NZ AIRPORTS

SUBMISSION ON COMMERCE COMMISSION EMERGING VIEWS ON THE WACC PERCENTILE FOR AIRPORTS

16 MARCH 2016

1. The Commerce Commission ("**Commission**") recently published Professor George Yarrow's expert report ("**Yarrow Report**"), responding to questions raised by the Commission concerning WACC estimates for information disclosure ("**ID**") purposes in the airports sector. At the same time, the Commission published its Emerging Views on the airport weighted average cost of capital ("**WACC**") percentile ("**Emerging Views Paper**").

2. The New Zealand Airports Association Inc. ("**NZ Airports**") welcomes the opportunity to respond to Professor Yarrow's expert advice and the Commission's emerging views, as part of its review of input methodologies ("**IM Review**") under section 52Y of the Commerce Act 1986 ("**Commerce Act**").

3. This submission is supported by expert reports from Sapere Research Group:

   (a) a report discussing Professor Yarrow's conceptual distinction between allowed rate of return and WACC ("**WACC v ROR Report")**; and

   (b) an analysis of the relevance and likely magnitude of asymmetric impacts for airports under ID ("**Asymmetric Impacts Report**").

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Executive summary

5. NZ Airports believes the Emerging Views Paper and Yarrow Report provide a sound platform for interested parties to consider the role of the WACC IM when assessing airport performance under ID Regulation. To address the underlying adverse effects arising from the exercise of market power ("**AEEMP**"), or, put otherwise, in an assessment of whether Part 4 of the Commerce Act is being met, the core theme in the Yarrow Report is that contextual analysis is critical, and WACC estimates should not have a privileged position in that analysis. That is, excessive profits should not be identified and assessed by comparing returns to a WACC estimate.

6. As we understand it, the Commission proposes to adopt that advice. It is looking to move away from a resolute focus on number comparisons, and instead wishes to promote a

proportionate contextual assessment of airport profitability (both target and actual). We fully support this approach, as it is much closer to how we envisaged ID Regulation would be implemented under Part 4. There is an opportunity to remove the focus on technical and narrow discussions around the comparisons of returns with a WACC estimate (where the risk of regulatory error is high), and increase focus on assessing whether airports are delivering outcomes that are in the long term interests of consumers.

7. We support the Commission's proposal to simply publish WACC at every 5th percentile. We think this is the best way to assist with the type of contextual analysis envisaged in the Yarrow Report, and to present WACC in a way that demonstrates it is an inherently uncertain estimate (compared to publishing the mid-point and standard error, which could invite undue focus on the mid-point as the only published estimate).

8. However, without a common understanding of what proportionate contextual analysis looks like, there is a risk that in an effort to reduce focus on the 75th percentile as a "*de facto*" upper limit of an acceptable range, that same focus will be (inappropriately) transferred to the mid-point.

9. The Commission appears to be comfortable emphasising the role of the mid-point due to its suggestion that the potential asymmetric impacts on consumers from underinvestment are likely to be weaker for airports compared to electricity. It also seems to be of the view that if asymmetric impacts exist, then that will be something for airports to explain when they set prices. We are advised by Sapere that their preliminary analysis shows that the asymmetric impact is likely to be greater for airport consumers compared to the energy sector. In our view, these asymmetric impacts need to be considered now - not to establish a permissible percentile (which we do not support) but as *part* of the rationale for not placing undue emphasis on the mid-point as a relevant benchmark, and is an additional legitimate reason why targeted returns may be above the mid-point yet promote the purpose of Part 4 of the Commerce Act.

10. It would greatly assist if the Draft Decision (and Final Decision) Reasons Paper more clearly acknowledges the Commission's acceptance, for both *ex ante* and *ex post* assessments of returns, of the following features of Professor Yarrow's advice:

(a) It is important to implement the principle of proportionality. ID is an "intermediate" response to the risk of exercise of market power, and therefore the degree of influence over conduct should be lower than for price control.[1] If the Commission is highly reactive to deviations from the WACC estimate, then business conduct can be expected to be more sensitive to the WACC estimate.[2] That is at odds with the findings of courts in Europe and North America, who have correctly tended to be very reluctant to find excess pricing unless there has been some egregious deviation or unless prices are manifestly arbitrary in some other way.[3]

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[1] Professor George Yarrow, *Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector* ("**Yarrow Report**"), 19 February 2016, at p.2.
[2] Yarrow Report, at p.8.
[3] Yarrow Report, at p.3.

