

Review of Wellington Airport's 2019-2024 Price Setting Event

Final report

Date: 28 September 2022

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Executive summary

Purpose of this report

- X1 This report contains our review of Wellington International Airport Limited’s (**Wellington Airport**) pricing decisions for the period 1 April 2019 to 31 March 2024, and our conclusions on whether its pricing decisions and expected performance are likely to promote the long-term benefit of consumers.
- X2 Wellington Airport is one of three international airports subject to information disclosure regulation under Part 4 of the Commerce Act 1986 (**the Act**).
- X3 In April 2021, Wellington Airport reset its prices for the period 1 April 2019 to 31 March 2024 following consultation with airlines, its major customers. Wellington Airport refers to this as its fourth price setting event (**PSE4**). Wellington Airport provided the required disclosures for PSE4 in June 2021.
- X4 We are publishing our final report under section 53B(2)(b) of the Act, which requires us to publish a summary and analysis of information disclosed by Wellington Airport, including information about its price setting event. As Wellington Airport had an extended consultation for PSE4, first due to capital expenditure planning and subsequently the Covid-19 pandemic, we have considered the full series of consultation documents in our analysis.
- X5 To promote greater understanding of Wellington Airport’s performance, this report contains our analysis and conclusions on Wellington Airport’s pricing decisions and expected performance over the PSE4 period of 1 April 2019 to 31 March 2024. Our review of Wellington Airport’s pricing decisions and expected performance for the PSE4 period focusses on:
- X5.1 **Expected profitability** – is Wellington Airport limited in its ability to earn excessive profits?
- X5.2 **Risk allocation** – is risk shared appropriately between Wellington Airport and its major customers in pricing decisions?
- X5.3 We have abbreviated our usual process for this review. The abbreviated process in this instance is partially in response to the fact that airports are still experiencing a difficult operating environment because of the Covid-19 pandemic. We note that this may limit stakeholders’ ability to engage with a protracted or complex consultation. We have focussed our analysis on expected profitability and risk allocation as noted at paragraph X5, and provided limited comments on other facets of Wellington Airport’s pricing-related decisions in a summary table in Chapter 4.

Our conclusions on Wellington Airport's expected profitability

- X6 Having considered the reasons and evidence provided by Wellington Airport, we are broadly satisfied that its target return of 5.88% on its total regulatory asset base (**RAB**) is reasonable and consistent with promoting the long-term benefit of consumers.
- X7 At 5.88%, Wellington Airport's target return on its total RAB is 0.21 percentage points higher than our mid-point post-tax weighted-average cost of capital (**WACC**) estimate of 5.67%, as at 1 April 2019.
- X7.1 The target return on Wellington Airport's total RAB is below, but based upon, Wellington Airport's own estimation of its post-tax WACC of 6.08%.
- X7.2 Wellington Airport's target return on its total RAB is the key measure affecting its profitability. It has been set using the airport's own estimated WACC as a starting point, which has then been adjusted (downward) by Wellington Airport following consultation with its major customers.
- X8 We consider our 2019 mid-point WACC estimate to be the appropriate starting point for assessing the appropriateness of Wellington Airport's target return, which the airport has used in agreement with airline customers and has applied it consistently. The assumptions underlying the airport's estimation of WACC also consistently apply information from 1 April 2019.
- X9 We acknowledge that a WACC for Wellington Airport is unobservable to both us and Wellington Airport itself, and as such we would not expect Wellington Airport to meet our own estimation of its reasonable return exactly.¹ We have no significant concerns that Wellington Airport is targeting excessive profits over the PSE4 pricing period with its targeted return of 5.88%, which is 0.14 percentage points higher than the upper end of our estimate range for a reasonable return (5.72% to 5.74%).
- X10 We have assessed the reasons put forward by Wellington Airport for its own estimation of its WACC which is higher than Wellington Airport's targeted return for the pricing period. We have considered the reasons behind this estimate as these can provide guidance to our assessment of its target return across its total RAB.
- X11 In estimating its WACC for PSE4, Wellington Airport:
- X11.1 had forecast its cost of debt based on existing debt instruments, which at 4.66% is 1.45 percentage points higher than our estimated cost of debt of 3.21%; and

¹ Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 64.

- X11.2 applied an asset beta uplift of 0.03 to our benchmark asset beta of 0.60 to account for the risks associated with its forecast capex profile at the time of its initial pricing proposal, including its operating leverage and the proportion of domestic passengers in its traffic mix.
- X12 We consider there may be legitimate reasons to depart from the benchmark credit rating of A- that we have used in calculating our mid-point WACC estimate to BBB+, which is consistent with a debt premium of 1.60% (0.36 percentage points higher than our benchmark estimate of 1.24%). We also agree that some additional compensation for the longer tenor of debt is justified for the debt premium of up to 0.18 percentage points.
- X13 We consider that the available evidence suggests our revised estimate range for the cost of debt of 3.57% to 3.75% for Wellington Airport is reasonable in the airport's specific circumstances, compared to our benchmark estimate of 3.21%. As suggested in paragraph X12, where the 3.57% to 3.75% range for the cost of debt reflects the BBB+ credit rating adjustment, a higher cost of debt may be justified as a term credit spread differential (**TCS**D)-type adjustment for longer term debt. Whilst it has provided some information, Wellington Airport has not provided the information we require to calculate this additional debt premium exactly, therefore, we have indicated a range (see paragraph A120).
- X14 We consider there are some reasons why our cost of equity may be a conservative estimate. However, we find the evidence provided by Wellington Airport insufficient to justify an uplift to the asset beta and we have not investigated further given we do not have concerns with the overall level of its targeted return.
- X15 We have adjusted our mid-point WACC estimate for the higher cost of debt, to estimate a range for a reasonable return of 5.72% to 5.74% for Wellington Airport for PSE4. This is a difference of 0.05 to 0.07 percentage points from our mid-point post-tax WACC of 5.67%.
- X16 Table X1 below provides a summary of the expected returns and associated expected revenues over the five-year pricing period of PSE4.

Table X1 Summary table of Wellington Airport's expected returns and revenue

	Expected return (post-tax)	PV revenue (\$m)	WACC percentile
Wellington Airport's target return on its total RAB	5.88%	\$344.3m	56th
Target return on its priced services	5.93%	\$313.9m	57 th
Target return on its other regulated activities	5.18%	\$30.5m	37 th
Our mid-point WACC estimate	5.67%	\$338.7m	50 th
Our adjusted WACC estimate reflecting a BBB+ credit rating and longer debt tenor	5.72% - 5.74%	\$340.0m - \$340.6m	51st – 52nd

- X17 Wellington Airport's target return of 5.88% on its total RAB is consistent with an expected revenue of \$344.3m in present value terms. This is \$3.7m or 1.09% higher than the \$340.6m in revenue that would be consistent with the upper limit of our estimate range for a reasonable return, and an additional \$3.4m in profit after tax over five years.
- X18 We also note that Wellington Airport consulted on and subsequently revised its target return (on the pricing asset base, forming 93% of Wellington Airport's total opening RAB in PSE4) and the airport stated in its pricing disclosure that this has been accepted by most major airline customers.

Our conclusions on risk allocation between Wellington Airport and its major customers

- X19 Wellington Airport has introduced three revenue-related carry forward adjustments, which defer revenue from PSE4 to later pricing periods, during a period of Covid-19 induced uncertainty for the airport and airlines. These are a passenger demand wash-up, revenue deferral, and a net revaluation carry forward adjustment. As a result of deferring revenue via the adjustments, the airport and airlines have reallocated risk during PSE4: airlines bear more demand risk, while Wellington Airport is exposed to funding and credit risk by (temporarily) foregoing revenue.
- X20 We consider that, unless doing so would be inconsistent with the purpose of Part 4, risks should be allocated to suppliers or consumers depending on who is best placed to manage them.² This is consistent with how risks tend to be allocated in workably competitive markets.

² Commerce Commission "Input methodologies review decisions: Framework for the IM review" (20 December 2016).

- X21 It is reasonable that Wellington Airport and its major customers have agreed to reallocate risk between them under the circumstances, using the passenger demand wash-up mechanism. The demand wash-up provides Wellington Airport with guaranteed revenue recovery, but delays the recovery into the future. This makes expenditure recovery for the airport more certain.
- X22 We believe that the revenue deferral mechanism may be appropriate to provide price relief to major customers in the short term. The revenue deferral may also provide an incentive for Wellington Airport to improve efficiency and reduce costs during the years of revenue deferral prior to its significant capital expenditure programme anticipated in the next pricing period (**PSE5**), which would be consistent with the purpose in s 52A(1)(b) of the Act.
- X23 Lastly, we are generally comfortable with the net revaluation carry forward adjustment, made up of a market value alternative use (**MVAU**) valuation gain and the recovery of a historical revaluation deficit, being carried forward into PSE5. This is because we expect:
- X23.1 Wellington Airport to be transparent about how it calculates and allocates the historical revaluation deficit and MVAU valuation gain; and
 - X23.2 that customers are, in general, not worse off given the allocation to two pricing periods.
- X24 As with the revenue deferral mechanism, the net revaluation gain reduces the exposure of consumers to higher prices during PSE4. However, by spreading the net revaluation gain across two pricing periods, Wellington Airport trades lower revenues in PSE4 (through applying the entire net revaluation gain) for a smoother transition in pricing through to PSE5. We consider this carry forward adjustment is consistent with the purpose of Part 4, as the allocation of the revaluation deficit recovery and MVAU valuation gain is being spread across the two pricing periods evenly.

Our conclusions on other pricing-related decisions made by Wellington Airport for PSE4

- X25 In forming our views on Wellington Airport's other pricing-related decisions for PSE4, we consider whether there are concerns that the pricing decision is inconsistent with the purpose of Part 4.

X26 Our conclusions on other key aspects of Wellington Airport's pricing-related decisions are that, with one exception, these are all either consistent with the purpose of Part 4 of the Act, or else do not detract from that purpose. The exception is the approach taken by Wellington Airport in relation to market value existing use (**MVEU**) valuation for the assets being transferred from commercial use into its RAB for aeronautical use in PSE4.

Chapter 1 Introduction

Purpose of this report

1. This report contains our review of Wellington International Airport Limited's (**Wellington Airport**) pricing decisions for the period 1 April 2019 to 31 March 2024.
2. Wellington Airport is one of three international airports subject to information disclosure regulation under Part 4 of the Commerce Act 1986 (**the Act**).
3. We are publishing this report under section 53B(2)(b) of the Act, which requires us to publish a summary and analysis of information disclosed by Wellington Airport, including information about its price setting event.³
4. The conclusions and analysis in this report take into account the submissions and cross-submissions that we received in response to our consultation paper published on 13 May 2022.⁴

Context for this report

Wellington Airport has reset its prices

5. In April 2021, Wellington Airport reset its prices for the period 1 April 2019 to 31 March 2024 following consultation with airlines, its major customers. Wellington Airport refers to this as its fourth price setting event (**PSE4**).
6. Airports set prices to recover costs and earn a return on specified services, the nature of which we describe further at paragraph 15. In the case of Wellington Airport, its pricing includes charges for airfield and terminal use, (aircraft) parking and noise mitigation activities.
7. Wellington Airport has delayed PSE4 twice, in agreement with major customers⁵:

³ Wellington Airport is required to publicly disclose information about its price setting event in accordance with the *Airport Services Information Disclosure Determination 2010*. Throughout this report we refer to the *Airport Services Information Disclosure 2010*, as amended on 18 June 2019. This consolidated determination includes the principal determination and the all amendments listed as follows: *Commerce Act (Specified Airport Services Information Disclosure) Determination 2010* [2010] 715; *Amendment to Commerce Act (Specified Airport Services Information Disclosure) Determination 2010* [2012] NZCC 5; *Airport Services Information Disclosure Amendments Determination 2016* [2016] NZCC 29; *Airport Services Information Disclosure Amendments Determination 2017* [2017] NZC 36; and *Airport Services Information Disclosure (Backward-looking Profitability) Amendments Determination 2019* [2019] NZCC 5.

⁴ Our consultation paper, the Review of Wellington Airport's price setting event – Consultation paper – 13 May 2022, and submissions on this document can be found at: <https://comcom.govt.nz/regulated-industries/airports/projects/review-of-price-setting-event-4?target=timeline>

⁵ Wellington Airport sought and received exemptions from the Commission that permitted the delay of its PSE4. These exemptions were granted on 14 August 2019: https://comcom.govt.nz/data/assets/pdf_file/0024/168171/Wellington-International-Airport-

- 7.1 In June 2018, Wellington Airport and its major customers agreed on a six-month extension in order to complete consultation on the airport's 2040 Master Plan, with prices held at 2019 levels to be washed up when prices were set. This agreement was later extended for a further six months.
- 7.2 Wellington Airport then undertook a price setting consultation between September 2019 and February 2020, progressing through several different pricing proposals. It had mostly finalised pricing inputs by April 2020, but sought agreement from major customers to keep the charges constant for another 12 months, and price whatever volumes eventuated in FY2021 at this holding price due to the uncertainty associated with the Covid-19 pandemic.
- 7.3 Wellington Airport ultimately finalised FY2022-2024 prices for PSE4 in April 2021 having regard to the PSE4 period as a whole (which for passenger volumes and capital expenditure would be two years of actuals and three years of forecasts).⁶ We note the exceptional and unusual circumstances of the Covid-19 pandemic giving rise to some of the retrospective adjustments and wash-ups introduced by Wellington Airport in its PSE4 pricing period.
8. Wellington Airport has been subject to information disclosure (**ID**) regulation under the Act since 2011 but has been consulting with airlines concerning proposed price changes before this, under the Airport Authorities Act 1966 (**AAA**).
9. Under the AAA, airports are able to set prices as they think appropriate, but must consult with airlines prior to fixing or altering charges, and within at least five years of fixing or altering charges.⁷ This means that airports reset prices at least every five year period. Consultation on the price setting event also includes the inputs to the prices being set, for example, cost of capital, expenditure programmes, and demand forecasts.
10. The major customers that Wellington Airport has consulted with during its PSE4 price setting process are Air New Zealand (**AirNZ**), the Qantas group of companies including Jetstar (**Qantas**), and the Board of Airline Representatives New Zealand (**BARNZ**) which represents the broader airline industry. We note that Qantas (who is a member of BARNZ) has indicated their support of BARNZ's submission on our consultation paper. AirNZ is also a member of BARNZ and provided their own submission on our consultation paper.

[Exemption-request-response-14-August-2019.PDF](https://comcom.govt.nz/data/assets/pdf_file/0035/217889/Wellington-International-Airport-Amendment-to-exemption-dated-14-August-2019-29-May-2020.pdf) and 29 May 2020: https://comcom.govt.nz/data/assets/pdf_file/0035/217889/Wellington-International-Airport-Amendment-to-exemption-dated-14-August-2019-29-May-2020.pdf.

⁶ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 8.

⁷ Specifically, s 4B of the AAA requires airports to consult with "substantial customers", the meaning of which is set out in s 2A of the AAA.

Wellington Airport has provided information disclosures for its pricing decisions

11. After a price setting event, the three airports subject to ID regulation (Auckland, Wellington and Christchurch International Airports) must publicly disclose information relating to their forecast total revenue requirement for their regulated services.⁸ This includes (but is not limited to) information about their pricing, a summary of the consultation process they have engaged in with major customers, and information regarding the rationale behind preparing forecast inputs. Wellington Airport provided the required disclosures for PSE4 in June 2021.⁹
12. While not the subject of this report, each regulated airport must also publish historical information annually on its financial position in relation to specified airport services and the quality of those services.¹⁰
13. The regulated services that are the subject of Wellington Airport's PSE4 disclosure and this report can be grouped into two categories:
 - 13.1 **'Priced services'** are those regulated services for which standardised prices are set for the pricing period, after the airport consults with 'substantial customers'; and
 - 13.2 **'Other regulated services'** are those which are priced through contractual arrangements with individual customers (rather than on standardised terms). The length and start dates of these contracts may not necessarily align with the pricing period.
14. Wellington Airport also offers services that are not regulated under Part 4 of the Act and are outside the scope of this report. Examples of these services include the space for retail outlets inside the terminals, access for taxis and public transport, and car parks.
15. Examples of priced and regulated services are provided in Table 1.1 below.¹¹

⁸ Under s 53B(1) of the Act, every supplier of goods or services that are subject to ID regulation must publicly disclose information in accordance with the ID requirements set out in the relevant s 52P determination. For airports, the relevant determination is the *Airport Services Information Disclosure Determination 2010*, above n 3.

⁹ Wellington Airport's PSE4 disclosures can be found on its website:

<https://www.wellingtonairport.co.nz/business/investor-services/regulatory-disclosures/>

¹⁰ *Commerce Act (Airport Services Information Disclosure) Determination 2010*, above n 3, clauses 2.3 and 2.4.

¹¹ These regulated services are defined in s 56A of the Act and in further detail in s 2 of the AAA.

Table 1.1 Regulated airport services

Priced services typically include	Other regulated services typically include
<ul style="list-style-type: none"> airfield landing facilities and services, such as the provision and maintenance of airfields, runways and taxiways. airfield parking facilities and services. specified passenger terminal activities such as passenger seating areas, thoroughfares, and air-bridges. 	<ul style="list-style-type: none"> aircraft and freight activities – facilities and services that help maintain aircraft and the handling of freight transport by aircraft. This could include facilities and services for the refuelling of aircraft, flight catering, waste disposal, and the storing of freight. other specified passenger terminal activities, which may include identified leases, facilities and services for the operation of customs, immigration, quarantine checks, security and police services, terminal lounges, and collection facilities for duty free.

We must publish a summary and analysis of Wellington Airport's disclosed information

- Under s 53B(2)(b) of the Act, we are required to publish summary and analysis of the information disclosed publicly by Wellington Airport as soon as practicable. The purpose of the summary and analysis is to promote greater understanding of Wellington Airport's performance, its performance relative to other regulated airports, and changes in its performance over time.
- To promote greater understanding of Wellington Airport's performance, this report contains our analysis and conclusions on Wellington Airport's pricing decisions and expected performance over the PSE4 period of 1 April 2019 to 31 March 2024.
- As Wellington Airport has had an extended consultation for PSE4, first due to capital expenditure planning and subsequently the Covid-19 pandemic, we have considered the full series of consultation documents described in Table 1.2 below, starting with its initial pricing proposal.

Table 1.2 Timeline of Wellington Airport's PSE4 proposals

Year	Month	Proposal
2019	September	Initial pricing proposal
	December	Revised pricing proposal
2020	April	Final pricing document
	December	Concessionary pricing proposal
2021	March	Final prices

Focus of our review

- Our review of Wellington Airport's pricing decisions and expected performance for the PSE4 period focusses on:

- 19.1 **Expected profitability** – is Wellington Airport limited in its ability to earn excessive profits?
- 19.2 **Risk allocation** – is risk shared appropriately between Wellington Airport and its major customers in pricing decisions?
20. We have also reviewed all other key pricing-related decisions described in Wellington Airport’s PSE4 disclosure. We have taken care to examine where stakeholders have raised concerns or decisions differ from expectations under the current rules.
21. We have reviewed these aspects of Wellington Airport’s performance to assess whether they are likely to promote outcomes that are consistent with the purpose of Part 4 of the Act.
22. The purpose of Part 4 as set out in s 52A(1) of the Act is to:

promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

 - (a) have incentives to innovate and to 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.
23. Our focus on expected profitability and risk allocation does not necessarily cover all outcomes reflected in the purpose of Part 4 of the Act.
24. Incentives to innovate and improve efficiency and sharing the benefits of efficiency gains are not explicitly considered within this review. We acknowledge the feedback provided on our consultation paper by submitters on the importance of considering innovation, service quality and efficiency.¹² In future we may look more closely at the performance indicators of innovation, service quality, and efficiency using the forward-looking information contained within pricing disclosures alongside the ex-post annual disclosures described in paragraph 12 to allow comparison of planned and achieved outcomes.

¹² BARNZ: “Submission on review of Wellington Airport’s price setting event consultation paper” (10 June 2022), paragraph 9, Air New Zealand: “Submission on review of Wellington Airport’s price setting event consultation paper” (13 June 2022), page 2, and NZ Airports Association: “Submission on review of Wellington Airport’s price setting event consultation paper” (10 June 2022), page 1.

25. As noted at paragraph 7, this price setting event includes historical data for the first two financial years of the pricing period. Within our review we assess outcomes for the entire period, as the historical outcomes for FY2020 and FY2021 influence the pricing decisions made for the remainder of the period, and therefore the profitability across the entire pricing period.

Our approach to assessing pricing decisions and expected performance in this report

26. In this report we consider the decisions and rationale used by Wellington Airport in setting its revenues and target return, as described in its PSE4 disclosure. We do this in the context of the input methodologies (**IMs**) relevant to regulated airport services (**Airports IMs**).¹³
27. IMs are the rules, requirements and processes we must determine for services that are regulated under Part 4 of the Act.¹⁴ The Airports IMs contain clear rules for our estimation of the weighted-average cost of capital (**WACC**), which we use as a benchmark for assessing profitability.
28. We have also considered the views of Wellington Airport's major customers regarding the airport's pricing decisions, as expressed within the PSE4 disclosure, as well as the submissions and cross-submissions that we received on the initial views in our consultation paper.
29. In the case of decisions where IMs are less prescriptive, we assess whether Wellington Airport's PSE4 produces outcomes that we would expect under workably competitive market conditions. In particular, we consider whether there is any significant reason for a pricing decision that is inconsistent with the purpose of Part 4 of the Act.
30. The purpose of the analysis is to assess whether the expected outcomes of Wellington Airport's pricing decisions are inconsistent with the purpose of Part 4 of the Act. This analysis does not determine the specific choices that Wellington Airport ought to have made in its pricing decisions, or what we would have done in its place, therefore we are not required to identify alternative approaches unless we choose to do so. To the extent that we find the outcomes of the airport's pricing decisions are consistent with the purpose of Part 4 of the Act, we have described those decisions as being reasonable.

¹³ As airports can set prices as they see fit, the Airport IMs (Commerce Commission "*Airport Services Input Methodologies Determination 2010 – consolidated as of 20 December 2016*") only apply to Airports ID for the purposes of assessing whether the purpose of Part 4 is being met, and do not apply to the way airports set prices.

¹⁴ A review of most IMs, including Airports IMs, was last completed in December 2016. We have begun our next review of the IMs and must complete our review by December 2023.

Structure of this report

31. The report is structured as follows:
 - 31.1 **Chapter 2** contains our analysis and conclusions on the appropriateness of Wellington Airport's targeted return. Our detailed assessment of Wellington Airport's cost of capital is contained in **Attachment A**.
 - 31.2 **Chapter 3** contains our analysis and conclusions regarding whether Wellington Airport is sharing risk appropriately with its major customers.
 - 31.3 **Chapter 4** provides our conclusions on other pricing-related decisions.

