

## **IM REVIEW – Professor Yarrow report and emerging views on the airport WACC percentile.**

### **Introduction**

1. As part of the input methodologies (IMs) review, we are considering the suitability of the current Weighted Average Cost of Capital (WACC) percentile range specified in the airport IMs determination.<sup>1</sup> The topic was previously defined as an area for review in our IMs review problem definition paper.<sup>2</sup>
2. We are publishing today an expert view from Professor George Yarrow on the WACC that applies to airports subject to information disclosure regulation.<sup>3</sup>
3. We have considered the views of Professor Yarrow together with submissions received in response to the problem definition paper.
4. This paper provides our emerging views on this topic. We are now providing an opportunity for stakeholders to comment on Professor Yarrow’s advice and our emerging views.
5. In particular, we would like to hear from stakeholders on the questions outlined in paragraph 29 of this paper.
6. Comments on Professor Yarrow’s advice and our emerging views are due by 5pm, **Friday 11 March 2016.**

### **Commission’s emerging views**

7. We have reviewed Professor Yarrow’s advice and stakeholder submissions to the problem definition paper. We agree with views that suggest there could be a number of contextual or airport specific factors which *may* result in an airport’s returns legitimately increasing above a mid-point estimate of the WACC. This could be true on both an ex-ante basis (when assessing the appropriateness of airport prices following a price-setting event) and an ex-post basis (when assessing disclosed returns).
8. However, as indicated by the imposition of information disclosure regulation, larger airports in New Zealand are deemed to have strong natural monopoly characteristics. This enables them to set prices above those that would prevail in a workably competitive market.<sup>4</sup> As a result there is an important balance to consider

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<sup>1</sup> Commerce Commission “Input Methodologies (Airports) Reasons Paper” (December 2010), Section E11.

<sup>2</sup> Commerce Commission “Input methodologies review: Invitation to contribute to problem definition” (16 June 2015), Topic 7.

<sup>3</sup> Professor George Yarrow “Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector” (February 2016). The terms of reference for Professor Yarrow’s advice are published alongside this paper.

<sup>4</sup> Explanatory Note to the Commerce Amendment Bill 2008, p.35.

when determining an appropriate WACC for the purposes of profitability assessment.

9. We consider the distinction Professor Yarrow makes between the allowed rate of return and the cost of capital is particularly relevant for this topic.<sup>5</sup> An airport's return on investment may differ from the IMs-specified mid-point estimate of the WACC because:
  - 9.1 an airport's own mid-point estimate of the cost of capital is different from that estimated by the Commission; and/or
  - 9.2 an airport is targeting returns above (or below) its mid-point estimate of the WACC.<sup>6</sup>
10. Flexibility was provided in the original IMs by publishing a WACC percentile range together with a view that the starting point of any assessment of profitability should be the 50<sup>th</sup> percentile (mid-point).<sup>7</sup> As noted in the s56G report on Christchurch Airport, the publication of a specific range (25<sup>th</sup> to 75<sup>th</sup> percentile) was intended to take into account the uncertainty associated with the Commission's estimate of the cost of capital.<sup>8</sup>

...the 75th percentile cost of capital allows for the uncertainty of estimating the cost of capital and limits the potential asymmetric consequences of estimation error on investment.

11. The existence of the WACC percentile range in this way resulted in the 75<sup>th</sup> percentile being used as the 'de-facto' upper limit of an 'acceptable range' when assessing airport profitability as part of the s56G reports for the Wellington, Auckland and Christchurch airports.<sup>9</sup>

#### *Consideration of the High Court Judgment*

12. The general approach as outlined in the airport IMs, including the use of the 50<sup>th</sup> percentile as the starting point for profitability assessment, was subsequently endorsed by the High Court as appropriate for information disclosure regulation.<sup>10</sup>
13. However, in the same judgment the court also outlined its scepticism about the use of a WACC percentile substantially above the mid-point when setting price-quality paths for electricity and gas businesses. It noted the lack of evidence for the choice of the 75<sup>th</sup> percentile used in that context.

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<sup>5</sup> Professor George Yarrow "Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (February 2016), p.11.

