

2 December 2009

Networks Performance Branch
Commerce Commission
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NZ Airports' Submission on Cost of Capital following the Commission Workshop and on the Straw Person Example

Introduction

The New Zealand Airports Association ("NZ Airports") makes this submission on cost of capital ("WACC") following the Commission's cost of capital workshop of 12-13 November ("Workshop").

NZ Airports provides:

- Its preliminary views on the appropriate approach to establishing a WACC methodology for airports under Part 4 of the Commerce Act 1986 ("Act").
- The attached expert paper provided by Dr Alastair Marsden, of Auckland University, commenting on the Commission's Straw Person example and other issues raised at the Workshop.

NZ Airports also notes that the Commission has received information on airport funding issues directly from the airports. This submission should also be read in conjunction with views provided by the airports.

These documents together provide the airports' initial views on WACC issues. However NZ Airports and the individual airports cannot make full and informed submissions until the Commission provides further information on its views for a WACC methodology that applies to airports under information disclosure only regulation.

In that context, NZ Airports expressed its disappointment in its Cross Submission following the Input Methodologies Conference that the Commission had reversed its initially advised intention not to determine an input methodology for airport WACC.

In the Input Methodologies Discussion Paper, the Commission stated that:

"At this stage, the Commission's preliminary view is that it will not develop input methodologies on pricing methodologies and cost of capital for specified airport services by 30 June 2010, as they are not required to be applied by suppliers of these services. The Commission may determine these input methodologies at a later date if it considers it would be appropriate".¹

Following the Commission's initial advice the airports did not provide full submissions on the earlier WACC documentation published by the Commission and did not commit resource to this

¹ Input Methodologies Discussion Paper, paragraph 10.8.

area, given the range of other issues being considered by the Commission, and the signalled direction by the Commission.

The Commission has yet to provide reasons for its change in view. Further, it has not explained its views on how a WACC methodology should be appropriately established when information disclosure is the only form of regulation that applies to the regulated supplier. NZ Airports asks that the Commission provides those reasons and explanations as soon as possible, so that the airports can provide informed responses in accordance with the Commission's obligation to consult fully and fairly with interested parties.

Summary Airport Preliminary View on a WACC Input Methodology

The Commission has not demonstrated that it has appropriately considered the Part 4 and Information Disclosure purpose statements in its consideration of WACC issues to date. In particular it is not clear that the Commission is appropriately recognising the distinction between a WACC input methodology that is required to enable the Commission to determine price paths and a methodology that may be applied by the Commission in fulfilling its section 53B monitoring role.

Use by the Commission of a WACC input methodology to undertake ex post monitoring of airport outcomes conflicts with the fundamental forward looking principle for establishing WACC. The Commission must recognise this fundamental difference and determine a WACC input methodology that is specific to airports subject to information disclosure.

In particular this requires a WACC methodology for airports that:

- Should not establish a specific WACC since this is not required under information disclosure and is not reflective of workably competitive markets. The Commission should determine a range of WACC outcomes that provides:
 - A lower bound that may provide an indication that an airport's return is insufficient to incentivise it to undertake investment and retain a commitment to improving quality; and
 - An upper bound that enables consideration of whether airports are earning excessive profits.

This approach would also be efficient for the Commission as it means that the Commission would not need to engage in determining separate WACCs for each of the airports which would be required, due to the different business and market characteristics of each airport, if a prescriptive approach was required to be taken by the Commission for a price setting role.

- Recognises that airports establish prices under the AAA regime and hence will be applying a WACC and other pricing inputs for future time periods (normally five years). It is important to note that this is likely to be different to the ex post WACC determined by the Commission each year during the same time period.
- Does not establish a default price control regime.
- Does not confuse the annual monitoring role with future requirements to consider the effectiveness of information disclosure in 2012.
- Recognises that outcomes from the Commission's annual monitoring will need to be considered over time and need to be reviewed with airports to ensure that the Commission in considering variances from its own methodology gives due regard to:
 - Variations from traffic forecasts established at the time prices were established;
 - Unexpected events that have occurred since prices were set, such as changes in timing or scale of capital investment; and
 - Differences in assumptions due to the date at which a methodology is determined.