Our abbreviated review process

32. This year, we conducted an abbreviated review process relative to past reviews by publishing a consultation paper which included our proposed timeframe and initial views of whether Wellington Airport's pricing decisions are broadly reasonable. The abbreviated review in this instance was partially in response to the fact that airports are still experiencing a difficult operating environment because of the Covid-19 pandemic. We noted in our consultation paper that this may limit stakeholders' ability to engage with a protracted or complex consultation. Submitters on our consultation paper generally supported this abbreviated review process.¹⁵
33. We appreciate the time taken by interested parties to provide submissions and cross-submissions on the initial views in our consultation paper and we have acknowledged submission and cross-submission comments within this report.

¹⁵ BARNZ: "Submission on review of Wellington Airport's price setting event consultation paper" (10 June 2022), paragraph 9, NZ Airports Association: "Submission on review of Wellington Airport's price setting event consultation paper" (10 June 2022), page 1, Wellington Airport: "Submission on review of Wellington Airport price setting event consultation paper" (10 June 2022), paragraph 2.1.

Chapter 2 Expected profitability

Purpose of this chapter

34. This chapter contains our analysis and conclusions on whether Wellington Airport is limited in its ability to earn excessive profits.
35. We focus on whether Wellington Airport's targeted return, and associated profit over the PSE4 pricing period and beyond has been sufficiently justified, such that it is likely to be in the long-term interest of consumers.

Our conclusions

We believe the rate of return targeted by Wellington Airport does not raise significant concerns of targeting excessive profits

36. At 5.88%, Wellington Airport's target return on its total regulated asset base (**RAB**) is 0.21 percentage points higher than our mid-point post-tax WACC estimate of 5.67%, as at 1 April 2019.
 - 36.1 The target return on Wellington Airport's total RAB is below, but based upon, Wellington Airport's own estimation of its post-tax WACC of 6.08%.
 - 36.2 Wellington Airport's target return on its total RAB is the key measure affecting its profitability. It has been set using the airport's own estimated WACC as a starting point, which has then been adjusted (downward) by Wellington Airport following consultation with its major customers.

We find Wellington Airport's target return of 5.88% to be reasonable

37. Having considered the reasons and evidence provided by Wellington Airport, we are broadly satisfied that its target return of 5.88% on its total RAB is reasonable and consistent with promoting the long-term benefit of consumers.
38. We consider our 2019 mid-point WACC estimate to be the appropriate starting point for assessing the appropriateness of Wellington Airport's target return, as the airport agreed on the timing of the WACC estimate with its major customers when it delayed its price setting event. We consider this is appropriate to the extent that Wellington Airport has applied the WACC timing consistently. For example, the assumptions underlying the WACC should be consistently applying information from 1 April 2019.
39. We acknowledge that a WACC for Wellington Airport is unobservable to both us and Wellington Airport itself,¹⁶ and as such we would not expect Wellington Airport to

¹⁶ Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 64.

meet our own estimation of its reasonable return exactly. We do not have significant concerns that Wellington Airport is targeting excessive profits over the PSE4 pricing period with its targeted return of 5.88%.

40. We have assessed the reasons put forward by Wellington Airport for its own estimation of its WACC, which provides guidance to our assessment of its target return across its total RAB. The target return is the key measure impacting profitability.
 - 40.1 We have considered the evidence Wellington Airport provided to justify its estimated WACC exceeding our mid-point WACC. Where we considered these arguments to be sufficiently reasoned we have adjusted our estimated mid-point WACC to produce a reasonable return estimate.
 - 40.2 We then compared our estimate of a reasonable return to Wellington Airport's target return to assess whether it is targeting excessive profits over the PSE4 pricing period.

A target return reflecting a cost of debt higher than our benchmark is reasonable

41. In estimating its WACC for PSE4, Wellington Airport:
 - 41.1 forecast its cost of debt based on existing debt instruments, which at 4.66% is 1.45 percentage points higher than our initial estimated cost of debt of 3.21%; and
 - 41.2 applied an asset beta uplift of 0.03 to our benchmark asset beta of 0.60 to account for the risks associated with its forecast capex profile at the time of its initial pricing proposal, including its operating leverage and the proportion of domestic passengers in its traffic mix.
42. We consider there may be legitimate reasons to depart from the benchmark credit rating of A- and justify a higher debt premium than we have used in calculating our mid-point WACC estimate. We also agree that some additional compensation for the longer tenor of debt has been justified for the debt premium, of up to 0.18 percentage points.
43. In our view, the available evidence suggests a BBB+ credit rating assumption and the higher debt premium estimate range of 1.60% to 1.78% are reasonable in Wellington Airport's specific circumstances and appear to be consistent with prudent levels of debt financing.
44. Therefore, we consider that using a higher cost of debt in estimating Wellington Airport's WACC would be appropriate for the airport's specific circumstances. As a result, we have used an adjusted cost of debt estimate range of 3.57% to 3.75% as an input to our reasonable return estimate, 0.36 to 0.54 percentage points higher than

the cost of debt estimate of 3.21% used in our mid-point WACC. As noted in paragraph 42, a higher cost of debt has been justified through the provision of sufficient supporting evidence of a longer original term of debt.

45. We consider there are some reasons why our cost of equity may be a conservative estimate. However, we find further evidence would be required to justify an uplift to the asset beta. There is no asset beta uplift reflected in our estimated reasonable return for Wellington Airport.
46. Holding all other parameters in our mid-point WACC constant, including the 0.60 asset beta, the adjusted 3.57% to 3.75% cost of debt assumption corresponds to a reasonable return estimate of 5.72% to 5.74%, a difference of 0.05 to 0.07 percentage points from our mid-point WACC estimate of 5.67%.
47. Table 2.1 below provides a summary of the expected returns and associated expected revenues over the five-year pricing period of PSE4.

Table 2.1 Summary table of Wellington Airport’s expected returns and revenue

	Expected return (post-tax)	PV revenue (\$m)	WACC percentile
Wellington Airport’s target return on its total RAB	5.88%	\$344.3m	56th
Target return on its priced services	5.93%	\$313.9m	57 th
Target return on its other regulated activities	5.18%	\$30.5m	37 th
Our mid-point WACC estimate	5.67%	\$338.7m	50 th
Our adjusted WACC estimate reflecting a BBB+ credit rating and longer debt tenor	5.72% - 5.74%	\$340.0m - \$340.6	51st – 52nd

48. Wellington Airport’s target return of 5.88% on its total RAB is consistent with an expected revenue of \$344.3m in present value terms. This is \$3.7m or 1.09% higher than the \$340.6m in revenue that would be consistent with the upper limit of our estimate range for a reasonable return (5.72% to 5.74%), and an additional \$3.4m in profit after tax over five years.
49. BARNZ commented in their submission on our consultation paper, that any additional revenue and profit after tax associated with Wellington Airport’s target return may be a material amount to airline customers, and that any difference between Wellington Airport’s cost of capital and our estimate of a reasonable return would result in higher prices to airline customers that have made significant losses during the pandemic.¹⁷ We acknowledge this, however, having considered the

¹⁷ BARNZ: “Submission on review of Wellington Airport’s price setting event consultation paper” (10 June 2022), paragraph 6.

evidence provided by Wellington Airport, we are broadly satisfied that its target return is reasonable.

50. We also note that Wellington Airport consulted on and subsequently revised its target return (on the pricing asset base, forming 93% of Wellington Airport's total opening RAB in PSE4) and the airport stated in its pricing disclosure that it has been accepted by most major airline customers.

Our approach to assessing Wellington Airport's targeted return

51. For the purposes of assessing the targeted level of profitability we have focussed on Wellington Airport's actual targeted return on total regulated assets (5.88%), and as this is set following its consultation with airlines rather than estimated, we have also assessed the reasons put forward for the airport's stated mid-point post-tax WACC (6.08%).
52. We have used our mid-point WACC estimate provided for in the IMs as our starting point to assess whether Wellington Airport is targeting excessive profits.¹⁸ We have assessed the appropriateness of the airport's target return specifically as it is the key measure that affects profitability, which differs from its estimated WACC as we discuss at paragraphs 59 to 61.
53. We estimated Wellington Airport's expected returns over PSE4 using an internal rate of return (**IRR**) calculation. The IRR allows us to assess the airport's expected returns across the remaining lifetime of the assets used in supplying regulated airport services during the pricing period.
54. As part of our assessment, we have considered the arguments and evidence provided by Wellington Airport to justify its own WACC estimate, which exceeds the mid-point WACC estimate that we determined. We accept that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate.¹⁹ The onus is on the airport to provide sufficient reasoning,²⁰ and any reasoning needs to consider the long-term benefit of consumers. Our detailed analysis of Wellington Airport's reasoning is provided within our assessment of its cost of capital in Attachment A.
55. If appropriate, we have reflected these arguments in an adjusted WACC or reasonable return estimate. The reasonable return is the main point of comparison that we use to assess whether Wellington Airport is targeting excessive profits.

¹⁸ The IMs require us to determine estimates of WACC for regulated suppliers such as Wellington Airport. Estimates of WACC for ID purposes are determined annually.

¹⁹ Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 87.

²⁰ *Airport Services Information Disclosure Determination 2010*, above n 3, clause 2.5(1)(i).

56. We note that in our assessment of Wellington Airport's target return, all return estimates are as at 1 April 2019.
57. In summary:
- 57.1 Wellington Airport's **target return** on its total RAB is the key measure affecting its profitability. It has been set using the airport's own **estimated WACC** as a starting point, which has then been adjusted (downward) by Wellington Airport following consultation with its major customers.
- 57.2 Our estimated **mid-point WACC** is the starting point we use to assess the appropriateness of Wellington Airport's target return. We consider the evidence Wellington Airport provides to justify its estimated WACC exceeding our mid-point WACC, and if sufficiently reasoned we have reflected these arguments in an adjusted WACC or **reasonable return**.
- 57.3 The reasonable return is compared to Wellington Airport's target return to assess whether it is targeting excessive profits over the PSE4 pricing period.
58. Note that any references to WACC within this chapter relate specifically to post-tax WACC, unless explicitly stated to be the vanilla WACC.

Wellington Airport is targeting a return of 5.88% on its total regulated asset base for PSE4

59. During the price setting event process, Wellington Airport estimated its WACC to be 6.08%, but set a target return across its total RAB of 5.88% following consultation with airlines.
60. Our focus in this chapter is upon the target return, rather than Wellington Airport's estimate of its WACC, as the target return is what the airport used to set prices and the targeted level of its profit during PSE4. We assess whether the target return is set at a level that would be expected to result in Wellington Airport earning excessive profits over the pricing period.
61. As Wellington Airport's target return has been set following consultation with airlines during its price setting consultation process, it is not possible to directly identify the individual reasons for the differences to our mid-point WACC estimate. Therefore, we have assessed the reasons put forward by Wellington Airport for its own estimation of its WACC (6.08%), which provides guidance to our assessment of its target return across its total RAB (5.88%).

Wellington Airport’s target return across its priced assets is 5.93%, while the forecast return on its other regulated services is 5.18%

62. Wellington Airport’s target return across its priced assets, which form 93% of its total opening RAB for PSE4, is 5.93%. We note that Wellington Airport consulted on and subsequently revised its target return on priced assets and the airport stated in its pricing disclosure that it has been accepted by most major airline customers.
63. Wellington Airport’s target return on its priced assets differs from the 5.88% target return for its total RAB, due to the returns on its other regulated services at 5.18%. Wellington Airport’s other regulated services include property leases for aircraft and freight activities, terminal leases, airfield leases, and a long-term commercial arrangement for airport noise mitigation activities that targets a net present value of zero over the lifetime of the noise mitigation project.
64. The forecast returns for Wellington Airport’s other regulated services reflects “the outcomes achieved by [Wellington Airport] from the commercial processes to establish lease rent levels”.²¹ Wellington Airport notes however that the returns achieved for the leased activities are not readily reconcilable to a target return or WACC, due to:
- 64.1 the different points in time at which prices are set;
 - 64.2 varying contract durations for individual leases;
 - 64.3 particular lease terms required by individual tenants; and
 - 64.4 conventional property market price setting processes which differ from the building block approach for regulated activities.
65. We consider that an airport’s returns on other regulated services are likely to be better assessed over a longer timeframe.²² For example, the individual contracts for these services may have durations and start dates that do not necessarily align with our mid-point WACC estimate, which is consistent with the five-year PSE4 pricing period. There are also a wide range of factors, such as market conditions, rent reviews and break clauses, that can affect the prices under contracts that apply to these services.

²¹ Wellington International Airport Limited “WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024” (1 June 2021), page 20.

²² Commerce Commission “Review of Auckland International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report” (1 November 2018), paragraph X33.

Our approach to modelling Wellington Airport's profitability has resulted in slightly different target return estimates

66. We have modelled Wellington Airport's profitability in a manner consistent with the IMs, using the information the airport has provided to us as part of its price setting event. This has resulted in two minor differences between Wellington Airport's price setting event disclosure and our modelling of Wellington Airport's targeted return and associated profitability over PSE4.
67. These two differences are in the treatment of tax on Wellington Airport's long-term noise mitigation project, and the values for the opening and closing carry-forward adjustments used in IRR calculations. The resulting target return estimates we have calculated are:
- 67.1 5.90% for Wellington Airport's total RAB, compared to its reported 5.88%; and
- 67.2 5.88% for its pricing assets only, compared to its reported 5.93%.
68. We discuss these differences further in **Attachment B**. However, for the remainder of the chapter, we refer to the target returns reported by Wellington Airport in its pricing disclosure only.

In 2019 we determined Wellington Airport's post-tax WACC to be 5.67%

69. In our 2019 determination of Wellington Airport's WACC, we estimated its mid-point post-tax WACC to be 5.67%, as at 1 April 2019. This reflected the parameters in Table 2.2 below. In particular, we applied an A- credit rating, an average debt premium of 1.24%, cost of debt of 3.21%, and an asset beta of 0.60.

Table 2.2 Parameters used in WACC calculation for Wellington Airport

Parameter	2019 determination value	Wellington Airport value
Risk-free rate	1.77%	1.77%
Debt premium	1.24%	n/a
Leverage	19%	19%
Asset beta	0.60	0.63
Equity beta	0.74	0.78
Tax-adjusted market risk premium	7.0%	7.0%
Average corporate tax rate	28%	28%
Average investor tax rate	28%	28%
Debt issuance costs	0.20%	0.20%
Cost of debt	3.21%	4.66%
Cost of equity	6.46%	6.72%
Mid-point vanilla WACC	5.84%	6.33%
Mid-point post-tax WACC	5.67%	6.08%

70. We consider our 2019 mid-point WACC estimate to be the appropriate starting point for assessing the appropriateness of Wellington Airport's target return, as the airport agreed on the timing of the WACC estimate with its major customers when it delayed its price setting event. We consider this is appropriate to the extent that Wellington Airport has applied the WACC timing consistently. For example, the assumptions underlying the WACC should be consistently applying information from 1 April 2019. We discuss this further at paragraphs A18 to A21, A29 to A30, and A76 to A77.
71. The parameters used by Wellington Airport in its calculation of WACC, as at 1 April 2019, are also shown in Table 2.2. Wellington Airport's debt premium, asset beta and cost of debt differ from the parameters we have used in our estimation of its mid-point WACC.
72. While Wellington Airport's target return for PSE4 is below its estimated WACC, the differences in these parameters are also key reasons for the airport's targeted return on its total RAB exceeding our mid-point WACC estimate.

Wellington Airport's target return is 0.21 percentage points higher than our mid-point WACC estimate

73. At 5.88%, Wellington Airport's target return on its total RAB is 0.21 percentage points higher than our mid-point WACC estimate of 5.67%.
74. As discussed at paragraph 72, the target return for Wellington Airport's total RAB is below, but based upon, Wellington Airport's own estimation of its WACC.
75. Wellington Airport stated in its price setting disclosure that in estimating its WACC, it had forecast its cost of debt based on existing debt instruments, which is higher than our estimated cost of debt; and applied an asset beta uplift of 0.03 to account for the risks associated with its forecast capex profile, including its operating leverage and the scale of planned investments. Its rationale for these differences, and major customer feedback, are as follows.

Cost of debt

76. Wellington Airport's cost of debt estimate of 4.66% is 1.45 percentage points higher than our 3.21% benchmark. Overall, Wellington Airport's cost of debt results in a 0.20 percentage point difference to our mid-point WACC estimate.
- 76.1 For all regulated suppliers of airport services, we use a 'simple' approach to estimate the cost of debt. Wellington Airport's approach to estimating its cost of debt, using actual debt costs for its historic portfolio of debt and estimated costs for its expected new debt (post 2019), is closer to a 'complex' approach. We describe the differences in approach within Attachment A at paragraphs A67 to A75.

- 76.2 The airport's implied overall debt premium from its estimation approach is 2.69% compared to our 1.24% benchmark, a difference of 1.45 percentage points.
77. Wellington Airport considers that the Commission's mid-point WACC underestimates its cost of debt. In particular, Wellington Airport noted in its price setting event disclosure that:
- 77.1 it estimated its expected weighted average cost of debt based on existing debt costs and expected new issues of debt over PSE4;
- 77.2 it had entered the PSE4 period with different forms of debt including fixed rate corporate bonds, floating rate corporate bonds, swaps, drawdowns on bank facilities, and US Private Placement and other debt with an issuance term between seven and twelve years;
- 77.3 that it is willing to commit to incorporating actual cost of debt into all future WACC estimates; and
- 77.4 it considered the Commission's feedback on Auckland Airport's pricing that Auckland Airport's cost of debt estimate based on its actual costs was "for the most part reasonable" and has taken a similar approach.
78. Houston Kemp, advising for Wellington Airport, also provided views which we discuss in Attachment A. This includes Houston Kemp referring to the use of Wellington Airport's existing debt in its weighted average approach to estimating the cost of Wellington Airport's debt over PSE4.
79. BARNZ submitted to Wellington Airport as part of the airport's pricing consultation process that Wellington Airport was able to use interest rate swaps to broadly match the risk-free rate for the five-year pricing period; and that treasury risk management should be in the hands of the regulated entity "where it belongs".²³

Asset beta

80. Wellington Airport has used an asset beta of 0.63, an uplift of 0.03 compared to our estimate of 0.60. Wellington Airport's main reason for the asset beta uplift provided in its price setting disclosure document was to account for a higher asset beta associated with Wellington Airport's significant capex programme and risk profile.
- 80.1 In Wellington Airport's view, the Commission had accepted in principle an asset beta uplift for Auckland Airport in its PSE3, based on an increasing capex programme increasing exposure to systematic risk. It proposed that an

²³ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 35.

equivalent uplift for Wellington Airport would be appropriate, given its own operating leverage and the scale of investments anticipated at the time of its initial pricing proposal.

81. Wellington Airport's initial pricing proposal was produced in September 2019, prior to the deferral of growth projects from within its capex programme into later pricing periods. We consider the evidence provided within the initial pricing proposal, which incorporates Wellington Airport's original capex programme, as to do so is consistent with the use of WACC as at 1 April 2019.
82. The rationales that Wellington Airport had provided for its 0.03 asset beta uplift in its initial pricing proposal were related to:
 - 82.1 capex increasing leverage and exposure to investment risk;
 - 82.2 investment impacting the proportion of fixed to variable costs, affecting operating leverage;
 - 82.3 the Commission's view on Auckland Airport's PSE3 asset beta uplift; and
 - 82.4 a high proportion of domestic passengers in Wellington Airport's traffic mix, likely to be more highly correlated to non-diversifiable risk.
83. Further detail on these rationales are provided in Attachment A along with the views of the airport's advisor Houston Kemp.
84. BARNZ, upon advice from TDB Advisory (**TDB**), did not support the methodology used by Wellington Airport to calculate its operating leverage, which resulted in the proposed 0.03 uplift. Wellington Airport has stated that TDB provided its own analysis which supported a smaller increase of 0.02.

We do not find that Wellington Airport has sufficiently justified its asset beta uplift, but that there may be legitimate reasons for a higher cost of debt

85. We note that although our mid-point WACC estimate is an appropriate starting point, we consider that for the purpose of profitability summary and analysis under section 53B(2)(b), it is possible to depart from WACC parameters specified in the IMs when there are legitimate reasons to do so.²⁴
86. We do not find that Wellington Airport has sufficiently justified its asset beta uplift or the approach it has used to estimate its cost of debt. However, we do consider there may be legitimate reasons to depart from the benchmark credit rating we have used in calculating the mid-point WACC estimate, which would result in a higher

²⁴ Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 87. The parameters detailed in the IMs are for the Commission's determination of the mid-point WACC estimate.

estimated cost of debt. We discuss these points below and in further detail in Attachment A.

Cost of debt

87. We consider Wellington Airport's high level approach to estimating its cost of debt (reflecting its actual debt portfolio) leads to a significant departure from our preferred benchmark approach to the cost of debt, and has not been sufficiently justified by the reasons and evidence provided by Wellington Airport. We note both AirNZ and BARNZ agreed with our assessment of this issue in their submissions.²⁵
88. We prefer to use a benchmark cost of debt approach in the WACC estimate rather than Wellington Airport's actual debt costs, as the relevant estimate of the cost of capital (including the cost of debt) is the market's view of the cost of capital for providing the service, not the actual debt costs of any individual firm.²⁶ We discuss this further at paragraphs A80 to A91.
89. While we agree that we described Auckland Airport's high-level cost of debt approach, based on its actual costs, as 'for the most part reasonable', we did not find that a departure from the IM methodology was sufficiently justified.
- 89.1 We acknowledge that in describing both Auckland Airport's approach and estimate, and our own cost of debt estimate, as reasonable, we generated unintended ambiguity.
- 89.2 Auckland Airport's cost of debt estimate was close to our own (0.20 percentage point difference) and led to a 0.02 percentage point difference in the estimated WACC. This may explain the use of the term 'reasonable' to describe Auckland Airport's approach, even though we ultimately did not find it fully justified.²⁷
90. Although we consider that the available evidence suggests Wellington Airport's approach to cost of debt overall has not been justified, we do consider there may be legitimate reasons for Wellington Airport to depart from the A- benchmark credit rating in these specific circumstances.

²⁵ BARNZ: "Submission on review of Wellington Airport's price setting event consultation paper" (10 June 2022), paragraph 11. Also, Air New Zealand: "Submission on review of Wellington Airport's price setting event consultation paper" (13 June 2022), page 2).

²⁶ As set out in the IMs, the WACC is estimated because it cannot be observed directly, and the relevant estimate is the market's view of the cost of capital for providing the service, not the cost of capital specific to one regulated supplier, or a regulated supplier's view of its cost of capital for that service. See Commerce Commission "Input methodologies review decisions - Topic paper 4: Cost of capital issues" (20 December 2016), paragraph 23.

²⁷ Commerce Commission "Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph 216.

