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BY EMAIL

Dear Mr Woods,

RE: INVITATION TO HAVE YOUR SAY ON WHETHER THE COMMERCE COMMISSION SHOULD REVIEW OR AMEND THE COST OF CAPITAL INPUT METHODOLOGIES

1. Auckland Airport has reviewed the Commission's discussion paper published on 20 February 2014, which seeks views on whether the Commission should review or amend its cost of capital input methodologies for services regulated under Part 4 of the Commerce Act 1986.
2. Auckland Airport supports the submission of the New Zealand Airports Association on the discussion paper, which addresses the key issues and concerns on behalf of the three airports that are regulated under the Act. Auckland Airport's submission should be read in conjunction with that submission.
3. In this submission, Auckland Airport addresses the following points in support of its position that the Commission should only consider amendments to WACC as part of the scheduled IM review:
 - (a) There is no evidence of an existing problem that requires an immediate solution. We remain of the view, as supported by market evidence, that the 75th percentile is likely to under-estimate Auckland Airport's WACC for its aeronautical activities, and that this issue should be considered further at the next scheduled review of the WACC IM.
 - (b) The incentives for investment in the airport sector must be carefully considered. Mere assumptions about investment incentives should be avoided, and cannot be used to justify an immediate review of part of the WACC IM in isolation.
 - (c) Considering the question of asymmetric costs is difficult, and requires careful consideration of the inter-sectoral impacts of under-investment in the airport sector. Properly addressing this question in a robust manner is likely to be a lengthy process, best suited to the scheduled review of the WACC IM.
4. We note the Commission has asked interested parties what evidence there is in support of the 75th percentile or credible alternatives. It has also asked interested parties to

provide views on how significant it is that regulated outputs are inputs to other sectors of the economy.

5. To the extent to which these substantive issues are addressed in this submission, Auckland Airport's comments represent its preliminary views. As the Commission will appreciate, providing robust and reliable evidence on these substantive matters will be a lengthy process. It is therefore not possible to provide supporting evidence in the three-week timeframe provided for this initial submission.
6. If the Commission decides to proceed with a formal consultation process (which we do not consider to be the appropriate outcome), Auckland Airport strongly emphasises the importance of providing interested parties with full opportunity to put the necessary evidence before the Commission prior to it making its draft determination. In our view, it will not be possible for the Commission to reach a conclusion on a proposed amendment within its timeframe if parties are given the appropriate opportunity to put their views forward. This strongly suggests that the appropriate time to consider these complex issues is as part of the scheduled review of the WACC IM.

There is no current evidence of an existing problem requiring an immediate solution

Uncertainty has not been created by the Court's comments

7. Auckland Airport does not agree that uncertainty has been created by the Court's comments themselves. The Court decided the matter was not sufficiently material to direct a change at this time, based on the evidence that was currently available. The Court also drew this conclusion on a number of other parts of detail in its judgment. Rather, in our view, uncertainty has been created by the Commission signalling that it may be prepared to bring forward a WACC review to deal specifically with the issue of the 75th percentile in isolation.
8. As an example, Auckland Airport did not receive any questions on the detail of the Court's decision from investors following the release of the judgment in the merits review proceedings. Similarly, we are not aware of any analyst commentary following the release of the Court's decision that would suggest uncertainty had been created by the Court's comments. Rather, it appears that analyst commentary and investor questions have been triggered by the Commission's invitation for parties to provide views on whether it should review or amend the WACC IM. Investors have subsequently expressed concerns to Auckland Airport about the implications and uncertainty created by the possibility of the Commission accelerating a review on one part of the IMs in isolation in response to the judgment.

