Section 53B review of Auckland Airport's pricing decision and expected performance for PSE3: cross-submission on WACC in light of Christchurch Airport's Draft Report.

23 August 2018

Auckland Airport

Executive summary

1. The Commerce Commission ("**Commission**") has invited submissions on its assessment of Auckland Airport's cost of capital in light of its draft assessment of Christchurch Airport's expected returns.

2. We appreciate having further guidance from the Commission that allows us to continue to develop our understanding of a relatively new and evolving regulatory regime. We also appreciate the Commission has provided the opportunity as part of its Draft Reports for all stakeholders to submit and participate in the developing process.

3. Auckland Airport considers that the draft assessment of Christchurch Airport impacts on the Commission's assessment of Auckland Airport's expected returns in two key ways:

   (a) Aspects of the draft Christchurch Airport assessment have reinforced our view that the assessment approach needs to be refined to provide the flexibility intended to take account of airport-specific factors, and to provide interested parties with a better understanding of how airports have exercised judgement in their specific circumstances.

   (b) The proposed flexible approach for assessing non-priced services over the long-term should lead to adjustments in the way Auckland Airport's target returns for PSE3 are assessed and presented.

Non-priced services

4. Auckland Airport supports the approach to non-priced services taken in the Draft Report for Christchurch Airport.

5. We ask the Commission to take the same approach for Auckland Airport. This would mean that**:**

   (a) non-priced services should be treated separately and differently to priced services**;**

   (b) there would be no findings of excess profitability for Auckland Airport's non-priced services for PSE3; and

   (c) the "headline" figures on expected profitability above the WACC IM mid-point would be removed, because they incorporate expected returns from non-priced services.

Priced services

6. We are encouraged by the Commission's view that Christchurch Airport's expected returns for priced services for PSE3 are reasonable. Given that Christchurch Airport's target return equates to the 52nd percentile of the Commission's WACC IM range, airlines may be encouraged to argue that this demonstrates that all airports should be comfortable with returns at or very near the WACC IM mid-point.

7. This is not the case. Auckland Airport has provided extensive evidence demonstrating its unique circumstances and systematic risk profile. When setting prices, each airport is required to apply judgement to balance the specific contextual

challenges it faces against the Commission's expected approach to target returns. This involves an assessment of the appropriate target return to commit to an investment programme and to retain the appropriate incentives for the airport to be responsive to price, time and quality trade-offs throughout the pricing period. The outcome is that appropriate target returns for each airport will differ.

8. We believe that a strong and effective ID Regime should provide flexibility for the assessment of performance to reflect the 'real world' operating circumstances of each airport. We encourage the Commission to consider whether its technical analysis fairly conveys to interested parties the commercial realities in which airports have made their pricing decisions, and the implications of that context for the long-term interests of consumers.

9. In this submission, we encourage the Commission to:

   (a) take into account airport-specific data and commercial factors (to the extent evidenced) when assessing the reasonable WACC for each airport;

   (b) make clear for interested parties that there is no perfect WACC estimate and that judgement is required when making conclusions around risk and expected returns in light of the benchmark cost of capital;

   (c) de-prioritise its parameter-by-parameter technical WACC assessment, in favour of a more flexible approach which delivers the airport specific contextual analysis signalled in the Input Methodologies ("**IM**") review and provides interested parties a better understanding of each airport's specific pricing context; and

   (d) take a more consistent approach in the presentation of its overall assessment between Christchurch and Auckland.

10. The critical fact that should be conveyed to interested parties in the Final Report is that Auckland Airport has set prices at a level that provides it with confidence to proceed with an unprecedented investment programme, which will deliver immeasurable long-term benefits for passengers, shippers, and the broader economy.

11. A common theme in any consultation with, or submissions from, airlines is the need for airports to reduce the amount that we charge. This is unsurprising and expected of any competitive player in any industry. However, evidence shows that if Auckland Airport was to reduce its aeronautical price by the Commission's estimated 61 cents per passenger, so as to align with its sector wide mid-point estimate, those price reductions are unlikely to result in lower airfares for passengers (as this is subsumed in air fares)[1].

12. The Commission's technical analysis in the Auckland and Christchurch Draft Reports is materially removed from the real world context for each airport. We ask that the Commission more carefully consider the real world scale and risks of Auckland Airport's investment programme, and what is most important for the long-term benefit of consumers in those circumstances. Professor Yarrow warned of:[2]

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[1] Indeed a lesser amount if non-priced activities are removed from the assessment.

[2] Professor George Yarrow *Responses to Questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector,* February 2016 at 4.

> undue focus on narrowly technical, financial issues (eg. uncertainties surrounding WACC estimates) to the neglect of wider, economic factors that are, or should be, relevant to assessment in a particular case.

13. We are concerned that not giving weight to the very real risks we face in the Commission's assessment of our target return could lead to unintended consequences. For example, based on the findings in Draft Reports, there is real potential for the Commission to find that Christchurch Airport's "sufficiently justified" WACC is higher than Auckland Airport's due to adjustments for Christchurch Airport's higher cost of debt. Such an outcome would be out of step with the risk that Auckland Airport is facing in comparison to Christchurch Airport, given the scale of Auckland Airport's imminent investment and the systematic risks we have set out in submissions to date and our ability to demonstrate the real-world benefits that will accrue to consumers.

14. We also encourage the Commission to have regard to the challenges of delivering large scale infrastructure projects in the New Zealand market. There is very little discussion of risk as part of the Commission's Draft Report on Christchurch or Auckland. We encourage the Commission as part of its assessment to provide greater insights to interested parties on how the commercial realities and risks which are part and parcel of the contextual analysis factor in the Commissions overall assessment.

15. We draw interested parties' attention to the particular risks that we face in PSE3 delivering the investment programme, building up to $1bn in work in progress, in an environment when the returns from these future assets (particularly the domestic terminal) are far from guaranteed.

16. When setting our target return, Auckland Airport described a context where we sought to balance the limbs of Part 4 and the interests of consumers and investors.[3] We identified the price and quality outcomes that were most valued by our customers and adjusted our investment programme accordingly.

17. Whilst the pricing decision is set, through PSE3 we must continue to make price, time and quality trade-offs, informed by the incentives we face to invest. We are keen to avoid an outcome where we are disincentivised from providing high quality facilities and services, and there is a consequential detrimental impact on the long-term interests of travellers.

18. We think these factors should have a material impact on the final report. Auckland Airport set prices based on the return we considered necessary to support an unprecedented investment programme that will deliver lasting benefits for consumers. We carefully considered airport-specific data, and our commercial circumstances, and sought to reflect these in a fair and balanced target return – informed by the available evidence and the regulatory guidance. We remain hopeful that the final report will step back and consider the big picture – one in which Auckland Airport's $2 billion investment programme, the material risks involved in that programme, and the benefits that will be delivered for travellers and airlines justify an airport-specific target return that differs to the Commission's generic mid-point sector-wide WACC estimate.

[3] See in particular Section 4 of Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3,* 29 May 2018.

Section 1: Non-priced Services

In light of the approach taken in the Draft Report for Christchurch Airport, we encourage the Commission to draw a stronger distinction between priced and non-priced activities for Auckland Airport.

19. Auckland Airport set out its position on how non-priced services should be assessed in Section 5 of its submission on the Draft Report for Auckland Airport and its submission on the Draft Report for Christchurch Airport.

20. In short, we agree with the Commission's proposed approach to assess non-priced services, as set out for Christchurch Airport in its Draft Report. A key element of this was to recognises that the approach to the assessment of non-priced services should be proportionate to the size of risk presented by these services.[4]

21. The Commission, in the Draft Report on Christchurch Airport, drew interested parties' attention to the proportion of the asset base and profile of price setting terms. We note for interested parties that:

    (a) the non-priced portion of Auckland Airport's regulated asset base is 8.5%, compared to 15% for Christchurch Airport.[5]

    (b) the average commencement date for Auckland Airport's existing and ongoing aircraft and freight leases is 2003. The average duration of these leases is 18.8 years, or 22.1 years including lease extensions (which are at the option of the leasing customer).

