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WELLINGTON AIRPORT PRICE SETTING EVENT REVIEW – SUBMISSION

1 This is Wellington International Airport Limited's (***WIAL's***) submission in response to the Commission's consultation on WIAL's 2019-2024 price setting event (***PSE4***). This submission does not include any confidential information. Certain confidential information will also be provided separately to the Commission as noted in this submission.

Executive summary

2 The circumstances of WIAL's PSE4 price-setting were unprecedented and the particular features of this price-setting reflect those circumstances. The Commission's consultation paper also acknowledges those unique circumstances. In summary:

2.1 We support the Commission's proposal to adopt an abbreviated process and the focus on expected profitability and risk allocation given the ongoing challenges and difficult operating environment within the aviation sector. We have similarly aimed to adopt a streamlined approach to responding to the Commission's consultation. But if the scope of the Commission's review expands, or the Commission materially revises its views on profitability and risk allocation, it would be appropriate to allow a further opportunity to comment.

2.2 WIAL's WACC is unobservable to both WIAL and the Commission and must therefore be estimated. We agree with the Commission that it could not expect WIAL to exactly meet the Commission's own estimate of its reasonable return and that parameters may be amended where justified. The difference between the Commission's revised estimate of WACC and WIAL's targeted return on its total RAB is only 16 basis points. We welcome the Commission's indication that it does not have significant concerns with WIAL's expected profitability.

2.3 The Commission has indicated that a higher cost of debt would be justified based on WIAL's lower credit rating and with evidence of a longer average tenor of WIAL's debt. We can confirm that WIAL's weighted average original tenor was 8.6 years for this period. We will provide the (confidential) supporting calculations showing WIAL's weighted average original tenor to the Commission separately.

2.4 There are a number of other points of difference between WIAL's own estimate of WACC and the Commission's revised estimate of WACC. We remain of the view that a post tax WACC of 6.08% is justified in WIAL's particular circumstances. But it is not necessary to resolve these remaining points of difference in the context of this review and so we propose the Commission instead address these matters as part of the 2023 IMs Review.

2.5 We welcome the Commission's indication that the passenger demand wash-up mechanism shares risk appropriately between WIAL and its major customers under the circumstances; that the deferral of revenue into PSE5 to provide price relief to customers is appropriate; and that it is comfortable with the net revaluation gain being carried forward into PSE5.

Introduction and context

3 As the Commission has observed, WIAL's 2019-2024 price-setting took place against the background of unprecedented circumstances occasioned by the Covid-19 pandemic. The particular features of WIAL's price-setting for this period, and particularly the approach to risk allocation, reflect these unique circumstances.

4 WIAL and airlines had agreed to defer price-setting by 12 months (to April 2020) to allow time to complete consultation on WIAL's 2040 Master Plan. In late March 2020, as we were on the point of finalising prices for this period, the Government imposed a national lockdown, ending all but essential travel for over four weeks. As a result, passenger numbers were down 40% in March and then 99% down in April.

5 At that point the outlook for passenger air services was extremely uncertain. But it was apparent that pre-COVID passenger forecasts no longer provided a sound basis for price-setting. Rather than revise its pricing model to account for the expected (but uncertain in magnitude) shock to passenger demand, WIAL determined to hold charges at FY19 rates for a second year and then finalise prices in FY22-24 having regard to the PSE4 period as a whole, including actual passenger numbers over the period. This gave price certainty to airlines at an uncertain time, avoided the price increase that would have resulted from revising downward passenger forecasts, ensured no windfall gains or losses (to WIAL or airlines) due to forecasting error, and gave WIAL and its customers an opportunity to revisit volume forecasting risk with better information.

6 Subsequent to its decision in April 2020 to hold prices at FY19 levels, additional lockdowns in August 2020 and February 2021, as well as the opening and then closing of the trans-Tasman bubble, have vindicated WIAL's approach.

7 In the course of FY21 we took a number of significant steps to reduce costs. This included a resizing of operations, including a 30% reduction in staff, and cutting consultancy, marketing and travel expenditure. We also reviewed our Masterplan substantially deferring and resizing our investment plans and reducing spend on capital projects by $54 million for the year. We also needed to undertake a range of measures to enhance liquidity and overall financial resilience. This included increasing bank facilities by $70 million to $170 million, securing temporary covenant waivers with lenders and issuing $225 million of retail bonds. Our shareholders also provided equity commitments totalling $75.8m, giving confidence to our lenders and enabling us to proceed with essential projects with certainty.