91. In our view, the use of a BBB+ credit rating would be appropriate as:
- 91.1 Wellington Airport's actual credit rating as at 1 April 2019 of BBB+ is still an adequate investment grade rating, and is sufficiently high to ensure there is an adequate buffer against the possibility that economic downturns or shocks lead to financial distress (while providing some flexibility over the level of gearing and the choice of debt instruments);
 - 91.2 Wellington Airport's BBB+ credit rating appears to be consistent with a prudent level of debt financing;
 - 91.3 BBB+ is consistent with the benchmark credit rating we use for regulated electricity lines and gas pipelines businesses; and
 - 91.4 a debt premium uplift consistent with a BBB+ credit rating appears to have been accepted by airlines.
92. To implement this BBB+ credit rating adjustment in our estimation of Wellington Airport's reasonable return for PSE4, we have adopted the 1.60% debt premium assumption used in Houston Kemp's advice to Wellington Airport, as noted at paragraph A100.
93. As noted at paragraph 77, Wellington Airport's approach to estimating fixed rate debt reflects longer-term debt. We agree 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. We find the supporting evidence of a longer debt term sufficient to justify an additional debt premium up to 0.18 percentage points. We discuss this at paragraphs A105 to A122.

Asset beta

94. When Wellington Airport set its final prices for PSE4, its estimate of WACC at that time was not adjusted for the changed profile of capex when the price reset was deferred. Our assessment of the merits of adopting an increased asset beta is therefore based on Wellington Airport's consultation conducted prior to the adjustment of the capex profile, which is consistent with the use of our 1 April 2019 mid-point WACC estimate as the starting point.
95. Our view is that Wellington Airport's asset beta uplift has not been sufficiently justified. We acknowledge the practical difficulties in comparing Wellington Airport's exposure to systematic risk to the companies in our asset beta comparator sample. We also accept in principle that operating leverage and traffic mix can impact airport systematic risk and therefore asset beta. However, we find further evidence would be required in both areas to justify an asset beta uplift, which we discuss in further detail in Attachment A at paragraphs A31 to A66.

96. We also consider that the points Wellington Airport has made in relation to leverage and investment risk are either not reasoned, or are not sufficiently reasoned, in relation to our framework for assessing airports' WACC and, in particular, in relation to our mid-point asset beta parameter as a starting point.
97. We accept that BARNZ and some airlines submitted that an asset beta uplift of 0.02 was reasonable, however we have not seen the TDB advice nor evidence of BARNZ's position to consider within our analysis.
98. We recognise that our assessment (for cost of debt and asset beta) is in the context of this PSE. Some issues raised may be considered more widely as part of the 2023 IM review, and we welcome submissions of evidence of these issues in our IM review process.

We have estimated a reasonable return of 5.72% to 5.74% for Wellington Airport, reflecting a higher cost of debt than our midpoint WACC estimate

99. We have adjusted our mid-point WACC estimate for a higher cost of debt, to estimate a reasonable return of 5.72% to 5.74% for Wellington Airport for PSE4.
100. Our methodology for estimating the cost of debt is specified in the IMs.²⁸ Our proposed adjustment to the mid-point WACC that we estimate for Wellington Airport uses a cost of debt based on publicly traded New Zealand corporate bonds, with a BBB+ long-term credit rating and a five-year term to maturity, and a debt premium estimate of 1.60%.
101. We consider that the evidence provided suggests that the BBB+ credit rating assumption and higher debt premium estimate range of 1.60% to 1.78% are reasonable in Wellington Airport's specific circumstances.
102. As a result, we have used an adjusted cost of debt estimate of 3.57% to 3.75% as an input to our reasonable return estimate for assessing Wellington Airport's profitability. This differs from the cost of debt estimate of 3.21% used in our mid-point WACC (as at 1 April 2019).
103. As we have discussed in paragraphs 95 to 98, we find that Wellington Airport has not provided sufficient evidence to justify an uplift to its asset beta in estimating its WACC, and as such there is no asset beta uplift reflected in our estimated reasonable return for Wellington Airport.
104. Holding all other parameters in our mid-point WACC constant, including the 0.60 asset beta, the alternative 3.57% to 3.75% cost of debt assumption corresponds to a

²⁸ Commerce Commission "Airport Services Input Methodologies Determination 2010 – consolidated as of 20 December 2016", paragraph 5.1.

post-tax reasonable return estimate of 5.72% to 5.74%, a difference of 0.05 to 0.07 percentage points from our mid-point WACC estimate of 5.67%.

105. The waterfall chart in Figure 2.1 below summarises the factors that explain the differences between:

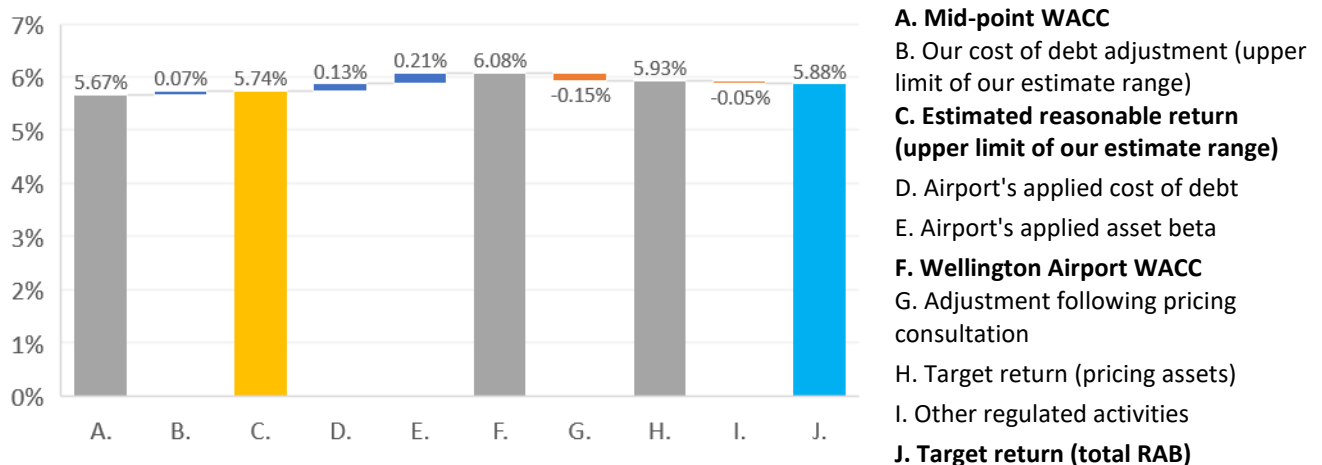
105.1 our mid-point WACC estimate of 5.67%;

105.2 our adjusted WACC or reasonable return (upper limit of our estimate range) of 5.74%;

105.3 Wellington Airport's estimated WACC of 6.08%; and

105.4 It's targeted return across its total RAB of 5.88%.

Figure 2.1 Impact of parameter adjustments upon expected returns



106. Sensitivities indicating the impact of an increase in asset beta and debt premium upon our WACC estimate are provided in Attachment A.

The value and impact of Wellington Airport's expected returns

107. Wellington Airport's expected returns are compared in Table 2.3 below, along with the associated expected revenues over PSE4.

Table 2.3 Summary table of Wellington Airport's expected returns and revenue

	Expected return (post-tax)	PV revenue (\$m)	WACC percentile
Wellington Airport's target return on its total RAB	5.88%	\$344.3m	56th
Target return on its priced services	5.93%	\$313.9m	57 th
Target return on its other regulated activities	5.18%	\$30.5m	37 th
Our mid-point WACC estimate	5.67%	\$338.7m	50 th
Our adjusted WACC estimate reflecting a BBB+ credit rating and longer debt tenor	5.72% - 5.74%	\$340.0m - \$340.6m	51st - 52nd

108. Wellington Airport's target return of 5.88% on its total RAB is consistent with an expected revenue of \$344.3m in present value terms. This is \$3.7m or 1.09% higher than the \$340.6m in revenue that would be consistent with the upper limit of our estimate range of a reasonable return, and an additional \$3.4m in profit after tax over five years.
109. We note that the reasonable return estimate range reflects a higher debt premium, which in principle is warranted for the longer tenor of Wellington Airport's debt.

The rate of return targeted by Wellington Airport over PSE4 is not likely to achieve excessive profits

110. Having considered the reasons and evidence provided by Wellington Airport, we are broadly satisfied that its target return of 5.88% on its total RAB is reasonable and consistent with promoting the long-term benefit of consumers.
111. This is based on our view that Wellington Airport has sufficiently justified, in some areas, a higher cost of debt than we used to determine our mid-point WACC estimate. We consider that the evidence suggests the BBB+ credit rating assumption and higher debt premium estimate range of 1.60% to 1.78% are reasonable.
112. We also consider there are some reasons why our cost of equity may be a conservative estimate. While we accept in principle that operating leverage and traffic mix can impact airport systematic risk and therefore asset beta, we find further evidence would be required in both areas. Overall there may be many different factors that affect systematic risk to varying degrees. This means that we are relatively cautious in considering departures from the asset beta used in our mid-point WACC estimate. In general, we emphasise that airports need to provide clear evidence, including the consideration of any countervailing effects, in justifying a change to asset beta.
113. BARNZ commented in their submission on our consultation paper, that the additional revenue and profit after tax associated with Wellington Airport's target return may be a material amount to airline customers, and that any difference between Wellington Airport's cost of capital and our estimate of a reasonable return would result in higher prices to airline customers that have made significant losses during the pandemic.²⁹ We acknowledge this, however, having considered the evidence provided by Wellington Airport, we are broadly satisfied that its target return is reasonable.

²⁹ BARNZ: "Submission on review of Wellington Airport's price setting event consultation paper" (10 June 2022), paragraph 6.

114. In particular, we acknowledge that a WACC for Wellington Airport is unobservable to both us and Wellington Airport itself³⁰, and as such we would not expect Wellington Airport to exactly meet our own estimation of its reasonable return. We do not have significant concerns that Wellington Airport is targeting excessive profits over the PSE4 pricing period with its targeted return of 5.88%, which is 0.14 to 0.16 percentage points higher than our estimate of a reasonable return of 5.72% to 5.74%.

³⁰ Commerce Commission “Input methodologies review decisions – Topic paper 6: WACC percentile for airports” (20 December 2016), paragraph 64.

Chapter 3 Risk allocation

Purpose of this chapter

115. This chapter contains our analysis and conclusions on whether Wellington Airport's pricing decisions share risk appropriately with its major customers.
116. This chapter focusses on whether the revenue adjustment mechanisms introduced for PSE4 are allocating the risk of material variation in demand, and consequently revenue, between Wellington Airport and airlines in a manner that is consistent with the purpose of Part 4 of the Act.

Our conclusions

117. Wellington Airport has introduced three revenue-related carry forward adjustments, which defer revenue from PSE4 to later pricing periods, during a period of Covid-19-induced uncertainty for the airport and airlines. These are a passenger demand wash-up; revenue deferral; and a net revaluation carry forward adjustment. As a result of deferring revenue via the adjustments, the airport and airlines have reallocated risk during PSE4: airlines bear more demand risk, while Wellington Airport is exposed to funding and credit risk by (temporarily) foregoing revenue.
118. It is reasonable that Wellington Airport and its major customers have agreed to reallocate risk between them under the circumstances, using the passenger demand wash-up mechanism. The demand wash-up provides Wellington Airport with guaranteed revenue recovery, but delays the recovery into the future. This makes expenditure recovery for the airport more certain. While it is largely shielded from losses associated with the temporary demand shock, Wellington Airport will still bear the risks of its costs being higher (or lower) than forecast, so continues to have incentives for efficiency.
119. We believe that the revenue deferral mechanism may be appropriate to provide price relief to major customers in the short term. The revenue deferral may also provide an incentive for Wellington Airport to improve efficiency and reduce costs during the years of revenue deferral prior to its significant capital expenditure programme anticipated in the next pricing period (**PSE5**), which would be consistent with the purpose in s 52A(1)(b) of the Act.
120. Lastly, we are also generally comfortable with the net revaluation carry forward adjustment, made up of a market value alternative use (**MVAU**) valuation gain and the recovery of a historical revaluation deficit, being carried forward into PSE5. This is because we expect:
- 120.1 Wellington Airport to be transparent about how it calculates and allocates the historical revaluation deficit and MVAU valuation gain; and

120.2 that customers are, in general, not worse off given the allocation to two pricing periods.

121. As with the revenue deferral mechanism, the net revaluation gain reduces the exposure of consumers to higher prices during PSE4. However, by spreading the net revaluation gain across two pricing periods, Wellington Airport trades lower revenues in PSE4 (through applying the entire net revaluation gain) for a smoother transition in pricing through to PSE5. We consider this carry forward adjustment is consistent with the purpose of Part 4, as the allocation of the revaluation deficit recovery and MVAU valuation gain is being spread across the two pricing periods evenly.

Risk allocation in the context of Part 4

122. We consider that, unless doing so would be inconsistent with the purpose of Part 4, risks should be allocated to suppliers or consumers depending on who is best placed to manage them.³¹ This is consistent with how risks tend to be allocated in workably competitive markets.
123. While our discussion in this chapter focusses on Wellington Airport and airlines, we note that the allocation of risk also carries downstream implications in the form of higher or lower costs being passed through to airline passengers, freight customers and other airport users.

Covid-19 continues to create uncertainty for Wellington Airport's revenue during PSE4

124. The Covid-19 pandemic continues to create uncertainty for airports and their major customers, and it has been difficult for airports and airlines to forecast medium and long-term passenger demand. Wellington Airport's passenger revenues are likely to be negatively impacted for a significant portion of the PSE4 pricing period.
125. We would expect Wellington Airport to use the best information it has available for passenger demand forecasting. However, the current uncertainty renders the medium and long-term passenger forecasts less useful than they would be under ordinary circumstances. As a result, it may be appropriate for Wellington Airport to adjust its passenger revenues for significant deviations between forecast and actual passenger demand, when the actual demand is known at the end of the pricing period. The extent of the adjustment should be consistent with the appropriate risk allocation between the airport and its customers.

³¹ Commerce Commission "Input methodologies review decisions: Framework for the IM review" (20 December 2016), paragraph 124.

126. The Covid-19 pandemic is a Type I asymmetric risk.³² These are risks that are generally unrelated to the day-to-day operations of a firm, and arise through infrequent events that could produce large losses. In workably competitive markets, it is often unfeasible for firms to recover the cost of catastrophic events after the fact.
127. We consider that, to mitigate the risk of under-preparation for Type I asymmetric risks, that regulated providers such as airports should be exposed to at least some of the costs of such risks materialising. This encourages them to spend efficiently ex ante to prepare for such a possibility and not fully rely on ex post relief.³³
128. We note that Wellington Airport did not raise the issue of asymmetric risk during the period of its price setting process that occurred during the pandemic. Wellington Airport agreed with Houston Kemp's analysis for the airport's initial pricing proposal in September 2019 that a number of asymmetric risks would justify a target return of 6.10%, above Wellington Airport's WACC of 6.08%, but Wellington Airport chose not to target the higher rate of return.³⁴

Wellington Airport has adjusted its PSE4 revenue through passenger demand wash-up, revenue deferral, and revaluation carry forward adjustment mechanisms

129. Wellington Airport has included three revenue-related carry forward adjustments for this pricing period:
- 129.1 A **passenger demand wash-up mechanism**, where revenue would be adjusted at the end of PSE4 by the difference between actual and forecast demand for FY2022 to FY2024, to then be recovered in subsequent pricing periods;
- 129.2 A pricing recovery deferral or **revenue deferral** into PSE5 which limits prices to \$15 per passenger on average, applicable during the latter years of the pricing period as prices increase; and
- 129.3 A **net revaluation carry forward adjustment** that spreads land revaluation gains and a historical revaluation deficit evenly over PSE4 and PSE5.
130. These mechanisms are intended to share demand risk over the pricing period between Wellington Airport and airlines (and ultimately consumers), and provide

³² Commerce Commission "Input methodologies (airport services) - Reasons paper" (22 December 2010), paragraphs E12.4 and E12.6.

³³ Commerce Commission "Fibre input methodologies: Main final decisions - reasons paper" (13 October 2020), paragraph 6.1017.3

³⁴ Wellington International Airport Limited "Initial Pricing Proposal - For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), page 71.

revenue stability to Wellington Airport and cost stability to airlines during the period of uncertainty.

The impact of the passenger demand wash-up mechanism, and airline views

131. Wellington Airport notes that under ordinary circumstances, it can assess and share volume risk with airlines over a price setting period, but that there is a strong chance of “material variance to PSE4 revenue recovery” in the absence of a passenger volume correction.³⁵

132. AirNZ proposed a passenger demand wash-up adjustment during Wellington Airport’s pricing consultation process, explicitly as a risk sharing mechanism:

Noting the inherent uncertainty in forecasting, and particularly in the current circumstances, Air NZ considers there would be value in adopting a risk sharing mechanism in respect of passenger forecasts over the remainder of PSE4, where actual passenger revenue - based on actual passenger numbers - is used to calculate the revenue shortfall carry forward adjustment at the end of the period, rather than the forecast shortfall, as per the Proposal. With such a mechanism in place, [Wellington Airport] would achieve a guaranteed full recovery over PSE4, including for the period impacted directly by COVID-19 (unlike other players in the sector), and the lower charges over PSE4 and PSE5 (assuming the recovery is faster than [Wellington Airport] is forecasting) would enable Air NZ to maintain lower fares over the period.

133. This suggests that passenger demand forecasts are too uncertain for ex ante price setting to be efficient in providing incentives under the current circumstances. Wellington Airport considered the wash-up a sensible proposal to address ongoing uncertainty and chose to adopt it.³⁶ AirNZ and BARNZ supported the proposal, while Qantas did not provide a view.

134. BARNZ, AirNZ and Qantas commented in their submissions on our consultation paper that the unique timing of the pricing setting event process has allowed Wellington Airport to avoid losses and earn a full recovery for the PSE4 period.³⁷ We acknowledge this and recognise that it is only because the decision to defer the pricing decision was made in advance of the pandemic, with most of Wellington Airport’s customers being generally supportive of the arrangement, that we view this outcome as acceptable.

³⁵ Wellington International Airport Limited “WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024” (1 June 2021), page 24.

³⁶ Wellington International Airport Limited “WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024” (1 June 2021), page 24.

³⁷ BARNZ: “Submission on review of Wellington Airport’s price setting event consultation paper” (10 June 2022), paragraph 11, Air New Zealand: “Submission on review of Wellington Airport’s price setting event consultation paper” (13 June 2022), page 2, and Qantas: “Submission on review of Wellington Airport’s price setting event consultation paper” (14 June 2022), page 1.

135. In its cross-submission, Wellington Airport noted that given the level of uncertainty around demand in April 2020 (ie, the time of its final pricing document), there was an unacceptable risk that:
- 135.1 any passenger forecast adopted would result in windfall gains or losses for either Wellington Airport or its airline customers; and
 - 135.2 airline customers also benefited from Wellington Airport’s approach as it avoided the risk that demand would recover more quickly than might have been reasonably forecast in April 2020 (resulting in airline customers facing a windfall loss).³⁸
136. We also acknowledge that had PSE4 occurred when originally intended (pre-pandemic), some of the risk sharing mechanisms (eg, the passenger demand wash-up) would not have occurred.

We believe the passenger demand wash-up mechanism shares risk appropriately between Wellington Airport and its major customers under the circumstances

137. The Commission recognises that Wellington Airport and airlines will continue to face uncertainty regarding passenger demand for some time. The passenger demand washup mechanism as suggested by AirNZ and implemented by Wellington Airport seems appropriate in this context, to address under- or over-recovery of revenues by the airport, and share demand-related risk with airlines over the pricing period.
138. With capex and opex programmes mostly stripped down to maintenance and regulatory compliance activities, under-recovery of revenue could lead to a lower quality of service through further expenditure cutbacks. The guaranteed revenue recovery in this uncertain time means that expenditure recovery for Wellington Airport becomes more certain.
139. The passenger demand wash-up mechanism has effectively moved Wellington Airport from a price path to a revenue path. In the short term, risk is being shared with airlines and the airport bears funding and credit risk associated with deferred revenue, but in the long-term Wellington Airport is still expecting to achieve its return. While it is largely shielded from losses associated with the temporary demand shock, Wellington Airport will still bear the risks of costs being higher (or lower) than forecast, so continues to have incentives for efficiency.
140. The passenger demand adjustment mechanism also provides an incentive for airlines to stimulate demand over the PSE4 pricing period. By effectively shifting to a

³⁸ Wellington Airport: “Cross-submission on Review of Wellington Airport’s price setting event consultation paper” (29 June 2022), paragraph 11.

revenue path, increased passenger demand would lead to a decrease in the charges ultimately paid by each passenger *on average*.

141. We find the use of the passenger demand washup mechanism, and the resulting risk allocation between Wellington Airport and its major customers, consistent with the purpose of Part 4 of the Act.

The impact of revenue deferral via concessionary price path to PSE5, and airline views

142. Wellington Airport's final pricing proposal would raise prices from an average of \$12.97 per passenger to \$16.63 per passenger by the end of the pricing period.³⁹ Through a concessionary price path option, Wellington Airport proposed to limit prices to \$15 per passenger on average by FY2024, with the total difference in revenue of \$15.1m deferred from PSE4 into PSE5.
143. Wellington Airport noted in its PSE4 disclosure that BARNZ and Qantas did not disagree with its proposed mechanism for revenue deferral specifically, but believed that Wellington Airport should reduce its target revenue, including the deferred amount, in response to Covid-19 and the resulting financial pressure faced by airlines.
144. AirNZ preferred the alternative concessionary price path (which includes the revenue deferral into PSE5) and noted that the adjustment could be mitigated with updates to forecast passengers and the introduction of the risk sharing arrangement described at paragraph 132.

We find that the revenue deferral mechanism may be appropriate to provide price relief to major customers

145. In Chapter 2 we found that Wellington Airport's targeted level of return over PSE4 would not result in it earning excessive profits. The revenue required to achieve that return is therefore set at or near the level that we would expect, acknowledging that Wellington Airport's forecast revenue is lower in the earlier years of the PSE4 pricing period, in line with low travel demand during the Covid-19 pandemic.
146. In the later years of the PSE4 pricing period, it may still be appropriate for Wellington Airport to provide price relief to airlines, achieving lower revenues in the process, if travel demand has not sufficiently recovered. We find that the deferral mechanism

³⁹ At the time of the final proposal, the primary path proposed by Wellington Airport, where prices reflected the outcomes of all final decisions, would increase to \$19.67 on average per passenger by the end of the pricing period. However, in response to airline feedback, Wellington Airport updated its opex forecast which decreased by \$18.6m, which along with other input changes such as updated traffic forecasts, reduced the FY2024 average price per passenger to \$16.63 and reduced the total amount of revenue being deferred into PSE5 from \$42.2m to \$15.1m.

would be sensible under such conditions and have included the revenue deferral in our assessment of Wellington Airport's expected profitability.⁴⁰ By including the revenue that has been deferred in our assessment of Wellington Airport's target return for PSE4, we recognise this revenue as contributing to the airport's profitability during PSE4. We expect that the deferral will be reflected in an opening carry forward adjustment for PSE5, and we will assess Wellington Airport's target return for PSE5 without double counting the impact of any deferred revenue from PSE4.

