COMPETITION ECONOMISTS GROUP

Errata to August 2014 report

FOR THE NZ AIRPORTS ASSOCIATION

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1 Errata

1. In our August 2014 report entitled *Economic Review of the Draft Decision on the WACC Percentile* we presented analysis in section 4.1.4 that had, as an input, the historical share price for Vector. It has come to our attention that we inadvertently accessed a share price history from Bloomberg that adjusted the historical share price for dividends paid rather than the actual share price history.

2. It is possible to conceive of a justification for using the adjusted series[1], however, it was not our intention to use this series and, on balance, we do not consider it is the best series to be used for the purpose of the analysis that we performed. In what follows we have corrected (in "mark-up") our previous analysis (retaining the original paragraph numbering).

3. We consider that the fundamental points that we made in that section remain valid after this correction. However, what we believed were data errors in the Commission's analysis are actually explained by our own error in using the Bloomberg adjusted historical price series.

4.1.4 Snapshots versus sustained trends

107. The Commission has reported snapshot estimates of RAB multiples rather than any estimate of a sustained RAB multiple in excess of 1.0. This can be problematic if the market value of equity in that snapshot period is unusually high. This might demonstrate a RAB multiple temporarily materially in excess of 1.0 when the average RAB multiple through time is much lower and, may even be materially below 1.0. For this reason it is important that the equity value of a business used in a RAB multiple analysis represents the average value of equity through time.

108. In our view, the snapshots of equity values for Vector which the Commission uses in its RAB multiple analyses are not representative of the value of Vector's equity through time. ~~In this regard we note that, contrary to the statement at paragraph A18.2.1 of the draft decision, the Commission has not used Vector's average share price for the 20 trading days to June 2013 in its analysis. The average share price over this period was $2.63 whereas the Commission has used a share price of $2.78.~~

109. The use of a figure of $2.78 is ~~somewhat puzzling because there is no 20 day period since Vector shares became publicly traded when the average share price has been this high (the highest 20 day average of Vector's share price is $2.71 for the period ending 25 May 2013). We note that the~~ only 8.5c below the highest ever 20 day

[1] The adjusted series essentially removes the value of dividends through time from the traded share price. This will be appropriate to the extent that one wishes to assess the return on a stock inclusive of dividends between two points in time.

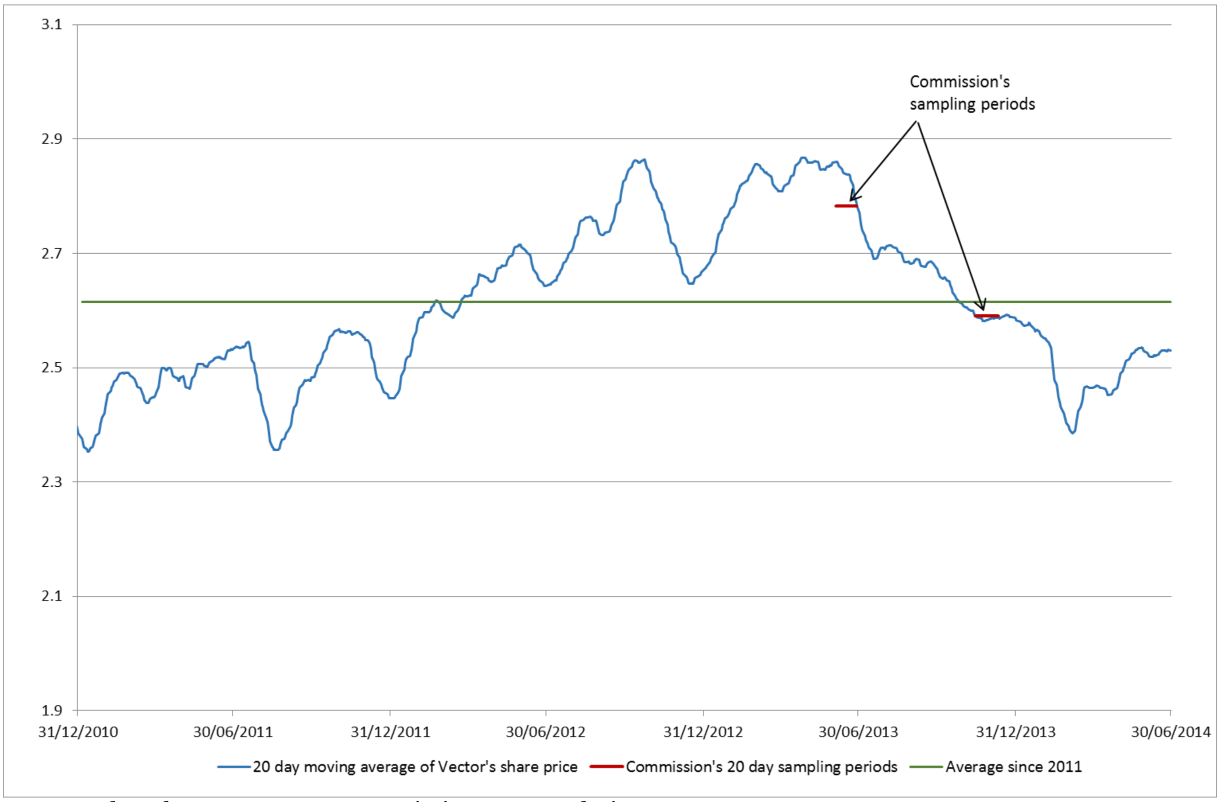
average of daily closing values for Vector's share price ~~is, perhaps by coincidence,~~ of $~~2.78~~2.87 which occurred on ~~17 May~~ 29 April 2013.

