

**AUCKLAND AIRPORT'S
SUBMISSION ON THE
SECTION 56G REVIEW DRAFT WIAL
REPORT
30 NOVEMBER 2012**

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SECTION 1: INTRODUCTION

1. In this submission, Auckland Airport responds to the Commission's proposed analytical framework under the section 56G Review ("**Review**"), set out in chapter 2 and attachment A of the WIAL Draft Report ("**Draft Report**"). Auckland Airport supports the submission made by the NZ Airports Association.
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3. The Commission intends to follow the same assessment approach for each airport under the Review:¹

Although we will report separately, we are using the same assessment approach for each airport. This draft report only applies to Wellington Airport as it set its prices first, however the framework for our review that we describe in Chapter 2 and Attachment A is relevant to the review of all three airports.
4. Accordingly, in this submission Auckland Airport focuses on analytical framework matters that it perceives will be applied to all regulated airports.

¹ Commerce Commission "Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport", 2 November 2012 ("**WIAL Draft Report**"), paragraph A7.

SECTION 2: OVERVIEW

5. Auckland Airport acknowledges that the Draft Report provides a structured analytical framework for assessing the effectiveness of information disclosure ("ID").
6. However, Auckland Airport believes the Commission's approach could be improved in a number of key respects.
 - (a) In its preliminary assessment of the effectiveness of ID, the Commission's analysis:
 - (i) Incorrectly elevates the importance of limb (d) of the purpose statement; and
 - (ii) Fails to appropriately and explicitly reflect the interdependence of the limbs of the purpose statement.

In our view, this approach is misaligned with what was intended for the ID Regime. Instead, the Commission should give proper consideration to each limb of the purpose statement in a manner that more appropriately reflects that ID is light-handed regulation that is designed to incentivise, rather than control outcomes that promote all limbs of the purpose statement.

- (b) The Commission's assessment of whether ID is effectively promoting the limbs of the Part 4 purpose statement should explicitly recognise that the outcomes are long term rather than short term objectives. While the Commission expects to see a more immediate impact on pricing outcomes than for other limbs of the purpose statement, we note the following:
 - (i) Although assessing profitability more readily allows conclusions to be drawn in the short-term, this should not mean that the Commission loses sight of the intent of Part 4 to promote long term outcomes - focus on dynamic efficiency (which is harder to measure) rather than static efficiency.
 - (ii) An expectation that there should be an immediate effect on pricing does not (and should not) equate to drawing a definitive conclusion that ID has been ineffective in limiting WIAL from extracting excessive profits. This is because it does not necessarily follow that perceived "misconduct" in one price setting event ("**PSE**") (the first under the new ID regime) equates to ID being ineffective - a regime which is expressly intended to promote outcomes consistent with workably competitive markets *over time*.
 - (iii) In our view, the Commission's analysis needs to better recognise that ID should encourage airports towards incrementally promoting the Part 4 purpose statement (if current performance is questionable), rather than unrealistically expecting an immediate alignment with the Commission's preferred benchmarks.
 - (iv) The Commission's recommendations to the Ministers in the Draft Report involve unsubstantiated assumptions regarding WIAL's future price setting approaches. While we accept that any modelling necessarily requires some inferences and judgment calls, we are concerned that the Draft Report fails to:

- (aa) Make explicit that its conclusions and recommendations are underpinned by judgment calls and inferences regarding *potential* future behaviour;
 - (bb) Acknowledge the limitations of its modelling, which include a presumption of "misconduct" (in the Commission's view). In our view, the Commission should make it clear that WIAL may in fact take an approach in future pricing which *may not* lead to the extraction of excessive profits, or that the Commission's modelling could be found to be incorrect;
 - (cc) Properly account for the role that airlines play in determining Airport Authorities Act 1966 ("**AAA**") outcomes, particularly in reaching conclusions about likely conduct and outcomes in future price setting consultations; and
 - (dd) Acknowledge that the conclusions of the Review may modify future airport and airline behaviour.
- (v) The Commission deciding to conduct the section 56G Review and section 53B summary and analysis reports concurrently has necessarily meant that airports have not been given any opportunity *prior* to the section 56G Review to:
- (aa) Understand the framework against which their behaviour would be assessed; or
 - (bb) Modify and/or tailor their behaviour in response, if necessary.
- (vi) Consequently, Auckland Airport expects the Commission to:
- (aa) Recognise that it is too early to draw definitive conclusions about the effectiveness of ID; or
 - (bb) Couch its conclusions on the effectiveness of the ID Regime (in respect of *all* of the limbs of the purpose statement) in a less definitive manner.
- (c) The Draft Report characterises the Input Methodologies ("**IMs**") as providing certainty to airports regarding the tool against which they will be assessed in the Review at the time of pricing:²

... while it is accepted that there may be other avenues for promoting the purpose of Part 4 other than input methodologies, the purpose of setting the input methodologies is to provide certainty to regulated suppliers as to the tool the Commission will use in assessing the impact of information disclosure on the promotion of outcomes consistent with outcomes produced in workably competitive markets such that s 52A(1)(a) to (d) occur.

Consistent with the Commission's acknowledgement that IMs do not need to be applied in pricing to promote the purpose statement, Auckland Airport wishes to emphasise that:

- (i) Although Auckland Airport has always considered the IMs for ID relevant and important to pricing, it did not consider that the IMs are

² WIAL Draft Report, paragraph A7.

the only view that is consistent with workably competitive markets or that it would be at risk of adverse findings simply because its pricing decision did not precisely align with the IMs.

- (ii) As outlined in our submission and cross-submission, the IMs were a significant discipline and point of reference. However, we believed that the Commission would take in to account other possible outcomes and commercial factors relevant to our business that would promote the outcomes of Part 4.
- (iii) Although the Commission has indicated that there are factors that may justify a departure from its WACC IM, the Draft Report:
 - (aa) Does not provide any guidance on what those might be; and
 - (bb) Does not appear to have assessed or modelled any departures from the WACC IM in the case of WIAL.
- (iv) In the absence of doing so, Auckland Airport is concerned that the Draft Report adopts a position tantamount to price control.
- (d) Auckland Airport is genuinely surprised that WACC does not feature more prominently either in the Commission's discussion or approach to modelling profitability:
 - (i) Although WACC is the material issue that divides airports and airlines (and is the subject of High Court merits review proceedings) the Commission's assessment of profitability objectives in the Draft Report only appears to have limited consideration of WACC arguments advanced by WIAL.
 - (ii) Furthermore, consideration of variations from the WACC IM is absent from the Commission's sensitivity analysis in its modelling (discussed in greater detail below, together with suggestions for how this might be addressed).
- (e) While we appreciate that this is the first occasion on which the Commission is assessing a new regime, we are concerned that the Draft Report is absent a level of commercial consideration that we would have expected to see from the expert industry regulator. In this regard, we would like to see a Final Report that takes account of industry and firm specific factors, some of which are addressed in greater detail in the body of this submission. We also note that airports were subject to ID only because, amongst other things, the commercial complexities of the sector makes it unsuited to a price control type approach.³
- (f) We are therefore concerned that the Commission has resorted to a mechanical price control type analytical framework that fails to fully consider the industry and commercial context. For example, it has not considered to what extent, if any, passengers are adversely affected by the alleged excess profit.

7. This submission also comments on the Commission's approach to modelling, in particular:

³ Offices of the Ministers of Transport and Commerce *Commerce Act Review: Airports* (Cabinet Paper, 21 November 2007), paragraph 48. See also *Commerce Act Review: Airports - Regulatory Impact Statement*, paragraphs 30 and 36.

- (a) The Commission's preference for the 7 year Internal Rate of Return ("**IRR**") rate which conflates the assessment of PSE1 and PSE2 outcomes. That is, the Commission is using the same approach to assess two PSEs when one is an *ex ante* and the other an *ex post* ID assessment. In our view, a better approach would be to acknowledge that:
- (i) The assessment of the first PSE (which predated ID regulation) is an *ex-post* assessment. Accordingly, it should take into account *ex ante* risk sharing arrangements and acknowledge that airports set reasonable forecasts, with the prospect of retaining efficiency gains for the period.
 - (ii) The assessment of the second PSE is an *ex ante* assessment which should focus on whether forecasts are unbiased and efficient at the time of the price setting decision and incentivise efficient behaviour.
- (b) In the context of a light-handed ID Regime, which uses an imprecise WACC IM and which is not binding for pricing purposes, the Commission's assessment of returns should be either:
- (i) Compared to both the WACC IM and a firm specific WACC estimate, to the extent variations to the WACC IM are compelling; or
 - (ii) Include WACC sensitivities.

SECTION 3: APPROACH TO ASSESSING THE POTENTIAL IMPACT OF ID

8. The key points we make in this section are:
- (a) The Commission's approach has inappropriately elevated limb (d) of the purpose statement;
 - (b) The background to the ID Regime highlights the importance of investment;
 - (c) The Commission's approach fails to adequately address the interdependence of the limbs of the purpose statement;
 - (d) It is too early to draw a definitive view when outcomes consistent with the Part 4 purpose statement are long term rather than short term objectives
 - (e) It is inappropriate to prejudge future airport pricing decisions
 - (f) The Commission has made assumptions about future conduct which are driving its conclusions on forecast excess returns; and
 - (g) The Commission's approach fails to consider the important influence that annual summary and analysis reports will have in contributing to the effectiveness of ID.

The Commission's approach has inappropriately elevated limb (d) of the purpose statement

9. Auckland Airport is concerned that the Draft Report fails to strike the correct balance between the various limbs of the Part 4 purpose statement, and incorrectly elevates the importance of limb (d) of the purpose statement.
10. Airline submissions on the section 56G Review advocated focusing on limb (d) of the purpose statement.⁴
11. Auckland Airport believes that assessing effectiveness of ID involves giving proper consideration to each limb in a consistent manner. We note that if anything, limb (a) should be elevated above limb (d) (as has previously been argued before the Commission and now before the High Court). As discussed in further detail below, this approach reflects Parliament's clear intent for the ID Regime.
12. Conversely, the Commission appears to have taken the approach in the Draft Report that has been advocated for by airlines – that is, limb (d) appears to be the focal point of its analysis and conclusions. In doing so, it incorrectly assumes that ID is supposed to have an immediate impact on prices. This contradicts the fact that light-handed regulation is preferred because it was decided that the risk of excess profits was not high enough to justify heavier-handed regulation, which would undermine incentives to invest.

The background to the ID Regime highlights the importance of investment

13. Accordingly, in our view the Draft Report does not properly reflect Parliament's intent that investment is the primary objective of the Part 4 purpose statement, rather than limiting the extraction of profits.

⁴ BARNZ Response to WIAL Section 56G Issues Paper, 29 June 2012, page 3.

