31May 2021

Andy Burgess,
Head of Energy, Airports, and Dairy Regulation
Commerce Commission New Zealand
PO Box 2351,
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Dear Andy,

RE: Open letter—ensuring our energy and airports regulation is fit for purpose

Wellington Airport would like to thank you and the Commission's team for the opportunity to respond to your open letter on energy distribution and airports regulation.

The main issues identified by the Commission – namely, Covid-19 and climate change – both require a real response by regulated entities, which we believe will need to be accommodated by the regulatory regime.

The impact of Covid-19 has been unprecedented and extremely challenging for Wellington Airport and the entire aviation industry. In April 2020, our passenger numbers dropped to just 1% of usual levels, and Government lockdowns in August 2020 and February 2021 created further setbacks.

Throughout the year we took several steps to reduce costs. This included moving to a four-day working week with staff salary and director fee reductions, cutting consultancy, marketing and travel expenditure. We also reviewed our Masterplan, reducing spend on capital projects by $54m for the year and undertook 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 $100 million of retail bonds in August 2020. Our shareholders also provided equity commitments totalling $75.8m, giving confidence to our lenders and enabling us to proceed with essential projects with certainty. Amongst other things, the additional debt commitments, the pre-funding of borrowing, and the shareholder commitments have a significant actual and inferred cost. Which have raised Wellington Airport's actual cost of capital and should be reflected in the regulatory cost of capital too.

Despite these challenges, Wellington Airport remains essential for the region and continues to play a vital role in New Zealand's economic recovery post-Covid. As a largely domestic airport, our passenger numbers have recovered strongly, reaching 66% of pre-Covid levels in December/January and 48% for the year ended 31 March 2021.

The impact of climate change is also expected to be significant and will likely require innovation in the Commission's approach to the energy distribution sector to ensure investment is incentivised, and new technologies are able to replace old. We welcome the Commission's early focus on these issues and urge a full-scale focus on energy distribution to ensure New Zealand is adequately prepared to meet the demands of decarbonisation.

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Insofar as airports are affected by the issues raised, we have collated some thoughts below. However, we acknowledge the needs of the airport sector are much less immediate or significant than others, and recognise these issues will need to be appropriately weighted. We are therefore not asking the Commission to take immediate action on these matters – we raise them as issues that will require further consideration as and when the Commission undertakes its regulatory tasks, such as reviewing airport price setting and the upcoming input methodologies (IMs) review.

Covid-19 and Climate Change

Covid-19's impact on airports – reduced passengers, resized airport operations and customised airline pricing

The Commission has acknowledged that Covid-19 had a substantial impact on airports with a sharp decline in the number of flights and passengers. On the positive side, Covid-19 has led to stronger working relationships between airports and airlines as we have collaborated to meet shared challenges.

We note that over the last year Wellington Airport was obliged to lay off 32 staff and to defer significant capital works. This amounts to a material impact on the Airport's operational capability and on its stakeholders and shows that retrenchment is not costless, even if it is disclosed as reduced operating and capital expenditure.

Wellington Airport has been required to work through these issues with airlines as they arose in the midst of our recent PSE4 airline pricing consultation (price setting event for the period 1 April 2019 to 31 March 2024). Our decisions and compromises with airlines will be reviewed by the Commission following publication of our PSE4 pricing disclosures and we will not canvass them here. However, we will be encouraging the Commission to consider the full context of our price setting event, which we consider was a one-off and unique process due to the nature and timing of the consultation.

Airports are affected as energy users – increased electricity demand

The major impact of climate change on airports will be as a user of energy. Wellington Airport is planning to transition fully away from natural gas, but issues with cost and availability of electricity supply are impeding our plans. And as we move to provide vehicle charging infrastructure and electrify ground services, terminal functions, and, ultimately, aircraft, we are concerned about the capacity of the electricity distribution network to meet growing demands. Electrification of aircraft is not in the distant future; rather, we are planning for electrified regional routes as early as 2028. Inadequate incentivisation of investment in electricity infrastructure, and inadequate mobilisation of resources from government and business, will hold back New Zealand's ability to meet its climate targets.

We are not in a position to offer regulatory solutions but are pleased to see the Commission considering these issues, and acknowledging that regulatory rules can support and incentivise innovation and technology uptake. Unfortunately, when not well-formed, regulatory rules can also do the opposite. We urge the Commission to consider these matters.

Impact of climate change on airports - increasing costs while seeking to maintain strong airline competition

The Commission has also acknowledged that decarbonisation efforts may impact airports, with fewer flights or changing requirements. It should also be noted that the direct impact of climate change will also require significant investment in infrastructure (eg.Wellington Airport intends replacing its seawall protection at a cost of over $200 million) and is already facing much higher insurance charges and Council rates.

Wellington Airport does not believe there are significant barriers to decarbonisation in Part 4 or the IMs per se. We believe airline customers will work supportively with us on decarbonisation initiatives, as it is in our shared interest to do so. However, decarbonisation of the aviation sector will bring cost and risk as new technology is introduced, and this will ultimately have an effect on pricing. If this is combined with fewer flights as the Commission suggests, the ability of airlines to meet charges will be even more affected.