The Commission's approach to the 75th percentile needs to be considered alongside other WACC elements

9. Auckland Airport understands the Commission's approach to the 75th percentile estimate in its previous regulatory decisions is broader than indicated in its invitation paper. For example, the Commission has previously referred to its use of the 75th percentile in different contexts as taking into account asymmetric risks,¹ allowing for variations between airports (particularly in relation to asset beta²), and reflecting that not all risks can be passed on to the consumer but will have to be managed by the firms themselves.³

¹ Commerce Commission *Setting the customised price-quality path for Orion New Zealand Limited: Final reasons paper*, [2013] NZCC 21 (29 November 2013) at paragraphs C25-29.

² Commerce Commission *Christchurch Airport section 56G conference transcript*, 24 May 2013 at page 60 (per Commissioner Duignan).

³ See, for example, Commerce Commission *Input methodologies (airport services) reasons paper*, 22 December 2010 at paragraph E11.53. See also Commerce Commission *Input methodologies (electricity distribution and gas pipeline services) reasons paper*, 22 December 2010 at paragraph H11.54.

10. Auckland Airport does not consider that any evidence has been provided that suggests the current approach to the 75th percentile estimate (including the use of that estimate as part of the WACC range for information disclosure purposes) somehow "over-accounts" for these factors, such that an immediate review can be justified. In fact, Auckland Airport has considerable doubt about whether these factors are appropriately "compensated" for by the use of the 75th percentile WACC estimate. In any event, the Commission's approach to these factors suggests there would be very significant issues if the Commission were to consult on the percentile estimate in the absence of a full and careful review of **all** aspects of the WACC IM as part of its scheduled review of the IMs.
11. Aside from whether the 75th percentile appropriately accounts for these factors, it is also far from clear that a review of the 75th percentile issue focusing on the asymmetric social consequences of under and over-investment would result in a percentile estimate below the 75th percentile. As noted by the Commission's expert during consultation on the WACC IM, the 75th percentile estimate may be the lower bound of a loss function analysis, and there could be justification for "easily" choosing a point "well above" that percentile.⁴

Market evidence does not suggest the current WACC IMs are "too high"

12. Although the Commission of course has not made any decisions at this point, we are concerned that the paper appears to be driven by a concern that using the 75th percentile over-compensates suppliers. As Auckland Airport has previously submitted, there are considerable concerns about the lack of precision in the WACC IM, and dangers associated with relying on theoretical models as the absolute truth. We have previously noted that Auckland Airport considers the theoretical position on WACC is diverging from business reality, which will have a significant impact on whether Auckland Airport has the right incentives to invest and is able to attract the necessary capital to do so. It is therefore of concern that the paper presents the WACC IM as something capable of precise adjustment to get the "right" answer.
13. The Commission presents two isolated observations (2013 valuation of Transpower, and the 2013 Powerco transaction) that it considers might suggest the use of the 75th percentile WACC is higher than is needed to promote efficient investment.⁵ In Auckland Airport's view, selecting two WACC observations and attempting to draw assumptions about what may be motivating acquisition prices is a dangerous task. For example, there could be a range of reasons for the prices paid in these circumstances, including current or anticipated superior performance (such as market share changes within a regulatory period, or superior gains in cost efficiency), or growth in non-regulated parts of the business.
14. We are also concerned to ensure suppliers are not exposed to one-sided risks by the Commission's approach to reviewing WACC. For example, the Commission also cites evidence that, at the time it set the WACC IM, the market considered the resulting Commerce Commission estimate to be too low. Such evidence did not cause the Commission to consider amendments to increase the WACC estimate.
15. In any event, two observations in the electricity sector do not provide sufficient evidence to suggest there may be a "problem" that requires fixing.
16. For example, there have been a range of market estimates for Auckland Airport's WACC over the course of the development and application of the WACC IM. We set out below a comparison of the Commission's WACC estimate (at the 50th and 75th percentiles) against a range of estimates from sell-side analysts for Auckland Airport at three different times:

⁴ Commerce Commission *Cost of capital workshop transcript (day 2)*, 13 November 2009 at page 225 (Martin Lally).

