23 August 2018

INTRODUCTION

1. This is the New Zealand Airports Association ("**NZ Airports**") cross-submission on the Commerce Commission's ("**Commission"**) draft report "Review of Auckland International Airport Limited's pricing decisions and expected performance (July 2017 – June 2022)" ("**Auckland Draft Report**") in light of the draft report "Review of Christchurch International Airport Limited's pricing decisions and expected performance (July 2017 – June 2022)" ("**Christchurch Draft Report**").

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EXECUTIVE SUMMARY

3. Now that the Commission has released both the Christchurch Draft Report and the Auckland Draft Report, it is timely to reflect on a key question under section 53B(2)(b): does the Commission's summary and analysis promote greater understanding of the performance of airports, their relative performance, and changes in performance over time?

4. In many respects, the answer is yes. The Commission has sought to convey the rationale of certain key decisions and judgements made by airports, and provided views on whether the outcomes of those decisions are likely to be consistent with the Part 4 purpose statement. For example, it has promoted understanding of Christchurch Airport's restructuring of prices, and Auckland Airport's runway land charge.

5. For target returns, the outcomes are mixed. The Commission's assessment framework has encouraged airports to fully disclose their evidence and reasoning for their target returns, so that interested parties can assess whether, in light of airport-specific circumstances, the airport's exercise of judgement is likely to promote the long-term interests of consumers.

6. On the other hand, the Commission's method for assessing that evidence and reasoning has created some doubts about the extent to which, in principle, it is open to airports justifying airport-specific WACCs above the WACC IM mid-point (which is an industry-wide average). We think it is important that the final reports demonstrate that the Commission is willing to adopt an approach that recognises that there are material limits on airports' ability to realistically provide empirical evidence to justify adjustments to WACC IM parameters (of which the most material, asset beta, is a global average). Our fear is that if it does not, then the flexible and context-specific approach signalled at the conclusion of the IM review will be practically unachievable, to the detriment of consumers.

7. Accordingly, we ask that the final assessments better reflect the complexity, context and judgement that informed airport decision-making and performance, which cannot be condensed to an artificially precise point on a percentile scale. To illustrate, the challenges and risks facing Auckland and Christchurch Airports are very different for PSE3, yet the Commission's assessment method implies that they are essentially the same.

8. To assist interested parties to fully understand the differences between airports, and the airport-specific circumstances that informed their decision-making, the final reports should:

   (a) clarify that by assessing a "sufficiently justified" WACC, the Commission is not purporting to determine the "correct" WACC for each airport;

   (b) more clearly express to interested parties that estimating an airport-specific WACC is not capable of the type of precision conveyed by both the Auckland and Christchurch Draft Report;

   (c) recognise that there are differences in views on WACC that are within an acceptable range of returns; and

   (d) engage more fully with judgement calls airports have made and better summarise airport evidence and specific circumstances that establish a legitimate conceptual reason for a departure from the WACC IM mid-point.

9. The Draft Report for Auckland Airport should also be adjusted to reflect the Commission's approach to non-priced services in the Christchurch Draft Report. NZ Airports agrees with the Commission's approach in the Christchurch Draft Report that target returns for non-priced services are better assessed on a more flexible basis over a longer period than the standard five-year pricing cycle. In particular, the Commission should:

   (a) not seek to determine whether Auckland Airport is seeking excessive profits for non-priced services in its Final Report; and

   (b) avoid making any headline statements regarding Auckland Airport's profitability across all regulated services.

TARGET RETURNS FOR PRICED SERVICES

Implications of Draft Christchurch Report

10. The Commission has correctly found that Christchurch Airport is targeting reasonable returns for priced services.

11. However the Commission's assessment of a "sufficiently justified" WACC for Christchurch Airport is of most relevance to the assessment of Auckland Airport's target return.