147. The revenue deferral into PSE5, in effect, transfers some of the risk associated with demand and price variation that would otherwise occur during PSE4. The revenue deferral also maintains an incentive for Wellington Airport to improve efficiency and reduce costs during the years of revenue deferral prior to its significant capital expenditure programme anticipated in PSE5, which would be consistent with the purpose in s 52A(1)(b) of the Act.

The impact of the net revaluation carry forward adjustment over PSE4 and PSE5, and airline views

148. Wellington Airport's net revaluation carry forward adjustment arises from:
- 148.1 The increase in the MVAU valuation of land, resulting from revaluation undertaken in 2019. The uplift in land value effective from the start of PSE4 is \$42.6m across its pricing asset base, and \$46.1m across its total RAB.
- 148.2 A historic revaluation deficit, due to differences between Wellington Airport's forecast real revaluations in previous pricing periods and actual real revaluation outcomes. The revaluation shortfall calculated by Wellington Airport is \$33.6m for its pricing asset base, and \$36.5m for its total RAB.
149. Wellington Airport considered that spreading the gains (or losses) over more than one period would mitigate "the short-term impact on required revenue, and reduces the likelihood of volatility in pricing from a short term approach". It thus proposed to allocate the net revaluation adjustment evenly over PSE4 and PSE5, necessitating closing and opening carry forward adjustments between the two pricing periods. Wellington Airport does not believe it problematic if a larger revaluation gain is adopted for PSE5 in addition to the carry forward from PSE4.
150. Wellington Airport noted that AirNZ was supportive of its approach for the uplift resulting from the 2019 MVAU valuation, "reducing the cash revenue requirement in

⁴⁰ While we have included the revenue deferral in our estimation of Wellington Airport's target return, we have not included a revenue deferral when we estimate the total forecast revenue requirement for Wellington Airport to achieve our mid-point WACC or reasonable return, as part of assessing Wellington Airport's expected profitability. As such, the revenue required to achieve our mid-point WACC or reasonable return is assumed to be recovered entirely within PSE4.

each of [PSE4 and PSE5]”. However, TDB (advising on behalf of airlines) disagreed with Wellington Airport’s advisor, Sapere, that the present value (PV) adjustment to carry forward items should be adjusted forward at a pre-tax cost of debt, preferring instead an escalation using the consumer price index (CPI).

151. BARNZ indicated that it would prefer the revaluation adjustment was allocated to PSE4 only “in order to avoid building on any revaluation gain to be returned from PSE5 (which is likely to be larger)”.

We are generally comfortable with the net revaluation gain being carried forward into PSE5

152. We are generally comfortable with Wellington Airport recovering the net revaluation gain over PSE4 and PSE5, as we would expect:

152.1 Wellington Airport to be transparent about the calculation and allocation of the revaluation deficit recovery and MVAU valuation gain; and

152.2 that customers are, in general, not worse off given the allocation to two pricing periods, relative to the case where the net revaluation gain is applied entirely to PSE4.

153. If the present value adjustment to carry forward items was made at Wellington Airport's estimated WACC, it would reflect the full cost to Wellington Airport of delaying a portion of its net revaluation gain to PSE5. This includes:

153.1 the real return that Wellington Airport would have earned on their assets if the MVAU valuation gain and historical revaluation deficit had been allocated to PSE4 only; and

153.2 revaluation of the additions to the RAB at the forecast rate of inflation as noted by TDB, which would have occurred if the net revaluation carry forward adjustment had been fully allocated to PSE4.

154. While Wellington Airport's use of the pre-tax cost of debt for the PV adjustment does not reflect the full cost to Wellington Airport of delaying a portion of its net revaluation gain to PSE5 (ie, the real return and revaluation of additions to the RAB), we are not concerned with its choice for the PV adjustment. TDB's preference for CPI to be used for the PV adjustment does not account for the real return foregone by Wellington Airport in PSE4 by allocating part of the net revaluation gain to PSE5.

155. As with the revenue deferral mechanism, the net revaluation gain reduces the exposure of consumers to higher prices during PSE4. However, by spreading the net revaluation gain across two pricing periods, Wellington Airport trades lower revenues in PSE4 (through applying the entire net revaluation gain) for a smoother

transition in pricing through to PSE5. We consider this is consistent with the purpose of Part 4, as the allocation of the revaluation deficit recovery and MVAU valuation gain is being spread across the two pricing periods evenly.

Chapter 4 Other pricing decisions

Purpose of this chapter

156. This chapter summarises our conclusions on other pricing-related decisions made by Wellington Airport for PSE4.
157. In reviewing all key aspects of Wellington Airport's PSE4 disclosure, we have taken note of where stakeholders have raised concerns, or decisions differ from our IMs. Stakeholder views are as reported by Wellington Airport through its price setting disclosures.
158. The summary table below references various iterations of Wellington Airport's pricing proposals. The timeline of these proposals is described at Table 1.2.

Summary of other pricing decisions and Commission conclusions

159. A summary of Wellington Airport's other pricing-related decisions, and our conclusions, is provided in Table 4.1 below. In forming our views, we consider whether there are concerns that the pricing decision is inconsistent with the purpose of Part 4.
160. Stakeholders did not provide us with new evidence during the consultation process that identified significant issues with the pricing decisions in Table 4.1. Therefore, we have not undertaken any additional analysis to assess any pricing decisions in greater detail.

Table 4.1 Summary of Wellington Airport’s other pricing decisions, and Commission views

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
Airport Costs				
Investment	Wellington Airport proposed reductions in its real capex forecast from \$541.6m at its revised pricing proposal to \$298.5m in its final proposal.	<p>As a result of the changed profile of passenger demand, Wellington Airport fully reviewed its capital expenditure programme following its revised pricing proposal. Several projects related to its 2040 Master Plan were deferred by a number of years in response to the shock to passenger numbers, reducing capex to \$299.1m.</p> <p>In response to Qantas’ comments during final consultation feedback, Wellington Airport removed a further \$600k of capex that was earmarked for possible Government requirements relating to Covid-19 (eg, additional medical rooms or queueing space).</p>	<p>AirNZ was supportive of Wellington Airport’s revised forecast and considered it appropriate for the current and forecast operating environment.</p> <p>BARNZ supported the proposed changes to the capital plan, with one query regarding apron investment to “develop the remote apron to meet future growth needs”. BARNZ requested more information about why the investment for future growth needs to occur in PSE4.</p> <p>Qantas expressed appreciation for Wellington Airport’s efforts to reduce its capital programme, while believing further reductions were necessary. For the most part, feedback was in the form of further questions rather than suggested reductions. Qantas also suggested government agencies meet the cost of their own health screening requirements.</p>	Our view is that Wellington Airport’s decision to limit its PSE4 capex programme to necessary operational, regulatory compliance, and maintenance spend is reasonable, as it has largely deferred growth projects into future pricing periods once passenger demand and revenues are expected to recover.
Operating expenditure (opex)	Wellington Airport updated its opex forecast in line with actual expenses and revised forecasts, resulting in a \$18.6m (13%) reduction of opex between the initial and final pricing proposals.	Opex was not originally intended to be one of the parameters reconsidered in light of Covid-19. However, as a result of airline views, Wellington Airport accepted the proposal to reduce opex from previously proposed levels.	<p>Airline customers provided limited specific feedback on opex, both in early consultation and following Wellington Airport’s final reset of forecasts in February-April 2021.</p> <p>BARNZ were concerned by escalating insurance costs and thought Wellington Airport should take all possible action to keep these down.</p>	While our view is that Wellington Airport’s opex forecast is reasonable, we agree with airlines that Wellington Airport should continue to seek efficiencies within its

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
		<p>The approach consulted and now agreed with airlines was to update FY2021 to reflect latest forecast and FY2022 to reflect the latest budget (both using the same aeronautical cost allocations as FY20), along with updating key growth assumptions to apply from FY2023 onwards.</p> <p>From the initial proposal, Wellington Airport:</p> <ul style="list-style-type: none"> • Changed its CPI forecast from 1% to 1.5%; (see asset valuation below for more explanation) • Reduced employee remuneration growth to 2.5%; and • Agreed to lobby local authorities for less aggressive rates increases. 	<p>Qantas provided consistent, though non-specific, feedback that opex should be kept low and efficiencies found wherever possible.</p> <p>On the initial pricing proposal, airlines:</p> <ul style="list-style-type: none"> • had no comment on software costs forecasts; • acknowledged rates, fire service staffing and insurance costs are largely unavoidable, but wanted to see them managed as much as possible; • considered Wellington Airport's inflation rate to be too low; • encouraged Wellington Airport to consider further economies of scale as passenger numbers grow; and • considered the employee remuneration growth rate of 3% should reduce to 2%. 	operating costs where possible.
Noise mitigation charges	For PSE4, the charge will be 32c per passenger (unchanged from previous charges). This charge is set at the level required for Wellington Airport to achieve NPV=0 over its long term noise mitigation project (between PSE1 and PSE5).	Wellington Airport used a separate building block calculation to determine the revenue required from noise mitigation activities, and the subsequent pricing that would achieve NPV=0 for the project.	Airlines were comfortable with the charges early in the consultation process. Wellington Airport updated the calculation for revised input costs prior to finalising, which resulted in an uplift from 26c per passenger in the initial pricing proposal, to 32c per passenger. Airlines have not provided feedback on the final number.	As Wellington Airport is able to recover the cost of noise mitigation activities, our view is that the level of the charge seems to be reasonable.
Route incentives	Not applied for remainder of PSE4.	Given the short-term material impact of Covid-19 on domestic and international passenger volumes, Wellington Airport will not apply the		Our view is that this is reasonable given the impact of Covid-19: lower travel demand

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
		published growth incentive programme during the remainder of PSE4.		means that the growth associated with the incentive programme is unlikely to be achieved, likely to result in Wellington Airport achieving lower revenues than forecast.
Passenger Demand				
Domestic demand Forecasts	<ul style="list-style-type: none"> FY2021 forecast of 3.0Mppa (actuals of 2.6Mppa to 28 February 2021 with forecast of 350k in March 2021). FY2022 forecast of 4.4Mppa (based on recovery to 80% of FY2020 levels in April 2021, improving to 90% by March 2022). FY2024 forecast of 5.7Mppa (9% increase on FY2020, but a 7% reduction on pre-Covid expectations). 	<p>While domestic capacity at Wellington Airport has recovered more strongly than initially anticipated, passenger numbers are increasing at a slower rate.</p> <ul style="list-style-type: none"> For the most recent months unaffected by lockdowns (November 2020 - January 2021) domestic capacity recovered to an average 84% of the year prior, but passengers only recovered to 78%. FY2024 reflects an economic recovery to the pre-Covid trajectory, partially offset by the longer-term impacts of disrupted travel patterns. 	<p>All airlines recognise that the current operating environment is challenging.</p> <p>AirNZ noted the “inherent uncertainty” associated with demand forecasting in the current situation, with pandemic-related travel restrictions. To manage the reality of the short timeframe in which it is difficult to accurately forecast demand, AirNZ suggested a mechanism whereby the level of the revenue shortfall carry forward adjustment would be calculated on the basis of the actual passengers handled during PSE4, as opposed to the forecast passenger volumes proposed earlier.</p> <p>AirNZ noted in its response that Wellington Airport’s forecast for FY2021, having been prepared in December 2020, had since proved overly conservative. AirNZ considered a forecast of 3Mppa for domestic passengers in FY2021 to be a more realistic assessment. AirNZ expressed general agreement with Wellington Airport’s view of volumes for the remainder of PSE4, supporting the industry expectation that demand will materially</p>	<p>We recognise that Wellington Airport will continue to face uncertainty regarding passenger demand for some time. Our view is that the recovery of passenger demand to pre-Covid levels by the end of the pricing period seems broadly reasonable, noting that the operating environment is still changing quickly.</p> <p>Our view of the passenger demand washup mechanism as suggested by AirNZ and implemented by Wellington Airport is that it seems reasonable</p>
International demand forecasts	<ul style="list-style-type: none"> No scheduled services in FY2021. Services forecast to commence during FY2022 (October 2021) but initially 	<ul style="list-style-type: none"> In FY2023-FY2024, Wellington Airport expects the international market to rebound as a new normal in international travel is reached. Widespread vaccination and adoption of 		

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
	<p>at a lower frequency than pre-Covid.</p> <ul style="list-style-type: none"> FY2023 recovers to 83% of FY2020 and, in FY2024, exceeds pre-Covid levels and returns to business-as-usual growth. 	<p>travel passes, combined with pent-up international demand and airline competition for passengers will see international travel recover.</p>	<p>revert to its long term expected trendline once travel restrictions are permanently removed.</p> <p>Qantas expected a “materially faster recovery” than Wellington Airport, but noted that the underlying assumptions driving this view were likely to change with time, particularly during the pandemic.</p> <p>BARNZ did not challenge Wellington Airport’s updated forecasts, but noted demand forecasting in the current environment is more challenging than usual.</p>	<p>in this context, to address under- or over-recovery of revenues by Wellington Airport, and share demand-related risk with airlines during this period. We discuss this mechanism in more detail within Chapter 3 – Risk Allocation.</p>
Asset Base				
Valuation approach	Revised 2019 aeronautical land valuation adopted for PSE4.	The updated 2019 MVAU land valuation for PSE4 was based on a report commissioned from Savills NZ Limited (Savills).	Airline customers indicated comfort with the Savills valuation, given that the valuation gain is treated as income and recognised as a carry forward adjustment in the pricing calculations for PSE4. No feedback was received on the valuation methodology for non-land assets, which is consistent with the IMs and Wellington Airport’s 2019 annual information disclosures.	Our view is that the Savills MVAU land valuation adopted for Wellington Airport’s aeronautical land for PSE4 is reasonable, being consistent with IMs.
Revaluations	<p>The 2019 land revaluation gain is treated as income and recognised as a carry forward adjustment in the pricing calculations for PSE4.</p> <p>Wellington Airport also recognises a carry forward allowance for the historical revaluation deficit.</p>	Wellington Airport allocates the net revaluation carry forward adjustment across two pricing periods, to more closely match the benefit to airlines of reduced prices, with the benefit to Wellington Airport of an increased asset base; and to assist in smoothing the impact of the revaluation on pricing.	BARNZ have commented that it does not oppose Wellington Airport’s calculation of the revaluation carry forward adjustments because the “adjustments seem consistent with the Input Methodologies”. BARNZ raised a technical issue relating to depreciation on the non-land assets included in the calculation, which resulted in Wellington Airport (upon consultation with BARNZ) providing an adjustment to the depreciation thereby amending the carry forward amount. This	We discuss the net revaluation carry forward adjustment in further detail in Chapter 3 – Risk allocation.

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
		<p>Wellington Airport states that the 2014 revaluation shortfall was the result of a variation from forecast for an MVAU land valuation and is correctly included in the revaluation shortfall calculation. Therefore, the revaluation carry forward balance for the pricing asset base, of \$9.2m, is correct.</p>	<p>increased the carry forward adjustment for the pricing asset base from \$8.934m in the initial pricing proposal, to \$9.224m.</p> <p>AirNZ queried Wellington Airport’s calculation and whether the net credit adjustment to income should be \$24.4 million, rather than the \$8.9m proposed by Wellington Airport.</p> <p>AirNZ commented that the historic shortfall calculation includes an amount of \$15.4m in 2014 which resulted from a change in land valuation methodology from market value existing use (MVEU) to MVAU; and submitted that this amount should be excluded from the calculation because a change in methodology is not a variation in revaluation forecast rates that is addressed by the IMs.</p> <p>TDB, who advised on behalf of airlines, disagreed with Wellington Airport’s advisor, Sapere, that the present value adjustment to carry forward items should be adjusted forward at a pre-tax cost of debt, preferring instead an escalation using CPI.</p>	
Consumer price index (CPI)	<p>The initial pricing proposal proposed to include forecast revaluations for the period at a CPI assumption of 1% p.a., with the annual revaluation changes included as income.</p> <p>A methodology change in the revised pricing proposal as a</p>	<p>The initial pricing proposal noted that in recent pricing periods Wellington Airport has tended to over-forecast CPI, and proposed an alternative ‘breakeven’ method of forecasting inflation based on market data derived from CPI-linked bond yields.</p>	<p>In feedback, BARNZ provided analysis from TDB which was also supported by AirNZ and Qantas. BARNZ concluded that it was “not comfortable with applying the new and untested breakeven rate methodology as the sole forecast of CPI... [however] a reasonable outcome would be to use an average of market forecasts of CPI, but include the breakeven analysis as another forecast within this assessment”.</p>	<p>Our view is that Wellington Airport’s method to average across several inflation forecasts, including the Reserve Bank forecast, seems to be a reasonable approach.</p>

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
	result of feedback from airlines resulted in average forecast inflation of 1.5% over PSE4.	Wellington Airport accepted BARNZ's proposal of averaging the 'breakeven' method with the Reserve Bank and NZIER forecasts.		
Assets transferred from commercial to aeronautical use	Wellington Airport determined that assets transferred from commercial to aeronautical use would be valued at their MVEU (plus the actual cost of civil development), rather than MVAU as prescribed by the IMs.	<p>The construction of terminal and apron developments will require Wellington Airport to reallocate land currently used for commercial activities (specifically, car parking land and leased land) to its RAB. Wellington Airport believes the MVEU actually reflects the real alternative use value of those assets, being their value immediately prior to being transferred into the RAB.</p> <p>Wellington Airport considered that the impact on its PSE4 revenue is minor.</p>	<p>Airline feedback was not in agreement on this point.</p> <p>Both BARNZ and AirNZ disagreed with Wellington Airport's proposal and responded that the land should be included in the RAB at its MVAU valuation to comply with the IMs.</p>	<p>We disagree with Wellington Airport's approach of MVEU valuation for the commercial assets being transferred into the RAB in PSE4. We consider there is likely to be a value difference compared to MVAU (though likely to be minor); for example, the value of land currently used for car parking (ie, existing use) would be inflated by its association with the airport, as Wellington Airport probably has some market power with respect to carparking. However, we do acknowledge that Wellington Airport thinks that the current specification of the MVAU method is an issue with respect to the</p>

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
Depreciation	<p>Wellington Airport’s depreciation forecast in its initial pricing proposal had three components:</p> <ul style="list-style-type: none"> • Existing assets; • Existing assets where asset lives have been reviewed, with the depreciation forecast adjusted for some specific building assets: <ol style="list-style-type: none"> a) Specific buildings, or components of buildings, that are expected to be demolished during PSE4 and PSE5; and b) Other buildings where Wellington Airport’s valuers recommended amended asset lives during their valuation of Wellington Airport’s buildings, for FY2018 financial reporting; • Capital additions. 	<p>Wellington Airport considers it is using an IM compliant approach to the valuation and roll forward of assets, and it is intended that its approach to depreciation is also consistent with IM requirements. The IMs provide for depreciation lives to be accelerated in such circumstances, provided that customers are consulted on the changes.</p> <p>Wellington Airport disagrees with the BARNZ approach because:</p> <ul style="list-style-type: none"> • The main driver for the accelerated lives is the higher passenger growth rates that have occurred in recent years which results in higher asset utilisation; • Wellington Airport will not be incentivised to withdraw or dispose of productive assets and, in fact, has a long history of the opposite approach where longer term efficiencies have 	<p>The only substantial feedback from airline customers was regarding depreciation of existing assets where lives have been reviewed. This relates to cases where Wellington Airport is proposing to accelerate depreciation for assets that are to be moved or demolished as part of its 2040 Master Plan development.</p> <p>AirNZ advised that it is “comfortable with the proposed depreciation approach”, which included recognition of the accelerated building depreciation lives proposed by Wellington Airport in its initial pricing proposal.</p> <p>BARNZ however proposed that “[a]ssets that are to be moved/demolished should remain in the asset base and depreciate over their current lives. There is no need to accelerate the depreciation for these assets.” BARNZ further comments that it is concerned “the ability to accelerate depreciation by moving or demolishing assets may create an incentive to move assets unnecessarily”.</p>	<p>(reduced) incentives for repurposing of land. We welcome further evidence on this issue as part of the 2023 IM review.</p> <p>Our view of the non-standard depreciation approach to the assets that are expected to be demolished during PSE4 and PSE5 is that it is reasonable. We expect that Wellington Airport should be able to recover its investment in its RAB, using a non-standard approach to depreciation if that properly reflects the assets use over its useful life. Our view of Wellington Airport’s decision to accelerate the depreciation on assets to be demolished, as a result of revised shorter asset lives, is that it would not detract from the purpose of Part 4 of the Act.</p>

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
	<p>Wellington Airport commissioned an updated valuation of its buildings from Savills for financial reporting in FY2018. Savills also undertook a review of asset lives used to depreciate assets to ensure these continue to reflect reasonable expectations for future asset use.</p> <p>Savills recommended changes to the remaining asset lives, which Wellington Airport adopted in its financial reporting to ensure that the depreciation of the remaining asset values occurs over the actual expected lives of assets, and therefore asset stranding, with short term lump sum recovery of remaining depreciation, is avoided. These changes have been similarly updated to the RAB.</p>	<p>been achieved by making incremental changes to established assets;</p> <ul style="list-style-type: none"> • Retaining asset values, and therefore depreciation, for demolished assets in the RAB for their unadjusted asset lives: <ul style="list-style-type: none"> a) Will result in future customers incurring the ongoing cost of the demolished assets at the same time as they are being requested to meet the cost of new assets; and b) Will result in Wellington Airport receiving an ongoing capital return on the higher value of the assets in the RAB, resulting in an offset against the short-term cost benefit of reducing the depreciation charge; and • It increases the risk of asset stranding if changes to the airlines operating at Wellington Airport occur in future years. New airline entrants could quite reasonably contest any ongoing charge relating to demolished assets. 		
Wash-ups				

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
Wash-up of FY2020 prices	<p>A wash-up arrangement has been agreed for the difference between the amounts paid by airlines under the FY2019 pricing schedule used for FY2020 billing purposes, and the amounts that would have applied under the finalised PSE4 schedule from 1 April 2019.</p> <p>This was valued at \$1.044m over PSE4.</p>	<p>Prices were held at FY2019 rates throughout FY2020 to enable extended consultation on Wellington Airport's capex in its 2040 Master Plan.</p> <p>In order to calculate the wash-up amount, Wellington Airport applied the FY2020 charges that were proposed in the revised pricing proposal. This provides a fair reflection of the charge that would have been applied for FY2020, prior to the impact of Covid-19 being known. The collection of the wash-up amount has been incorporated into charges over the remainder of the pricing period (ie, FY2022-2024).</p>	Collection of wash-up over the remainder of PSE4 was agreed with airlines.	We consider both wash-ups to be reasonable given the current circumstances.
Wash-up of FY2021 prices	Charges were held at FY2019 levels for FY2021.	Prices were held at FY2019 rates throughout FY2021 to avoid a possible price increase during the height of the Covid-19 pandemic.	Agreed with airlines.	
Pricing structure				
Price structure simplification	Wellington Airport has converted several charges to per passenger charges, including airfield charges (which were previously based on maximum certified take-off weight (MCTOW)) and all terminal charges.	Airline feedback featured a view that a simplification of the price structure would be welcomed. Wellington Airport has thus converted airfield and terminal charges into a per passenger charge.	<p>Airlines were generally supportive of the price structure simplification:</p> <ul style="list-style-type: none"> • AirNZ acknowledged the proposed change would simplify the invoicing process. • BARNZ recognised the logic of the proposal and supported the structure. • Qantas acknowledged the simplification of the pricing methodology. 	Our view of the simplification of the price structure is that it is reasonable, allowing airlines more flexibility regarding aircraft choice.