8 Throughout this process, WIAL has been conscious of the need to support airline recovery, while appropriately securing the airport's financial position. WIAL has made a number of concessions, and taken additional steps, to support airlines through COVID-19. This included capping price increases during PSE4 and deferring revenue (which had the effect of reducing targeted returns in PSE4 from 5.88% to 5.43%). Those steps are detailed in our pricing disclosure and we do not repeat them here.[1] These steps have influenced operating and capital expenditure in PSE4, return on investment, and the profile of cash recovery in PSE4 and future periods. When reviewing WIAL's price-setting against the

[1] Wellington International Airport Limited, *Price Setting Event Disclosure for the Pricing Period 1 April 2019 to 31 March 2024* (1 June 2021) at section 2.3.

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Part 4 purpose, it is important that the Commission have regard to the whole picture, including the steps WIAL has taken to support airlines, rather than mechanically focusing on a single parameter.

Comments on Commission's consultation process

9 The Commission has proposed an abbreviated review process for PSE4 in recognition of the ongoing challenge of COVID-19. The Commission has indicated its intention to focus on expected profitability and risk allocation. We understand the Commission's intention is to conduct this single round of consultation and then move to a final determination. In other words, this consultation paper will serve in place of a draft determination.

10 We support the Commission's proposal to adopt an abbreviated process and the focus on expected profitability and risk allocation. We have similarly aimed to adopt a streamlined approach to responding to the Commission's consultation, particularly in reliance on the Commission's indications that:

10.1 it does not have significant concerns that WIAL is targeting excessive profits over the PSE4 pricing period and WIAL's target return of 5.88% is reasonable; and

10.2 WIAL's approach to risk allocation for PSE4, including wash-ups for passenger demand, revenue deferral and revaluation carry-forward, are reasonable under the circumstances.

11 As regards profitability, the Commission has identified a number of points of difference between WIAL's and the Commission's estimates of WACC. This submission responds to the Commission's analysis but, given the Commission's indication that, overall, it does not have significant concerns with targeted profitability, it is unnecessary to fully resolve those differences. We have therefore focused on those matters in relation to which we can readily provide additional evidence in the time available for this submission process.

12 We offer our observations on the remaining points of difference but consider they may be better resolved in the course of the Commission's 2023 IMs review. However, were the Commission to reconsider its level of concern regarding WIAL's targeted profitability, those points of difference would be material considerations, and at that point we would want to address them more fully before the Commission finalises its decision.

13 The Commission has also asked whether there are any other issues that should be in focus for the review. Our view is there are not and we are consequently comfortable with the Commission's abbreviated approach. However, should the Commission subsequently determine it is necessary to extend its analysis beyond profitability and risk allocation, it would be appropriate for the Commission to set out its views on those further issues and allow a further opportunity for consultation. Similarly, were the Commission to substantially revise its position on profitability and risk allocation on the basis of submissions received in response to this consultation, it may be appropriate to issue a draft determination to provide a further opportunity for all parties to respond.

Expected profitability

14 The Commission's 2019 mid-point estimate of WIAL's post-tax WACC was 5.67%. This estimate assumed an A- credit rating, an average debt premium of 1.24%, cost of debt of 3.21% and an asset beta of 0.60. In contrast, WIAL estimated its WACC at 6.08%, the difference principally attributable to:

14.1 WIAL's actual credit rating (as of 1 April 2019) of BBB+ rather than the A- assumed credit rating in the IMs;[2]

14.2 WIAL's actual cost of debt reflecting the existing mix of debt financing and expected new issues of debt over PSE4 (including the tenor of that debt in comparison to the 5 years assumed in the IMs); and

14.3 an asset beta of 0.63 rather than 0.60 recognising the increase in systemic risk arising from WIAL's substantial (as of April 2019) capex programme. This is consistent with the asset beta used by AIAL to set its prices.