12. Despite Christchurch Airport's extensive evidence, the Commission's draft finding is that its WACC estimate at the 61st percentile of the WACC IM range was not sufficiently justified, because adjustments to asset beta were not justified. The outcome was a "sufficiently justified" WACC for Christchurch Airport of 6.47% (compared to its expected return for priced services of 6.44%), which equates to the 52nd percentile of the WACC IM range.

13. It is not clear whether the Commission intends to determine a "sufficiently justified" WACC in the final Auckland Airport report.[1] However, based on the combined effect of the draft reports, it is possible that the Commission will find that Auckland Airport should have used the WACC IM mid-point when it set prices.[2]

14. Such findings would imply that:

(a) both airports have the same systematic risk (ie there are no relevant airport-specific circumstances); and

(b) investors nevertheless expect a slightly higher financial return from Christchurch Airport given its risk.[3]

15. This implies that each airport is in the same situation, when the reality is that their circumstances for PSE3 are very different. Interested parties are therefore at risk of not receiving the full picture in the final reports.

16. We also consider there is a real risk that the Commission's assessment approach will (unintentionally) control pricing outcomes in a manner that goes far beyond the intent of ID regulation (to provide sufficient information to interested parties to assess whether the Part 4 purpose is being met). More broadly, the ID regime was designed to allow airports to have flexibility in setting prices, but to provide incentives for them to limit their profitability (among other objectives). This is partly because airports were considered to be in the strongest position to determine approaches that best addressed challenges in a complex environment. We are worried that the flexibility for airports to address this real world complexity is being unduly limited by an excessive focus on artificially precise outcomes produced by WACC parameter estimation methods. Commenting on differences in forecast WACC or target returns without full evaluation of actual outcomes for consumers cannot provide a balanced assessment of whether airports are acting in the long term interests of consumers.

17. We therefore take this opportunity to step back, and provide ideas on how the Commission can:

(a) better convey to interested parties the differing challenges airports faced when they set prices; and

(b) provide airports with comfort that it remains, in principle, open to them justifying airport-specific WACCs on grounds other than cost of debt adjustments.

18. Achieving these objectives will involve:

(a) better recognition that the WACC IM mid-point is an imprecise benchmark subject to estimation error, that is not necessarily an accurate indicator of airport-specific performance that promotes the long-term interests of consumers;

(b) acceptance that seeking onerous amounts of evidence to justify adjustments to the WACC IM asset beta (which is an average from a diverse global sample) may be

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[1] In the Auckland Draft Report, the Commission expressed the view that Auckland Airport's WACC estimate had not yet been sufficiently justified. It did not express a view on a WACC that had been sufficiently justified, and also noted that not all of its headline figures on profitability above the WACC IM mid-point necessarily indicated excessive profits.

[2] If, for example, it maintains its view that no adjustment to cost of debt is justified for Auckland Airport, and if it finds (as it did for the Christchurch Draft Report) that no adjustments to asset beta are justified.

[3] The Commission has stated that "the cost of capital is the expected financial return investors require from an investment given its risk". See IM Review Topic Paper 4 at [10].

unachievable, and may not help to inform interested parties about whether airport decision-making and performance is likely to promote the long-term benefit of consumers in their specific circumstances; and

(c) a more holistic and flexible assessment of airports' evidence, reasoning and judgement, which focusses on whether the airports are actively seeking to promote the long-term benefit of consumers.

The WACC IM mid-point is not a precise indicator of acceptable airport-specific performance

19. We believe that to establish a framework that encourages a deeper understanding of airport-specific context, it is important for the final reports to more clearly convey to interested parties that estimating a WACC that best promotes the long-term benefit of consumers at each airport requires significant judgement based on the circumstances at the time prices were set. Estimating WACC is not capable of the type of precision conveyed by the Commission's assessment framework.

