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Dear Keston

**IM Review: Professor Yarrow report and emerging views on the airport WACC percentile**  
**Introduction**

Thank you for the opportunity to respond to the expert advice of Professor Yarrow (*Yarrow Report*), and the Commerce Commission's Emerging Views on the airport WACC percentile.

Wellington International Airport Ltd (*Wellington Airport*) has participated in the development of the New Zealand Airports Association (*NZ Airports*) submission and supports the points made in that submission (including the Sapere reports attached to the NZ Airports submission).

**Direction of change is positive**

By commissioning and publishing the Yarrow Report the Commission has opened up the opportunity to move the information disclosure regime into a role that we consider is true to the original intention of information disclosure, distinct from price control regulation and has the ability to better serve the interests of consumers. This is a very significant development in the Part 4 regulation of airports and Wellington Airport highly commends the Commission for taking this step.

We consider that there are two key features of the change proposed by the Yarrow Report. First, a contextual analysis of all the relevant factors is the primary focus for assessing profitability. Consequently, comparing returns with WACC reduces greatly in significance, because it provides no meaning without proper context, and because it is simply one factor of many to be considered:

*It cannot be over-emphasised that a given difference between profitability and the cost of capital, i.e. one which is independent of relevant factual circumstances at a given time, cannot reasonably be taken to be the basis for a judgment that profits are excessive for Part 4 basis ... The extent of any such divergence is one factor of relevance in assessment, but it is only one of many, and there is no particular reason to give it a privileged position, although the interpretation of divergences will properly*

*differ as between ex ante and ex post assessments.*<sup>1</sup>

The required contextual approach will include broadening the analysis of airport returns beyond an abstract comparison with a WACC estimate.

Second, and more generally, the Commission should endorse a role for information disclosure regulation that is distinct from price control regulation and does not result in de facto price control. Therefore, to the extent that WACC remains in the frame despite its de-emphasis, the Commission should publish its WACC estimate and statistical measures of the range of accuracy of the estimate (every 5<sup>th</sup> percentile, from the 5<sup>th</sup> through to the 95<sup>th</sup> percentile) but not endorse any particular percentiles. As we discuss below, the Commission must take great care if it considers it expedient to publish the mid-point of its WACC estimate:

*Given these points, in my view the purpose of s53A would be best served by publication of the regulator's views on the relevant cost of capital, with no further judgments added. That would involve specification of such parameters of the probability distribution of the WACC as might feasibly be estimated. If legislation or administrative expediency requires a point estimate, this would amount to a single estimate of central tendency (estimate of the mean, median or mode), but additional information on parameters such as the estimated variance, upper and lower bounds, 5th and 95th deciles, skewness, etc. would be of value and would merit publication if considered sufficiently reliable.*<sup>2</sup>

Wellington Airport endorses both the specific and general changes above proposed by Professor Yarrow, for the reasons he gives and as expanded in the NZ Airports submission. In essence, experience with the status quo shows that it results in de facto price control at the highest endorsed WACC percentile, which can be both harmful to consumers and investors, and is contrary to the Government's policy settings and Parliament's intent. Information disclosure regulation must be implemented in a way that is distinct from price control.

### **Successful implementation of the new direction**

We want to highlight what we consider to be the points that are key to implementing the new direction. First, the Commission needs to make a very clear and prominent statement that it does not endorse any percentile of the WACC estimate (whether the end points or mid-point of that estimate). More specifically, if the Commission decides to publish the mid-point WACC, then it must be very clear that divergence of airport returns from the mid-point WACC estimate does not automatically (or tend to) indicate excessive returns, but it will fall to airports to provide context by explaining their returns.

As discussed in the NZ Airports submission, there is a real risk that the new approach could collapse into de facto price control at the mid-point estimate. This is not what Professor Yarrow is advising the Commission should do. In fact, to the contrary, Professor Yarrow has explained why anticipated returns are typically higher than WACC, as discussed further in the NZ Airports submission.

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<sup>1</sup> Yarrow Report, page 20

<sup>2</sup> Yarrow Report, page 21



With the recent history of the application of information disclosure regulation it will take a very clear statement by the Commission, plus follow up in its decisions, to shift the perceptions of stakeholders of how the Commission's regulation works.

Second, we envisage the Commission endorsing Professor Yarrow's advice that ex post review of actual returns is much more important than ex ante review in a well-functioning information disclosure framework – and great care is required when performing an ex ante review.