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
Transfer passenger pricing	No discounts will be applied.	In the absence of information required to accurately incorporate transfer discounts into Wellington Airport's financial modelling and traffic forecasts, the revised pricing proposal does not include discounts for transfer passengers.	It was suggested by AirNZ that a discount for transfer passengers could assist in developing Wellington Airport as a domestic hub.	Given the absence of significant transfer passenger numbers, our view is that this is a reasonable approach.
Check-in charges	Wellington Airport initially proposed to replace the current per counter-hour charging regime with a charge per passenger, which is differentiated to reflect the facilities used. Wellington Airport also decided to incorporate the revenue forecast to be collected from check-in charges into the general passenger charge.	Wellington Airport recognised BARNZ airlines' concerns about the ability to introduce informed differential check-in charges at this point. Wellington Airport sees considerable merit in encouraging carriers to move to common use facilities over time. A larger scale common use environment would minimise the cost of providing check-in services for all carriers, and would provide Wellington Airport accurate information regarding differential equipment use. This information could then in future periods be used to inform differential charges such as those proposed in the initial pricing proposal.	BARNZ noted that the proposed check-in charges seem reasonable in principle, though there are some details to be worked through regarding how the relevant equipment usage information can be collected for charging purposes. AirNZ urged Wellington Airport to reconsider its check-in charges proposal in respect of AirNZ passengers, with a view to providing a discount reflective of AirNZ's investment in airline specific facilities. Qantas requested further consultation on the direction of the common user check-in environment.	While our view is that the check-in charges are reasonable, we would encourage further dialogue between Wellington Airport and airlines on this issue.
Peak ⁴¹ pricing	Wellington Airport has updated its peak pricing mechanism in	The way the simplified passenger-based peak charges in the initial	AirNZ highlighted that the proposed change of the peak pricing mechanism (to be levied on a per	Peak charging may be reasonable as it provides

⁴¹ Wellington Airport determines the peak time period as being 07.45-08.45 and 18.15-19.15 on weekdays, and the shoulder time period applying 30 minutes either side of the peak.

Topic	Decision	Airport rationale	Airline views (as stated by Wellington Airport)	Commission view
	<p>PSE4 to be an aircraft movement-based charge (previously a per passenger charge).</p> <p>Consistent with PSE3, the rates have been proposed at \$20 per peak movement and \$10 per shoulder movement.</p>	<p>pricing proposal act to discourage aircraft upgauging in the peak was an unintended consequence of the simplification.</p> <p>Wellington Airport considered the impact of this and is in agreement with the view expressed by AirNZ that the mechanism of this important feature of the price structure should be reviewed.</p>	<p>passenger basis as opposed to per aircraft movement) in the initial pricing proposal would penalise the operators of larger, higher capacity aircraft. AirNZ noted that this appears to work against the objective of encouraging the gradual upgauging of aircraft.</p>	<p>signals of when the airfield or terminal is at capacity. Wellington Airport appear to have taken note of stakeholder concern that there may be a disincentive by switching away from aircraft movements, as the peak charges in their final pricing are based on aircraft landing and departure.</p>

Attachment A Our assessment of Wellington Airport's cost of capital

Purpose of this attachment

- A1 This attachment contains our analysis and conclusions on whether Wellington Airport has sufficiently justified its cost of capital, equivalently WACC estimate, of 6.08%.
- A2 This attachment does not assess Wellington Airport's target returns of 5.93% (target return on pricing assets) and 5.88% (target return on total RAB), which are discussed in Chapter 2. The target returns were set following consultation on the WACC estimate. This means that the reasoning Wellington Airport provided to justify its cost of capital underpins its target return.

Structure of this attachment

- A3 This attachment sets out the following:
- A3.1 our framework for assessing Wellington Airport's estimated cost of capital, taking into account the relevant context of the IM Review undertaken in 2016, and our reviews undertaken in 2013 and 2014 in accordance with s 56G of the Act (s 56G reports)⁴²; and
 - A3.2 our assessment of Wellington Airport's cost of capital, focussing on the reasons it has provided for adopting a higher cost of equity and cost of debt than our benchmark values.

Our framework for assessing Wellington Airport's estimated cost of capital

- A4 This section outlines our approach to assessing Wellington Airport's estimate of its cost of capital in this review. This approach differs from the s 56G reports prepared in 2013 and 2014, reflecting changes to the IMs made in 2016. It is consistent with the approach taken in our reports on Auckland Airport and on Christchurch Airport.⁴³

⁴² Section 56G of the Act, as was in effect at the time of the reviews, was a transitional provision requiring the Commission to report to the Ministers of Commerce and Transport on how effectively ID regulation was promoting the Part 4 purpose in respect of specified airport services. The report was to be made 'as soon as practicable' after any new price for airport services was set in or after 2012. We produced the final reports for Wellington, Auckland and Christchurch Airports in February 2013, July 2013 and February 2014 respectively. Section 56G has since been replaced by way of amendment in October 2018. The current s 56G relates to the Commission conducting an inquiry and making a recommendation to the Minister as to whether one of negotiate/arbitrate regulation, default/customised price-quality regulation or individual price-quality regulation should be imposed on the specified airport services in addition to ID, and, if so, how it should apply.

⁴³ Commerce Commission "Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), Attachment A. Commerce

- A5 This section discusses:
- A5.1 our past approach in the s 56G reports, where we primarily focussed on the 75th percentile WACC estimate;
 - A5.2 our current approach, where we now publish a mid-point WACC estimate and associated standard error, following the 2016 IM Review;
 - A5.3 our mid-point WACC estimate for airports as at 1 April 2019, which is a key reference point for this review;
 - A5.4 our proposed framework for assessing Wellington Airport’s estimate of its cost of capital in this review, in light of the changes made in the 2016 IM Review; and
 - A5.5 our assessment of Wellington Airport’s use of the 1 April 2019 WACC.

Our past approach in the s 56G reports primarily focussed on the 75th percentile

- A6 In our s 56G reports, we considered a range from the mid-point WACC estimate to the 75th percentile WACC estimate when assessing airport profitability. We noted that:⁴⁴
- A6.1 the mid-point (50th percentile) was the appropriate starting point;
 - A6.2 the 75th percentile allowed for the uncertainty of estimating the true cost of capital, in light of the potential asymmetric consequences of estimation error on pricing and investment; and
 - A6.3 the low end of the range (the 25th percentile) was not relevant when considering whether airports were targeting excessive profits.
- A7 Any supplier-specific adjustments to our benchmark cost of capital were rejected in the s 56G reports. We made the following points.⁴⁵
- A7.1 A supplier which sets prices based on a higher estimate of cost of capital than the actual cost at which capital is available in an industry cannot expect consumers in a workably competitive market to pay these higher prices.

Commission “Review of Christchurch International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report” (1 November 2018), Attachment A.

⁴⁴ For example, see Commerce Commission “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” (8 February 2013), paragraphs F36-F42.

⁴⁵ For example, see Commerce Commission “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” (8 February 2013), paragraphs F45-F50.

- A7.2 The purpose of IMs is to promote certainty in the rules and assumptions to assess performance. This certainty would be undermined by ad hoc adjustments.
- A7.3 Although individual airports are subject to company-specific risks, investors can diversify these away. The cost of capital reflects risks which investors cannot diversify away.
- A8 This approach reflected our original IM Determination in 2010, where we decided to use a WACC range from the 25th to the 75th percentile. We also decided that service-specific (ie, industry-wide), rather than supplier-specific, WACC estimates would be used.⁴⁶
- A8.1 we noted that leverage, debt premium and beta could potentially be considered on a supplier-specific basis;
- A8.2 however, we considered each of these parameters individually and concluded that service-specific estimates would be more appropriate for each of them.
- A9 In the s 56G reports the upper limit of our WACC range (the 75th percentile) was effectively the benchmark used to assess airport profitability. This was also the percentile that was used when setting price-quality paths for energy businesses at that time.⁴⁷

We now only publish a mid-point WACC estimate following the 2016 IM Review

- A10 In the 2016 IM Review, we decided to change our approach due to two main problems with the previous framework.⁴⁸
- A10.1 the upper limit of our WACC range had become the de facto benchmark when assessing airport profitability; and
- A10.2 there was limited and weak rationale for using the 75th percentile as the upper limit of the WACC percentile range.

⁴⁶ Commerce Commission “Input Methodologies (Airport Services) - Reasons paper” (22 December 2010), paragraph E2.82.

⁴⁷ We now use the 67th percentile when setting price-quality paths for energy businesses. Commerce Commission “Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services – Reasons paper” (30 October 2014).

⁴⁸ Commerce Commission “Input methodologies review decisions – Topic paper 6: WACC percentile for airports” (20 December 2016), paragraph X4.

- A11 We decided to remove the WACC range, and instead publish only the mid-point WACC and a standard error so that any required percentile can be calculated. We noted that this approach:⁴⁹
- A11.1 enables flexibility in assessing the acceptability of airport returns, and will reduce the focus of any assessment on the upper limit of the range; and
 - A11.2 will provide flexibility to enable any assessment to take into account different contextual factors affecting an airport’s required return expectations, or the expectations of a particular project.
- A12 The 2016 IM Review also reiterated our 2010 decision that the 50th percentile is the appropriate starting point for any assessment of airport profitability.⁵⁰
- A13 Given airports are not subject to price-quality path regulation, it is not necessary to specify a particular WACC percentile estimate. This is in contrast to electricity lines and gas pipelines, where we specify the 67th percentile WACC estimate for price-quality path regulation.

Our mid-point WACC estimate for airports as at 1 April 2019

- A14 When considering Wellington Airport’s estimate of its cost of capital for this review, the key reference point is our mid-point WACC estimate for airports as at 1 April 2019.
- A15 The parameter values used to calculate our Wellington Airport WACC estimate as at 1 April 2019 are shown in Table A1 below.

Table A1 Parameters used to calculate our Wellington Airport WACC estimate as at 1 April 2019⁵¹

Parameter	Wellington Airport
Risk-free rate	1.77%
Average debt premium	1.24%
Leverage	19%
Asset beta	0.60
Equity beta	0.74
Tax adjusted market risk premium (TAMRP)	7.0%

⁴⁹ Commerce Commission “Input methodologies review decisions – Topic paper 6: WACC percentile for airports” (20 December 2016), page 3.

⁵⁰ Commerce Commission “Input methodologies review decisions – Topic paper 6: WACC percentile for airports” (20 December 2016), paragraph 22 and 87.

⁵¹ Commerce Commission “Cost of capital determination for disclosure year 2020 for information disclosure regulation – electricity distribution businesses and Wellington International Airport [2019] NZCC 7”, page 4, table 3; with asset beta 0.60 in addition.

Average corporate tax rate	28%
Average investor tax rate	28%
Debt issuance costs	0.20%
Cost of debt	3.21%
Cost of equity	6.46%
Standard error of midpoint WACC estimate	0.0146
Mid-point vanilla WACC	5.84%
Mid-point post-tax WACC	5.67%

Our proposed framework for assessing Wellington Airport's estimated cost of capital

- A16 We have developed a framework for assessing Wellington Airport's estimate of its cost of capital in this review, taking into account the relevant context of the s 56G reports, and the changes made during the IM Review in 2016.
- A17 Our high-level framework for assessing Wellington Airport's cost of capital, including the key factors we have considered, is set out below.

Departure from mid-point: Is the airport's estimate of its WACC different to our mid-point WACC estimate?

- The mid-point WACC represents our starting point when assessing returns for profitability analysis, but we accept that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate.⁵²
- If the airport has departed from our mid-point WACC estimate, what are each of the parameter values used? Has the airport applied an uplift to its mid-point cost of capital (eg, due to asymmetric risks), and if so, what adjustment is made?

Legitimate reasons for departure in relation to each WACC parameter: For each WACC parameter (including any overall WACC uplift), what is the explanation for departing from our IM-based estimate?

- What evidence is provided to support the departure? (For example, is there support from academic articles or other regulatory decisions?). Note: the onus is on airports to provide evidence/sufficient reasoning on any relevant factors.⁵³

⁵² Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 87.

⁵³ Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 99.

- Has the airport considered consistency with its past pricing decisions (ie, has it applied the same logic consistently over time, or considered the trade-off between short-term fluctuations in parameter values vs predictability)?
- Are we satisfied that the evidence provides legitimate reasons for the departure from our benchmark value, in light of the Part 4 purpose (particularly the section 52A(1)(d) requirement to limit the ability of airports to earn excessive profits)?⁵⁴
- **If we are not satisfied there are legitimate reasons, then the airport-specific adjustment to that parameter is unjustified.**

Legitimate reasons for the *size* of departure in relation to each WACC parameter: Is the quantum of the adjustment to each parameter (including any overall WACC uplift) justified?

- What evidence is provided to support the quantum? (For example, quantitative analysis demonstrating firm-specific difference from our benchmark value, evidence from academic articles, or other regulatory decisions?). Note: the onus is on airports to provide evidence/sufficient reasoning on any relevant factors.⁵⁵
- Are there counter-arguments (or other off-setting considerations) which would reduce the size of the adjustment made by the airport? (For example, consider whether arguments made by the other regulated New Zealand airports would work in the opposite direction for the specific airport in question).
- Is the evidence/reasoning sufficient to support the value of the adjustment made to our benchmark value considering the Part 4 purpose (particularly the section 52A(1)(d) requirement to limit the ability of airports to earn excessive profits)?
- **If the evidence/reasoning is not sufficient, then we consider the airport-specific adjustment to that parameter is unjustified.**

Legitimate reasons for departure in relation to overall WACC: Is the airport's overall estimate of its WACC (combining each of the individual parameter values) reasonable?

- Are there any additional factors relevant to the airport's overall WACC (for example, off-setting considerations regarding other parameters)?

⁵⁴ Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraphs 87 and 94.

⁵⁵ Commerce Commission "Input methodologies review decisions – Topic paper 6: WACC percentile for airports" (20 December 2016), paragraph 99.

- **If each of the individual parameter adjustments are acceptable, and there are no other off-setting considerations, then we consider that airports have legitimate reasons to target above our mid-point WACC estimate.**
- **However, if there are some adjustments we consider not sufficiently justified (or there are other off-setting considerations), then the airport's cost of capital is unjustified.**

Our assessment of Wellington Airport's use of the 1 April 2019 WACC

- A18 The WACC estimate selected by Wellington Airport, after consultation with airlines, is assessed against our mid-point WACC estimate for airports as at 1 April 2019.⁵⁶
- A19 We consider this WACC estimate is an appropriate reference point, as Wellington Airport agreed on the timing of the WACC estimate with its major customers when it delayed its price setting event. We consider this is appropriate to the extent that Wellington Airport has applied the WACC timing consistently. For example, the assumptions underlying the WACC should be consistently applying information from this date.
- A20 Consequently, our assessment of Wellington Airport's reasons for initially targeting the 6.08% WACC is based on the information that was available at the time, consistent with the adoption of the 2019 WACC.
- A21 The decision to use a 2019 WACC throughout the pricing period means that considerations about any potential impact of the pandemic on the WACC are ignored in this Attachment A assessment.

Our assessment of Wellington Airport's cost of capital

Wellington Airport's estimated WACC is 6.08%

- A22 Wellington Airport estimates that its cost of capital is 6.08%, which is equivalent to the 61st percentile of our WACC range (estimated as at 1 April 2019).^{57 58}
- A23 When estimating its cost of capital, Wellington Airport has used our inputs for WACC parameters except for asset beta and cost of debt overall. Wellington Airport has used:

⁵⁶ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), pages 36 to 37.

⁵⁷ This 6.08% post tax WACC estimate is 0.41 percentage points higher than our mid-point post tax WACC estimate of 5.67% and equivalent to the 61st post-tax WACC percentile of our WACC range.

⁵⁸ We note that Wellington Airport's stated post tax WACC of 6.08% differs to the WACC we calculate using Wellington Airport's stated WACC parameters, which is 6.09% (irrespective of rounding on our benchmark parameters).

A23.1 an asset beta of 0.63, which is 0.03 higher than our benchmark; and

A23.2 an overall cost of debt estimate of 4.66%, comprising of Wellington Airport's existing portfolio of debt costs and estimated costs for debt expected to be raised post 2019.

A24 The sections below discuss our assessment of Wellington Airport's approach to asset beta and cost of debt in more detail.

Our assessment of Wellington Airport's approach to asset beta

A25 Wellington Airport has decided to use an asset beta of 0.63 rather than our benchmark estimate of 0.60.⁵⁹

Difference between our mid-point and Wellington Airport's asset beta assessment

A26 Our benchmark mid-point asset beta estimate of 0.60 was based on a sample of 26 international comparator companies.

A27 Wellington Airport has departed from this benchmark, applying a 0.03 uplift to the asset beta and has provided several explanations for this.

A28 In this section we consider whether Wellington Airport has legitimate reasons to depart from our mid-point asset beta estimate and to what extent.

Our assessment of consistent use of 1 April 2019 parameters

A29 We have considered whether Wellington Airport's cost of equity parameters, and underlying assumptions, for the 1 April 2019 WACC consistently apply information from this date.

A30 We find that Wellington Airport has applied the 1 April 2019 WACC consistently, for example the application of the 7.0% TAMRP.⁶⁰

Does Wellington Airport provide legitimate reasons for the difference between our mid-point and Wellington Airport's asset beta assessment?

A31 Wellington Airport's main reasons for its 0.03 asset beta uplift in its disclosure document are:⁶¹

⁵⁹ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 33.

⁶⁰ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 36.

⁶¹ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), pages 33 and 35.

- A31.1 to account for a higher asset beta associated with Wellington Airports' significant capital expenditure programme and risk profile "(...)to account for the risks associated with its capital expenditure profile"; and
- A31.2 Wellington Airport's view that the Commission accepted in principle an asset beta uplift for Auckland Airport based on an increasing capex program increasing exposure to systematic risk; and that an equivalent uplift for Wellington Airport would be appropriate given its own operating leverage and scale of investments.
- A32 In its initial pricing proposal, Wellington Airport gives four reasons for its 0.03 asset beta uplift, and three of these are in relation to its proposal "to invest more than \$1 billion in capital projects over the next two pricing periods, effectively doubling its asset base":⁶²
- A32.1 **Leverage and investment risk** - this scale of capex significantly increases Wellington Airport's leverage and exposure to investment risk;⁶³
- A32.2 **Operating leverage** - the investment will also increase the proportion of fixed to variable costs, affecting Wellington Airport's operating leverage and resulting in higher systematic risk compared to both Wellington Airport's historical position and the position of other airports used as comparators by the Commission;⁶⁴
- A32.3 **Commission's view on Auckland Airport** - Wellington Airport's view that the Commission accepted in principle an asset beta uplift for Auckland Airport based on an increasing capex program increasing exposure to systematic risk;⁶⁵ and
- A32.4 **Domestic passenger** - Wellington Airport's relatively high exposure to demand by domestic passengers is likely to be more highly correlated to non-diversifiable risk, as advised by Houston Kemp.⁶⁶
- A33 Wellington Airport notes that detailed analysis of operating leverage and passenger mix is provided by Houston Kemp's analysis.

⁶² Wellington International Airport Limited "Initial Pricing Proposal – For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), paragraph 340.

⁶³ Wellington International Airport Limited "Initial Pricing Proposal – For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), paragraphs 60, 341, and 364.

⁶⁴ Wellington International Airport Limited "Initial Pricing Proposal – For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), paragraph 341.

⁶⁵ Wellington International Airport Limited "Initial Pricing Proposal - For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), paragraphs 360 to 362.

⁶⁶ Wellington International Airport Limited "Initial Pricing Proposal - For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), paragraph 365.

- A34 Houston Kemp gives two main reasons for the 0.03 asset beta uplift for Wellington Airport:
- A34.1 **Operating leverage rationale** – a greater exposure to systematic risk arising from operating leverage that is increasing and higher than the comparator sample;⁶⁷ and
- A34.2 **Domestic passenger rationale** – a greater exposure to domestic travellers is expected to result in greater systematic risk relative to the other New Zealand airports, and therefore to the comparator sample.⁶⁸
- A35 We consider that Wellington Airport has provided substantive evidence for two broad rationales for the difference between our mid-point asset beta and its asset beta estimate:
- A35.1 operating leverage rationale; and
- A35.2 traffic mix rationale.
- A36 We give our views on Wellington Airport's reasoning and evidence for the operating leverage and traffic mix rationales for the 0.03 asset beta uplift below.

Wellington Airport's operating leverage rationale

- A37 We note that Houston Kemp finds that Wellington Airport has a greater exposure to systematic risk arising from:
- A37.1 **a higher expected operating leverage in PSE4 than historically** – Houston Kemp considers Wellington Airport's operating leverage is increasing through an increase in the ratio of fixed to variable costs, and presents information on increasing capex, and increasing capex proxies;⁶⁹ and
- A37.2 **a higher operating leverage than the comparator sample and than Auckland Airport** – Houston Kemp finds the operating leverage of Wellington Airport is substantially above that reported by Auckland Airport and the comparator sample, presenting operating leverage estimates.⁷⁰

⁶⁷ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 8 to 11.

⁶⁸ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 11 to 14.

⁶⁹ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 8 to 10, including figures 2, 3 and 4.

⁷⁰ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 10 and 11.

A38 We accept in principle that a higher operating leverage can be expected to impact asset beta for airports.⁷¹ Conceptually we also agree that an increase in operating leverage may increase Wellington Airport's exposure to systematic risk. However, it is Wellington Airport's operating leverage relative to the average operating leverage of the comparator sample over PSE4 that is relevant in the assessment of the asset beta uplift.

A39 We find Wellington Airport's evidence of a higher operating leverage than the average of the comparator set is only partial. Recognising this is difficult to evidence, we provide our views below.

A39.1 Evidence comparing Wellington Airport's operating leverage to that of the comparator sample average and Auckland Airport: Houston Kemp suggests that Wellington Airport's operating leverage is substantially higher than the companies in our asset beta comparator sample including Auckland Airport, referring to data on underlying growth in earnings before interest and tax (**EBIT**) to revenue growth.⁷² However, this evidence appears to use two sets of analysis (or numbers) for operating leverage estimates, with one for Wellington Airport and another for the comparator sample and Auckland Airport.

A39.2 In one set of analysis, Houston Kemp estimates operating leverage values for Wellington Airport, including an unadjusted average operating leverage of 8.96 over the FY2013 to FY2017 period.⁷³

A39.3 The table from Houston Kemp's report, presenting this set of analysis for Wellington Airport is shown below.

⁷¹ Our review of Auckland Airport's PSE3 proposal explains this in more detail. Commerce Commission "Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), Figure A2 on page 111, and paragraphs A87 to A98.

⁷² Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 10.

⁷³ See Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 11 and Table 4.