20. We think this is a reasonable request, because the Commission clearly agrees that estimating a WACC that promotes the Part 4 purpose statement is a difficult exercise. For example, it has said that:[4]

> The WACC must be estimated because its components, for example the cost of equity, cannot be observed directly. This raises the prospect of estimation error since it is not possible to know the true cost of equity.
>
> To illustrate the potential for estimation risk, the previous IMs included a WACC percentile range based on the 25th to 75th percentile estimates of a probability distribution of the WACC estimate. The probability distribution was determined from our estimate of the standard error of the WACC.

and:[5]

> The main disadvantages of this approach [to determining standard error] are that, although greater use is made of statistical information, the use of such information might create a sense of precision that is not warranted. Also, some degree of judgment is still involved when applying this approach. Finally, the assumption of the overall cost of capital estimate being normally distributed is unlikely to be satisfied in reality.

21. We understand and accept that, as part of the IM Review, the Commission wished to reduce focus on the upper bound of its percentile range. However, we expected that estimation error would still be an important part of the new assessment framework.

22. The important point is that the WACC IM mid-point is not an empirically justified "correct" WACC for each airport. Rather, it is the Commission's best estimate of an industry-wide WACC for airports, which required the exercise of considerable judgement to produce.

23. We do not raise this to suggest that the Commission's estimate is somehow wrong, or that airports are entitled to use higher estimates as a matter of course. Our point is that the Commission's assessment framework correctly leaves open the possibility than an appropriate airport-specific WACC could be different to the WACC IM mid-point - which is

[4] IM Review Topic Paper 6 at [20] to [21].

[5] Input Methodologies (Airport Services) Reasons Paper at [E11.21].

materially based on a global average asset beta. We strongly believe that, when assessing the choices and decisions made by airports, it is incorrect to treat the WACC IM as having been empirically justified, and/or require an airport-specific WACC to be empirically justified to a higher standard than the WACC IM itself.

24. The reality remains that, when estimating an appropriate WACC and target return that best promotes the long-term benefit of consumers, it is not possible for each airport to precisely and empirically quantify what that estimate should be in its specific circumstances. The Commission's assessment should therefore consider whether the airport's exercise of judgement was reasonable in the circumstances. Key considerations in that respect are:

    (a) What factors informed the airport's exercise of judgement, and do those factors provide a legitimate conceptual reason for the approach it took?

    (b) Bearing in mind the risk of estimation error and the inherent difficulty in quantifying adjustments, was the airport's exercise of judgement reasonable based on the evidence before it at the time it made the decision?

25. We think engaging on such questions provides the best prospect of assisting interested persons to understand whether airports are seeking to promote the long-term interests of consumers.

26. If airports can demonstrate that there is a rational and direct link between their target return and tangible benefits they will provide to consumers, then we believe the Commission should be very slow to make adverse findings based on technical analysis that brings an artificial sense of precision to an exercise that inevitably requires significant exercise of judgement.

False precision risks obscuring the full context

27. The views expressed in the Christchurch Draft Report regarding a "sufficiently justified" WACC have not mitigated the concerns expressed in our submission on the Auckland Draft Report that the new assessment framework appears to make it very difficult to justify a WACC appropriate for each airport's risk profile, based on airport specific data and other evidence. A key reason is that there is little or no accommodation for standard error and the necessary exercise of judgement.[6] In particular, it now appears that to justify a different airport-specific WACC, each airport is required to empirically justify an adjustment to the WACC IM cost of debt or asset beta (even if that does not represent how they determined their target return).

28. It is also unhelpful that the Commission identifies a "sufficiently justified WACC" of 6.47% for Christchurch Airport. This could be wrongly interpreted by interested parties as being the "correct" WACC. We recommend that the final reports make it clearer that the Commission has not purported to determine the correct WACC for each airport.

29. The Commission has made some statements that indicate it remains open to a more flexible and context-based assessment approach. For example:[7]

> We do not intend to necessarily determine an alternative, company-specific, WACC estimate for an airport if we consider it has legitimate reasons for targeting a different return to our mid-point estimate. Instead, we consider it appropriate to base our profitability assessment

[6] See NZ Airports *Submission on Auckland Airport Draft Report*, 29 May 2018 at [43] – [54] and NZ Airports *Cross Submission on Auckland Airport Draft Report*, 26 June 2018 at [20] – [25].

