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Summary and analysis of Wellington Airport's third price setting event

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1. Introduction

Purpose of report

1. On 30 June 2014, Wellington Airport disclosed information about the prices that will apply during the period 1 June 2014 to 31 March 2019. This report provides our summary and analysis of the airport's price setting event having taken into account the submissions received on our draft report.[1]

Summary and analysis of third price setting event

2. Wellington Airport is one of the three airports in New Zealand that are currently subject to information disclosure regulation under Part 4 of the Commerce Act 1986.[2] Wellington Airport must publicly disclose information about its performance annually, and following a price setting event.

3. After information is disclosed by an airport, we must publish a summary and analysis of the disclosed information. The purpose of summary and analysis is to promote greater understanding about the performance of each airport, their relative performance, and the changes in performance over time.[3]

4. The disclosure of information about the price setting event in 2014 is the third of its kind for Wellington Airport since information disclosure requirements were set under Part 4.[4] This third price setting event is referred to in this report as PSE3.

Review of second price setting event was undertaken as part of a wider exercise

5. Our review of Wellington Airport's second price setting event (PSE2) was undertaken as part of a wider exercise that reviewed the effectiveness of the information disclosure regime. This review was required under s 56G of the Act.[5]

6. Importantly, the prices set as part of PSE3 supersede the prices that had been set by Wellington Airport for PSE2. PSE2 was originally intended to run from 1 April 2012 until 31 March 2017. New prices came into effect under PSE3 on 1 June 2014.

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[1] The 'draft report' refers to: Commerce Commission "Feedback requested on analysis of Wellington Airport's third price setting event (17 April 2015).

[2] Section 56A of the Act sets out the Airport companies that are subject to information disclosure regulation under Part 4, namely: Auckland, Wellington, and Christchurch airports.

[3] Refer: s 53B of the Act.

[4] Further information on the information disclosure regulation is available on our website: http://www.comcom.govt.nz/regulated-industries/airports/airports-information-disclosure/.

[5] 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" (8 February 2013).

7. In the final 's 56G report' for Wellington Airport we noted that for PSE2:[6]

   7.1 Wellington Airport targeted an excessive return over time based on its own forecasts of expenditure and revenue growth;[7] and

   7.2 innovation, quality, and pricing efficiency were appropriate or at least improving at Wellington Airport.

8. The apparent ineffectiveness of information disclosure at limiting the ability to extract excessive profits from specified airport services was of particular concern.[8]

Focus of summary and analysis of third price setting event is profitability

9. We have focussed our summary and analysis of Wellington Airport's third price setting event on promoting greater understanding about changes in Wellington Airport's expected profitability. This is because the primary change introduced by Wellington Airport at PSE3 was a reduction in charges.

10. Other areas were generally not changed at PSE3 or were not considered to be of significant concern during consultation between the airport and the airlines. Therefore, consistent with the approach in the s 56G report, we have not reviewed the expenditure and revenue growth forecasts relied on by Wellington Airport when setting charges.

11. To analyse the profitability of Wellington Airport, we have adopted the same approach we used in the s 56G report and the draft version of this report.[9] For example, we have estimated the internal rate of return (IRR) over the pricing period 1 June 2014 to 31 March 2019.

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[6] We were unable to conclude on efficiency of operational expenditure, investment efficiency, or sharing the benefits of efficiency gains.

[7] For PSE2, we found that Wellington Airport targeted a return of 8.9% based on its understanding of how we might assess its performance given the information disclosure requirements and input methodologies in place at the time. This compares to our estimate of an acceptable range of returns at that time of 7.1% to 8.0% (50th to 75th percentile post-tax WACC used in our s 56G report).

[8] 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" (8 February 2013), paragraph 3.3.

[9] Further information on the framework for considering the effectiveness of information disclosure and our approach to profitability assessment is available in: 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" (8 February 2013).

Wellington Airport was targeting an acceptable level of returns

12. Our analysis shows that at PSE3, Wellington Airport was targeting returns within the Commission's likely estimate of an acceptable range, albeit at the top end of that range, based on Wellington Airport's understanding of how we might assess its profitability given the information disclosure requirements and the input methodologies that were in place at the time.