Adjustments required

22. To be consistent with the Christchurch Airport Draft Report, we ask the Commission to:

    (a) more clearly distinguish between the returns analysis for Auckland Airport's priced and non-priced services;

    (b) consider more carefully how its Final Report and media statement will be quoted by the media, and remove the "headline" findings that Auckland Airport's overall target return could result in $47 million of additional profits (which it acknowledged may not all be in excess) or 61 cents in additional charges per person;[6] and

    (c) not include Auckland Airport's target returns for non-priced services in any quantification of returns above the WACC IM mid-point.

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[4] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 19 July 2018 at [76].
[5] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 19 July 2018 at [74].
[6] Commerce Commission, *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 26 April 2018 at [87]-[88].

23. For Christchurch Airport, the Commission:

(a) was not satisfied that returns on non-priced assets were not excessive, but acknowledged that, due to their nature, the assessment should occur over the longer term;[7]

(b) calculated an overall regulated return for both priced and non-priced services but did not comment on it, instead preferring to discuss priced and non-priced returns separately;[8] and

(c) accordingly, did not calculate "headline" total company figures for projected excess target returns.

24. By comparison, for Auckland Airport the Commission:[9]

(a) split Auckland Airport's expected return of 7.06% on all regulated assets into:

(i) 7.9% on 'other regulated services'; and
(ii) 6.99% on aeronautical pricing services; but

(b) nevertheless focussed its assessment on the total company aeronautical return of 7.06% and based its headline per passenger excess return estimate on that figure.

25. We appreciate that at the time of the Draft Report for Auckland Airport, the Commission had less information on non-priced services. Consequently the 'headline' numbers that the Commission drew attention to in its Draft Report for Auckland Airport were amplified in a way that the Draft Report for Christchurch Airport was not. We note for example the Commission's wording:[10]

> We estimate that Auckland Airport's target revenue is $1,559m over PSE3 in present value terms. This is $65m more than the $1494m of revenue required to support our mid-point WACC estimate. This means that customers can expect to pay an additional $65m (or 4%) in airport charges over PSE3 (in present value terms) compared to what they would pay if Auckland Airport was targeting our mid-point WACC estimate.
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> Put another way, airport customers can expect to be charged an additional 61 cents per flight over the five-year period. After accounting for tax, this means that Auckland Airport is expected to earn an additional $47m in profits.

26. These figures were based on Auckland Airport's forecast return on its total RAB, and therefore included the return for non-priced services. While the Commission went on to note that not all of this additional $47m profit may be found to be in excess, this did little to ease the impact of the 'headline' figure.

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[7] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 19 July 2018 at [X23].
[8] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 19 July 2018 at Attachment A.
[9] Commerce Commission, *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 26 April 2018 at [63].
[10] Commerce Commission, *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report,* 26 April 2018 at [86]-[87].

27. If the final assessment of Auckland Airport's price setting is consistent with the Christchurch Airport Draft Report, then we are confident that the Commission will reach a different conclusion on Auckland Airport's target returns, in particular that:

(a) It would not find that Auckland Airport has not provided sufficient information to justify the returns on its non-priced services. Instead, as for Christchurch Airport, it may not yet be satisfied that the returns are not excessive, but require a longer timeframe to reach a definitive conclusion. We note that Christchurch Airport's target return on its non-priced assets (7.87%) is almost identical to Auckland Airport's (7.9%).

(b) Auckland Airport's target return of 6.99% for non-priced services should be the primary focus of its assessment.

(c) This may also help to bring the focus back to the key priced-services judgements made by Auckland Airport at the time of the pricing decision.

28. This approach would reduce the quantum of profits above the Commission's sector-wide WACC mid-point estimate by $8.2m. We again refer the Commission to the amended per passenger calculations that we set out in our submission on the draft report for Auckland Airport, which reduced the difference between our target return for priced services and the benchmark sector-wide midpoint WACC to $0.47 per passenger (assuming this entire amount was passed on by airlines, which is unlikely).[11]

29. In conclusion, we strongly believe that, until such time as the Commission settles upon an appropriate method for assessing prices for non-priced services, it should not draw conclusions that Auckland Airport is targeting excess returns for these services. Nor should it draw adverse conclusions about Auckland Airport's overall regulated returns based on the impact of non-priced activities.

[11] Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3,* 29 May 2018 at [194]-[195].

Section 2: The Commission's views on WACC and profitability assessment

30. The Draft Report for Christchurch Airport has reinforced our discomfort with the way the Commission is using a technical sector-wide average approach to assess the reasonableness of Auckland Airport's WACC and airport-specific target return. We are particularly concerned about the use of a strict sector-wide approach to assessing systematic risk (asset beta) in relation to an airport's target return. Asset beta is clearly airport-specific in the same way that cost of debt is – yet the Draft Report for Christchurch Airport could imply that the Commission is open to airport-specific adjustments to cost of debt, but not to asset beta and the cost of equity.

The evidential framework provided by the Commission for airport-specific adjustments to WACC is not working in the Draft Reports

31. Auckland Airport believes that the way the Commission reviews expected returns for PSE3 is critical to the success (or otherwise) of its new "flexible" assessment framework as set out in the final IM review determination. There is a risk that if airports perceive that the Commission is not open to engaging with the reasoning and judgement that informed their decisions on target returns, then their incentives to adopt appropriate airport-specific approaches and fully disclose their evidence and reasoning will be significantly undermined and regulatory uncertainty will prevail.

32. The Christchurch Airport Draft Report has reinforced our concern that there is a material disconnect between the Commission's previous statements on how it intends to apply the framework, and its assessments under that framework.

33. Previously, the Commission has encouraged the airports to provide company-specific information to justify a target return that differs to the Commission's WACC estimate. For example, the Commission has previously indicated its intent to:[12]

> de-emphasise the specific WACC percentiles and encourage airports to fully disclose the specific evidence and reasoning behind each divergence from the mid-point estimate.

34. The Commission has also made extensive requests for further information to aid its determination of the appropriateness of an increase in asset beta for Christchurch and Auckland airports.[13]

35. However, from the draft reports for both airports it appears unlikely that airports will be able to satisfy the evidential threshold that the Commission demands before it will agree with their approach. The problem is so acute that, in its submission on its draft report, Christchurch Airport felt compelled to ask for express confirmation that the Commission was, in principle, open to accepting airport-specific adjustments for systematic risk.

36. The core difficulty is that an airport-specific asset beta is compared with the average asset beta of a global sample set, where the evidential threshold for adjustments is set so high that no movement from the Commission's WACC estimate is feasibly possible.

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[12] Commerce Commission, *Review of Input Methodologies – Topic Paper 6 – WACC estimate for airports at [117]*.
[13] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 19 July 2018 at [A73]; Commerce Commission, *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 26 April 2018 at [A121].

37. Further, the Commission continues to express an aversion to asset beta adjustments. This is apparent in the Commission's discussion on leisure-based travellers:[14]

> even if Christchurch Airport has a materially higher proportion of leisure-based travellers than the sample of comparator airports, it is not clear that the asset beta should be increased. In the IMs reasons paper we stated that "[i]n the context of information disclosure for Airports, the Commission considers a service or Airport-specific asset/equity beta to be more appropriate, as making supplier-specific estimates is not practical or necessary, and would require even greater judgement than making service specific estimates"; and
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> ad hoc adjustments to the asset beta specified in the IMs would undermine the certainty intended by setting the IMs.

38. It is possible that these comments are simply a reflection of the Commission's historic approach (from the section 56G reviews) to making supplier-specific changes to asset beta on the basis of passenger-mix. If that is correct, then it is nevertheless unhelpful to repeat the comments now. At the conclusion of the IM Review, the Commission indicated that it wished to move away from its historic approach and head in a new direction for target return assessments, which provided greater flexibility to take account of evidenced airport-specific factors[15].

39. We understood that airports would be required to provide airport specific evidence. For asset beta, this was informed by 20 years of data for Auckland Airport. We were surprised this was put to one side in the Auckland Airport Draft Report and instead for the first time the Commission conveyed that it expected systematic risks comparison directly against the comparator sample average.

40. We encourage the Commission to refine its approach to asset beta, and, in particular, seek to align it with its approach to assessing the debt premium for Christchurch Airport. Asset beta is clearly airport-specific in the same way that cost of debt is. However, the cost of debt is more observable for each airport. Because asset beta can only be estimated from historic market data, it is subject to more estimation uncertainty:

    (a) The Commission has specifically drawn attention to asset beta as a parameter that is prone to error, but has nevertheless requested that we provide real-world evidence to justify any departure from its sector-wide asset beta estimate.[16] It is clear to us that the strongest evidence available is the 20+ years of Bloomberg asset beta data for Auckland Airport contained within the Commission's sector wide sample set. Our previous submissions have provided expert evidence that this Auckland Airport asset beta data is statistically reliable.