15 We note that WIAL targeted a return of 5.88%, which was below our estimated WACC of 6.08%.

16 The Commission has accepted that some adjustments to the 2019 IMs-compliant WACC estimate is appropriate to reflect WIAL's specific circumstances. The Commission's provisional view is that it:

16.1 does not accept that WIAL has sufficiently justified an uplift in asset beta; but

16.2 does accept that an adjustment to WIAL's cost of debt is appropriate (although not to the extent proposed by WIAL in reliance on HoustonKemp's advice).

17 As regards cost of debt, the Commission does not accept that an approach based on the actual mix of WIAL's current and future debt is appropriate (as opposed to the 'simple' approach utilised in the IMs), but that it is appropriate to adopt:

17.1 WIAL's actual credit rating of BBB+ as of 1 April 2019; and

17.2 a higher debt premium of 1.60% rather than the 1.24% in the Commission's April 2019 WACC estimate.

18 This results in a revised cost of debt of 3.57% (compared to the Commission's April 2019 estimate of 3.21% and WIAL's estimate of 4.66%). The Commission has also signalled that a cost of debt higher than 3.57% could be justified with supporting evidence for a longer original term of debt.[3]

19 We agree that WIAL's targeted profitability should be assessed against an estimated WACC that takes account of WIAL's actual credit rating and longer debt tenor. We remain committed to managing the funding for WIAL in the most optimum and efficient manner. Our approach is applied to WIAL's whole of business and is therefore the same across our regulated and non-regulated businesses. This should evidence our confidence in this approach which is reflective of workably competitive markets.

20 These adjustments to the cost of debt result in an estimated mid-point WACC of 5.72%, materially lower than WIAL's estimate of 6.08%. However, in the course of consultation on its pricing, WIAL agreed with airlines to set prices for PSE4 based on a concessionary WACC for priced services of 5.93%. The feedback we took into account in reaching this compromise position is set out in our pricing disclosure.[4] Accounting for the lower target return on other regulated activities of 5.18%,

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2 WIAL's credit rating is now lower at BBB, but was rated BBB+ in April 2019 when the WACC parameters for the period were fixed.

3 At paragraph 106.

4 Wellington International Airport Limited, *Price Setting Event Disclosure for the Pricing Period 1 April 2019 to 31 March 2024* (1 June 2021) at pages 35-36.

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WIAL's target return on its total RAB is 5.88%, a difference of only 16 basis points from the Commission's revised WACC estimate.

21 WIAL's WACC is unobservable to both WIAL and the Commission and must therefore be estimated. We therefore agree with the Commission that it could not expect WIAL to exactly meet the Commission's own estimate of its reasonable return.[5] Put another way, while the Commission's methodology reflects its best estimate of a reasonable return, that does not mean that a minimal departure from the Commission's estimate represents excessive profits. The Commission has indicated that it does not have significant concerns that WIAL is targeting excessive profits and we agree.

22 In response to the Commission's revised estimate of WACC we address:

22.1 the appropriate debt premium in light of the average tenor of WIAL's debt;

22.2 the principled basis for determining cost of debt based on the actual mix of WIAL's current and future debt;

22.3 the conservative settings in the Commission's cost of equity; and

22.4 accounting for material asymmetric risks.

Appropriate debt premium in light of average tenor of WIAL's debt

23 WIAL optimised its funding during the historically low interest rate environment by issuing longer-term debt instruments (for example, its March 2019 issue of 11-year retail bonds) in accordance with sound treasury practice for businesses with long life assets. This approach is commonly taken by utility companies and infrastructure businesses including airports, in order to match their funding tenor more closely with the life of assets. The Commission's benchmark cost of debt therefore underestimates WIAL's (efficiently incurred) cost of debt.

24 The Commission recognises that the issuance of longer term debt may provide long-term benefits to consumers due to reduced refinancing risks. However, the longer tenor of debt implies a higher debt premium than the Commission's midpoint benchmark estimate provides for. The Commission also acknowledges that the greater debt premium on long-term debt cannot be economically removed through a swap. WIAL continues to bear the greater debt premium on its longer-term debt.[6]

25 The Commission therefore agrees 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. The Commission has indicated that, to assess whether additional compensation could be appropriate for WIAL, it would need to determine whether WIAL's average original term of debt is longer than 5 years, and to what extent. If a 7-year average debt term were sufficiently evidenced, the Commission considers an additional adjustment of up to 10 basis points may be appropriate as a TCSD-type premium.[7]

26 WIAL confirms that its average tenor of debt for PSE4 was above the 7 year term noted by the Commission and its weighted average original tenor was 8.6 years for this period. We will provide the

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[5] At paragraph 116.

