

Further work on the cost of capital input methodologies for airports

Proposal to consider the WACC percentile for airports as part of the input methodologies review

Date: 27 February 2015

Purpose of this paper

1. This paper seeks your views on a proposal that we should discontinue the amendment process on the WACC percentile for airports, which we commenced last year, and consider this issue as part of our proposed review of input methodologies under section 52Y of the Commerce Act 1986 (the Act).

We propose to consider the WACC percentile for airports as part of the input methodologies review

2. Last year we commenced a process to consider amending the WACC percentile for services regulated under Part 4 of the Act as a stand-alone process. We completed that process in respect of electricity lines and gas pipeline services, but not for specified airport services.
3. We have issued an open letter to interested parties inviting feedback on the proposed timing, scope and focus of our statutory review of input methodologies under section 52Y of the Act.¹ In particular, we propose commencing the statutory review of input methodologies shortly, with the aim of completing that review by December 2016.
4. Given the proposed timing of the input methodologies review, we propose discontinuing the stand-alone amendment process on the WACC percentile for airports, and instead suggest that we review the WACC percentile as part of the input methodologies review. We seek to complete this input methodologies review by December 2016, which should provide sufficient time for any changes to be considered by Auckland and Christchurch airports prior to resetting their prices (due July 2017).

Background and context

We previously issued a notice of intention to amend the WACC percentile used in the input methodologies

5. We issued a notice of intention to do further work on the cost of capital input methodologies for electricity distribution businesses, gas pipeline businesses, Transpower, and specified airport services, on 31 March 2014. The decision to publish the notice of intention was made after seeking views from interested parties on whether to review or amend the cost of capital input methodologies.²

¹ Commerce Commission "Open letter on our proposed scope, timing and focus for the review of input methodologies" (27 February 2015).

² Commerce Commission "Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies" (20 February 2014). The submissions are on our website at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/further-work-on-wacc/>.

What we were trying to achieve by amending the WACC percentile

6. That amendment process for the cost of capital input methodologies was limited to the WACC percentile, and was intended to address the High Court's concerns in its judgment in the merits appeals of the input methodologies regarding our use of the 75th percentile (rather than the mid-point) WACC estimate when setting price-quality paths. The Court questioned whether empirical and theoretical evidence sufficiently justified our use of the 75th percentile.³
7. We considered the Court's comments questioning the appropriateness of the WACC percentile uplift could undermine the investment incentives the uplift was intended to promote. As a result we were concerned that consumers could be paying prices reflecting the use of the 75th percentile, but be getting no benefit from this in terms of stronger incentives on suppliers to invest. Therefore, we needed to consider possible amendments to the WACC percentile in time to allow a revised WACC to be used to set the price-quality paths for electricity lines and gas pipeline services.
8. The WACC percentile amendment process included a consideration of the appropriate WACC range for electricity lines and gas pipeline services under information disclosure regulation, and for airports.

We subsequently separated airports from the amendment process because there were airport-specific issues to consider

9. A number of airport-specific matters were raised by interested parties. Given the time-constraints due to the impending price-quality path resets for electricity, the Commission prioritised a reconsideration of the WACC percentile in relation to electricity lines and gas pipeline services, and deferred its consideration in relation to airports.⁴ In December 2014 we proposed to issue a process update in respect of the WACC percentile for airports in the first quarter of 2015.

We now propose to review all input methodologies by December 2016

10. We are proposing to commence the review of input methodologies shortly with the aim of completing that review by December 2016. We see benefit in completing the review by that date so that the reset of price-quality paths for gas pipeline businesses (due May 2017) can be based on the reviewed input methodologies. As we propose to undertake a cross-sector review of input methodologies, we propose to seek to complete the review of all input methodologies, including for airports, by the same date.
11. Completing the input methodologies review by December 2016 should provide sufficient time for any changes that are applicable to airports, to be taken into account prior to the Auckland and Christchurch airport price-setting events in 2017.

³ *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC [11 December 2013], paragraphs 1448-1487.

⁴ Commerce Commission "Further work on cost of capital input methodologies: Process Update" (23 June 2014). The WACC percentile applicable to price-quality regulation was determined on 30 October 2014, the WACC range for information disclosure for energy services was determined on 12 December 2014.

Submissions already received on the WACC percentile for airports

12. We acknowledge the submissions already received from interested parties during the amendment process for the WACC percentile for airports. If, following consideration of your views on this paper, we do conclude the WACC percentile for airports should be considered as part of the input methodologies review, those previous submissions can be included on the formal record for that review.
13. NZ Airport Association (NZAA) suggested that the appropriate place to address this issue was through the review of input methodologies.⁵ Given our proposed timing of the input methodologies review, we agree. NZAA also submitted that the Court endorsed our current approach to the WACC range.⁶ However, we consider that our decision on the appropriate percentile should be reviewed during the input methodologies review, drawing on additional analysis and evidence available since 2010 and provided during the review.
14. BARNZ⁷ and Air New Zealand⁸ argued that the Commission should undertake its review as a matter of urgency. We note that our proposal is to begin the input methodologies review soon.

Next steps

15. This section explains how to provide your views on our proposed process.

We will consider all feedback as part of our process for the input methodologies review

16. Responses to this paper will be considered to be submissions on our “Open letter on our proposed scope, timing and focus for the review of input methodologies” which was also published today. That open letter can be found at:

<http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/amendments-and-clarifications/>.

17. After we have considered comments on these two papers, we will decide on the scope and timing for the review of input methodologies. The next steps for that review are provided in the open letter.

⁵ Submission by NZ Airports, *Further work on the cost of capital input methodologies: Response to invitation to provide evidence on the WACC percentile*, 5 May 2014, paragraph 77.

⁶ Submission by NZ Airports, *Further work on the cost of capital input methodologies: Response to invitation to provide evidence on the WACC percentile*, 5 May 2014, para 35(a).

⁷ BARNZ, Letter to the Commission, 23 December 2013.

⁸ Air New Zealand, *Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies*, 13 March 2014, p.2.

How you can provide your comments

18. Please provide your comments on this paper by **5pm, Friday 20 March 2015**.
19. Comments should be addressed to:

Keston Ruxton (Manager, Market Assessment and Dairy, Regulation Branch)
c/o regulation.branch@comcom.govt.nz
20. We prefer to receive your comments in both MS Word and PDF file formats.
21. Please use as the subject line of your email, "Comments on proposed review of input methodologies".