    (b) We have also demonstrated that our forward-looking operating leverage will be at unprecedented levels, which will have a corresponding impact on the cost of equity

[14] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022),* 19 July 2018 at [A54.2]-[A54.3].

[15] Commerce Commission, Review of Input Methodologies – Topic Paper 6 – WACC estimate for airports at [107-117 and 158].

[16] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report,* 19 July 2018 at [A67].

41. We do not consider that consideration of differences in credit rating, in itself, is evidence that the Commission is taking full account of airport-specific factors, as promised in the IM Review:

(a) It was apparent in the Draft Report for Christchurch Airport that the Commission is prepared to allow an uplift to debt premium based on 'real world' credit ratings being lower than the hypothetical benchmark.[17] Christchurch and Wellington Airports will therefore be able to justify a larger cost of debt on this basis. We support this proposition.

(b) Credit ratings are not the only real-world airport-specific factor that legitimately affects an airport's target return. We are concerned that, if the Commission does not accept the evidence put forward by Auckland Airport about its systematic risk and airport-specific asset beta, this could imply that a higher target return is appropriate for Christchurch Airport than for Auckland Airport. With respect to Christchurch Airport, we do not think this reflects the commercial reality of the two airports for PSE3 and the respective commercial risk profiles over the next five years. A $2 billion investment plan introduces enormous real-world risk. The risks we are facing will have a real and substantial impact on our cost of capital – and is it legitimate for us to reflect these in an airport-specific target return. Any risk to our investment incentives in PSE3 could have major consequences given the unprecedented size and scale of planned investment over this period. We remain concerned that an overly narrow and technical sector-wide parameter-based approach to assessing the reasonableness of Auckland Airport's airport-specific WACC and resulting target return will not appropriately reflect these factors. An approach which accepts airport-specific cost of debt measures and does not properly recognise airport-specific cost of equity measures raises the same concerns.

(c) The Commission only appears to allow adjustments when the IM calculations are unquestionably inapplicable to a particular airport (ie. Where the credit rating is observably different). Auckland Airport contends that this is not the same as allowing adjustments for airport-specific circumstances, in the way indicated by previous guidance from the Commission. That said, the Commission could remedy this to a material degree if it accepted Auckland Airport's evidence that shows the sector wide asset beta is unquestionably inapplicable to Auckland Airport for PSE3.

42. In that context, we believe the Commission should reconsider the measure it is using to calculate operating leverage in the Draft Reports, and amend its finding in Auckland Airport's Draft Report that, "on balance, the likely increase in Auckland Airport's operating leverage between PSE2 and PSE3 would be immaterial."[18]

(a) In its Draft Report for Christchurch Airport, the Commission continues, in our opinion, to use an inappropriate measure of operating leverage. The Commission accepted the estimates put forward by Incenta, which defined operating leverage in terms of underlying EBIT. Based on this measure, the Commission determined that, for FY2013-2017, Christchurch Airport's operating leverage was 2.23, below the mean (3.47) and above the median (1.91) of the comparator sample. The Commission concluded that, unlike

[17] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report,* 19 July 2018 at [A87].
[18] Commerce Commission, *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report,* 26 April 2018 at [A74].

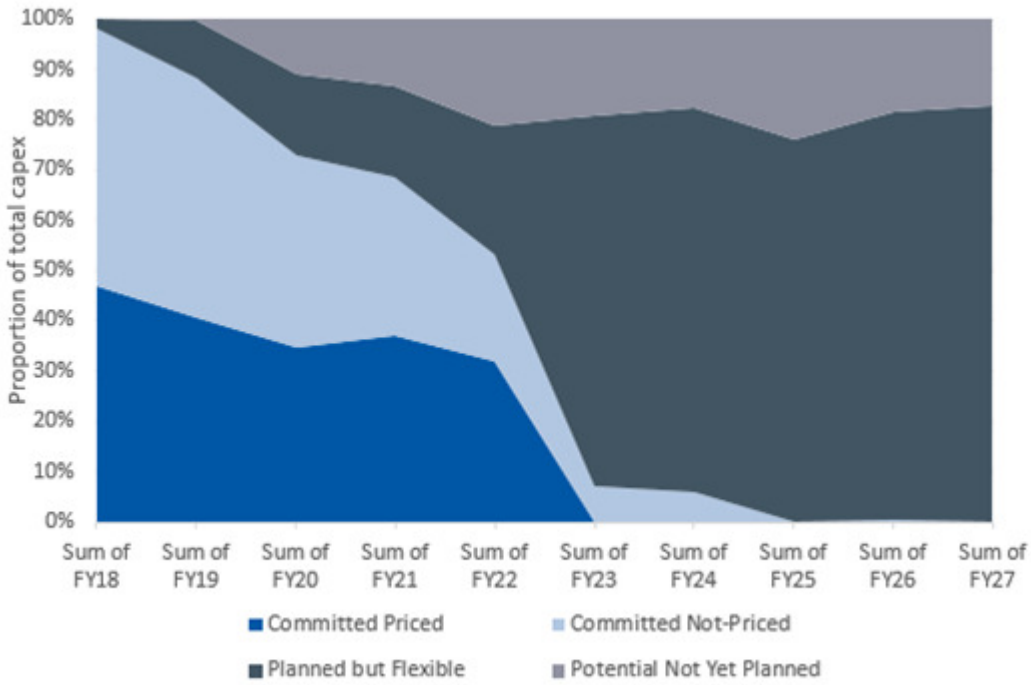
Auckland Airport, Christchurch Airport does not have a large capital expenditure programme planned over the PSE3 period, and that there was therefore 'no strong reason to consider an adjustment to Christchurch Airport's asset beta based on its degree of operating leverage'.[19]

(b) The same measure was used by the Commission in its Draft Assessment of Auckland Airport. Initially provided by Bloomberg, the measure assesses the relationship between EBIT growth and revenue growth, which takes no account of the cash flow impact of capex that is driving the change in Auckland Airport's "real-world" risk.[20] We reiterate the point made in our submission on the Draft Report on Auckland Airport that no regulator in any other jurisdiction has relied on the Bloomberg measure to assess operating leverage.[21]

(c) Operating leverage should be a measure of a company's ability to absorb adverse developments in economic activity, which is essentially its economic and financial resilience.[22] The widely accepted approach to measuring operating leverage is to measure an airport's fixed costs as a fraction of its total cost base. Whilst this is difficult to estimate precisely, a relatively large share of fixed costs leaves little room for a company to absorb adverse economic shocks.[23] Airports with a high operating leverage are left more susceptible to shock. This would be more accurately reflected if the Commission focussed on cashflow based measures of operating leverage that are affected by capital expenditure, as explained by NERA, and as indicated in our submission on Auckland Airport's Draft Report (Section 3).

(d) As a result of the large capex programme that we are facing, Auckland Airport will face large cash outflows in PSE3. This investment will significantly increase our fixed costs. The investment programme will grow our capability. However, because it is yet to be achieved, the programme carries material risk. This programme cannot be scaled back or reversed easily should demand materially decrease. Further Auckland Airport is unlikely to re-price in the face of changing market conditions. As shown in the chart below, the majority of Auckland Airport's planned capex for PSE3 is committed.

[19] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report,* 19 July 2018 at [A94].
[20] As discussed in Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3,* 29 May 2018 at [108].
[21] Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3,* 29 May 2018 at [108].
[22] NERA Economic Consulting, *Response to the NZCC's View on Auckland Airport's Asset Beta,* 29 May 2018 at 22.
[23] NERA Economic Consulting, *Response to the NZCC's View on Auckland Airport's Asset Beta,* 29 May 2018 at 22.