[7] Christchurch Draft Report at [A22].

on our mid-point WACC, but allow for any legitimate differences between the individual airport's WACC and our benchmark WACC when reaching our conclusions on profitability.

30. However it is not yet apparent from the Commission's assessment approach that a proportionate and contextual approach is being applied. Instead, it appears to be an "all or nothing" technical approach, that does not convey to interested parties how airports made their decisions and/or the level of uncertainty and imprecision when comparing their approach to the Commission's preferred approach.

31. NZ Airports acknowledges that the WACC IM mid-point is the Commission's "starting point" for profitability assessment, and that airports need to provide legitimate reasons for any expected returns above that benchmark.

32. However, if airports have identified legitimate conceptual reasons why the WACC IM mid-point may not best promote the long-term benefit of consumers in their specific circumstances, then it is important that airports are not prevented from adopting an alternative approach due to an evidential standard that gives the WACC IM mid-point undue weight as a reliable indicator of appropriate returns.

33. Following the draft reports for Auckland and Christchurch Airports, it appears that:

(a) Adjustments for airport-specific cost of debt can be justified.[8] This amounts to 2 percentile points for Christchurch Airport on the basis of its credit rating being different to the IM benchmark.

(b) On the other hand, it will be very difficult to justify adjustments to cost of equity given the same clear evidence does not exist. This is not because real and material differences between airports and the IM benchmark do not exist, but because the Commission's method for determining the WACC IM asset beta, and then assessing airport-specific asset betas in comparison, acts as a block on airports justifying an asset beta that better reflects their systematic risk.

34. Even though it is unlikely that the average asset beta from the IM comparator sample is an accurate estimate for each New Zealand airport's asset beta, the opaqueness of the systematic risk for each of the comparator sample airports acts as a barrier to each airport demonstrating, in the manner demanded by the Commission, that their asset beta is different.

35. We struggle to understand how the Commission has arrived at a position where it believes that it is reasonably possible for airports to empirically justify airport-specific asset betas to a higher standard than it has required of itself. In the past, it has noted that:[9]

> The Commission agrees that as the equity beta measures an asset's or a security's sensitivity to market risk and airport services may face different levels of systematic risk, different equity betas could apply, in principle, to different airports.

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[8] We note that although the Commission's draft view was that Auckland Airport's approach to estimating cost of debt was reasonable, it preferred to use its IM value for assessment purposes. Among other reasons, this was because the difference between Auckland Airport's approach and the Commission's approach only amounted to a 2 basis point adjustment to the overall cost of capital.

[9] Input Methodologies (Airport Services) Reasons Paper, at E8.9 to E8.11. We also note that paragraphs A7 and A8 of the Draft Report recount the Commission's decision under the section 56G reviews to reject supplier-specific adjustments.

> However, the Commission notes that estimating asset betas for an industry (or specific service) is inherently imprecise and involves a significant degree of judgement. Estimating supplier-specific equity betas would require an even greater degree of judgement that estimating service-specific equity betas.
>
> Two of the three airports, subject to regulation under Part 4, are not listed and there is no reliable information available to the Commission to enable it to estimate supplier-specific beta estimates.

36. It is not clear to us what has changed since the IMs were determined such that an airport now has greater ability than the Commission to empirically estimate a supplier-specific asset beta. The reality is that a degree of judgement will always be required.

37. If the Commission is unwilling to allow for the exercise of judgement, then it is difficult to understand how it will ever be possible under the new assessment framework to give effect to the Commission's intention that it will provide flexibility for airports to justify a WACC estimate that is appropriate to their circumstances.

38. The risk for interested parties is that the assessment approach will not accurately convey how airports are seeking to promote the long-term interest of consumers in light of the specific challenges and risk they face.

39. It is apparent to NZ Airports that Christchurch and Auckland Airports consider that they have different risk profiles, due to their materially different circumstances and context.

