

31 July 2009

## Commerce Commission Draft WACC Guidelines Paper

### Introduction

This is a submission from Auckland Airport in response to the Commerce Commission's ("Commission") Revised Draft Guidelines<sup>1</sup> for estimating the cost of capital ("Draft Guidelines").

Auckland Airport will also be submitting on the Commission's Input Methodologies Discussion Paper. In that paper, the Commission indicated that it does not propose to establish a cost of capital methodology for regulated airports to be used for monitoring and analysis purposes (regulated airports are not required to apply any cost of capital methodologies). Auckland Airport supports that decision.

The Commission's approach to cost of capital is nevertheless of significant interest to Auckland Airport. As the Chair notes in the forward to the Draft Guidelines, it is an important issue for all regulated suppliers. We therefore consider it important to submit on the Draft Guidelines. Our comments are limited to matters of general principle that would be relevant if the Commission decided to determine a cost of capital methodology for regulated airports in the future. In that case, Auckland Airport would expect the proper process under Part 4 of the Commerce Act 1986 to be followed such that it would be able to submit on further detail.

The New Zealand Airports Association ("NZAA") has commissioned LECG to comment on issues relating to the cost of capital in the Commission's Input Methodologies Paper and the Draft Guidelines.

Auckland Airport endorses LECG's comments on the cost of capital in their submission to the Commission and the comments made in NZAA's submission. In addition we note the following points.

### Term of the risk free rate and debt finance

The Commission in its Draft Guidelines considers that the term of the risk free rate should match the term of the pricing period and not the life of the regulated firm's assets. This is on the basis that depending on the term structure of interest rates, the choice of a long-term risk free rate may over-compensate the owner of regulated assets where the price re-set period is a shorter duration.

It is not clear, however, that this approach reflects best commercial practice and will achieve its desired objectives. First, we note that the Commission (Draft Guidelines, paragraph 141) suggests the term premium in New Zealand is very close to zero on average. Second, a prudent approach to financing assets would be to source term finance that as close as possible matches the average life or duration of the assets. For infrastructure assets this is likely to be much longer than the regulatory price review period. Third, prudent companies will seek to have their debt maturities staggered over different time periods, thereby reducing re-financing risk compared to a scenario if all debt were to mature on a price re-set date.

Thus, there are sound commercial reasons to suggest the term of the risk free rate and the term of debt finance should be a long-term rate that matches, as close as possible, the duration of the asset lives of the regulated assets.

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<sup>1</sup> Commerce Commission, *Revised draft guidelines: The Commerce Commission's approach to estimating the cost of capital*, 19 June 2009.



A regulated business should not face a penalty for adopting a prudent and commercial financing strategy, particularly in the current market where access to debt capital is constrained and re-financing risk is high.

It is also not clear how the Commission's approach in its Draft Guidelines will provide any compensation for re-financing risk or that it is practical to offset refinancing risk via hedging instruments. This is despite the Commission's claim (Draft Guidelines, paragraph 148) that if regulated firms seek to borrow longer than the regulatory cycle any interest rate risk associated with doing so could be offset in the interest rate swap market. In the current market counterparties are not offering term swaps. In the few instances that Auckland Airport are aware of term swaps, these come with prohibitive cash collateral terms and debt premiums.

### **Debt risk premium**

The Commission (Draft Guidelines, paragraph 77) proposes to estimate the cost of debt as the estimated debt premium over the risk free rate. For conceptual consistency, the risk free rate used to measure the debt premium should be the same risk free rate used to estimate the cost of equity in the CAPM formula (Draft Guidelines, paragraph 223).

Wholesale debt for many regulated firms is sourced from capital markets, with the cost of debt priced at a margin over swap rates. It is not clear that determining a debt margin based on traded retail bond yields over the risk free rate will provide an appropriate estimate of the firm's cost of debt for wholesale funds. In the NZ debt market many corporate bonds are thinly traded and retail "yields" on small dollar values of traded debt may not reflect the actual cost of raising significant amounts of debt in the capital markets.

We agree with the Commission's observation that debt risk premiums have increased since the global financial crisis. We have observed five year debt raising at yields in a range of 7.25% and 8.5%, representing a significant premium on yields for corresponding Government stock rates

### **TAMRP (Tax-adjusted market risk premium)**

The Commission (Draft Guidelines, paragraph 164) states that it considers its preliminary view is that it should continue to use its estimate of 7.0% in respect of the tax-adjusted market risk premium under the Brennan-Lally CAPM.

There should be consistency between the term of  $r_f$  in the intercept term of the CAPM and the term of  $r_f$  in the market risk premium.