13. Using alternative approaches to profitability assessment, Wellington Airport may expect to earn higher returns during and after the pricing period than we have estimated. However, the approaches adopted by Wellington Airport appear reasonable based on the information disclosure requirements in place at the time.

Information disclosure is limiting Wellington Airport's ability to earn excessive profits

14. Based on our analysis of PSE3, the announcement of price changes suggests that information disclosure regulation is limiting excessive profits from specified airport services. The prices set for PSE3 have reduced Wellington Airport's expected revenue by $33 million relative to the PSE2 prices over the period 1 June 2014 to 31 March 2017.[10]

Material published alongside this report

15. We have published our analytical model and Wellington Airport's model on our website. These models have not changed in response to submissions on our draft report.

Submissions received on our draft report

16. We requested feedback on our draft analysis of Wellington Airport's PSE3 on 17 April 2015. We received four submissions, which we have considered in our summary and analysis and published on our website. Our responses to the main points of these submissions are provided in Attachment A.

Next steps

17. We will be publishing our final summary and analysis report of Christchurch Airport's re-disclosure of information relating to its second price setting event.

18. We recognise that some stakeholders have concerns with Wellington Airport's prices and how they are assessed. We are proposing that some of the concerns relating to information disclosure and our assessment of such information will be considered as part of our input methodologies review.

[10] This is the present value of the reduction as of 1 April 2012, discounted using the 75th percentile weighted average cost of capital (WACC) as used for PSE2 (8.0%).

2. Profitability analysis

Purpose

19. This chapter sets out the results of our analysis of Wellington Airport's expected profitability for the period 1 June 2014 to 31 March 2019 following the third price setting event.

Two parts to profitability assessment for Wellington Airport

20. Consistent with our approach to the s 56G report, we have considered the returns being targeted by Wellington Airport in two main ways:

    20.1 The returns targeted by Wellington Airport based on a reasonable assessment of how, at the time of resetting prices, it considered we might assess its profitability (referred to as the 'conduct' assessment in the s 56G report).

    20.2 The returns that Wellington Airport could expect to earn in practice if certain matters (such as the timing of cash flows) are treated in an alternative way that may be more accurate, but where that alternative treatment is not required by the regulatory requirements that were in place at the time prices were set (referred to as the 'performance' assessment in the s 56G report).[11]

21. Also consistent with the s 56G report, the conduct assessment provides for a better understanding of the effectiveness of information disclosure regulation at promoting the purpose of Part 4 of the Commerce Act, particularly limiting excessive profits, which we identified as an area of concern in our s 56G report.[12]

Target returns are within an acceptable range based on information disclosure requirements

22. Our analysis shows that at PSE3, Wellington Airport was targeting returns within the Commission's likely estimate of an acceptable range, albeit at the top end of that range, based on Wellington Airport's understanding of how we might assess its profitability given the information disclosure requirements and the input methodologies that were in place at the time.

[11] For this summary and analysis report, we have estimated the impact of alternative treatments individually (see paragraphs 44 and 48).

[12] The purpose of information disclosure regulation is to ensure that sufficient information is available to interested persons to assess whether the purpose of Part 4 is being met.

24. In particular, for the period 1 June 2014 to 31 March 2019, Wellington Airport set prices such that its expected returns over the whole of the period are equivalent to a return of 8.4% when the information disclosure framework is applied.[13] This targeted return is above our estimate of a normal return but is just within the upper limit of our estimate of an acceptable range of 7.4% to 8.4%.

25. Our estimate of the range of acceptable returns reflects the 50th to 75th percentile estimates of a post-tax weighted average cost of capital (WACC) as at 1 July 2014.[14] We consider that the range of 50th to 75th percentile of WACC remains the most appropriate to use for our summary and analysis until we have completed a review of the airport industry WACC percentiles.[15]

Returns expected in practice may be higher

26. Wellington Airport may expect to earn higher returns during and after the pricing period than we have estimated; however, the approaches adopted by Wellington Airport appear reasonable based on the information disclosure requirements in place at the time.

27. Alternative treatments of tax that we consider more appropriate result in expected returns of 8.5% rather than 8.4%. Alternative assumptions on the timing of cash flows suggest that expected returns could be up to 8.9% when also using the alternative tax treatments.

