

Wellington Airport Draft report



Briefing for financial market analysts
2 November 2012

Overview

- Draft report to Ministers on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport
- This presentation summarises:
 - our task under s 56G of the Commerce Act
 - the analytical framework we have used
 - our draft conclusions

Our task under s 56G

- Report to Ministers of Commerce and Transport on how effectively information disclosure (ID) regulation is promoting the purpose of Part 4 of the Commerce Act
- We are not considering whether other types of regulation should apply to the airports
- This draft report examines the effectiveness of ID regulation at Wellington Airport
- The effectiveness of ID regulation at Auckland and Christchurch airports will be considered in separate reports in 2013
- We will apply a consistent approach for each airport

Summary of draft conclusions

- Our draft conclusions on the effectiveness of ID regulation vary between the different outcomes sought under Part 4
- Our review for Wellington Airport has found that:
 - ID is effective in some areas (innovation, quality, pricing efficiency)
 - ID is not effective at limiting excessive profits
 - we are unable to conclude whether ID regulation is effective in other areas (operating efficiency, efficient investment, sharing of efficiency gains)

Purpose of Part 4 (s 52A(1))

- To promote the long-term benefit of consumers by promoting outcomes that are consistent with outcomes produced in workably competitive markets such that suppliers of regulated airport services –
 - (a) have incentives to innovate and invest, including in replacement, upgraded, and new assets; and
 - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
 - (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
 - (d) are limited in their ability to extract excessive profits.

Regulated airport services

- ID regulation under Part 4 applies to specified airport services only. These are:
 - aircraft and freight activities
 - airfield activities; and
 - some passenger terminal activities
- Car-parking and retail activities are not regulated under Part 4

Analytical framework

- ID can promote the purpose of Part 4 by providing incentives to achieve outcomes consistent with those found in workably competitive markets
- We assess Wellington Airport's performance (historical and projected) and conduct to identify whether Wellington Airport has moved closer to the outcomes sought by the Part 4 purpose
 - This is the practical test of whether incentives are working to promote the long-term benefit of consumers in that area
- If so, we assess whether these changes are likely to be attributable to ID regulation
- Suppliers have incentives other than those provided in ID to improve performance. We may therefore conclude that ID is effectively promoting the purpose of Part 4 with respect to a particular area of performance, even if ID regulation is having a limited impact on that outcome

Draft conclusion – operating efficiency

- We are unable to conclude whether information disclosure regulation is effectively promoting improvements in Wellington Airport's operational expenditure (opex)
 - We consider it is too early to assess meaningful trends in opex
 - The evidence of whether Wellington Airport is improving its operating efficiency is mixed
- Submissions indicate that information disclosure has had a limited impact on Wellington Airport's operating efficiency to date
- We consider this may be a concern as airlines have submitted that Wellington Airport may not be operating efficiently, or improving its operating efficiency

Draft conclusion – efficient investment

- We are unable to conclude whether information disclosure regulation is effectively promoting efficient investment at Wellington Airport
 - We consider it is too early to conclude whether information disclosure is effective until we know whether the issue of timing of investment raised by airlines in the first pricing period continues to raise concerns
- Submissions to this review indicate that information disclosure may have had a limited impact
- We do not consider this to be a concern at this time as:
 - forecast levels of capex for the second pricing period appear prudent given current information
 - no evidence in submissions that Wellington Airport is not undertaking necessary investments
 - we expect ID to be as effective as it can be in this area over time

Draft conclusion – innovation

- Information disclosure regulation under Part 4 is effectively promoting appropriate innovation
- Information disclosure has had a limited impact on incentives to innovate at Wellington Airport, but this is not a concern
 - Submissions have not raised any substantive concerns with innovation at Wellington Airport
 - Few concerns were raised by airlines about Wellington Airport's facilitation of airline-led innovation
 - It appears that innovation has been appropriate at Wellington Airport both before and after the introduction of information disclosure regulation under Part 4
 - Other incentives play a more important role in driving innovation

Draft conclusion - quality

- Information disclosure is effectively promoting the provision of quality at a level that reflects consumers' demands
- The key reasons for this are:
 - quality of service at Wellington Airport compares well against other airports
 - airlines appear to be generally satisfied with the quality of service provided at Wellington Airport
 - Wellington Airport has attributed the introduction of information disclosure as partly responsible for improvements to customer survey results
 - concerns raised relate to price-quality trade offs airlines wish to make