If the Commission continues to take the view that the intercept term of  $r_f$  in the CAPM should match the price review period, the term of  $r_f$  in the market risk premium should be measured relative to the same period.<sup>2</sup> Most empirical evidence (e.g., Dimson, E., Marsh, M. and Staunton, M., 2009)<sup>3</sup> shows that the market risk premium measured relative to short-term bonds is higher than the market risk premium measured relative to long-term bonds.

With respect to the impact of the global credit crunch and the liquidity crisis resulting from the US subprime market, credit margins on debt around the world, including New Zealand, have significantly increased.

If bondholders now expect and demand significantly increased yield spreads over Government stock or treasury bonds compared to historical spreads, it follows that equity holders will not accept greater risk without a compensatory adjustment or an increase to the equity risk premium.

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<sup>2</sup> The Draft Guidelines (paragraph 223 (ii)) also state for conceptual consistency that when estimating debt premiums "the risk-free rate used to measure the debt premium should be the same risk-free rate used to estimate the cost of equity in the CAPM formula".

<sup>3</sup> Dimson, E., Marsh, M. and Staunton, M., 2009, Credit Suisse, Global Investment Returns Yearbook 2009.



## Adjustments to WACC

The Commission (Draft Guidelines, Section 5) recognises the need to provide for asymmetric risks split between:

- Type I risks i.e. infrequent events that can produce large losses e.g. natural disasters, earthquakes; and
- Type II risks i.e. risks such as the threat of competitive entry or asset stranding from technical innovations, etc.

Assessment of the level or quantum of adjustment for asymmetric risks is difficult. Insurance to cover asymmetric risks is often not available and even where available is often much more expensive than an “actuarially-fair” premium charge.

In respect of ex-post protection for adverse asymmetric risks it is not clear in the Commission’s Draft Guidelines how the firm would receive full recovery if an adverse event occurs. We assume the Commission does not intend that this would apply to industries operating under information disclosure only, if it decided to establish a WACC for monitoring purposes in the future. Assets owned by regulated firms typically have long expected asset lives and any contract for ex-post protection would need to be binding on the parties (including the regulator) and of long-term duration.

The burden of proof on the existence and quantum of any asymmetric risks should not fall solely on the provider of the regulated services. It would not be appropriate for the Commission to assume asymmetric risk is zero on the basis that the size of any adjustment could not be easily quantified.

Common commercial practice is also often to add an increment to the discount rate as opposed to providing for asymmetric risks in the “cashflow” expectations. This recognises modelling any asymmetric risks in the expected cashflows is often not practical and also subjective.

The Commission should also recognise an appropriate allowance for asymmetric risks before concluding that a supplier is earning an excess return over its cost of capital. A multi-year analysis will also be more meaningful than a single year return.

### Estimation error

The Commission (Draft Guidelines, paragraph 239) notes that the Commission accepts the general proposition that the social costs of setting allowed rates of return too low probably outweigh the costs of setting allowed rates too high. Reflecting this view the Commission often selects a WACC estimate above the midpoint of the estimated range when selecting allowed rates of return.

Under regulation there is a risk that model and/or regulatory errors result in firms facing diminished incentives to undertake replacement and new investment. This suggests the Commission should adopt a conservative position for firms subject to regulation and in most cases adopt a cost of capital estimate at the upper end of any plausible range.

### Real Options, Costs of Financial Distress and Other Resource Constraints

The Commission notes (Draft Guidelines, paragraph 256) that real options theory predicts that firms facing investment decisions that are largely irreversible and subject to considerable uncertainty will not invest when the conventionally calculated NPV is zero.

In addition costs of financial distress and resource constraints may impose costs and lost opportunities to regulated firms.

It is important that the Commission keeps an open mind with respect to these issues. There may be cases where the costs or losses to firms associated with real options, the possibility of financial distress and resource constraints are significant and represent a material cost to the firm.



## **Financeability Tests and Credit Ratings**

The Commission ((Draft Guidelines, paragraph 49) proposes a sanity check on its overall cost of capital estimate.

Any financeability and sanity check should ensure that the regulated firm will earn sufficient expected revenues and profits to maintain an investment grade credit rating, maintain assets and to provide some buffer against adverse shocks. This is to minimise the possibility that market turbulence or an adverse shock outside the control of the firm could lead to a drop in the firm's credit rating below investment grade and expose the regulated firm to potential large financial distress costs.

### **Other matters**

The appropriate measurement of ex-post ROI will depend, inter-alia, on the Commission's (i) use of nominal vs real cash flows; (ii) the treatment and approach to value the regulatory asset; (iii) treatment with respect to corporate tax and the tax base; (iv) the treatment of revaluation gains or losses (if any); and (v) the treatment of asymmetric risks.

We believe that it would be useful for the Commission to clarify and provide more detail on any proposed approach to measure the ex-post ROI in the future for monitoring purposes.

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