SECTION 56G REVIEW OF AUCKLAND AIRPORT: POST CONFERENCE SUBMISSION

15 March 2013

The Commerce Commission held its conference on the review of Information Disclosure (ID) regulation applying to specified airport services provided by Auckland International Airport Limited (AIAL) under part 4 of the Commerce Act.

Christchurch International Airport Ltd (CIAL) in making this submission advise that the contact for matters regarding this submission is:

Neil Cochrane
General Manager Business Services
PO Box 14001
Christchurch

Email: neil.cochrane@cial.co.nz

1 Introduction

CIAL has read and endorses the NZAA cross-submission. In particular, the starting point for this inquiry is a healthy and well-performing airport sector, characterised by quality airport services at a level reflecting passenger and airline demands, efficient and innovative airports, and reasonable charges that benchmark well by international standards. The effectiveness of information disclosure regulation needs to be assessed in this context.

In making this submission CIAL comment on two themes which emerged from the conference:

- The role of the Input Methodologies (IM) in assessing whether the ID is promoting the desired outcomes from Part 4 of the Commerce Act.
- How to interpret any difference between the Weighted Average Cost of Capital (WACC) proposed by individual airports and the IM WACC.

2 Role of Input Methodologies under Information Disclosure

The Commission regulates information disclosure of specified airport services supplied by Auckland (AIAL), Wellington (WIAL) and Christchurch (CIAL) International Airports. The aim of the ID is to ensure that interested persons have sufficient information available to assess if the purpose of Part 4 of the Commerce Act is being met.

The Commission is endeavouring to identify if this ID regulation is achieving the goal of promoting the desired outcomes from Part 4. These outcomes include incentives to invest, for innovation, efficiency, and limiting the ability to extract excessive profits.

In relation to the objective of "limiting the ability to extract excessive profits", the Commission presently makes the assessment primarily by comparing the targeted rate of return calculated by the airport to the WACC calculated using its Input Methodology.

CIAL is firmly of the belief that the Commission must take care in how it uses such comparisons. The Commission has repeatedly emphasised that—appropriately—it does not see ID as a form of price control. Airports are not required to apply IMs in setting their prices although they must disclose information consistent with the input methodologies for information disclosure purposes.

The Commission has emphasised many times that the IM WACC is a benchmark. A benchmark is just that - a basis for asking questions rather than being an answer in its own right.

The key issue is that WACC is difficult to observe. Market analysts who have to value assets use various indicators and highlight the range of risks around their valuations arising out of market imperfections. The Commission must appreciate that deviations between model-derived estimates and market realities can occur for many reasons.

Apart from any question of exceptional performance justifying exceptional returns, a number of hypotheses are possible when the Commission observes a disparity between its IM WACC and the targeted and expected rate of return:

- The model that produces the benchmark—like any model—is subject to error as a predictor of the actual cost of capital. The degree of error will differ between the periods, depending on market conditions. Hence, a possible explanation of the disparity is that the benchmark is not an accurate reflection of market reality.
- The rate of recovery of the cost of long-lived infrastructure may vary over the life-time of the assets. A snap-shot of returns over any short period may be misleading as it could be at a period of higher or lower return which averages over the lifetime of the asset. Airports have a large proportion of long life assets therefore could be affected by this.
- An airport may be earning higher than normal profits.

The Commission needs to use the best available information to distinguish between the hypotheses. In observing the Commission's approach to WIAL and the AIAL conference, CIAL would like to remind the Commission of the dangers—and the intellectual pitfalls—of being mechanistic in the use of the IMs, while not using the available market information to inform the assessment.

3 Current Disparity between IM and Reality

At the best of times, CAPM is an empirical approximation of the cost of capital. It is heavily dependent on theoretical assumptions. Some disparity between the IM WACC, which relies on particular judgements about WACC components, and market realities should be expected. However in the current economic climate following the global financial crisis, the CAPM is appearing even less reliable for determining an accurate value for the cost of capital.

In their submissions, both WIAL and AIAL have emphasised that current market realities lead to a significant disparity between the mechanical application of CAPM to calculate IM WACC and observed market reality. WIAL stated in their submission to the Commission on the WIAL draft report that

> *"the Commission has not given due weight to other WACC factors that compensate for the reduction in risk free rates".*[1]

AIAL also voiced concerned with the model in the current economic climate in their submission on the WIAL report.

> *"Auckland Airport is concerned that the WACC IM does not appropriately recognise the difficulties that arise from comparing a long-run estimate of TAMRP with short-term or spot interest rates. We consider that this dislocated approach runs the risk of understating the cost of equity, and therefore producing a cost of capital that is too low and does not reflect a realistic cost of capital in the current market."* [2]

[1] WIAL Submission to the Commission on its s56G Draft WIAL Report, p 49.