The Commission will mitigate the risk of establishing a WACC input methodology that is contrary to the long term interests of consumers and exceeds the requirements of the Act if it incorporates these key principles in an input methodology for airports.

We provide further detailed comment on these issues below.

Context for an Airport WACC Methodology

The Revised Draft WACC Guidelines, at page 14, define the cost of capital including the fact that it is a forward looking concept. The context in which a WACC input methodology for airports is to be applied by the Commission under information disclosure regulation fundamentally contradicts this concept. In particular we note:

- Airport pricing will continue to be set on a forward looking basis under the Airport Authorities Act 1966 ("AAA") regime and as such airports will be required to consult with airlines on setting WACC's for future pricing periods.
- Section 53F of the Act specifies that suppliers subject only to information disclosure are not required to apply a WACC input methodology determined by the Commission, and critically these suppliers will not be subject to price control regulation.
- Section 53F (2) of the Act clarifies that the Commission may establish a WACC input methodology to monitor and analyse information disclosed by airports (as allowed by section 53B of the Act).
- The monitoring will be undertaken on an ex post basis and compare airport financial outcomes, determined from pricing inputs established at a different time from the Commission's consideration of WACC and other input methodologies.

We establish this context as a basis for the discussion below and for NZ Airports' conclusions on principles that should guide a WACC input methodology for airports.

Intent of Legislation

NZ Airports has provided considerable comment on the Part 4 Purpose Statement and the section 53A purpose statement for information disclosure in its various submissions to the Commission. The correct interpretation of the legislative requirements for airports that will be subject to information disclosure only is particularly critical for a WACC input methodology, because an overly determinative approach will establish a default price control regime for airports, which is contrary to Parliament's intent.

Comments made by the Commission at the Workshop have increased our concern that this is indeed the Commission's intent. For example we refer to the comments made:

By the Commission Chair²:

"And under the legislation we have to formulate each of these input methodologies, including that as for WACC, to set out matters in sufficient detail so that each effective supplier is reasonably able to estimate the material effects of the methodology. So we are being put in a position of having to give specificity to some significant degree it seems in relation to each input methodology, and so to us wide-ranging submissions about ranges and uncertainty and so on, that may be the inherent nature of the subject matter here, I accept that, but at the end of the day the legislative task that we are required to perform means that we will have to specify an input methodology for WACC that doesn't have those kind of characteristics. We have to put out something that has some degree of specificity such that each of you will know how it affects your organisation."

² Cost of Capital Workshop Transcript page 116, lines 19-29

And Commissioner Duignan³:

"I think it would be useful just to briefly mention that under the Commerce Act as amended last year under Part 4, the input methodologies section, it is effectively mandated that the form of regulation that we will be implementing is CPI-X regulation. The role of the WACC under that is to be applied effectively to the regulated asset base to translate into a notional revenue path corresponding to the CPI-X and one of the implications of that is that we are setting a path for effectively some five years under what is described as the default price quality path."

It is clear that the Act does not require the Commission to set prices for airports. The Act requires the Commission to undertake a fundamentally different role which is to monitor airport outcomes on an ex post basis (we comment further below). Consequently consideration of the WACC input methodology requirements for airports needs to be undertaken separately from consideration of the price setting role referred to by the Commission.

Further, in terms of level of detail, as noted by the Chair the Act requires the methodology to be set in sufficient detail so that each affected supplier is able to estimate the material effects of the methodology on the supplier. However the Commission has not explained how this test should be applied, if at all, when only information disclosure regulation applies. In that case, the regulated supplier is not required to apply the WACC methodology, such that it should have little or no material effects on its business. NZ Airports therefore reiterates its submission that the Commission should set out fully and clearly, for consultation, its views on why and how a WACC input methodology should appropriately be established for airports and the basis upon which it has been concluded that that is consistent with the relevant provisions of the Act.

We make some key points below to highlight the risks that arise if an inappropriate input methodology is established for airport WACC.

Part 4 Purpose Statement - Competitive Markets

NZ Airports has previously commented on its interpretation of the section 52A Purpose Statement, which is consistent with the Commission's interpretation.⁴ That is, sub paragraph s52A (1) (a) to (d) are outcomes of workably competitive markets, and should not be pursued as objectives in their own right. The Commission must therefore seek to promote the long term benefit of consumers by promoting outcomes that are consistent with workably competitive markets.