(b) It is wrong to assume that any positive deviation of target or actual returns from the WACC IM estimate is indicative of excessive profitability. There is no reason to give this factor a privileged position.[4] This cannot be over-emphasised. Judgement of excessive profitability must be based on some underlying analysis if it is not to be arbitrary. Uncertainties about the estimated WACC are also relevant.

(c) That is consistent with it being important to maintain a distinction between the information produced for the purpose of assessment (which includes estimates produced by the WACC IM), and the assessment exercise itself. Any assessment exercise should take into account a full range of factors relevant to the Part 4 purpose criteria, such as innovation, service quality and efficiency. The objective is to identify harm from use of market power - not the extent to which returns deviate from an estimate of WACC.

(d) Allowed rates of return (or, in this context, acceptable returns[5]) are typically higher than WACC.6 Great care is therefore required when using the WACC as an indicator of reasonable price levels under an ID regime.

(e) Further, seeking to constrain profitability to a level no higher than the estimated WACC will tend to skew a business's anticipated probability distribution of rates of return on capital - with the consequence that riskier, more innovative, investments may not occur.

11. We are encouraged by the Commission's Emerging Views. Our hesitancy at this early stage arises from the apparent judgement by the Commission that the mid-point is a robust proxy for returns that meet the purpose of Part 4 of the Commerce Act. We read the Yarrow Report as providing clear advice that such an approach should not be followed.

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[4] Yarrow Report, at p.20.

[5] We note that Professor Yarrow prefers the term "allowable" rate of return. Under ID, the relevant assessment is more appropriately referred to as an "acceptable" rate of return and so we use that terminology in the remainder of this submission. For the purposes of the submissions advanced herein, its use can be regarded as interchangeable with Professor Yarrow's concept of "allowable" rate of return.

[6] Yarrow Report, at p.11.

I. Positive features of Emerging Views Paper and Yarrow Report

12. Our reaction to the Yarrow Report, and the Commission's adoption of Professor Yarrow's advice in the Emerging Views Paper (where that is the case), is positive. In our view, they signal an approach to profitability assessment under ID that is much closer to our view of how ID regulation should operate.

13. The overarching advice we take from the Yarrow Report is that under ID only regulation for airports, it is not possible to identify behaviour that is inconsistent with the purpose of Part 4 of the Commerce Act by comparing returns to an estimate of WACC. A broader (yet still proportionate) contextual analysis of performance (including profitability) is required. Accordingly, it would be wrong to draw any particular conclusion from a divergence between the WACC IM and airport returns (target or actual). Indeed, as Professor Yarrow notes, the WACC, in and of itself, is not an appropriate benchmark for setting a threshold at which profits might reasonably be judged to be excessive.[7]

14. Particular themes from the Yarrow Report that we support include:

   (a) ***Proportionality and the role of ID regulation****:* ID Regulation is an intermediate level response to the risk of market power that lies between general competition law and more interventionist price control type responses.[8] This means WACC estimates should play a lesser role compared to price control. Further, the role of WACC estimates will vary according to the risk of harmful exercise of market power in the specific context that ID regulation applies.[9] Put simply, ID can and should be effective at preventing airports exercising market power without pressuring airports to price in accordance with the Commission's estimate of WACC.[10]

   (b) ***Airports have less ability or incentives to exercise market power:*** Proportionality considerations also require the Commission to recognise that there are constraints on airports' ability to exercise market power. The Yarrow Report notes that airports are not necessarily naturally monopolistic in the way that an electricity transmission or distribution system might be. For example, there is more significant demand-side substitution among airports by both airlines and passengers, and airlines have a degree of choice as to which airports they serve and the frequencies of their services.[11] This may mean, for example, a modest deviation between WACC and returns may not indicate AEEMP in the airport context, although it might under full price control where the risk of exercise of market power is higher.[12]

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[7] Yarrow Report, at p.20.
[8] Yarrow Report, at p. 2.
[9] Yarrow Report, at p.3.
[10] Yarrow Report, at p.3.
[11] Yarrow Report, at p. 13.
[12] Yarrow Report, at p.4.