<sup>6</sup> As noted previously, there could be both appropriate and inappropriate reasons for an airport to target returns above or below their mid-point estimate of the WACC.

<sup>7</sup> Commerce Commission "Input Methodologies (Airports) Reasons Paper" (December 2010), para 6.4.37.

<sup>8</sup> Commerce Commission "Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch Airport" (13 February 2013), footnote 128.

<sup>9</sup> Ibid, footnote 128.

<sup>10</sup> *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC [11 December 2013], paras 1488-1492.

14. The High Court’s comments led us to review the most appropriate percentile to be used for setting the price-quality path of electricity and gas network businesses. The percentile used in this context was subsequently reduced to the 67<sup>th</sup> percentile.<sup>11</sup> As part of this process, we specifically noted the importance of airport specific factors, which meant that airports should be considered separately from the energy network businesses.<sup>12</sup>
15. These developments mean that there is limited rationale for using the 75<sup>th</sup> percentile (which has been greeted with scepticism by the court) or the 67<sup>th</sup> percentile (which was determined in the context of electricity and gas businesses) as the de-facto upper limit of an acceptable WACC range for airports.<sup>13</sup>
16. In addition, the rationale for using a percentile above the mid-point appears weaker for airports than for electricity and gas businesses. As noted in the problem definition paper, we consider that the potential asymmetric impacts on consumers from underinvestment are likely to be weaker for airports compared to electricity and gas businesses because they:<sup>14</sup>
- 16.1 are only subject to information disclosure (which means that the regulated WACC is only likely to have an indirect effect on investment decisions);
  - 16.2 are subject to a dual-till structure (whereby they can earn significant amounts of revenue from unregulated complementary activities); and
  - 16.3 have regular consultations with a small number of engaged customers (airlines).
17. We note that submissions from airports, to the problem definition paper, challenge the relevance of these factors.<sup>15</sup> However we continue to believe that all could be significant and note no specific evidence to the contrary. Professor Yarrow’s advice outlines the importance of complementary revenue streams, which would need to be considered for both pricing and determining investment programmes.<sup>16</sup>

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<sup>11</sup> Commerce Commission “Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services: Reasons paper” (30 October 2014).

<sup>12</sup> Ibid, paras X28-X30.

<sup>13</sup> Our final decision for electricity and gas businesses subject to information disclosure retained a 25<sup>th</sup> to 75<sup>th</sup> WACC percentile range as it was considered potentially useful for assessing ex post profitability. We considered that a 67<sup>th</sup> percentile estimate was useful for assessing returns anticipated by the supplier ex-ante. See: Commerce Commission “Amendments to the WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services: Reasons Paper” (12 December 2014).

<sup>14</sup> Commerce Commission “Input methodologies review: Invitation to contribute to problem definition” (16 June 2015), para 395.

<sup>15</sup> NZ Airports “Submission on Commerce Commission’s Input Methodologies Review: Invitation to Contribute to Problem Definition” (21 August 2015), paras 140-161.

<sup>16</sup> Professor George Yarrow “Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector” (February 2016), p.17.

18. Given this background, we consider that a precisely defined WACC percentile range applied to all airports in all situations is not appropriate for the IMs. Airport specific factors should be considered when undertaking an assessment of whether individual airports are meeting the purpose of Part 4.
19. Our emerging view is that information disclosure is better served by publishing the Commission's mid-point estimate of the cost of capital together with the probability distribution of the WACC estimate. This could be done by either publishing WACC estimates at regular percentile estimates (eg, every 5<sup>th</sup> percentile) or by only publishing the mid-point estimate together with our estimate of the standard error.<sup>17</sup>
20. This approach would enable a certain amount of flexibility in assessing the acceptability of airport returns and would reduce the focus of any assessment on the upper limit of the WACC percentile range. It is also consistent with the original intentions of the IMs to start any assessment at the mid-point estimate of the WACC.
21. This emerging view would enable any assessment to take into account different contextual factors. These could include whether the assessment is taking place on an ex-ante or ex-post basis, airport specific circumstances, or other factors that should be taken into account in assessing airport profitability.