14. Part 4 was clearly aimed at regulating airports in a manner that would promote investment. In January 2008, Cabinet recommended major reform of the regulatory control provisions of the Act, noting that:⁵

The amendments are expected to be generally welcomed by regulated businesses. They aim to improve certainty and apply more internationally conventional forward-looking approaches to regulation than the Act currently allows. The changes are expected to improve business confidence and, as a consequence, improve the climate for investment in infrastructure.

15. The objectives of the Bill set out in the Explanatory Note included to "...improve clarity, certainty, timeliness and predictability for businesses", and to "...provide specifically for incentives to invest in infrastructure."⁶

16. The Bill introduced a specific requirement to promote incentives to invest for the first time. This was contained in a purpose statement similar to that proposed by the Ministry of Economic Development ("MED") in 2007 as part of its review of the regulatory control provisions of the Act.⁷ While MED proposed that incentives to innovate and invest be fourth on the list of purpose outcomes,⁸ the Bill ultimately prioritised incentives to innovate and invest in the purpose statement as the first outcome in the list, with limiting excess profits listed fourth in the purpose statement. The significance of this was noted by the Hon Lianne Dalziel MP (then Minister of Commerce) at the time:⁹

I do not think we should ignore the fact that [incentives to innovate and invest] is No.1 of a series of four tests against which those outcomes are being measured.

Starting with the incentives to innovate and invest is really sending a signal about how important it is not to forget that future needs are just as important when we are looking at a non-competitive market....I think we have the order right, and that sends a very good signal.

17. Upon introduction of the Bill, the Ministers of Commerce and Energy commented that:¹⁰

The Bill introduces a purpose statement specifically for this section of the Act to give clearer guidance to the Courts and the regulator that the aim of regulation is to promote investment.

18. The Minister of Commerce further explained this position during the First Reading of the Bill:¹¹

[T]he issue is...how do we balance the need to protect consumers from excessive prices while ensuring that suppliers have incentives to invest, to innovate, and to improve efficiency so we can be assured of reliable, efficient supply over the long term? **I believe that the new bill gets the balance right, and that it makes significant improvements to the current legislation.** [Emphasis added.]

19. Accordingly, the Minister of Commerce recognised that while the Commission must seek to achieve all four objectives in the Part 4 purpose statement, the right balance between

⁵ Offices of the Ministers of Commerce and Energy *Review of Parts 4 and 4A of the Commerce Act* (Cabinet Paper, 22 January 2008), paragraph 7.

⁶ Commerce Amendment Bill 2008 (201-1) (explanatory note), pages 3-4.

⁷ Commerce Amendment Bill 2008 (201-1) (explanatory note), page 4. Also see *Vector Limited v Commerce Commission* HC Wellington CIV-2011-485-536 26 September 2011 (Clifford J).

⁸ Ministry of Economic Development *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document* (30 March 2007) at [6].

⁹ Commerce Amendment Bill, Third Reading: Hon Lianne Dalziel (2 September 2008) 649 NZPD 18541.

¹⁰ Dalziel, L. and Parker, D., "Bill gives better incentives for infrastructure investment", 13 March 2008.

¹¹ Commerce Amendment Bill, First Reading: Hon Lianne Dalziel (20 March 2008) 646 NZPD 15157.

incentives to invest and protection of consumers from excess profits needed to be achieved.

20. There was a high degree of cross-party support during the final vote on the Bill.¹² The importance of improving incentives to invest was also expressed by a number of members of Parliament, for example [emphasis added]:

I would go so far as to say that the absence of such a purpose statement has led to considerable uncertainty, which has affected the ability of infrastructure companies to make timely investment decisions.¹³

[A] significant change with the introduction of a purpose statement specifically for the purpose of the Act, to give **clearer guidance to the courts and the regulator that the aim of regulation is to promote investment**. It is very easy to forget that. We are not seeking in this particular bill to stifle business activity. Rather, it is the opposite, and that is to promote investment.¹⁴

The third objective of the legislation is to provide for incentives for regulated firms to invest in infrastructure, and that is what we need to do. If we want a modern economy, and if we are serious about growing the wealth of this nation and about lifting wages, then there is no doubt that our basic infrastructure has to be world-leading. ... So providing those incentives is critical.¹⁵

The overarching objective of this bill is to provide for efficient and cost-effective regulation of the price and quality of key goods and services that are not subject to competition, **and to do so in a way that promotes greater certainty, and incentives to invest and innovate for regulated businesses**.¹⁶

New Zealand needs to focus on its commercial law and on fostering innovation and investment, and we believe that this bill goes towards that... This bill gives better incentives for infrastructure investment. Infrastructure businesses like electricity lines companies and airports will gain improved incentives to innovate and invest while consumers will be given protection from excessive prices and poor quality. Also, the purpose statement of the bill gives a clear guidance to the courts and the regulator, **and the aim of this regulation is to promote investment**.¹⁷

The main changes are that for the first time there is a clear emphasis on the importance of incentives for regulated businesses to invest.¹⁸

[Incentives to innovate and invest is in itself] a worthy statement, and in National's view it would be very difficult to disagree with it, because it includes the replacement and upgrading of new assets. It also makes sense that those suppliers have incentives to improve efficiency and to provide those services at a quality that reflects consumer demands... so a new test relating to the long-term benefit of consumers requires inclusion and clarification, but equally important in many respects is the incentive for these organisations to invest in the long-term infrastructure of New Zealand.¹⁹

"(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets;" - that is absolutely vital and it was lacking in the previous framework.²⁰

¹² Commerce Amendment Bill, Third Reading (2008) 649 NZPD 18548.

¹³ Commerce Amendment Bill, Second Reading: Hon Lianne Dalziel (2 September 2008) 649 NZPD 18313.

¹⁴ Commerce Amendment Bill, Committee of the Whole House: Hon Richard Worth (2 September 2008) 649 NZPD 18545.

¹⁵ Commerce Amendment Bill, Second Reading: Hon Chris Tremain (2 September 2008) 649 NZPD 18325.

¹⁶ Commerce Amendment Bill, Second Reading: Hon Lianne Dalziel (2 September 2008) 649 NZPD 18313.

¹⁷ Commerce Amendment Bill, Second Reading: Hon Lindsay Tisch (2 September 2008) 649 NZPD 18321.

¹⁸ Commerce Amendment Bill, Committee of the Whole House: Hon Richard Worth (2 September 2008) 649 NZPD 18545.

¹⁹ Commerce Amendment Bill, First Reading: Hon Simon Power (20 March 2008) 646 NZPD 15159.

²⁰ Commerce Amendment Bill, First Reading: Hon Nandor Tanczos (20 March 2008) 646 NZPD 15167.

21. In short, the Government recognised that a change in investment outcomes required a change in regulatory approach. On the passing of the new legislation in September 2008, the Minister of Commerce noted:²¹

The passing of this Bill is excellent news for the growth and improvement of New Zealand infrastructure businesses that are natural monopolies. It will provide greater certainty for regulated businesses and incentives for investing in infrastructure while giving consumers protection from excessive prices and poor quality.

The Bill draws upon best practice overseas to achieve these objectives. In particular it seeks to ensure that regulation is not imposed unnecessarily, and that where it is required, it is applied in the most efficient way to promote the long-term interests of consumers.

This is another important step in the Government's ongoing efforts to foster investment in innovation and infrastructure that will help our business grow and improve productivity.

22. The importance of investment has also been recognised more recently by the courts. In *Vector Ltd v Commerce Commission*,²² Clifford J expressed the view that the limb requiring the promotion of incentives to innovate and invest should, given the legislative history, be given prominence.²³ Similarly, the Court of Appeal accepted on appeal in that case that ... "an important purpose of Part 4 was to create incentives for suppliers to undertake long term investments in infrastructure".²⁴

23. In *Wellington International Airport Ltd v Commerce Commission*, Clifford J summarised his analysis in *Vector Limited*, noting that:²⁵

The new, stand-alone, Part 4 purpose statement summarises the outcomes looked for from Part 4 regulation. These are based on the three outcomes for the thresholds regime that had previously applied to electricity lines businesses to which **the Government chose to add, and give prominence to, a new outcome, namely that regulated firms were to have incentives to innovate and invest.** [Emphasis added].

24. Accordingly, although the Commission may be correct to note that ID itself may not promote incentives to invest (which already exist), it is wrong to say that ID should therefore have the most immediate and noticeable impact on prices. Such an approach disregards the fact that a light-handed ID Regime was imposed because there is no evidence of excessive pricing that would justify heavier-handed regulation. Although ID may help to uncover excessive pricing that would justify further intervention if not addressed by the supplier, that is not the same as finding that ID is ineffective because it has failed to require suppliers to immediately change their behaviour as though price control applied now.

The Commission's approach fails to adequately address the interdependence of the limbs of the purpose statement

25. The Draft Report suggests that the Commission will assess *all* analytical areas prior to assessing the effectiveness of ID in promoting one particular outcome. Commenting specifically on profitability at paragraph 3.9 of the Draft Report, the Commission provides that:

²¹ Dalziel, L., "Infrastructure investment gets boost from law changes", 5 September 2008.

²² *Vector Ltd v Commerce Commission* HC Wellington CIV-2011-485-536, 26 September 2011 at [52].

²³ *Vector Ltd v Commerce Commission* HC Wellington CIV-2011-485-536, 26 September 2011 at [52].

²⁴ *Commerce Commission v Vector Ltd* [2012] NZCA 220 at [34]. Note that this aspect of the regulatory framework was not discussed by the Supreme Court in upholding the decision of the Court of Appeal.

²⁵ *Wellington International Airport Ltd v Commerce Commission* HC Wellington CIV-2011-485-1031, 22 December 2011 at [88(b)].

We are unable to assess the effectiveness of information disclosure in promoting particular outcomes observed in workably competitive markets without first assessing outcomes in other areas. For example, we were not able to reach a draft conclusion on profitability without considering each of the other analytical areas.

26. However, the Draft Report does not subsequently explain if or how the Commission has taken in to account other limbs of the purpose statement when assessing profitability.
27. In our view, a greater appreciation of the interdependence of the limbs of the purpose statement is required. Part 4 outcomes are variable and competing and are therefore necessarily interlinked. We understand this to be consistent with the view expressed by the Chair of the Commission Dr. Berry at the Wellington Airport Conference "...that each of these areas of performance [relevant to the purpose of Part 4] interrelate."²⁶
28. The Commission's Final Report needs to actually consider the interdependence of the limbs in making an assessment about the effectiveness of ID, rather than merely noting that there is an interrelationship. This will better reflect the statutory intent of the ID Regime and recognise the significant influence the Final Report will have on future price setting behaviour, for both airlines and airports.
29. In simple terms, profits may reasonably be higher where consumers are enjoying higher quality that reflects their needs. Conversely, a lower profit may still be deemed excessive if a regulated supplier has a comparatively low performance in respect of all of the other limbs of the purpose statement.
30. While such an assessment could arguably be captured by considering whether there is "superior performance", the Draft Report adopts a narrow approach to superior performance, concluding that, in the case of WIAL:²⁷
- ...there is no evidence of superior performance or other external conditions that would justify the existence of excess profits.
31. In assessing the various limbs of the purpose statement, the Commission has:
- (a) Concluded that it is too early to draw definitive conclusions based on its predictions of what may occur in PSE2 and beyond regarding operating efficiency, investment and the sharing of efficiency gains; but
 - (b) Drawn definitive conclusions regarding returns based on an assumption of what will occur in PSE3.
32. In our view, that approach fundamentally shifts the focal point of ID Regulation towards a more heavy-handed regime as sought by airlines.
33. In summary, we think that it will be very difficult for the Commission to establish a robust evidential foundation to conclude that excess profits are being earned when it is too early to make any findings on efficiency.