[6] At paragraph A110.

[7] At paragraph A116.

(confidential) supporting calculations showing WIAL's weighted average original tenor to the Commission separately.

27 Taking account of this 10 basis point adjustment to the debt premium results in an estimated midpoint WACC of 5.73%.

Cost of debt based on actual mix of WIAL's current and future debt

28 As explained in HoustonKemp's report, the Commission's cost of debt allowance assumes that a benchmark average provider of airport services raises debt by:

28.1 exclusively issuing New Zealand dollar denominated corporate debt with a five-year term and a credit rating of A-;

28.2 periodically issuing floating rate debt (or issuing fixed rate debt and immediately purchasing swaps so as effectively to convert the debt to floating rate debt);

28.3 purchasing swaps to fix the underlying base rate (ie, the risk-free rate component of the cost of debt) of all debt immediately before the start of the pricing period; and

28.4 refinancing all retiring debt, during the regulatory period, with floating rate debt carrying the same debt premium as the retiring debt.

29 In HoustonKemp's opinion, adopting a WACC that allows WIAL to either recover a reasonable estimate of its actual cost of debt would be consistent with outcomes produced in a workably competitive market.[8]

30 The Commission's position is that it won't accept the use of actual debt costs from a historic portfolio of debt on the basis that actual debt costs would not support the Part 4 purpose statement and especially s 52A(1)(b) incentives to improve efficiency. The Commission refers to its discussion of benchmark debt costs in the context of the Fibre IMs.[9]

31 While we accept that the Commission must be satisfied that a regulated airport's debt costs are within the bounds of what would be considered prudent, it does not follow that the Commission should adopt a benchmark cost of debt in place of the airport's actual cost of debt. Utilising a benchmark is appropriate in the context of incentives-based price control, where the benchmark creates an incentive for the supplier to reduce its actual costs relative to the benchmark. Indeed, the Commission refers to such an incentive in its reasoning at paragraph A83. But airports are subject to information disclosure rather than price control. And in the context of information disclosure the Commission's role is to examine the airport's actual costs and assess whether those actual costs are broadly efficient and therefore consistent with the Part 4 purpose.

32 Accordingly, in the absence of any indication that WIAL's approach to raising debt finance is inefficient or contrary to the interests of consumers, the Part 4 purpose statement, and the purpose of information disclosure regulation, does not necessitate adopting a cost of debt that diverges from WIAL's actual debt costs.

33 However, while we think utilising actual cost of debt is more consistent with the purpose of information disclosure regulation than the Commission's approach, we do not think this issue needs to be resolved

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8 HoustonKemp at page 4.

9 At paragraph A82.

as part of this process given the negligible difference between the Commission's estimated WACC and WIAL's targeted return. We therefore suggest that this issue is considered more fully in the context of the 2023 IMs Review.

Commission's cost of equity is conservative

34 WIAL has proposed an uplift to the asset beta of 0.03, supported by HoustonKemp's analysis of the greater systematic risk that WIAL faces as a result of:

34.1 the increase in operating leverage assumed at the outset of the pricing period as a result of WIAL's capex programme; and

34.2 WIAL's greater exposure to domestic travellers and therefore to variations in GDP, which is a non-diversifiable risk.

35 The Commission has indicated that, in its view:

35.1 while it acknowledges that WIAL's anticipated capex programme as at 1 April 2019 may have some impact on asset beta, the comparison of WIAL's operating leverage to the comparator set is incomplete and therefore provides only partial evidence of WIAL's higher operating leverage; and

35.2 the evidence of a higher asset beta than the comparator set due to traffic mix is similarly incomplete, although the Commission agrees in principle that relative proportions of international and domestic travellers may be relevant to systematic risk.

