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Emerging Views on the Airport WACC Percentile

The Commission, on 19 February 2016, published its *Emerging views on airport WACC percentile* along with an expert report prepared by Professor George Yarrow of the UK Regulatory Policy Institute.

These papers follow on from work undertaken by the Commission during 2014 on the appropriate WACC percentile to use when assessing airport profitability and setting price-quality paths for electricity and gas businesses. This work itself was in response to scepticism expressed by the High Court in 2013 regarding use of the 75th percentile WACC when the Commission was undertaking its functions under Part 4 of the Commerce Act. While the Commission subsequently moved to adopting a 67th percentile WACC for assessing returns anticipated by gas and electricity businesses, it deferred further work on the airports sector, preferring instead to deal with this as part of the wider Input Methodologies Review.

BARNZ, on behalf of its members, commissioned an expert report from COVEC to provide comment on Professor Yarrow's advice to the Commission and the Commission's emerging views. That report has been provided to the Commission by BARNZ. Air New Zealand supports the views expressed by COVEC and the BARNZ submission. The following comments should be read in conjunction with that submission.

As noted in the Commission's emerging views, as a result of its work over 2014 it considers "…there is limited rationale for using the 75th percentile (which has been greeted with scepticism by the court) or the 67th percentile (which was determined in the context of electricity and gas businesses) as the de facto upper limit of an acceptable range for airports."

The Commission goes on to state that "…the rationale for using a percentile above the mid-point appears weaker for airports than for electricity and gas businesses."

Air New Zealand whole-heartedly endorses this view. The WACC IM already takes account of the different risk profile of airports vis a vis other regulated sectors in the form of the asset beta and other inputs. To add a further uplift to the return is simply over-compensating suppliers at consumers' expense. It is unfortunate that the clear articulation in the Input Methodologies that the mid-point was the appropriate starting point – a view endorsed by the High Court – has been undermined by subsequent practice of deeming a return at the 75th percentile as being appropriate. This was particularly evident in WIAL's setting of prices for the period commencing on 1 June 2014 and effectively ensures an above normal return over this period.

As noted in the Commission's emerging views there are other factors specific to the regulated airports which weaken any potential asymmetric impacts on consumers arising from underinvestment. Professor Yarrow discusses in some detail the "cross-network" and "platform" effects peculiar to airports under which "…it is quite normal to find that rates of return calculated on aeronautical assets (as calculated on a dual till basis) are below estimated costs of capital." Due to the complementary nature of activities, investment in aeronautical activities and facilities improves the overall "attractiveness" of an airport to airlines and passengers, thereby increasing non-aeronautical revenues and resulting in overall returns in line with an appropriate return. The fact that the airports subject to Part 4 regulation earn a significant portion of their overall revenue from unregulated complementary services provides a substantial incentive to invest as "…in considering whether to cut back on an investment programme in the face of lower aeronautical revenues, an airport will tend to give consideration to factors such as the negative effects that cutbacks might have on complementary service revenues." This is a powerful incentive, unique to the airports sector, which is only heightened as a result of the dual till approach New Zealand airports take in their approach to pricing.

The Commission has expressed its emerging view as being that it should publish its mid-point estimate of the cost of capital, and in addition either publish regular percentile estimates, or its estimated standard error. This approach would, in the Commission's view, be "…consistent with the original intention of the IMs…" and "…enable any assessment to take into account different contextual factors.", including the timing of the assessment, airport specific factors or other factors.

Air New Zealand agrees with the Commission's intention to publish its mid-point estimate and its contention that this would reduce the focus which has emerged on the upper limit of the WACC range. Such an approach would be significantly more in accordance with the objectives of the section 52A purpose statement. Air New Zealand considers there to be no value in publishing percentile estimates other than the mid-point or the estimated standard error.

As noted by both the Commission and Professor Yarrow, this approach will require airports to provide evidence of relevant factors and justification for diverging from the Commission's mid-point estimate. The effectiveness of this approach will be dependent to a large extent on the regulatory framework itself, which is currently under review by MBIE. In the absence of a credible threat of regulatory action arising from abuse of monopoly power any requirements for greater justification and evidence will ultimately prove meaningless.

The Commission has asked stakeholders to comment on whether there are factors that should or should not allow airports to target returns that diverge from a mid-point estimate using the IM WACC methodology. Air New Zealand notes that considerable effort went into developing the WACC IM as part of the IM development process, with the resulting outcome reflecting the considered views of experts and the Commission. Indeed, at the time the Commission assessed the resulting mid-point WACC against relevant market comparatives and concluded that the cost of capital IM produces estimates which are reasonable and commercially realistic.

As such, it is questionable whether there are valid reasons for adopting different inputs. In any case it is difficult to come up with a definitive list of reasons why this may be appropriate. Given the Commission's emerging view that airport contextual factors will play a larger part in the information disclosure process it is probably unhelpful to attempt to specify these at this time as this will undermine the Commission's contention that the mid-point WACC is the appropriate point for assessing whether returns are commercially realistic.

The Commission is also seeking views on whether there are factors that could be used to justify an airport targeting returns above or below their mid-point WACC. Air New Zealand considers that there is no commercial justification whatsoever for an airport, when setting prices, targeting returns above the mid-point WACC. As noted in the COVEC expert report prepared for BARNZ, "A target of the WACC mid-point strikes a balance between these two forms of excess [pricing and investment]." Targeting returns in excess of this will achieve nothing more than creating a framework within which airports are not limited in their ability to extract excessive profits, contrary to the purpose of Part 4.

However, as noted by Professor Yarrow, given the extent of complementary activities in the airports sector there may well be circumstances where returns on aeronautical assets are below the estimated cost of capital. Again, this is an assessment which can be made in light of an individual airport's specific context.

It has been suggested that "superior quality" could be a basis for justifying returns above the mid-point WACC. Any such claims would need to subject to rigorous review, including support from users regarding the quality achieved. There is a question as to exactly what superior quality entails, e.g. if it involves a level of infrastructure above what is required to meet consumer demands, then the appropriate return on any additional capital expenditure required to achieve that level of quality would be captured through the use of the mid-point WACC rather than requiring any uplift to the return target.

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The Commission is lastly seeking views on whether a quantitative framework could be useful in informing an appropriate percentile in the airport context. Given our view that the mid-point is the appropriate point when assessing target returns there seems little value in developing a framework to allow deviations from this point. The intent to rely on greater airport-specific justification, reasoning and evidence when assessing returns should be sufficient to allow all interested parties to reach appropriate conclusions as to the appropriateness of those returns.

Air New Zealand appreciates the opportunity to comment on the Commission's emerging views on this issue and looks forward to further engagement with the Commission as its IM review progresses.

Please contact sean.ford@airnz.co.nz if you have any queries relating to the above.

Yours sincerely

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