

Report on the effectiveness of information disclosure regulation at Wellington Airport



Briefing for financial market analysts

8 February 2013

Overview

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

Our task under s 56G

- Report to Ministers on how effectively information disclosure (ID) regulation is promoting the purpose of Part 4 of the Commerce Act
- Report must be made 'as soon as practicable' after prices set in or after 2012
 - We will provide further advice to Ministers if the airports' IM merits appeals are successful
- We did not consider other types of regulation for Wellington Airport
- The effectiveness of ID regulation at Auckland and Christchurch airports will be considered in separate reports using a consistent approach

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

To promote the long-term benefit of consumers by promoting outcomes that are consistent with outcomes produced in workably competitive markets such that suppliers of regulated airport services –

- (a) have incentives to innovate and invest, including in replacement, upgraded, and new assets; and
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
- (d) are limited in their ability to extract excessive profits.

Summary of conclusions

- Our conclusions on the effectiveness of ID vary between the different outcomes sought under Part 4
- Our review for Wellington Airport has found at this point:
 - ID is effective in some areas (innovation, quality, pricing efficiency)
 - ID is not effective at limiting excessive profits
 - We cannot conclude in some areas (operating expenditure efficiency, efficient investment, sharing of efficiency gains)

Comparison with our draft report

- Our overall conclusions are unchanged since the draft report
- We have refined our assessment of returns:
 - We calculate the IRR for five years 2013-17 (PSE2), rather than seven years 2011-17 (since ID was implemented)
 - In sensitivity analysis we have used the land valuation provided by BARNZ and a mid-year cash flow assumption (versus end of year)
- Made clearer our analysis of performance (historic and future) and conduct (behaviour)

Regulated airport services under Part 4

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

Analytical framework

- We assessed Wellington Airport's performance and conduct before and after Part 4 ID regulation was imposed
- We assessed what changes were due to ID regulation
- We took into account other incentives to improve performance
- ID regulation should most strongly influence excessive profits and sharing of efficiency gains with consumers

Conclusion – innovation

- ID regulation under Part 4 is effectively promoting appropriate innovation at Wellington Airport:
 - innovation appropriate before and after ID regulation
 - innovation comparable to other airports in New Zealand and overseas
 - few concerns were raised by airlines
 - ID regulation has not negatively affected existing incentives

Conclusion – quality

- ID regulation is effectively promoting the provision of quality at a level that reflects consumers' demands:
 - quality at Wellington Airport compares well to other airports
 - airlines generally satisfied with the quality of service
 - Wellington Airport has attributed the introduction of ID regulation as partly responsible for improvements to customer survey results
 - concerns raised relate to price-quality trade offs airlines wish to make

Conclusion – pricing efficiency

- ID regulation is effectively promoting efficiency of pricing:
 - prices in this period are more likely to promote efficiency than those previously in place
 - Wellington Airport indicated that ID was one reason for changing its pricing methodology
- Airlines had some concerns – further improvements may be possible

Conclusion – profitability (I)

- ID regulation has not been effective in limiting Wellington Airport's ability to extract excessive profits
 - Wellington Airport set prices knowing that its estimate of return (8.9%) would exceed the Commission's estimate of an appropriate return (7.1% to 8.0%)
 - Wellington Airport's expected return based on a five year IRR is between 12.3% and 15.2%
 - Excess returns are between \$81m and \$139m over remaining life of assets, and between \$20m to \$46m during pricing period on PV basis

Conclusion – profitability (II)

- The impact of the excess return on consumers is \$38m to \$69m of excess revenue in PSE2 (pre-tax, not discounted)
- We use the input methodologies (IMs) as a benchmark
- Wellington Airport has not provided evidence of superior performance to justify this level of excess return

Key reasons for level of excessive returns

- Excessive returns are largely attributable to two factors:
 - Wellington Airport has valued land using a MVEU basis rather than MVAU (as set out in our asset valuation IM)
 - Wellington Airport is targeting a return higher than we consider appropriate (as set out in our cost of capital IM)

Differences with Wellington Airport's approach (I)

- Land valuation:
 - Wellington Airport values land using MVEU (MVAU plus hypothetical holding costs of converting land to airport use)
 - Our analysis uses MVAU - conversion costs that are not reflected in land value or already recovered are treated as specialised assets
- Cost of capital:
 - Wellington use their own cost of capital estimate, in part to reflect claimed company specific risks
 - Our cost of capital reflects the industry cost of capital

Differences with Wellington Airport's approach (II)

- Terminal wash-up as a result of delay in building new terminal:
 - Our analysis attributes reduction in revenue as a result of wash-up to the first pricing period (PSE1)
 - Wellington Airport recognises reduction in revenue in second pricing period (PSE2)
- Closing asset base:
 - We use Wellington Airport's forecast of its pricing asset base as the best estimate of Wellington Airport's future cash flows in our IRR calculation
 - Wellington Airport suggests the rolled forward ID asset base should be used

Conclusion – operating expenditure efficiency

- We are unable to conclude whether ID regulation is effectively promoting improvements in operating efficiency
- Available evidence is mixed
- It is too early to assess meaningful trends in opex (eg forecast opex may not include all expected efficiencies)
- Information on actual opex during PSE2 will assist in drawing conclusions
- We expect ID regulation to become more effective over time

Conclusion – efficient investment

- We are unable to conclude whether ID regulation is effectively promoting efficient investment
- Unclear at this time if ID regulation will result in fewer concerns about:
 - the timing of investment
 - the level of investment
- Airlines consider Wellington Airport's forecast capex is prudent, particularly relative to PSE1
- We expect ID regulation to become more effective over time

Conclusion – sharing of efficiency gains

- We cannot conclude whether ID regulation is effectively promoting sharing of efficiency gains
- There is limited evidence of historic efficiency gains that could be shared
- There is limited evidence of forecast efficiency gains that could be shared

Next steps

- The technical calculations supporting our analysis of Wellington Airport's returns will be made available on our website shortly
- We will use the same process and assessment approach for Auckland and Christchurch Airports
 - We will be holding a conference for Auckland Airport on 26 February 2013
 - Our Process and Issues paper for Christchurch Airport released today
- Separate reports on the effectiveness of ID regulation at these airports will be published later this year

Questions?

For more information

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Or visit:

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