

3 August 2009

Murray Reynolds  
Economist  
Economic Services Branch  
Commerce Commission  
PO Box 2351  
WELLINGTON

Dear Mr Reynolds

### **CIAL SUBMISSION ON THE REVISED COST OF CAPITAL GUIDELINES**

Thank you for the opportunity for Christchurch International Airport Limited (CIAL) to make a submission in response to the Commerce Commission's ("Commission") Revised Draft Guidelines for estimating the cost of capital ("Draft Guidelines").

CIAL will also be providing a submission in response to the Commission's Input Methodologies Discussion Paper. CIAL welcomes the Commission's statement in that Discussion Paper that it will not produce input methodologies on the weighted average cost of capital (WACC) in relation to the airports, noting that such a methodology would cause a substantial shift in the balance of the regime from a disclosure regime towards shadow control.

However, the Commission's methodological decisions with respect to the WACC are of key interest to all regulated suppliers, and as such CIAL considers it important to comment on the principles embodied in the Draft Guidelines. If the Commission decided to determine a cost of capital methodology for regulated airports in the future, or to estimate a cost of capital, CIAL 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, the Revised Draft Guidelines Paper and the recommendations made by the international panel.<sup>1</sup> CIAL supports LECG's comments on this matter. This submission will therefore focus only upon the particular issues or themes that CIAL considers particularly important.

As an overriding comment, CIAL urges the Commission to temper the essentially academic advice that it typically receives on the cost of capital with an understanding of how models from finance theory are applied in practice in the finance community and by firms. This includes *observing* how firms actually behave, including how they choose to finance themselves, rather than attempting to *predict* optimal or best-practice behaviour.

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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 and Julian Franks, Martin Lally, and Stewart Myers, *Recommendations to the New Zealand Commerce Commission on an appropriate cost of capital methodology*, 18 December 2008.

### ***Risk free rate***

The Commission's position on the term of the risk free rate (being one that reflects the length of a regulatory period) is not consistent with the standard practice in the finance community, where the norm is to use long term bonds as the risk free rate and measure the market risk premium in a manner that is consistent with this. It also seems clear that the academic advice on this matter is not unanimous, with the academic experts appointed to the Commission's Expert Panel coming up with multiple plausible approaches between them, but no unanimous view as to which should be preferred. The Commission should be aware that, when assessing required returns, the market treats infrastructure assets as an investment for which cash flows are locked-up for a long term, which is unaffected by the frequency with which regulators may look at charges.

### ***Market risk premium***

CIAL also notes that the Commission's preferred market risk premium results from applying equal weight to a range of sources of evidence, irrespective of how reliable or orthodox are those different pieces of evidence. CIAL observes that the standard practice in the finance community when assessing the market risk premium is to consider the long term average premium to equities from the New Zealand equity market and overseas markets, which would lead to a premium that is materially higher even when the same evidence summarised by the Commission's adviser is assessed.

CIAL also notes that a rational interpretation of the recent events on world financial markets is that the market risk premium has increased compared to the pre-existing levels – given that we have seen a 'flight to quality' from investors (suggesting increasing risk aversion), an increase in share market volatility (suggesting an increasing risk of holding equities), but falling government bond rates. Indeed, the Australian Energy Regulator has recently decided to add 0.5 percentage points to what it otherwise would have determined for the market risk premium as a result of the Global Financial Crisis. As the WACC parameters for Australian electricity businesses are now 'locked-in' for an extended period (and for some businesses, the AER's current view on the market risk premium will still be factored into prices in 10 years time), this can be interpreted as the AER's view on the impact of the crisis on the average premium over that extended period.

### ***Cost of debt***

CIAL also considers the Commission's view that it should assume that firms raise debt for 3 to 5 years is not consistent with prudent debt management and the observed practice of Australasian infrastructure firms. Again, the Australian Energy Regulator recently reviewed at some length the practices of the Australian energy utilities – which access the same pool of investment funds as New Zealand firms – and concluded that the standard practice was a term of debt (in fixed rate terms) of greater than 7 years, and adopted a benchmark financing term of 10 years (in fixed rate terms) for simplicity. The same benchmark assumption would be reasonable for New Zealand.