⁵ Commerce Commission *Invitation to have your say on whether the Commerce Commission should review of amend the cost of capital input methodologies*, 20 February 2014 at paragraph 42.

- (a) when the IMs were first set;
- (b) during the Commission's section 56G review for Auckland Airport; and
- (c) in more recent analysts' papers.⁶

Figure 1: WACC estimates when the IMs were set

Party	WACC estimate	Date
PwC	8.90%	July 2010
Range of New Zealand Broker estimates	7.0% - 9.1% (avg 8.3%)	June - July 2010
Commerce Commission (50 th percentile)	8.06%	1 July 2010 (for 2011 disclosure year)
Commerce Commission (75 th percentile)	9.05%	

Figure 2: WACC estimates during the section 56G review⁷

Party	WACC estimate	Date
Deutsche Bank/Craigs	8.50%	21 Feb 2013
Forsyth Barr	8.10%	21 Feb 2013
Goldman Sachs	7.70%	12 Nov 2012
JP Morgan	8.80%	21 Feb 2013
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
Commerce Commission (50 th percentile)	6.49%	1 July 2012 (for 2013 disclosure year)
Commerce Commission (75 th percentile)	7.48%	

Figure 3: WACC estimates from most recent published analysts' reports

Party	WACC estimate	Date
Deutsche Bank/Craigs	7.92%	20 Feb 2014
Forsyth Barr	8.00%	20 Feb 2014
JP Morgan	8.80%	11 March 2014
Macquarie	7.80%	19 Feb 2014
UBS	7.30% ⁸	24 Feb 2014
Commerce Commission (50 th percentile)	6.77%	1 July 2013 (for 2014 disclosure year)
Commerce Commission (75 th percentile)	7.75%	

⁶ We note that the estimates from the sell-side analysts are to the 50th percentile estimate of WACC.

⁷ As per our submission during the s56G review non-published broker data has been redacted.

⁸ UBS publishes that they use 7.3% to 2024 and 8.4% thereafter.

17. The range of WACC estimates produced by analysts over this time highlights that:
- (a) There is no one "correct" answer for the best estimate of WACC. Views can (and do) reasonably differ on the best model, values for particular parameters, and overall estimate.
 - (b) Estimating WACC is inherently imprecise, and a search for precision carries inherent dangers.⁹ Faced with the knowledge that it is not possible for to determine the true (unknown and unknowable) WACC, it is important to adopt an overall approach to estimating WACC (including the percentile estimate) that:
 - (i) acknowledges there are a variety of legitimate approaches to setting WACC;
 - (ii) reflects the uncertainty inherent in doing so;
 - (iii) properly compensates regulated suppliers for the risks that they bear;
 - (iv) is likely to result in commercially realistic estimates (taking into account the available market evidence); and
 - (v) which appropriately balances the risks of over and under-estimating the WACC, including the flow-on effects for investment.
 - (c) In our view, the currently available market evidence does not suggest that there is any need for use of the 75th percentile to be reconsidered prior to the scheduled review of the input methodologies in 2017, even if it were possible to complete the required analysis in the timeframe contemplated by the Commission (which we do not consider to be realistic). This is particularly the case when there is nothing in the Court's comments in the judgment that would suggest any urgency is required (as fully discussed in the NZ Airports submission).
18. Overall, these observations are consistent with our view that the question of the best percentile estimate of WACC in a regulatory context cannot be separated from the question of whether the overall WACC estimate is commercially realistic, or from a careful analysis of the best estimates of each parameter.¹⁰
19. Further, this issue cannot be adequately addressed by simply conducting reasonableness checks on any proposed amendment to the 75th percentile, and repeating these checks when the balance of the IMs are reviewed. This is because, in our view, the evidence above does not suggest that the consideration of reducing the 75th percentile would reflect a closer approximation of the estimate of a theoretical "true WACC". Other parameters and the way in which asymmetric risks are to be shared and/or provided for in returns are part of the fact set to be considered when contemplating the overall objectives of establishing a WACC under Part 4.
20. All relevant evidence that will be required to fully explore and address these issues must be carefully analysed by the Commission at the appropriate time, which Auckland Airport considers to be the purpose of the review of the IMs scheduled for 2017.

