Infratil

5 February 2016

Dr Mark Berry / Ms Keston Ruxton
Commerce Commission
PO Box 2351
Wellington 6140

Dear Dr Berry and Ms Ruxton

Re: Infratil Limited Submission to the Commerce Commission on the cost of capital disclosures required of Wellington Airport

Infratil is the 66% shareholder of Wellington Airport on behalf of its 35,000 share and bond holders.

It is our opinion that the Commission does not fully appreciate the long-term consequences of its requirement that Wellington Airport apply a proscribed formula to define its cost of capital for inclusion in annual disclosures. It is our submission that the Commission should take a cautious approach in regards to this requirement and consider dropping or softening it, at least until potential consequences are better understood.

Wellington Airport has an open invitation to Commission staff and commissioners to spend time at the Airport learning more about its operations and challenges. This invitation was accepted last year and it would be fruitful to repeat the exercise at present with the Airport undertaking initiatives that will change many aspects of its users' experience.

1. Summary

We believe the Commission is thinking about airports incorrectly and this is leading to regulation that will hamper Wellington's attempts to create growth.

Based on the Commission's decisions and explanations over the last five years, we infer that the Commission views airports in the following terms:

- The market offers reliable demand growth for a business with monopoly assets and low cost and demand volatility.
- Airport charges, operational efficiency and facility quality are key determinants of passenger welfare.
- Non-aeronautical investments have few risks and high returns.

The reality is different:

- The priority discretionary objective of an airport such as Wellington is to stimulate traffic growth by:
  - Encouraging airlines to initiate services on new routes and to compete on existing routes.
  - Taking a total-journey view of a traveller's experience and working to provide value for money choices that reflect a range of individual preferences.

The market is not on "autopilot" and Wellington Airport's activities to promote service and capacity growth also occur in an environment with challenges:

- Airline alliances, which are carved out from the Commerce Act, create network benefits but also less competition between airlines and constraints on airline provision of new services which do not conform to alliance obligations.
- Air New Zealand's use of Auckland as its hub and its level of government agency support creates financial and regulatory challenges for Wellington and limits partnership opportunities.
- Auckland Council's development agency has substantially more resources to support air services and to encourage inbound traffic than are available in Wellington.

- Passenger services and facilities require investment in risky sunk assets with no possibility of a secondary market.
  - Multilevel car parks cost approximately $50,000 per parking spot to build (not including land) and capacity needs to be front-loaded ahead of demand.
  - Wellington is obliged to invest in facilities such as a hotel to offset the effect of airline networks and scheduling that otherwise results in traffic from the Airport's catchment being bled away.
  - Consumer demand and regulations can evolve quickly changing the economics of retail and food and beverage offerings.

The Commission's prioritisation of a target return on assets and a narrow range of service quality metrics does not recognise the risks faced by Wellington Airport nor its initiatives to encourage and support airline capacity growth.

2. Air traffic growth is stimulated by new services and increasing airline capacity

Wellington Airport's overarching role on behalf of its community is the enablement of air traffic growth. As shown by civic and central government support for air transport and sectors that attract offshore visitors, there is wide recognition of the national and community benefits of better air services and inbound traffic.

A key feature of this growth is that it is usually supply led. Of course people can't fly from A to B if there is no aircraft on the route, but more than that, as soon as there is an aircraft on the route it stimulates demand.

There are endless examples of this, including Wellington's three new international services that started operation just prior to the six months ended 30 September 2015. These resulted in the Airport accommodating 28% more international passengers than in the same period a year prior, with growth evenly split between inbound and outbound travellers.

The following table shows Wellington Airport's passenger numbers on each of its international routes for that period and the same period a year prior.

Route	Service	Pax latest ½ year	Pax prior period	Change
Melbourne	Existing services	92,785	92,183	+1%
	New services	24,311	-	-
	Total	117,096	92,183	+27%
Sydney	Existing services	169,994	163,020	+4%
Queensland	Existing services	99,141	96,278	+3%
	New services	21,678	-	-
	Total	120,819	96,278	+25%
Fiji	Existing services	5,454	5,615	-3%
	New services	5,776	-	-
	Total	11,230	5,615	+100%

In most cases new services follow years of development as it increasingly falls to airports to identify route opportunities and to present them to suitable airlines. The airport and civic partners (and occasionally, although not in Wellington, central government partners) will also provide assistance to airlines in the form of infrastructure, help with regulatory barriers, marketing and financial support.