It is too early to draw a definitive view when outcomes consistent with the Part 4 purpose statement are long term rather than short term objectives

34. Auckland Airport is concerned that the Commission's definitive conclusions on limb (d) of the purpose statement are at odds with the measured approach taken regarding its other findings, which more appropriately acknowledge the limitations of a Review conducted while the ID Regime is in its infancy.

²⁶ Section 56G Wellington Airport Conference Transcript, 7 August 2012, page 3 (line 31) - page 4 (line 7).

²⁷ WIAL Draft Report, paragraph H5.3.

35. The Commission has correctly acknowledged the lack of time series data available to it in conducting the Review.²⁸

While we are not persuaded that the benefit of more data overrides the wording of s 56G, we acknowledge that a potential outcome of conducting the s 56G review now could be that it is too early to draw firm conclusions about the effectiveness of the information disclosure regime **in relation to some of the intended Part 4 outcomes**. Accordingly the conclusions drawn in this review reflect the level of data available. [Emphasis added]

36. The approach outlined by the Commission is mostly correct. However, Auckland Airport is concerned that a distinction is being drawn regarding the appropriate time period for assessing profits, compared to an assessment of other limbs under the purpose statement.
37. The Commission is clear that it expects to see a more immediate impact on pricing outcomes, than for other limbs of the purpose statement, such as quality, which take further time to influence behaviour and outcomes. While Auckland Airport accepts that it may be possible to draw a conclusion in respect of pricing in one PSE in isolation, it does not follow that a forecast of extracting excessive profits in one PSE equates to ID being ineffective over time.
38. The critical question is whether there is any evidence that a fully operational ID Regime will be ineffective at limiting excess profits over time. In that context, we do not think it is possible to disguise assumptions about future conduct as actual findings of long term outcomes.

It is inappropriate to prejudge future airport pricing decisions

39. In order to overcome the limitations of conducting a review after only one PSE since the introduction of the ID Regime, the Commission has made an assumption regarding what may occur in PSE3. The conclusion that the Commission draws on profitability largely hinges on projections of future decision-making, in both its modelling and discussions throughout the Draft Report. We attach a report (**Attachment 1**) from NERA Economic Consulting which discusses the implications of the Commission's assumptions for its modelling and analysis.
40. Accordingly, the Commission's recommendations to the Ministers in the Draft Report involve unsubstantiated inferences regarding WIAL's future price setting approaches, which provide no evidence regarding the effectiveness of ID now.
41. In our view, an approach which draws definitive conclusions about the effectiveness of a new regime in its infancy based on what *may* occur in future, is inappropriate. This is particularly so when there are a number of regulatory steps aimed at modifying and incentivising behaviour consistent with the purpose statement, that have not yet occurred, or had an opportunity to be properly tested.
42. While we accept that any modelling necessarily requires some assumptions and judgment calls, we are concerned that the Draft Report fails to:
- (a) Make explicit that the Commission's conclusions and recommendations are underpinned by judgment calls and inferences regarding potential future behaviour;
 - (b) Acknowledge the limitations of the approach the Commission has taken in modelling. If the approach outlined in the Draft Report is retained, it should be

²⁸ WIAL Draft Report, paragraph A42.

highlighted that it involves predictions about WIAL's future approach to pricing - namely, that it will continue to use an MVEU asset valuation irrespective of:

- (i) The Commission's conclusions in the section 56G Review;
- (ii) Any arguments advanced by airlines during the next PSE3;
- (iii) Any direction from the Courts in the merits review proceedings; and
- (iv) Any external factors or developments in the airport industry during the coming five year period that may impact on management's approach to pricing.

In our view, the Commission should make it clear that WIAL may in fact take an approach in future pricing which may not lead to the extraction of excessive profits (whether because of the factors outlined above or otherwise);

- (c) Properly account for the role that airlines have played in determining AAA outcomes, particularly in reaching conclusions about likely conduct and outcomes in future price setting consultations; or
- (d) Acknowledge that the Review itself is important.

The Commission has made critical judgements about future conduct which are driving its conclusions on forecast excess returns

43. The Commission's assessment of future pricing in part relies on predictions about likely future conduct. The Draft Report notes that:²⁹

...significant disagreement exists between Wellington Airport and its customers over the financial inputs to its price-setting decisions. While there has been increased transparency, the existence of Part 4 information disclosure regulation has not appeared to reduce the extent of disagreement as to price-setting outcomes. Against this background we are not confident that there is a likelihood of Wellington Airport's excessive profits being limited at PSE3 or beyond.

44. The Commission's preliminary conclusions in the Draft Report:

- (a) Are at risk of over-emphasising areas of difference rather than areas of alignment. In this respect we note that in workably competitive markets, it is unrealistic for customers and suppliers to agree on all aspects of innovation, quality, efficiency and price, because of differences in perspectives on each of these factors.
- (b) Fails to adequately acknowledge that consultations require the good faith participation of airlines. In this respect we note:
 - (i) Concern that airlines have raised new or different views during the section 56G Review to those raised during pricing consultation with Auckland Airport; and
 - (ii) The airlines' public campaign of undermining ID which appears to demonstrate that, as a starting point, airlines do not believe that ID can achieve the right outcomes.

²⁹ WIAL Draft Report, paragraph H5.5.

45. By way of example, the following table highlights inconsistencies in views provided by BARNZ during consultation and during the section 56G Review regarding WACC:

Table A: Inconsistencies in arguments that BARNZ put to Auckland Airport during consultation and raised during the section 56G Review regarding WACC

Views BARNZ put to Auckland Airport during consultation	Different view BARNZ put to the Commission during the section 56G Review
BARNZ recommended the Board make changes to achieve no more than an 8.04% return, based on the 75 th percentile April 2012 Commission Determination. [Auckland Airport Board Minutes: AAA Consultation - BARNZ presentation on the Revised Pricing Proposal, 16 May 2012, page 2.]	BARNZ advocates calculating excess returns against a point estimate of 6.49% based on the mid-point WACC, some 20% below the estimate provided to Auckland Airport as their preference. [BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, page 6.]

46. BARNZ and Air New Zealand have made a number of public statements in an apparent attempt to undermine the ID regime.³⁰ These statements appear to suggest that airlines believe that ID is not and will not be effective, and that stronger regulation is therefore required. While we are unable to comment on WIAL's pricing consultation since we were not a participant in it, it is our experience that the pricing consultations conducted under the AAA regime have overall been overwhelmingly effective in creating alignment on a broad range of areas. As discussed previously in our submissions and cross-submissions:

- (a) In general there was constructive input from the airlines in respect of many of the building blocks.³¹

145. As part of this Review process, Auckland Airport has provided the full record of our consultation process to the Commission on a confidential basis. In our view, this record clearly demonstrates that we approached consultation with an open mind and used the consultation process constructively to better inform and influence our pricing decisions.

146. When appearing before the Auckland Airport Board on 16 May 2012 Auckland Airport's Price Setting Disclosure reflects that BARNZ Represented Airlines made the following acknowledgement regarding our process and the quality of our consultation:

Mr John Beckett, on behalf of BARNZ Represented Airlines confirmed that the BARNZ Represented Airlines considered that Auckland Airport's consultation process had been constructive and had enabled good dialogue between the parties.

147. Mr. Beckett's views expressed to the Board align with our experience of the consultation process. In particular, we were left with the impression that while there was not absolute concurrence or agreement at the end of the consultation, the airlines felt that they had been listened to and the effectiveness and scope of the second PSE markedly improved upon experiences during the first PSE.

148. We also note that views of substantial customers included a broad spectrum of contrasting priorities and characteristics. That is, our substantial

³⁰ BARNZ Response to Productivity Commission's International Freight Transport Services Issues Paper, August 2011; H McNeilly "Dogfight breaks out over landing fees", Otago Daily Times, 29 March 2012 (<http://www.odt.co.nz/news/dunedin/203331/dogfight-breaks-out-over-landing-fees>); O Hembry "Call for regulation of airport", New Zealand Herald, 19 October 2011 (http://www.nzherald.co.nz/airlines/news/article.cfm?c_id=113&objectid=10760061&ref=rss); R Van Den Bergh "Wellington Airport landing fee rise 'excessive'", The Dominion Post, 17 March 2012 (<http://www.stuff.co.nz/dominion-post/business/6591895/Wellington-Airport-landing-fee-rise-excessive>).

³¹ Auckland Airport Submission on the section 56G Review AIAL Process and Issues Paper, 19 October 2012, paragraphs 145-148.

customers did not share the same views on all matters for very sensible reasons relating to their various business models/interests. In this context, it is our view that the level of consensus that was achieved during the consultation process was significant. Further, we believe that the substantial common ground that was achieved by the end of the process is testimony to the fullness and robustness of Auckland Airport's consultation process - that is, our responses to requests for further information and our willingness to consider customer feedback, increased mutual understanding and resulted in movement of positions.

- (b) There was disagreement between airlines in relation to some building blocks and price structure.³²

150. Auckland Airport made a number of changes to its proposed pricing structures throughout the consultation process in response to matters and concerns raised by airlines. While some differences in opinion between Auckland Airport and substantial customers remained at the time of our final pricing decision, we are confident that we genuinely considered all feedback with an open mind and ultimately struck an appropriate balance between competing variables in our final pricing decision.

151. In this regard, we note that full agreement would not have been practical in any event, as substantial customers had different views on points of detail. One example demonstrating divergence between BARNZ and Air New Zealand, is the split between domestic and international charges. BARNZ's opinion was that Auckland Airport's charges could be likely to result in international airlines cross-subsidising the airfield costs of airlines which are operating freight services, or are not utilising the terminal. Conversely, Air New Zealand disagreed that this was necessarily the case, on the basis that the under recovery may instead reflect that charges for larger (international) aircraft are not appropriately recovering all the costs associated with the airfield assets and facilities required for aircraft, which are not required for smaller domestic aircraft. Air New Zealand argued that care should be taken in reaching these sorts of conclusions.

152. The volume of materials, matters and issues traversed during any pricing consultation on a five year forward looking basis is vast. This was certainly the case in Auckland Airport's aeronautical pricing consultation. In reviewing Auckland Airport's conduct, it is our view that the Commission should consider whether the priority matters raised by customers in consultation were considered by Auckland Airport (and we are confident that the record will show that they were genuinely considered in what was a fulsome consultation process). In our view, it would be disadvantageous and ultimately misleading to focus on a small number of points of remaining difference, particularly if any of these points of difference were not raised by airlines during consultation.

