MAJOR ELECTRICITY USERS' GROUP

26 January 2018

Jo Perry
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Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Jo

Cross-submission on airport price setting event PSE3

1. This is a cross-submission by the Major Electricity Users' Group (MEUG) on the submissions of experts as part of the airport price setting event (PSE3) that commenced with the Commerce Commission process and issues paper "Have your say on the review of Auckland and Christchurch Airports' third price setting events (July 2017 – June 2022), 20 October 2017.[1, 2]

2. This submission is not confidential.

3. NERA Economic Consulting in a report dated 23 May 2017 for Auckland International Airport Ltd (AIAL) responded to Dr John Small, advisor to the Board of Airline Representatives of NZ (BARNZ) on estimating the regulated weighted average cost of capital (WACC) that should apply for PSE3 for AIAL.[3]

4. NERA refute the submission by Dr Small that "NERA offer no empirical anchor for the theory on which it relies". MEUG is not convinced by the counterview arguments by NERA. A common-sense check on some of the arguments leads us to think some of it is clutching at straws. A case in point is the argument the asset beta relevant to setting WACC over PSE3 materially changes upwards due to the announcement of a new "Masterplan" for a new runway and that discrete material change will stand once that runway is commissioned.

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[1] Unless otherwise stated all documents referred to in this cross-submission are published on CC web page http://www.comcom.govt.nz/regulated-industries/airports/airports-information-disclosure-summary-and-analysis/price-setting-event-3-pse3-for-auckland-and-christchurch/.
[2] CC process and issues paper URL http://www.comcom.govt.nz/dmsdocument/15840
[3] URL http://www.comcom.govt.nz/dmsdocument/16064

5. In 2016 Dr Lally in his "Review of WACC" adopted "revenue" as the basis for adjusting the industry asset beta to derive its regulated component. MEUG submitted on that issue:[4]

> **Asset beta adjustment for airports**
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> 15. The issues for Dr Lally are the Commission's 2010 approach to estimating the average proportion of airport value arising from that of regulated services and average asset beta for the unregulated services of the comparator airports. Dr Lally estimates these as being 39% (value) and 0.67 (comparator average asset beta) for his estimate of a downward asset beta adjustment of 0.03 to derive an implied 0.62 regulated asset beta.
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> 16. Dr Lally concludes
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> > "… the estimates of the two underlying parameter values are very imprecise, and the point estimate of the average weight on regulated services is also low, leading to an extremely imprecise estimate for the beta deduction."[10]
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> 17. MEUG has tested the estimated current value weights on Auckland International Airport Limited (AIAL). As at 30th June 2015 the enterprise value of AIAL was about $7.8 billion (calculated as total assets less cash and sundry creditors and with a share price of $4.94 (current share price is $6.51)). The regulated value is assumed to be equivalent to the Regulatory Asset Base (RAB including capital work in progress). The RAB is a proxy for the current valuation of the regulated assets which are assumed to just earn the cost of capital set by the Commerce Commission for disclosure purposes. On this basis the regulated assets are about 16% of the AIAL enterprise value. In contrast Dr Lally considers a 39% weighting for regulated assets is low. A 16% weighting for regulated assets in Dr Lally's example would increase the downward asset beta adjustment to 0.07.[11]
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> 18. For AIAL, where some 84% of the value is in the unregulated businesses, inappropriate adjustments have the potential to be exaggerated relative to the residual 16% for regulated business.
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> 19. Both Dr Lally and MEUG have illustrated issues with determining the regulated asset beta. MEUG also has concerns that the same issues may potentially apply in the comparator analysis for gas and EDB businesses.

6. NERA justify their proposed increase in the regulated asset beta to be used for AIAL's WACC based on "operational leverage" which considers revenue, capex and fixed and variable costs (of AIAL) relative to the observed asset beta (of AIAL). However, the relevant part of the airport specific analysis is the regulated business. Given a RAB market proxy value for the regulated business, the estimated share of enterprise value (EV) is currently around 11.5%. Once new runway capex of $1 billion is spent it increases to about 19.3%.

7. MEUG suggest the NERA asset beta assessment should be grounded in observable market indicators of the value of AIAL. Great care is needed if the Commission decides to apply an AIAL specific asset beta analysis given the RAB weighting is a small fraction of the market enterprise value of AIAL. Analysis for AIAL should be anchored to market information as contained in share prices (for EV) and given the Commission's regulatory value (for RAB). The observed AIAL asset beta reflects the market weighting of regulated (small) and unregulated activities (large).

Yours sincerely

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[4] Document URL http://www.comcom.govt.nz/dmsdocument/14194 at http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/cost-of-capital-im-review/