⁹ Referred to by the Court, and others, as the need for caution in the face of what may be a search for "spurious precision" - see eg *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289 at paragraph 1189.

¹⁰ To this end, the Court in the IM judgment recognised the importance of independent assessments of WACC in assessing the robustness and reasonableness of the Commission's WACC estimate. Although the Court (as it was required to do) considered each element of the appeal before it on its own merits, the Court's comments suggest that the independent estimates provided information about a level for the WACC IM that would be appropriate given the Part 4 purpose, and provided important context for its consideration of the individual parameter values. See *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289 at page 405, under the heading "outcome" (following paragraph 1228).

The incentives for investment in the airport sector need to be carefully considered

21. The Commission has previously made a number of assumptions about investment incentives faced by regulated suppliers. Similarly, in the judgment in the merits review proceedings, the Court made a number of statements about investment incentives that must be treated with caution. In the context of investment incentives, such assumptions should be avoided as they:
 - (a) oversimplify the nature of the incentives involved and the way these incentives influence supplier behavior;
 - (b) are not supported by evidence; and
 - (c) fail to account for the countervailing pressures and risks that operate to control these incentives in practice (for example, the significant countervailing pressure applied by airlines during consultation on airport investment).
22. In particular, these assumptions have generally related to the supposed incentives on suppliers to over-invest.¹¹ There is no factual evidence in the airport sector of any such over-investment. Rather, the evidence at Auckland Airport demonstrates a pattern of careful and considered investment decisions that are designed to balance the short-term and long-term interests of passengers, airlines and the wider economy.
23. This includes circumstances where Auckland Airport has prudently deferred investment in the Northern Runway in response to market conditions, and has obtained court and shareholder approval to return approximately \$454 million to shareholders in 2014. These are not the actions of a business that engages in "wasteful investment".
24. Mere assumptions cannot justify an urgent review of the use of the percentile estimates of WACC used by the Commission, or of its long-standing position on the appropriateness of the 75th percentile in a pricing context. The appropriate time for testing such assumptions, and taking action if supported by factual evidence and empirical analysis, is as part of the full review of the WACC IM.

Assessing the consequences of getting the WACC estimate wrong

25. All airports play a vital role in the economic productivity of New Zealand. Auckland Airport, as the country's largest airport, plays a particularly crucial role in facilitating international travel, trade and tourism. The wider sectoral impact of investment in the airport sector is far-reaching, and promotes positive outcomes in a range of industries beyond the airline market.
26. All parties agree that the WACC IM involves inherent uncertainty and imprecision. In this context, considering the asymmetric consequences of getting that estimate wrong (either "too high" or "too low", when compared to an unknown and unknowable "true" WACC) must be very carefully considered.
27. In that consideration, it will be important to place significant emphasis on the end users (passengers and freight forwarders) of airport services when undertaking the necessary cost/benefit analysis to determine where the asymmetric costs lie (and, as a result, how a percentile estimate can be chosen to minimise those costs and expected losses).
28. This is particularly important given that airlines have natural incentives to constrain airport investment so as to limit airport capacity. For example:
 - (a) The former chief economist at Qantas recently analysed the impact of a congested airport on airline economics, noting that if airlines could live with a

¹¹ See, for example, the Court's comments at paragraphs 1479-1480, where it notes that "if anything, an abundance of capital is likely to lead to wasteful investment".

congested airport, this would "stifle some of the capacity that's coming into the market (and that will be a benefit to airlines)".¹²

- (b) This is consistent with comments made by the UK Competition Commission, which has previously noted that incumbent airlines have an interest in constraining airport capacity, to limit competition and maintain their operational yields. As the UK Competition Commission recently noted:¹³

The incumbent airlines might oppose efficient, economic and commercially justified expansion plans in order to restrict the amount of capacity available to new entrants.

