TRANSPOWER

Transpower House
96 The Terrace
Wellington 6140
New Zealand
Telephone +64-4-590 7000
www.transpower.co.nz
Jeremy.cain@transpower.co.nz
04 590 7544

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Keston Ruxton
Manager, IM Review
Commerce Commission
Wellington

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

Dear Keston

Airport WACC percentile review consultation

We welcome the opportunity to comment on the Commerce Commission's airport WACC percentile review consultation. In this submission we make the following points.

- Setting the regulatory WACC has an important role in satisfying reasonable investor expectations, and promoting innovation, efficiency and improvements in service quality.
- The Commission should be clear that its proposed approach for airports does not mean the mid-point is the de facto limit for acceptable returns – higher returns may be justified by asymmetric risk of underinvestment or efficiency improvements.
- The limited (qualitative) analysis presented on airport versus energy does not appear adequate to conclude "the rationale for using a percentile above the mid-point appears weaker for airports than for electricity and gas businesses". Similarly, the mid-point decision for Chorus provides limited relevant precedent.
- It does not appear to be possible for any airport to replicate the Commission's annual Information Disclosure (ID) WACC determination in its debt funding – this further limits the usefulness of the ID WACC determinations for assessing whether airports are earning above normal returns/reasonable investor expectations are being satisfied.

We expand on each of these points below.

Setting the WACC

The Commission's decisions on setting WACC have an important role in promoting regulatory certainty, and ensuring reasonable investor expectations (the ability to recover the prudent and efficient costs of investment) are met. The return regulated suppliers are able to earn also has an important role in both ensuring incentives to invest and rewarding/encouraging regulated suppliers to improve efficiency which can be shared with consumers.

The Yarrow paper usefully highlights that ID is an "intermediate" form of regulation, compared to more "interventionist forms of policy" including price control. There are decisions the Commission has to make to set prices under price control that it does not necessarily have to make for ID – for example, the Commission could refrain from both setting a specific WACC percentile (as proposed) and undertaking its own WACC calculation. We recognise there is a potential trade-off between regulatory certainty and ID effectively becoming more like price control.

The Commission should be clear, though, that in proposing not to establish a particular WACC percentile for airports, as it has in determining prices for energy networks and Chorus' copper access services, this does not mean that mid-point is the de facto optimal WACC percentile or that returns above mid-point are not permissible. If the Commission is not clear on this point there is a risk this is how the ID regime will be interpreted.

Variances in optimal WACC percentiles across sectors

Industry and regulatory-specific factors can mean the optimal WACC percentile may vary across sectors (even potentially within different parts of the same sector), as was highlighted by the Commission's acceptance that the optimal WACC percentile for energy networks is higher than for Chorus' UCLL and UBA services.

We have not formed a view on potential asymmetric impacts on consumers from underinvestment in airports, or whether the impact differs from energy networks. The (qualitative) analysis the Commission has provided on this point is limited and does not appear to provide a reasonable basis for reaching a conclusion one way or the other.

The mid-point decision for Chorus was based on a number of factors, none of which are relevant or applicable to energy networks or airports. The Chorus' decision did, however, usefully detail why a percentile below mid-point would not be appropriate.

Related matters

We consider the way in which the Commission updates its annual WACC determination for ID purposes is problematic and not conducive to a meaningful assessment of supplier profitability.

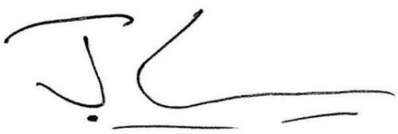
Producing an annual WACC update when the WACC is determined on the basis of refinancing all debt for a 5-year period creates a logical disconnect between the ID WACC and reality. It would be impractical and uneconomic for a supplier to annually refinance all its debt for a 5 year period.

This results in airport returns being assessed against a cost of capital that neither reflects their actual cost of capital, nor efficient debt financing. As a consequence, it is not necessarily possible – by comparing the airport returns against the ID WACC – to reliably determine whether the airport is earning above normal returns. An airport with returns above the ID WACC could be making a loss.

These problems reinforce our view that the Commission should adopt a trailing average cost of debt approach to calculation of WACC for price control and ID purposes.[1] The trailing average approach reflects efficient debt funding practices and, in an ID context, provides a more suitable basis for assessing profitability.

Please let me know if you have any queries regarding our submission. No part of the submission is confidential.

Yours sincerely



Jeremy Cain
Regulatory Affairs & Pricing Manager

[1] The merits of a trailing average approach are detailed in our responses to the Commission's energy IMs and cost of capital review.