29 May 2018

Jo Perry
Chief Advisor, Compliance and Performance Analysis
Regulation Branch
Commerce Commission
PO Box 2351
Wellington 6140

By email: regulation.branch@comcom.govt.nz

Dear Jo

RESPONSE TO DRAFT REPORT ON AUCKLAND AIRPORT'S PSE3 PRICING

This is Wellington International Airport Limited's (WIAL) submission on the Commerce Commission's (Commission) draft report "Review of Auckland International Airport Limited's pricing decisions and expected performance (July 2017 – June 2022)" (Draft Report).

WIAL has been involved in the preparation of the New Zealand Airports Association submission and supports it. In this submission we highlight some key points and themes that we consider are important and warrant further consideration by the Commission.

Assessing airport performance and the benefits to consumers

WIAL continues to be concerned that New Zealanders are not being provided with a full contextual assessment of airport performance in New Zealand.

The reports provided by the Commission have to date tended to lead to a public discussion primarily focused on target profitability. This has been a tendency even when the Commission report addresses the full range of consumer interests promoted in the Part 4 section 52A purpose statement.[1] Where, as here, the Draft Report focuses on a subset of topics – target returns, efficiency of investment, and efficiency of pricing – that narrow public understanding of airport performance is reinforced.

While there are reasons for the reduced focus of the Draft Report, and recognising the limited information available in the price setting disclosure, WIAL would welcome the opportunity to work with the Commission on providing consumers with a full contextual picture of airports' performance in future. The purpose of Part 4 information disclosure can only be advanced when interested persons are well-informed on all aspects of

1 Section 52A provides that the purpose of Part 4 is to promote outcomes consistent with outcomes produced in competitive markets such that suppliers of regulated goods or 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.

Wellington Airport
Main Terminal
PO Box 14175
Wellington 6241
New Zealand

T 04 385 5100
F 04 385 5139
mail@wellingtonairport.co.nz
wellingtonairport.co.nz

airport performance relevant to the long-term interests of consumers. This includes issues of real relevance to consumers such as:

- the quality of service and their experience at the airport,
- the success of the airport in fostering sustainable airline competition, with the flow on of increased airline options and lower airfares,
- timing of investment to anticipate future demand and technology change,
- the success of the airport in increasing available routes,
- efficiency and reliability of operations,
- the role of the airport in regional development, and so on.

Of course the Commission has to scrutinise and comment on the target return as part of this full contextual assessment, but the Act entitles consumers to expect a wider performance summary that informs them about all aspects of airport performance from the regulatory regime. Different stakeholders can then form their views of the overall performance of the airport. At the moment, the public perception of the regulatory regime is that the "score" for target returns is reflective of how consumers would rate an airport for all features of performance, which is not correct. Further, some consumers could value some areas of performance more than others, or perhaps decide that an area of exceptional performance offsets lesser performance in another area.

WIAL encourages the Commission to work with airports and airlines on this problem going forward. It must be possible to develop regulatory performance reporting for airports that more accurately informs the public about the performance of an airport across all aspects relevant to the long-term interests of consumers – both as a snapshot, and over time.

Assessing target returns

How the Commission responds to the analysis submitted by AIAL in response to the Draft Report and applies the Yarrow framework in its final decision is going to be extremely important. This will be the signal to the sector as to whether the Yarrow framework has in practice created space for a dialogue about target returns, or whether the level of evidence and proof required for any departure from the midpoint WACC is so high that in fact makes that impossible.

At this important point it is helpful to recall the framework proposed by Yarrow.

First, recognise that WACC estimates made by companies and by regulators are uncertain. Professor Yarrow advised:[2]

> "In relation to WACC estimates, it can be noted that these themselves are derived from a series of propositions that contain significant, speculative elements. Among these are the validity of the CAPM model variant that is used in the process and the assumption that the WACC will remain the same over the relevant assessment period, neither of which has much substantive underpinning in empirical

2 Professor George Yarrow, *Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector* ("**Yarrow Report**"), 19 February 2016, p 50.

research on financial markets (the evidence leans toward conclusions that each of the propositions is unlikely to be true)."

This point had earlier been made by the High Court:

"The estimation of WACC is, all accept, a complex task involving significant exercising of judgement and is open not only to the possibility of error, but also to there being a range of views."

Second, it is rational to expect that a target return is higher than an estimate of WACC. As Professor Yarrow set out, wanting to "be helpful to the Commission":[3]

- Regulatory economic theory draws a distinction between an allowed rate of return (for assessing revenue and prices) and the weighted average cost of capital (which is the cost of one input, capital). Professor Yarrow correctly observed that the economically efficient allowed rate of return would typically be higher than the WACC. The Commission needs to make clear to stakeholders that its starting point, for an assessment of a rate of return, should typically be above its estimate of WACC, before it considers the context of a particular pricing decision.