40. However, due to the Commission's (potentially insurmountable) requirement that differences in systematic risk must be empirically justified to its satisfaction, a potential outcome is that, despite their diligent efforts to explain their circumstances, each airports is deemed to have the same systematic risk profile. We do not think that conveys an accurate picture to interested parties.

41. We think it is important that the final reports provide a more positive and clear indication that the Commission is open to airport-specific asset beta estimates. This is particularly important, given that the draft reports include references to historic findings (eg in the section 56G reviews) where the Commission was not open to adjustments.

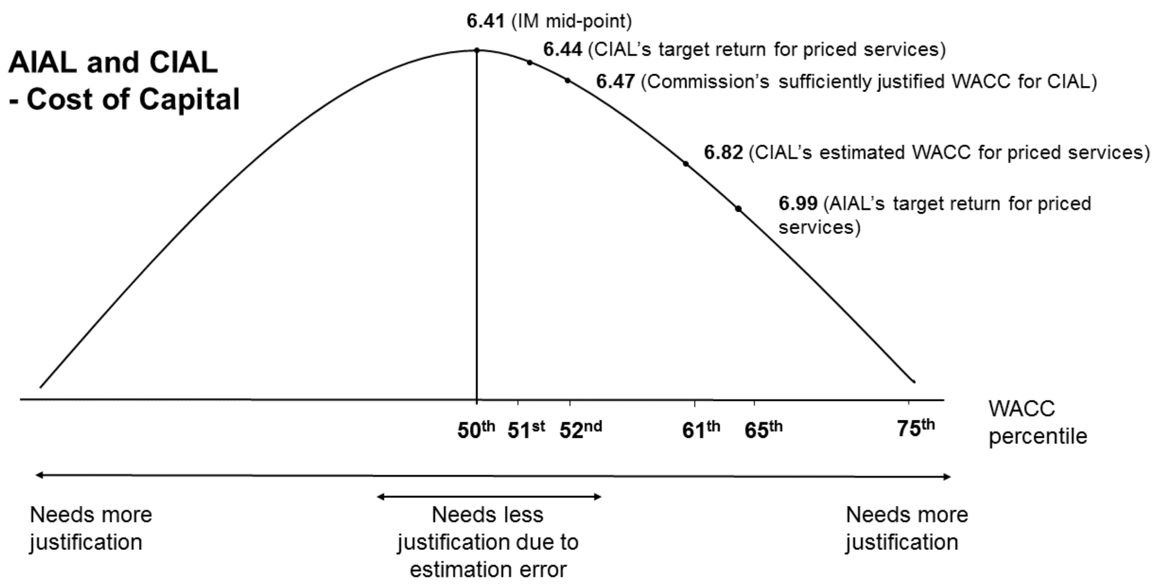
A more holistic and flexible assessment is required

42. As previously submitted, to provide confidence to airports that the Commission is open to airport-specific WACCs as set out at the conclusion of the IM Review, we think it is important for the assessment to better reflect that there are material limits on the extent to which empirical evidence can justify precise parameter-by-parameter adjustments. As illustrated in the diagram below, we believe that an approach that would more accurately inform interested parties about each airport's target returns would:

    (a) recognise that differences in views on how judgement should be exercised are within a reasonable range of returns produced by the standard error of the WACC IM;

    (b) better summarise airport evidence that establishes a legitimate conceptual reason for departures from the WACC IM, and explains the contextual factors and challenges that were material to each airport's price setting – particularly in terms of delivering benefits for consumers; and

(c) require the extent of explanation for departures from the WACC IM mid-point to be proportionate to the magnitude of departure from the mid-point. That is, the larger the adjustment, then the greater the need for airports to demonstrate that they will deliver long-term benefits for consumers (eg via an extensive investment programme).



