The Commerce Commission's Draft 56G Report on WIAL:

Comments on Selected Aspects

Report to BARNZ

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1. Introduction

On 2 November 2012 the Commerce Commission (the Commission) released its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 of the Commerce Act for Wellington International Airport Ltd (WIAL).[1] The Commission is required to prepare this report under s 56G of the Commerce Act 1986 (the Act).

The Commission has invited interested parties to make submissions on its *Draft Report*. It will consider these submissions when finalising its report. The Board of Airline Representatives in New Zealand (BARNZ) has asked me to comment on the following two aspects of the Commission's *Draft Report*:

- The use of the 75th percentile estimate of WACC when estimating *ex-ante* WIAL's excessive profits; and
- The inclusion of both revenue and costs from leased assets in the calculation of Regulatory Profit.

2. Use of the 75th percentile WACC estimate

2.1 The Commission's rationale

The Commission explains its use of the 75th percentile WACC estimate in addition to the midpoint in the following terms:

> *The 75th percentile estimate of the cost of capital has been considered as a benchmark in addition to the midpoint because in trade-offs between assessing outcomes that promote dynamic efficiency (eg, incentives to invest) and static allocative efficiency (ie, higher short-term pricing) under Part 4, we generally favour outcomes that promote dynamic efficiency.*[2]

This explanation and the slight variations on it offered at other points in the *Draft Report*[3] are far from clear. However, a clearer explanation is provided in the Commission's 2008 Decision Paper in relation to the authorisation of control of Powerco and Vector's natural gas distribution services.[4] In the *Gas Control Decision Paper*, the Commission recognises that its midpoint estimate of WACC reflects seven parameters over which there is uncertainty: the market risk premium; the four components of the asset beta;[5] leverage; and the debt premium. This parameter

[1] Commerce Commission, *Draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport: Section 56G of the Commerce Act 1986*, 2 November 2012. (Hereinafter referred to as the "*Draft Report*").

[2] Commerce Commission, *Draft Report*, Footnote 171, pp.101-02.

[3] See also Commerce Commission, *Draft Report*, Table H4, Note 1, p.95 and para I74, p.142 for similar statements.

[4] Commerce Commission, *Authorisation for the Control of Supply of Natural Gas distribution Services by Powerco Ltd and Vector Ltd: Decision Paper*, 30 October 2008, pp.180-82. (Hereinafter referred to as the "*Gas Control Decision Paper*").

[5] The equity beta, the market values of equity and debt and the debt beta.

uncertainty results in uncertainty over the WACC estimate that can be thought of as giving rise to a probability range for WACC.

Moreover, the Commission also recognises there are other potential sources of uncertainties concerning the true value of WACC, including:[6]

- the Capital Asset Pricing Model (CAPM) does not fully describe expected returns from investments;
- the Brennan-Lally version of the CAPM used by the Commission is inappropriate;
- the market portfolio in the CAPM is poorly proxied by a single country's share market index and not an index of all market returns; and
- the betas are estimated using higher frequency data than the investor horizon, which should be used.

The Commission notes these additional uncertainties could be considered as raising the spread of the WACC range.

According to the Commission, the consequences of underinvestment in infrastructure by regulated businesses, if the allowed rate of return is below the true cost of capital, can have a more significant impact on the interest of acquirers in the long term than the consequences of excessive prices to acquirers in the short term. This is because, without the necessary investment in infrastructure to provide the services, acquirers will not have the opportunity to consume as much as they would be willing to pay for at efficient prices.

For this reason "the Commission considers that the WACC value at the 75th percentile provides an appropriate balance between achieving normal rates of return that can be considered commercially realistic (for comparable businesses) and the interests of acquirers of controlled services."[7]

In other words, the Commission uses the 75th percentile WACC as a benchmark for excessive profits in the circumstances of control of gas distribution businesses because it believes the social costs of controlled providers under-investing due to returns being too low outweigh the social costs of consumers paying prices that are too high. There is, according to the Commission, an asymmetric social welfare loss function from errors in the WACC applied to controlled entities; the costs are higher for under-estimates of WACC than for over-estimates. In a supporting document to the *Gas Control Decision Paper*, Professor Lally has shown that if the asymmetric loss function is linear, the use of the 75th percentile WACC is optimal if the costs of under-estimates of WACC are three times the costs of over-estimates.[8]

[6] Commerce Commission, *Gas Control Decision Paper*, p.181.

[7] *Loc. cit.*

[8] Martin Lally, *The Weighted Average Cost of Capital for Gas Pipeline Business*, 28 October 2008, Appendix 8.

2.2 Appropriateness for WIAL

How appropriate is it for the Commission to use the 75th percentile WACC, in addition to the midpoint estimate when assessing *ex-ante* WIAL's excessive profits?