- (c) The conduct of airlines during PSE2 in relation to WACC was unconstructive in comparison to their fulsome and helpful engagement on other important matters.³³

124. Auckland Airport considers that a critical element of the AAA regime is the open mind that Auckland Airport brings to its pricing consultation. Our practice is to consider and balance the views we receive from airlines, expert advisors, regulators and shareholders. A similar disposition is not required of airlines, which allows them to vigorously pursue outcomes that best suit their individual interests.

125. Despite a number of requests to airlines during the consultation process, Air New Zealand did not provide Auckland Airport with expert advice,

³² Auckland Airport *Submission on the section 56G Review Process and Issues Paper for Auckland Airport*, 19 October 2012, paragraphs 150-152.

³³ Auckland Airport *Cross-submission on the section 56G Review AIAL Process and Issues Paper for Auckland Airport*, 9 November 2012, paragraphs 124-126..

or respond to arguments advanced by Auckland Airport or Uniservices supporting deviation from the Commission's IM.

126. Although the airlines are entitled to believe that the Commission's industry-wide benchmark WACC for ID purposes should be applied by Auckland Airport in pricing, we would have appreciated feedback on our carefully considered reasons why Auckland Airport specific parameters were required in some cases.

47. However, this does not detract from the fact that overall our experience during consultation has been very constructive, with significant areas of alignment. As highlighted in our submission on the Auckland Airport process and issues paper, BARNZ acknowledged to Auckland Airport's Board that they were pleased with Auckland Airport's consultation process, and considered that consultation had been constructive with good dialogue between the parties.³⁴
48. Against this backdrop, Auckland Airport expected the Commission's Draft Report to at the very least acknowledge that airline conduct may have had some part to play in the level of disagreement during pricing. This is particularly important in the context of a broader airline agenda to promote more heavy-handed regulation perceived to be a better outcome for themselves, rather than an open mind to ID having the potential to be effective.
49. It must also be acknowledged that in some cases airports and airlines have genuinely divergent views that are not possible to reconcile, particularly when the positions adopted are subject to merits review proceedings. We therefore expect the Commission to acknowledge that in relation to matters such as asset valuation and WACC, it is unrealistic to expect ID to have reduced disagreement at this stage, and therefore no negative inferences should be drawn regarding the effectiveness of ID if disagreement still exists.

The Commission's approach fails to consider the important influence that annual summary and analysis reports will have in contributing to the effectiveness of ID

50. Auckland Airport is also concerned that the Draft Report does not adequately acknowledge that section 53B(2) summary and analysis reports (which the Commission is yet to prepare) are an important step in the process of contributing to the effectiveness of the ID Regime.
51. In Auckland Airport's view, the section 53B summary and analysis reports serve two key purposes:
- (a) Summarising or simplifying complex data in order to assist the understanding of interested parties; and
 - (b) Providing feedback to regulated suppliers, by providing an independent assessment of airport performance by the Commission.
52. The Commission has previously acknowledged the importance of the section 53B(2) summary and analysis reports:³⁵

The requirement to publish a summary and analysis confers an ongoing, active role on the Commission in respect of the information disclosure regime after the information disclosure requirements have been set. The Commission considers

³⁴ Auckland Airport Board Minutes: AAA Consultation - BARNZ presentation on the Revised Pricing Proposal, 16 May 2012, page 1.

³⁵ Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2010 ("**ID Reasons Paper**"), paragraph 2.46.

that its summary and analysis obligations will contribute to ensuring that sufficient information is made available to interested persons.

53. Indeed, the summary and analysis reports were always intended to impose a discipline on airport pricing behaviour. In the Ministry of Economic Development's advice to the Commerce Committee considering the Bill it was recognised that:³⁶
- ... information disclosure, combined with annual analysis by the Commission and the requirements for a review, will impose some disciplines on pricing behaviour.
54. Conversely, in the Draft Report the Commission appears to have formed the opinion that the section 53B summary and analysis reports are *unlikely* to have any influence on airports pricing behaviour.
55. Auckland Airport strongly disagrees.
- (a) If the Commission's section 53B(2) summary and analysis reports highlighted an issue, Auckland Airport is confident that it would consider and be influenced by issues raised, where appropriate.
 - (b) Conversely, the Commission's approach appears to infer that airports will not be open to modifying their behaviour in response to any issues or concerns highlighted in section 53B(2) summary and analysis reports.
 - (c) The Commission's decision to conduct the section 56G Review prior to its preparation of section 53B(2) summary and analysis reports further suggests that it does not see its annual reporting as an opportunity to influence airport behaviour.
56. In our view, a negative finding in the conclusions of the section 56G Review is likely to impact the approach of an airport in future PSEs. Similarly, the Commission's guidance in its section 53B(2) summary and analysis reports are an opportunity to provide useful guidance to airports.

³⁶ Ministry of Economic Development *Commerce Amendment Bill: Report of the Ministry of Economic Development*, 4 July 2008, page 50.

SECTION 4: THE ROLE OF THE IMS

57. Key points we address in this section are:

- (a) The IMS do not represent the only outcome in workably competitive markets;
- (b) The role of the WACC IM in pricing and the section 56G Review;
- (c) WACC is a material issue;
- (d) A WACC estimate is imprecise;
- (e) Other reasonable WACC parameters exist in workably competitive markets; and
- (f) The commercial reasonableness of the Commission's WACC estimate.

The IMS do not represent the only outcome in workably competitive markets

58. The Draft Report outlines the Commission's view on the appropriate role of the IMS to the section 56G Review:³⁷

We acknowledge that airports are not required to apply the input methodologies to their pricing. Rather, the input methodologies provide the Commission with a benchmark for assessing whether the objectives specified in s 52A(1) are being promoted. They are our assessment of how certain building blocks (eg asset valuation) should be specified to promote the Part 4 purpose. As such, the input methodologies are a tool the Commission can use in its analysis of both historic and forecast performance.

59. Although Auckland Airport agrees that the IMS are relevant and important, we are concerned that the approach taken in the Draft Report fails to recognise that:

- (a) There are no IMS for quality, innovation, efficiency gains or investment. The Commission's focus on the IMS (that is, asset valuation, cost allocation and tax methodologies) necessarily leads it to focus on pricing and limb (d) of the purpose statement.
- (b) The purpose of the IMS is to provide certainty and consistency regarding the information disclosed by airports in the Schedules, and in the methods used for monitoring and analysis.
- (c) However, the benchmark established for monitoring returns should not be treated as a rigid line that must not be crossed in pricing. This would undermine the correct position indicated by the Commission before prices were set, which is that the IMS are not mandatory for pricing purposes.³⁸

Some submitters have argued that the Commission is setting de facto price control of airport services. This is incorrect. The Commission appreciates that Airports are able to charge as they see fit.

- (d) IMS are imprecise and a range of other possible outcomes can appropriately achieve outcomes consistent with the Part 4 purpose statement. Although the Commission accepts this in principle, its analysis does not demonstrate it has considered variants to its IMS to support this.

³⁷ WIAL Draft report at paragraph A19.

³⁸ ID Reasons Paper, paragraph 2.30.

60. As part of its analysis of the regulatory framework, the Commission referenced Auckland Airport's statement in its reply submissions to the High Court in the appeal under section 52Z on IMs.³⁹

IMs are of distinct importance. In respect of airports, subject only to information disclosure, IMs determine whether information disclosure functions as intended (to ensure that sufficient information is readily available to interested persons) or applies with undue weight (akin to de facto price control). In at least the context of information disclosure the IMs, in substance, do the heavy lifting. They determine the key information required to be disclosed and the evaluative benchmark against which airports' returns, and the effectiveness of the regime, will be assessed.

61. Auckland Airport does not consider that this quote has any bearing on the role of IMs in the section 56G Review process. When placed in context, it is clear that Auckland Airport's comments were responding to the Commission's submissions in the merits review proceedings that sought to downplay the importance of IMs for ID.⁴⁰

The role of the WACC IM in pricing and the section 56G Review

62. At the time of pricing, Auckland Airport genuinely expected its pricing decision on WACC to be subject to considered scrutiny - by interested parties, the Commission and Ministers. We approached pricing with this in mind, and the IMs, together with this Review, acted as a significant discipline on our approach to pricing. The full consultation record, and our submissions and cross submissions on the section 56G Review demonstrate our considered approach. This evidence provides a detailed picture of the shifts made in our approach to pricing and building blocks methodology in response to airline concerns and submissions.

63. Although we understood that the WACC IM would be used for monitoring purposes, Auckland Airport did not understand that the WACC IM would form the sole regulatory yardstick against which its pricing would be assessed, or that, in the case of WACC, strict application of the WACC IM would be the reference point for its returns in the section 56G Review. Rather, we expected the Commission would:

- (a) Assess the reasonableness of each of the parameter estimates at the time WACC was estimated for the pricing decision;
- (b) Consider that commercial entities may not model cashflows in the same manner as a monitoring disclosure regime formulated by a Regulator, but would look beyond this to check for internal consistency in the approach taken (such as whether asymmetry of risk was included in cashflows or the WACC estimate); and
- (c) Focus on the effective return achieved in the pricing outcome, rather than the airport "WACC". For example, Auckland Airport acknowledged that a difference in opinion remained in respect of an appropriate WACC, and then targeted an effective return of 8.475 percent, but did not price at its WACC estimate.

³⁹ *Auckland International Airport Limited v Commerce Commission* HC Wellington CIV 2011-404-000820, 3 September 2012: Reply Submissions for Auckland Airport in response to the Commerce Commission's Submissions dated 6 August 2012, 20 August 2012, paragraph 2.4.

⁴⁰ This is clearly demonstrated by the paragraph of Auckland Airport's reply submissions to the High Court that precedes the text quoted by the Commission in the Draft Report, which states that: "In observing that IMs are not the regulatory controls themselves, but rather set out in advance certain rules, requirements and processes that will apply to those controls, the Commission risks understating their importance." (Reply Submissions for Auckland Airport in response to the Commerce Commission's Submissions dated 6 August 2012, 20 August 2012, paragraph 2.3).

WACC is a material issue

64. As demonstrated by the full consultation record, submissions and cross submissions by airlines and airports throughout the section 56 Review to date, WACC was the material issue and point of contention during PSE1 and PSE2. Accordingly, Auckland Airport expected the Draft Report to set out detailed consideration of:
- (a) The arguments put forward by WIAL and the airlines during price consultation for each WACC parameter, in the context of WIAL's approach to modelling of cash flows for pricing; and
 - (b) A fulsome explanation of why WIAL's parameter estimates did not support a partial or full adjustment to the WACC IM in the context of a firm specific pricing decision.
65. Auckland Airport is concerned that, while the Draft Report sets out a framework against which performance of all regulated airports will be assessed, it does not include any guidance regarding what would in fact substantiate a variation in returns from its WACC IM. Notable in this respect is a lack of clear guidance on:
- (a) Other reasonable parameters in WACC which might be expected to be seen as individual firms set their firm specific requirements in workably competitive markets;
 - (b) The commercial reasonableness of the Commission's WACC estimate;
 - (c) Superior performance; or
 - (d) Other factors.

