

**SUBMISSION ON THE COMMERCE COMMISSION'S
PROCESS AND ISSUES IN THE REVIEW OF CHRISTCHURCH AIRPORT
(AIRPORT SERVICES - SECTION 56G REPORTS)
22 MARCH 2013**

INTRODUCTION

1. This is Auckland International Airport Limited's ("**Auckland Airport**") submission to the Commerce Commission ("**Commission**") in response to the Commission's Process and Issues Paper for Christchurch Airport, released 8 February 2013. The paper outlines the proposed process and timing for the statutory review of the information disclosure for specified airport services under section 56G of the Commerce Act 1986 ("**section 56G review**").
2. Auckland Airport supports the New Zealand Airports Association's ("**NZ Airports**") submission on the Process and Issues Paper ("**NZ Airports submission**"). The NZ Airports submission addresses the issues and concerns on behalf of the three regulated airports, Auckland Airport, Wellington International Airport ("**WIAL**") and Christchurch International Airport ("**CIAL**"). Auckland Airport's submission should be read in conjunction with the NZ Airports submission.
3. Auckland Airport has focussed this submission on the following key issues:
 - (a) the overall approach to the review of Christchurch Airport; and
 - (b) our continuing concerns with the Commission's approach to assessing returns.
4. Auckland Airport's contact regarding the matters raised in this submission is:

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APPROACH TO THE SECTION 56G REVIEW

5. Christchurch Airport has provided evidence in its price setting disclosure that it:
 - (a) conducted a robust and constructive consultation process in which it was willing to reconsider its methodologies and adjust substantial aspects of its pricing proposals in response to airline feedback;
 - (b) is committed to stimulating economic growth, demand for air services, and regional and national tourist activity;
 - (c) has largely applied the Commission's input methodologies ("**IMs**") for ID purposes;

- (d) made carefully considered departures from the Commission's cost of capital IM to reflect the airport specific circumstances and risks that it faces, as well as the market evidence which demonstrates that it would not be possible to raise debt and equity at the cost implied by the cost of capital IM; and
 - (e) sought to achieve the right package of charges balancing its needs with those of airlines and the travelling public, while aiming for no more than an appropriate return for its shareholders.
 - (f) considered economic efficiency in setting its price structure and has taken a longer term approach to its price setting, prompted by the commissioning of a major investment in the Integrated Terminal Development.
6. We continue to encourage the Commission to recognise the strength of New Zealand's airport sector and the positive performance of the individual airports. We consider the Commission can do so by:
- (a) Recognising the positive impact that ID regulation has had on understanding airport performance and promoting transparency. In our view:
 - (i) The Commission has a significant body of evidence before it which supports a conclusion that ID Regulation is:
 - (aa) positively increasing the ability of interested parties to understand airport performance; and
 - (bb) is therefore promoting the transparency and associated incentives for airports to align their performance with the Part 4 purpose statement, and to continue to do so over time.
 - (ii) It is clear that all three airports have invested significant time and resources in the systems necessary to provide detailed disclosure under ID. Further, it is clear that the airports have taken a considerable degree of time and care to prepare and present the annual and price setting disclosures. Auckland Airport also notes that in several areas Christchurch Airport's price setting disclosure includes disclosures beyond the minimum requirements which improve the understanding of interested parties.
 - (iii) Auckland Airport remains concerned that airlines are resistant to acknowledge the amount and the quality of the information that is now disclosed under ID Regulation, and continue to diminish the importance of ID Regulation and the disclosed information in providing a full and comprehensive understanding of airport performance. In our view, interested parties (including ourselves), now have access to a wealth of information that was not previously available, including:
 - (aa) detailed annual information disclosures; and
 - (bb) detailed forecast information in relation to price setting events, including the rationale behind and basis for price setting in each of the airports.

- (iv) This information has been prepared on a consistent basis, allowing interested parties to make informed assessments and comparisons between airports, including having a full and comprehensive understanding of the differences between those airports which may affect any such comparisons. The ability to do this will be strengthened as the body of information available to interested persons increases over time.
- (b) Focussing equal care and attention on each limb of the purpose statement.

We do not believe there is any basis for the Commission's position that it is primarily interested in the impact of ID Regulation on whether airports are limited in their ability to extract excessive profits.
- (c) Acknowledging the impossibility or difficulty in reducing positive performance to a number or an adjustment to a model. It is important to reflect on and ensure that positive performance in all areas is fully acknowledged in the Commission's conclusions.
- (d) Re-considering the narrow approach taken to assessing returns in the section 56G review so far, and broadening that approach to consider the full range of evidence which demonstrates that ID has had a positive impact on limiting the ability of airports to extract excess profits.
- (e) Accepting that neither the regulatory framework nor efficient pricing principles would require pricing outcomes to mirror annual ID compliant forecasts.