Table A2 Houston Kemp table showing Wellington Airport’s underlying EBIT growth to revenue growth

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
WIAL revenue (\$m)	\$99.5	\$106.2	\$110.9	\$108.3	\$113.5	\$119.6	\$128.6
% change in Revenue		6.76	4.43	-2.33	4.80	5.33	7.59
WIAL EBIT (\$m)	\$19.1	\$36.7	\$44.8	\$26.2	\$29.3	\$38.5	\$47.3
% change in EBIT		92.18	21.84	-41.55	11.96	31.39	22.93
Unadjusted operating leverage		13.64	4.93	17.85	2.49	5.89	3.02
WIAL EBIT excluding fair value movement in swaps (\$m)	\$28.7	\$37.4	\$34.6	\$27.3	\$31.9	\$30.2	\$45.4
% change in EBIT		30.43	-7.57	-20.95	16.76	-5.54	50.63
Adjusted operating leverage		4.50	-1.71	9.00	3.49	-1.04	6.67

- A39.4 Using another set of analysis, Houston Kemp reports the Commission’s operating leverage estimates for the comparator sample and Auckland Airport,⁷⁴ including:⁷⁵
- A39.4.1 an unadjusted average operating leverage of 1.93 for Auckland Airport over the FY2013 to FY2017 period; and
- A39.4.2 an unadjusted average operating leverage of 3.47 for the comparator sample over the FY2013 to FY2017 period.
- A39.5 It appears there are inconsistencies across these two sets of analysis (one for Wellington Airport, and another for the comparator sample), leaving the comparison to the comparator sample incomplete.
- A39.6 For example, it is not clear that Houston Kemp’s approach to generating ‘unadjusted’ and ‘adjusted’ operating leverage numbers for Wellington Airport is consistent with the “degree of operating leverage” Bloomberg methodology underlying the comparator set numbers from our review of Auckland Airport’s PSE3 pricing decisions.
- A39.7 In our review of Auckland Airport’s PSE3 proposal, we noted that the degree of operating leverage, which corresponds to earnings before interest and taxes growth by revenue growth, is a recognised measure of operating leverage, and is measured as:⁷⁶

⁷⁴ Where this set of analysis is from the Commission’s review of Auckland Airport’s PSE3 pricing decisions. See Commerce Commission “Review of Auckland International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report” (1 November 2018), paragraphs A91 to A96.

⁷⁵ See Houston Kemp “WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd” (July 2019), page 10.

⁷⁶ Commerce Commission “Review of Auckland International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report” (1 November 2018), paragraphs A88 to A90.

$$\text{Degree of operating leverage} = \frac{\% \Delta EBIT}{\% \Delta \text{revenue}}$$

- A39.8 We collected data on the “degree of operating leverage”, sourced from Bloomberg using the field “DEGREE_OPERATING_LEVERAGE”, for each company in the comparator sample. We note that Houston Kemp appears to have separately measured each of “% change in EBIT” and “% change in revenue” rather than using the equivalent Bloomberg field, resulting in figures that we cannot fully reconcile to the Bloomberg figures.⁷⁷
- A39.9 It is also unclear if Houston Kemp has used an equivalent adjusted measure of EBIT for the Wellington Airport numbers as for the comparator sample. In that same analysis of Auckland Airport’s PSE3 proposal, we stated that our adjusted measure of EBIT specifically excludes ‘share of profit of associates’, ‘derivative fair value movement’, ‘investment property fair value increases’, and ‘property, plant and equipment revaluation decrease’.⁷⁸ Houston Kemp describes its adjusted measure of EBIT as “WIAL EBIT excluding fair value movement in swaps (\$m)”, which we cannot confirm is equivalent.⁷⁹
- A39.10 **Evidence on higher expected operating leverage for Wellington Airport in PSE4 than historically:** Houston Kemp advised Wellington Airport that its operating leverage would increase over PSE4 as increasing capex would increase the ratio of fixed to variable costs. Houston Kemp claims higher operating leverage on the basis of increasing capex but does not compare to the comparator sample. We note the following statements by Houston Kemp:⁸⁰

When a business undertakes a substantial capex program, its operating leverage will increase through an increase in the ratio of its fixed costs to its variable costs.

WIAL’s substantial capex program over PSE4 and PSE5 will increase the proportion of WIAL’s costs that do not vary with passenger numbers such as its depreciation allowance. This increase in the proportion of fixed costs over time would be expected to increase WIAL’s operating leverage as a given change in revenues has a bigger impact on EBIT for companies with high proportion of fixed costs.

⁷⁷ Houston Kemp “WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd” (July 2019), Table 4.

⁷⁸ Commerce Commission “Review of Auckland International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report” (1 November 2018), paragraph 352.

⁷⁹ Houston Kemp “WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd” (July 2019), Table 4.

⁸⁰ Houston Kemp “WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd” (July 2019), pages 9 and 11.

A39.11 However, without a capex comparison to the comparator sample, there is insufficient evidence of a higher operating leverage than the average of the comparator set following this rationale. We note that Houston Kemp has provided charts showing the evolution of the capex proxy, “cumulative capex to RAB ratio”, for Wellington Airport,⁸¹ and comparing Wellington to Auckland Airport.⁸² Nonetheless, these are not sufficient as a comparison to the comparator sample.

A39.12 We also consider that whether operating leverage would increase with capital expenditure, and the extent of any increase, is quite uncertain.

A39.13 In our review of Auckland Airport’s PSE3 pricing decisions we accepted that Auckland Airport’s operating leverage might increase during PSE3 due to its large capital expenditure programme, but we also concluded that:⁸³

[E]stimating the impact on operating leverage is difficult as Auckland Airport has not separated out its costs into fixed and variable and (...) we do not consider that increases in capital expenditure necessarily results in higher operating leverage.

[I]t is not clear to us that Auckland Airport’s operating leverage over PSE3 will be materially higher than the average of the comparator sample, in a way that would meaningfully impact asset beta.

A39.14 **Argument for an equivalent uplift to Auckland International Airport based on equivalent capex and operating leverage and Commerce Commission approval:** Wellington Airport and Houston Kemp consider that an asset beta of 0.63 would be consistent with that approved by the Commission in principle for Auckland Airport on the basis of higher operating leverage and capex. For example, Houston Kemp expressed the view that “[g]iven this higher operating leverage and capex program the adoption by WIAL of an asset beta of 0.63 consistent with that implicitly adopted by AIAL is reasonable.”^{84 85}

A39.15 This is a mischaracterisation of the Commission’s view on Auckland Airport’s asset beta.

⁸¹ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), figure 3.

⁸² Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), figure 4.

⁸³ Commerce Commission "Review of Auckland International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraphs A101 to A104.

⁸⁴ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 11.

⁸⁵ See also Wellington International Airport Limited "Initial Pricing Proposal – For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), pages 69 to 70.

A39.16 In our review of Auckland Airport’s PSE3 pricing decisions we were not convinced of the case provided by Auckland Airport for the asset beta uplift:⁸⁶

However, based on the available evidence, we are not convinced that any increase in operating leverage will be significant enough to materially impact Auckland Airport’s position relative to the comparator companies.

On balance, we consider that the available evidence suggests the likely increase in Auckland Airport’s operating leverage will be relatively immaterial in PSE3 (...) The main rationale continues to be an intuition or assumption that increasing capital expenditure is likely to increase fixed costs and therefore operating leverage, but with no evidence on how fixed costs would be expected to increase.

[B]ased on the evidence before us, we are not convinced that (...) Auckland Airport’s expected operating leverage over PSE3 will be materially above the average operating leverage for the companies on our comparator sample; and even if it was, there is little evidence to support the magnitude of its implicit 0.08 adjustment to asset beta. Therefore, we consider that Auckland Airport’s implicit adjustment to asset beta has not been sufficiently justified.

A40 We also find that evidence supporting the quantum of Wellington Airport’s 0.03 asset beta uplift in relation to operating leverage is missing. For example, the evidence does not include quantitative analysis estimating the firm-specific difference from our benchmark value as a result of the impact of operating leverage on asset beta, although we note the proposed adjustment is modest.

Conclusion on the operating leverage rationale

A41 An adjustment to our asset beta estimate may, in principle, be justified if Wellington Airport can demonstrate that:

A41.1 its operating leverage is (or is expected to be) significantly higher than the companies in our comparator sample; and

A41.2 any difference is of a magnitude that can reasonably be expected to meaningfully impact the asset beta.

A42 However, based on the evidence before us, we are not convinced that:

A42.1 Wellington Airport’s expected operating leverage over PSE4 has been shown to be materially above the average operating leverage for the companies on our comparator sample; and

⁸⁶ Commerce Commission “Review of Auckland International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report” (1 November 2018), paragraphs A134 to A135 and A202 to A203.

A42.2 even if it was, there is insufficient evidence to support the magnitude of its 0.03 adjustment to asset beta.

A43 We consider that Wellington Airport's adjustment to asset beta has not been sufficiently justified by the operating leverage rationale, particularly as the sets of analysis comparing Wellington Airport's operating leverage to the comparator sample appear to be inconsistent.

A44 We recognise that while increasing capex does not necessarily cause increased operating leverage, it may do so. Therefore, we agree that Wellington Airport's anticipated capex program (as at 1 April 2019) may have some impact on beta. We note that this assessment is complicated by the difficulty in knowing where Wellington Airport sits in operating leverage and systematic risk in comparison to the comparator set.

Wellington Airport's traffic mix rationale

A45 Following advice from Houston Kemp, Wellington Airport consider that its relatively high exposure to demand by domestic passengers provides further justification for a small asset beta uplift.⁸⁷

A46 We note Houston Kemp's view that Wellington Airport's high exposure to demand by domestic passengers strongly suggests that Wellington Airport is exposed to higher systematic risk than the Commission's comparator sample of 26 airports, as the relatively high exposure to demand by domestic passengers is likely to be more highly correlated to variations in GDP and therefore non-diversifiable risk.⁸⁸

A47 Houston Kemp found 85.7% of all passenger movements at Wellington Airport related to domestic travel, compared to 45.6% at Auckland Airport and 75.5% at Christchurch Airport.⁸⁹

A48 Houston Kemp's analysis included the following table comparing passenger mix at New Zealand airports.

⁸⁷ Wellington International Airport Limited "Initial Pricing Proposal - For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), paragraph 365.

⁸⁸ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 12.

⁸⁹ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 12.

Table A3 Houston Kemp’s table showing mix of domestic and international passengers at Auckland, Christchurch and Wellington Airports⁹⁰

	2012	2013	2014	2015	2016	2017	Average
AIAL							
Domestic	44.5%	46.6%	45.9%	45.5%	45.8%	45.2%	45.6%
International	55.5%	53.4%	54.1%	54.5%	54.2%	54.8%	54.4%
CIAL							
Domestic	74.4%	76.3%	76.2%	75.6%	75.4%	74.8%	75.5%
International	25.6%	23.7%	23.8%	24.4%	24.6%	25.2%	24.5%
WIAL							
Domestic	86.2%	86.5%	86.2%	85.8%	84.5%	85.1%	85.7%
International	13.8%	13.5%	13.8%	14.2%	15.5%	14.9%	14.3%

A49 We also note that Houston Kemp used proxy analysis in support of the domestic passenger rationale and concluded that this supports a 0.03 uplift. Houston Kemp indicates that it replicated Incenta’s proxy analysis for Christchurch Airport’s proposal for PSE3, which we noted:⁹¹

A49.1 was intended to test whether Christchurch’s asset beta was higher than the comparators, and that Incenta had proposed this as Christchurch Airport was not a listed business and its asset beta could therefore not be directly estimated from financial market data (as a direct comparison to companies in the comparator sample was not possible); and

A49.2 involved regression analysis of changes in passenger volumes against changes in real GDP, where Incenta pooled data on percentage changes in GDP and passenger volumes for the sample of 26 comparator companies spanning 2005-2015, and then compared this to data for Christchurch Airport for 1987-2015.

A50 Following its own proxy analysis, Houston Kemp found that Wellington Airport has:

A50.1 a higher proxy beta for domestic passenger demand, where over the period 1993 to 2017 (24 observations) the proxy beta for Wellington Airport for domestic passenger demand was 0.94, and for international passenger demand was 0.74.⁹²

⁹⁰ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), table 5.

⁹¹ Commerce Commission "Review of Christchurch International Airport’s pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraphs A72 to A75.

⁹² Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), paragraph 3.2.2.

A50.2 a proxy beta of 0.92 which is substantially higher than the average proxy beta of the Commission's comparator sample (0.67) and a little below the proxy beta for Christchurch Airport (1.08) which Incenta had calculated.

A51 Houston Kemp's results table is shown below.

Table A4 Houston Kemp table showing airport and comparator sample proxy beta estimates⁹³

		Observations	Intercept	Proxy beta	R ²
Average airport in the Commission's sample	Parameter		0.04	0.66	
	Standard error	233	0.01	0.09	18%
	p-value		0%	0%	
WIAL - whole sample	Parameter		0.01	0.92	
	Standard error	24	0.01	0.07	88%
	p-value		40%	0%	
WIAL - excluding 1999 and 2000	Parameter		0.01	0.90	
	Standard error	22	0.01	0.43	18%
	p-value		56%	5%	
CIAL - whole sample	Parameter		0.01	1.08	
	Standard error	28	0.02	0.54	13%
	p-value		57%	5%	

A52 We agree in principle that traffic mix can be related to income elasticity and therefore asset beta (systematic risk). We also agree that the relative proportions of international and domestic leisure travellers may be relevant when considering an airport's exposure to systematic risk.

A53 However, we find the evidence of a higher asset beta than the comparator set due to traffic mix is incomplete. We provide our reasons for this view below.

A53.1 Evidence comparing Wellington, Auckland, and Christchurch airports passenger mix: Houston Kemp's analysis, comparing the passenger mix (domestic and international) across the three airports, indicates Wellington Airport has the highest percentage of domestic passengers at 85.7%.⁹⁴

A53.2 Whereas Houston Kemp considers high exposure to demand by domestic passengers is likely to be more highly correlated with systematic risk, we consider that an assessment of domestic and international passenger mix alone is unlikely to be sufficient in the assessment of an airport's systematic risk exposure.

⁹³ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), table 6.

⁹⁴ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 12.

- A53.3 We consider that a distinction should be made between purely domestic passengers and those passengers that are transferring to or from international travel, and who are therefore international passengers.
- A53.4 We also consider that multiple categories of passenger mix are likely to be relevant when considering an airport's exposure to systematic risk. We discussed this in our reviews of the Auckland and Christchurch Airport PSE3 pricing decisions.⁹⁵
- A53.5 For example, we previously considered Auckland Airport's view that the systematic risk associated with long-haul passengers is higher than for short-haul passengers because a higher jet fuel price negatively impacts general economic performance. We concluded that more information would be required to assess the impact and that many factors may affect systematic risk to varying degrees:⁹⁶

This may have some effect on asset beta, but we consider more information would be required before we could judge the significance of any impact on asset beta.

Overall, there may be many different factors that affect systematic risk to varying degrees. This means that we are relatively cautious in considering departures from the asset beta used in our mid-point WACC estimate. It is also why we are keen to emphasise the need for airports to provide clear evidence including the consideration of any countervailing effects in justifying a change to asset beta.

- A53.6 In our review of Christchurch Airport's PSE3 pricing decisions we agreed conceptually that leisure travel could be expected to affect an airport's asset beta because leisure-travel has a relatively high income elasticity of demand.⁹⁷ However, we again found that an assessment of passenger split along one line was insufficient:⁹⁸

[A]ssessing the percentage of business and leisure travellers without reference to whether they are international or domestic travellers provides limited information. It does not provide further understanding on how the split of passengers affects Christchurch Airport's exposure to systematic risk, and consequently their asset beta.

⁹⁵ Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraphs A82 to A95.

⁹⁶ Commerce Commission "Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraphs A198 to A200.

⁹⁷ Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A83.

⁹⁸ Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A94.

A53.7 In that review, we also discussed the approach to assessing the impact of passenger mix on systematic risk in the ACCC's 2001 pricing decision for Sydney Airport:^{99 100}

The ACCC report suggests that changes to national income have the least impact on international (foreign) leisure travellers and the most impact on domestic leisure travellers (whether travelling domestically or internationally). The impact on business travellers (whether international or domestic) lies somewhere in between these two categories.

A53.8 We note that this approach applies income elasticity measures to seven specific passenger categories, having divided passenger numbers along three lines (business or leisure, international or domestic, inbound or outbound), resulting in a weighted average income elasticity figure for each airport, which acts as a proxy for asset beta.¹⁰¹

A53.9 **Evidence on domestic and international passenger mix at Wellington Airport (proxy betas for domestic and international):** Houston Kemp finds that over the period from 1993 to 2017, the proxy beta for Wellington Airport was 0.94 for domestic passenger demand and 0.74 for international passenger demand.¹⁰²

A53.10 However, Houston Kemp does not provide equivalent results for the average of the comparator sample and therefore no comparison to comparator sample is made.

A53.11 **Evidence comparing Wellington Airport to the comparator sample (Wellington Airport overall proxy beta and average of comparator sample proxy beta):** Houston Kemp uses three sets of analysis or numbers (one for Wellington Airport, one for Christchurch Airport, and another for the sample of comparators) with inconsistent time periods.

A53.12 Houston Kemp reports a 0.92 proxy beta for Wellington Airport, stating this is substantially higher than the average proxy beta of the Commission's comparator sample (0.67) and a little below the proxy beta for Christchurch Airport (1.08). The underlying sample periods appear to be:

⁹⁹ See our discussion of the ACCC's report at Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A93.

¹⁰⁰ ACCC "Sydney Airports Corporation Ltd: Aeronautical pricing proposal – Decision" (May 2001), pages 184-187.

¹⁰¹ For example, the approach described in the ACCC paper applies the highest income elasticity measure to the category 'International outbound leisure'. ACCC "Sydney Airports Corporation Ltd: Aeronautical pricing proposal – Decision" (May 2001), page 186.

¹⁰² Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 12.

A53.12.3 Wellington Airport: 1992 to 2017 for the 0.92 proxy beta;¹⁰³

A53.12.4 comparator sample: 2005 to 2015 for the 0.67 proxy beta;¹⁰⁴ and

A53.12.5 Christchurch Airport: 1987 to 2015 for the 1.08 proxy beta.¹⁰⁵

A53.13 We consider this evidence is incomplete given the inconsistent sample periods. This particular area of Houston Kemp's analysis also does not address our previous concerns highlighted in the assessment of Christchurch Airport's PSE3 proposal:

When reaching its conclusions, Incenta does not assume any specific factor is the underlying driver of Christchurch Airport's higher exposure to systematic risk.¹⁰⁶

[W]e are concerned that Incenta appears to rely almost exclusively on statistical analysis to support its recommended asset beta (...) Incenta has not provided clear justification regarding the underlying factor (or factors) it expects to cause Christchurch Airport to have a greater exposure to systematic risk relative to the average of our comparator sample.¹⁰⁷

[W]e would again be concerned about simply accepting the results of statistical analysis alone, in the absence of sound supporting evidence regarding the underlying factor(s) expected to drive the difference.¹⁰⁸

A54 As we find the evidence of a higher asset beta is incomplete, we also find that evidence supporting the quantum of Wellington Airport's 0.03 asset beta uplift in relation to passenger mix is missing.

¹⁰³ Houston Kemp has used a sample period of 1992 to 2017 to estimate Wellington Airport's proxy beta. Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 12 to 13.

¹⁰⁴ Houston Kemp refers to Incenta's original estimate for the average of the Commission's 26 company comparator sample which was produced from a sample period of 2005 to 2015. See Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 12 to 13. See also Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A74.

¹⁰⁵ Houston Kemp refers to Incenta's original estimate for Christchurch Airport with a sample period of 1987 to 2015. Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 12 to 13. See also Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A74.

¹⁰⁶ Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A75.

¹⁰⁷ Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A98.

¹⁰⁸ Commerce Commission "Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph A106.

Conclusion regarding the traffic mix rationale for an asset beta uplift

A55 An adjustment to our asset beta estimate may, in principle, be justified if Wellington Airport can demonstrate that:

A55.1 its exposure to systematic risk as a result of its traffic mix is, or is expected to be, significantly higher than the companies in our comparator sample; and

A55.2 any difference is of a magnitude that can reasonably be expected to meaningfully impact the asset beta.

A56 However, based on the evidence before us, we are not convinced that:

A56.1 Wellington Airport's expected exposure to systematic risk as a result of its traffic mix over PSE4 has been shown to be materially above the average for the companies in our comparator sample; and

A56.2 even if it was, there is little evidence to support the magnitude of its 0.03 adjustment to asset beta.

A57 In our view, multiple categories of passenger mix are likely to be relevant when considering an airport's exposure to systematic risk. These categories include business or leisure, international or domestic, and inbound or outbound.

A58 We also note that this has wider implications. Adjusting for the impact of domestic passenger mix in isolation from other passenger mix categories could result in an asset beta uplift for some airports, and a reduction for others. For example, if we were to increase the asset beta for Wellington Airport for its high proportion of domestic passengers, should we also decrease the asset beta for Auckland Airport based on Houston Kemp's analysis?

A59 Finally, Wellington Airport may have many domestic flights connecting international travellers. It is unclear whether these travellers are counted toward the proportion of domestic passengers.

Other considerations in the assessment of the asset beta uplift

A60 Wellington Airport states that BARNZ, based on advice from TDB, did not support Wellington Airport's methodology for calculating its operating leverage which produced the proposed 0.03 asset beta uplift. Wellington Airport also states that TDB provided its own analysis which supported an asset beta uplift of 0.02.¹⁰⁹

TDB provided its own analysis which supported an increase of 0.02. WIAL did not agree with TDB, noting that WIAL's approach was consistent with the Commerce

¹⁰⁹ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), pages 35 to 36.

Commission, and that TDB had not fully recognised WIAL's forecast capital expenditure cash flows.

A61 We accept that BARNZ and some airlines submitted that an uplift of 0.02 was reasonable, however we have not seen the TDB advice nor evidence of BARNZ's position.

Conclusion regarding Wellington Airport's asset beta

A62 We acknowledge the practical difficulties in comparing Wellington Airport's exposure to systematic risk to that of the companies in our asset beta comparator sample, in particular given that:

A62.1 Wellington Airport is not publicly listed, so standard beta estimates are not available;

A62.2 beta estimates for an individual company tend to be unreliable (given beta estimates are 'noisy'); and

A62.3 it may be difficult to obtain reliable data across the 26 companies in our comparator sample (particularly detailed statistics regarding the breakdown of passenger volumes).

A63 While we accept in principle that operating leverage and traffic mix can impact airport systematic risk and therefore asset beta, we find the evidence insufficient to justify departures from the asset beta used in our mid-point WACC estimate.

A64 We also consider that multiple offsetting categories of passenger mix are likely to be relevant when considering an airport's exposure to systematic risk.

A65 We find the other points Wellington Airport has made in relation to leverage and investment risk are either not reasoned or not sufficiently reasoned in relation to our framework for assessing airports' WACC estimates and, in particular, in relation to our mid-point asset beta parameter as a starting point.