We agree with Professor Yarrow that this is also relevant when considering the inherent uncertainty in estimating WACC as part of a broader profitability assessment:

> for example, it is important to have some sense of the effects of market power on the probability distribution of an airport's profitability, and in particular to develop some appreciation of the riskiness of returns in circumstances where there is no adverse exercise of market power.[13]

(c) ***Limitations of WACC in assessing returns under ID regulation:*** The Yarrow Report is clear that the use of a bright line estimate for the assessment of an airport's returns is neither a legislative requirement, nor appropriate:[14]

> The legislation already allows for the conceptual separation of the information discovery and assessment: there is no forced link between the cost of capital and the resulting regulatory decision, and in particular there is no legislative requirement to deem any returns in excess of the cost of capital to be 'excessive'.

Rather, in Professor Yarrow's view, what is and what is not excessive is left to judgements that can be made on the basis of all the relevant factors that might reasonably be taken into account.[15] NZ Airports agrees with this approach. However, if the Commission decides to publish a WACC estimate (it does not need to), then according to Professor Yarrow the purpose of ID would be best served by the Commission publishing its view of the relevant WACC estimate, "*with no further judgments added*":[16]

> That would involve specification of such parameters of the probability distribution of the WACC as might feasibly be estimated. If legislation or administrative expediency requires a point estimate, this would amount to a single estimate of central tendency (estimate of the mean, median or mode), but additional information on parameters such as the estimated variance, upper and lower bounds, 5th and 95th deciles, skewness, etc. would be of value and would merit publication if considered sufficiently reliable.

Accordingly, an assessment of the specific market context should inform the interpretation of any deviation of returns from WACC estimates - "*a judgment has to be made as to whether or not any assessed deviation can reasonably be interpreted as indicating that profits are 'excessive', and such a judgment must, if it is not to be arbitrary, be based on some underlying analysis*."[17] NZ Airports endorses Professor Yarrow's carefully articulated view on this issue: [18]

> It cannot be over-emphasised that a given difference between profitability and the cost of capital, i.e. one which is independent of relevant factual

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[13] Yarrow Report at p. 5.
[14] Yarrow Report, at p.20.
[15] Yarrow Report, at p.20
[16] Yarrow Report, at p.21.
[17] Yarrow Report, at pp.2-3.
[18] Yarrow Report, at p.20.

> circumstances at a given time, cannot reasonably be taken to be the basis for a judgment that profits are excessive for Part 4 basis. ... The extent of any such divergence is one factor of relevance in assessment, but it is only one of many, and there is no particular reason to give it a privileged position, although the interpretation of divergences will properly differ as between ex ante and ex post assessments.

It follows that "*the application of great care is therefore required when using the WACC as an indicator of reasonable price levels under an information disclosure regime, particularly when the assessment is made on an ex ante basis*." In particular, as Professor Yarrow notes "*Courts in Europe and North America have (rightly in my view) tended to be very reluctant to find violations on the basis of 'excessive pricing' unless there has been some egregious deviation between prices from costs or unless prices are judged to manifestly arbitrary in some way or another*."[19]

(d) ***Distinction between WACC and Rate of Return:*** Crucially, there exists a clear and justified distinction between a regulator's estimate of WACC and an allowed (acceptable) rate of return. That conceptual distinction (which, as detailed below, is explored in Sapere's WACC v ROR Report) is not an airport-specific factor that falls to be assessed on a case by case basis when airport returns are examined. Rather, it is a key factor to inform the overall framework for assessment of returns under ID regulation - and reinforces the need for the role of regulatory WACC estimates in profitability assessment to be de-emphasised.