A WACC estimate is imprecise

66. In the IM Reasons Paper, the Commission acknowledged the significant uncertainty in estimating the cost of capital, and that the exercise involved inherent imprecision and judgment:⁴¹
- 6.1.4 The cost of capital, in particular the cost of equity, cannot be observed directly. Rather it must be estimated from the available data using a number of tools and techniques. This is not a simple task. The available tools are imperfect, the data can be hard to obtain or unreliable, and can change over time. Older data can be reinterpreted in new ways; newer data may call into question previous assumptions. The cost of capital is forward-looking. That is, it reflects expectations of the returns required in the future, which cannot be observed in advance.
 - 6.1.5 In estimating the cost of capital, there are also choices around the analytical models to be used, over the level of each parameter, and around the estimate of the cost of capital to be applied under the different regulatory instruments. The estimation of a cost of capital is not a mechanical task. To determine the methodology for estimating the cost of capital, and to assure itself that the estimate is reasonable and meets the Part 4 Purpose and the purpose statement of information disclosure regulation, the Commission has had to exercise a degree of judgement over these matters. The Commission has carefully considered the effect of a number of choices individually and in combination. The Commission has used its IM to estimate the cost of capital based on current market conditions. It has then tested the resulting estimate of the cost of capital against a range of market information to ensure the IM is reasonable and

⁴¹ Commerce Commission *Input Methodologies (Airport Services) Reasons Paper*, 22 December 2010 ("**IM Reasons Paper**"), paragraphs 6.1.4 - 6.1.5.

commercially realistic, in the context of how the cost of capital is to be applied in regulation under Part 4.

67. Similar notes of caution were expressed by the Expert Panel advising the Commission during the IM consultation process.⁴² In particular, the Expert Panel considered that describing the uncertainty surrounding the WACC estimate needed to be carefully considered by the Commission, in order to avoid giving "...a false sense of rigour, when in fact judgment is unavoidable",⁴³ and to avoid providing a "...misleading sense of precision".⁴⁴
68. In short, the Commission's WACC estimate must be understood in the context of the judgment and imprecision which is inherent in the nature of the WACC IM. The Commission's WACC estimate is not (and cannot be) a precise measure of the "true" cost of capital for either a notional or a specific airport. Auckland Airport understands that the difficulty in attempting to achieve precision in this area has also been acknowledged in an Australian context. For example, the Australian Productivity Commission has recently noted:⁴⁵

However, there is no single 'correct' asset beta or market risk premium, and setting parameters that result in a lower-than-required WACC (and thus lower prices as the cost of capital feeds into the building blocks model) can result in inadequate or delayed investment, as investors seek higher returns elsewhere. For a regulator targeting a particular rate of return that it deems to be 'appropriate', the risks of over- or under-shooting the cost of capital are not symmetrical.

69. And further noted that:⁴⁶

The ACCC continues to be the regulator for a number of industries. For many of the price determinations made by the ACCC, industry participants and the regulator continue to debate such aspects as the correct gearing ratio for the businesses, the relevant market risk premiums, appropriate credit ratings and debt margins, the value of the regulated asset base, and the asset betas. The fact that this process is often drawn out, and requires extensive industry consultation (potentially resulting in litigation), demonstrates that rather than being an 'objective' process for regulating prices, it is often much more 'art than science'.

70. Auckland Airport considers that the Draft Report does not appropriately draw attention to the judgment that has been identified as inherent in the Commission's WACC IM. Instead, the Commission appears to present its WACC estimate as an accurate yardstick for assessing returns and profitability, without properly highlighting:
- (a) The judgments and subjectivity involved in developing that yardstick; and / or
 - (b) The corresponding limitations of the Commission's approach in assessing profitability.

⁴² Franks, Lally, Myers *Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology*, 18 December 2008 at page 4, 5, 6.

⁴³ Franks, Lally, Myers *Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology*, 18 December 2008 at paragraph 143.

⁴⁴ Franks, Lally, Myers *Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology*, 18 December 2008 at paragraph 144.

⁴⁵ Australian Productivity Commission *Economic Regulation of Airport Services*, Inquiry Report no. 57, Canberra (11 December 2011), page 126.

⁴⁶ Australian Productivity Commission *Economic Regulation of Airport Services*, Inquiry Report no. 57, Canberra (11 December 2011), page 128.

Other reasonable WACC parameters exist in workably competitive markets

71. As set out in our previous submission on the section 56G review, Auckland Airport believes parameter estimates it adopted in producing its WACC estimate are reasonable. By way of example, we have included below a discussion of the asset beta and Tax-Adjusted Market Risk Premium ("**TAMRP**") decisions made by Auckland Airport.
72. More generally, we note that Auckland Airport must use its judgment, based on observable market conditions, to ensure that its WACC estimate is commercially realistic in the circumstances.

Asset Beta

73. In the Final Pricing Reasons Paper, Auckland Airport was clear that it carefully considered the Commission's estimate of asset beta in its WACC IM, and considered that it had good reason to depart from that industry benchmark estimate.⁴⁷ In particular, when developing the WACC IM, the Commission had found that the asset beta for Auckland Airport was higher (between 0.75 and 0.79) than the industry average (between 0.6 and 0.72).
74. During the pricing consultation, Uniservices considered a number of approaches when estimating the appropriate asset beta for Auckland Airport, including first principles and direct measures of Auckland Airport's asset beta. It also updated the analysis of the comparative asset betas for the sample of airports (including Auckland Airport) used by the Commerce Commission in its Input Methodologies Reasons Paper (2010).
75. The direct estimate of Auckland Airport's asset beta as at the end of August 2011 was between 0.79 and 0.62, calculated using two years' weekly data and five years' monthly data respectively, with an overall average of 0.71.

From this data, Uniservices advised that first principles analysis suggests that Auckland Airport is exposed to:

- (a) Systematic volume risk from the nature of services provided; and
- (b) Systematic risk from high operating leverage.

76. Accordingly, Uniservices concluded that:⁴⁸

... an appropriate point-estimate asset beta for AIAL's aeronautical assets is 0.65.

77. An aeronautical asset beta of 0.65 is below Auckland Airport's average asset beta of 0.71 derived from the Commission's sample (as updated by Uniservices). It is also below the updated Uniservices average estimate (0.69) of the comparative company sample using two and five years data. Further, it is below the value the Commission directly estimated for Auckland Airport (0.75 based on monthly observations and 0.79 based on weekly observations) when developing its WACC IM.⁴⁹
78. A downwards adjustment for the regulated business asset beta has been made consistent with the Commission's approach to the IM in this respect.⁵⁰

⁴⁷ Auckland Airport *Aeronautical Pricing: Final Reasons Paper*, 7 June 2012, page 49.

⁴⁸ Uniservices *The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd*, 6 October 2011, page 31.

⁴⁹ IM Reasons Paper, Table E19.

⁵⁰ Uniservices *The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd*, 6 October 2011, page 31.

This downward adjustment to AIAL's asset beta for its aeronautical assets reflects some allowance for lower systematic risk compared to the systematic risks of parts of AIAL's other business units.

79. Auckland Airport considers that the 0.65 estimate of asset beta is also conservative because the historically observed asset beta includes decades of a TSC passenger, MCTOW and lease price structure, with approximately 80 percent of charges varying with underlying demand. Under the Final Pricing Decision, 97 percent of forecast revenue is demand dependent. This represents a fundamental change in Auckland Airport's risk profile, which has implications for the asset beta. A key factor in this respect is that the TSC was removed in favour of variable charging. This new structure is based on requests from substantial customers for greater risk sharing. As a result, our view is that we will be faced with increased systematic risk going forward, beyond that indicated in any historic regression analysis, and/or based on historic fundamental risk factors. This is consistent with Uniservices observation in its October 2011 report that.⁵¹

Any shift in pricing towards the PSC and away from the TSC will increase the overall systematic risk of AIAL's aeronautical assets.

TAMRP

80. Auckland Airport has used a point estimate of 7.5 percent for the TAMRP in its pricing, which we consider is appropriate based on its expert advice and the weight of market evidence. We note that, during the Commission's briefing for market analysts on the Draft Report, Commissioner Begg noted that the industry approach to TAMRP was between 7 and 7.5 percent. We are pleased that the Commission is also considering current industry approaches.
81. 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.
82. Auckland Airport understands that Forsyth Barr has recently reviewed the market risk premium it uses in its WACC model and have increased its estimate of market risk premium to 8 percent.
83. Auckland Airport requests that the Commission review the basis on which the "temporal" 0.5 percent adjustment to the TAMRP was provided and withdrawn under the IM, and whether its model is generating commercially realistic WACC estimates in the current economic climate.

Commercial reasonableness of the Commission's WACC estimate

84. Auckland Airport is also concerned that the Commission has not given sufficient consideration to the commercial reasonableness of its WACC estimate (and, therefore, its appropriateness as a measure of returns). The Commission notes.⁵²