A66 We note that we have received submissions on Wellington Airport's asset beta. Some submitters expressed their support for our decision on the asset beta.¹¹⁰ Wellington Airport maintained its view that a higher asset beta is necessary, however, chose not to pursue this issue and did not supplement its view with any evidence additional to Houston Kemp's report.¹¹¹

¹¹⁰ Submissions received from Air New Zealand and BARNZ (supported by Qantas) support the Commerce Commission's decision on the asset beta. Air New Zealand: "Submission on review of Wellington Airport's price setting event consultation paper" (13 June 2022), page 1, BARNZ: "Submission on review of Wellington Airport's price setting event consultation paper" (10 June 2022), paragraph 14, and Qantas: "Submission on Wellington Airport price setting event review" (14 June 2022).

¹¹¹ Wellington Airport: "Wellington Airport price setting event review – submission" (10 June 2022).

A67 Finally, we recognise that our assessment of Wellington Airport’s asset beta is in the context of this PSE. Some issues raised may be considered more widely as part of the 2023 IM review, when submissions of evidence of these issues will be welcome.

Our assessment of Wellington Airport’s approach to cost of debt

A68 This section discusses Wellington Airport’s decision to use its cost of debt of 4.66%, rather than our benchmark estimate of 3.21% (as at 1 April 2019).¹¹²

Difference between our mid-point and Wellington Airport’s cost of debt assessment

A69 We prefer to use a benchmark cost of debt estimate in the WACC estimate rather than Wellington Airport’s actual debt costs. The relevant estimate of the cost of capital, including the cost of debt, is the market’s view of the cost of capital for providing the service, not the debt costs of a firm which may or may not be efficient.¹¹³

A70 This leaves the firm with the opportunity to out (or under) perform against the benchmark as long as that benchmark is reasonable.

A71 We use a simple approach to estimate the cost of debt by observing the interest rate paid by the New Zealand Government, and the additional premium corporate borrowers pay to compensate investors for the additional risks of lending to them (relative to the Government).¹¹⁴

A72 For all regulated suppliers of airport services, our estimate of the cost of debt comprises three parameters:¹¹⁵

A72.1 the risk-free rate;

A72.2 the debt premium; and

A72.3 debt issuance costs, which include an allowance for swap costs.

¹¹² Wellington Airport: “Wellington Airport price setting event review – submission” (10 June 2022), page 33.

¹¹³ As set out in the IMs, the WACC is estimated because it cannot be observed directly, and the relevant estimate is the market’s view of the cost of capital for providing the service, not the cost of capital specific to one regulated supplier, or a regulated supplier’s view of its cost of capital for that service. See Commerce Commission “Input methodologies review decisions - Topic paper 4: Cost of capital issues” (20 December 2016), paragraph 23.

¹¹⁴ As discussed in Commerce Commission “Input methodologies review decisions - Topic paper 4: Cost of capital issues” (20 December 2016), paragraphs 34 to 40.

¹¹⁵ Commerce Commission “Input methodologies review decisions - Topic paper 4: Cost of capital issues” (20 December 2016), paragraph 35.

- A73 This 'simple' approach to estimating the cost of debt focusses on one type of debt. An alternative, which considers each option a supplier has for raising debt (eg, issuing bank debt, or issuing bonds overseas) has been called the 'complex approach'.¹¹⁶
- A74 The evidence provided indicates that Wellington Airport's approach to cost of debt departs from our benchmark approach, is closer to a complex approach, and broadly appears to be:¹¹⁷
- A74.1 actual debt costs for its historic portfolio of debt; and
 - A74.2 estimated costs for its expected new debt (post 2019).
- A75 While we can observe Wellington Airport's broad approach to assessing cost of debt, we have not seen the underlying calculations and cannot break down the estimate to individual elements such as debt premium to compare to our cost of capital calculation in our input methodologies.

Our assessment of consistent use of 1 April 2019 parameters

- A76 We have considered whether Wellington Airport's cost of debt parameters, and underlying assumptions, for the 1 April 2019 WACC consistently apply information from this date.
- A77 We note that in Houston Kemp's report¹¹⁸ for Wellington Airport the forward yield estimates based on 2019 data are consistent with the timing of the 1 April 2019 WACC estimate but we do not have enough information to be sure the timing is consistent across the entire estimate.

Does Wellington Airport have legitimate reasons for the difference between our mid-point and Wellington Airport's cost of debt assessment

- A78 We have identified four main differences between our mid-point cost of debt and Wellington Airport's estimate:
- A78.1 use of actual debt costs;
 - A78.2 use of a BBB+ credit rating in estimating the debt premium;¹¹⁹

¹¹⁶ Commerce Commission "Input methodologies review decisions: Topic Paper 4: Cost of capital issues" (December 2016), paragraphs 214 to 215.

¹¹⁷ See Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 4 to 6, section 3.1.

¹¹⁸ See Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), pages 6 to 7, including table 3 and figure 1, and Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 34.

¹¹⁹ Where this is specific to the assumptions for cost of new debt on fixed rate bonds. See Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), Table 3 at page 6.

A78.3 use of a longer-term risk-free rate; and

A78.4 use of a longer-term debt premium.

A79 We consider the explanations for these and whether the evidence provides legitimate reasons for the departure from our benchmark value and for the magnitude of difference.

Wellington Airport's use of actual debt costs from historic portfolio of debt

A80 Wellington Airport considers that the Commission's benchmark cost of debt underestimates Wellington Airport's cost of debt.¹²⁰ Wellington Airport used a weighted average cost of debt for PSE4 of 4.66%, including its actual historic debt portfolio, when developing its firm-specific WACC estimate.

A81 Wellington Airport notes in the pricing disclosure that:¹²¹

A81.1 it estimated its expected weighted average cost of debt based on existing debt costs and expected new issues of debt over PSE4;

A81.2 it had entered the PSE4 period with different forms of debt including fixed rate corporate bonds, floating rate corporate bonds, swaps, drawdowns on bank facilities, and US Private Placement and other debt with an issuance term between seven and 12 years;

A81.3 that it is willing to commit to incorporating actual cost of debt into all future WACC estimates; and

A81.4 it considered the Commission's feedback on Auckland Airport's pricing that Auckland Airport's cost of debt estimate based on its actual costs was "for the most part reasonable" and has taken a similar approach.

A82 Houston Kemp, in its advice to Wellington Airport, also refers to the use of Wellington Airport's existing debt in its weighted average approach to estimating the cost of Wellington Airport's debt over PSE4.¹²²

¹²⁰ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 34.

¹²¹ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), pages 34 to 35.

¹²² See Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 4.

A83 Houston Kemp's report for Wellington Airport also provides a table summarising its approach to estimating Wellington Airport's cost of existing and future debt over PSE4.¹²³

Table A5 Houston Kemp table "Estimated the cost of different debt instruments over PSE4"

Debt Instrument	Cost of existing debt	Cost of new debt	Comments
Fixed rate bonds	Based on the yields of WIAL's existing bonds, plus debt issuance costs.	Base rate + 1.80% which is the Commission's debt premium (2019) for five-year BBB+ debt, plus debt issuance costs. The base rate in the future is estimated for each bond issue using observed forward rates.	Forecasts of new bond issues during PSE4 taken from WIAL's corporate model. WIAL anticipates issuing 10-year corporate debt. Conservatively adopts the debt premium for five years and a BBB+ credit rating, together with the forward rates for 10-year risk free rates. Adopts the Commission's allowance of 20 basis points for debt issuance costs.
Commercial paper	Based on the yields on WIAL's existing commercial paper, plus debt issuance costs	No new commercial paper expected to be issued during PSE4.	Adopts the Commission's allowance of 20 basis points for debt issuance costs.
US dollar private placements	Based on actual costs to WIAL after cross currency swaps plus the average cost of existing swaps.	No new US placements forecast to be issued during PSE4.	

A84 We have not previously accepted use of actual debt costs from a historic portfolio of debt. In general, we consider that the use of actual debt costs would not support the Part 4 purpose statement and especially 52A(1)(b) incentives to improve efficiency.¹²⁴

A85 Consequently, we prefer the benchmark cost of debt approach. We consider that Wellington Airport, rather than its customers, should enjoy the benefits if it is more efficient in its debt raising than the benchmark and bear the costs if not as this is a matter that is largely within the airport's control.

¹²³ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), page 6.

¹²⁴ We recognise that in practice, an actual cost of debt approach would materially diminish rather than eliminate such incentives as the parameters would still be fixed across the control period. We considered an actual cost of debt approach in the Fibre IMs, concluding that a benchmark cost of debt methodology better meets the purpose statement given that it better provides for incentives to invest whilst limiting the ability to extract excessive profits. See for example Commerce Commission "Fibre Input Methodologies – Main final decisions reasons paper" (13 October 2020), paragraphs 6.69 to 6.79.

- A86 We also recognise that within our benchmark cost of debt approach there may be inputs to parameters to reconsider. In relation to this, we acknowledge that an actual cost of debt approach has some similarities to a trailing average cost of debt approach employed by other regulatory authorities overseas.
- A87 However, even if a trailing average approach was evidenced as appropriate in these circumstances, its application would need to be consistent across price setting events to prevent potential windfall gains or losses.¹²⁵ We note that where overseas regulators have applied a trailing average approach, they have used it as an estimate of an efficient benchmark portfolio of debt rather than for actual debt costs of individual companies.¹²⁶ Where these regulators have switched the methodology, they have phased the switch to prevent windfall gains or losses.¹²⁷
- A88 As discussed in the 2010 and 2016 IMs reasons papers, we prefer a simple over a complex approach to estimating the cost of debt for practical reasons, although in principle either can be used.¹²⁸ Our preference for a simple approach is a matter of access to data and information rather than a belief that this is an optimal approach to debt raising. As we do not have the evidence to assess Wellington Airport's more complex approach it is difficult for us to assess its efficiency.¹²⁹
- A89 Finally, we note Wellington Airport's statements on our review of Auckland Airport's PSE3 actual cost of debt proposal.¹³⁰ However, we consider this mischaracterises our views as we found the actual cost of debt approach was not sufficiently justified.
- A89.1 While we agree that we described Auckland Airport's high-level cost of debt approach, based on its actual costs, as "for the most part reasonable", we did not find that a departure from the IM methodology was sufficiently justified. We note that we used our own cost of debt estimate in our assessment of Auckland Airport's profitability.

¹²⁵ We acknowledge Wellington Airport's proposal to incorporate actual cost of debt into all future WACC estimates. Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 34.

¹²⁶ See for example AER "Final decision Jemena distribution determination 2016 to 2020: Attachment 3 – Rate of return" (May 2016), section H.2, pages 280 to 284, sections H.2.1 to H.2.2.

¹²⁷ AER "Final decision Jemena distribution determination 2016 to 2020: Attachment 3 – Rate of return" (May 2016), section H.2, pages 288 to 290, section H.2.3.

¹²⁸ See also Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) reasons paper" (22 December 2010), paragraphs H5.29-H5.43.

¹²⁹ We acknowledge the information that we do have, including in Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019) pages ii and 4 to 7. Also in Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" 1 June 2021, pages 34 to 35, and Wellington International Airport Limited "Revised pricing proposal – For aeronautical prices for the period 1 April 2019 to 31 March 2024" (6 December 2019), page 30.

¹³⁰ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" 1 June 2021, page 35, and Wellington International Airport Limited "Initial Pricing Proposal - For aeronautical prices for the period 1 April 2019 to 31 March 2024" (9 September 2019), pages 68 to 69.

A89.2 We acknowledge that in describing both Auckland Airport's approach and estimate, and our own cost of debt estimate, as reasonable, we generated unintended ambiguity.

A89.3 Auckland Airport's cost of debt estimate was close to our own with a difference of 0.20 percentage points in the cost of debt, and a 0.02 percentage point difference in the overall WACC. This might explain the use of the term 'reasonable' to describe Auckland Airport's approach, even though we ultimately did not find it fully justified.¹³¹

A90 Overall, we consider the reasons and evidence provided are not sufficient to support the departure from the benchmark cost of debt approach to the use of Wellington Airport's actual debt costs from its historic portfolio of debt. We recognise that our assessment for Wellington Airport's cost of debt is in the context of this PSE. Some issues raised may be considered more widely as part of the 2023 IM review, and we welcome submissions of evidence of these issues in our IM review process.

A91 In the sections below, we consider adjustments to parameters within our benchmark cost of debt approach.

Wellington Airport's use of a BBB+ credit rating

A92 Our benchmark cost of debt approach uses an S&P A- credit rating assumption for the debt premium estimate as stated in the IMs.¹³²

A93 Wellington Airport has used a BBB+ credit rating assumption in forming its complex debt cost estimate.

A93.1 Houston Kemp, in its advice to Wellington Airport, assumes a BBB+ credit rating debt in the cost of new fixed rate debt raised during PSE4 for five-year corporate bonds.¹³³

A93.2 Wellington Airport in its pricing disclosure notes that it had it had a credit rating of BBB+/Stable rather than the assumed credit rating of A-.¹³⁴

A94 In general, we have some concerns with using a supplier's actual credit rating when estimating its debt premium in the regulatory context.

¹³¹ Commerce Commission "Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022) - Final report" (1 November 2018), paragraph 216.

¹³² Commerce Commission "Input methodologies review decisions - Topic paper 4: Cost of capital issues" (20 December 2016), paragraph 250.2.

¹³³ Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), Table 3, page 6.

¹³⁴ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 34.

- A95 In the 2016 IM Review, we noted that we specify a notional benchmark credit rating when estimating the debt premium because “if suppliers’ actual credit ratings were used, there may be an incentive for them to increase leverage, leading to adverse implications for consumers”.¹³⁵
- A96 In our 2010 IM reasons paper we noted that excessive levels of debt are not in the long-term interests of consumers, because there are potentially significant costs and risks to consumers if a supplier becomes financially distressed. For example, a supplier in financial distress may curtail maintenance spending or reduce or defer efficient investment in network assets. This, in turn, may adversely affect the quality and reliability of service experienced by consumers.¹³⁶
- A97 S&P’s minimum long-term credit rating that is considered investment grade is BBB-. In the regulatory context, we consider that the credit rating should provide a sufficient margin above the minimum required for investment grade and therefore be estimated by reference to a bond with a S&P long-term credit rating no lower than BBB (or equivalent rating from another recognised credit rating agency).
- A98 In this case, we note in relation to Wellington Airport’s BBB+ credit rating assumption that:
- A98.1 Wellington Airport’s actual credit rating as at 1 April 2019 of BBB+ is still an adequate investment grade rating, and is sufficiently high to ensure there is an adequate buffer against the possibility that economic downturns or shocks lead to financial distress (while providing some flexibility over the level of gearing and the choice of debt instruments);
- A98.2 Wellington Airport’s BBB+ credit rating appears to be consistent with a prudent level of debt financing;¹³⁷
- A98.3 BBB+ is consistent with the benchmark credit rating we use for regulated electricity lines and gas pipelines businesses; and
- A98.4 a debt premium uplift consistent with a BBB+ rating appears to have been accepted by airlines.
- A99 We consider there are legitimate reasons to depart from the A- benchmark credit rating in these specific circumstances and consider a BBB+ credit rating appropriate.

¹³⁵ Commerce Commission “Input methodologies review decisions - Topic paper 4: Cost of capital issues” (20 December 2016), paragraph 252.

¹³⁶ Commerce Commission “Input methodologies (airport services): Reasons paper” (December 2010), paragraph 6.3.21.

¹³⁷ We note that Houston Kemp’s report stated that Wellington Airport’s states debt gearing ratio over PSE4 was forecast to increase. Houston Kemp “WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd” (July 2019), page 7.

A100 To implement this BBB+ adjustment we have adopted the 1.60% debt premium assumption used in Houston Kemp’s report.¹³⁸

A101 For the 1.60% debt premium assumption we note that:

A101.1 1.60% is close to Wellington Airport’s actual debt premium (1.58%) on its qualifying 5-year bond as at 1 April 2019;¹³⁹ and

A101.2 1.60% is consistent with the benchmark debt premium estimate we use for regulated electricity lines (as at 1 April 2019), where the DPRY 2019 estimate was 1.60% and the average debt premium across the five years was 1.63%, resulting in the benchmark debt premium estimate of 1.63%;¹⁴⁰ and

Table 4: Average debt premium for EDBs (%)

	DPRY 2015	DPRY 2016	DPRY 2017	DPRY 2018	DPRY 2019	Average
Debt premium	1.76	1.59	1.59	1.63	1.60	1.63

A101.3 Houston Kemp’s 1.60% assumption is consistent with the single DPRY 2019 estimate from the EDB WACC determination of 1 April 2019, whereas our benchmark approach uses a five-year average, which for EDBs is 1.63%.

A102 Our estimate of the appropriate debt premium for EDBs is 1.63% (as at 1 April 2019) and is based upon our EDB bond hierarchy, which differs to our airport bond hierarchy. Both hierarchies are available in our determinations.¹⁴¹

A103 Houston Kemp has proposed a 1.60% assumption and our airports bond hierarchy is supportive of this.¹⁴² We note that no conclusions on the overall WACC turn on

¹³⁸ We note that Houston Kemp refers to 1.80% as the combination of the “Commission’s debt premium (2019) for five-year BBB+ debt” plus the “Commission’s allowance of 20 basis points for debt issuance costs”. Houston Kemp “WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd” (July 2019), page 6.

¹³⁹ See for example, *Commerce Act Cost of capital determination for disclosure year 2020 for information disclosure regulation - Electricity distribution businesses and Wellington International Airport [2019] NZCC 7*, Table 5, page 6.

¹⁴⁰ Commerce Commission, “Commerce Act Cost of capital determination for disclosure year 2020 for information disclosure regulation - Electricity distribution businesses and Wellington International Airport [2019] NZCC 7”, page 5.

¹⁴¹ See *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 (as of 31 January 2019), clauses 2.4.4(7)-(8)(a). See *Commerce Act (Airport Services Input Methodologies) Determination 2010* [2016] NZCC 28 (as of 20 December 2016), clauses 5.4(7)-(8)(a).

¹⁴² See clauses 5.4(7)-(8)(a) of the Airports IM determination. *Commerce Act (Airport Services Input Methodologies) Determination 2010* [2016] NZCC 28 (as of 20 December 2016). See also Commerce Commission “Guidelines for WACC determinations under the cost of capital input methodologies” (27 May 2021), paragraphs 52 to 55.

whether a debt premium of 1.60% or 1.63% is used and the difference between these estimates on the overall midpoint post-tax WACC is 0.004 percentage points.¹⁴³

A104 In our view, the available evidence suggests the BBB+ assumption and the higher debt premium estimate of 1.60% are reasonable in Wellington Airport's specific circumstances and appear to be consistent with prudent levels of debt financing.

Wellington Airport's use of a longer-term portfolio of debt and risk-free rate

A105 In our benchmark approach to cost of debt, the risk-free rate is estimated from the observed market yield to maturity of New Zealand Government bonds with a term to maturity that matches the typical term of Airports' pricing agreements of five years.¹⁴⁴

A106 Wellington Airport's approach has different assumptions for the cost of existing bonds and the cost of new bonds. For the cost of existing bonds, we presume the approach uses the actual tenor of debt from Wellington Airport's existing portfolio of bonds (see Table A5, "Fixed rate bonds" and "Cost of existing debt"). For the cost of new bonds, Wellington Airport's approach assumes observed forward rates for 10-year risk-free rates (see Table A5, "Fixed rate bonds" and "Cost of new debt" and "Comments").¹⁴⁵

A107 In principle we consider that the term of the risk-free rate should be matched to the term of the pricing period. We have considered this in depth multiple times, including in 2010 and 2016 and in our Fibre IMs.¹⁴⁶

A108 In our view, the evidence supporting a departure from the five-year risk-free rate estimate is incomplete.

¹⁴³ The vanilla WACC of 5.91% and the post-tax WACC of 5.72% do not change for debt premiums of 1.60% and 1.63% (when rounding WACC to two decimal places).

¹⁴⁴ Under our IMs methodology, we estimate the risk-free rate and debt premium as part of publishing annual WACCs for all regulated suppliers. The risk-free rate is estimated from the observed market yield to maturity of benchmark vanilla New Zealand Government NZ\$ denominated nominal bonds with a term to maturity that matches the typical term of Airports' pricing agreements (five years). See Commerce Commission "Guidelines for WACC determinations under the cost of capital input methodologies - Regulation under Part 4 of the Commerce Act 1986 and Part 6 of the Telecommunications Act 2001" (27 May 2021), paragraphs 33 to 62; and see Commerce Commission "Input methodologies review decisions - Topic paper 4: Cost of capital issues" (20 December 2016), paragraphs 34 to 40.

¹⁴⁵ See Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), Section 3.1.1. at pages 5 to 6, including "Comments" in Table 3 "fixed rate bonds".

¹⁴⁶ See Commerce Commission "Input methodologies (airport services) - Reasons paper" (22 December 2010), paragraph 6.3.6 and 6.3.9. See Commerce Commission "Input methodologies review decisions - Topic paper 4: Cost of capital issues" (20 December 2016), paragraph 536. See also our Fibre IMs for a related discussion, Commerce Commission "Fibre Input Methodologies – Main final decisions reasons paper" (13 October 2020), paragraphs 6.13 to 6.139.4, and 6.142 to 6.159.

Wellington Airport's use of longer-term debt and debt premium

- A109 We use a five-year estimate for the original term of the debt premium in our benchmark approach to cost of debt.¹⁴⁷
- A110 The evidence provided indicates that Wellington Airport's approach to estimating fixed rate debt reflects longer-term debt. We note the original tenor of existing debt ranges between seven and 12 years,¹⁴⁸ and based on evidence provided by Wellington Airport we have used the term of approximately 8 years.¹⁴⁹
- A111 We acknowledge Wellington Airport's statements that:¹⁵⁰
- A111.1 it looked to optimise its funding in the low interest environment by issuing longer-term debt instruments (eg, its March 2019 issue of 11-year retail bonds) in accordance with sound treasury practice for businesses with long life assets; and
- A111.2 it issued \$100 million of 11-year bonds on 1 April 2019 and that while these bonds were longer dated than the Commission's 5-year approach, the minimum coupon required by the market at the time was 4% which was above the cost of debt assumption included in the Commission's WACC (published as at 1 April 2019).
- A112 We also note BARNZ's support for a small uplift for term credit spread of longer-term debt alongside general concerns with Wellington Airport's approach, according to Wellington Airport.¹⁵¹
- A113 When considering the approach taken by Wellington Airport, we have previously recognised that the issuance of longer-term debt may provide long-term benefits to consumers due to reduced refinancing risks, and that the longer tenor of debt may imply a higher debt premium than our mid-point estimate provides for.¹⁵² As we

¹⁴⁷ We estimate the debt premium as the difference between the risk-free rate and the yield on publicly traded corporate bonds for Airports with a Standard and Poor's long-term credit rating of A- and a term to maturity which matches the pricing period (typically five years). See Commerce Commission "Guidelines for WACC determinations under the cost of capital input methodologies" (27 May 2021), page 16.