Having said that, we do not believe airport pricing is by any means the biggest issue facing the aviation industry when it comes to decarbonisation. Airlines are grappling with increased regulation, possible increased taxes and visitor levies, increased carbon prices, and escalation in other government charges such as for Aviation Security.

These challenges may well have an impact on airline competition, with low cost airlines or those who cannot adapt to changing costs and consumer behaviour falling out of the market. This is in addition to the impact of Covid-19 which has been devastating for the aviation sector. We suggest the Commission remains cognisant of this if and when it considers wider issues in the aviation sector, such as airfare and capacity levels on routes served by fewer than three carriers, code shares and other airline cooperative agreements.

One of the main changes to air travel over the last 50 years has been its democratisation. Efficiency and competition has driven fares down to levels that are affordable for a great many people. The goal going forward should be to maintain affordability while also de-carbonising. For this to happen requires appropriate regulatory settings.

It is apparent that the main financial impact of climate change and de-carbonisation will be the need to increase investment. Delivering this investment and maintaining affordability is the challenge of the aviation sector.

Efficiency indicators

We welcome the Commission's note that its summary and analysis could be broadened, including indicators of comparative efficiency. We encourage the Commission to continue looking at indicators such as this (and also whether airports are meeting the needs of the end consumer) as well as numerical pricing indicators.

Other key themes and issues for the Commission's IMs review

Cost of capital

There are some longer-term issues highlighted by Covid-19 which we would like to see the Commission consider in its upcoming IMs review (which, as per the last IM Review, could also consider adjustments to the ID settings). It has been demonstrated that airports (and their customers) are exposed to material and sudden demand risks that other sectors regulated by the Commission do not face. In the context of the Commission using the same methodology to estimate WACC for all regulated sectors, this raises the question of whether the Commission's calculation of the WACC for airports establishes a benchmark where, if it is applied in pricing, airports would be adequately compensated for that risk.

It is not necessarily the case that the WACC IM (and in particular the asset beta) will need to be changed (although that should be considered). However, as it did for fibre services, the Commission should be open to considering whether airports face unsystematic risk that is not fully compensated by the WACC IM and, if so, what mechanisms may be appropriate to compensate airports for that risk (whether ex ante or ex post, or both).

We consider that any review of the risk profile of airports should account for learnings from Covid-19, and consider whether there have been historic under-estimations of risk. We would like to see this fully addressed in the IM review. We have avoided addressing these issues in our recent pricing due to the complexity involved and lack of full information whilst the pandemic remains at its height. However, as discussed above it will be an enduring issue, which all airports may seek to address in future price settings.

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Airports are willing to bear the risk of ordinary passenger fluctuations, but are not compensated for very large, very unlikely, one-off shocks. Wellington Airport is concerned about this not only for pandemic risk but also for earthquake risk, and possibly also when considering increased climate risks.

A rigid application of the building block model does not provide an ability to cope with these very large demand shocks. The technical response of the model is for prices to dramatically increase when passenger numbers dramatically fall. This produces obvious challenges when airlines are already suffering from a demand shock. This could possibly be avoided to an extent if airports were more adequately compensated over the long term for one-off shocks and/or airports had the confidence to adopt pricing approaches that would seem them appropriately compensated over time following a shock (ie so that returns assessed on a building blocks basis are not deemed to be excessive).

On an entirely empirical level, it is practical to look at the initiatives of Wellington and other New Zealand metro airports to buttress their balance sheets (additional standbys, pre-funding, shareholder calls) and to derive a cost, both one-off and ongoing. We consider that it will be important for the Commission to note this when reviewing its WACC IM and assessing airport pricing and returns.

Our last point in relation to the cost of capital is the Tax Adjusted Market Risk Premium (TAMRP). During its recent PSE4 pricing consultation, Wellington Airport noted the Commission's 19 November 2019 draft decision on the Fibre IMs, which applied a TAMRP of 7.5% based on an updated analysis from Dr Martin Lally. As noted by the Commission, the TAMRP is an economy-wide parameter which should not vary by sector, service or company. Whilst we did not end up adopting the higher TAMRP in our PSE4 pricing consultation we considered it should apply to airports, and ask that the Commission should review the TAMRP for airports (and all regulated sectors) in its IMs review.

CPI Forecasting

Wellington Airport has grappled with the vexed issue of inflation forecasting in our latest PSE4 pricing consultation. While we appreciate the options airports have in this area, we are keenly aware of the impact of indexing revaluations to CPI changes, particularly in the current low-WACC environment.

There are several issues. The appropriate methodology for forecasting CPI. The consequences of mis-forecasting CPI. The problem with extremely lost cash returns due to central bank initiatives to reduce bond and deposit rates. The desire to maintain real asset values with some alignment with market values.

While we are not commenting at length on these issues in this letter, we would especially note that ultra-low interest rates resulting from central bank interventions are distortionary and this is certainly one area where this is manifest.

Conclusion

Thank you for the opportunity to raise these matters with you in advance. We appreciate the Commission has a large work programme ahead, and we appreciate the Commission's acknowledgment that regulation must be fit for purpose and encourage investment and innovation, and that many sector risks are novel and perhaps not well captured by backward-looking metrics. You have a considerable task ahead and we are willing to assist with any information or resources at our disposal.

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Yours sincerely

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