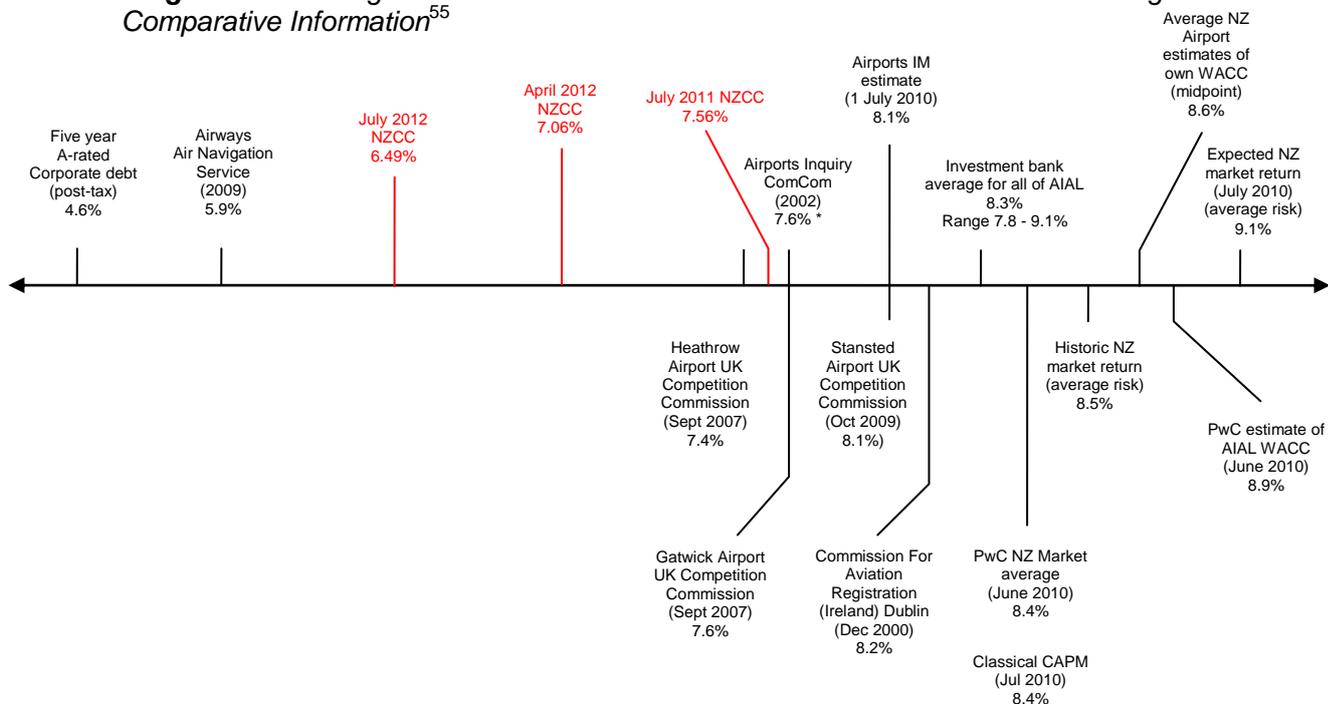
WIAL's WACC for PSE2 is 246 basis points (2.46%) higher than the Commission's estimate of midpoint WACC. It is also higher than the estimates of WACC considered by the Commission in estimating a commercially realistic WACC for New Zealand airports.

⁵¹ Uniservices *The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd*, 6 October 2011, at page 30.

⁵² WIAL Draft Report, paragraph I67.

85. Auckland Airport notes that, when developing the WACC IM, the Commission tested its estimate of the post-tax WACC produced by its WACC IM (as at June 2010) against a range of information to ensure that estimate was reasonable and commercially realistic.⁵³
86. This comparative information included:⁵⁴
- estimates of the long-run historical returns earned by New Zealand investors on investments of average risk (over the period 1900-2009);
 - estimates of future returns expected by New Zealand investors on investments of average risk;
 - estimates of the post-tax WACC for airports regulated services in other regulatory contexts especially in New Zealand and the United Kingdom;
 - independent estimates of the post-tax WACC for New Zealand airports; and
 - estimates of the post-tax WACC using other approaches, including using the classical CAPM.
87. In doing so, the Commission considered cost of capital estimates over a range of time-frames, including using estimates from 2007 through to 2010, as well as long-run historical estimates. From this comparative analysis, the Commission concluded that its estimate of the post-tax estimate of WACC (which, at that time, was 8.1 percent at the 50th percentile) was reasonable and commercially realistic for suppliers of regulated airport services. The diagram below reproduces the Commission's reasonableness checks in its IM Reasons Paper, with the Commission's most recent WACC estimates added.

Diagram A: Testing the Reasonableness of the IM Estimates of the WACC Against Comparative Information⁵⁵



* Updated for changes in risk-free rate and debt premium.

Note: Estimates of post-tax WACC (midpoint) based on Figure 6.6 - Input Methodologies Reasons Paper

⁵³ IM Reasons Paper, paragraph E13.7.

⁵⁴ IM Reasons Paper, paragraph E13.8.

⁵⁵ The original diagram is found at: IM Reasons Paper, page 355.

88. In Auckland Airport's view, as part of the section 56G Review, the Commission should continue to follow its approach in the IM Reasons Paper, and should evaluate its current WACC estimate for commercial realism, including forming a view on the reasonableness of its estimate and airport estimates against a range of other estimates in recent history. In our view, the Commission has not adequately addressed why it considers its current estimate of WACC to be commercially realistic given that:
- (a) It is now 20 percent lower than its WACC estimate in July 2010; and
 - (b) It now sits well outside the majority of the checks that the Commission used to conclude that a figure of 8.1 percent was a reasonable estimate of WACC.
89. Auckland Airport understands that academic experts and industry analysts continue to debate the appropriateness of using an MRP estimate based on long term averages, together with spot interest rates (now at historic lows). Auckland Airport, like any business, does not have a limitless opportunity to access capital. In practice, when looking at our option set of investment decisions, aeronautical investment is unlikely to be prioritised based on the WACC IM benchmark.
90. In light of this debate, Auckland Airport considers that:
- (a) Airports should not be criticised for adopting a commercially realistic WACC at the time prices were set, given the extreme volatility of the Commission's WACC estimate; and
 - (b) As part of the section 56G Review, the Commission should consider whether the figure produced by the WACC IM is commercially realistic in the current circumstances. Auckland Airport invites the Commission to consider using a range of reasonableness checks for this purpose, including its own estimate in July 2010, the effective airport return and the various external sources that it used to assess the reasonableness of its WACC estimate when developing the WACC IM.

SECTION 5: THE COMMISSION'S APPROACH TO ASSESSING PROFITABILITY

91. Key points we make in this section are:
- (a) The Commission's Draft Report should demonstrate that efficiency, quality and innovation have impacted on its profitability analysis;
 - (b) The IRR calculation has clear limitations;
 - (c) The Commission's approach may dis-incentivise risk sharing arrangements;
 - (d) The Commission's framework should consider WACC arguments and assess the impact of those arguments on its assessment of excess returns;
 - (e) It is unclear how the Commission will assess superior performance; and
 - (f) The Commission's approach creates uncertainty going forward (50th versus the 75th percentile).

The Commission's Draft Report should demonstrate that efficiency, quality and innovation have impacted on its profitability analysis

92. The Draft Report asserts that the Commission will assess all analytical areas prior to assessing the effectiveness of ID in promoting each particular outcome under the Part 4 purpose statement. Commenting specifically on profitability at paragraph 3.9 of the Draft Report, the Commission provides that:

We are unable to assess the effectiveness of information disclosure in promoting particular outcomes observed in workably competitive markets without first assessing outcomes in other areas. For example, we were not able to reach a draft conclusion on profitability without considering each of the other analytical areas.

93. However, the Draft Report is absent any discussion or indication that *demonstrates* that efficiency, quality or innovation have impacted on the Commission's profitability analysis. Auckland Airport asks the Commission to supplement its Final Report to the Ministers with the assessment it has undertaken in this regard (as well as making this transparent for the benefit of airports and interested parties).

94. Auckland Airport is also concerned that the Draft Report does not include:

- (a) Explicit consideration of variations to the WACC IM for pricing, either by way of:
 - (i) Sensitivity analysis for departures from its WACC IM in its modelling;
 - (ii) Comparison to the WACC IM and an adjusted "pricing WACC" yardstick; or
 - (iii) Analysis in the body of the Draft Report regarding expert review of WACC parameter arguments advanced by WIAL.

95. In fact, the Draft Report gives an overall impression of an elevated and unjustified level of precision and objectivity to the WACC IM.

96. While we accept that it is appropriate for the Commission to apply its WACC IM in monitoring and analysis of airport performance, we are concerned that the Draft Report fails to demonstrate:

- (a) Substantive evaluation and consideration of the differences in opinion or alternative outcomes put forward by airports that may be consistent with Part 4 outcomes;
- (b) A clear indication of what constitutes superior performance;
- (c) A clear indication of what would, in the Commission's view, justify a departure from its WACC IM; and
- (d) How the Commission is accounting for asymmetric risks in its cash flow analysis, if no allowance has been made for this in the WACC yardstick.

97. In our view, the conclusions on profitability currently leave significant doubt as to whether the Commission is prepared to accept that performance outside its WACC benchmark could be acceptable. In this regard, Auckland Airport is concerned that the Commission has misjudged Parliament's intent for the ID Regime, and that the approach taken in the Draft Report contradicts the Commission's prior comments on the purpose of WACC for airports. Accordingly, we invite the Commission to provide:

- (a) Greater explanation of its approach and thinking, which will provide airports with a greater understanding of how airports will be monitored and assessed going forward;
- (b) The Commission's thinking as to how the intended light-handed regime is distinguished from the model used in the Draft Report, which is borne out of a more heavy-handed regulatory regime; and
- (c) Explanation of whether the Commission has adequately considered why its benchmark WACC estimate is so volatile and whether it represents the only plausible estimate in the current economic environment.

The IRR calculation has clear limitations

98. The Commission has used its IM compliant opening Regulatory Asset Base ("**RAB**") asset valuation as the key reference point in its assessment of returns.⁵⁶ While the Commission uses various analytical tools for assessing economic returns, it indicates a preference in the WIAL Draft Report:⁵⁷

We consider that the best estimate of the economic return being earned over time by Wellington Airport after the introduction of Part 4 information disclosure is provided by the Internal Rate of Return (IRR) for the period 2011 to 2017. (As explained in paragraph H89, we have used an opening asset value based on an IM compliant asset value and a closing asset value based on Wellington Airport's pricing closing asset base value).

99. Auckland Airport considers that the IRR calculation is unstable and has the following key limitations:

- (a) The Commission's preference for the 7 year IRR rate conflates the assessment of PSE1 and PSE2 outcomes. That is, the Commission is using the same approach to assess two PSEs when one was *ex ante* and the other *ex post*. In our view, a better approach would be to acknowledge that:
 - (i) *Ex post assessment*: in assessing the first PSE pre ID regulation, this is an assessment which should take in to account risk sharing

⁵⁶ WIAL Draft Report, paragraphs H49, H77-78, I37.

⁵⁷ WIAL Draft Report, paragraph H11.5.

parameters and acknowledge that airports set reasonable forecasts, with the prospect of retaining efficiency gains for the period.