¹⁴⁸ See Houston Kemp's comments including that Wellington Airport "issues corporate debt with a term at issuance of between seven and 12 years", and "Comments" in Table 3 "fixed rate bonds". Houston Kemp "WACC and target rate of return for PSE4: A report for Wellington International Airport Ltd" (July 2019), Section 3.1.1. at pages 5 to 6.

¹⁴⁹ Wellington Airport: "Submission of Wellington Airport PSE4 review – Debt Tenor" (10 June 2022) [CONFIDENTIAL]

¹⁵⁰ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), pages 34 to 35.

¹⁵¹ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 35.

¹⁵² Commerce Commission "Input methodologies review decisions: Topic Paper 4: Cost of capital issues" (December 2016), paragraph 897.3. Commerce Commission "Input methodologies (airport services) - Reasons paper" (22 December 2010), paragraph 6.3.29.

noted in the 2010 IM Reasons Paper, the greater debt premium on long-term debt cannot be economically removed through the swap market in the way the risk-free rate can be swapped.¹⁵³ The firm continues to bear the greater debt premium on longer-term debt.¹⁵⁴

A114 Therefore, we agree 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.¹⁵⁵

A115 To assess whether additional compensation would be appropriate for Wellington Airport we needed to determine, based on evidence provided by Wellington Airport, whether its average original term of debt is longer than 5 years, and to what extent. The evidence provided indicates that the weighted average term of Wellington Airport's portfolio of debt is longer than 5 years.¹⁵⁶

A116 We evaluated the evidence submitted by Wellington Airport on the length of their average debt term. We found the average term to be up to around 8 years.¹⁵⁷ We agree that issuing longer term debt can be prudent for suppliers to manage their funding costs, so we have allowed for the increased term to be taken into account within the debt premium.¹⁵⁸

A117 We have also taken account of the longer debt term for debt issuance costs in our assessment.

Our debt premium estimates for longer tenor debt under the BBB+ credit rating assumption

A118 The 2016 IM Review evidence showed that a term credit spread differential (TCSD) premium was not required for airports issuing debt with original tenors longer than 5 years. However, some additional compensation may be appropriate for airports under the alternative BBB+ assumption.

¹⁵³ As we noted in the 2016 IM Review, there is no practical way to hedge the debt premium in New Zealand (ie, there is no significant credit default swap market). Commerce Commission "Input methodologies review decisions - Topic paper 4: Cost of capital issues" (20 December 2016), paragraph 139.

¹⁵⁴ Commerce Commission "Input methodologies (airport services) - Reasons paper" (22 December 2010), paragraphs 6.3.27 to 6.3.29.

¹⁵⁵ In practice we allow additional compensation in Part 4 on qualifying debt of energy businesses through the TCSD, although not for airports. See Commerce Commission "Input methodologies review decisions: Topic Paper 4: Cost of capital issues" (December 2016), paragraphs 52 to 54, 172, 176.

¹⁵⁶ Wellington Airport: "Submission of Wellington Airport PSE4 review – Debt Tenor" (10 June 2022) [CONFIDENTIAL]

¹⁵⁷ We have looked to estimate the average debt term of the years 2015 to 2019 on a financial year basis (1 April to 31 March). Wellington Airport only provided evidence on the debt term of 2019 from these years. This evidence gives an average debt term of around 8 years. We note that the WIA060 retail bond issued on 1 April 2019 would have increased the average debt term but was outside the period analysed.

¹⁵⁸ We have applied a TCSD premium adjustment and have cross-checked the results with those from the NSS curve which produces a similar sized premium.

A118.1 In 2016 we found, for airports, that the decrease in debt issuance costs offset the debt premium increase from longer term debt. We therefore decided not to apply a TCSD allowance for airports because we found that based on the evidence at the time, the lower debt issuance cost and higher debt premium, both for longer term debt, would cancel each other out.¹⁵⁹ This was based on a A- credit rating.

A118.2 In order to establish whether additional compensation can be appropriate for Wellington Airport under the alternative BBB+ assumption, we have examined the Nelson-Siegel-Svensson (**NSS**) curve for BBB+ rated bonds for five and ten-year terms to maturity, where:¹⁶⁰

A118.2.1 we have estimated annual debt premiums as at 1 April of each year from 2015 to 2019, for example, for the 2019 estimate this is the 12 months up until 1 April 2019 (1 April 2018 to 31 March 2019), and then averaged these;

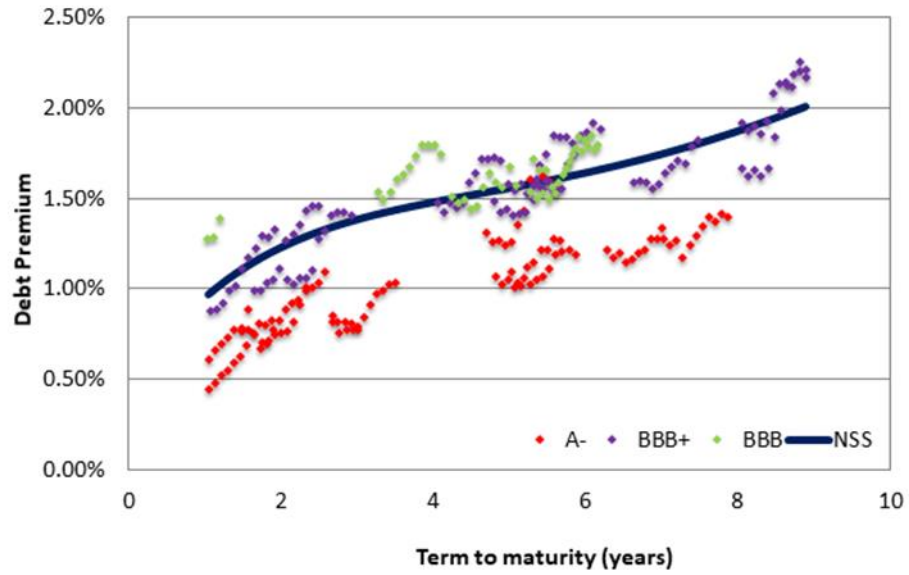
A118.2.2 we note there is some extrapolation of the NSS functional form in our NSS estimates of the 10-year term to maturity, particularly as there are few qualifying bonds with terms to maturity beyond nine years, as shown below;¹⁶¹ and

¹⁵⁹ Commerce Commission “Input methodologies review decisions - Topic Paper 4: Cost of capital issues” (20 December 2016), paragraphs 190 to 192, and 916.

¹⁶⁰ The NSS approach uses the target credit rating (in this case BBB+) and takes one credit rating either side of the target credit rating, taking into account the average difference in debt premium for each credit rating based on the NSS functional form. That is, the sample only includes bonds with credit ratings of BBB+, BBB and A-, which we consider to be the most relevant comparators for our target credit rating. For more information see Commerce Commission “Input methodologies review decisions - Topic paper 4: Cost of capital issues” (20 December 2016), Attachment D.

¹⁶¹ The chart shows our NSS curve for the 2015 debt premium estimate (we have NSS curves for each year 2015 to 2019) where there is little bond data beyond the eight-year term.

Figure A1 NSS debt premium estimate 2015 (BBB+ rated bonds)



A118.2.3 we note that the NSS curve approach does not apply a weight to any bonds, including no extra weighting on airports bonds.¹⁶²

A119 Our NSS estimation indicates room for an increase by up to 0.5 percentage points less 0.1 percentage points for lower debt issuance costs, 0.4 percentage points in total.

A119.1 We note that the 0.5 percentage points is the difference we observe on the NSS curve between the estimated debt premiums for 5- and 10-year original tenor bonds with a BBB+ rating. Our estimated debt premiums for the five- and 10-year tenor lengths are in the table below.¹⁶³

Table A6 Estimated debt premiums by tenor length for BBB+ rated bonds

Term to maturity	Average NSS debt premium estimate 2015-2019
5-years	1.57%
10-years	2.07%

¹⁶² We explain our NSS approach further in our WACC Guidelines, see Commerce Commission “Guidelines for WACC determinations under the cost of capital input methodologies” (27 May 2021). We have regard to this approach when reaching our final estimate of the debt premium for the relevant DPRY in our WACC determinations.

¹⁶³ For the 5-year term to maturity of 1.57%, we have estimated and averaged the following values: 1.56% for 2015, 1.49% for 2016, 1.65% for 2017, 1.55% for 2018, 1.61% for 2019. For the 10-year term to maturity of 2.07%, we have estimated and averaged the following values: 2.20% for 2015, 2.03% for 2016, 2.09% for 2017, 1.86% for 2018, 2.15% for 2019.

A119.2 We also note that the 0.1 percentage points is the downward adjustment on debt costs for bonds with an original tenor length of 10 years, based on evidence from the 2016 IM Review (see the table below).¹⁶⁴

Table A7 TCSD adjustment for different original tenor lengths (EDBs, GPBs and Transpower) from the 2016 IM Review

Tenor	5	6	7	8	9	10
Spread premium	0.00%	0.075%	0.15%	0.225%	0.30%	0.375%
Debt issuance adjustment	0.00%	-0.03%	-0.06%	-0.07%	-0.09%	-0.10%
TCSD premium	0.00%	0.05%	0.09%	0.16%	0.21%	0.28%

A119.3 By comparison, the overall TCSD adjustment (including the downward adjustment on debt issuance costs) used for other regulated companies with 10 year debt and a BBB+ credit rating is 0.28 percentage points, and for 7 year debt and a BBB+ rating is 0.09 percentage points, based on the fuller evidence from the 2016 IM Review.¹⁶⁵

Conclusion regarding Wellington Airport's cost of debt

A120 We agree that issuing longer term debt can be prudent for suppliers to manage their funding costs, so we have allowed for the increased term to be taken into account in the estimate of the debt premium. The lower end of the range, 1.60%, reflects the benchmark 5-year term for a BBB+ credit rating, while the upper end of the range, 1.78%, reflects the same credit rating with an approximately 8-year debt tenor. We consider that the evidence suggests this debt premium estimate range of 1.60-1.78% is reasonable.

A121 We note that most submitters supported our approach to Wellington Airport's debt premium.¹⁶⁶ Wellington Airport maintained its view that its debt tenor justified a higher debt premium.¹⁶⁷

A122 Adopting the reasonable range for the debt premium of 1.60-1.78%, and adjusting for lower debt issuance costs associated with the longer debt tenor at the upper end of the range, results in an updated cost of debt range of 3.57% to 3.75%.

¹⁶⁴ Commerce Commission "Input methodologies review decisions: Topic Paper 4: Cost of capital issues" (20 December 2016), table 39.

¹⁶⁵ Commerce Commission "Input methodologies review decisions: Topic Paper 4: Cost of capital issues" (20 December 2016), table 39.

¹⁶⁶ Submissions received from Air New Zealand and BARNZ (supported by Qantas) support the Commerce Commission's view on Wellington Airport's cost of debt. Air New Zealand: "Submission on review of Wellington Airport's price setting event consultation paper" (13 June 2022), page 1, BARNZ: "Submission on review of Wellington Airport's price setting event consultation paper" (10 June 2022), paragraph 15, and Qantas: "Submission on Wellington Airport price setting event review" (14 June 2022).

¹⁶⁷ Wellington Airport: "Wellington Airport price setting event review – submission" (10 June 2022).

Our conclusion regarding Wellington Airport's cost of capital

- A123 Our view is that Wellington Airport's estimate of its cost of capital of 6.08% has not been sufficiently justified.
- A124 Overall, we accept in principle that it could be higher than our mid-point estimate of 5.67% but we lack the information to know by what magnitude. Nonetheless we have taken this into account in our assessment of targeted profitability in Chapter 2.
- A125 We have adjusted our post-tax mid-point WACC estimate to reflect what we consider to be the reasonable range of estimates of the cost of debt. The range represents the reasonable tenor of debt of 5-years to around 8-years. This results in an updated cost of debt range of 3.57% to 3.75% and a post-tax mid-point WACC range of 5.72% to 5.74%.
- A126 We also consider there are some reasons why our cost of equity may be a conservative estimate. While we accept in principle that operating leverage and traffic mix can impact airport systematic risk and therefore asset beta, we find further evidence is required in both areas.

Table A8 Our WACC estimate compared to parameter variations described in Wellington Airport's pricing disclosure

Parameter	Our benchmark - Airports ID WACC estimate (as at 1 April 2019) (1.24% for A- credit rating)	Varying debt premium only – Houston Kemp assumption in actual cost of debt (1.60% for BBB+ credit rating)	Wellington Airport's stated WACC (1 April 2019) (cost of debt 4.66%, asset beta 0.63)	Varying debt premium only – WACC estimate (as at 1 April 2019) based on a BBB+ credit rating and a debt term range of 5 to ~8 years
Risk-free rate	1.77%	1.77%	1.77%	1.77%
Average debt premium	1.24%	1.60%	n/a	1.60% - 1.78%
Leverage	19%	19%	19%	19%
Asset beta	0.60	0.60	0.63	0.60
Debt beta	–	–	–	–
TAMRP	7.0%	7.0%	7.0%	7.0%
Corporate tax rate	28%	28%	28%	28.0%
Investor tax rate	28%	28%	28%	28.0%
Debt issuance costs	0.20%	0.20%	0.20%	0.20%
Equity beta	0.74	0.74	0.78	0.74
Cost of equity	6.46%	6.46%	6.72%	6.46%
Cost of debt	3.21%	3.57%	4.66%	3.57% - 3.75%
Vanilla WACC (mid-point)	5.84%	5.91%	6.33%	5.91% - 5.94%
Post-tax WACC (mid-point)	5.67%	5.72%	6.08%	5.72% - 5.74%

Table A9 WACC estimates and Wellington Airport's stated target returns

	Commission's mid-point WACC for Wellington Airport (as at 1 April 2019)	Wellington Airport's estimated WACC ¹⁶⁸ (as at 1 April 2019)	Wellington Airport's Target rate of return on pricing assets (commercial compromise) ¹⁶⁹	Wellington Airport's Stated actual return on pricing assets PSE4 ¹⁷⁰	Wellington Airport's Overall targeted return on total regulated assets ¹⁷¹	Commission's revised WACC estimate range (1.60% to 1.78% debt premium)
Mid-point vanilla WACC	5.84%	6.33%				5.91% to 5.94%
Mid-point post-tax WACC	5.67%	6.08%	5.93%	5.43%	5.88%	5.72% to 5.74%

¹⁶⁸ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 33. On page 11 Wellington Airport indicates this 6.08% was the PSE4 target return in its IPP of September 2019 and RPP of December 2019.

¹⁶⁹ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), pages 8, 10 to 11, 13, and 36 to 37. Wellington Airport notes "WIAL's WACC for PSE4 is 6.08% (our information on how this WACC was determined is provided in our comments on clause 2.5(1)(c)(ii)), although following consultation WIAL adopted a lower target return of 5.93% for its pricing activities. This brought WIAL's return more in line with that advocated by airlines". Wellington Airport indicates this 5.93% has been the PSE4 target return since the FPD in April 2020.

¹⁷⁰ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 13. Wellington Airport notes "The post-tax return on pricing assets of 5.93% over PSE4 has been applied using the Commission's Internal Rate of Return (IRR) calculation. A portion of revenue has been deferred for collection in PSE5, which reduces WIAL's actual return on pricing assets over PSE4 to 5.43%."

¹⁷¹ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 13. "WIAL notes that its overall targeted return on total regulated assets is 5.88% post tax. This is lower than both its WACC and target return on pricing assets, because the returns from its non-pricing activities are below those on its pricing assets."

Attachment B Profitability modelling considerations

Purpose of this attachment

- B1 This attachment describes aspects of the approach we have taken to modelling Wellington Airport’s profitability, including estimating its IRR over PSE4.
- B2 This includes discussion of:
- B2.1 the differences between Wellington Airport's price setting event disclosure, and our modelling which is consistent with the IMs; and
 - B2.2 our treatment of the carry forward adjustments when estimating the profits of Wellington Airport over PSE4, using our midpoint WACC and reasonable return estimates.

Differences between Wellington Airport's price setting event disclosure, and our modelling

- B3 We have modelled Wellington Airport’s profitability in a manner consistent with the IMs, using the information the airport has provided to us as part of its price setting event. This has resulted in two minor differences between Wellington Airport's price setting event disclosure, and our modelling of Wellington Airport's IRR over PSE4, with the differences in targeted return shown in Table B1 below.

Table B1 Differences in target return

Target return over	Reported by Wellington Airport in pricing disclosure ¹⁷²	As modelled by Commission
Total RAB	5.88%	5.90%
Pricing assets only	5.93%	5.88%

- B4 These two differences are in the treatment of tax on Wellington Airport's long term noise mitigation project, and the values for the opening and closing carry forward adjustments used in IRR calculations. These are discussed below.

Tax treatment on Wellington Airport's long term noise mitigation project

- B5 Wellington Airport established a separate company, Wellington Airport Noise Treatment (**WANT**) Limited, to administer its noise mitigation obligations.¹⁷³

¹⁷² Wellington International Airport Limited “WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024” (1 June 2021), page 13.

¹⁷³ Wellington International Airport Limited “WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024” (1 June 2021), page 19.

Wellington Airport then used a stand-alone building block model to determine the revenue required.

- B6 Wellington Airport sought and received a binding ruling from the IRD regarding the tax treatment of house removal and noise mitigation costs associated with WANT Limited.¹⁷⁴ Its building block model reflects what the airport is forecasting its actual tax obligation to be, factoring in the impact of the binding ruling. In FY2020 it also uses the actual tax outcome from its audited accounts.
- B7 Our profitability model uses our default calculation of unlevered tax, without reflecting this binding ruling (nor the actual tax outcome for FY2020). We have not included these changes at this time, as accounting for the relatively small difference requires several structural changes to our model. The result is that the unlevered tax that we calculate is a smaller cash outflow within our profitability model and IRR calculations than what Wellington Airport forecasts within its building block model, thereby slightly increasing the IRR in comparison to Wellington Airport’s reported target return.
- B8 Note that the difference in unlevered tax impacts the calculation of return on the total RAB but does not impact the calculation of the return on pricing assets only, as the noise mitigation project is not a pricing activity.

Differences in the opening and closing carry forward adjustments

- B9 In Wellington Airport’s price setting disclosure, the opening and closing carry forward adjustments reported for its total RAB relate to its pricing asset base only. The closing carry forward adjustments are also in nominal terms, rather than in present value terms. This results in the difference in carry forward adjustments shown in Table B2 below.

Table B2 Difference in carry forward adjustments¹⁷⁵

	Total RAB	Pricing asset base only	Difference
Opening carry forward adjustment	\$10.003m	\$9.224m	\$0.779m
Closing carry forward adjustment reported by Wellington Airport	\$5.002m	\$4.612m	\$0.389m
Closing carry forward adjustment used in our modelling	\$6.485m	\$5.980m	\$0.505m

- B10 When calculating the IRR for Wellington Airport, we have used the opening and closing carry forward adjustments for the total RAB and pricing asset base as

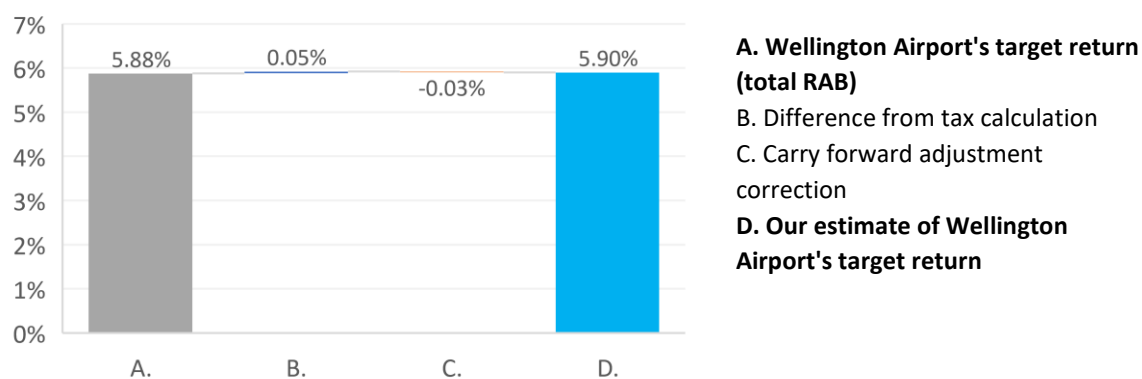
¹⁷⁴ Wellington International Airport Limited “Final Pricing Document – Pricing to apply to identified airport activities from 1 June 2014” (30 June 2014), page 87.

¹⁷⁵ Wellington International Airport Limited “Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024 – Schedules 18, 19 and 20” (1 June 2021).

appropriate, and for closing carry forward adjustments we have used values in present value terms rather than nominal. This has the effect of slightly decreasing the IRR, compared to Wellington Airport's reported target return.

B11 Figure B1 below shows the impact of the differences between Wellington Airport's reported target return on its total RAB and our IRR calculation.

Figure B1 Impact of differences between Wellington Airport's reported target return and our IRR calculation¹⁷⁶



Our treatment of the carry forward adjustments when estimating the profits of Wellington Airport over PSE4

B12 In order to estimate the forecast profits of Wellington Airport over PSE4, we account for the revenue deferral described at paragraph 142, and the historical revaluation deficit described in paragraph 148.

B13 We allocate the carry forward adjustment for the historical revaluation deficit evenly across each year of the PSE4 pricing period, at its present value. The carry forward adjustment for the revenue deferral is used as reported at the end of the period, as it has already been discounted to the end of the PSE4 period by Wellington Airport in its pricing disclosure.

B14 In calculating the forecast total revenue requirement that would achieve our midpoint WACC and reasonable return estimates, we treat the carry forward adjustments as we would a revaluation gain. This reduces the forecast revenue required in a given year to achieve the midpoint WACC or reasonable return across the pricing period.

¹⁷⁶ Wellington International Airport Limited "WIAL Price Setting Event Disclosure for the Period 1 April 2019 to 31 March 2024" (1 June 2021), page 13.

Attachment C Glossary

Acronym/abbreviation	Meaning
AAA	Airport Authorities Act 1966
ACCC	Australian Competition & Consumer Commission
AirNZ	Air New Zealand
Airports IMs	IMs for specified regulated airport services
the Act	Commerce Act 1986
BARNZ	Board of Airline Representatives New Zealand, Incorporated
Capex	Capital expenditure
CPI	Consumer price index
EBIT	Earnings before interest and tax
ID	Information disclosure
IM	Input methodology
IRR	Internal rate of return
MCTOW	Maximum certified take-off weight
Mppa	Million passengers per annum
MVAU	Market value alternative use
MVEU	Market value existing use
Opex	Operating expenditure
PSE	Price setting event
PSE4	Fourth price setting event (1 April 2019 to 31 March 2024)
PSE5	Fifth price setting event
PV	Present value
Qantas	Qantas group of companies, including Jetstar
RAB	Regulated asset base
TCSD	Term credit spread differential
TDB	TDB Advisory
WACC	Weighted-average cost of capital
WANT	Wellington Airport Noise Treatment (Limited)
Wellington Airport	Wellington International Airport Limited