

Introduction

1. The Commerce Commission ("**Commission**") has invited cross-submissions on submissions responding to Topic paper 4 (Cost of capital issues) of its draft decision of 16 June 2016 ("**draft decision**") as part of its review of input methodologies ("**IM Review**") being undertaken pursuant to section 52Y of the Commerce Act 1986 ("**Act**").
2. The New Zealand Airports Association ("**NZ Airports**") contact for this submission is:

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Overview and approach to cross-submission

3. NZ Airports provided its submissions on the Commission's draft decision on cost of capital issues in Part 3 of its submission of 4 August 2016. We note from our review of the submissions from other aviation sector participants that they did not materially comment on the Commission's draft decision on cost of capital issues.¹
4. We have also reviewed other (non-aviation sector) parties' submissions on cost of capital issues. We do not in this cross-submission comment on all cost of capital matters raised in those submissions. However, our decision not to comment on those submissions should not be read as support or tacit acceptance.
5. Indeed, NZ Airports remains of the view that it is not appropriate to automatically transfer regulatory cost of capital concepts from the energy sector (where different forms of regulation are present) into the information disclosure ("**ID**") regulatory regime in the airports sector.² There are key differences between the forms of regulation (ie between ID regulation and price control regulatory regimes) and the sectors themselves. Among other things, an ID only regime should provide greater scope for assessments of performance to take into account the uncertainties associated with estimating regulatory weighted average cost of capital ("**WACC**"), such that there is less need to constantly refine the WACC IM in a search for further precision (which is likely to be illusory in any event).
6. That said, it remains important to ensure that the Commission's decisions on WACC parameters are robust - ie supported by evidence.
7. Subject to those caveats, in this cross-submission we comment briefly on some of the cost of capital issues explored in third party energy sector submissions, which have the potential to have some bearing on the approach to cost of capital parameters in the ID regulatory regime for airports.

¹ We note and welcome BARNZ's support for the Commission's proposed change to "maintain a relatively steady set of inputs to the WACC calculation" (BARNZ "Submission on Airport for Input Methodology Review Draft Decision" (4 August 2016)).

² See, for example, NZ Airports' "Submission on Commerce Commission's Input Methodologies Review: Invitation to Contribute to Problem Definition" (21 August 2015), pp 25, 26.

Leverage

8. The Commission proposes updating its estimate of notional leverage for airports from 17% to 19%. It does so by retaining its 2010 approach of using the average leverage of its asset beta comparator sample set of airports³ - the change comes about from updating that sample set.
9. Powerco's submission argues that the Commission should retain the existing notional leverage parameter for the energy sector and considers that:⁴

The Commission's proposal to adjust notional leverage is unnecessary tinkering and, we think, contrary to the approach to this review signalled by the Commission at the outset of the process.

10. This raises a general regulatory principle, which we briefly comment on. As the Commission is aware, we have previously submitted that the Commission should avoid pursuing repeated changes in search of the 'perfect' parameter, which does not exist.⁵ This is unlikely to advance the purpose of the IMs and may be contrary to the Commission's decision-making framework for any amendment to the IMs. A key consideration in assessing whether to change the IMs is that the perceived benefits of changing the IM must be carefully balanced against the possible increases in complexity or compliance costs.⁶ Continual refinement is unlikely to realise net benefits when weighed in that way.
11. However, we do not see the adjustment the Commission is proposing to adopt for the airports' leverage as 'tinkering'. That would involve some change in its methodology or additional adjustment or judgement being applied to the existing methodology. Rather, we see the leverage adjustment to 19% for airports as a continuation of the Commission's 2010 approach to estimating notional leverage (and is a product of the updated comparator sample).

