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5 April 2013

Dr Mark Berry
Chair
Commerce Commission

BY EMAIL: regulation.branch@comcom.govt.nz

Dear Dr Berry

Cross Submission on Christchurch Airport Process and Issues Paper

Auckland Airport has reviewed the submissions on the Christchurch Airport Process and Issues Paper. Auckland Airport supports the New Zealand Airports Association cross submission on the Process and Issues Paper, which addresses the issues and concerns on behalf of the three regulated airports: Auckland Airport, Wellington International Airport and Christchurch International Airport. Auckland Airport's submission should be read in conjunction with the NZ Airports submission.

Auckland Airport addresses the following points in this cross submission:

- We are pleased that BARNZ and its independent adviser have acknowledged that airport-specific factors are a relevant factor when an airport is setting aeronautical charges.
- We provide further comment on the recognition by BARNZ and its independent adviser that the asset beta ought to reflect the systematic risk of the airport.
- We discuss the importance of considering the real world pressures on airports when developing a WACC estimate for use in pricing.

Airport-specific factors are relevant to setting aeronautical charges

As the Commission is aware, Auckland Airport has concerns that the Commission appears to be treating the cost of capital IM as establishing a "target rate of return" or "specific returns benchmark" that airports must achieve in order to support a finding that information disclosure ("ID") regulation is effective.

Consistent with our earlier submissions to the Commission,[1] Auckland Airport encourages the Commission to put the WACC IM in context for the reviews of Christchurch and Auckland Airport. We continue to encourage the Commission to acknowledge and assess the reasons advanced by the airports for the decisions made on the appropriate WACC estimates for pricing purposes, and to factor these aspects into its modelling and analysis (including as a sensitivity analysis).

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[1] Auckland Airport Post Conference Submission, 15 March 2013, Section 4.

In the Auckland Airport post-conference submission, we asked the Commission to carefully consider how it applies the WACC IM in the section 56G review in light of:

- the nature and purpose of ID regulation;
- the nature and purpose of the WACC IM;
- the Commission's statements about the role of ID regulation and the way the WACC IM would be used in that context;
- Auckland Airport's understanding, at the time of price setting, about how the WACC IM would be used;
- airline views at the time of price setting; and
- the prospect of regulatory error and disincentivising investment.

Auckland Airport has consistently stated that it did not understand the WACC IM would be used as an absolute benchmark, given the clear statutory requirement that it not be binding on airports. It is clear this understanding was common among the airports, and that each airport therefore sought expert advice and provided detailed explanation of the rationale behind any departures from the WACC IM in developing a WACC estimate for use in setting aeronautical charges.

In its May 2012 report, Futures Consultants Limited (the expert adviser to BARNZ) summarised and analysed each departure from the WACC IM recommended by Christchurch Airport's advisers (PricewaterhouseCoopers). Notably, in its report on Christchurch Airport, Futures Consultants accepts that airport specific circumstances are relevant to airport pricing:[2]

> In my opinion, since leisure based travel is more sensitive to income movements than business travel the higher percentage of leisure travel through CIAL warrants a slightly higher asset beta for aeronautical assets as CIAL's returns are likely to be more strongly correlated with movements in the overall market. An uplift of 0.05 points may be justifiable. If this is applied to the Commission's 0.60, the result is an asset beta for CIAL to 0.65.

This estimate of 0.65 was then applied by Futures Consultants in developing its own estimate of the appropriate WACC estimate for Christchurch Airport, instead of the Commission's industry estimate of 0.60.[3] BARNZ then used this estimate in assessing Christchurch Airport's pricing proposals.

Auckland Airport is pleased that the submissions from BARNZ and Futures Consultants on the Christchurch Airport section 56G review make it clear that they accept the WACC IM is not an absolute standard. We are pleased that BARNZ accepts that airport-specific circumstances are a relevant factor for airport pricing and for assessing forecast airport returns.

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[2] Futures Consultants Limited, CIAL's Weighted Average Cost of Capital: Update Report to BARNZ, 6 September 2012, page 3.

