

SUBMISSION ON EXPERT ADVICE ON COST OF CAPITAL TOPICS

24 MARCH 2016

1. The Commerce Commission ("**Commission**") recently published Dr Martin Lally's Review of WACC Issues,¹ providing his advice on asset beta adjustments and Black's simple discounting rule ("**BSDR**") (the "**Lally Review**").
2. The New Zealand Airports Association ("**NZ Airports**") welcomes the opportunity to respond to the Lally Review, as part of the Commission's review of input methodologies ("**IM Review**") under section 52Y of the Commerce Act 1986 ("**Commerce Act**").
3. The NZ Airports contact for this submission is:

Kevin Ward
Chief Executive
PO Box 11 369
Manners Street
Wellington 6011
Email: kevin.ward@nzairports.co.nz.

Executive Summary

4. The Lally Review demonstrates that:
 - (a) making asset beta adjustments is an inherently imprecise exercise;
 - (b) there is insufficient evidence to credibly quantify any downward adjustment;
 - (c) accordingly, the most robust approach would be to not make any downward adjustment to the airport asset beta;
 - (d) in the event the Commission nevertheless considers a downwards adjustment to be appropriate, there is no evidential foundation to sustain a downwards adjustment that is greater than the current 0.05 deduction; and
 - (e) to the extent that the Lally Review provides any meaningful evidential value, Dr Lally suggests that any downwards adjustment should be no greater than 0.03.
5. As regards BSDR (the other matter covered in the Lally Review), NZ Airports agrees with Dr Lally's findings and would therefore encourage the Commission to confirm that it does not propose to consider BSDR for airports subject to information disclosure ("**ID**") regulation.

¹ Dr Martin Lally, *Review of WACC Issues* ("**Lally Review**").

Asset beta adjustments

6. NZ Airports understands that Dr Lally was commissioned to consider (using relevant empirical or theoretical evidence, or judgement, as required) whether the Commission's current deduction of 0.05 to the asset beta for airport businesses was suitable.²
7. According to the IMs Reasons Paper, the Commission's rationale for its downward adjustment to the asset beta for Airports (0.65) is to account for the "differences in systematic risk" due to the mix of regulated and non-regulated activities.³ The Commission formed the view that regulated activities are less risky, and therefore have a lower asset beta, than unregulated services (ie airport retail activities) on account of there being less demand uncertainty.⁴
8. As part of the initial consultation when the IMs were being set, the airports' expert challenged the Commission's reasoning:⁵

Airports derive revenues and profits from both aeronautical and non-aeronautical sources. Non-aeronautical sources include income from retail, car parks, utilities and rental income on property. Some of these activities may have lower asset betas than the Airports' aeronautical activities and others may be higher.

Thus, a priori, it cannot be assumed that the beta of the aeronautical component of airport activities will be lower than the beta of the combined airport (i.e. aeronautical and non-aeronautical activities).

9. Having reviewed Dr Lally's advice to the Commission, we remain of the view that the quantification of a downward adjustment of 0.05 to the asset beta for regulated airports is not justified by evidence.

Uncertainty in the parameter values

10. Dr Lally's advice is clear that:⁶
 - (a) the estimates of the two underlying parameter values (ie the average proportion of airport value arising from regulated services and the average asset beta for the unregulated services of the comparator airport firms) are "very imprecise"; and
 - (b) the point estimate for the average weight on regulated services is also low.
11. According to the Lally Review, this leads to an "extremely imprecise estimate for the beta deduction".⁷
12. We also note that the Commission previously had similar reservations associated with the estimation of these parameter values:⁸

...the necessary data is not available for any of the available options above to estimate the difference in systematic risk between the unregulated and regulated services.

² Commerce Commission, *Terms of reference - Expert advice on cost of capital topics*, 22 December 2015, at paragraphs 9-10.

³ Commerce Commission, *Input Methodologies (Airport Services) Reasons Paper ("IM Reasons Paper")*, December 2010, at paragraphs [E8.72], [E8.81]-[E.83].

⁴ IM Reasons Paper, at paragraph [E.83].

⁵ Uniservices, *Comments on the Commerce Commission's Approach to estimate the Cost of Capital*, 2 December 2009, at paragraph [3.2.6].

⁶ Lally Review, at p.4.

⁷ Lally Review, at p.4.

⁸ IM Reasons Paper, at paragraph [E.82]-[E8.83].

13. Despite this imprecision, the Commission (having not revealed its estimates for the two above parameters) nevertheless formed the view that it could estimate and apply a downwards adjustment to the average asset beta for regulated airport services.
14. The imprecision highlighted by Dr Lally continues to concern us. Indeed, Dr Lally's advice calls into question whether sufficiently robust empirical evidence can ever be provided to quantify any downward adjustment. Based on Dr Lally's advice, it appears that:⁹
- (a) the Commission's presumed evidential foundation for quantifying a downward adjustment rests on a "very imprecise" estimation; and
 - (b) it will inevitably be the case that any attempt to quantify an estimated downward adjustment is highly likely to be inaccurate.
15. In those circumstances, we do not believe that the Commission can have sufficient confidence in any evidence available to support quantification of any downward adjustment. The most robust approach would be to not apply any downward adjustment to the airport asset beta. It certainly must not be increased from the current 0.05.
16. Alternatively, in the event that the Commission considers that the Lally Review has provided some evidential justification for quantifying a downward adjustment, Dr Lally's advice suggests the adjustment ought to be reduced. In the absence of the Commission's parameter values, Dr Lally has determined parameter estimates of 0.39 for regulated services, and 0.67 for unregulated services, which implies deducting 0.03 from the estimated asset beta of the comparator airports in order to estimate the asset beta of the regulated airport services.¹⁰
17. According to Dr Lally, this analysis is subject to imprecision due to:¹¹
- (a) revenue proportions being an "imperfect proxy" for value proportions due to differences in costs relative to revenues and differences in discount rates; and
 - (b) value weights for Auckland International Airport's ("AIAL") underlying activities (ie retail, levies on providers of taxis and public transport to/from the airport, car parking and property leases) being unknown, or having no apparent comparators among the Commission's sample.
18. As a result, Dr Lally records his view that he has "very little confidence in the estimated deduction of 0.03".¹² Nevertheless, he clearly has more confidence in 0.03 than the current 0.05 adjustment.

Black's simple discounting rule

19. Dr Lally was also commissioned to evaluate the application of BSDR as a cross-check against the returns of suppliers under different forms of regulation. The overarching advice we take from the Lally Review is that under ID only regulation for airports, BSDR is not applicable. This is because:¹³

...the regulator merely estimates the WACC for comparison with the actual rate of return of the business. So, the expected cash flows of the regulated business (or expected output in a regulatory scenario) would never be estimated and therefore Black's Rule could not be applied in this case.

⁹ Lally Review, at pp. 27-28.

¹⁰ Lally Review, at p. 4.

¹¹ Lally Review, at pp. 26-27.

¹² Lally Review, at p. 27.

¹³ Lally Review, pp.4-5.

20. NZ Airports agrees with Dr Lally's findings and would therefore encourage the Commission to confirm that it does not propose to consider BSDR for airports under ID.

Next steps

21. We would be pleased to discuss any aspect of our response to the Lally Review on asset beta adjustments and BSDR with the Commission. Otherwise, we look forward to further engagement with the Commission following the publication of Dr Lally's advice on the other cost of capital topics.