Asset beta

12. First Gas' submission on the Commission's draft decision highlighted to us that, for asset beta estimation in the energy sector, the Commission proposes to bundle gas pipeline businesses with electricity businesses - ie to use an average asset beta from a comparator sample containing a mix of gas businesses, electricity businesses and combined gas/electricity businesses.
13. The Commission proposes to move away from its existing approach of applying a 0.1 uplift to obtain an asset beta for Gas Pipeline Businesses (**GPBs**), which was applied in 2010 on the basis that GPBs may face greater systemic risk than electricity distribution businesses ("**EDBs**").⁷ The Commission is now of the view "that there is no strong case" for applying different asset betas for GPBs and EDBs. In response, First Gas has put forward evidence that the asset betas for GPBs in the Commission's sample set have been materially above the electricity businesses for the past eight years.⁸
14. In order to arrive at an asset beta for a regulated airport business, in its draft decision the Commission distinguishes between the regulated and unregulated activities of airports, on the basis that its statutory task is to establish an asset beta for the regulated business only. In order to arrive at an asset beta the Commission proposes to make a downwards adjustment to

³ Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 443.

⁴ Powerco "Submission on Input Methodologies Review Draft Decisions" (4 August 2016), p 10.

⁵ NZ Airports "Submission on Commerce Commission's Input Methodologies Review: Invitation to Contribute to Problem Definition" (21 August 2015), p 16.

⁶ NZ Airports "Submission on Commerce Commission's input methodologies review draft decision" (4 August 2016), p 8.

⁷ Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 335, citing advice provided to the Commission by Dr Martin Lally.

⁸ First Gas "Submission on Input Methodologies Review Draft Decisions: Cost of Capital Issues" (4 August 2016), p 2.

its comparator sample estimate (which, analogous with the mixed gas/electricity businesses in the energy sample, includes airports with a mix of aeronautical and non-aeronautical activities).

15. We are concerned to ensure that the Commission applies a consistent evidential standard when estimating asset beta for the energy and airport sectors. In our view, its approach to the evidential threshold required to make an adjustment to the average beta produced from its comparator sample is inconsistent between the two sectors. In short, the Commission proposes to make an adjustment to airport asset beta without robust evidence,⁹ in contrast to the energy sector where it has adopted the position that in the absence of robust evidence, it is reluctant to quantify and make such an adjustment (see above).
16. In our view, the Commission has not identified clear and robust evidence to justify an adjustment to the average asset beta produced from its airport sector comparator sample. It should therefore take the same approach as it is proposing in the energy sector. That approach would be to draw the estimation of the asset beta from the average of its comparator sample without then drawing an unsubstantiated distinction between regulated and unregulated services. Doing so would apply the same evidential standard to both the electricity and the airport sectors when attempting to estimate the sectors' asset beta.
17. Our view on this issue is reinforced by the expert evidence provided to the Commission by Dr Lally; that the estimates of the two underlying parameter values associated with his estimate of the downwards adjustment to give the asset beta for regulated airport services are "very imprecise".¹⁰ Dr Lally's advice highlights that there is an insufficiently certain basis to justify the 0.05 downwards adjustment. Certainly, there is no evidence that would support a downward adjustment of greater than 0.03.

Cost of debt

Three month averaging period

18. Our starting point is to caution against minor adjustments that do not meet the criteria set out in the Commission's decision making framework.¹¹ Making minor amendments on technical matters where it cannot be observed that doing so leads to more accurate outcomes should, as a matter of principle, be resisted.
19. However, if the Commission is minded to make amendments to the approach to determining the risk free rate and debt premium, in principle we support the submission made by PwC:¹²

We consider that the use of a three month averaging period is preferable to one month for determining the risk-free rate and debt premium. However **we remain of the view that an averaging period of around five years is more suitable...** (emphasis added)

20. A five-year averaging period is preferable to a one month average rate for calculating the cost of debt parameter of the regulatory WACC. That is because it would better reflect the approach to raising debt airports take in practice. The Commission's current approach creates an artificial situation, which does not reflect the fact that the cost of debt reflects a blend of financing transactions undertaken over multiple years. This approach is adopted by commercial organisations to better manage finance costs, liquidity and refinancing risk. The spot market

⁹ Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 408.