Given the distinction between WACC and an acceptable rate of return, it follows that, as Professor Yarrow states, "*the WACC by and of itself is not an appropriate benchmark for setting a threshold at which profits might reasonably be judged to be excessive.*"[20] Among other things, this is because there needs to be a clear distinction between an acceptable rate of return and the cost of capital, and a clear distinction between acquiring information under ID and interpreting that information.[21]

It appears that historically these distinctions have been blurred by the Commission, meaning that:

> ... too much weight is being placed on one set of numbers, deriving from exercises to estimate the cost of capital, and too little weight is being placed on the contextual factors that can influence the interpretation of disclosed information. Put another way, there is an implicit assumption that the cost of capital to be published should itself be based on judgments that, in effect, reflect views on how the information should be interpreted."[22]

A further outcome of losing the distinction between an acceptable rate of return and the cost of capital is that the "unfortunate" practice of "massaging" cost of

[19] Yarrow Report, at pp. 6 and 8.
[20] Yarrow Report, at p. 20.
[21] Yarrow Report, at pp. 11 and 19.
[22] Yarrow Report, at p. 20.

capital estimates (or other estimates) is encouraged in order to obtain what a regulator considers to be a sound final determination. This can be remedied by reinstating into the framework of ID regulation a valid conceptual distinction between an acceptable rate of return and cost of capital.[23]

The Yarrow Report also notes that allowed (acceptable) returns would, for sound economic reasons, be higher than WACC (we return to this point later in this submission, and the concepts are further discussed in the enclosed Sapere WACC v ROR Report).[24]

(e) ***Disproportionate regulatory responses can create negative outcomes:*** Professor Yarrow notes that regulated businesses constantly assess regulatory behaviour for signals of likely future regulator conduct, with significant effects on business conduct. If the Commission's conduct is to apply stringent criteria and to be highly reactive to relatively small deviations between projected or out-turn returns and the Commission's WACC estimate, businesses "can obviously be expected to be more sensitive to the WACC estimate".[25] If ID seeks to constrain returns to a level no higher than the WACC estimate, then this will skew the risk of investment and distort incentives. At the very least there could be a bias against risky and more innovative projects on the basis they could attract regulatory intervention if they result in higher returns.[26] These concepts are further discussed in the enclosed Sapere WACC v ROR Report.

15. In our view, if the Yarrow Report was adopted in full by the Commission, key features of profitability assessment in the context of Airport ID would include:

(a) A proportionate contextual analysis, with the objective of seeking to identify clear cases where an airport's use of market power will harm the long term interests of consumers.

(b) De-emphasising (in comparison to past practice) the role of the WACC IM estimate. There should be recognition in the Commission's conceptual framework that the WACC IM may not provide reliable evidence of AEEMP (and, in particular, may not provide reliable evidence of whether airports are limited in their ability to extract excessive profits).

(c) Maintaining a clear distinction between acceptable returns and WACC estimates (as discussed by Sapere in the enclosed WACC v ROR Report).[27]

16. The Emerging Views paper takes positive steps towards implementation of the Yarrow Report. The Commission states that:

(a) a precisely defined WACC percentile range is not appropriate for the IMs;[28]

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[23] Yarrow Report, at p. 20.
[24] Yarrow Report, at p. 11.
[25] Yarrow Report, at pp.8-9.
[26] Yarrow Report, at p. 6.
[27] Sapere Research Group, *The distinction between the "allowed rate of return" and the "cost of capital"*, 16 March 2016, at section 1.2

(b) ID regulation would be best served by publishing a mid-point estimate of the cost of capital together with the probability distribution of the WACC estimate (eg either regular percentile estimates of, say, every 5th percentile or publishing the mid-point together with the estimate of standard error);[29]

(c) a specific point estimate is not helpful when assessing profitability in the context of ID;[30] and

(d) instead, under full contextual analysis, airports should be required to provide information and evidence to justify the reasons for any divergence from the mid-point.

17. The following sections focus on point (d), and explain why we think the Commission needs to be more cautious regarding the proposed emphasis on the mid-point as a clear benchmark.

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[28] Commerce Commission, *IM Review - Professor Yarrow report and emerging views on the airport WACC percentile* ("**Emerging Views Paper**"), 19 February 2016, at paragraph 18.
[29] Commerce Commission, Emerging Views Paper, at paragraph 19.
[30] Commerce Commission, Emerging Views Paper, at paragraph 25.

