NZ AIRPORTS

SUBMISSION ON ADDITIONAL EVIDENCE FOR COST OF CAPITAL INPUT METHODOLOGIES

5 FEBRUARY 2016

1. The New Zealand Airports Association ("**NZ Airports**") makes this submission in response to the Commerce Commission's update paper of 30 November 2015 on the cost of capital topic ("**WACC Paper**"), as part of its review of input methodologies ("**IM Review**") under section 52Y of the Commerce Act 1986 ("**Commerce Act**").

2. 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

Overview

3. NZ Airports understands from the WACC Paper that, at this early stage of the review of the WACC IM, the Commission is seeking further stakeholder input and additional evidence on the WACC parameters. Also, as directed by the WACC Paper, we have had regard to the Commission's most recent determination on the cost of capital parameters for Chorus' UCLL/UBA services.[1] NZ Airports has approached this submission with those directions in mind.

4. Our general approach to the Commission's review of the WACC for airports continues to be, as outlined in NZ Airports' problem definition submission, that:

   (a) Despite our historic concerns with various aspects of the WACC IM, in the interests of regulatory stability and predictability, the Commission should avoid pursuing changes in search of the "perfect IM".

   (b) There needs to be clear evidence that a problem exists and that the benefits of change will outweigh the costs.

   (c) It is in the interests of all parties to maintain investor confidence in the IMs, and that they are adequately designed to preserve the ability of regulated suppliers to earn normal returns consistent with workably competitive market outcomes.

[1] *Commerce* Commission, Input methodologies review: update paper on the cost of capital, 30 November 2015, at para. 1.8.

5. At this early stage we have not provided expert evidence to support changes to the WACC IM parameters. But we have provided some short comments on the asset beta for regulated airport services below. We will of course continue to engage on the Commission's views on all WACC parameters when they are presented later in the process (including in the report the Commission has commissioned from Dr Martin Lally), and would encourage the timely provision of an emerging views paper in advance of a draft decision.

6. We envisage our primary focus on WACC being the Commission's proposed review of the WACC percentile range for airports, which is being addressed separately and so is not commented on in this submission.

Asset beta

7. The Commission's update paper indicates that it will be re-estimating the asset beta value using updated data and re-assessing its comparator sample of international companies.[2]

Comparator analysis

8. NZ Airports expressed concerns with the Commission's approach to the comparator sampling in 2010. However, we recognise that, as part of the Merits Review proceedings, the Commission's approach of a larger global sample was endorsed by the High Court. We understand that a key rationale for increasing the sample set from 10 (in the draft decision) to 25 (in the final decision) was to provide the most robust estimate possible.

9. In these circumstances, NZ Airports expects the Commission to maintain its existing approach of using the largest possible comparator sample of airport operators to estimate the asset beta. Doing so will provide regulatory certainty, which best gives effect to the purpose of Part 4 and the IM.

10. We recognise that the Commission's original sample of 25 firms, assembled in 2010, has been subject to changes in ownership structure. For example, some airport companies have since been de-listed and others may have been subject to M&A activity; some may no longer be characterised as airport operators or owners.[3] Inevitably, it will need to be considered how this impacts on the sample. As a general principle, we support an approach that minimises any change to the greatest extent possible, to provide comfort that the asset beta will not be subject to ongoing volatility due to changes in the sampling method each time it is reviewed. NZ Airports encourages the Commission to provide stakeholders with transparency, as well as the opportunity to comment, on any proposed updates to the sample as part of this process.

11. NZ Airports also invites the Commission to consider how it might give more weight to Auckland Airport's asset beta with its overall framework. As highlighted in the Bush/Earwaker Report attached to NZ Airport's August Problem Definition submission, airports are a heterogeneous set of investments compared to the Commission's use of a relatively homogenous sample of electricity and gas distributors subject to revenue cap regulation, with broadly similar risk

[2] Commerce Commission, *Input methodologies review: update paper on the cost of capital*, 30 November 2015, at para. 2.9.
[3] We note the Commission's decision in 2010 was to only include overseas firms that operate airports in its sample of comparable firms. See Commerce Commission, *Airports Input Methodologies Reasons Paper,* December 2010, at para. E8.42.

profiles.[4] The airports' different operating characteristics, as well as differences in prevailing economic conditions and regulatory frameworks, make it difficult to obtain an accurate empirical beta estimate which is applicable to all regulated suppliers of airport services in New Zealand.[5]

12. To mitigate against the inevitable heterogeneity of the airports in a global sample, Auckland Airport's observable asset beta readily provides a good empirical indicator of the risks faced by airport operators in the New Zealand ID-regulated market. That is, we think it is reasonable for the Commission to consider Auckland Airport's observed beta as a broad cross-check as to whether the estimate produced by the Commission's comparator sample is a fair reflection of the systematic risk faced by the three New Zealand airports (in addition to the other cross-checks it carries out within its six-step process).

13. NZ Airports also invites the Commission to consider the impact that the heterogeneity of airports will have on the standard error estimate for asset beta. As further noted in the Bush/Earwaker August Report, the standard error that applies to the three regulated New Zealand airports should be materially higher than the standard error in the Commission's electricity/gas distribution estimate to account for that heterogeneity.[6]

14. Finally, NZ Airports supports the Commission's suggestion that the form of regulation is a relevant consideration in the assessment of the asset beta. Indeed, that is consistent with the Commission's previous observation that:[7]

> Firms subject to rate-of-return regulation (with annual price resetting) can be expected to have lower sensitivity to unexpected changes in real GDP, because the regulatory process is geared towards achieving a fair rate of return.

15. The discussion in the WACC paper is focussed on issues raised by price versus revenue path regulation. As part of its proposed analysis, we also ask the Commission to consider the greater systematic risk airport businesses are subject to on account of ID-only regulation relative to those businesses subject to DPP/CPP regulation.

Next steps

16. We would be pleased to discuss any aspect of the asset beta parameter further with the Commission. More generally, NZ Airports looks forward to further engagement with the Commission on WACC parameters following publication of the Lally Report and subsequently in the IM Review process. In particular, we understand the Commission is due to release data from its survey of cost of debt issues for regulated suppliers in mid-February and we anticipate we may have further comments on the relevant parameters once that is available.

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[4] Bush/Earwaker, *Evidence Relating to the Assessment of the WACC Percentile for Airports,* August 2015, section 2.3, pp. 25-27.
[5] Bush/Earwaker Report, section 2.3, p. 27.
[6] Bush/Earwaker Report, section 2.3.2. p. 27
[7] Commerce Commission, *Draft Guidelines - The Commerce Commission's approach to estimating the cost of capital*, October 2005, at p.21.