- (ii) *Ex ante assessment*: in assessing the second PSE, the Commission should focus on whether forecasts are unbiased and efficient at the time of the price setting decision, but acknowledges that they are forecasts only.
 - (iii) The benchmark WACC should be either the *ex ante* WACC at the time of price setting for PSE1 (as it is for PSE2), or appropriately acknowledge that the benchmark WACC for PSE1 has been strongly influenced by factors outside of airport control, since PSE1 prices were set. This has significant implications for the assessment of the "margin" between the airport's IRR and the benchmark WACC.
- (b) The IRR calculation for the forecast period is heavily dependent on the Commission's assumption about WIAL's future pricing behaviour (for PSE3 and beyond) in two respects:
- (i) The closing asset base in the 7-year IRR calculation is effectively an assumption about the net present value of cash flows in PSE3 and beyond.
 - (ii) How revaluations or devaluations will be accounted for. The Draft Report provides that:

We do not know what asset value Wellington Airport will use as the basis for setting prices in PSE3, or **whether there will be any wash ups associated with any revaluations**. However, we believe it is reasonable to assume that, at the very least, Wellington Airport expects to price off its current forecast of the closing asset value for PSE2. [Emphasis added]

- (c) It is inappropriate that an assumption about future behaviour (PSE3 and beyond) influences an assessment of current behaviour (that is, behaviour during PSE2). The Commission is assuming that WIAL "misbehaves" in the future, which biases the Commission towards a finding that WIAL is "misbehaving" now.
100. Auckland Airport considers there should be a de-linking of *ex post* and *ex ante* profitability assessments. The Commission's 5 year IRR approach is a more principled assessment of *ex ante* profitability intentions. However, it still has limitations in terms of measuring *actual* profitability, which should be appropriately acknowledged.
101. The Commission's analysis should also clearly distinguish the WACC reference point for PSE1 and PSE2 analysis. Auckland Airport has provided analysis (**Attachment 2**) of the *ex ante* IM compliant WACC reference point for PSE1 (ie the estimate produced by the WACC IM as at July 2007). In Auckland Airport's view, the Commission should either supplement its analysis of PSE1 with the *ex ante* IM compliant WACC range of 9.11 percent to 10.09 percent, or take the approach that the substantial change in WACC estimates since FY2008 is due to factors outside of the airport's control. In our view, an *ex ante* versus *ex post* assessment would be unlikely to lead the Commission to conclude that excess profits have been extracted. In our experience, this is particularly so given that investor requirements have not changed as much as that implied by the 2012 WACC estimate.

Table B: Summary of feedback on IRR analysis

	IRR Analysis	Draft Report WACC Reference point	Comment
PSE1 and PSE2	7 year analysis		The Commission should not use this approach and should instead separately analyse PSE 1 and PSE2 as below, as the 7 year analysis is based on a flawed combination of ex ante and ex post analysis and reference points.
PSE2	5 year analysis – ex-ante	7.06% - 8.04% 50 th – 75 th percentile	Setting aside the issue that the timing of this estimate post-dates the pricing decision and concerns around the commercial acceptability of spot rates, it is appropriate for the Commission to assess the forecast returns against an assessment of what is a reasonable return at the time of price setting. Taking this a step further we would expect that the Commission will review actual performance for PSE2 against the ex ante benchmarks and range it considers relevant now. Otherwise it ought to acknowledge ex post increases or deviances in the required return as being outside of airport control.
PSE1	2 year analysis – ex-post	8.19% for 2011 7.75% for 2012	It would be appropriate for the Commission to assess the actual returns against the estimate of what was reasonable return at the time of price setting in 2007, or acknowledge that the change in reference returns has been outside of airport control. Attachment 2: Uniservices analysis which estimates the Commerce Commission compliant benchmark as at June 2007 was for a WACC range of 9.11% -10.09%

102. Irrespective of what approach the Commission adopts, the Commission should make the limitations of modelling explicit to Ministers. First, any assessment of PSE1 ought to acknowledge that:
- (a) The pricing for this period pre-dated changes to Part 4 and the ID Regime; and
 - (b) The limitations of drawing any conclusion on the basis of two years of historical analysis.
103. In its current approach in the Draft Report, the Commission is assuming that WIAL expects to price off its current forecast of the closing asset value for PSE2 when it prices for PSE3.⁵⁸
- If Wellington Airport's approach to setting charges persists in future price-setting periods, profitability assessments such as the one carried out in this s 56G review will continue to show excessive profits expected to be earned by Wellington Airport over the longer run.
104. If the Commission continues to adopt an IRR methodology in its approach to modelling, it should be explicit that the closing value assumption in the IRR calculation is a key sensitivity. The Final Report to Ministers should be explicit that the modelling involves assumptions, and that:
- (a) The analysis is based on two years of historic data and five years of forecast data;

⁵⁸ WIAL Draft Report, paragraph H19.

- (b) The Commission's assumption about WIAL's approach in PSE3 is being made prior to receiving and considering the Commission's guidance and conclusions in the section 56G Review (or indeed the Commission's annual summary and analysis reports and outcome of the merits appeal);
- (c) Modelled financial outcomes are only one part of an assessment of effectiveness; and
- (d) If WIAL meets all forecasts through PSE3 and continues to price off the same asset valuations, then there would likely be evidence that it has extracted excessive profits.

105. Our proposed approach above will ensure that the critical and uncertain assumptions and limitations made in modelling (particularly those relating to predicting future behaviour and WACC) are explicitly acknowledged.

The Commission's approach may dis-incentivise risk sharing arrangements

106. In the Draft Report, the Commission discusses various commercial risk-sharing arrangements that existed or exist at Wellington Airport.⁵⁹ From that discussion, it appears that:

- (a) If there was no risk sharing arrangement between the airport and airlines, the Commission does not adjust profitability.
- (b) If there was a risk arrangement between airlines and the airport, the Commission adjusts profitability to fully account for this.

107. Auckland Airport is concerned in two key respects:

- (a) The Commission's approach is likely to dis-incentivise airports to enter in to future risk-sharing arrangements if those risk-sharing arrangements will be treated unfavourably when assessing returns. This risk should be balanced against any potential for extracting excessive profits. Based on the Draft Report, it is not apparent that this balancing exercise has been undertaken.
- (b) The Commission appears to have taken a unique approach to risk-sharing arrangements regarding revaluations - that is, despite the presence of risk-sharing arrangements between WIAL and the airlines, the Commission has not adjusted its profitability calculation for WIAL to take this in to account. Auckland Airport is concerned that the Draft Report does not provide a fulsome explanation for why this approach has been taken.

108. Auckland Airport also notes that, during the conference on asset valuation, Commissioner Begg indicated that the treatment of revaluations *ex post* would be influenced by mutual understanding of what was set out on an *ex ante* basis:⁶⁰

... in principle our thoughts are that if the airports had set the prices *ex ante* on a reasonable basis and they were reasonable forecasts at the time, and there was an understanding that they bear the risks of the upside and the downside, then it would be reasonable for the *ex post* returns to be retained by the airports.

109. And further:⁶¹

⁵⁹ WIAL Draft Report, paragraphs I89 - I104.

⁶⁰ Input Methodologies Conference (Airport Services), 15 September 2009 at page 93, lines 26-30 (Commissioner Begg).

⁶¹ Input Methodologies Conference (Airport Services), 15 September 2009 at page 97-98 (Commissioner Begg).

One of the examples....where we seem to have the most information is Wellington in terms of what people's expectations were at the time of the previous price negotiation in 2002...

Forecasting is intrinsically difficult, but when you've got two parties who have different interests, for them to be so close I think, for example, in land, Wellington was forecasting 3 percent per annum and the BARNZ airlines were forecasting 3.5 percent per annum. That seems quite close to me and on other things they actually were the same and so on....so I mean to me there's a situation more or less you could say ex-ante there was a reasonable arrangement where the forecasts were pretty much agreed, and Wellington clearly was bearing those risks.

So ex-post it would seem not unreasonable to me that they would capture, you know, they'd bear those risks which in this case turned out to be a great big unexpected revaluation gain. And I get the impression that the forecasts were about property prices rising by about 20 percent over the five years but in fact it rose by, I don't know, 50, 100 percent So the problem is that what seemed reasonable at the time has turned out to be quite a - what looks like an unfair outcome, I guess, but the parties, they were bearing the risk and went ahead with that.

110. In the Draft Report, the Commission does not appear to have followed the approach indicated by Commissioner Begg. This change in approach has occurred without:

- (a) Signalling a change in its approach *prior* to the Draft Report; or
- (b) Providing an explanation in the Draft Report for why it has done so.

The Commission's framework should consider WACC arguments and assess the impact of those arguments on its assessment of excess returns

111. WIAL's deviations from the WACC IM were rejected by the Commission, on the basis that:

- (a) WIAL's WACC parameters for pricing differ (are higher) than those WIAL is arguing for before the High Court in the merits review proceedings; and
- (b) WIAL's targeted WACC for PSE2 is roughly the same as that for PSE1, despite the fact that its WACC should have fallen over the period due to reductions in the risk free rate.

112. Auckland Airport notes that:

- (a) It considers that WACC ought to be *relatively* stable over time;
- (b) Auckland Airport's targeted WACC has nevertheless fallen between PSE1 and PSE2;
- (c) It is concerned that the current framework set out in relation to WIAL does not sufficiently consider key aspects of WACC which Auckland Airport believes need to be tested to account for the fact that each airport has a different risk profile (including asymmetric risks)⁶², treasury policy and approach to modelling cashflows, which will be reflected in the pricing forecasts.
- (d) Auckland Airport's WACC parameters are largely consistent with those it is arguing for under the merits review. Indeed, for two parameters (term of the

⁶² See, for example: IM Reasons Paper, at paragraph E12.2, where the Commission acknowledged that suppliers of a regulated service are exposed to different levels of asymmetric risks and at possibly different time periods.

risk-free rate and leverage), Auckland Airport considered that its firm-specific factors justified taking a more conservative approach for its price-setting purposes than it argued for in the merits review.⁶³ For completeness, we note that Auckland Airport did adopt a WACC range of the 75th to 85th percentile in pricing, which is higher than that advocated during the merits review. However, this uplift includes an allowance for Type I and II asymmetric risk, which were argued as a separate 1 to 2 percent uplift to WACC in the merits appeal.

- (e) In any event, Auckland Airport notes that its effective return of 8.475 percent means that it priced below the 80th percentile of its WACC estimate. Auckland Airport emphasises that its final pricing decision is based on a combination of its building block inputs, commercial factors, and feedback from customers through the consultation process. It is this combined outcome (ie Auckland Airport's actual target return) that should be the focus of the Commission's analysis, rather than an unbalanced focus on Auckland Airport's WACC estimate. This point has recently been noted by the Australian Productivity Commission.⁶⁴

The [building block] model is a starting point, and may be used to 'test' the reasonableness of offers made during commercial negotiations. As such, the final price set may not emerge as the result of the scientific application of formula, but rather a balance of issues (including the bargaining power brought to bear) during tough commercial negotiation. In effect, the price contains more 'information' about the use of market power. Given this, it is appropriate to observe the final prices that emerge from negotiations (rather than ambit claims that may be made relating to model parameters at various stages) when monitoring for market power purposes.

113. The above points are demonstrated in the following table:

Table C: Differences in Auckland Airport's targeted WACC parameters between PSE1 and PSE, also showing arguments made during the merits appeal

	PSE1 to 30 June 2008	PSE1 30 June 2008 – 30 June 2012	PSE2	Comment between PSE1 and PSE2	Merits Appeal	Comment between PSE2 and Merits Appeal
Risk-free rate	7.26%	7.26%	3.48%	Changed from a 5 year period to a 7 year period – consistent with average term at issuance	Expert considered 10 years to be materially better	Approach in pricing more conservative than Merits Appeal
Post-tax market risk premium	7-8%	7-8%	7.50%	NC.	7.50%	Approach consistent with Merits Appeal
Company tax rate	33%	30%	28%	NC.	-	Not at issue in appeal
Debt premium to	1.29%-1.39%	1.29%-1.39%	1.72%	NC.	2.00%	Approach in pricing more

⁶³ For the avoidance of doubt, Auckland Airport maintains that the parameter estimates it advocated for in the merits review are appropriate for an industry-wide WACC estimate for information disclosure purposes.

