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Feedback requested on analysis of Wellington Airport's third price setting event

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1. Introduction

Purpose of this draft report

2. On 30 June 2014, Wellington Airport disclosed information about the prices that will apply during the period 1 June 2014 to 31 March 2019. We are seeking feedback on our analysis of this price setting event.

Review of third price setting event required under information disclosure regulation

3. Wellington Airport is one of the three airports in New Zealand that are currently subject to information disclosure regulation under Part 4 of the Commerce Act.[1] Under this type of regulation, Wellington Airport must publicly disclose information about its performance annually, and following a price setting event.

4. After information is disclosed by an airport, we are required to provide summary and analysis of the disclosed information. The purpose of summary and analysis is to promote greater understanding about the performance of each airport, their relative performance, and the changes in their performance over time.[2]

5. The disclosure of information about the price setting event in 2014 is the third of its kind for Wellington Airport since information disclosure requirements were set under Part 4.[3] This third price setting event is referred to in this draft report as PSE3.

Review of second price setting event was undertaken as part of a wider exercise

6. Our review of Wellington Airport's second price setting event (PSE2) was undertaken as part of a wider exercise that reviewed the effectiveness of the information disclosure regime. This review was required under s 56G of the Act.[4]

7. Importantly, the prices set as part of PSE3 supersede the prices that had been set by Wellington Airport for PSE2. PSE2 was originally intended to run from 1 April 2012 until 31 March 2017. New prices came into effect under PSE3 on 1 June 2014.

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[1] Section 56A of the Act sets out the Airport companies that are subject to information disclosure regulation under Part 4, namely: Auckland, Wellington, and Christchurch airports.

[2] Refer: s 53B of the Commerce Act.

[3] Further information on the information disclosure regulation is available on our website: http://www.comcom.govt.nz/regulated-industries/airports/airports-information-disclosure/.

[4] 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.

8. In the final ‘s 56G report’ for Wellington Airport we noted that for PSE2:[5]

    8.1 An excessive return was being targeted over time based on Wellington Airport’s own forecasts of expenditure and revenue growth;[6] and

    8.2 Innovation, quality, and pricing efficiency were appropriate or at least improving at Wellington Airport.

9. The apparent ineffectiveness of information disclosure at limiting excessive profits from specified airport services was of particular concern.[7]

Focus of review of third price setting event is profitability

10. We have focussed our review of Wellington Airport’s third price setting event on promoting greater understanding about the change in Wellington Airport’s expected profitability. This is because the primary change introduced by Wellington Airport at PSE3 was a reduction in charges.

11. Other areas were generally not changed at PSE3 or were not considered to be of significant concern during consultation between the airport and the airlines. Therefore, and consistent with the approach in the s 56G report, we have not reviewed the expenditure and revenue growth forecasts relied on by Wellington Airport when setting charges.

12. To analyse the profitability of Wellington Airport, we have adopted the same approach to that which was tested through consultation on the s 56G report.[8] For example, we have estimated the internal rate of return (IRR) over the pricing period 1 June 2014 to 31 March 2019.

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5 We were unable to conclude on efficiency of operational expenditure, investment efficiency, or sharing the benefits of efficiency gains.

6 For PSE2, we found that Wellington Airport targeted a return of 8.9% based on its understanding of how the Commission might assess its performance in light of the information disclosure requirements and input methodologies in place at the time. This compares to our estimate of an acceptable range of returns at that time of 7.1% to 8.0% (50th to 75th percentile post-tax WACC used in our s 56G report).

7 Refer: 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; paragraph 3.3.

8 Further information on the framework for considering the effectiveness of information disclosure and our approach to profitability assessment is available in: 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.

How you can provide your views

13. Feedback should be provided to John McLaren (Manager, Regulation Branch) by 8 May 2015 by email (c/o regulation.branch@comcom.govt.nz).

Material published alongside this draft report

14. Published alongside this draft report is correspondence received from the Board of Airline Representatives New Zealand (BARNZ), which we will consider as a submission on this draft report.[9] We have also published our analytical model and Wellington Airport's model on our website.

Next steps

15. We will release a final report on the expected profitability of Wellington Airport for PSE3 before 30 June 2015 after consideration of feedback on this draft report. We also intend to separately consider the information provided in Christchurch Airport's re-disclosure of pricing information.