It is not clear how the Commission has given consideration to the requirements of the section 52A Purpose Statement in developing its Revised Draft Guidelines⁵ or Straw Person Example.⁶ NZ Airports submits that the Commission is required to show that its proposed WACC methodology is consistent with the section 52A Purpose Statement.

In NZ Airport's view, in order to establish an input methodology for WACC, the Commission must have due regard to competitive market implications for WACC. This means that inputs to the determination of WACC must:

- Recognise that there is considerable imprecision in the inputs to a WACC calculation;
- Recognise that there are a range of feasible judgments that can be made in competitive markets and as such there is no requirement to be overly prescriptive for individual inputs.
- Consider whether the approaches proposed in any area meets a competitive market test – i.e. could be realistically implemented by the industry parties and would be the optimal competitive market solution.

³ Cost of Capital Workshop Transcript page 117, lines 1-7

⁴ Input Methodologies Conference Transcript page 30, lines 19-27

⁵ Commerce Commission revised Draft guidelines, The Commerce Commission's Approach to Estimating the Cost of Capital, 19 June 2009

⁶ Commerce Commission, Cost of Capital Straw Person Example – Electricity distribution industry

WACC Range is Appropriate for Information Disclosure

If insufficient weight is given to these factors it increases the risk that the Commission will establish a position that harms rather than benefits consumers. For example, if undue weight is given to an outcome that avoids excessive profits in establishing the WACC parameters, and the Commission determines a specific industry WACC, then it could in fact deter investment and constrain aviation market growth.

For information disclosure regulation, in considering the long term benefit of consumers the Commission need only establish a feasible range for WACC that will allow the Commission to provide its summary and analysis of airport performance (based on the information disclosed by airports), to assist interested parties to assess whether the section 52A (1) (a) to (d) outcomes are being achieved. It does not need to establish a specific WACC as it would if price control applied. Logically, this means that there will be an outlying:

- Lower bound that may provide an indication that an airport's return is insufficient to incentivise an airport to undertake investment and retain a commitment to improving quality; and
- Upper bound that prompts a consideration of whether airports are earning excessive profits. It follows that actual returns measured against these bounds will allow the Commission to comment on whether the Purpose Statement sub paragraph (a) to (d) outcomes are being met.

Analysing outcomes against such a range will decrease the risk that an incorrect approach or assessment will harm the industry, and will provide some flexibility to accommodate changing market circumstances and for shorter term strategic decisions to be undertaken without concern for the regulatory outcome.

In proposing that a range approach is necessary for airports subject to information disclosure NZ Airports is aware that this will lead to comment that airports will seek to take advantage of the range by consistently establishing prices that reflect the top end of the WACC range. Indeed at the workshop Dr Layton, adviser to the Board of Airline representatives, commented that⁷:

"I do have points to make about the point in the range and I will make them in the cross-submissions. But they are not exactly the same as the points made by those wanting consumers to pay higher and higher returns to investors."

NZ Airports and the individual airports have made considerable comment in earlier submissions on the outcomes of the consultation process and in particular commercial concessions made by airports. These submissions clearly demonstrate that the consultation process leads to outcomes that do not price at the maximum level. Outcomes from the most recent consultations include:

- Prices set below levels that would produce the WACC's determined by airports;
- Assets being excluded from the pricing asset base; and
- Risk sharing arrangements particularly in respect of asset revaluations.

Subsequent to the consultations there has also been deferral or discounting of price increases in recognition of the contraction in the industry due to the economic recession. These behaviours clearly show that commercial outcomes of the current pricing process do not result in price maximising behaviour by the airports. NZ Airports has also shown that New Zealand airport pricing is not excessive or inconsistent with prices in other jurisdictions.

⁷ Cost of Capital Workshop Transcript page 226, lines 6-9

Application of WACC to Suppliers Under Information Disclosure

In addition to the Part 4 Purpose Statement the Commission must consider the separate purpose for information disclosure to *"ensure that sufficient information is readily available to interested persons to assess whether the purpose of this Part is being met."* Quite clearly this is different to a price control regime and as such the Commission must consider the requirements for input methodologies differently where information disclosure is the only form of regulation.

