Commerce Commission*, High Court, 11 December 2013, para 268.

Christchurch Airport treated all revaluations as income in its charge setting process

The clarity of the Commission's principle that un-forecast as well as forecast revaluations must be treated as income led Christchurch Airport and the airlines to the consensus that going forward, all revaluations would be treated as income when Christchurch Airport set its charges. In order to achieve this, when the airport set its charges at the end of 2012, it included a revaluation credit of $33.5m (the amount of previously un-forecast revaluations) as an off-set to its required revenue for PSE2. BARNZ agreed.

The Commission did not treat un-forecast revaluations as income in its assessment of Christchurch

However, the Commission did not make any recognition of this revaluation wash-up in its s56G modelling of the profitability being targeted by the Airport. The Commission only treated cash returns and forecast revaluations as income during PSE2. It did not treat the un-forecast revaluations undertaken at the end of PSE1 as income, revaluations which increased the asset values used to set prices in PSE2 and which therefore provided the airport with a higher revenue stream going forward.

BARNZ estimates that un-forecast revaluations of $20m were made since the commencement of Part 4. When they are treated as income they raise the return sought by the Airport from 8.9% to 9.3% in the 20 year model; and they raise the return sought by the Airport from 6.8% to 7.9% in the current pricing period (when they are treated as income in that pricing period).[3] We attach a note by Covec setting out the basis for this calculation.

While the Commission acknowledged its approach was 'conservative', which we interpret as meaning likely to understate the returns being targeted by the Airport, it omitted to make any adjustment to reflect the un-forecast revaluations.

In doing so, not only did the Commission understate the returns being targeted, it has also significantly undermined the clarity which had emerged from its input methodologies, accompanying reasons paper and the High Court merits review decision, all of which had laid down as uncontroversial the principle that going forward from the initial RAB, all revaluations, whether forecast or un-forecast, had to be treated as income for pricing purposes.

Wellington Airport now u-turning on treatment of un-forecast revaluations

Already, within a month of the final report on Christchurch Airport's pricing decision, Wellington Airport has performed a full circle in its position over the treatment of revaluations over the previous few months. Initially, Wellington Airport held to its previous position that only forecast revaluations had to be treated as income for pricing purposes, with un-forecast revaluations being to the benefit of the asset owner, and not being required to be treated as income for the purposes of price setting. However, following the merits review hearings, where the principle that all revaluations must be treated as income for pricing purposes was, as the Court described, 'generally accepted', in November 2013 Wellington Airport proposed setting charges on the basis that at the end of PSE3 (the new pricing period it is soon to enter), all actual revaluations in excess of (or below) the forecast revaluations used to set charges at the beginning of PSE3 would be treated as a credit (or debit) to charges in PSE4. BARNZ agreed with this approach, which reflected the approach of Christchurch Airport and was in accordance with the High Court's acceptance of how un-forecast revaluations should be treated.

[3] If the treatment as income is spread across 20 years as per Christchurch Airport's financial model, the return would only be lifted to 7.3%.

However, following the Commission's decision to not take account of un-forecast revaluations in its profitability analysis of Christchurch Airport, Wellington Airport has just this week recanted from that position, and instead reverted to only treating forecast revaluations as income.

Treatment of revaluations now open to abuse to facilitate extracting excess profits

In assessing the targeted returns in price setting, BARNZ considers it is essential that the Commission takes account of whether the Airport did treat un-forecast revaluations as income in the determination of revenue required over the period immediately following the un-forecast revaluations. The information disclosure regime is not functioning properly if it does not enable this principle to be applied.

This decision by the Commerce Commission to not treat un-forecast revaluations as income when assessing the returns being targeted by Christchurch Airport as it set charges has significantly reduced the effectiveness of input methodologies and information disclosure in preventing excess returns being earned. As the High Court explained in its merits review decision:[4]

> Because a supplier's allowed maximum revenue (or assessed return) is derived in part from the value of the RAB, an increase in valuation directly affects the level of allowed revenue. In other words, in the absence of a regulatory constraint a regulated supplier could increase its allowed revenue simply by revaluing its assets, without any increase in investment or efficiency. Higher profits resulting from such a revaluation would be a windfall gain rather than a reward for superior performance, which is contrary to the long term benefit of consumers, and to the objective in s 52A(1)(d) of limiting a supplier's ability to extract excessive profits.

The Commission has effectively left airports able to revert to their approach prior to the introduction of Part 4 in which they forecast relatively low levels of revaluations, so that any actual revaluations in excess of those forecast, can be used by the airport to set higher charges going forward, without the need for any off-setting treatment of those un-forecast revaluations as income. As set out above, Wellington Airport has already within a month taken the opportunity to revert to its previous practice.

The Commission's approach is inconsistent with the objective in s52A of limiting the ability of suppliers to extract excessive profits, and represents a significant step backwards in the interests of consumers.

Commission should address how to close this loophole

BARNZ sees this issue as creating a very serious shortcoming in the ability of information disclosure and the input methodologies to promote the long term benefit of consumers and, in particular, to limit the ability of suppliers to extract excessive profits. We request that the Commission look at what changes could be made to the input methodologies and information disclosure requirements to eliminate this material loophole.

Yours sincerely

John

John Beckett
Executive Director

---

[4] *Wellington International Airport Ltd v Commerce Commission*, High Court, 11 December 2013, para 383.