⁶⁴ Australian Productivity Commission "Economic Regulation of Airport Services" (Inquiry Report no. 57, Canberra), 14 December 2011, page 129-130.

	PSE1 to 30 June 2008	PSE1 30 June 2008 – 30 June 2012	PSE2	Comment between PSE1 and PSE2	Merits Appeal	Comment between PSE2 and Merits Appeal
risk free rate						conservative than Merits Appeal
Debt to debt plus equity ratio	35-45%	35-45%	30%	Reduced consistent with revised view of leverage	40%	Approach in pricing more conservative than Merits Appeal
Asset beta	0.5-0.7	0.5-0.7	0.65	Revised based on updated empirical information, which was not inconsistent with Commission's asset beta analysis for Auckland	0.65	Approach consistent with Merits Appeal
Nominal after tax WACC range	8.67-10.88%	8.76-11.00%	8.88% - 9.45%	In both circumstances consider WACC could not be precisely estimated. In PSE1 advisor considered low, medium and high parameter estimates, in PSE2 adopted the Commission's methodology for the distribution range, but adopted the 75 th – 85 th percentile inclusive of model error.	9.30% (mid-point estimate with no allowance for model error) 10.3-11.3% (with 1-2% uplift for model error adjustment)	Approach in pricing more conservative than Merits Appeal

114. Despite the fact that an assessment of Auckland Airport may therefore be more favourable, Auckland Airport is concerned that the framework does not provide adequate direction on the Commission's thinking. In particular, the Draft Report is absent:

- (a) An acknowledgement that the Commission has ultimately made a judgment call in setting WACC for the industry for ID monitoring purposes, and that its estimate was necessarily imprecise and to be updated annually for ID (a process not practical for pricing purposes); and
- (b) An assessment of whether a departure from the Commission's WACC IM can be demonstrably justified in light of specific matters relevant to each airport.

It is unclear how the Commission will assess superior performance

115. In the Draft Report, the Commission indicates that there is no evidence of "superior performance" for WIAL that might justify returns over the Commission's WACC IM.⁶⁵

Our analysis of historical and expected profitability suggests that Wellington Airport has extracted excessive profits in PSE1 and, on the basis of the prices set by Wellington Airport for PSE2, that excessive profits are expected to be extracted for the future.

There is no evidence of superior performance or other external conditions that would justify the existence of excessive profits.

116. However, the Commission has only referred to concepts of allocative and dynamic efficiency in its characterisation of "superior performance".
117. Auckland Airport believes that superior performance ought to be considered in relation to each of the components of the purpose statement - that is, innovation, investment, cost reductions, quality improvements, volume increases and other key factors.
118. One way to think about this is that customers of an airport pay the WACC for a "normal" level of performance, but might pay more (ie above WACC) in exchange for a "superior" level of performance (which might benefit customers now, or in the future).
119. It is important that the framework of analysis in the Draft Report approaches superior performance in a manner which preserves incentives to achieve outcomes consistent with all of the limbs of the purpose statement, and therefore a target of normal to superior performance.

The Commission's approach creates uncertainty going forward (in relation to the inconsistent use of 50th versus the 75th WACC estimates

120. The Commission's analysis includes a WACC estimate at the 75th percentile for its analysis of profitability looking forward, on the basis that this is important in considering the trade-off between outcomes that promote dynamic efficiency and static allocative efficiency. However, the Commission does not consider this to be important for an *ex post* analysis of returns, and has used only the mid-point estimate as a benchmark of normal returns looking backward.⁶⁶
121. This approach creates considerable uncertainty for Auckland Airport going forward. In particular, this approach creates a very real risk that prices and expected returns for investments at the start of a pricing period may be seen as reasonable going forward (when assessed against the 75th percentile), but will be incorrectly perceived as excessive at the end of that pricing period (when compared to the 50th percentile estimate). This will undermine investment certainty.
122. For this reason, it is important for the Commission to take a consistent approach, and to incorporate the 75th percentile estimate of WACC in to its assessment of both historic and projected outcomes. This is consistent with advice previously provided to the Commission, which is clear that:⁶⁷

In the context of assessing excess profits, it would be appropriate to choose a WACC value from above the 50th percentile (this margin is denoted type 1), because the consequences of judging excess profits to exist when they do not are more severe than the contrary error.

⁶⁵ WIAL Draft Report, paragraphs 3.26.2 - 3.26.3.

⁶⁶ WIAL Draft Report, Table H4, Note 1.

⁶⁷ Lally *The Weighted Average Cost of Capital for Gas Pipeline Businesses*, 28 October 2008 at page 94-95.

...Accordingly the type 1 WACC margin should implicitly incorporate a significant allowance for the risk of deterring investment.

123. We are also concerned that the Commission has selected a WACC for its assessment that post-dates pricing consultation and updates the annual cost of capital estimate in ID, which is inconsistent with pricing principles.

SECTION 6: THE COMMISSION'S FRAMEWORK SHOULD INVOLVE A HELICOPTER VIEW IN ORDER TO AVOID RISK OF REGULATORY ERROR

124. Critically, the Draft Report fails to illustrate an understanding or acknowledgement of the appropriate context against which airport performance should be addressed. Auckland Airport would like to see the Final Report take in to account:
- (a) That there is a potential for unintended consequences flowing from the Review of the effectiveness of ID, as a result of the assessment methodology adopted by the Commission. For example, dis-incentivisation of risk sharing arrangements or efficient behaviour, as discussed above.
 - (b) That de-prioritisation of investment may have serious consequences for the industry, consumers and economy as a whole. Despite the fact that the Commission concludes that it is too early to tell whether ID regulation under Part 4 is effectively promoting efficient investment, it does feel able to conclude that the profits being extracted by WIAL are excessive. This fails to appreciate the link between profits, innovation and incentives to invest. In the context of Auckland Airport we note the following:
 - (i) Auckland Airport, like any business, does not have a limitless opportunity to access capital. In practice, when looking at our option set of investment decisions, aeronautical investment is unlikely to be prioritised based on the most recent WACC benchmark. We also note that the rate of return for investors was a factor we considered at the time of pricing, and in that context, we determined that 8.475 percent was sufficient in the circumstances.
 - (ii) As outlined in earlier submissions, there are a number of significant investment decisions on the horizon for Auckland Airport, such as the New Terminal Facility.
 - (c) The implications of the Australian regulatory approach where, for example, a 10-year term for the risk-rate has been fairly consistently applied by regulators in a number of industries, in accordance with the proposition that a 10-year term is appropriate where the life of the assets and the length of the investment in those assets is long.⁶⁸ The AER considers that this approach most closely reflects the financing strategy of the networks in question.⁶⁹
 - (d) Auckland Airport is concerned that the effect of the Commission's approach, combined with the current yield structure of interest rates, may fail to incentivise investment in the short term, contrary to limb (a) of the Part 4 purpose statement. This risk is exacerbated for large scale infrastructure investments in long-life assets, as required for airports. Auckland Airport is concerned that it will fail to attract investors willing to invest in significant infrastructure based on the WACC IM benchmark.
 - (e) Auckland Airport is also concerned that the Commission's approach may risk our ability to access capital markets, and may compromise rather than promote our competitiveness against Australian airports which do not have a WACC IM equivalent and seek higher returns than those published by the Commission.

⁶⁸ See, for example: *Re Gasnet Australia (Operations) Pty Limited* [2003] ACompT 6; *Application by Telstra Corporation Limited ABN 33 051 775 556* [2010] ACompT 1 at [403]-[404].

⁶⁹ *Application By Actewagl Distribution* [2010] ACompT 4 at [7].

SECTION 7: CONCLUSION

125. Auckland Airport acknowledges that the Commission's Draft Report represents the Commission's first opportunity to set out a comprehensive framework for the evaluation of the effectiveness of the ID Regime applying to airports.
126. As outlined in this submission, Auckland Airport believes that the Final Report on WIAL to the Ministers would be strengthened by making explicit that its conclusions rely on a number of assumptions (including those embedded in the model):
- (a) In relation to PSE3 and beyond, we are particularly concerned that the Commission's approach in the Draft Report:
 - (i) Assumes misbehaviour in future PSEs (which also influences its conclusions about the approach to pricing in PSE2);
 - (ii) Contains assumptions that do not appropriately acknowledge the role that airlines play in contributing to effective AAA outcomes; and
 - (iii) Fails to acknowledge that there are a number of factors that may influence airports' future pricing decisions, including the outcome of this Review and the Commission's guidance through section 53B(2) summary and analysis reports over the next four years.
 - (b) In the Final Report the Commission should correct the assumption that airports ought to have known that the effectiveness of the ID Regime would be assessed against a strict IM benchmark (on the basis that this is the approach that has been taken in relation to WIAL). Although the IMs have played a critical role in Auckland Airport's approach to pricing, the Commission has mischaracterised our understanding by concluding that all airports ought to have known that the effectiveness of ID would be assessed primarily against the IMs. In this regard, we note airline submissions make it clear that airlines did not expect a strict application of the IMs for the Review either (although they advocate for WIAL).⁷⁰
127. In terms of the Commission's framework against which it assesses effectiveness, Auckland Airport expects the Commission's Final Report to address the following critical factors:
- (a) That the limbs of the Part 4 purpose statement operate interdependently, and the evaluation of whether an airport's behaviour is promoting outcomes consistent with those limbs is a long-term rather than short-term assessment. Accordingly, the Commission's assessment of the effectiveness of ID Regulation should:
 - (i) Explicitly involve an evaluation of the interdependence of the limbs of the purpose statement; and
 - (ii) Assess all of those outcomes on a long term basis, including profitability.
 - (b) A parameter by parameter evaluation of the WACC parameters put forward by WIAL and a reasonable test of its own WACC estimate. Auckland Airport

⁷⁰ BARNZ, Cross-Submission on Wellington Airport Process and Issues Paper Submission, 20 July 2012, page 3; Air New Zealand, Submission on Section 56G Review of Wellington Airport, 29 June 2012, page 10, paragraph 28; Air New Zealand Cross-submission to the Commerce Commission on Section 56G Review of Wellington Airport, 20 July, paragraph 3.4.10.

considers these to be material omissions from the Commission's framework in the Draft Report.

- (c) Analysis and understanding of the airport sector in general and the specific context for WIAL, which would allow the Commission to better assess the impact of its recommendations to Ministers.

128. In conclusion, Auckland Airport would like to see a Final Report to the Ministers that:

- (a) Recognises that it is too early to draw definitive conclusions about the effectiveness of ID (and in our view, that there is no evidence that ID is ineffective at limiting excess profits over time); or
- (b) Couches its conclusion on the effectiveness of the ID Regime (in respect of all of the limbs of the purpose statement) in a less definitive manner.