(e) The risk is particularly significant for Auckland Airport, given that works under construction do not enter the asset base until they are commissioned, and therefore we do not receive any return on the rapidly growing works under construction balance.[24] This is out of step with the Australian model for the building block approach (used commonly in services such as electricity networks and urban water supply), which allows a business to recover the components of its estimated costs, of which, working capital is specifically contemplated.[25]

(f) The practical effect of this is that there will be $1 billion of works under construction that will build up on Auckland Airport's balance sheet toward the end of PSE3. During PSE3 none of this will be funded by aeronautical charges, and we expect to see a material softening in our credit metrics as set out in our prior evidence.[26]

(g) We expect to have a much higher operational leverage than in the past, and relative to the Commission's comparator companies which are not overall undertaking such large scale capital expenditure. The significance, and materiality of this increase in operating leverage was set out in the NERA report, which predicted operating leverage to more than double, a rise from an average of 8%, as a proportion of asset base, in PSE2 to 20% in PSE3.[27] It would be very disappointing if in the Final Report the Commission ignored this material influence on our cost of capital.

(h) We request that in the final report the Commission's measure of operating leverage be calculated in line with the recommendations in the NERA report, ie:

(aa) Capex to RAB (used by Ofgem); and

[24] Commerce Commission, *Airport Services Input Methodologies Determination 2010,* 20 December 2016 at 19.
[25] Australian Productivity Commission, *Economic Regulation of Airports - Productivity Commission Issues Paper* at 7.
[26] NERA March 2017 Report, p38.
[27] NERA Economic Consulting, *Response to the NZCC's View on Auckland Airport's Asset Beta,* 29 May 2018 at page 7.

(bb) FCF to revenues (a variant on the measures used by the CMA and the CRE).[28]

43. In summary we do not see how the Commission could finally conclude that Auckland Airport faces the same systematic risk as Christchurch Airport and the average of the global sample of 25 airports, and should therefore be assessed against the same mid-point sector-wide WACC estimate. In the Final Report we would like to see the Commission's detailed assessment of the extensive evidence Auckland Airport has provided in its submissions. We would also like due consideration of the regulatory precedents which support an uplift to the Commission's asset beta of 0.08 which would, in turn, justify a target return above the Commission's mid-point WACC of 6.99%.

Section 3: Confidence levels and exercising judgement

44. The Draft Report for Christchurch Airport has increased our concern that the Commission is treating the mid-point estimate of the benchmark WACC as a precise bright-line test, and that it is making no allowance for estimation error in its assessments.

An 'all or nothing' approach to assessing target returns against a midpoint WACC estimate is inappropriate.

45. Airports have always understood that a departure from the WACC mid-point estimate is appropriate where it can be sufficiently justified for airport-specific reasons. However, there has been no recognition that there should also be an acceptable range for WACC, to reflect the inherent imprecision of a WACC estimate and the nature of judgement required.

46. The effect is that instead of assessing, and explaining to interested parties, how airports have exercised judgement to set prices, the Commission instead seeks to assess the outcomes of airports' decisions by reference to its sector-wide WACC mid-point estimate, as though that is the default "correct" pricing point for each airport. This was not anticipated, nor applied, by Auckland Airport when it set prices. The approach is creating confusion. It risks signalling undue confidence in the mid-point estimate of the benchmark WACC and falsely conveying to interested parties that estimating an airport-specific WACC and target return for individual airports is not possible.

47. Auckland Airport has invested significant time and effort both during our 2017 price-setting event, and during the section 53B review process, to provide evidence to explain how we exercised judgement, given the inherent uncertainty in estimating the cost of capital and to support our company-specific target return. We would appreciate the Commission making clear, as it has done in the past, that:

(a) airport-specific WACC estimates are necessary to inform target returns for pricing; and

(b) setting and assessing such estimates requires a significant degree of judgement, from airports, and from the Commission.

[28] NERA Economic Consulting, *Response to the NZCC's View on Auckland Airport's Asset Beta,* 29 May 2018 at page 18.

48. One outcome of applying a technical sector-wide assessment in its Draft Report for Christchurch Airport is that the Commission appears to adopt an “all or nothing” approach to any differences in views on WACC estimates. That is, either the evidential threshold for an adjustment is entirely met at the WACC parameter level, or it is not met at all.

49. An 'all or nothing' approach to WACC misleads interested parties about the uncertain nature of WACC estimation. Asset beta is the company specific parameter that captures the differences between individual companies and the market that has the strongest impact on WACC.

50. We acknowledge the Commission’s concerns about making adhoc changes to its WACC IM and industry wide asset beta estimate. We are however confident the Commission can draw conclusions in its s53B assessment that recognise valid differences between airports and the presence of parameter error in its models without implying that ad hoc adjustments have been made to the Commission's benchmark values or the WACC IM or that the evidential bar is low.

51. Consistent with the uncertainty around estimating WACC, we ask the Commission to place greater weight on drawing conclusions about whether airports have exercised reasonable judgement in the circumstances, rather than misleadingly seeking to confirm the "correct" WACC as though it was capable of precise verification. To put this in the too hard basket now suggests the Commission has decided that the approach it signalled in the WACC IM is unworkable in practice.

Assessing WACC requires a reasonable exercise of judgement

52. As the Commission has previously acknowledged, a degree of judgement is required to estimate WACC:

> [The cost of capital] must be estimated from the available data using a number of tools and techniques. This is not a simple task. The available tools are imperfect, the data can be hard to obtain or unreliable, and can change over time.[29]
>
> In estimating the cost of capital, there are also choices around the analytical models to be used, over the level of each parameter, and around the estimate of the cost of capital to be applied under the different regulatory instruments. The estimation of a cost of capital is not a mechanical task. To determine the methodology for estimating the cost of capital, and to assure itself that the estimate is reasonable and meets the Part 4 Purpose and the purpose statements for information disclosure regulation and price-quality regulation, the Commission has had to exercise a degree of judgement over these matters.[30]

53. In the 2010 Reasons Paper for the Input Methodologies, the Commission also acknowledged that usual practice is to estimate a WACC range:[31]

> The WACC must be estimated since its components, *for example the cost of equity, cannot be observed directly*. This raises the prospect of error since it is not possible to know the true cost of equity. To allow for this estimation error, it is usual practice to estimate a range for WACC.

[29] Ibid, at [6.1.4].
[30] Ibid, at [6.1.5].
[31] Commerce Commission *Input Methodologies (Airports) Reasons Paper*, 22 December 2010 at [6.7.3].

54. Recognising the imperfections in WACC estimation, Auckland Airport has always calculated its aeronautical pricing WACC within a range.

55. In its section 56G reports, the Commission's consideration of the range (from the mid-point to the 75th percentile) was to:[32]

> allow for the uncertainty of estimating the true cost of capital, in light of the potential asymmetric consequences of estimation error on pricing and investment.

56. As part of the IM Review in 2016, the Commission adjusted its methodology away from a range in favour of a sector-wide point estimate, on the understanding that its assessment of profitability would incorporate airport-specific flexibility with upward or downward adjustments.

57. We appreciate that the Commission removed its WACC range to avoid the 75th percentile becoming a hard target. However, the risk is that the mid-point is now interpreted as a hard target. The Commission's WACC IM mid-point estimate remains an indicative benchmark only, and as such should be interpreted with caution. The principles and reasons behind the previous WACC range are no less applicable today, as confidence levels and estimation uncertainty for the WACC IM have not changed. With the Commission choosing not to publish a WACC range, or a distribution, the level of uncertainty associated with the parameter levels chosen to estimate WACC is now captured solely in the published standard error and is obscured for interested parties.[33]

The CIAL draft report reinforces concerns that the existence of uncertainty is being obfuscated as the 50th percentile estimate is held up as a perfect brightline benchmark

58. The Commission describes its estimates as a benchmark.[34] Comparing an individual price against a benchmark requires consideration of the specific factors that may affect the individual. The Commerce Commission has acknowledged in the past that the results of benchmarking should be interpreted with caution.[35]

59. Based on the Commission's own indicator of confidence (the standard error), it is unlikely that the mid-point estimate is the true cost of capital for the industry (ie even before airport-specific factors are considered). There is approximately a 1.4% chance that the true cost of capital lies between 6.40% and 6.45% (on the Commission's distribution). The mid-point merely represents the centre of the distribution of possible values for the sample average cost of capital.

60. There is a significant risk (50%) that the true (but unobservable) cost of capital for airports lies above or below the mid-point estimated by the Commission.

61. Statistical testing usually calls for far greater confidence than the Commission is applying. The 25th-75th percentile range indicates only a 50% confidence interval.