APPROACH TO ASSESSING RETURNS

7. We have previously requested that the Commission follow the approach we understood it would take in its monitoring and analysis: to put the WACC IM in context and analyse the decisions each airport actually made in pricing as part of that context.¹
8. We continue to have concerns that the language used by the Commission in its Process and Issues Paper indicates it remains unwilling to fully consider and engage with submissions to date that:
 - (a) The detailed reasoning provided by the airports in support of the departures from the cost of capital IM made in pricing are absolutely relevant to the Commission's task under the section 56G review.
 - (b) The cost of capital IM is not a bright line test, and should not be used in this way to draw conclusions on airport returns or the overall effectiveness of ID regulation. In our view, the better approach is to get a full and comprehensive picture of performance by examining and evaluating:
 - (i) the understanding of airports at the time of price setting, about the role of the cost of capital IM in pricing and in assessing airport performance;
 - (ii) the views of airlines at the time of price setting;

¹ Auckland Airport post conference submission 15 March 2013, page 15.

- (iii) expert advice in relation to each to the parameter estimates adopted by airports and how these were considered in relation to the cost of capital IM (including expert advice in relation to the systematic risk of each airport's aeronautical business);
 - (iv) market evidence which gives the necessary context to the WACC estimate produced by the Commission's cost of capital IM;
 - (v) the impact of asymmetric risks and how these are provided for in pricing (ie whether these have been provided for in the cashflow forecasts, WACC estimate or as an ex-post adjustment); and
 - (vi) the relationship between the effective return sought in PSE1 and PSE2 and the role of the WACC IM in that relationship.
9. In our view, the Commission's approach risks creating flow-on disincentives for investment, as well as carrying an inherent risk of regulatory error. We continue to emphasise the importance of distinguishing WACC modelling in theory from WACC expectations in practice.
10. 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. In particular, we note that:
- (a) Auckland Airport was disappointed that the Commission declined to undertake reasonableness checks on the WACC estimate on the basis that it undertook extensive reasonableness testing in 2010 and its subsequent cost of capital estimates reflect changes in the risk free rate and debt premium since that time.² In addition, we are concerned that the Commission may have misunderstood the reason why we consider such tests to be important.
 - (b) In light of current financial market conditions and the imprecision of WACC estimates,³ there is increasing recognition of the importance of taking into account a great deal of contextual information on debt and equity estimates, including sources such as external peer reviews from banks, corporate treasuries, debt and equity consultants, and monitoring of market evidence.⁴ Further, it is simply not the case in practice that investors' expectations for long-term returns are fluctuating as wildly as the Commission's theoretical WACC model suggests. In our view, it is sensible and responsible for the airports to consider these factors in their pricing decisions.
 - (c) For example, the Australian Energy Market Commission ("**AEMC**") recently reviewed regulatory approaches to WACC. Importantly, the AEMC considered that regulators should have regard to a wide range of approaches and sources of information when estimating WACC. The finding recognised the uncertainty

² Wellington International Airport, Final s56G Report, 8 February 2013, page 100.

³ Grant Samuel Australian Infrastructure Fund Proposal, Appendix 1: Selection of Discount Rate, 7 December 2012 at page 1.

⁴ Australian Energy Market Commission, Economic Regulation of Network service Providers, and Price and revenue Regulation of Gas Services, Final Position Paper, 15 November 2012 and Review of the method for determining the WACC Independent Pricing and Regulatory Tribunal page 42 and 71.

in estimating WACC, and the AEMC proposed that a good rate of return framework would include the flexibility to deal with changing market conditions and the availability of new evidence.⁵

- (d) Similarly, we have previously discussed the expert advice of Grant Samuel, provided as part of the Future Fund's offer for stakes in Australian Airport assets.⁶ As we have previously submitted, Grant Samuel's report recognises the imprecision in producing cost of capital estimates, and the dangers in treated cost of capital estimates and model outputs as "an absolute truth".⁷ The report notes:⁸

However, while the theory underlying the CAPM model is rigorous the practical application is subject to shortcomings and limitations and the results of applying the CAPM model should only be regarded as providing a general guide. There is a tendency to regard the rates calculated using CAPM as inviolate. To do so is to misunderstand the limitations of the model.

- (e) Auckland Airport recommends that the Commission fully consider such information as part of the section 56G review process. This will 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.
- (f) A strict application of the WACC IM, in the way proposed by the Commission in the Final Report on Wellington Airport, may have significant implications on whether airports have the right incentives to invest and are able to attract the necessary capital to do so. Considering such implications is an important element of assessing the effectiveness of ID regulation and the incentives and disincentives which may be created by that regulation.

⁵ Australian Energy Market Commission, Economic Regulation of Network service Providers, and Price and revenue Regulation of Gas Services, Final Position Paper, 15 November 2012

⁶ See Auckland Airport post conference submission 15 March 2013, page 18.

⁷ Grant Samuel Australian Infrastructure Fund Proposal, Appendix 1: Selection of Discount Rate, 7 December 2012 at page 1.

⁸ Grant Samuel Australian Infrastructure Fund Proposal, Appendix 1: Selection of Discount Rate, 7 December 2012 at page 1.