



2 March 2015

John McLaren  
Manager  
Compliance and Performance Analysis Team  
Commerce Commission

Dear John,

**Wellington Airport Price Reset for PSE3**

BARNZ understands that the Commerce Commission is intending to update its IRR calculations in relation to Wellington Airport (WIAL) as a result of WIAL having reset its prices in the middle of last year. I thought it timely to provide the Commission with a summary of the key concerns held by BARNZ with respect to WIAL's price re-setting decision.

BARNZ participated in the pricing consultation undertaken by WIAL as the representative of Virgin Australia Airlines authorised under s2A of the Airport Authorities Act.

At the outset I should note that BARNZ was pleased that WIAL had moved to apply the Commission's input methodologies for asset valuations (MVAU for land and the indexed approach for specialised assets) rather than its previous much higher approaches (MVEU for land and a new ODRC valuation of specialised assets) and the Commission's 75th percentile WACC forecast, which it calculated was 8.36%, rather than its own targeted WACC which was previously 9.51%.

These changes were welcome. They brought WIAL's proposal and the BARNZ Assessment of what revenue is reasonably required under the Commerce Commission information disclosure and input methodology framework much closer together for the terminal cost centre, where the difference between appropriate charges assessed by BARNZ and WIAL reduced to between \$12m if the mid-point WACC was applied and \$2m if the 75<sup>th</sup> percentile WACC was applied.

However, significant differences remained for the airfield cost centre, primarily due to differences over the application of the MVAU land valuation methodology and the question of appropriate forecast revaluation rates for land. For the airfield cost centre BARNZ calculated that an appropriate return was some \$29m to \$45m lower than WIAL was targeting. Again, the range represented whether it was appropriate to target a return at the mid-point or at the 75<sup>th</sup> percentile estimate of the WACC.

BARNZ does not accept WIAL's characterisation at the beginning of its pricing disclosures that the remaining differences *reflect the natural situation where the different organisations are seeking their own commercial objectives*. The airport is suggesting that these differences are inevitable. In BARNZ

view they arise from a situation of natural monopoly where there are still material issues which information disclosure has proved insufficient to address and where WIAL is misusing its market power to impose on airlines an outcome which does not reflect likely outcomes in workably competitive markets.

Below I briefly discuss the key differences between the BARNZ assessment and the airport's approach. I also attach BARNZ's final response to WIAL during the pricing consultation where these issues are discussed in greater detail. I trust these comments will be of assistance to the Commission as it updates its analysis of WIAL's price setting behaviour.

### ***Where in the WACC range returns should be targeted?***

WIAL continued to target the 75<sup>th</sup> percentile estimate of the cost of capital range even though the High Court had expressed scepticism over the appropriateness of targeting returns above the mid-point in the merits review decision, and, at the time consultation over pricing was occurring, the Commission had already commenced re-examining the appropriate WACC percentile estimate. Subsequent to WIAL having reset its prices the Commission released its decision that the 67<sup>th</sup> percentile represented an appropriate percentile estimate to apply in customised and default pricing paths for electricity line businesses and gas pipeline businesses. The difference between the mid-point WACC estimate and the 75<sup>th</sup> percentile used by WIAL amounted to approximately \$26m of required revenue over the pricing period. If the 67<sup>th</sup> percentile had been used, the required revenue would have been approximately \$8m to \$9m less over the pricing period.

### ***Land valuation issues***

WIAL amended its valuation methodology to apply the MVAU methodology specified by the Commission, rather than the MVEU methodology previously used by the airport. While that was a shift that was welcomed by BARNZ, significant differences of view exist between WIAL's valuation and the independent valuation advice BARNZ received as to the proper application of the Commission's valuation guidelines in Schedule A of the information Disclosure Determination.

The valuation advice BARNZ has received is that WIAL's MVAU land valuation is \$41m over-stated, due to:

- Insufficient allowance being provided for the time necessary to obtain the required planning changes from its current airport zone to the zones which would enable the envisaged mixed use subdivision. WIAL have allowed nine months, whereas the advice received by BARNZ is that it would take two to three years.
- No allowance being made in the costs for ongoing seawall maintenance, which will either need to be funded through a mechanism such as a capitalised maintenance contribution to the Council or additional reserve contributions to set off the future liability assumed by the Council.
- The land use mix containing a town centre 7.7 ha larger than justifiable, and insufficient land for reserves.

BARNZ notes that these concerns were echoed by the Commission's valuation expert, Darroch, in its expert reports to the Commission on WIAL's 2009 and 2011 MVAU land valuations in the course of the s56G review process.

The first issue regarding the question of the time allowed to obtain the appropriate planning changes was the most significant issue. BARNZ considers that the airport's approach is at odds with the clear direction in Schedule A of the Airport Services Input Methodologies Determination 2010 for account to be taken of any zoning changes required. The airport's approach is also contrary to the view expressed by the Commission's valuation expert, Darroch, that Schedule A requires any likely zoning or plan changes and associated costs to be taken into account and that WIAL's 2009 and 2011 valuations were not compliant with Schedule A due to consideration not being given to the likelihood or costs of any zoning changes. This is discussed at some detail at pages 16 to 18 of BARNZ's submission to WIAL, which I have provided to the Commission with this letter.