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[32] Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report,* 19 July 2018, at [A6.2].

[33] The Commission makes no explicit provision for model uncertainty.

[34] For example, Commerce Commission, *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022) Draft report – Summary and analysis under section 53B(2) of the Commerce Act 1986*, 26 April 2018, paragraph 59.

[35] For example, Commerce Commission, *International Price Comparison for Retail Mobile Telecommunications Services 2013, Telecommunications monitoring report*, March 2014, page 8.

This means that there is a 50% chance that the true WACC lies outside this range.[36] In its commentary on the 2014 amendments to the IMs, Uniservices noted that:[37]

> In using any estimate within its 25th or 75th WACC percentile range, there is still a significant chance that the true WACC is outside this range. The choice of a 50% confidence interval estimate is also below the usual levels for statistical testing of 90% or greater.

62. Because of the uncertainty with respect to the TAMRP, debt premium and asset beta parameter inputs and the uncertainty with respect to the measures of the standard errors of the input parameters used to calculate the WACC range Uniservices has also argued that even the 25th to 75th WACC percentile range may be too narrow.[38] However we acknowledge that too broad a band raises other problems which is why more common statistical robust standards of the 90th or 95th percentiles are not used.

63. In light of the uncertainty in estimating WACC, we do not understand how the Commission can apply the mid-point of the estimated industry WACC range to Auckland Airport strictly and without exercising greater statistical and contextual judgement. The findings in the Christchurch Draft Report reflect false confidence in the certainty of the WACC industry mid-point estimate, and fail to adequately take into account the standard error associated with WACC that has been described by the Commission, statisticians and economists alike.

64. We are concerned that an underlying reason for the Commission having (undue) comfort in the industry WACC mid-point is its view that risks of under-investment are mitigated in the airport sector because of the dual till, extensive consultation in determining the WACC IM, and similar arguments addressed in previous submissions.[39] We disagree that these factors automatically protect against asymmetric risks and adverse social consequences. We have previously explained, and continue to believe, that the ability for individual airports to set a target return above the Commission's mid-point WACC, informed by an understanding of airport-specific factors and risks, is the most appropriate way of protecting against these risks and promoting the long-term interests of consumers.[40]

We request the Commission demonstrate that its 50th percentile estimate is not a bright-line by clarifying to interested parties the confidence levels and distribution curve that exists around its industry WACC estimate

65. Based on our analysis of the CIAL draft report we set out below an illustration that will make clearer to interested parties the uncertainty of estimating WACC. Together with a contextual analysis (discussed later), this will help interested parties understand how the Commission has assessed an airport's target return in light of the potential asymmetric consequences of estimation error.

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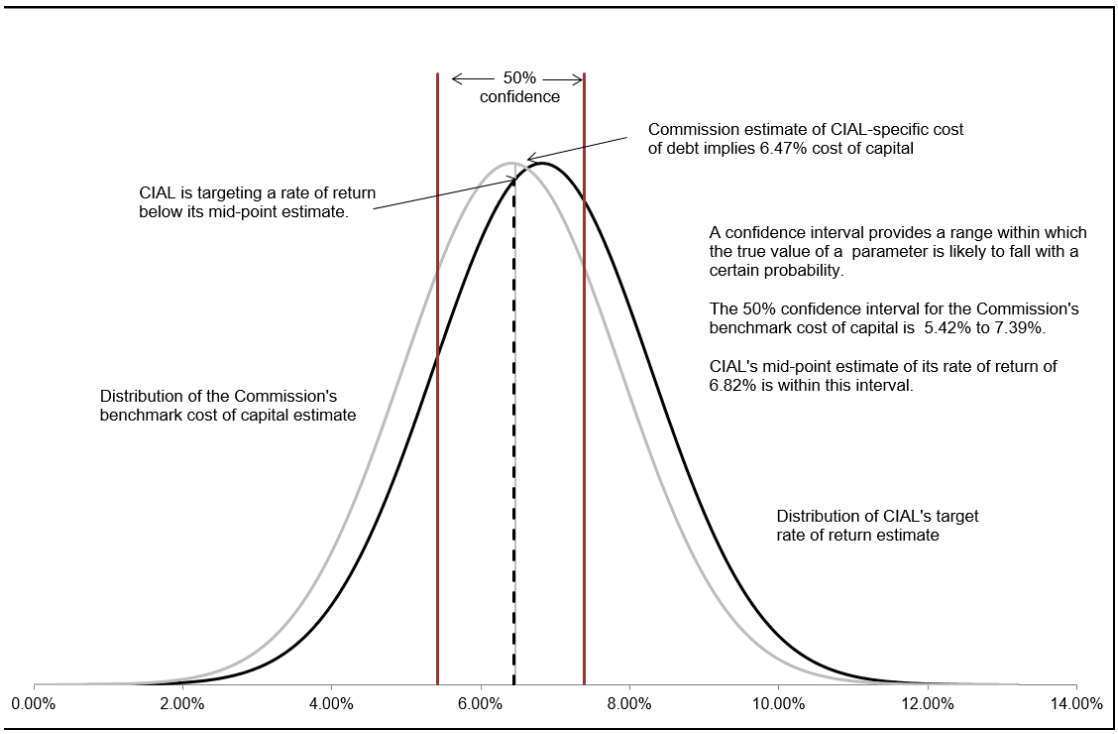
[36] Uniservices, *Comments on Air New Zealand's and BARNZ's Submissions to the Commerce Commission's Approach to estimate the Cost of Capital in its Input Methodologies Draft Reasons Paper,* 3 August 2010 at page 17.
[37] Uniservices, *Comment on 'Further work on the Cost of Capital Input Methodologies. Commerce Commission invitation to provide evidence on the WACC percentile,* 1 May 2014 at page 4.
[38] Uniservices, *Comment on 'Further work on the Cost of Capital Input Methodologies. Commerce Commission invitation to provide evidence on the WACC percentile,* 1 May 2014 at page 4.
[39] Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3,* 29 May 2018 at [136] and [54]-[58].
[40] Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3,* 29 May 2018 at [135].



66. We consider this picture usefully follows Table 2.1 of the Draft Report for Christchurch Airport and illustrates the judgement applied when the pricing decision in particular was made. This would make the following clear to interested parties:

    (a) There is a distribution curve around any WACC estimate because of estimation uncertainty.[41]

    (b) The degree of overlap between the sector-wide and airport- specific WACC estimates.

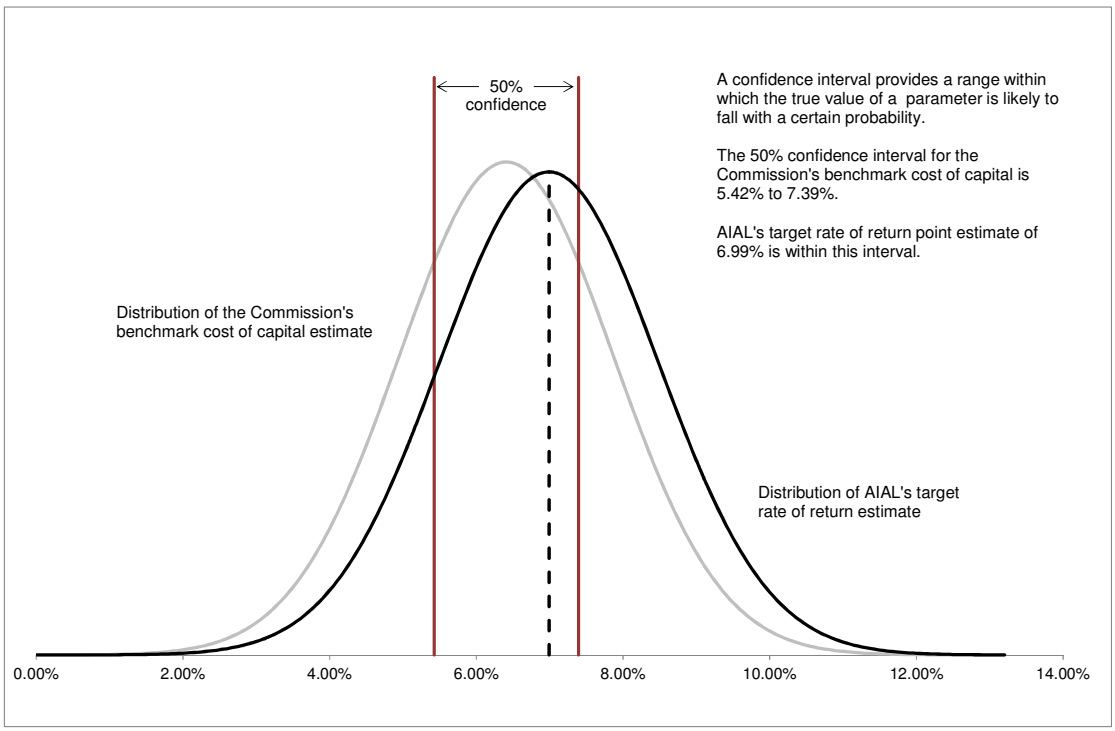
    (c) The way airports have exercised judgement by selecting a target return point.