The first point to note is that although it might be necessary to ensure the returns of gas pipeline businesses are likely to be on the high side to stimulate investment; this is not the case for WIAL. A significant part of WIAL's revenue is generated by unregulated activities, such as, car parking, provision of shopping space, restaurants and bars, and leasing airline lounges. The revenue it derives from these ancillary activities depends critically on the flow of passengers and the visitors to the airport they attract. The expansion of regulated assets to service increased flows of passengers also helps generate ancillary revenue and profits for WIAL.

A decision by WIAL not to invest in regulated assets to the point it impacted passenger volumes would inhibit its profits from these other activities. A more or less guaranteed super-normal return is not required to ensure dynamic efficiency at WIAL. Virtually the only source of revenue for a gas distribution business is from the provision of pipelines. Revenue opportunities from the provision of ancillary services are nowhere near as important for gas distribution businesses as for airports like WIAL.

The second point to note is that three of the four non-parametric sources of uncertainty in estimating WACC identified by the Commission in its 2008 Gas Control Decision Paper will tend to lead to it being overstated. In the paper, the Commission notes that there is evidence suggesting the use of a domestic rather than an international CAPM and use of monthly data for estimating betas may inflate the estimates of WACC by up to 1.4%.[9]

Moreover, arguments presented by MEUG at the input methodology conference related to the cost of capital in 2010 identified that the Brennan-Lally model with leverage leads to an overstatement of WACC. This was confirmed in a paper prepared by Professor Lally in response:

> *This paper shows that there is some deficiency in the WACC model currently employed by the Commerce Commission [i.e. the Brennan-Lally model], but these are not readily correctable, leaving the choice between the status quo (which overstates WACC) and a simple alternative in the form of setting WACC equal to the unlevered cost of capital (which would understate WACC).*[10]

Illustrative calculations suggest the bias towards overstatement could be material.

With three of four non-parametric uncertainty factors all working in the direction to overstate WACC it is likely that the true range for WACC, if it were known, would be centred on a point materially below the midpoint estimate using the Brennan-Lally model and monthly data. In these circumstances, using the midpoint estimate is likely to result in super-normal profits, and using the 75th percentile will compound this bias towards excessive prices and profits.

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[9] Commerce Commission, *Gas Control Decision Paper*, p.181.

[10] Martin Lally, *WACC and Leverage*, 17 November 2009, p.7.

A third point is that sometimes it is argued that one should disregard the dynamic inefficiencies that excessive prices will have by altering the investment and innovation decisions of the customers of monopoly providers. This is because the costs of monopolised inputs tend to make up a small proportion of the total prices of the products and services produced by their consumers. For example, gas distribution charges are typically a small proportion of the costs of gas consuming businesses.

This used to be the case with airlines. However, the advent of discount carriers and more aggressive pricing to attract "marginal" consumers has changed that. The proportion of a standard ticket price between Auckland and Wellington corresponding to the airport charges is relatively small, less than 10%; but this is far from the case with a $39 one-way fare.

A significant amount of the innovation by airlines is related to marketing and service provision of these "low-value" customers and it is incorrect to continue to dismiss the impact of airports overcharging on the innovation and dynamic efficiency of airlines when assessing the social costs of excessive profits and overcharging. This is what the Commission's approach to assessing the impact of overcharging on dynamic efficiency implicitly does.

For these three reasons I consider it inappropriate for the Commission to use the 75th percentile along with the midpoint WACC as the benchmarks for the *ex-ante* assessment of excessive profits for regulated airports. If the Commission wishes to indicate the uncertainty around the estimates of WACC then I believe a preferable approach is to show both the 25th and 75th percentiles along with the estimated midpoint. It should be noted that the midpoint calculated using the Brennan-Lally model and monthly data is likely to be an overstatement of the true midpoint.

3. Leased assets

3.1 The Commission's rationale

The Commission is aware that the aeronautical revenue figures it has do not include income from leased assets. However, it is unable to separately identify and remove from the calculation of regulatory profits the costs associated with these revenue streams. The Commission has, therefore, decided to include both the revenue and costs from leased assets in the regulatory profit figures it calculates.[11] The Commission goes on to state:

> *We have assumed that this does not materially affect the analysis on the basis that income from leased assets accounts for less than 7% of total regulatory income and the profitability targeted in relation to leased asset activities is comparable to that of other services provided.*[12]

[11] Commerce Commission, *Draft Report*, Footnote 179, p. 108.

[12] *Loc. cit*.

3.2 Appropriateness for WIAL

The fact that only 7% of total regulatory income is derived from leased assets does suggest that the impact of the Commission's assumption on its analysis is not likely to be material. However, historically what has been found is that WIAL has tended to earn less on its leased assets than its target WACC, with a reasonable margin between the two. This fact by itself tends to suggest that WIAL's targeted WACC has been excessive as it has been unable to achieve its target WACC in commercial negotiations where it customers faced options, albeit limited in many cases. If leased assets still yield less than WIAL's target WACC, the effect of the Commission's assumption that the two are the same will be to underestimate WIAL's excessive profits.

I believe the Commission should investigate WIAL's returns on leasehold assets for what it may reveal about WIAL's returns in a marketplace where it does face limited competitive pressures, albeit constrained.