BARNZ
BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND

11 March 2016

Keston Ruxton
Manager Input Methodologies Review
Commerce Commission
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Dear Keston,

Emerging views on airport WACC percentile

BARNZ thanks the Commission for providing interested parties with the opportunity to respond to the Commission's emerging views on the airport WACC percentile together with the report the Commission requested from Professor Yarrow.

BARNZ supports the Commission's move to give greater recognition to the importance of the mid-point WACC estimate as the starting point for any assessment of airport profitability. We consider that this approach is in accordance with the S52A purpose statement of promoting the long term benefit of consumers by promoting outcomes that are consistent with outcomes produced in competitive markets.

In particular, it is aligned with supplier expectations in competitive markets where the expectation (or hope) is that a normal return will be earned. As was observed by the High Court in its merit review decision at paragraph 1472 *'...the expectation of earning (only) a normal return on new investment ought to be an attractive proposition for a regulated supplier'*. A mid-point estimate of the WACC, being the best estimate of a normal return, should therefore provide sufficient incentive to invest, as per s52A(1)(a).

The renewed recognition of the importance of the mid-point WACC as the starting point for assessing airport profitability is also more likely to lead to more efficient outcomes and to encourage innovation, which are within the outcomes sought by paragraphs (a) and (b) of the s52A purpose statement. As the High Court observed at paragraph 1473 of its merit review decision:

> [1473]...it is far from obvious that higher than normal expected returns would stimulate greater efficiency of any kind. On the contrary, they would render excess profits likely, even if less effort were made by suppliers to generate efficiencies than in a workably competitive market. In monopoly enterprises, the concern is always to prevent inefficiency creeping in. Providing a revenue cushion is not the way to create the right incentives.

It also prevents a likelihood that suppliers will earn excess returns on a permanent basis, which was a significant component of the High Court's concern regarding the Commission's original emphasis on returns at the upper end of its published WACC range, and which is inconsistent with the s52A(1)(d) intended outcome of Part 4 of limiting the ability of regulated suppliers to extract excessive profits.

BARNZ echoes the following statements of the High Court which encompassed the Court's concern with the use of the 75th percentile:

> [1479] In our view, applying the 75th percentile estimate to the initial RAB is unlikely to be necessary to promote incentives to invest and innovate. Future investment choices by suppliers must rationally be influenced by expected earnings on those future investments, not by earnings on past investments. (The experience with past investments may of course be relevant to future investments, but that is another story.)
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> [1480] The idea that greater revenues produced by higher allowed earnings on past investments (ie on the initial RAB) provide the wherewithal for more future investment is contrary to rational investment choice. Those existing higher earnings, once earned, are a given. The source of funds for future investments does not influence the riskiness of future investments; nor, therefore, does it influence their attractiveness. If anything, an abundance of capital is likely to lead to wasteful investment.

In BARNZ's experience, the fact that the Commission published a 75th percentile estimate has resulted in the airports treating this as the de facto return to be targeted across the RAB, without any consideration of why an uplift from the mid-point is necessary, or any identification of how that additional return resulted in long term benefit to consumers.

For airports, which have the ability to earn significant complementary revenue through associated activities such as duty free retail, food and beverage offerings and car-parking, there is no justification for automatically targeting a return above the mid-point. These complementary revenue streams already provide additional incentives to invest, over and beyond the prospect of earning a normal return, which, for most participants in competitive markets, is by itself a sufficient incentive to invest.

BARNZ considers that the Commission's proposed move to emphasise the importance of the mid-point as the starting point for assessing airport profitability is consistent with the s52A purpose of Part 4, addresses the concerns which were articulated by the High Court in its merit review decision in relation to the Commission's previous approach and better promotes the long-term benefit of consumers.

BARNZ requested Dr John Small of Covec to review the report from Professor Yarrow and consider the questions posed by the Commission at paragraph 29 of its paper. The report from Covec is attached. In essence, Covec considers:

- It would be unwise for the Commission to attempt in advance to set out possible good reasons that airports might have for disagreeing with the Commission's WACC analysis and therefore adopting a different WACC. The onus should be on the airport to justify any departure from the Commission's estimate of the appropriate mid-point WACC.
- There is no case for justifying targeting returns in excess of the WACC mid-point. Doing so would not be consistent with the purpose of Part 4.
- Because there is no case for departing from the mid-point of the WACC distribution Covec sees no reason or merit to develop quantitative models for estimating a WACC percentile other than the mid-point, or a probability distribution.

We thank the Commission again for the opportunity to comment on its emerging views and on the advice it received from Professor Yarrow.

Yours sincerely,

John Beckett
Executive Director