28. Further analysis of the assumptions relied on by Wellington Airport and the alternative treatments can be found in Chapter 3.

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13 We use the internal rate of return (IRR) as the primary measure of profitability. The scope of the analysis only covers aeronautical services (i.e. aircraft, freight, airfield, and specified passenger terminal activities) and excludes other non-regulated services such as car parks and retail facilities.

14 We consider that the WACC that was determined in July 2014 for Auckland Airport and Christchurch Airport information disclosure is appropriate to use for the assessment of Wellington Airport's PSE3 because Wellington Airport finalised its prices for PSE3 at approximately the same time. This WACC was published in: Commerce Commission "Cost of capital determination for information disclosure year 2015 for Transpower, gas pipeline businesses and suppliers of specified airport services (with a June year-end)" (31 July 2014). Attachment A shows the relevant vanilla and post-tax WACC and the parameters that were used to calculate the WACC.

15 We have recently changed our position on the appropriate WACC percentile range from 75th percentile to 67th percentile for a number of other sectors, but have not yet reviewed the appropriate WACC range for airports information disclosure. We intend to undertake this review as part of the current input methodologies review. Refer: Commerce Commission "Input methodologies review, Invitation to contribute to problem definition" (16 June 2015), topic 7.

Price reductions reflect changes to pricing approach

29. The price reductions introduced as part of PSE3 reflect a number of changes that Wellington Airport has made to its pricing approach. Below are the three main changes from the PSE2 approach that we assessed in the s 56G report.

    29.1 Wellington Airport has used a target cost of capital that is within our estimate of an acceptable range. The target cost of capital used for PSE2 was higher than our assessment of an acceptable range.

    29.2 Wellington Airport has used a 'market value alternative use' (MVAU) approach to land valuation for PSE3 which is consistent with the input methodologies. For PSE2, Wellington Airport used a market value existing use (MVEU) approach to land valuation.[16]

    29.3 For PSE3, Wellington Airport recognised that the wash-up for 'the Rock' terminal development does not represent a reduction in its target return, which is more consistent with the approach we adopted when preparing the s 56G report.[17]

30. Overall, Wellington Airport indicates that it has intended for the approach to PSE3 to be consistent with the input methodologies.

Information disclosure regulation has helped limit excessive profits

31. The extent to which Wellington Airport's expected profitability has changed as a result of PSE3 has determined whether to modify our view on the effectiveness of information disclosure in the s 56G report.

32. Based on our analysis of PSE3, the announced price changes suggests that information disclosure regulation has been effective at limiting excessive profits from specified airport services, given the information disclosure requirements and input methodologies in place at the time.[18] Specified airport services include aircraft, freight, airfield, and specified passenger terminal activities, but exclude other non-regulated services such as car parks and retail facilities.

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16 Wellington Airport's land valuation for its regulated portion of land used for PSE3 pricing was $106 million, while it used a regulated land valuation of $204 million for its PSE2 pricing.

17 This issue for PSE2 is described in paragraphs F55 to F59 of the s 56G report.

18 Under section 4A(1) of the Airport Authorities Act 1966 (the AAA), Wellington Airport remains able to set charges for specified airport services as it "thinks fit".

33. The prices set for PSE3 have reduced Wellington Airport's expected revenue by $33 million relative to the PSE2 prices over the period 1 June 2014 to 31 March 2017.[19] This is the present value of the reduction as of 1 April 2012, discounted using the 75th percentile WACC as used for PSE2 (8.0%).

34. The effectiveness of the information disclosure regime at limiting the ability of Wellington Airport to earn excessive profits is relevant to the reviews of the regulation of airports that are currently being undertaken by the Ministry of Business, Innovation, and Employment and the Ministry of Transport.[20]

[19] Although Wellington Airport benefitted from PSE2 prices from 1 April 2012 to 30 May 2014, our calculations indicate that the expected over-recovery for that period is equivalent to less than $1 million of excess revenue (present value as at 31 March 2012, using the WACC 75th percentile (8.0%) as the discount rate). This is because the majority of the over-recovery during the PSE2 pricing period was expected during the period now superseded by PSE3 pricing.