Parliament expressly recognised this difference by determining that suppliers subject only to information disclosure would not be required to apply a WACC input methodology determined by the Commission (section 53F in the Act). The reason why WACC is not binding for regulated airports is because Parliament recognised that, if only information disclosure regulation applies, then establishing a binding WACC methodology would effectively convert information disclosure regulation into price control. As stated by officials advising the Commerce Committee considering the Commerce Amendment Bill (In response to submissions that WACC should be binding for airports):

"Such a requirement [a binding WACC methodology] could be interpreted to mean that the business has to price in a certain way including earning no more than its WACC. This amounts to price control, but the business is not under price control."⁸

While section 53F also provides that the Commission may apply a WACC input methodology in fulfilling its annual monitoring role as required by section 53B, the Commission must take care to ensure that it does not establish a price control regime by stealth. That is, if it establishes a single specific WACC against which disclosed returns are measured, then this will amount to the very type of *de facto* price control regime that Parliament sought to avoid by making WACC non-binding. We comment further on the specific implications for the Commission's annual monitoring role below.

Annual Monitoring by the Commission

Section 53(2)(b) provides that the Commission *"must, as soon as practicable after any information is publicly disclosed, publish a summary and analysis of that information for the purpose of promoting greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time."*

The monitoring requirement does not therefore require the Commission to publish its own assessment of whether the Part 4 Purpose Statement outcomes have been met, but rather to provide information in a form that assists interested persons to make their own assessment of whether the purpose of Part 4 is being met.

As acknowledged above the Commission can apply a WACC input methodology in undertaking this analysis however it is clear that the intent of the monitoring role is not to focus on short term outcomes but to develop an understanding over a period of time. An overly prescriptive approach by the Commission which is based on methodology judgments at a point in time risks inappropriate and/or inaccurate short term views being formed by interested persons reviewing the Commission's monitoring reports. To avoid such an outcome it is important that the Commission:

- Avoids establishing a *de facto* control process under which it establishes prescriptive methodologies for the key inputs to the price setting process. Instead, it should provide guidance to assist interested persons to make their own assessments.
- Provides sufficient flexibility to accommodate short term changes in market circumstances.
- Acknowledges that the Commission's WACC range will be based on a competitive market standard at the time the Commission may undertake monitoring of airport information disclosures and that this could differ from market conditions at the time prices were set, i.e.

⁸ Commerce Amendment Bill, Report of the Ministry of Economic Development, 4 July 2008, page 25.

for the purpose of establishing clear rules and processes appropriate for the form of regulation that currently applies to the regulated entity.

Relationship to Price Setting Process

As the Commission is aware pricing for the three airports will continue to be set within the requirements of the AAA. This means that airports are required to consult with airlines over the full range of pricing inputs (e.g. asset valuation, asset allocation, capital expenditure, cost forecasts and allocation, traffic forecasts, pricing structure, WACC and tax) at least once every five years unless a longer period is agreed between an airport and its significant airline customers.

The pricing inputs determined by the airports following consultation will be determined at different time periods than the methodologies established by the Commission and may reflect different market circumstances or expectations. The recent credit crisis provides a topical example of a significant market event that substantially impacted the inputs to a WACC calculation with Government bond rates falling substantially and the cost of debt increasing significantly.

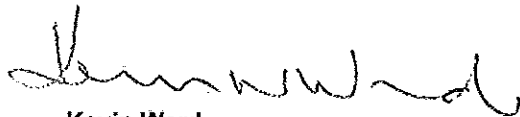
Clearly this creates a situation where outcomes from the pricing calculation may produce variations from the Commission's methodologies that are due to market circumstances. The Commission in establishing a WACC input methodology should recognise that this is a likely outcome and consequently again invite comment from airports on circumstances that may influence the outcomes disclosed by the airports.

Conclusion

NZ Airports will provide further comment to the Commission on the prospective WACC input methodology for airports when the Commission advises more specific views on a methodology for airports and how this would apply in an information disclosure context;

In the interim we are willing to meet with the Commission to discuss our views in this submission if this would be of assistance to the Commission.

Yours sincerely



Kevin Ward

Chief Executive

Attachment: *Comments on the Commerce Commission's Approach to estimate the Cost of Capital*, by Dr Alastair Marsden