    (d) The level of confidence the Commission can have around the industry benchmark WACC estimate, its assessed airport-specific WACC and the return the airport has targeted for pricing.[42]

67. We also illustrate the distribution curves for Auckland Airport below, and attach the workings for these graphs in Appendix 1.

[41] There is also a distribution curve for the Commission's view of a "sufficiently justified" airport-specific WACC We have not illustrated this as there is no material difference to the industry wide WACC distribution curve.

[42] We note that a 50% confidence interval is 0.6745 x standard error either side of the mean, known statistically as the z-score. The Commission may also like to assess the target return within the distribution that exists around the Commission's assessed airport-specific WACC.



68. This chart shows that Auckland Airport's target return is well within the margin of error around the Commission's sector-wide mid-point estimate. On this basis, even if estimation error or uncertainty was the only factor taken into account in assessing airport returns, our target is within the bounds of reasonableness. As we have explained elsewhere in this submission and during the section 53B process (and discuss further in Section 4 below), airport-specific evidence and real world context provide further support and justification for Auckland Airport's target return for PSE3 – including why this target return is consistent with long-term consumer interests.

Section 4: Giving due weight to real world context

69. As alluded to at the highest of levels in the previous section, context is critical to understanding the comparative target returns of airports. Following our review of the Christchurch Draft Report, we are concerned that the assessment approach is not clearly conveying the relevant airport-specific circumstances, and how they differ.

The Commission's Draft Reports should be refined to give more weight to context when assessing target returns.

70. When assessing the reasonableness of the judgements airports make on where their target return should sit in the confidence interval for the Commission's industry-wide benchmark estimate, it is important to fully consider the relevant context. In particular, is the airport able to demonstrate that the target return will support an investment programme that will deliver real world benefits for consumers over the long term?

71. We encourage the Commission to reconsider its draft findings on Auckland Airport's target return, given that:

    (a) The issues facing Auckland and Christchurch for PSE3 are fundamentally different.

(b) The broader context is that investment incentives are crucially important, and customers will receive significant tangible benefits from Auckland Airport's investment programme. This compares to the counterfactual, which is likely to lead to a wealth transfer from airports to airlines only, and not passengers.

(c) We are not attempting to justify a target return at the 75th percentile for the industry-wide WACC estimate. At the 65th percentile, Auckland Airport's target return for priced activities sits well within estimation confidence levels.

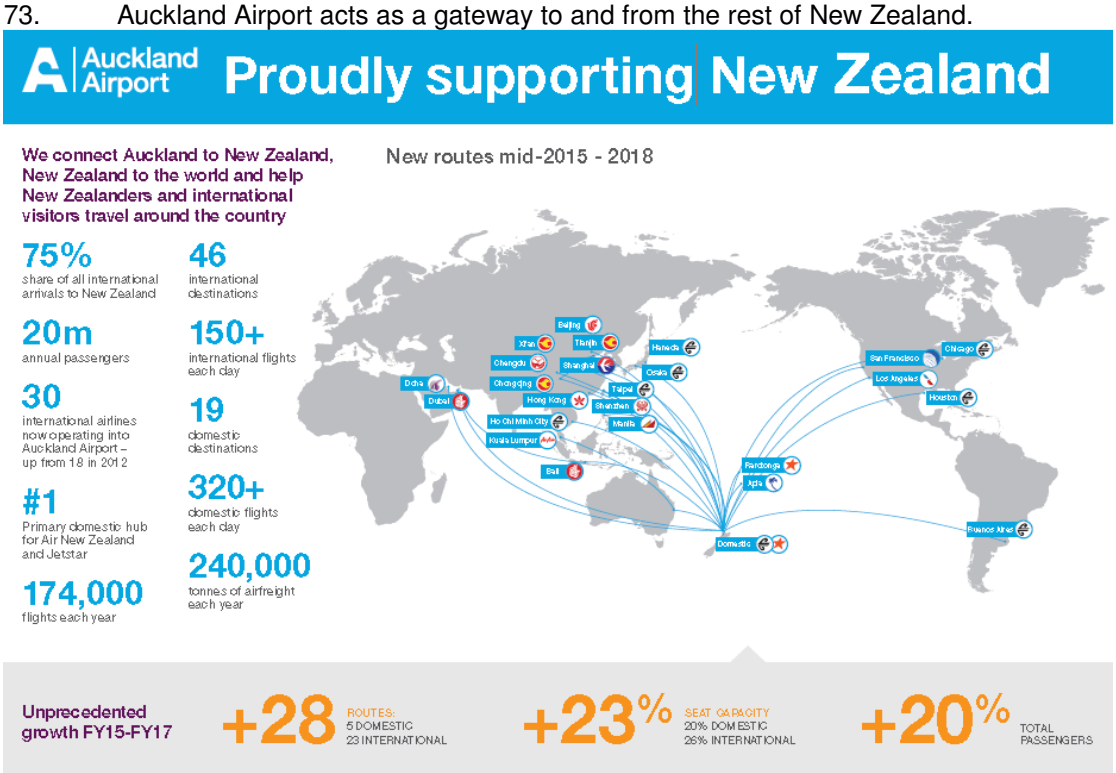
(d) The conceptual reasons, and evidential basis, for being above the mid-point estimate are strong.

(e) The asymmetric consequences of estimation error are particularly high for Auckland Airport, as the negative consequences for consumers of any scaling back of Auckland Airport's massive aeronautical infrastructure programme over PSE3, or potential service level / cost trade-offs, are very large.

72. We summarise this real-world context below in a way that seeks to make it most accessible to interested parties.

Stepping back to the overall contextual assessment of Auckland Airport's target return.

73. Auckland Airport acts as a gateway to and from the rest of New Zealand.



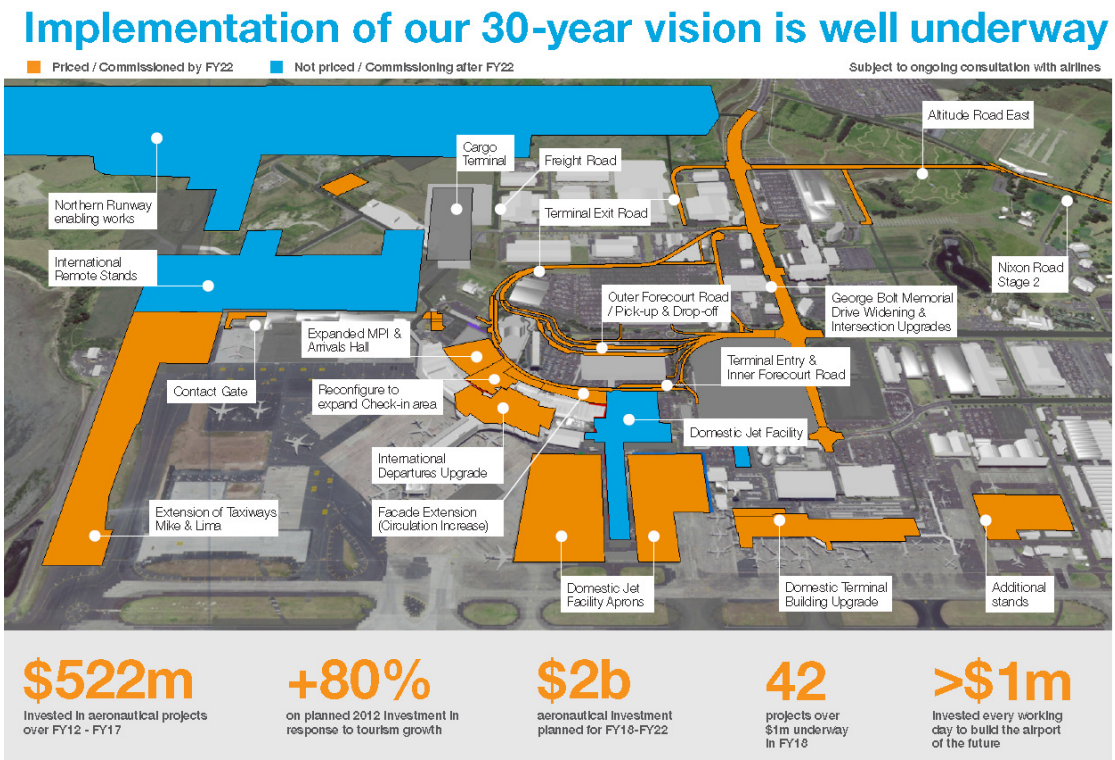
74. We facilitate 75% of New Zealand's international arrivals and departures, which makes us a significant player in New Zealand's second largest industry, tourism. Just after we last set prices, tourism generated $9.8 billion for the country in export earnings (2013).