*Practical application of suggested approach*

22. The suggested change to the IMs, as outlined above, would enable airports to target (ex-ante) or achieve (ex-post) returns above the mid-point when they have legitimate reasons for doing so. However airports would be required to provide information and evidence to justify those reasons to interested parties. This justification could then be balanced against the s52A(1)(d) requirement to limit the ability of airports, as regulated suppliers, to earn excessive profits.<sup>18</sup>
23. We consider that this approach is consistent with Professor Yarrow's view that there should be an expectation that the airports will provide information on any relevant factors that need to be considered in a profitability assessment.<sup>19</sup>

Any assessment exercise should properly take account of a range of relevant factors, which it is reasonable to expect will be brought to the attention of the Commission by the airports themselves, as part of any information disclosure exercise.

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<sup>17</sup> An alternative would be to publish the WACC value consistent with a range of percentiles, eg, every 5% increase in the percentile.

<sup>18</sup> Commerce Act 1986.

<sup>19</sup> Professor George Yarrow "Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (February 2016), p.19.

24. We also consider that a key aspect of this approach is for airport disclosures to separately identify the different factors that result in an airport's target return on investment being above (or below) our mid-point estimate for the cost of capital. In particular, airports would need to identify factors which result in different mid-point estimates of the cost of capital (eg, due to a different methodological approach) from factors that could justify an uplift to a mid-point estimate (eg, due to concerns about potential asymmetric effects).
25. As noted above, we do not think a specific point estimate (other than the mid-point) is helpful when assessing airport profitability in the context of information disclosure. However, we would expect greater justification, reasoning and evidence to be required as any divergence from the mid-point increases.

#### *Application of a quantitative framework*

26. We have previously suggested that the use of a quantitative framework, as used for determining the optimal percentile for electricity and gas businesses, could be useful in the airport context.<sup>20</sup>
27. Although our suggested approach would not determine an 'optimal percentile', we think this type of model could help inform the materiality of the costs and benefits to consumers of airport services associated with different percentiles. We are interested in any further stakeholder comments on the application of this quantitative approach, given our emerging views on this topic.

#### *Summary of our emerging views*

28. In summary our views on airport WACC percentile are as follows.
- 28.1 There may be legitimate reasons why an airport's returns may be above or below our mid-point estimate of the cost of capital.
- 28.2 The current specification of a WACC percentile range is likely to have placed too much emphasis on the upper limit of the range (75<sup>th</sup> percentile) when assessing airport profitability.
- 28.3 The importance of the mid-point as the starting point for assessing airport returns has been confirmed by the High Court and airports should be required to provide justification for any divergence from that mid-point.
- 28.4 We think that this approach is best applied in the IMs by providing a mid-point estimate together with information on its probability distribution (eg, publication of a standard error term).

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<sup>20</sup> Commerce Commission "Input methodologies review: Invitation to contribute to problem definition" (16 June 2015), paras 398-400.

### Questions for stakeholders

29. Following the publication of Professor Yarrow’s report and our emerging views, we are keen to hear from stakeholders on the following questions to inform further analysis.
- 29.1 What are the specific factors that should (or should not) allow an airport to target returns that diverge from the mid-point WACC estimate? These factors should be differentiated between:
- 29.1.1 factors that result in airports estimating a different mid-point WACC from that estimated using the WACC methodology specified in the IMs; and
- 29.1.2 factors that result in an airport targeting returns above (or below) their mid-point WACC estimate.
- 29.2 We have previously suggested that the use of a quantitative framework could be useful for assessing an appropriate percentile in the airport context.<sup>21</sup> We are interested in any further views on the use of this type of framework given our emerging views outlined in this paper.

### How to provide your views

30. Comments on Professor Yarrow’s advice and our emerging views, including those specific points listed above, are due by 5pm, **Friday 11 March 2016**.
31. Please address your comments to:
- Keston Ruxton (Manager, IM Review)  
c/o [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

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<sup>21</sup> Commerce Commission “Input methodologies review: Invitation to contribute to problem definition” (16 June 2015), paras 398-400.