### ***Asset betas***

CIAL welcomes the Commission's view that, when deriving an asset beta for firms in a particular industry, it will look first and foremost at evidence on asset betas from that industry. CIAL notes that there is a large number of listed airports around the world – including Auckland Airport in New Zealand – which should be the primary source of evidence. The Commission's

approach in the 2001 airports inquiry – in which the asset beta for *airports* was derived from US *electricity* utilities – led to an illogically low asset beta for airports, which has turned out to be lower than the beta the Commission has used subsequently for the New Zealand gas distributors. A cursory examination of the events of the last decade – namely, the fall in airport passengers with September 11 and SARS, followed by strong growth during the boom years and the sudden drop-off in the last year – shows that airport cash flow is much more strongly related to economy-wide events than those of electricity and gas distributors, which in turn implies a significantly higher asset beta.

CIAL considers, however, that the Commission's suggestion that it will try to use statistical techniques to ascertain the asset beta for the aeronautical activity division of the airports to be impracticable and infeasible. Individual asset betas are estimated with such statistical imprecision that it would be erroneous to assume that the differences in asset betas would reflect the differences in the composition of each airports' activities. Secondly, it is difficult to obtain reliable information on the balance of airports' activities between aeronautical and non-aeronautical and on the precise composition of non-aeronautical activities. It is noted that some non-aeronautical activities may have a higher asset beta (such as retail concessions), whereas others (such as long term leasing) may have a materially lower asset beta than that of aeronautical activities, and hence reliable data on the precise composition of activities would be required for such an analysis.

#### ***Error in estimating the WACC***

The Commission 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 has adopted a practice of selecting a WACC estimate that is above the midpoint of the estimated range when selecting allowed rates of return.

CIAL welcomes the Commission's acceptance that WACC estimates are subject to material estimation error, and that the socially optimal WACC estimate when setting prices for infrastructure would be one that is at the upper end of the plausible range. CIAL further notes that the same risk from adopting a low WACC applies irrespective of the form of regulation, and hence would be equally relevant if a WACC were to be estimated to assess the profitability of suppliers under a disclosure regime.

#### ***Comparing the ROI to the WACC***

CIAL notes that there are a number of challenges to drawing reliable conclusions from a comparison of the return on investment (ROI) reported under a disclosure regime with a WACC. As CIAL will address in more depth in its submission to the Input Methodologies Discussion Paper, the annual volatility in revenue and costs means that focussing on annual observations may provide a misleading impression of profitability and ultimately expose the regulated supplier to asymmetric risk. In addition, focussing on profitability in isolation would dull incentives for regulated suppliers to make efficiency gains, which would be contrary to the purpose statement.

In addition, CIAL notes that Commission recognises the existence of – and consequent need to provide for – asymmetric risks, which it breaks down 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.

It is difficult to assess the level or size of adjustment for asymmetric risks. Insuring against such risks often is not available or priced above a fair charge given the probability of the event.

It is noted, however, that the allowance for these risks is not typically accounted for in financial accounts, and hence shows up as a *prima facie* excess return. Thus, the existence of asymmetric risk provides a further challenge to interpreting reported annual ROI.

In summary, CIAL's main points are that:

- the term of the risk free rate should follow the standard practice of market practitioners and long term nature of the investments, which dictates the use of long term (10 year) bonds;
- the more reliable evidence on the tax-adjusted market risk premium would lead to a higher value than proposed by the Commission, particularly when the effects of the 'global financial crisis' are considered;
- the cost of debt should reflect prudent borrowing practices for Australasian infrastructure firms – the Australian Energy Regulator's recent decision that 10 year fixed rate financing is a reasonable assumption is appropriate also for New Zealand;
- the Commission's signal that it will take account of evidence on asset betas from the industry in question is welcomed; however, it will be impracticable to use statistical techniques to infer an asset beta for the regulated activities in isolation, as the Commission suggests.
- the Commission's recognition that WACCs used for pricing purposes should be taken from the upper end of the plausible range is welcomed; and
- care should be taken when assessing annual returns on investment to a WACC, noting that:
  - annual revenue and costs – and hence profit – will fluctuate;
  - a focus on profit in isolation from factors like trends in cost will remove the incentive for airports to pursue cost reductions; and
  - the compensation required for asymmetric risks – the Commission's recognition of which is welcome – will lead to a higher reported profit when in reality it is a compensation for this risk.

Please contact the writer for any matters arising relating to this submission.

Yours sincerely



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