75. We are currently the second largest airport in Australasia for international passenger traffic. Not only do we welcome passengers to and from New Zealand, but 230,000 tonnes of airfreight cross through our door each year, making Auckland Airport New Zealand's second largest cargo port by value of exports and imports ($13 billion).

76. Auckland Airport faced unprecedented growth between FY15 and FY17, the speed of which was impossible to predict. By 2017 tourism export earnings had grown to $14.5bn.

77. Our customers have requested that we invest significantly in infrastructure to keep up with this growth. Through PSE2, Auckland Airport was able to invest 80% more than it planned in 2012 because the investment was ultimately supported by airlines and the incentives to invest were sufficient.

78. Our aeronautical investment programme is unprecedented in Auckland Airport's history. As illustrated below it will disrupt virtually every part of the existing operation, with aeronautical and non-aeronautical consequences.



79. Through PSE3 we will make critical choices on the price, quality and time trade-offs which best support the delivery of future aeronautical services. We are working with our airline customers to deliver this infrastructure in a way that best serves the interests of passengers.

80. The programme is undeniably complex. Unfortunately there are structural differences in the capability of construction contractors to deliver complex infrastructure in New Zealand versus offshore. Airports and hospitals are certainly an example of this. Contractors are increasingly seeking to transfer any risks of non-delivery to the owners of the finished development.

81. Due to the brownfields nature of much of our PSE3 aeronautical development programme there is no perfect decision. Rather we must seek to balance the development principles as best as possible and consider how to deliver projects in

stages whilst 55,000 passengers travel through the precinct daily. The non-aeronautical business is forecast to experience both trading and displacement risks due to the scale of the investment programme.

82. Nevertheless we plan to invest more than $1 million every working day in aeronautical infrastructure to ensure that we can accommodate 40 million passengers and 260,000 flights by 2040. Our latest estimates involve a $2 billion total aeronautical investment plan (for which development is already underway), or $15 per passenger over PSE3. This means that for every $1 Auckland Airport receives in revenue, we will be spending $1.75 to grow, operate and maintain New Zealand's largest airport.

83. Our investment programme is one of the most ambitious in New Zealand's aviation history and involves replacing ageing assets, increasing resilience and providing better quality experiences for airlines and passengers. As Auckland Airport commits to the construction programme our operating leverage will increase materially and we will become more exposed to external shocks.

84. Returns from our PSE3 investment programme are far from guaranteed. $1 billion of works under construction will build up on Auckland Airport's balance sheet toward the end of PSE3. None of this will be funded by aeronautical charges during PSE3, and we expect to see a corresponding impact on our credit metrics through the pricing period.

    (a) Airports generally experience higher volatility than other regulated industries because of the underlying volatility in demand for airport services. This is true at the regional, and at the aggregate level.[43] Since we dropped aeronautical prices in FY18 there have been a number of material changes to demand and supply conditions. Actual international passenger growth in FY18 (by far the most important aeronautical revenue driver), was only 80% of the aeronautical pricing forecast. These changes illustrate the fast changing nature of aviation competition. We have described in earlier submissions how Auckland Airport differs from global comparators, particularly due to the large cash outflows that we expect during our construction phase.[44]

    (b) Looking ahead, a concern we have (particularly given the size and scale of the domestic investment) is the fact that the domestic competitive market structure is not deep, nor particularly secure. Air New Zealand have a dominant domestic position and the long-term security of Jetstar is not guaranteed. We watch with interest as to how the Qantas and Air New Zealand codeshare on domestic routes will unfold.

85. As Auckland Airport commits to its investment programme our operating leverage will increase and our ability to reduce capital costs will markedly reduce should there be a structural change. Auckland Airport has set out why it is unlikely to reprice lightly in the face of changing market conditions. Indeed whilst we have sought to provide clear price signals for PSE4, carriers prefer that we invest during PSE3 and defer pricing implications to PSE4. The PR strategies deployed by airlines through this past 12 months foreshadow challenging pricing discussions in PSE4. Yet from a consumer perspective it is likely that passengers would not want that uncertainty to derail domestic integration.

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[43] Professor George Yarrow *Responses to Questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector,* February 2016 at 15.

[44] As discussed in further detail in Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3,* 29 May 2018 at [78]-[79].

86. International regulators, when considering target returns for regulated entities facing similar risks, have exercised judgement by referencing measures of operating leverage (such as OCF/Revenue and TOTEX/RAB) that are more capable of capturing the additional fixed costs of significant capex programmes.[45]

87. In this context it is noteworthy that there are material benefits to the economy and our local community associated with the Auckland Airport's operation and investment plan and it is important that Auckland Airport retains the confidence to invest with maximum effect.

Supporting New Zealand

We are driving benefits for New Zealanders today with:

Direct economic benefits from airport activity:

$2.7bn in GDP

20,180 FTEs

$1.2bn in household income

800+ businesses

Together with related business activity, total regional economic benefit:

$4.6bn in GDP

35,970 FTEs

$2.0bn in household income

ARA /Auckland Airport Jobs and Skills Hub

446 Placements

50% Placements off benefits

Source: Insight Economics and NZ Statistics

We are supporting New Zealand's tourism and trade ambitions:

$14.5bn
direct contribution of international tourism to GDP in the year ended March 2017

$200m
annual value to the New Zealand economy of every daily wide-body jet service secured

$11.8bn
value of imports handled by Auckland Airport (21% of New Zealand's total)

$6.8bn
value of exports handled by Auckland Airport (12% of New Zealand's total)

#2
Cargo import port by value
Cargo export port by value

Our next 10 years activity estimated to result in:

Direct economic benefits from airport activity:

$31.6bn in GDP

22,750 FTEs

$14.2bn in household income

Together with related business activity, total regional economic benefit:

$51.8bn in GDP

40,000 FTEs

$22.8bn in household income

Auckland Airport is acting in the interests of consumers.

88. Airlines have recently raised concerns that Auckland Airport has been under-investing. The evidence does not support this claim.

89. We have a history of listening to airlines and are careful to consult extensively on each major capex spend, to ensure that a range of stakeholder views are considered. This allows us to meet passenger experience, operational efficiency and resilience requirements as best as practical.

90. Conceptually, we consider that the increase in systematic risk caused by unprecedented investment in aeronautical infrastructure is a strong justification for a target return that is above the WACC IM mid-point. We expect that passengers will be comfortable to pay more for airport services when they receive tangible improvements to aeronautical infrastructure in return.

91. We can demonstrate in a concrete way that our prices will deliver higher quality infrastructure, which we believe will be fully understood and accepted by customers concerned about material infrastructure deficits across New Zealand.

[45] For example, the CMA for Bristol Water, as referenced in NERA Economic Consulting, *Response to the NZCC's View on Auckland Airport's Asset Beta,* 29 May 2018 at page 18.

92. Capacity and resilience of infrastructure is of strong interest to the airport, airlines and consumers. But there is a broad continuum of choices available on the quality to provide for each element of the investment plan.