[3] We note that PwC Australia also provided expert advice to CIAL in relation to its recommended WACC estimate to apply in pricing. In August 2010, PwC undertook a review of airport asset betas for the New Zealand Airports Association. On the basis of that review, it concluded that an appropriate asset beta for New Zealand (major) airports in general is 0.65. In relation to CIAL, PwC Australia noted that compared with other international airports, more of its business is dependent on the leisure market and this is likely to be more sensitive to economic activity in general than other air travel. PwC concluded this justified an uplift in CIAL's asset beta to 0.70.

The asset beta used in pricing decisions ought to reflect the systematic risk of the airport

Auckland Airport supports the position taken by BARNZ and Futures Consultants that the asset beta, in particular, is an airport-specific parameter.[4] We submit that:

- It is now common ground that the asset beta is an airport specific parameter, as it is an estimate of the different systematic risk facing each airport.[5]

- Although Futures Consultants did not consider a departure from the industry asset beta was necessary for Auckland Airport, there was no suggestion in the Futures Consultants report on Auckland Airport's WACC estimate that an adjustment could not be substantiated in principle. The possibility of doing so has since been clearly stated in Futures Consultants advice on Christchurch Airport.

- Estimating asset betas is inherently difficult, but can be informed by empirical regression analysis (which can be provided for listed companies such as Auckland Airport) and expert judgment. As such, Auckland Airport considers that the asset beta parameter is a prime example of where ID regulation should follow the approach advocated by the Commission in the merits review proceedings. In other words, the WACC IM should encourage the airports to be transparent about and explain the approaches they have in fact used in pricing.

- The Commission should evaluate the evidence provided in respect of the systematic risk facing each airport as part of the section 56G review. In relation to Auckland Airport, we have provided substantial evidence (including expert evidence) during our pricing consultation process, in our pricing disclosure, and to the Commission which substantiates why the asset beta we have adopted in pricing is appropriate.

- At the very least, the Commission should expressly acknowledge in its reports that it is valid, for pricing purposes, for each airport to seek to robustly substantiate an airport-specific asset beta.

It is important to consider the reality of WACC when assessing airport approaches

An evaluation of the WACC estimate used by each airport in pricing is, of course, not limited to a consideration of the asset beta. In our view, an analysis of airport returns and profitability is incomplete without a full consideration of the real world pressures on airports when selecting a WACC estimate for use in pricing.

Our review of the PwC advice provided to Christchurch Airport indicates that there was significant consideration of current market conditions and their effect on the appropriate WACC estimate for use in pricing. Particular consideration was given to the parameter estimates for the risk free rate and the market risk premium.

Consistent with Auckland Airport's concern that there is an emerging disconnect between WACC theory and commercial reality, PwC has identified that a respected WACC expert (Officer) and regulatory agencies in Australia (the Independent Pricing and Regulatory Tribunal of NSW) have recognised that current events in world financial

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[4] BARNZ Response to Commerce Commission Issues Paper on Christchurch Airport, 22 March 2013 page 3.

[5] Commerce Commission Input Methodology Reasons Paper, 22 December 2010, at E8.9; Futures Consultants Limited, CIAL's Weighted Average Cost of Capital: Update Report to BARNZ, 6 September 2012, page 3. This point has also been made consistently by Auckland Airport and UniServices Limited.

markets have caused challenges for estimation of WACC. We understand that, in Professor Officer's view, these challenges may lead to biased WACC estimates.[6]

We encourage the Commission to fully consider such information as part of the section 56G review process, in order to provide other interested parties and the Ministers with necessary information about:

- how the theoretical position on WACC relates to (and, in our submission, is diverging from) business reality; and
- the consequences which would flow from regulatory error if the WACC is insufficiently provided for.

In our view, airport specific factors, together with the divergence between theory and practice and the possibility of regulatory error are key reasons why the WACC IM must not be applied as an absolute benchmark under ID regulation.

If you have any queries in relation to any of the matters raised in this letter, please contact either myself or our Regulatory Affairs Manager, Adrienne Darling on 09 255 9090.

Yours sincerely,

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[6] R.R. Officer (16 February, 2009), Expert Report prepared in respect of certain matters arising from the AER's New South Wales Draft Determination 2009-10 to 2013-14, prepared for Energy Australia, paragraph 34.