110. ~~The use of $2.78 is clearly not based on what the Commission states it has done. It is possible that at some stage the Commission searched for the highest ever share price recorded by Vector and used this in a preliminary RAB multiple analysis - but failed to change this value in its analysis when it adopted a different period. Whether this is the basis of the Commission's use of $2.78 in its analysis we cannot know. However, It is the case that t~~The Commission's highest RAB multiple estimate for Vector of 1.16x is calculated based on a share price that is marginally below ~~equal to~~ the highest 20 day average price ever achieved by Vector shares.

~~111. Moreover, even the share prices recorded during the two periods that the Commission says it used (as opposed to the periods it actually used) are unusually high relative to both historical averages and the time since those two periods.~~

112. We have illustrated this by plotting the 20 day moving average of Vector's share price since 2011. In the same figure we have plotted the two 20 day sampling period 'snapshots' that the Commission has ~~said that it~~ used to perform its RAB multiple analysis for Vector ~~(as well as the $2.78 figure actually used)~~. It can be seen that, at least the first of these snapshots which is associated with the estimated 1.16x RAB multiple, ~~are~~ was taken during ~~in~~ a period~~s~~ when Vector's share price was unusually high relative to the average over the period (and relative to the time since).

Figure 1: Timing of Commission RAB multiple estimates and 20 day moving average of Vector share price (correct data used)



Source: Bloomberg, Commerce Commission, CEG analysis

113. Had the Commission used the average share price over the period January 2011 to June 2014 ($~~2.38~~$2.62) in its analysis then the RAB multiples estimated for Vector would have been 1.~~04~~11x and 1.~~03~~09x – hardly different from 1.0. It may be argued that this estimate includes too much data from the early period of the above chart and that the RAB in that period was also likely to be lower. However, the same point can be illustrated using only data from the first half of 2014. The average share price in this period was $2.~~46~~49 which, when used in the Commission's analysis, results in RAB multiples of 1.07x and 1.0~~5~~6x. Of course, these estimates are likely overstated because they do not account for Vector's investment in its RAB since then (i.e., since June and December 2013 respectively).

114. The fundamental conclusion from this analysis is that, even in the Commission's own analysis, Vector's RAB multiple was not materially higher than 1.0x. Correcting this by using more representative estimates of the market value of Vector's equity results in RAB multiples that are even lower.

115. When it comes to the RAB multiple 'snapshot' used to estimate Powerco's RAB estimate it must be recognised that the company is not publicly traded. Consequently, the Commission is in some sense forced to rely on a snapshot value of equity based on the period of any announced trade of Powerco's shares. In this

case, the Commission has relied on the purchase by AMP of Powerco shares announced on 4 July 2013.