- (c) The more that incumbent airlines succeed in constraining capacity at airports, the less incentive there is for them to pass on any of these savings to passengers. A similar observation was made by the Australian Productivity Commission regarding Sydney Airport in its 2002 report:¹⁴

... it is very difficult to obtain discounted fares to Sydney at peak times. In other words it is the airlines that are currently benefitting from the excess demand for landing slots at peak times ...

- (d) The explanatory note to the Commerce Amendment Bill recognised that, should any negotiate-arbitrate regime be introduced for airports, that this regime would need to mitigate the risk of incumbent airlines refusing to pay for investment that would encourage or facilitate increased competition by new entrant airlines.¹⁵

- 29. On the other hand, appropriate investment in airport infrastructure drives competition among airlines and resulting increases in seat capacity. This, in turn, promotes reduced price for passengers, increased choice of destinations, and improved quality of airport and airline services in order to attract consumers and continue to promote growth in passenger numbers. That growth will flow through to all sectors of the regional and national economy that rely on travel and tourism.
- 30. As recognised by the Chief Operating Officer of Flight Centre in Australia, travel spending "is about the availability of flights and the competition that creates around pricing, which continues to be a strong proposition for the traveler".¹⁶
- 31. Any such incentives will be an important consideration in evaluating where the overall social costs of getting the WACC estimate wrong lie for the airport sector. As such, Auckland Airport anticipates that the robust and thorough analysis needed to properly evaluate asymmetric costs in the airport sector will include detailed consideration of (at least):
 - (a) the ways in which airport charges flow through to passengers, and the role that airlines play in that process;
 - (b) the benefits that investment in airport infrastructure has for passengers in driving competition in the airline industry (and its consequential benefits through reduced price and increased destination choice); and

¹² Media article, Doug Nancarrow, 29 November 2013, available at: <http://www.aviationbusiness.com.au/news/why-airport-congestion-is-good-for-airlines-even-if-they-don-t-know-it>.

¹³ Competition Commission "Stansted Airport Ltd Q5 Price Control Review", 23 October 2008, Appendix C at paragraph 24.

¹⁴ Australian Productivity Commission *Price Regulation of Airport Services*, 23 January 2002, overview at XXXVIII.

¹⁵ Commerce Amendment Bill 201-1 (explanatory note) at page 39, 43.

¹⁶ Michael Smith *Dollar no deterrent to travellers*, Australian Financial Review, p 3 (27 February 2014).

- (c) the significant economic impact of airports on regional and national economies, considering both the direct and flow-on impacts of airport activity and investment in that activity.
32. In doing so, it will be important to consider that the types and extent of asymmetric costs in the airport sector are likely to differ considerably from those that apply in other regulated sectors. For example, factors such as the quality of the passenger experience and the availability of destination choice are important value drivers for passengers. Although such factors may be difficult to quantify precisely, they are important elements to be weighed into the overall cost/benefit analysis when considering the relative consequences of error in estimating WACC (and the overall expected social loss).
33. In Auckland Airport's view, attempting to consider such factors in the timeline proposed by the Commission would be very difficult, and risks turning the Court's recommended review into a superficial analysis that may be equally susceptible to challenge. Rather, Auckland Airport recommends that the Commission undertake the necessary inquiry at a time that it can carefully analyse and assess all relevant considerations. Doing so may very well result in an outcome where, having regard to all relevant factors, a percentile estimate higher than the 75th percentile is justified for airport services.
34. If you have any queries in relation to any of the matters raised in this letter, please contact either myself or our Regulatory Affairs Manager, Adrienne Darling on 09 255 9090.

Yours sincerely,

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