II. There is no need for a "precise" range

18. The Commission is concerned that undue emphasis has been placed on the upper limit of the current WACC range (75th percentile) and therefore proposes to change the way WACC is published.[31]

19. As the Commission has previously stated, the reasons for the current range under the WACC IM are that:

    (a) there is considerable uncertainty associated with estimating the WACC (due to the risk of model error and/or individual parameter uncertainty), as well as with the measurement of airports' actual levels of profitability;[32] and

    (b) there is no single "correct" level of an acceptable return for an airport business (or for all airport businesses).[33]

20. Indeed, it was for these reasons that the High Court endorsed a range approach, and in particular the 25th to 75th percentile, as appropriate for ID regulation.[34]

21. We think it remains important for the WACC IM to require the Commission to publish the WACC estimate in a manner that provides a clear indication that it is an inherently uncertain estimate (or put another way, avoids a false sense of precision).

22. We agree that the IM should support the type of contextual analysis envisaged by the Yarrow Report. Accordingly, NZ Airports supports the Commission's proposal to simply publish WACC estimates at every 5th percentile (eg 5th to 95th). This is the best way for the published WACC to signal that it is an uncertain estimate, while discouraging comparisons between returns and any defined percentile estimates.

23. We think this would be better than publishing only the mid-point together with the estimate of standard error. Such an approach would create a risk that interested parties will unduly focus on the mid-point as a precise estimate of normal returns (despite the standard error being published). Interested parties may be encouraged to take that approach because:

    (a) the Commission has made it clear that the 75th percentile is not an upper limit of acceptable returns;

    (b) the only clear guidance will be that the Commission considers the mid-point to be the best estimate of normal returns (which, for the avoidance of doubt, like Professor Yarrow, we disagree with);

    (c) the current emerging view suggests any departures from the mid-point must be justified by airports; and

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[31] Emerging Views Paper, at paragraph 28.2.
[32] Commerce Commission, *Input Methodologies (Airport Services) Reasons Paper* ("**IM Reasons Paper"**), December 2010, at paragraphs E11.54-11.60.
[33] IM Reasons Paper*,* at paragraph E1.24.
[34] *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289 ("**IM Judgment**"), at [1490]-[1491].

(d) accordingly, the mid-point becomes a "bright line" benchmark.

24. In summary, publishing WACC estimates at regular percentile intervals should discourage further debate about the "correct" percentile or range, and encourage interested parties to more productively focus their attention on how proportionate contextual profitability analysis should be undertaken.

III. Other matters that the Draft Decision could helpfully address

25. Our positive reaction to the framework introduced by the Emerging Views paper is tempered by our concern, raised in the previous section, of the risk that, in an effort to reduce focus on the 75th percentile, interested parties will inappropriately shift focus to the mid-point as a new bright line benchmark for returns assessment. This would clearly be contrary to Professor Yarrow's view that broader contextual analysis is required and also that conflating the WACC estimate and acceptable rate of return is not appropriate.

26. In our view, above and beyond Professor Yarrow's advice to the Commission, emphasising the mid-point as a clear benchmark with evidential value would be inappropriate because:

    (a) there is inherent uncertainty associated with estimating the unobservable, "true" WACC. To this end, the High Court noted that estimating WACC is "a complex task involving significant exercising of judgement and is open not only to the possibility of error, but also to there being a range of views";[35]

    (b) a headline figure would introduce an undue sense of precision and create an expectation that airports are to conform to a single, "correct" view of acceptable performance; and

    (c) as Sapere notes in the enclosed WACC v ROR Report (reviewing Professor Yarrow's advice):[36]

> Estimates of cost of capital are relevant for the first distinct exercise (disclosing), as the cost of capital is an estimate of an input cost... [T]he legislation does not force a link between the cost of capital and the regulatory assessment of what might be excessive.

27. Although we note that the Commission's views are only emerging at this stage of the process, parts of the Emerging Views Paper can be read as expressing the view that unless adequate justification is provided, all returns over the mid-point will be presumed excessive.[37] In our view, such an approach would be inconsistent with the Yarrow Report, which makes it clear that the Commission should not express judgement on what WACC equates to a normal return (at least in part because of the clear theoretical distinction between the two concepts).