Draft conclusion – sharing of efficiency gains

- We are unable to conclude whether information disclosure regulation is effectively promoting the sharing of efficiency gains with consumers at Wellington Airport
- This is because it is too early to conclude whether there are any opex and capex efficiency gains at Wellington Airport that could be shared with consumers

Draft conclusion – pricing efficiency

- Information disclosure regulation is effectively promoting efficiency of pricing
- Prices based on the pricing methodology for the second pricing period are more likely to promote efficiency than those previously in place
- Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure
- Airlines have raised concerns about the extent to which the revised pricing structure will promote efficiency. These concerns indicate that further improvements to pricing efficiency could occur, for example, in relation to price-quality trade offs

Draft conclusion – profitability

- Wellington Airport has earned, and is expecting to earn over 2013-2017, excessive profits. ID regulation has not been effective on limiting their ability to extract excessive profits
- Assessed against our input methodologies, we would expect ID regulation to have had an impact on profitability by now
- The following slides illustrate our analysis that led to this draft conclusion

Input methodologies as benchmark

- Airports not required to apply our IMs in setting prices
- IMs are most relevant to the profitability assessment – asset valuation, taxation and cost of capital
- We have compared what Wellington Airport is earning against our cost of capital IM
- We have considered variations from our IMs and impact on performance/expected performance

Profitability analysis

- Information disclosure regulation has not been effective in limiting Wellington Airport's ability to extract excessive profits

Wellington Airport target return for PSE1 and PSE2	9.5%
7 year IRR analysis	10.18%
Commerce Commission midpoint post tax WACC	7.06%
Commerce Commission 75 th percentile post tax WACC	8.04%

- Present values of Wellington Airport's estimated net cash flows over PSE2 in excess of 75th percentile cost of capital \$20.6m
- No evidence of superior performance or external factors justifying level of excess return

Key reasons for level of excess returns

- Land valuation methodology
- Cost of capital applied
- Conduct

Land valuation methodology

- Our analysis is based on the IM-compliant opening land valuation
 - Considered most consistent with promoting outcomes consistent with those of a workably competitive market
 - A MVAU approach
- Wellington Airport 's land valuation used for pricing is based on an MVEU approach (MVAU + land conversion costs)
- There is approximately a \$85m difference between the IM-compliant land valuation and Wellington Airport's land valuation for pricing

Cost of capital

- Wellington Airport targeted 9.5% return for both PSE1 and PSE2 despite risk free rate falling over this period

	Wellington Airport PSE1 Pricing	Wellington Airport PSE2 Pricing
Wellington Airport target cost of capital	9.50%	9.50%
Wellington Airport risk free rate assumption	6.16%	3.90%
Wellington Airport asset beta assumption	0.60	0.75

- No evidence to indicate that Wellington Airport's systematic risk has changed over time

Cost of capital cont.

- Wellington Airport has targeted a cost of capital that is higher than the Commission's estimate of a reasonable return
- Wellington Airport assumes an asset beta of 0.75
 - higher than the Commission's assessment of 0.60
 - higher than other independent estimates
 - higher than Wellington Airport's own arguments under the Merits Appeal of 0.65
- Wellington Airport assumes a TAMRP of 8.0%
 - higher than the Commission's assessment of 7.0%
 - higher than almost all other market participants
 - higher than Wellington Airport's own arguments under the Merits Appeal of 7.5%

Conduct

- Significant disagreement exists between Wellington Airport and its customers over the financial inputs to its price-setting decisions
- While there has been increased transparency, the existence of Part 4 information disclosure regulation has not appeared to reduce the extent of disagreement as to price-setting outcomes
- Against this background we are not confident that there is a likelihood of Wellington Airport's excessive profits being limited at PSE3 or beyond

Next steps

- We will be holding a 'Q&A' of the technical analysis underpinning the draft decision on 14 November

Milestone	Indicative date
Submissions on Wellington Airport draft report	30 November 2012
Cross-submissions on Wellington Airport draft report	12 December 2012
Final Wellington Airport report provided to Ministers	21 December 2012

Questions?

For more information

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Or visit:

<http://www.comcom.govt.nz/section-56g-reports/>

For information on:

- Process and issues in relation to the WIAL review
- Submissions received to date