[20] http://www.med.govt.nz/business/competition-policy/part-4-commerce-act/airport-regulation/effectiveness-information-disclosure-regulation and http://www.transport.govt.nz/air/caa-act1990-aa-act1966-review-consultation/.

3. Approaches to analytical issues

Purpose

35. This chapter explains our approaches to analytical issues for the analysis of Wellington Airport's PSE3, including:

    35.1 land valuation and forecast revaluations;

    35.2 alternative tax treatments;

    35.3 cash flow timing assumptions;

    35.4 treatment of the partial year; and

    35.5 treatment of leased assets.

36. Some of these approaches are different to those used by Wellington Airport in setting prices for PSE3. However, Wellington Airport's approaches appear reasonable given the regulatory requirements that were in place at the time.

Land valuation and forecast revaluations

37. Wellington Airport has used an MVAU approach to land valuation for PSE3, which is consistent with the input methodologies. For PSE2, Wellington Airport used an MVEU approach to land valuation.

38. The approach to land valuation employed by Wellington Airport is consistent with the input methodologies for aspects of the land valuation where the input methodologies specify an approach. Also, there are likely to be a range of valuations that are consistent with input methodologies, reflecting the range of opinions of professional valuers.[21]

39. Wellington Airport has forecast land revaluations based on forecast changes in the consumer price index (CPI), which is consistent with the input methodologies. Therefore, at PSE3, Wellington Airport's approach seems reasonable. To the extent that the value of land changes at a different rate to this forecast, careful scrutiny will be required on the way in which those revaluations are treated at future price setting events.

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21 The input methodologies for asset valuation, including land valuation, are due to be reviewed as part of a wider review of input methodologies.

41. We have considered the submissions regarding land valuation and forecast land revaluations. We have undertaken further analysis of the land valuation issues since receiving the submissions, but have not substantially changed our conclusions. We have not made any changes to this report due to the submissions on forecast land revaluation.

42. We consider that the submissions on these issues re-iterate the importance of considering these issues in the input methodology review. Our full response to the submissions is provided in paragraphs A10 to A22.

Alternative tax treatments

43. There is a small difference in Wellington Airport's treatment of the wash-up for the Rock terminal development compared to our approach in the s 56G report. The airport has included the tax adjusted value of the wash-up in its calculation of regulatory profit which is then used in its tax calculation. In the s 56G report we used the gross value. There is also a small difference between our calculation of tax depreciation and Wellington Airport's calculation.

44. Using the two alternative tax treatments together in analysing the expected returns of Wellington Airport raises our estimate of the expected returns from 8.4% to 8.5%.

45. We did not receive submissions regarding tax treatments.

Cash flow timing assumptions

46. Wellington Airport has made the assumption that its cash flows occur at the end of each year. While information disclosure requirements for airports specify end of period cash flows timings, we have specified more specific intra-year cash flow timing for other regulated sectors.

47. In the s 56G report we noted that the use of end of year cash flows is the most conservative assumption, and does not reflect actual cash flows at Wellington Airport. The use of mid-year cash flows would be the least conservative, while actual cash flow timing is likely to be somewhere between mid-year and year-end.

48. We have considered the impact of using intra-year cash flow timing assumptions on our assessment of Wellington Airport's expected profitability. We calculated a range of profitability, with the lower bound based on year-end cash flows and the upper bound based on mid-year cash flows. We also followed this approach for the s 56G report.

49. The impact of adopting a mid-year cash flow assumption as well as the two alternative tax treatments is an annual return of 8.9%, while a year-end cash flow assumption combined with the alternative tax treatments produces an annual rate of return of 8.5%. The range of returns given alternative cash flow timing is 8.4% to 8.8% if the alternative tax treatments are not applied. As noted in Chapter 2, however, the use of a year-end assumption by Wellington Airport was acceptable given the information disclosure requirements in place at the time.

50. We received a submission on the draft report that requested the use of mid-year cash flow timing assumptions. We have considered this submission and responded in paragraphs A23 to A25, although it has not changed the conclusions of this report.

