Auckland Airport

Keston Ruxton
Manager Input Methodologies Review
Commerce Commission
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25 August 2016

Dear Keston

Input Methodologies Review: Cross-submission on Draft Decision - Cost of Capital Parameters

1. The Commerce Commission has invited cross-submissions on the cost of capital topic paper in its draft decision released on 16 June 2016, as part of its review of input methodologies under the Commerce Act 1986. This cross-submission should be read in conjunction with NZ Airports' cross-submission, which Auckland Airport is a party to and supports.

2. In this cross-submission, we comment on two key points addressed in submissions by other parties – the tax adjusted market risk premium ("**TAMRP**"), and adjustment to the average asset beta produced by the Commission's comparator samples. These points are discussed in more detail in the attached report by Auckland UniServices Limited ("**UniServices**"), which forms part of this cross-submission.

TAMRP

3. We understand that the Commission intends to take a cross-sector approach to some parameters in its WACC estimate, including the TAMRP.

4. A number of suppliers in the energy sector have suggested that the approach used to determine the TAMRP estimate could be improved. We have reviewed these submissions and briefly comment below.

5. Based on advice from Dr Lally, the Commission has used the outcome of five estimation methods to generate an overall estimate of the TAMRP. ENA (based on advice from CEG) has put forward evidence to show that the "Siegel version 1" method and the "Surveys" method are not as robust as the other methods, and are not fit for purpose.[1] PwC agrees with and supports ENA's concerns.[2]

6. We agree with ENA and PwC that there are problems with the Commission's use of these estimates. Based on advice from UniServices (which is attached to this cross-submission), we believe there are flaws in the approaches that Lally has used to estimate the TAMRP according to these two methods. UniServices has also identified flaws in Lally's approach to estimating the TAMRP using the Ibbotson method for overseas markets.

7. The table below is extracted from the attached UniServices paper. It shows that UniServices agrees there are flaws with the "Siegel version 1" and the "Survey evidence" estimation methods that ENA and PwC have identified as problematic. ENA and PwC have suggested that these methods not be used. Given the Commission's apparent preference to retain and

[1] ENA "Input Methodologies review - Topic paper 4 cost of capital issues" (4 August 2016), p 22, *citing* CEG for Electricity Networks Association "Key reforms to rate of return under the IMs" (February 2016), Section 4.2.
[2] PwC "Submission to the Commerce Commission on Input methodologies review: draft decisions paper" (4 August 2016), para 250..

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rely on these methods, the attached UniServices paper sets out revised estimate values for the methods disputed by ENA and PwC. The reasons for these revised estimates are set out in full in the attached UniServices paper.

Estimates of the TAMRP with a five-year risk-free rate				
	Lally / Commerce Commission		**Revised Uniservices estimates**	
	New Zealand	**Other markets**	**New Zealand**	**Other markets**
Ibbotson estimate	7.1%	7.0%	7.1%	**7.9%**
Siegel estimate: version 1	5.9%	5.9%	5.9%	**6.7%**
Siegel estimate: version 2	8.0%	7.5%	8.0%	7.5%
DGM estimate	7.4%	9.0%	7.4%	9.0%
Survey evidence	6.8%	6.3%	**6.9%**	**6.5%**
Median	**7.1%**	**7.0%**	**7.1%**	**7.5%**
Average	-	-	**7.0%**	**7.5%**
TAMRP estimate	**7.00%**		**7.25%**	
Source: Lally (2015), Commission IM Review (2016), Table 9, para 428 and own analysis				

8. In our view, if the Commission continues to rely on all of the above methods despite the submissions of ENA and PwC, it needs to revise the estimate values for each affected method to reflect UniServices' advice.

Adjustments to the average asset beta produced by the comparator sample set

9. When estimating asset beta, the Commission has followed a similar approach for the energy and the airports sectors. It has identified a set of comparator companies that provide relevant services, and has determined the average asset beta from that comparator sample.