36 The Commission has set out the additional information and analysis it would require to revisit its view. Given the relatively short period for submissions, and the Commission's indication that it does not have significant concerns with WIAL's targeted profitability, we are not currently proposing to instruct HoustonKemp to prepare further analysis. However, we note that:

36.1 the Commission accepts that there are reasons why its cost of equity may be a conservative estimate. The Commission has prepared sensitivity analysis demonstrating that a 0.01 uplift to the asset beta (as opposed to the 0.03 proposed by WIAL) would result in a WACC estimate of 5.77%;[10] and

36.2 as the Commission has stated, TDB on behalf of BARNZ has prepared analysis supporting an asset beta uplift of 0.02. That advice is enclosed with this submission.

37 In our view, it is unnecessary to resolve this issue in the course of this process given the Commission's overall conclusion on WIAL's targeted profitability. We therefore suggest this could be dealt with in the course of the 2023 IMs Review.

Accounting for asymmetric risks

38 Finally, while our price-setting does not rely on this analysis, HoustonKemp has also argued that WIAL would be justified in targeting an overall rate of return that differs from its own WACC estimate to account for material asymmetric risks.[11]

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[10] At paragraph 115 and A121.

[11] See HoustonKemp, section 4.

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39 Asymmetric risk does not affect a supplier's WACC because asymmetric risks affect the calculation of expected returns, while the WACC compensates for the non-diversifiable risk of variations in expected returns. Consequently, the expected costs of asymmetric risks must be recovered by either adjusting the cash flows to which any overall target rate of return is applied or targeting an overall rate of return that is above the supplier's WACC.

40 In 2019, WIAL identified two significant asymmetric risks for PSE4:

40.1 earthquake risk, associated with a significant earthquake event that impacts the operations of WIAL during PSE4; and

40.2 the possibility of an exogenous event that caused the number of passengers using WIAL to fall substantially.

41 HoustonKemp observed that WIAL's risk register indicates a six percent chance in any given year of an event that would close the airport, resulting in a substantial shock to passenger demand. These risks are not factored into passenger forecasts in the ordinary course. In HoustonKemp's view, the existence of these risks would therefore support an upward adjustment in the target rate of return (above WACC).

42 We raise this simply to note that an event that resulted in an unprecedented passenger demand shock did in fact eventuate in the course of this pricing period – the COVID-19 pandemic. In the event, WIAL has managed that shock principally through risk allocation mechanisms. However, based on HoustonKemp's analysis, the potential for such a shock to occur would have supported a higher target return as of 1 April 2019. This is a further reason to accept that WIAL's concessionary target return of 5.88% is, on balance, reasonable.

43 In addition to pandemic risk, there are other risks that may impact passenger demand and asset beta in the future, including the increased prevalence of employees working from home and consumer sentiment on air travel and its carbon emissions.

44 In our view, it is unnecessary to resolve these in the course of this process given the Commission's overall conclusion on WIAL's targeted profitability. We therefore suggest this could be dealt with in the course of the 2023 IMs Review.

Risk allocation

45 As explained in the Commission's consultation paper, WIAL's price-setting for this period included a number of risk allocation mechanisms that were occasioned by the unique circumstances of this price-setting. We welcome the Commission's indication that:

45.1 the passenger demand wash-up mechanism shares risk appropriately between WIAL and its major customers under the circumstances;

45.2 the deferral of revenue into PSE5 to provide price relief to customers is appropriate; and

45.3 it is comfortable with the net revaluation gain being carried forward into PSE5.

MVEU valuation for land moving from commercial to aero RAB

46 The construction of the 8MPPA Terminal and apron developments (described in Appendix B) will require WIAL to reallocate land currently used for commercial activities to the RAB. This includes car parking land for terminal development and apron development, and leased land for apron development.

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47 For pricing purposes we have valued this land at its current commercial value, represented by MVEU plus the actual cost of civil development. We explained in our pricing disclosure that this treatment departs from the IMs, but in this instance the IMs should be amended because of the disincentive to repurpose commercial land to aero use that would otherwise result. As a general principle the regulatory rules should not deter regulated suppliers from engaging in conduct that is efficient and benefits consumers.

48 The Commission has noted this departure from the IMs, but we welcome the Commission's recognition that the issue warrants further consideration. In any event, because the pricing impact is negligible, the matter does not need to be resolved in the context of this review. We suggest instead that the Commission consider this issue in the course of the 2023 IMs Review.

Further information

49 For further information, please contact:

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