*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 most on a 'central' forecast and, in practice, it can be exceedingly difficult to incorporate regulatory risk into such a forecast any very explicit way.<sup>3</sup>*

This has not been the Commission's view to date, but for the information disclosure regime to work well the Commission must adjust its position. The sole focus on ex ante review of forecast returns has been a significant contributor to the current regulation shading into de facto price control. We have regularly reported to you that Wellington Airport's actual returns have been below targeted returns and the Commission's benchmarks since the start of information disclosure. The NZ Airports submission further discusses the role of ex post assessments.

Third, signal an open minded approach to assessing airport returns that is consistent with the move away from de facto price control. Stakeholders will obviously watch closely the Commission's first reviews under this new approach.

We do not see the need for the Commission to publish a list of factors (even if non-exhaustive) that are relevant to assessing airport returns ex ante and ex post, because the relevance of factors will vary depending on the context and over time. However, to ensure relevant factors are given due consideration when they arise, it would be helpful for the Commission to state clearly that there are no presumptions on any matters or on any specific percentiles.

In this regard, the Commission's acknowledgments should be high level, and flexible enough to accommodate varying circumstances over time (rather than being prescriptive). We would envisage that such acknowledgements could be relatively brief, and Wellington Airport is very mindful of approaching such matters from the perspective of a good corporate citizen.

We suggest that the Commission's acknowledgments should focus on the following principles:

- Express recognition of WACC estimation error (publishing every 5<sup>th</sup> percentile, from the 5<sup>th</sup> through to the 95<sup>th</sup> percentile)

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<sup>3</sup> Yarrow Report, page 6



- Acknowledgement that there may be the potential for asymmetric risks for consumers (resulting from estimation error) in relation to airports (the size and scale is not a matter for the Commission to pass judgement on in advance);
- Acknowledgment that the required rate of return is not expected to be the same as the mid-point WACC, and divergence from the mid-point WACC does not automatically infer excessive returns or under-recovery;
- No specific percentile will on its own be regarded as either “safe” nor “excessive”, and must be considered in the context of the information disclosed;
- It is important to consider the actual performance of airports as well as forecast performance;
- With ex ante assessment, forecasting and other uncertainties must be acknowledged as relevant factors;
- Impacts of airport performance on all consumers (airlines, passengers and the wider community) is a relevant consideration;
- Airport specific factors and context are relevant (e.g. actual cost of debt, asset beta, efficiency); and
- In relation to any factors, no adverse inferences are to be made in the absence of evidence.

#### Recent air travel growth in New Zealand

Over the last year, passenger growth in New Zealand has been at exceptional levels, in particular internationally. This is shown below for the main New Zealand airports:

Main NZ Airports	Domestic passenger increase *	International passenger increase *
Wellington	3.7%	15.8%
Auckland	6.3%	7.5%
Christchurch	5.8%	6.6%

\*: rolling 12 months to Jan 2016

The domestic network is expanding, in particular fuelled by Jetstar recently commencing regional services in New Zealand. Internationally there has been even greater growth with new airlines and routes commencing at Wellington Airport (Singapore airlines to Canberra/Singapore, Jetstar and Qantas flying new Trans Tasman routes and Fiji Airlines to Fiji). There has been similar growth at Auckland Airport (American Airlines to Los Angeles, Emirates to Dubai and several new Chinese airlines).



As previously reported to the Commission the role of airports in driving as well as facilitating this growth is significant. In the instance of Wellington Airport we have invested heavily in recent years in trying to secure new routes and new airlines as well as to incentive growth on existing routes - after a couple of years the results are starting to be seen. Furthermore, much of this growth drives airline responses and increased competition and in doing so secures lower air fares and better routes to the benefit of consumers.

It should be noted that an airport such as Wellington Airport does not face a perfect airline market where carriers come and go with no barriers. We operate in a complex market place and have a goal to maximise sustainable connectivity for the people of our region, on the one hand, and to strongly grow sustainable inbound traffic, on the other hand.

Also, we continue to stress the critical role of airports in promoting air travel growth and tourism. The importance of tourism to the New Zealand economy is undeniable and arguably it is now the number one industry sector by size. As a result, it is important that the Commission maintains a light handed regulatory regime that incentivises investment, efficiencies, and commercial outcomes that will continue to foster current and future growth.

### **Concluding comment**

This new direction is positive and will go some way toward addressing the concerns expressed in the recent Wellington Airport and Infratil submissions that regulation has the potential to limit the incentives on airports to grow connectivity and competition, for the long term benefit of consumers. It remains fundamentally important that the Commission expands its current view of airport performance to include a broader contextual assessment. Professor Yarrow's advice on airport services and the role of information disclosure regulation points in the right direction.

If you should have any questions in relation to this submission please contact me at [martin@wlg.aero](mailto:martin@wlg.aero).



**Martin Harrington**  
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