New services (whether on existing routes as noted above, or on new routes such as Wellington-Canberra-Singapore) require airlines to commit high value aircraft (B737-800 NZ$110 million, B777-200 NZ$400 million) so it is natural that they seek support from airports and other parties that will benefit if the service succeeds in attracting new traffic.

Wellington's efforts to attract additional services and capacity occurs in a market with a number of headwinds; including airline alliances and network commitments, government management of air treaty rights, and Air New Zealand's use of Auckland as its hub and how Tourism New Zealand and Trade & Enterprise prioritise their support initiatives and spend. In addition the Auckland Tourism, Events and Economic Development agency (ATEED) has a budget to support the city's air links that far exceeds anything available in Wellington. http://businessaucklandnz.com/visitorplan/goals-and-actions

Assuming barriers can be overcome; there is the potential to materially change air traffic flows over the medium term, as illustrated by developments in Australia. Since 1990 Australia's air services with Asia have gone from a third of total international capacity to half. With the majority of that growth reflecting expansion outside of Sydney; in part because smaller long-haul aircraft suit smaller markets, and in part because of active encouragement by Federal and State governments. https://theconversation.com/melbourne-airport-outpacing-sydney-in-aviations-asian-century-53491

3. Airline competition benefits travellers

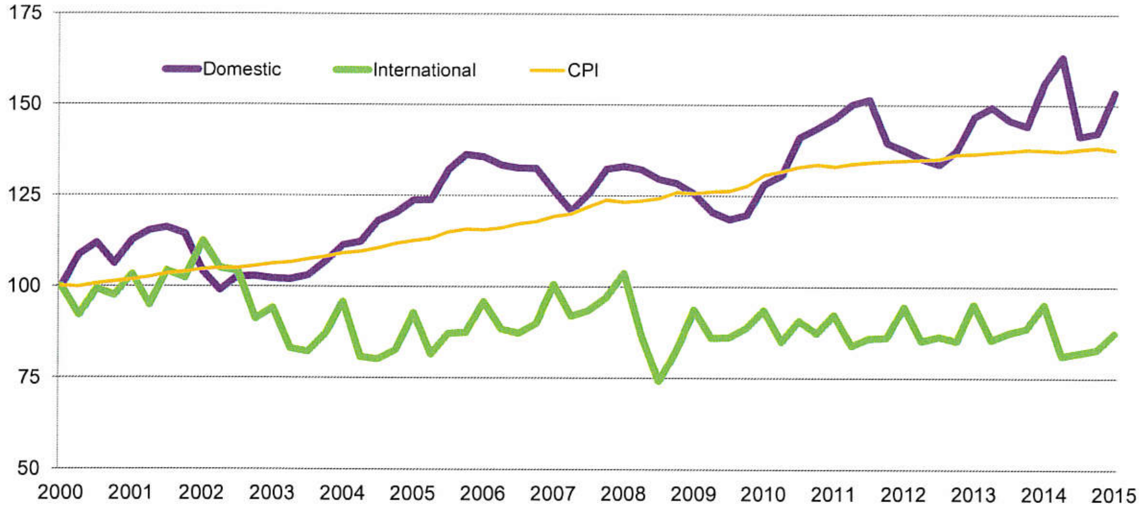
New services grow traffic by providing capacity and convenience not previously available, and by stimulating competition. This can result in many benefits to travellers, with the most visible and easily measured being lower fares.

There are endless examples of competition on individual routes causing lower fares, for instance from Stuff.co.nz on 14 January 2016 "Singapore Airlines' planned Wellington service has been meet [sic] with aggressive pricing by Qantas offering Wellington to Singapore flights for $800 return. The sale launched on the same day tickets for Singapore Airlines new service between Wellington and Singapore via Canberra went on sale from $1808 return".

The effect of different levels of competitive intensity over a lengthy period and a range of services is shown by the Statistics New Zealand indices of domestic and international air travel costs.

Given that a high proportion of the New Zealand domestic and international air travel covered by the survey will be on similar aircraft (B737 and A320) flown by the same airlines through the same New Zealand airports; differences in the rate of fare changes can reasonably be inferred to largely reflect the relative intensity of airline competition in the different markets.

Statistics New Zealand indices of domestic and international air travel costs



Over the fifteen year period between the December quarter 2000 and the December quarter 2015 (the latest figures):

- The cost of domestic air travel rose 54%
- The cost of international air travel fell 13%
- The consumer price index rose 38%

4. Consumer preferences and influences

While lower fares are a key driver of traffic growth they are not the only driver.