¹⁰ Dr Lally's expert advice on asset beta adjustments and Black's simple discounting rule "Review of WACC issues" (report to the Commerce Commission) (25 February 2016), p 28.

¹¹ NZ Airports "Submission on Commerce Commission's input methodologies review draft decision" (4 August 2016), p 35.

¹² PwC "Submission to the Commerce Commission on Input methodologies review: draft decisions paper" (4 August 2016), p 9.

rates (ie a one month average rate) currently used by the Commission are drawn from an arbitrary window of time immediately prior to the price setting period, and assume that an airport raises all of its debt in a one month period leading up to a price reset.¹³ Clearly, that is not commercially realistic and not in the long-term interest of consumers.

21. Therefore, the Commission's proposed adjustment to use a three month averaging period represents a modest improvement, but remains some way off the preferable and more accurate five-year averaging period.
22. Effecting a transition to an averaging period of five years would nevertheless require careful consideration, in particular as to when the averaging five year period takes effect from. Such transitional complexities are likely to be less material for airports under ID regulation, given their ability to explain any differences between approaches taken in pricing and the IMs.

Prevailing/trailing approach

23. We have reviewed other parties' submissions on the Commission's view that a trailing average cost of debt is unlikely to represent an improvement on its current prevailing rate approach.¹⁴ We do not have additional views on this issue beyond those expressed in the submissions and above, as to why a trailing average approach is superior to a prevailing approach. We would be open to the choice of approach being explored further at the Commission's WACC Workshop to take place on 7 September 2016.

The SBL-CAPM model for calculating the WACC

24. The Commission does not propose to change its use of the SBL-CAPM to estimate the cost of equity when determining the WACC.¹⁵ Although a number of submissions have expressed various issues with the model, the Commission is of the view that none of the alternative model suggestions are likely to provide more robust estimates than the SBL-CAPM.¹⁶
25. As we set out in some detail in our submission,¹⁷ we consider that the regulatory WACC estimate has a different role under ID regulation compared with price control regulatory regimes. Notably, under ID regulation, airports are able to be cognisant of any potential limitations with the SBL-CAPM model when estimating their WACC for pricing purposes. Furthermore, airports are able to set out their approach to WACC when consulting with airline customers under the Airport Authorities Act 1966 ("**AAA**") and justify reasons for any departure from the SBL-CAPM model.

Tax adjusted market risk premium

26. The Commission proposes to retain a tax adjusted market risk premium ("**TAMRP**") of 7%.¹⁸
27. NZ Airports has reviewed Auckland International Airport Limited's cross-submission on TAMRP (including the report prepared by Auckland UniServices) and endorses those submissions.

¹³ NZ Airports "Submission on Commerce Commission's Input Methodologies Review: Invitation to Contribute to Problem Definition" (21 August 2015), p 17.

¹⁴ See, for example: PwC "Submission to the Commerce Commission on Input methodologies review: draft decisions paper" (4 August 2016), p 45 and Vector "Submission to Commerce Commission on the IM review draft decision and IM report" (4 August 2016), p 27.

¹⁵ Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 533.

¹⁶ Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 527.

¹⁷ NZ Airports "Submission on Commerce Commission's input methodologies review draft decision" (4 August 2016), pp 19 - 24.

¹⁸ Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 424.

Debt issuance costs

28. The Commission is proposing to:
- (a) reduce the allowance for debt issuance costs from 35 basis points ("**bps**") (0.35%) p.a. to 20 bps (20%) p.a.; and
 - (b) remove an allowance for interest rate swap costs from the term credit spread differential (which the Commission is proposing to remove) and instead include it as part of the debt issuance costs.
29. In common with other submissions,¹⁹ we do not see any clear rationale to reduce debt issuance costs. However, for completeness, we note that each of the airports has a different credit rating or profile and debt issuance costs. Under ID regulation, each airport will be able to justify any departure from the Commission's debt issuance costs parameter when consulting on pricing under the AAA.

¹⁹ See, for example, Powerco "Submission on Input Methodologies Review Draft Decisions" (4 August 2016), p 9.