28. We therefore ask the Commission to reconsider whether it should be so firm in stating that:[38]

> The importance of the mid-point as the starting point for assessing airport returns has been confirmed by the High Court and airports should be required to provide justification for any divergence from that mid-point.

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[35] IM Judgment, at [1490].

[36] Sapere Research Group, *The distinction between the "allowed rate of return" and the "cost of capital"*, 16 March 2016, at section 2.2.1, 2.2.2.

[37] We note that investment analysts have interpreted the Commission's Emerging Views in this way, with them cautioning against the potential for regulatory earnings to fall materially through the next pricing period if the WACC percentile is set at the 50th (See for example, Forsyth Barr, *Auckland Airport - 1H16 Result: ComCom Spoiling Party*, 21 February 2016).

[38] Emerging Views Paper, at paragraph 28.2.

29. The following sections address matters that we believe require much less emphasis to be placed on the mid-point as a touchstone for justification. Together, they reinforce Professor Yarrow's advice that the WACC estimate should not occupy a privileged position.

Distinction between rate of return and WACC

30. As noted above, to us, an important aspect of the Yarrow Report that should be material to the Commission's future profitability assessments is the advice that there should be a clear distinction between WACC and an acceptable rate of return, and that rates of return would be expected to be higher than WACC.[39] The Commission also acknowledges that the distinction between WACC and an acceptable rate of return is particularly relevant, albeit it is not clear to us that it has fully incorporated the implications of Professor Yarrow's advice.[40]

31. As discussed in the attached Sapere WACC v ROR Report, in support of Professor Yarrow's articulation of the significance of this conceptual distinction in assessing airport rates of return:

(a) the problem identified by Professor Yarrow is that if the conceptual distinction between WACC and an acceptable return is blurred, then regulators risk inappropriately seeking to constrain returns to its estimate of WACC, which also leads to efforts to adjust the WACC rather the focussing on assessing whether a return is in fact excessive. That is, too much emphasis is placed on numbers, and not enough emphasis is placed on contextual assessment.[41]

(b) one adverse (and unintended result) is that investment decisions are distorted. For example, there could be a bias against risky and more innovative projects.[42]

(c) the solution is to clearly distinguish between acceptable returns and WACC, and the separate exercises of disclosing and assessing. In this context, it is not necessary to publish a point estimate of WACC.[43]

(d) a key rationale for distinguishing acceptable returns and WACC is that acceptable returns will generally exceed WACC. In addition to avoiding adverse incentives caused by and other costs of regulation, there are many reason why acceptable target returns will be higher than WACC and, as Sapere advises:[44]

> [E]ven if it was possible to design, implement and administer an information disclosure regime for airports that imposed no economic costs on the nation as a whole, it is still reasonable to expect that each airport will anticipate that they will derive a rate of return from each of their investments that will exceed the WACC for those investments.

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[39] Yarrow Report, at p.11.
[40] Emerging Views Paper, at paragraph 9.
[41] Yarrow Report, at p. 6.
[42] Yarrow Report, at p. 7.
[43] Yarrow Report, at pp. 8-9.
[44] Sapere Research Group, *The distinction between the "allowed rate of return" and the "cost of capital"*, 16 March 2016, at section 3.2.

(e) the Commission's emerging views appear to diverge from Professor Yarrow's advice in several important regards for reasons that are not explained. In particular, its language appears to conflate the relevant tasks. In particular, the starting point for assessment should not be the mid-point, but "an assessment of whether an airport's forecast or actual rate of return is efficient and reasonable, informed by the relevant circumstances". Again, an efficient return can typically be expected to be higher than WACC.[45]

32. NZ Airports asks the Commission to further consider the implications of this key conceptual distinction when developing its framework for assessing airport returns (on both *ex ante* and *ex post* bases) under ID regulation.

Potential asymmetric impacts on consumers remains relevant

33. The Commission has decided in the energy context that using the mid-point to set prices is not the best way to meet the purpose of Part 4, due to its (and Oxera's) analysis of asymmetric social costs.