- The NPV of an investment programme as a whole (that is, a forward looking view of the business activities of a firm) would be positive; that is, the anticipated profitability of a firm will be tend to be above the cost of capital. Again, this starting point, in this case for assessing expected returns, is before considering the context of a particular pricing decision.

Third, Professor Yarrow advised that the performance of an airport should be assessed in context, including the commercial context that the airport is operating in at the time it makes a pricing decision. He states:[4]

"too much weight is being placed on one set of numbers, deriving from exercises to estimate the cost of capital, and too little weight is being placed on the contextual factors that can influence the interpretation of disclosed information. Put another way, there is an implicit assumption that the cost of capital to be published should be itself be based on judgments that, in effect, reflect views on how the information should be interpreted."

Fourth, it is important to be sensitive to these legitimate differences between an uncertain WACC estimate and target returns. As Professor Yarrow advised, if the Commission's conduct is:[5]

"highly re-active to relatively small deviations between projected or out-turn returns and the Commission's WACC estimate, business conduct itself, including in relation to investment programmes, can obviously be expected to be more sensitive to the WACC estimate."

At a project level:[6]

"…consider an investment project under contemplation which is at the high risk end of the investment opportunities spectrum. If the project is added to the business plan, the spread of the returns distribution of the business as a whole will be increased. However, if regulatory policy is targeted simply at the upper end of the profitability spectrum, addition of the project will tend to increase the risk

3 Yarrow Report, pages 11 - 12.
4 Yarrow Report, page 20.
5 Yarrow Report, page 8.
6 Yarrow Report, page 7.

> of regulatory intervention. The result could be a bias against more risky, possibly more innovative, projects: policy intended to target market power succeeds in reducing the mean rate of return, but may do so by creating unintended distortions in investment."

Finally, it is relevant to have an eye to out-turn results as well as an ex ante assessment of target returns. As Professor Yarrow advised:[7]

> "The application of great care is therefore required when using the WACC as an indicator of reasonable price levels under an information disclosure regime, particularly when the assessment is made on an ex ante basis. The forecasting information disclosed by businesses is generally focused on a 'central' forecast and, in practice, it can be exceedingly difficult to incorporate regulatory risk into such a forecast in any very explicit way."

WIAL appreciates that the Commission is being open minded by being receptive to further evidence before drawing conclusions. However, from here some significant judgment will be required. Are evidential expectations achievable? Will judgment and advice from respected professionals carry weight (as the Commission has recognised in the area of land valuation; and the Commission itself has relied on in setting the IMs)?

With regard to cost of debt, WIAL agrees with AIAL and the Commission that it is appropriate to refer to an airport's forecast actual cost of debt. Where this can be forecast appropriately it should be used instead of an industry benchmark, as it should by definition be a better forecast and more appropriate.

Consultation process and flexibility in approach

In a number of areas the Commission's Draft Report sends helpful signals about the ongoing application of the regulatory regime.

It is appropriate that the Commission has not allowed itself to get drawn into second-guessing the consultation process. Airports, and its airline customers are never going to agree on everything in a consultation process, nor are airlines going to agree on everything amongst themselves. Were there to be disagreement, this should not reflect badly on the quality of the consultation process.

The Commission will need to have an eye on context when it assesses each airport, and our perception is that in a number of areas the Commission has done this. Some of the decisions made by airports are sensitive to scale, where the airport is at in the investment cycle and the level of congestion it is facing, or the options available to that airport at the time. There are areas where the Draft Report rightly records that AIAL appears to have run a good process and made a good decision specific to its context at that time. However, it could be appropriate for another airport in a different context to do something different. Examples include the capital expenditure consultation process (where AIAL's process reflected the scale of its proposals) and the price structure (where AIAL is grappling with the issue of congestion at the peak). These approaches are specific to AIAL and its situation, and it is important that the Commission continues to take these contextual factors into account when assessing each airport's consultation process.

Transparency and an evolving regime

As a general observation, the Commission's Draft Report demonstrates the very detailed scrutiny that is applied to airport pricing decisions. The Draft Report, and the information gathering and analysis that has

---

[7] Yarrow Report, page 6.

preceded it, is yet further evidence of a regulatory framework that applies significant pressure to airport decision-making, including airport price setting.

The Commission is also proposing a review of historic airport performance, which should be another useful evolution of the regime, providing complementary forecast and actual assessments. It would also be an opportunity to consider a wider, more inclusive approach to considering airport performance, as described above.

If you have any questions in relation to this submission please contact me at martin@wlg.aero.

Yours sincerely

Martin Harrington
Chief Financial Officer