43. The Commission has previously warned that its standard error is subject to judgement, and that the percentiles should not be treated as precise statistical measures. However, the diagram above still indicates that the various WACC estimates are all well within a 50% confidence interval around the WACC IM mid-point. An argument could be made that on this basis alone, the airport estimates are reasonable. But airports do not rely on this argument. Instead, they believe that they have produced evidence to establish that their airport-specific circumstances require a mid-point estimate of WACC that is above the WACC IM mid-point.

44. We remain worried that, unless the Commission considerably changes its approach between the draft and final reports for Auckland and Christchurch Airports, then the mid-point will be entrenched as a bright-line benchmark. That is because:

(a) There will be some ability to justify minor cost of debt parameter adjustments – where airport-specific values are observable, there is a low standard error, and the impact on overall WACC is minor. Nevertheless, when translated into an overall impact on WACC (small), there is little demonstration of a proportionate approach to considering adjustments.

(b) For parameters that are inherently more difficult to estimate (ie asset beta), with larger standard error and a greater impact on overall WACC, then airports will face significant, and unachievable, challenges justifying adjustments. The airports have, to the extent reasonably possible, provided evidence on how their systematic risk differs from the global sample average. However, the baseline evidence the Commission itself has provided on the systematic risk factors for the global sample is very limited. The Commission is effectively holding airports to a higher evidential standard than was applied when the IM asset beta was estimated. Even though asset beta is an airport-specific parameter, airports could be forced to adopt a global average that is unlikely to be an accurate reflection of their systematic risk, purely because of the assessment method chosen by the Commission.

(c) The risk is that:

(i) estimation uncertainty and error has no part to play in the assessment of target returns – the WACC IM mid-point is treated as a firm, accurate and precise estimate; and

(ii) airport context and circumstances that impact on forecast systematic risk have little part to play in the assessment. For example, although the systematic risk profiles for Auckland and Christchurch Airports are markedly different over the next 5 years and beyond, the draft reports treat them as being the same.

NON-PRICED SERVICES

45. The Commission's views on the assessment of non-priced services have appropriately evolved in the Christchurch Draft Report. Consistency now requires some changes to be made to how the Auckland Draft Report assessed non-priced services.

46. The Auckland Draft Report concludes that Auckland Airport has not justified its expected returns on non-priced services and notes that the returns expected are significantly above the mid-point for the Commission (7.9% to 6.41%).[10]

47. The Christchurch Draft Report has now appropriately recognised that it is difficult to assess over a single pricing period whether the returns on non-priced services are reasonable. Instead, it proposed a longer-term assessment approach:[11]

> Overall, we acknowledge that these contracts are affected by a range of factors, which make it difficult to determine whether returns on these contracts – over a given five-year pricing period – are appropriate.
>
> …
>
> Given the range of factors that could affect the appropriateness of returns on other regulated services, we consider it is appropriate to apply some flexibility in our assessment of these services and consider it may be better to assess returns on these services over a longer period of time. We intend to monitor the returns on other regulated services over the longer-term and the proportion of revenue captured under these services.

48. We note the Commission also states that:[12]

> The approach we take to assessing longer-term negotiated contracts will affect our review of other regulated airports' price setting events, including our final assessment of Auckland Airport's expected profits over PSE3.

[10] Auckland Draft Report at [119].
[11] Christchurch Draft Report at [121] – [124].
[12] Christchurch Draft Report at [127].

49. As noted in our submission on the Christchurch Draft Report, NZ Airports agrees with the Commission's acknowledgement that flexibility in its assessment of non-priced services is required. Accordingly, it is more appropriate to assess target returns for these services over a longer period of time than the current five year pricing cycle.

50. In light of the Commission's comments in the Christchurch Airport Report, our view is that the Commission should:

(a) not make a determination in Auckland Airport's Final Report as to whether its target returns for non-priced services are excessive; and

(b) remove non-priced services from its headline comparators of target profitability against the WACC IM mid-point.

51. Indeed, both final reports should be neutral on target returns for non-priced services at this stage. As previously indicated, we are happy to engage with the Commission on an appropriate assessment framework following the PSE3 reviews.