Qualitative factors also matter in determining if people will undertake a particular journey. An example of this will shortly unfold when Singapore Airlines' initiates the first ever Wellington-Canberra service. This will significantly reduce the time and inconvenience of that journey and consequently is expected to stimulate traffic and travel between the two cities (the service will provide 9,216 seats a month).

Another way to observe traveller preferences is to look at a particular journey where there are itinerary choices. An example of this is Lambton Quay to Queen Street.

The following table shows two itineraries for that journey which are available today. In fact today there will be literally hundreds of people paying about $124 to travel from Lambton Quay to Queen Street and also hundreds of people paying about $330 for the same trip.

Low Cost Traveller		High Cost Traveller	
City bus to Wellington airport	$3.63	$29.00	Taxi to airport
Coffee in terminal	$4.00	$20.00	Coffee/sandwich/magazine [1]
Low cost airfare	$100.00	$200.00	Medium cost airfare
Airport bus to Auckland CBD	$16.00	$80.00	Auckland taxi to CBD
	$123.63	**$329.00**	

Who got what from these two journeys?

Low Cost		High Cost	
Government as GST	$16.13	$42.91	
Wellington bus net of GST	$3.16	$25.22	Taxi net of GST
Shop net of rent and GST	$2.78	$13.91	Shop net of rent and GST
Airline net of airport/agency costs and GST	$61.23	$148.18	Airline net of airport/agency costs and GST
Wellington Airport from airline	$11.64	$11.64	[3]
Wellington Airport from pax	$0.70	$3.48	Ie. coffee/magazine shop rent
Airways + Av.Sec	$7.96	$7.96	[2]
Auckland Airport from airline	$6.13	$6.13	[3]
Auckland Airport from pax	$2.00	$6.00	Est airport transport charges
Auckland airport bus net	$11.91	$63.57	Auckland taxi net
Total one way cost	**$123.65**	**$328.95**	

1. The $20 for a coffee, sandwich, magazine allocated to the High Cost traveller is likely to be about the same as the average cost of visiting an airline lounge.
2. Av.Sec is $3.17 per domestic pax. Airways' $4.79 is the estimated average.
3. The pricing structures and higher proportion of larger aircraft at Auckland means a domestic jet incurs a higher per-passenger change in Wellington. Across all services, Wellington's average charges, on a per-passenger basis, are approximately 30% less than Auckland's.

Wellington Airport is aware that satisfying different people's different preferences is part of improving the region's air connectivity and both budget and the business-class travellers require value for money services.

While the Airport does not actually pick someone up from Lambton Quay give them a sandwich and put them down on Queen Street, it influences some of those that provide the services. It determines some charges, provides a range of terminal access, parking, refreshment and retail options and ensures its facilities are clean, reliable, uncongested and efficient. The planned on-site hotel is another example of the Airport's attempt to improve travellers' total journey experience.

5. Calculating a fair cost of capital for Wellington Airport

The main point of this submission is that Wellington Airport should not be obliged to include a cost of capital in its disclosure because the consequences of this requirement are not well understood.

An aspect of this is doubt about the accuracy of the Commission's cost of capital formula which uses the B-L CAPM model, a survey group of airports from around the world, the five year New

Zealand government bond yield, the observed cost of debt for an "A" rated New Zealand corporate, and an equity market risk premium which reflects recent financial market valuations.

- The airport companies from around the world which formed the Commission's survey group have highly individual operational, regulatory and financial circumstances. An averaging approach to their cost of capital is tantamount to saying a swimming pool is safe because its average depth is one metre notwithstanding that the actual depth ranges from three metres to three centimetres.

- It is evident today that there is a general problem in attempting to derive a corporate cost of capital from a formula that uses abnormal risk free rates. As shown in a recent Reserve Bank of Australia paper on the topic http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-1.pdf Australian companies' required hurdle rates of return on investment only loosely reflect current risk free and short term interest rates. This and concerns about the CAPM model is leading Australian regulatory agencies to look for the actual cost of capital of regulated company rather than attempting to derive a rate in the way still employed by the Commission.

- Wellington is also penalised by the Commission's approach by being lumped in with Auckland. The two airports and the two businesses are different and face different risks.

To an extent, but not fully, these factors are why the Commission allows a cost of capital probability range. Given that no new information has reduced the uncertainty surrounding the model or its variables the Commission needs to retain a wide probability range if it insists on requiring Wellington Airport include a cost of capital in its disclosures.

6. Price control and disclosures

Wellington Airport is not subject to price control, but in a way disclosing the Commission's acceptable return on invested capital creates a situation that is more onerous than price control.