16. After completing these reviews, we are likely to seek views on potential topics for future pieces of summary and analysis for airports. For example, analysis of historical returns may help provide a fuller picture of the performance of airports, as would developing our approaches for analysing expenditure and revenue forecasts.

17. At this stage, however, we invite you to provide your views on any aspect of this draft report; the correspondence received in advance from BARNZ; and the supporting model that we have published on our website.

9 Board of Airline Representatives New Zealand (BARNZ) "Wellington Airport Price Reset for PSE3" (letter), 2 March 2015.

2. Profitability analysis

Purpose

18. This chapter sets out the results of our analysis of Wellington Airport's expected profitability for the period 1 June 2014 to 31 March 2019 following the third price setting event.

Two parts to profitability assessment for Wellington Airport

19. Consistent with our approach to the s 56G report, we have considered the returns being targeted by Wellington Airport in two main ways:

    19.1 The returns targeted by Wellington Airport based on a reasonable assessment of how, at the time of resetting prices, it considered we might assess its profitability (referred to as the 'conduct' assessment in the s 56G report); and

    19.2 The returns that Wellington Airport could expect to earn in practice if certain matters (such as the timing of cash flows) are treated in an alternative way that may be more accurate, but where that alternative treatment is not required by the regulatory requirements that were in place at the time prices were set (referred to as the 'performance' assessment in the s 56G report).

20. Also consistent with the s 56G report, we have considered the conduct assessment as the basis for understanding the effectiveness of information disclosure regulation at promoting the purpose of Part 4 of the Commerce Act, particularly limiting excessive profits, which we identified as an area of concern in our s 56G report.[10]

Target returns are within an acceptable range based on information disclosure requirements

21. Our analysis shows that at PSE3, Wellington Airport was targeting returns within an acceptable range based on its understanding of how we might assess its profitability in light of the information disclosure requirements and the input methodologies that were in place at the time.

22. In particular, for the period 1 June 2014 to 31 March 2019, Wellington Airport set prices such that its expected returns over the whole of the period are equivalent to a return of 8.4% when the information disclosure framework is applied.[11] This target return is above our assessment of a normal return but is just within the upper limit of an acceptable range of 7.4% to 8.4%.

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[10] The purpose of information disclosure regulation is to ensure that sufficient information is available to interested persons to assess whether the purpose of Part 4 is being met.

[11] We use the annual internal rate of return (IRR) as the primary measure of profitability. The scope of the analysis only covers aeronautical services (i.e. aircraft, freight, airfield, and specified passenger terminal activities) and excludes other non-regulated services such as car parks and retail facilities.

23. Our estimate of the range of acceptable returns reflects the 50th to 75th percentile estimates of a post-tax weighted average cost of capital (WACC) as at 1 July 2014.[12] We consider that the range of 50th to 75th percentile of WACC remains the most appropriate to use until we have completed a review of the airport industry WACC percentiles.[13]

Returns expected in practice are broadly similar

24. In practice, Wellington Airport may expect to earn slightly higher returns during and after the pricing period than we have estimated; however, the approaches adopted by Wellington Airport appear reasonable based on the information disclosure requirements in place at the time.

25. Alternative treatments of tax that we consider more appropriate result in expected returns of 8.5% rather than 8.4%. Alternative assumptions on the timing of cash flows suggest that expected returns could be up to 8.9% when also using the alternative tax treatments.

26. Further analysis of the assumptions relied on by Wellington Airport and the alternative treatments can be found in Chapter 3.

[12] We consider that the WACC that was determined in July 2014 for Auckland Airport and Christchurch Airport information disclosure is appropriate to use for the assessment of Wellington Airport's PSE3 because Wellington Airport finalised its prices for PSE3 at approximately the same time. This WACC was published in: Commerce Commission "Cost of capital determination for information disclosure year 2015 for Transpower, gas pipeline businesses and suppliers of specified airport services (with a June year-end)", 31 July 2014. Attachment A shows the relevant vanilla and post-tax WACC and the parameters that were used to calculate the WACC.

[13] We have recently changed our position on the appropriate WACC percentile range from 75th percentile to 67th percentile for a number of other sectors, but have not yet reviewed the appropriate WACC range for airports information disclosure. We intend to undertake this review as part of the upcoming seven-year input methodologies review (see Commerce Commission "Open letter on our proposed scope, timing and focus for the review of input methodologies", 27 February 2015).