10. For the airport sector, the Commission has proposed an adjustment to this average asset beta to account for the fact that some companies in its sample set provide services other than aeronautical services. In contrast, in the gas sector, it has not made an adjustment to the average asset beta from its comparator sample to reflect that some companies in its sample set provide services other than gas pipeline services.

11. First Gas has strongly criticised the Commission's approach for the gas sector. It argues that an adjustment is required to generate an asset beta for gas-only services, and that there is strong evidence to support that adjustment.[3] We believe First Gas' submission raises important issues about the Commission's approach to adjusting the asset beta produced by its comparator sample, and we respond to those issues in this submission and the attached UniServices report.

12. In particular, First Gas considers that strong evidence supports an adjustment to the notional asset beta derived from the Commission's comparator sample in the gas sector. We are concerned that the Commission may interpret First Gas as suggesting that an adjustment is always required to the notional asset beta if some companies in the sample set provide different services to the regulated services the Commission is interested in.

13. We have reviewed NZ Airports' cross-submission on this issue, which we support. We wish to make the following additional points in response to First Gas' submission:

    (a) A consistent evidential threshold ought to be applied across sectors. For both the gas and airports sector, we do not believe the Commission should make any adjustments to the notional asset beta estimate from its set of relevant comparators unless there is robust and compelling evidence to do so.

[3] First Gas "Submission on Input Methodologies Review Draft Decisions: Cost of Capital Issues" (4 August 2016), p 2.

(b) We think this aligns with First Gas' view. We do not think First Gas has suggested that there is always a case for making an adjustment to the notional asset beta estimate. Instead, we interpret First Gas as suggesting that there is compelling evidence to make an adjustment for the gas sector only.

(c) We do not believe that any compelling evidence exists to make an adjustment for the airport sector. In contrast to the arguments for an adjustment for gas pipeline businesses, the attached UniServices paper sets out why a downwards adjustment to the asset beta for airports is not warranted based on the empirical evidence before the Commission. The information in UniServices' report is consistent with the logic contained in NZ Airports' submission of 4 August 2016 and the reasons set out in that submission about why a downwards adjustment to the asset beta for airports is not justified.

(d) The key points made by UniServices are as follows:

(i) Using the data from the Commission's comparator sample, there appears to be a weak positive relationship between asset beta and the percentage of aeronautical revenue for airports, not a negative relationship as the Commission has suggested. In Auckland Airport's view, this suggests there is limited rationale for the Commission's assumption that it needs to make an adjustment to generate an "aeronautical only" asset beta (this is in contrast to First Gas' submission that a '"gas only" asset beta can be identified within the Commission's energy comparator sample set).

(ii) Even if an adjustment was warranted, there are problems with the empirical sources the Commission uses to inform its decision to make a downwards adjustment and its selection of value for that adjustment. Taken together, these flaws mean that there is no empirical evidence for a downwards adjustment of 0.05 to the asset beta from the Commission's comparator sample.

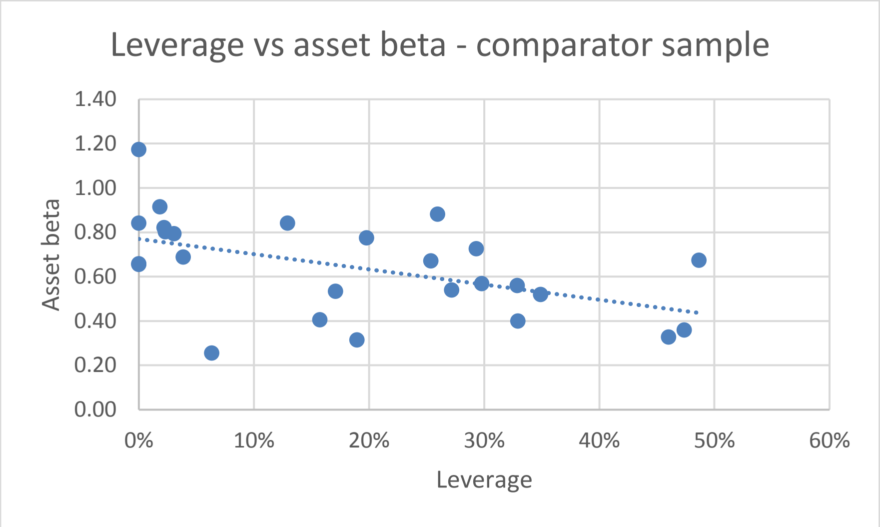
(iii) If any downwards adjustment is made for airports, UniServices concludes that it should be no greater than 0.03.

