11 July 2022

Commerce Commission
c/o im.review@comcom.govt.nz

PROCESS AND ISSUES/DRAFT FRAMEWORK SUBMISSION – WELLINGTON INTERNATIONAL AIRPORT LIMITED

1. This is Wellington International Airport Limited's (***WIAL's***) submission in response to the Commerce Commission's Part 4 Input Methodologies Review 2023 Process and Issues Paper.

2. This submission does not contain any confidential information.

We endorse the submission from NZ Airports Association

3. WIAL is a member of the NZ Airports Association. We have contributed to and support NZ Airports' submission in response to the Commission's Process and Issues Paper.

4. In addition to these matters, this submission briefly addresses several additional areas of particular relevance to WIAL.

We support the issues identified by the Commission for the IM Review

5. On the whole, the airport IMs work well. The framework for airport ID provides transparency into airport performance while allowing flexibility to enable airports to innovate and adopt airport-specific solution during consultation where necessary. We support the consideration of the issues identified by the Commission in the Process and Issues Paper.

6. We particularly support the Commission's recognition of the impact of Covid-19 and climate change on regulated businesses and the need for the IMs to respond to those issues. Covid-19 and climate change have had, and will continue to have, significant strategic, operational and investment implications for regulated entities, which we believe should be reflected in the regulatory regime.

Covid-19 and WIAL's PSE4 response

7. As noted in our submission to the Commission as part of its review of our PSE4 pricing, the Covid pandemic has had a significant impact on WIAL as well as our airlines. We do not reiterate the points made as they are also summarised in the NZ Airports' submission, other than to highlight that we worked hard with our airline customers during our PSE4 consultation to best manage the emerging pandemic circumstances. We held aeronautical prices flat for two years and this resulted in a substantial reduction in cash flow. We proposed a concessionary price path to minimise PSE4 price increases and defer a substantial amount of PSE4 revenue into PSE5. We also agreed a passenger wash up to best manage uncertain and volatile passenger movements.

8. These actions show that the regime is working well, enabling airports to respond to circumstances and provide appropriate and airport specific solutions where necessary.

Issues related to cost of capital

9. Of particular relevance to airports, the Commission has indicated it is considering:

   a. asset beta – the comparator sample set for airports; and

   b. credit rating for airports – whether the notional A- credit rating remains appropriate.

10. We agree these matters should be considered as part of the IMs Review. We also refer to the issues relating to asset beta set out in NZ Airports' submission. But in addition, the Commission should also consider:

    a. the use of a benchmark cost of debt for airports more generally;

    b. treatment of non-systematic risks for airports.

11. We summarise those issues below.

Cost of debt for airports

12. In the Commission's pricing review of our PSE4 consultation, we advocated for a change in the approach to determining the cost of debt for airports. The Commission currently uses a notional benchmark cost of debt, rather than airports' actual cost of debt.

13. As part of its review of WIAL's PSE4 consultation, the Commission noted that it may be appropriate to assess targeted profitability in light of airport-specific credit ratings and debt tenor. This is not provided for expressly in the IMs; rather the Commission exercises its judgement when reviewing pricing. This results in uncertainty for airports, which have to set prices before the Commission indicates whether or not these airport-specific parameters are appropriate. We would welcome a change to the IMs to expressly allow for airport specific credit ratings provided they are at least an adequate investment grade. This would enable airports to set prices with greater certainty regarding the evaluation the Commission will then apply.

14. The Commission also agreed in principle that additional compensation may be appropriate for the additional debt premium that can be incurred from issuing debt with a longer original term than the five-year regulatory period. Longer term debt instruments are typically undertaken by infrastructure businesses such as airports to match their funding tenor more closely with their life of assets and better manage refinancing risk. We would also welcome a change to the IMs to allow for debt tenor to reflect an airport's actual tenor.

15. Other than the exceptions discussed above, the Commission compares airports' targeted profitability to a WACC based on a notional cost of debt rather than the actual debt costs faced by the airport.

16. In our view this approach warrants reconsideration. Under information disclosure the Commission is not required to set prices but rather assess whether the prices that airports have set will result in excessive profits. In that context, it would be appropriate to compare airports' profitability to a regulatory WACC that more closely reflects their actual costs. As a further example, as a result of the pandemic WIAL raised additional retail bond debt, increased bank facilities and shareholders put in place an equity commitment. These steps were prudent, raised WIAL's funding costs and should be reflected in its regulatory cost of capital.