Price reductions reflect changes to pricing approach

27. The price reductions introduced as part of PSE3 reflect a number of changes that Wellington Airport has made to its pricing approach. Below are the three main changes from the PSE2 approach that we assessed in the s 56G report.

    27.1 Wellington Airport has used a target cost of capital that is within our assessment of an acceptable range. The target cost of capital used for PSE2 was higher than our assessment of an acceptable range.

    27.2 Wellington Airport has used a 'market value alternative use' (MVAU) approach to land valuation for PSE3 as required by the input methodologies. For PSE2, Wellington Airport used a market value existing use (MVEU) approach to land valuation.[14]

    27.3 For PSE3, Wellington Airport recognised that the wash-up for 'the Rock' terminal development does not represent a reduction in its target return, which is more consistent with the approach we adopted when preparing the s 56G report.[15]

28. Overall, Wellington Airport indicates that it has intended for the approach to PSE3 to be consistent with the input methodologies.

Information disclosure regulation has helped limit excessive profits

29. The extent to which Wellington Airport's expected profitability has changed as a result of PSE3 will determine whether our conclusion on the effectiveness of information disclosure has changed since the s 56G report was published.

30. Based on our analysis of PSE3, the announcement of price changes suggests that information disclosure regulation has been effective at limiting Wellington Airport in its ability to earn excessive profits from specified airport services.[16] These services include aircraft, freight, airfield, and specified passenger terminal activities, but exclude other non-regulated services such as car parks and retail facilities.

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[14] Wellington Airport's land valuation for its regulated portion of land used for PSE3 pricing was $106m, while it used a regulated land valuation of $204m for its PSE2 pricing.

[15] This issue for PSE2 is described in paragraphs F55 to F59 of the s 56G report.

[16] Under section 4A(1) of the Airport Authorities Act 1966 (the AAA), Wellington Airport remains able to set charges for specified airport services as it "thinks fit".

31. The prices set for PSE3 have reduced Wellington Airport's expected revenue by $33m relative to the PSE2 prices over the period 1 June 2014 to 31 March 2017.[17] This is the present value of the reduction as of 1 April 2012, discounted using the 75th percentile WACC as used for PSE2 (8.0%).

32. The effectiveness of the information disclosure regime at limiting the ability of Wellington Airport to earn excessive profits is relevant to the reviews of the regulation of airports that are currently being undertaken by the Ministry of Business, Innovation, and Employment and the Ministry of Transport.[18]

[17] Although Wellington Airport benefitted from PSE2 prices from 1 April 2012 to 30 May 2014, our calculations indicate that the expected over-recovery for that period is equivalent to less than $1m of excess revenue (present value as at 31 March 2012, using the WACC 75th percentile (8.0%) as the discount rate). This is because the majority of the over-recovery during the PSE2 pricing period was expected during the period now superseded by PSE3 pricing.

[18] http://www.med.govt.nz/business/competition-policy/part-4-commerce-act/airport-regulation/effectiveness-information-disclosure-regulation and http://www.transport.govt.nz/air/caa-act1990-aa-act1966-review-consultation/.

3. Approaches to analytical issues

Purpose

33. This chapter explains our approaches to analytical issues for the analysis of Wellington Airport's PSE3, including the following:

    33.1 Land valuation;

    33.2 Alternative tax treatments;

    33.3 Cash flow timing assumptions;

    33.4 Treatment of the partial year; and

    33.5 Treatment of leased assets.

34. Some of these approaches are different to those used by Wellington Airport in setting prices for PSE3. However, Wellington Airport's approaches appear reasonable in light of the regulatory requirements that were in place at the time.

Land valuation

35. Wellington Airport has used an MVAU approach to land valuation for PSE3 as required by the input methodologies. For PSE2, Wellington Airport used an MVEU approach to land valuation.

36. The approach to land valuation employed by Wellington Airport does not appear to be inconsistent with the input methodologies for asset valuation. There is likely to be a range of valuations that are consistent with input methodologies, reflecting the judgements required by professional valuers.[19]

37. Wellington Airport has forecast land revaluations based on forecast changes in the Consumer Price Index (CPI), which is consistent with the input methodologies. Therefore, at PSE3, Wellington Airport's approach seems reasonable. To the extent that the value of land changes at a different rate to this forecast, careful scrutiny will be required on the way in which those revaluations are treated at future price setting events.