34. The Commission's emerging view is that the rationale for using a percentile above the mid-point appears weaker for airports than for electricity and gas businesses, and therefore it appears to take greater comfort that the mid-point provides a solid starting point for profitability assessment. The Commission asserts that the potential asymmetric impacts on consumers from underinvestment are likely to be weaker for airports because they:[46]

(a) are subject to ID only, which means that the regulated WACC is only likely to have an indirect effect on investment decisions;

(b) are subject to a dual-till structure (whereby they can earn significant amounts of revenue from unregulated complementary activities); and

(c) have regular consultations with a small number of engaged customers.

35. We disagree with these assertions, for the reasons set out below, and as explained in the Asymmetric Impacts Report from Sapere. Indeed, Sapere has provided a preliminary analysis that indicates the potential asymmetric costs on consumers of airport services from underinvestment are likely to be higher than for electricity and gas businesses. We also refer to the expert report (prepared by Dr Harry Bush and Mr Earwaker) previously submitted by NZ Airports, which advised that costs from underinvestment will be extensive.[47]

36. Further, we disagree with the suggestion in the Emerging Views Paper that each airport will need to justify the existence of asymmetric social costs if they choose to target returns higher than the mid-point.[48] As we discuss below, the existence of asymmetric social costs

[45] Yarrow Report, at p.16.
[46] Emerging Views Paper, at paragraph 16.
[47] Dr Harry Bush and John Earwaker, *Evidence relating to the assessment of the WACC percentile for airports,* August 2015, at p.20.
[48] Emerging Views Paper, at paragraph 24.

means the mid-point of the WACC IM should not be emphasised as a proxy for normal returns.

Asymmetric social consequences are relevant under ID

37. We agree with the Commission and Professor Yarrow that it is unhelpful to establish a specific "optimal" percentile under airport ID regulation (and we do not seek such an outcome). The optimal percentile approach is only necessary for setting regulated prices. We also agree that under ID regulation the WACC IM can properly only have an indirect effect on pricing and investment decisions. It will nevertheless have an effect. As noted by Professor Yarrow:[49]

> ...investment incentives are clearly related to estimates of the cost of capital in an information disclosure regime both because of their direct effects (they carry implications about the Commission's view of things in the immediate pricing period) and longer-term, indirect effects (they convey signals about the general regulatory approach which may have implications for future decisions, e.g. how the Commission might react to subsequent out-turns).

38. Further, we acknowledge the advice of Professor Yarrow that adjusting WACC or choosing different percentiles risks creating confusion about the nature of the exercise and/or an undue focus on narrowly technical matters at the expense of wider and more relevant economic factors. That said, Professor Yarrow acknowledges that uncertainties in estimating WACC remain relevant to the broader assessment exercise.[50]

39. We encourage the Commission to recognise (as it did for the energy sector) that the impact of asymmetric social costs under ID remains relevant under the Emerging Views framework. The prospects for, and costs of, underinvestment are a real risk if, in practice, the Commission's assessment of normal returns focuses on the mid-point.

40. In our view:

    (a) At this stage, absent clarity to the contrary, it appears that - contrary to Professor Yarrow's advice - the Commission's mid-point estimate will be used as some type of benchmark or proxy for acceptable returns (the Commission's Emerging Views position appears to be that all departures from the mid-point will need to be justified).

    (b) When further reflecting on whether the mid-point should occupy such a privileged position, we believe the Commission should factor in the uncertainty in its WACC estimate and the potential asymmetric cost impacts on consumers.

    (c) To be clear, we see asymmetric costs as a factor that can be applied in a qualitative fashion as part of the Commission's broader contextual analysis (we are not suggesting consideration of asymmetric costs to establish an optimal percentile). Indeed, seeking to quantify a percentile uplift as for the energy

[49] Yarrow Report, at p.9.
[50] Yarrow Report, at p. 4.

sector would risk the distractions and confusion referred to by Professor Yarrow above.

(d) Instead, under a proportionate contextual analysis of airport profitability, one important factor (among others) that will need to be factored into the analysis is that focussing on the mid-point is not in the long term interests of consumers. As Professor Yarrow notes a great deal of caution needs to be exercised when using a WACC estimate as a proxy for normal returns.[51]

(e) Accordingly, it is too blunt to adopt a position that airports must justify all departures from the mid-point. A critical part of the analysis must be that there is a good chance (statistically) that airport returns above the mid-point do not need to be justified as "excessive". Or put another way, there is a risk that returns above the mid-point will be falsely diagnosed as excessive. We refer to the Yarrow Report in this respect, which explains the risks if the regulator is tightly focussed on "enforcing" any particular WACC value.