### ***Forecasting land valuation movements***

The question of the appropriate treatment of unforecast revaluations is a long-standing key difference which BARNZ has had with WIAL. BARNZ considers that both the Commerce Commission and the High Court have clearly articulated that where a nominal WACC is being used to determine prices, then all revaluations must be treated as income for the purpose of determining prices. WIAL accepted this principle in November 2013 during consultation with airlines, setting out its approach going forward as being that any actual revaluations above or below the revaluations forecast during PSE3, would be treated as a credit (or debit) when charges were reset for PSE4. However, the airport subsequently recanted in March 2014, in favour of remaining silent, purporting to leave the issue of treatment of unforecast revaluations undetermined until consultation begins at the end of PSE3 for new prices to be set for PSE4 (beginning 1 April 2019).

With WIAL not committing to treat any difference between actual and forecast revaluations as income at the end of PSE3, it became important to ensure that land revaluations are forecast at an appropriate level; one no more likely to be too low as too high. A CPI forecast is considered an appropriate place holder by BARNZ where the asset owner accepts the need for wash-ups which ensure that any differences between actual and forecast revaluations are treated as income for the purposes of determining charges. However, where the asset owner does not accept this, a specific forecast of likely movements in land valuation is required.

BARNZ sought advice from Property Advisory Ltd on likely movements in land values. Property Advisory Ltd advised that forecast increases of 4.5% pa to overall land values in the Wellington area are more plausible than the 2.1% CPI based forecast of no real increases to land values adopted by WIAL.

This issue directly affects the charges which were reset in 2014. The reasonableness of the forecast revaluation rate for land incorporated in the pricing calculations needs to be reviewed in the light of the fact there is no committed wash-up to reflect actual land valuation movements at the end of the pricing period.

### ***The inclusion of growth rebates in the required revenue calculations***

WIAL has developed an incentive growth scheme comprising various levels of rebates on airport charges for new or additional services introduced by airlines. We believe that WIAL calculated a gross revenue from its proposed charges and forecast volumes and deducts its forecast amount of the rebates (at \$8.5m per annum) from the gross revenue to obtain the net revenue it expects to receive from its charges. They disclose the net revenue figure, which equates the total of the building block costs, but do not disclose the gross revenue they are targeting before rebates. That figure is important to the airlines' understanding of the pricing calculations and BARNZ believes it should be explicitly disclosed in the airport's schedule 18 disclosures of its revenue from charges as well as in annual disclosures.

Putting to one side whether or not it is appropriate for WIAL to be recovering the cost of its growth rebate scheme from existing users (which has been held inappropriate by at least one European airport regulator), there is a disturbing lack of transparency for interested persons endeavouring to understand what the total revenue is that users will be paying to the airport in aeronautical charges in the first instance. By only disclosing the net revenue, after the forecast rebates, there is an understatement of the total revenue forecast to be received by WIAL. This lack of transparency also flows through to the annual information disclosures prepared by WIAL where it is not clear whether the disclosed revenue is before or after rebate payments.

BARNZ considers that this is a matter the Commission needs to specifically review when revising information disclosure requirements and when calculating the level of revenue WIAL is targeting over PSE3. Our concerns over WIAL's practice of charging the airlines for these forecast rebates, and the lack of transparency over how the airport has treated them, is discussed in some detail at pages 19 to 22 of BARNZ's Assessment of WIAL's Proposed Charges.

### ***IRR calculation***

During consultation WIAL undertook its IRR calculations using end of year cash-flows. This use of end of year cash-flows significantly under-states the returns being targeted by the airport because it does not reflect the time value of money in relation to the revenues received throughout the year. While the Commission used end of year cash-flows as its base scenario in the s56G reviews undertaken in 2013, it noted that this was only because that was the approach it used at the time airports set prices for PSE2. Subsequently, the Commission has moved to using a mid-year approach for information disclosure for EDBs and GDBs and it signalled in its s56G reports that it intended making the same change for information disclosure requirements for airports (see for example page 96 of the s56G report relating to Auckland Airport).

BARNZ expressed the view during consultation that WIAL should be undertaking the IRR calculations based on mid-year cash-flows. We noted that an IRR based on mid-year cash-flows produced an outcome approximately 0.5% above the outcome under an end of year approach.

**Conclusion**

We trust that this brief restatement of BARNZ's perspective on the outstanding issues from consultation over new charges by WIAL is helpful to the Commission as it updates its IRR analysis of the revenues targeted by WIAL as a result of the new prices it has set. If you have any queries or require any further information, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'John', is positioned above the printed name.

John Beckett

Executive Director