Treatment of the partial year

51. Assessing Wellington Airport's prices for PSE3 requires an approach to partial years because the PSE3 period covers four years and ten months. Our preferred approach to this issue is the same as the approach taken by Wellington Airport. We have re-created the partial year by accepting that the value of the asset base as of 31 March 2014 is representative of the value of the asset base as of 31 May 2014. Wellington Airport has provided cash flows that represent ten months of revenue, operating expenditure, and tax.

52. We did not receive submissions on our treatment of the partial year.

Treatment of leased assets

53. Wellington Airport excludes leased assets from its price setting events because the leased assets are less relevant to the airport's price setting consultation. However, leased assets form part of the regulated asset base. The airport has included information on leased assets in its PSE3 pricing disclosure and its annual information disclosure. Our analysis of Wellington Airport's expected returns includes the impact of leased assets. Wellington Airport targeted 8.4% returns for the leased assets, consistent with the rest of the airport's assets.

54. We did not receive submissions on the treatment of leased assets.

Attachment A: Detailed responses to submissions

Purpose

A1. This attachment summarises the main issues raised in submissions on the draft report and our response to these issues.

Submissions on the Wellington Airport draft report

A2. We received four submissions on the Wellington Airport draft report. These submissions were from Wellington Airport, New Zealand Airports, the Board of Airline Representatives New Zealand (BARNZ) and Air New Zealand.

A3. BARNZ and Air New Zealand raised a number of concerns about our analysis in relation to:

A3.1 whether changes are due to the s 56G review only or the information disclosure regime;

A3.2 Wellington Airport's land valuation;

A3.3 land revaluation forecasts;

A3.4 cash flow timing assumptions; and

A3.5 the weighted average cost of capital (WACC) percentile.

A4. The submissions from Wellington Airport and New Zealand Airports welcomed the draft report and did not request changes to our analysis.

Whether changes are due to the s 56G review only or the information disclosure regime

A5. While BARNZ acknowledges that Wellington Airport has significantly changed its approach to be more reflective of input methodologies, both BARNZ and Air New Zealand argue that the change was a result of the s 56G review and not the information disclosure regime itself. BARNZ states that:

> The s56G review was a one-off transitional provision contained in sub-part 11 of Part4 of the Commerce Act. It is not part of information disclosure regulation. It is not contained in sub-part 4 which contains the provisions relating to information disclosure regulation. It is not specified in s52B which sets out the effect of a supplier being subject to information disclosure regulation. It is not even an on-going part of airport regulation under sub-part 11, being transitional in nature only. It was inserted in order to review the effectiveness of information disclosure regulation – but does not itself form part of information disclosure regulation.

Our response: summary and analysis can achieve the same outcomes as the s 56G review

A6. The s 56G review has had a significant impact on the way airports set and disclose prices under information disclosure. As a result of the s 56G review, Wellington Airport has reset its prices to be more consistent with information disclosure and input methodologies. In our view, it was the assessment of airport conduct, particularly through profitability analysis, combined with the threat of more heavy handed regulation that influenced airport behaviour.

A7. Assessment of airport conduct will be continued as part of our summary and analysis of future price setting events in addition to summary and analysis of expected and actual performance under s 53B. This is likely to achieve similar outcomes as the s 56G review. The purpose of this summary and analysis is to promote greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time.

A8. We did not undertake similar summary and analysis of PSE2, as we had published the equivalent analysis in our s 56G report. Had we not been required to undertake that analysis under s 56G, we would have undertaken a similar assessment as summary and analysis under s 53B.

A9. Furthermore, we continue to assess the effectiveness of the information disclosure regime in promoting the purpose defined in Part 4 of the Act. Such assessments will inform our future decisions on what, if any, amendments may be necessary to the input methodologies or disclosure requirements in order to better promote the relevant purposes of Part 4.

Wellington Airport's land valuation

A10. BARNZ has challenged the compliance of Wellington Airport's MVAU valuation with the information disclosure requirements for land valuation.

A11. BARNZ believes that we should commission an updated independent review of Wellington Airport's land valuation as part of our summary and analysis of Wellington Airport's third price setting event. BARNZ considers that an independent review is required before we can express any views on the consistency of Wellington Airport's valuation with the input methodology requirements and before using that valuation as the basis for assessing the internal rate of return (IRR) being targeted by the Airport.