[2] Auckland Airport's Submission on the Section 56G Review Draft WIAL Report, p 24.

We do not wish to comment on the specific adjustments made either by WIAL or AIAL. However, we would urge the Commission not treat such adjustments as theoretical arguments about various aspects of CAPM. Rather, we would ask the Commission to acknowledge the imperfection of any model-derived estimate of real-world financial markets, and to exercise caution in drawing conclusions from comparisons to model-derived results.

We recognise that there is no perfect technique for adjusting for real-world financial market conditions. Each individual adjustment can be criticised, particularly within the theoretical construct of the CAPM model. However, such criticism does not remove the fundamental problem: there is a rich accumulation of evidence pointing to the fact that IM WACC estimates are at odds with the prevailing market conditions.

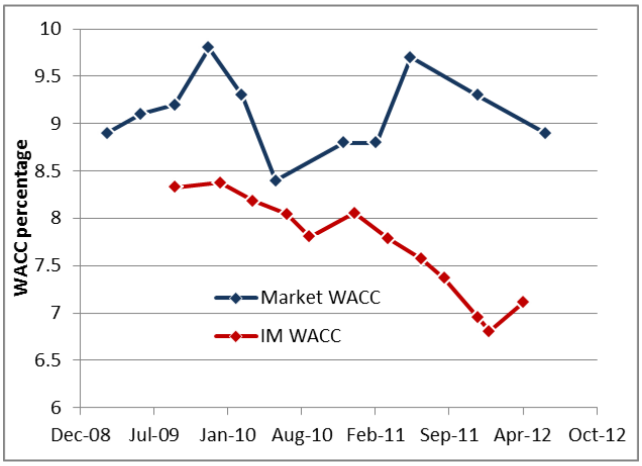
We would particularly like to draw the Commission's attention to the unusually large current divergence between the Commission's Input Methodologies and the estimates in the PwC's published quarterly reports on the cost of capital for New Zealand listed companies.

PwC derive the cost of equity for each listed company from information contained in share prices on the NZX. As an illustration, we compared PwC market average WACC estimates with the Commerce Commission's estimates of WACC over the same period.[3]

Clearly, not much can be drawn from the difference in the levels—the weighted average cost of capital for the NZX average would only coincidently be the same as the weighted average cost of capital for airport. However, the differences in the rate of change in recent years should be a concern. Figure 3.1 shows that market-average WACC estimated by PwC has remained broadly unchanged since 2009 (while going through significant fluctuations), while the IM WACC has declined persistently from 2009 to 2012.

We expect that neither the PwC methodology nor the Input Methodology is a perfect reflection of the market. This is not a criticism. But it is a reminder to exercise care in drawing conclusions.

Figure 3.1: New Zealand market WACC (PwC) and IM WACC



[3] Commerce Commission cost of capital determination for information disclosure year 2013 for specified airport services, p 4.

4 Drawing Conclusions from Differences in WACC

The Commission has now heard from many parties that CAPM is unlikely to be providing correct predictions during market disequilibria. Financial analysts—who carry liability for making predictions—recognise that the model is currently disconnected from the market and hedge their positions.

We believe the Commission should exercise similar caution in drawing strong conclusions from the application of the model. In continuing to use the IM, the Commission must be mindful that large differences in estimated WACC may arise from various adjustments for market reality. Hence, the Commission should not over-reach in drawing conclusions about "excessive pricing" from observed differences between its estimated WACC and the returns targeted by the airports. This would be equivalent to market analysts producing company valuations based on a mechanical application of a model and ignoring market signals: something that would lead to sharp consequences.

There is significant weight of evidence that, at least in the current market conditions, the Commission is not justified in simply using the fact of the difference from its model-derived benchmark as proof of excessive return.

The Commission must take all available market evidence into account in making its assessments. The Commission concluded in its final report on WIAL that the airport would earn excessive profits because its WACC was higher than the IM WACC. The Commission ignored other potential factors for the differences in WACC such as disconnect of the CAPM model with the market in the current economic climate.

It is important that the Commission does not ignore these important issues in the case of AIAL.

5 Conclusion

In conclusion, CIAL continues to hold the belief that ID is effectively promoting the purpose of Part 4 of the Commerce Act. We encourage the Commission to seriously consider the issues around WACC and to not apply it simply as a rigid yardstick in their assessment of airports economic performance. Such consideration should include all aspects of Part 4 - incentives to invest, innovation, efficiency, and limiting the ability to extract excessive profits, in making any conclusions as to whether ID is working. This should give full recognition to the overall performance of each airport, including consideration that improvements as with investments take some time to come to fruition and therefore it is the trend rather than the absolute for any one period that must be considered.