To illustrate, consider the determination of Chorus' UCLL price. In that instance the Commission's extremely low WACC for Chorus was balanced by a series of dispensations which ultimately allowed a $3 per month price rise.

With the airports, however, investment analysts merely feed the Commission's return on capital figures into their formula and identify "compliance" or "exposure to regulatory risk". Analysts (and other interested parties) focus on the worst case and raise competence and risk concerns about any company that does not fit within the Commission's boundaries.

Through financial market pressure and concern for reputations, de facto becomes de jure, usually without Chorus-type offsets. While the Commission has shown some flexibility with the airport model, through the dispensations granted to Auckland Airport, thus far at least Wellington has not received any such allowances or recognition of unique circumstances.

7. Measuring success

The impact of airport behaviour on individual consumers is largely indirect being via the services and fares offered by airlines and other features of the total journey. An airport could tick all the Commission's return on asset, investment, efficiency, innovation, and so on boxes and still deliver a very poor product to consumers if its air services were constrained, inconvenient or expensive.

Air travel is the metric of an airport's success for its community; whether the air travel is measured as a propensity of people to visit or the propensity for the catchment population to travel. Passenger numbers and forecasts are included in disclosures but with nothing like the granularity of the disclosed operational and financial data. Notwithstanding that passenger activity is the key metric of value created for both shareholders and community.

Five years of disclosure data is now available on Christchurch, Auckland and Wellington airports yet the Commission has not undertaken any time series analysis or measurement against peers or benchmarks. The Commission has opined in its s56G reports on each airport's efficiency, innovativeness, investment, and target returns but the level of analysis was modest. The Commission's overriding interest to date has clearly been each airport's target and actual return on assets.

8. The role of disclosures and the need to specify a hypothetical cost of capital

Disclosures are intended to provide public data to allow monitoring of the Airport's performance on behalf of its community and users, and of its management of the potential conflict of that objective with the goal of providing returns for shareholders. If this monitoring were to identify shortcomings Government would have the basis for requiring an explanation or taking remedial action.

The intended role of disclosures is laudable, but as noted above their effectiveness is problematic in part because of what they do and don't disclose and in part because they seem not to have been subject to much analysis.

It is our submission that the Commission's requirement that the airports are required to calculate a cost of capital in the manner proscribed is counter-productive to the utility of disclosures' purpose (as summarised above) and adverse to the operation of the airport in pursuit of its core roles.

- Clearly the Commission is more interested in target return on capital than the Airport's delivery of core functions and contribution to its community and users.
- It is a truism of regulation that close attention to variables causes changes in the behaviour of those variables. Requiring the calculation and publishing of an acceptable return on capital will cause changes in behaviour which could be adverse for the Airport's delivery to its community and users.
- The Commission's use of the current probability range does mitigate some of the above noted disadvantages and leaves the Commission free to opine as to the reasonableness of an airport's actual return on assets even if within the range. The High Court (in its review of inputs) expressed reservations about the empirical basis for a P25% to P75% range for the cost of capital, but this reflects misplaced confidence that the P50% is accurate and a misunderstanding by the court of the Commission's "moral suasion" capability.

9. In conclusion

Airports' main influence on a traveller's journey cost and experience is through encouraging airlines to increase capacity and to compete. Factors such as the quality of the airport experience and the choices available for other legs of the total journey also matter, but to a lesser extent.

Wellington Airport is leaving no stone unturned in its endeavours to attract new services and to improve travellers' experiences; through investing in air-services; through marketing to airlines, risk-sharing on routes, new infrastructure, and the provision of specialist expertise and facilities.

Does this risk sharing and investment fit well with the Commission's "almost one size fits all" approach to disclosures? Does the Commission's definition of "acceptable returns" align with low/no risk and would that be good for travellers?

Disclosures are a good concept and it is highly desirable that interested parties can monitor the airports to see how they have performed in delivering to their users and their communities. But as now structured the disclosure information is not sufficient to allow a balanced and sound conclusion to be drawn.

The Commission has shown a willingness to be pragmatic and flexible with the concessions granted to Auckland (ten year price setting, revaluation moratorium, second runway land revaluation) and even the damaging impact of the formulaic cost of capital disclosure is at least softened by the probability range.

If the Commission becomes more specific in its return on capital requirements it is not going to help the measurement of airport performance and it is likely to result in changes to Airport behaviour that are unlikely to further the key role of encouraging the provision of better air travel for the benefit of consumers.

Yours sincerely

Tim Brown