A12. BARNZ raised three specific concerns with the Wellington Airport MVAU land valuation. In particular these concerns related to whether the highest and best alternative use was feasible, the lack of ongoing seawall maintenance costs and the insufficient allowance for the time necessary to obtain the required planning changes from the current airport zones to zones enabling the envisaged mixed use alternative.

A13. BARNZ notes that its concerns about Wellington Airport's current land valuations were raised by our valuation expert for the s 56G reports and that these concerns were not addressed by Wellington Airport.

Our response: the land valuation is consistent with the input methodologies

A14. The approach to land valuation employed by Wellington Airport is consistent with the input methodologies for aspects of the land valuation where the input methodologies specify an approach. Therefore, the submissions on this topic have not changed our assessment of Wellington Airport's conduct in regards to profitability. We do not consider that Wellington Airport's MVAU land valuation fails to comply with the information disclosure requirements.

A15. Of the three issues noted in paragraph A12, BARNZ identified the time necessary to obtain the required planning changes as the most material difference in the valuations between Wellington Airport and that obtained by BARNZ. We understand BARNZ is concerned with the lack of support or reasoning for the representation by Telfer Young on behalf of Wellington Airport that "in a hypothetical scenario such as this a reasonable assumption is that the appropriate zoning would be in place (i.e. the current zoning would not exist)".

A16. The information disclosure requirements do not expressly require that an MVAU land valuation should assume that the appropriate land zoning is in place.[22] We have identified the relevant input methodologies on this subject as an area to review and potentially provide additional guidance or clarification as part of the input methodologies review. For the purposes of this summary and analysis, therefore, our view is that the valuation approach undertaken by Wellington Airport is consistent with the input methodologies to the extent the input methodologies prescribe a specific approach.

A17. In regards to the land mix allocation we do not consider the information presented by Wellington Airport fails to comply with the information disclosure requirements. We consider that the difference in valuations on this point reflect the different judgements of professional valuers. The Wellington Airport land valuation under a highest and best alternative use scenario represents a relatively rare greenfields development opportunity in Wellington City and it is therefore difficult to predict market demand for the proposed land mix allocation.

[22] It appears that BARNZ and Wellington Airport have different interpretations of the requirements of Schedule A of the input methodologies.

A18. The input methodologies do not specify any particular treatment of the costs of maintaining the seawall. Telfer Young on behalf of Wellington Airport has noted that no value in the valuation report is clearly attributable to the seawall. It is unclear from the information presented by BARNZ's valuers that an allowance for ongoing maintenance costs would be required by the Wellington City Council, and the issue is not dealt with explicitly in the input methodologies.[23]

A19. We propose to undertake further work as part of the input methodologies review to address the ambiguities contained within Schedule A of the input methodologies. This work may be undertaken on a 'fast tracked' basis.[24]

Land revaluation forecasts

A20. BARNZ argues that, since Wellington Airport has not committed to treating any difference between actual and forecast revaluations as income at the end of PSE3, it is important that land revaluations are forecast at a reasonable level. Advice provided to BARNZ suggests that forecast increases in land values for Wellington Airport of 4.5% are more plausible that the 2.1% consumer price index (CPI) based forecast adopted by Wellington Airport.

Our response: Wellington Airport's approach is consistent with the input methodologies

A21. Input methodologies for airports specify that land values may be indexed by inflation, or revalued to the current MVAU value. Wellington Airport's approach is consistent with these specifications, with future land revaluations forecast to occur in line with CPI.

A22. We have not made any changes to the conclusions of the report as a result of submissions on this issue. However, the treatment of un-forecast revaluation gains is an issue that could potentially be considered as part of the input methodologies review.[25]

Cash flow timing assumptions

A23. BARNZ considers that our use of end of year cash flow timings is not appropriate. Given that we have already moved to a mid-year approach for other regulated businesses, BARNZ does not consider it appropriate for us to continue to use end of year cash flow timings when it has clearly signalled its intention to make the same change for airports.

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[23] Paragraph 91–92 of the October 2011 report by Property Advisory.

