



16 March 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 advice of Professor Yarrow and the Commission's emerging views on the cost of capital disclosures required of Wellington Airport**

Professor Yarrow's paper is a fascinating read, albeit one which requires work to understand. If the Commission were of a mind to host a presentation or workshop by the professor on the topic of economic regulation we are sure it would be well supported.

Reading between the lines it feels as if he would like to restart the whole disclosure exercise. While his paper is a curate's egg our most salient inference is that he is concerned that airport disclosures are being seen as de facto price control and his recommendations would, if followed, change this.

As we explained in our submission of 5<sup>th</sup> February, we believe that the Commission should not be imposing a form of price control on Wellington Airport, and it seems that Professor Yarrow agrees.

We endorse the overall thrust of his advice and provide comments below on a number of specifics.

#### **1. Do not conflate disclosure and control**

An airport is a complex and unique economic entity. Each faces its own demand elasticity, supply substitution situation, passenger/airline mix, and combination of aeronautical and passenger service activities; to list only some of the differentiating factors.

Any assessment of the exercise of the Airport's market power should be mindful of the full package of factors and the Commission should ensure that it avoids structuring the disclosures in such a manner as to conflate the gathering of information and the imposition of controls.

We wholeheartedly endorse this. As noted in our earlier submission, financial market pressure and concern for reputations can result in de facto becoming de jure and we hope the Commission takes steps to minimise this risk.

We also note that in addition to the factors listed above, and noted by Professor Yarrow, Wellington Airport's performance is also subject to considerable scrutiny by the community who rely on the air services it facilitates. The Wellington Employers' Chamber of Commerce

polls its members from time to time about the Airport's activities and the Wellington City Council appoints two directors, one of whom is the Mayor, to the Airport company board.

The Commission is not the only external party interested in the Airport's performance and it is not the only party with influence over the Airport Company's behaviour.

## **2. Ex ante Vs. ex post**

Professor Yarrow makes a valid and important point about the respective weight that the Commission should give to forecast and actual returns.

We endorse his view that the Commission should change the respective priority it gives to the past and the future. We note that thus far the Commission seems to have given little weight to the five years of disclosure returns produced by the three airports.

## **3. Proportionality**

We doubt there is any real dispute about the theory of regulatory proportionality, but as with the point made above about de facto mutating into de jure, it would be helpful were the Commission to give explicit recognition to this.

## **4. Identifying WACC**

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

Apologies for the perhaps unnecessary quoting of Professor Yarrow, but practical common sense on this topic is rare and worth repeating.

As Professor Yarrow makes clear, estimates of WACC are problematic, as are regulators tendency to grant allowances, as are the impact of setting WACC too high or too low.

As noted in our previous submission, we are sceptical about the relevance of a WACC calculated for Wellington Airport that is not based on factors germane to Wellington Airport. For instance the investment hurdle returns Wellington Airport uses to assess investment projects bear little resemblance to WACC derived via BL-CAPM.

## **5. Explaining Returns**

The Commission has indicated that it will still require Wellington Airport (and the other airports) to calculate and publish a WACC, notwithstanding Professor Yarrow's views. That is a shame.

In due course Wellington Airport will disclose its financial and operational performance for the year ended 31 March 2016. This will be the sixth such disclosure by Wellington Airport.

Disclosures have, to date, largely been an exercise of compliance. Presumably the output has been acceptable as no feedback or follow up inquiry has been received from the Commission, and little interest has been shown by other stakeholders except the occasional broker analyst.

In future it is intended that Wellington Airport will provide greater commentary to explain its disclosed financial and operational results, so as to assist the Commission (and anyone else interested) understand the performance of the relevant areas of the Company's activities.

Hopefully this expanded approach to disclosures can be presented to the Commission face to face, so that a dialogue can be developed to assist the Commission's understanding of Wellington Airport.

## **6. Measuring success**

The following is quoted from our 5<sup>th</sup> February 2016 submission as an outline of the more holistic reporting approach Wellington Airport is considering for its disclosures.

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.

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.

## **7. The Commission's Criteria**

Page 21 of Professor Yarrow's report was, for us, the most problematic. On that page he notes the following:

To the extent that the Commission wishes to influence actual decisions via the information disclosure exercise in general, what I think is required is a separate exercise that sets out factors that will affect the interpretation of the resulting information and that may therefore influence the conduct of regulation in the future. In other jurisdictions this is provided by means of the publication of guidance.

Among other things, such guidance would be affected by the Commission's assessment of where airports lie in terms of the assessed risks of AEEMP (adverse effects arising from the exercise of market power), since it is those risks that should be central to determining the proportionality of any subsequent regulatory measures. In specific relation to profitability guidance might, for example, identify a series of thresholds for deviations of returns from, say, a central estimate of the WACC, which themselves would fall out of the Commission's wider appreciation of the relevant economic context(s), including factors such as the underlying uncertainties about profitability outcomes.

To illustrate a possible approach (and this is only an illustration), guidance might set out [bands]... This type of approach would not be dissimilar to that taken toward predatory pricing in some jurisdictions, where the bands are made explicit in guidance.

As we observed in our previous submission, we believe that the Commission has some way to go in its understanding of Wellington Airport's business. We do not believe the Commission should now come up with a manufactured guidance or bands.

In due course Wellington Airport will provide explanations of its returns and its other performance metrics, at which time it will be appropriate for the Commission to opine as to Wellington Airport's contribution to the long term welfare of its consumers and communities.

In the meantime, rest assured that Wellington Airport agrees with Professor Yarrow when he said "ultimately, the monopoly power of the state tends to be rather greater than that of individual businesses."

## **8. Summary**

Professor Yarrow's report ultimately focusses on AEEMP as the key factor that should define the form and nature of regulation.

We hope that this becomes the Commission's focus too, with less prioritisation of RoR/WACC as the paramount variable.

Infratil, and we are sure this is true of our co-shareholder, believes that a business such as Wellington Airport must be operated primarily for the benefit of its community by doing all it can to deliver sustainable efficient air travel. The rate of return is an outcome of Wellington Airport successfully accomplishing its over-arching mandate.

To repeat our final paragraph from our 5<sup>th</sup> February submission. "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