17. As part of our PSE4 consultation we commissioned advice from HoustonKemp regarding our actual debt costs. HoustonKemp observed that WIAL's actual cost of debt differs from the regulatory WACC in a number of respects:

Wellington Airport
Main Terminal
PO Box 14175
Wellington 6241
New Zealand

Tel: 04 385 5100
Fax: 04 385 5139
mail@wellingtonairport.co.nz
wellingtonairport.co.nz

a. WIAL had (at the relevant time) a credit rating of BBB+[1] rather than the Commission's assumed A- rating;

b. WIAL entered PSE4 with a number of different existing forms of debt; and

c. WIAL has raised new debt in the course of PSE4.

18. The Commission should consider whether, in adjusting its regulatory WACC for purposes of evaluating airports' price-setting events, it has regard to airport-specific parameters beyond just credit rating and debt tenor.

Asset beta

19. We consider that the Commission should continue its approach to estimating asset beta using its comparable airport sample. The Commission's use of a wide range of comparator airports to estimate asset beta is robust and transparent, being established in 2010 and used again in the IMs review in 2016. We refer to NZ airports'submisison in relation to this approach.

Airport-specific adjustments to beta

20. We consider that the Commission should remove its downward adjustment to asset beta of 0.05, made to account for its assumption that the aeronautical business is less risky than the airport business as a whole. We refer to NZ Airports' submission in relation to this adjustment.

Treatment of asymmetric risks for airports

21. An airport's WACC may diverge from its ex-ante overall target rate of return to provide for the costs associated with its material asymmetric risks. Asymmetric risks arise when there is a significant mismatch between the potential financial gains and losses from future events. The Commission has indicated it intends to consider the approach to addressing pandemics. As WIAL has just demonstrated, the risk allocation methods contemplated by the IMs provide one option for addressing pandemic-type demand shocks, albeit the practicality of these approaches depends on the timing of price-setting relative to anticipated risks. We refer to NZ airports' submission in relation to this approach.

22. In addition, the Commission should consider how the regulatory framework addresses other types of asymmetric risks, including – relevant to WIAL – an earthquake event. Earthquake risk is not well-fitted to the current risk allocation methods contemplated by the IMs, but perhaps could be better addressed through, for example, a WACC uplift.

Land valuation methodology for commercial to aero land transfers

23. In PSE4 and PSE5, WIAL expects to transfer land from its commercial (non-aero) balance sheet to the aeronautical RAB. This land is required in order to accommodate growth of the aeronautical business, including expansion of the main terminal building, baggage handling facilities and apron and parking space for aircraft. We are unsure of the land demands for the other regulated airports but WIAL has a very restricted land holding of approximately 130Ha, significantly lower than AIAL and CIAL who occupy over 1,000 Ha each. As a result, the ability to repurpose and utilise land in the most efficient manner is extremely important to us.

24. The IMs require that, when the airport acquires land from a related party, it is valued according to Schedule A, which provides that land is valued at its market value in its highest and best alternative use (***MVAU***). The 2010 Reasons Paper explains that the Commission applies MVAU because the value of land in workably competitive markets will broadly reflect its highest value in an alternative use.

[1] WIAL's current credit rating with S&P Global Ratings is BBB.

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25. The 2010 Reasons Paper does not, however, appear to have considered the incentives that an MVAU methodology creates in relation to land transferred from the commercial balance sheet to the aero balance sheet. Where the value of the land under its existing use is higher than its alternative use, the requirement to value the asset at MVAU:

    a. decreases the value of the assets held by the airport relative to their value pre-transfer; and

    b. therefore dis-incentivises land transfers that are necessary for the regulated service and in the interests of consumers.

26. Conversely, valuing land at its existing use (***MVEU***) where it is transferred from the commercial to aeronautical RAB ensures that airports are not disadvantaged by re-allocating assets for aeronautical use.

27. This approach would also be consistent with the treatment of other comparable transactions. If an airport purchases land from a third party, the IMs provide that the land enters the RAB at the cost of purchase, which would always be at least equal to the value of the land in its existing use (because, if not, the transaction would not take place). Valuing commercial to aero transfers at MVEU would address this inconsistency as between acquisitions from related parties versus unrelated parties.

28. We have previously raised this matter in discussions with Commission as it is important to facilitate our forecast aeronautical growth.

29. As a rule, the IMs should not dis-incentivise suppliers from taking steps that are for the long-term benefit of consumers. The Commission should re-examine the use of the MVAU methodology for commercial to aero land transfers to ensure the IMs create the right incentives for airport development.

30. If you should have any queries in relation to this submission please do not hesitate to contact me at martin@wlg.aero.

Yours sincerely

Martin Harrington
Chief Financial Officer

Wellington Airport
Main Terminal
PO Box 14175
Wellington 6241
New Zealand

Tel: 04 385 5100
Fax: 04 385 5139
mail@wellingtonairport.co.nz
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