[24] Commerce Commission "Cover letter for the Notice of Intention to commence a review of input methodologies" (10 June 2015), paragraph 19.

[25] Commerce Commission "Input methodologies review, Invitation to contribute to problem definition" (16 June 2015).

Our response: use of year-end cash flow timings was appropriate

A24. Our assessment of conduct is based on Wellington Airport's understanding of the information disclosure regime as at the time it set prices. It is this measure that drives our conclusion as to whether information disclosure has been effective at limiting excessive profits. For interested parties, we have estimated the effect that mid-year cash flow timings would have on the profitability analysis in paragraph 49.

A25. We have not changed our views as a result of submissions on this issue. However, we have highlighted that changes to cash flow timing assumption requirements, as signalled in the s 56G review, are another potential issue to be addressed as part of the input methodologies review.[26]

Weighted average cost of capital percentile

A26. Air New Zealand has argued that Wellington Airport is targeting a return at the extreme top end of its 25th–75th percentile range. The percentile range is subject to review (in the input methodologies review) and, given our conclusions in respect of other regulated industries, Air New Zealand considers it can be expected to be reduced. BARNZ has stated that the timing of our WACC review for airports has adversely affected the interests of consumers and resulted in an outcome which favours the supplier.

Our response: the 75th WACC percentile was appropriate for Wellington Airport to use

A27. At the time Wellington Airport set prices for PSE3, we had already commenced our review of the appropriate WACC percentile as a result of the High Court's merits review decision, which was sceptical about the appropriateness of targeting returns above the mid-point for price-quality regulation. This review, which set the new percentile for price-quality regulation of electricity lines businesses and gas pipeline businesses at the 67th percentile, was not completed until after Wellington Airport set prices. Furthermore, the appropriate WACC percentile for airports was not considered at this time due to airport specific considerations that may affect the appropriate WACC percentile for airports, eg, the role of the 'dual-till' approach to regulation.

[26] Commerce Commission "Input methodologies review, Invitation to contribute to problem definition" (16 June 2015).

A28. As indicated above, our assessment of conduct is based on Wellington Airport's understanding of the information disclosure regime as at the time it set prices. At the time Wellington Airport set prices for PSE3, the 75th percentile cost of capital was the appropriate upper limit for expected returns. In the s 56G report, we stated that we used the mid-point cost of capital as the starting point, but also considered the 75th percentile cost of capital.[27]

A29. The 75th percentile cost of capital will continue to remain the appropriate upper limit for expected returns and the 50th percentile the lower limit at least until the WACC percentile for airports is re-examined as part of the input methodologies review.

A30. We have not changed our views as a result of the submission on this issue. However, as noted above, we intend to undertake a review of the appropriate WACC percentiles for airports as part of the input methodologies review.[28]

[27] We note that information disclosure reports ex-post returns against the mid-point, 25th and 75th percentile.

[28] Ibid.

Attachment B: Weighted average cost of capital

Purpose

B1. This attachment sets out the WACC estimates and parameters used in analysing Wellington Airport's profitability.

Summary of WACC estimates

B2. The table below shows the airport WACC estimates for the appropriate time.

Table 1: WACC estimates[29]

	Mid-point	25th percentile	75th percentile
Vanilla WACC	7.64%	6.66%	8.63%
Post-tax WACC	7.37%	6.39%	8.36%

WACC estimate parameters

B3. The table below shows the parameters that were used to calculate the estimated WACC.

Table 2: WACC parameters[30]

Risk free rate (5 years)	4.17%
Debt premium (5 years)	1.18%
Equity beta	0.72
Tax adjusted market risk premium	7.0%
Average corporate tax rate	28%
Average investor tax rate	28%
Debt insurance costs	0.35%
Leverage	17%
Standard error of debt premium	0.0015
Standard error of WACC	0.015
Cost of debt (pre corporate tax)	5.70%
Cost of equity	8.04%

29 For Auckland and Christchurch Airports for the information disclosure year 2015, sourced from Commerce Commission "Cost of capital determination for information disclosure year 2015 for Transpower, gas pipeline businesses and suppliers of specified airport services (with a June year-end) [2014] NZCC 19" (31 July 2014).

30 Ibid.