[19] The input methodologies for asset valuation, including land valuation, are due to be reviewed as part of a wider review of input methodologies.

Alternative tax treatments

38. There is a small difference in Wellington Airport's treatment of the wash-up for the Rock terminal development compared to our approach in the s 56G report. The airport has included the tax adjusted value of the wash-up in its calculation of regulatory profit which is then used in its tax calculation. In the s 56G report we used the gross value. There is also a small difference between our calculation of tax depreciation and Wellington Airport's calculation.

39. Using the two alternative tax treatments together in analysing the expected returns of Wellington Airport raises the expected returns from 8.4% to 8.5%.

Cash flow timing assumptions

40. Wellington Airport has made the assumption that its cash flows occur at the end of each year. While information disclosure requirements for airports specify end of period cash flows timings, we have specified more specific intra-year cash flow timing for other regulated sectors.

41. In the s 56G report we noted that the use of end of year cash flows is the most conservative assumption, and does not reflect actual cash flows at Wellington Airport. The use of mid-year cash flows would be the least conservative, while actual cash flow timing is likely to be somewhere between mid-year and year-end.

42. We have considered the impact of using intra-year cash flow timing assumptions on our assessment of Wellington Airport's expected profitability. We calculated a range of profitability, with the lower bound based on year-end cash flows and the upper bound based on mid-year cash flows. We also followed this approach for the s 56G report.

43. The impact of adopting a mid-year cash flow assumption as well as the two alternative tax treatments is an annual return of 8.9%, while a year-end cash flow assumption combined with the alternative tax treatments produces an annual rate of return of 8.5%. The range of returns given alternative cash flow timing is 8.4% to 8.8% if the alternative tax treatments are not applied. As noted in Chapter 2, however, the use of a year-end assumption by Wellington Airport was acceptable in light of the information disclosure requirements in place at the time.

Treatment of the partial year

44. Assessing Wellington Airport's prices for PSE3 requires an approach to partial years because the PSE3 period covers four years and nine months. Our preferred approach to this issue is the same as the approach taken by Wellington Airport. We have re-created the partial year by accepting that the value of the asset base as of 31 March 2014 is representative of the value of the asset base as of 31 May 2014. Wellington Airport has provided cash flows that represent ten months of revenue, operating expenditure, and tax.

Treatment of leased assets

45. Wellington Airport excludes leased assets from its price setting events because the leased assets are less relevant to the airport's price setting consultation. However, leased assets form part of the regulated asset base. The airport has included information on leased assets in its PSE3 pricing disclosure and its annual information disclosure. Our analysis of Wellington Airport's expected returns includes the impact of leased assets. Wellington Airport targeted 8.4% returns for the leased assets, consistent with the rest of the airport's assets.

Attachment A: Weighted average cost of capital

Purpose

A1. This attachment sets out the WACC estimates and parameters used in analysing Wellington Airport's profitability.

Summary of WACC estimates

A2. The table below shows the airport WACC estimates for the appropriate time.

Table 1: WACC estimates[20]

	Mid-point	25th percentile	75th percentile
Vanilla WACC	7.64%	6.66%	8.63%
Post-tax WACC	7.37%	6.39%	8.36%

WACC estimate parameters

A3. The table below shows the parameters that were used to calculate the estimated WACC.

Table 2: WACC parameters[21]

Risk free rate (5 years)	4.17%
Debt premium (5 years)	1.18%
Equity beta	0.72
Tax adjusted market risk premium	7.0%
Average corporate tax rate	28%
Average investor tax rate	28%
Debt insurance costs	0.35%
Leverage	17%
Standard error of debt premium	0.0015
Standard error of WACC	0.015
Cost of debt (pre corporate tax)	5.70%
Cost of equity	8.04%

[20] For Auckland and Christchurch Airports for the information disclosure year 2015, sourced from Commerce Commission "Cost of capital determination for information disclosure year 2015 for Transpower, gas pipeline businesses and suppliers of specified airport services (with a June year-end) [2014] NZCC 19", 31 July 2014.

[21] Ibid.