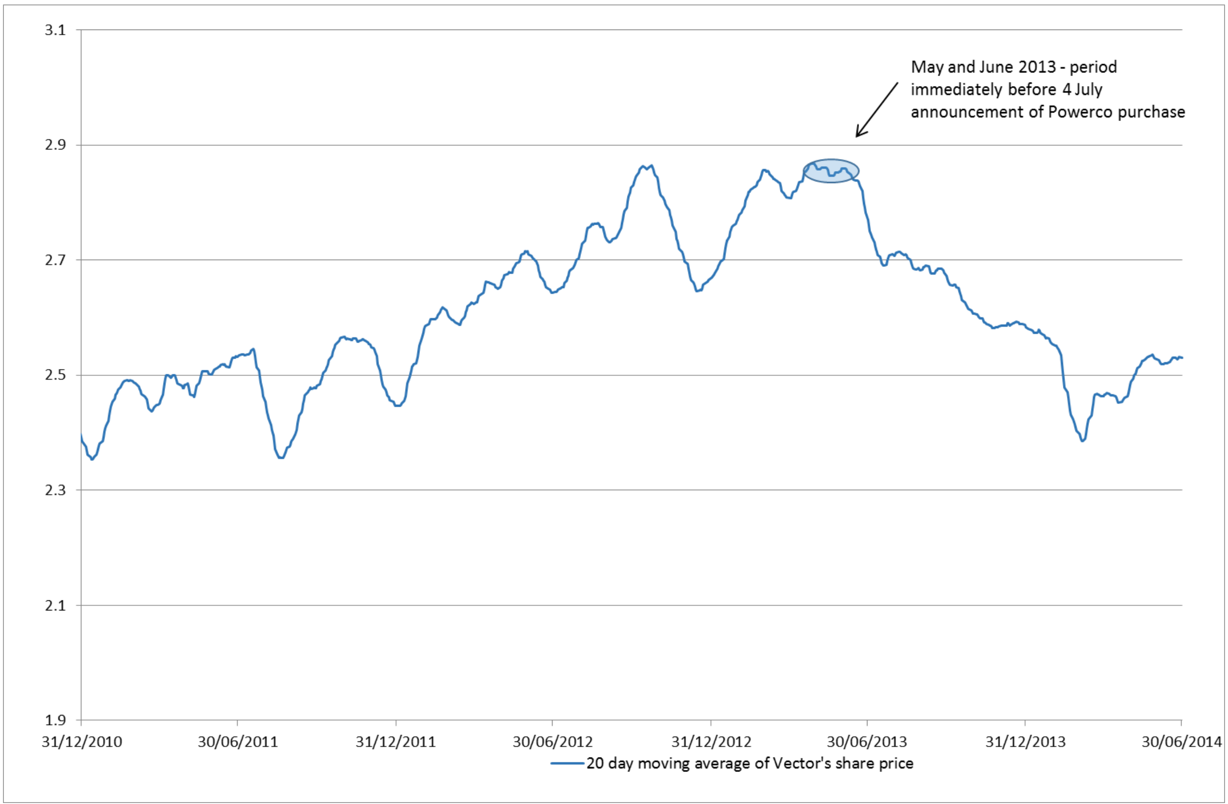
116. It is not possible to directly test how this estimate of the RAB multiple would be different if performed at different periods, because there are limited or no other publicly announced trades of equity in Powerco that can be used for this purpose. However, it is possible to indirectly test whether this snapshot is likely to be representative by examining the level of market transactions in similar assets.

117. For this purpose we have reproduced the same Vector share price data used in Figure 1 but have highlighted the two months before the 4 June 2013 announcement of the AMP purchase – on the basis that equity market valuations in those two months are likely to have played an important role in negotiating the announced sale price.

118. It can be seen that those two months have the highest average prices for Vector's share prices since 2011 (it is also the case, but cannot be seen, that this is higher than any period pre 2011). Obviously, this is for Vector and not Powerco. However, it is reasonable to believe that, given the similarity in their underlying regulated activities,[2] a period when Vector's share price was at its height would also be a period when investors valued Powerco at an unusually high level.

[2] Moreover, if this cannot be assumed because Powerco is in some sense fundamentally different to Vector then this would imply that the Powerco RAB multiple was of no wider significance for other regulated businesses – the very purpose for which the Commission is seeking to apply it.

Figure 2: AMP purchase of Powerco vs Vector share price (correct data used)



Source: Bloomberg, CEG analysis.

119. For those reasons, in our view, the Powerco RAB multiple snapshot should be treated with a great deal of caution. It is only a single snapshot, which should be treated with caution even if we have no reason to believe it is from a period of unusually high equity valuations. Furthermore, it is from a period where we have reason to believe that equity valuations for regulated businesses in New Zealand were their highest level ever (or at least since Vector listed 2005).