93. We continue to receive from airlines requests for discretionary quality investments (which do not inherently improve safety, capacity or resilience). Some of these requests have already increased our aeronautical investment plan over the base case set out in pricing from $1.9bn in the price setting disclosure to $2bn. Our appetite to invest in these will be influenced by the incentives we have to invest through PSE3. It would therefore be incorrect for the Commission to assume that its Final Report on Auckland Airport will have no impact on our investment choices.

The prices we charge reflect good value for money.

94. Auckland Airport made modest price changes in 2017. Off the back of strong demand Auckland Airport was able to reduce average charges and announce its plan for substantial investment, whilst keeping average charges broadly flat. To put the price changes in context over the 5 year period:

(a) domestic charges will rise on average by just 80c;

(b) international charges will increase on average by 16 cents;

(c) at the same time we will invest at unprecedented levels to improve resilience, safety, capacity and quality which will benefit consumers; and

(d) on average 55,000 customers pass through the airport every day. Independent surveys indicate that service levels remain very good but the airport is realistic that the extent of construction will test the customer experience and the airport is actively seeking to mitigate the effects of the construction on passengers through the period

Continuing to deliver good outcomes for consumers

Modest price changes

2017 — 2022

Average per passenger charges

Domestic
one of the lowest in Australasia
$5.77 ▶ $6.57
+80¢
2.6% p.a.

International
prices middle of the peer group
$23.34 ▶ $23.50
+16¢
0.1% p.a.

Average
$15.44 ▶ $16.10
+66¢
0.8% p.a.

A runway land charge of $1.19 per passenger will apply no earlier than FY21 and only once:
- Airline consultation has occurred
- Investment to date >$50m
- The Board decides to proceed with construction

Supporting a significant investment programme

$2bn plan

>$15
aeronautical investment per passenger

For every $1 in revenue we will be spending $1.75 to grow, operate and maintain NZ's largest airport

55,000
passengers plus per day

15,000 bags per day
477 aircraft movements per day
660T freight per day

At very good service levels

8/10
Despite over 20% growth in passengers and constrained space since FY15, customer experience has held up in both terminals

OVERALL SATISFACTION
very good

Over 1M passengers have scored us as very good via in-terminal kiosks since Q316

Ongoing focus

Further initiatives to underpin customer experience during infrastructure build

Collaboration with partners around joint service levels

95. As noted in our previous submissions, we do not agree with the Commission's suggestion in its Auckland Airport Draft Report that we are charging passengers excess returns of 61 cents per passenger. Regardless, this is a very misleading headline figure, as there is strong reason to believe that a 61 cent saving would not be passed through to passengers by the airlines.

(a) The ICF recently published a report on Identifying the Drivers of Air Fares. It compared ticket prices of similar routes that had different cost characteristics.

(b) The key finding was that the ticket price from London to New York did not change if you were flying from London Gatwick, or from Heathrow. This was true despite the fact that the outbound airport charge for London Gatwick was 13 pounds, but 45 pounds for Heathrow. The 32 pound delta was not passed through to passengers, but subsumed in the air fare.[46]

96. Even if 61 cents per flight was correct, this amount per passenger ticket appears good value given that passengers are prepared to pay:

(a) $6 per person per one way journey in credit card fees;

(b) $35 - $165 for an additional bag;[47]

(c) $5 - $75 for preferred seating;[48] and

(d) $1.50 to receive a text showing their travel itinerary.

Overall Auckland Airport has a different context to Christchurch Airport.

97. Context should inform the assessment of the reasonableness of target returns, as this informs what is at stake for consumers if the Commission's assessment is inaccurate. It is certainly not that case that just because Christchurch Airport is comfortable to target a return during PSE3 that is very near the industry wide WACC IM mid-point, that should also be appropriate for Auckland Airport. Based on our analysis of the CIAL disclosures and the CIAL Draft Report:

(a) Christchurch Airport's major infrastructure expansion is behind it. Its June 2017 disclosure indicated that it would continue to invest for business as usual for PSE3. In this context, it considered that a target return of 6.44% for priced services would be sufficient to incentivise its investment for PSE3.

(b) By contrast, Auckland Airport is just beginning its unprecedented investment programme and is facing a massive step change in its risk profile. We have sought to explain the contextual factors that support our 6.99% target return for priced services and have provided extensive supporting evidence.

(c) The Commission, in its Draft Report for Auckland Airport, did not consider that the amount of evidence (provided prior to the Draft Report) was sufficient to justify an uplift, despite the statistical reliability of the asset beta analysis. Extensive further evidence has been provided that demonstrates

[46] ICF, *Identifying the Drivers of Air Fares,* 3 May 2018 at page 37.
[47] Air New Zealand *Prepaid Extra Bags*¸ accessed 13 August 2018, at https://www.airnewzealand.co.nz/prepaid-extra-bags.
[48] Air New Zealand *Seat Select*, accessed 13 August 2018, at https://www.airnewzealand.co.nz/seat-select.

Auckland Airport's operating leverage will increase, increasing our exposure to systematic risks through PSE3.

(d) We do not consider the Commission has yet demonstrated a proportionate assessment of the evidence in determining whether our airport-specific target return, was appropriate or reasonable when compared to the industry-wide benchmark WACC, nor relative to Christchurch. NERA provides evidence that regulatory authorities and rating agencies apply uplifts of about 60 bps on WACC and/or 9% to 26% on the asset beta. NERA concludes that an asset beta uplift of 8 basis points (13%) would be consistent in terms of both relative and absolute magnitude with the adjustments applied by other global regulators in cases of differences in operating leverage.

We ask that the Commission takes a consistent approach in the presentation of its overall assessment between Christchurch and Auckland.

98. Finally, as a point of detail, we ask that the Commission use the same complete scale that it has in the Christchurch draft report showing the difference between its mid-point WACC and Christchurch Airport's estimated WACC. We note that small formatting differences can affect the perceptions of interested parties and that a full scale as used by the Commission in the Christchurch Draft Report shows no bias (intended or otherwise).

Figure A1 Waterfall chart showing the difference between our mid-point WACC and Christchurch Airport's estimated WACC

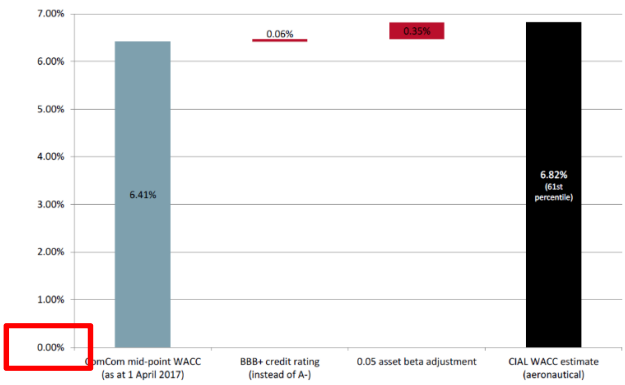
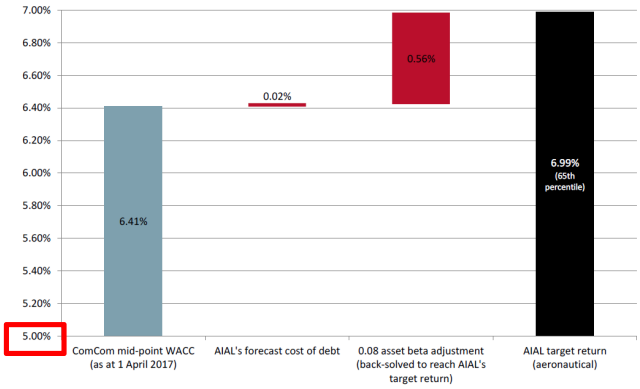


Figure A1 Waterfall chart showing the difference between our mid-point WACC and Auckland Airport's target return



99. We appreciate the Commission taking the time to review the evidence Auckland Airport has put forward in relation to our WACC and PSE3 target return. We look forward to continuing our constructive relationship with the Commission, based on our shared interests of ensuring New Zealand's largest airports are able to provide value to passengers and support New Zealand's travel and tourism sectors to compete on a global stage, whilst guided by clear and robust regulatory settings.

100. Auckland Airport believes that the way the Commission reviews expected returns for PSE3 is critical to the success (or otherwise) of its new "flexible" assessment framework as set out in the final IM review determination.