Relationship between leverage and asset beta

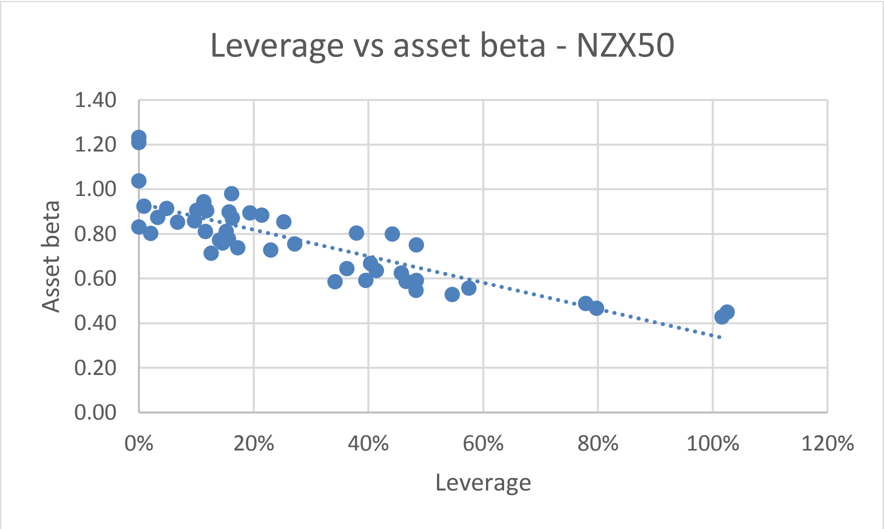
14. The ENA submits that the Commission should determine leverage for electricity lines that is different to that produced by the updated comparator sample (ie retain 44% instead of reducing it to 41%). We understand that ENA's position is specific to EDB leverage. In our view, it should not impact on the Commission's approach to leverage for airports. Our position is that, for airports, both asset beta and leverage should be determined by the average of the (updated) comparator sample, without adjustments. However, if the Commission adheres to its approach of downward adjusting the asset beta for airports, then it must also consider adopting a leverage for airports that is higher than that produced by the comparator sample.

15. The Commission released an accessible version of the leverage data for its airport comparator sample on 10 August 2016. Now that we have had the opportunity to review this data, we provide the following brief comments in response.

16. As shown in the following chart, when this leverage data is viewed against the asset beta information from the Commission's comparator sample, it suggests that companies with a lower asset beta typically have a higher leverage.



17. This trend can also be observed across the NZX50,[4] as shown in the following chart:



18. In our view, this analysis suggests that if the Commission continues to reduce the asset beta estimate from its comparator sample to estimate the asset beta of aeronautical services, it should make a corresponding upwards adjustment to the leverage estimate from its comparator sample.

Yours sincerely,

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[4] Asset beta estimates for this analysis are Local Predicted Betas sourced from BARRA Global Equity Monitor (GEM3) Long-Term Version adjusted for leverage using $B_{ASSET} = B_{EQUITY} / (1+(D/E))$. We also note that this analysis excludes NZX50 financial institutions ANZ Banking Group, Heartland Bank Limited, TOWER Limited and Westpac Banking Corporation.