(f) The better approach would be to implement Professor Yarrow's advice, and de-emphasise the prominence of the mid-point in assessing profitability, while at the same time recognising the impact of asymmetric social costs of underinvestment is a good reason for returns being above the mid-point.

41. In summary, under ID only regulation, it remains important for the Commission to ensure that the way it uses the WACC IM to assess profitability under a proportionate contextual analysis does not cause an underinvestment problem that undermines the long term interests of consumers. The existence of asymmetric social costs from underinvestment should be confirmed by the Commission (during this IM Review process) as being relevant to airport ID, and should not be presumed to be lower than for energy sectors. The existence of asymmetric social costs also reinforces Professor Yarrow's advice that there should be less focus on comparing returns to the (mid-point) WACC IM.

<u>Dual till does not support a focus on the mid-point</u>

42. The Commission is aware of NZ Airports' view that the dual till is not a relevant consideration and that the assumed impact of this structure (in both the Problem Definition and Emerging Views Papers) is unduly simplistic from an economic perspective.[52] Indeed, NZ Airports commissioned international experts (including a former airport regulator) to provide their views on the potential relevance of the dual till to the profitability of the airports' regulated business. To date, the Commission has not responded in any substantive way to that evidence. Nevertheless, the Commission states it continues to believe it could be significant but notes no specific evidence to the contrary.

43. In the Emerging Views Paper, the Commission's proposition appears to be that when assessing profitability, despite the inherent uncertainty in estimating a normal return, it can nevertheless have more confidence in assessing returns above the mid-point as

[51] Yarrow Report, at p.20.
[52] NZ Airports, *Submission on Commerce Commission's Input Methodologies Review: Invitation to Contribute to Problem Definition*, 21 August 2015, at pp.39-42.

"excessive" because the dual till will provide incentives to invest even if that assessment is wrong. NZ Airports believes that this position contradicts the evidence it has provided. If the Commission intends to rely on the assumption that the dual till makes it more appropriate to use the mid-point in profitability assessments, then we ask that it provides evidence to substantiate that position.

44. The Commission does refer to the Yarrow Report, which considers the importance of complimentary revenue streams. However, the key advice in the Yarrow Report is that: [53]

> These points serve to emphasise the dependency of economic effects on the specifics of the relevant factual context. General propositions about effects of lower prices, in the sense of propositions that are not sensitive to context, are hard to come by.

45. NZ Airports agrees with the Yarrow Report's observation that determining or analysing the impact of the dual till structure on incentives to invest in regulated infrastructure, and therefore the impact on consumers, is complex and is but one part of a careful contextual analysis.[54]

<u>Regular consultations with small number of customers</u>

46. The Commission's proposition in the Emerging Views Paper appears to be that airlines can be relied on to encourage airports to invest, even if airports face a higher risk of their returns on investment being wrongly diagnosed as "excessive" when compared to the mid-point WACC estimate.

47. It is true that airlines make a valuable contribution to investment planning during pricing and capex consultations. However, it does not follow that regular consultation displaces the need for the Commission to exercise caution (as advised by Professor Yarrow) if it uses its WACC estimate to assess returns under a full contextual analysis.

48. Dynamics under consultation are complex. NZ Airports has previously submitted expert evidence from Dr Bush and Mr Earwaker (which has yet to be responded to by the Commission), highlighting:[55]

   (a) airlines cannot be relied on to support investment, even when that delivers superior service quality;

   (b) the potential for divergences between airline and passenger interests, which can lead to sub-optimal outcomes for passengers; and

   (c) related to the above, a preference by airlines for certain types of investment (eg those that go to operational efficiency) over others that go to passenger, comfort, ambience etc.

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[53] Yarrow Report, at p.17.
[54] Yarrow Report, at p.17.
[55] For example, see Dr Harry Bush and John Earwaker, *Evidence relating to the assessment of the WACC percentile for airports,* August 2015, pp. 30-35.

49. NZ Airports submits that it would be appropriate to consider specific circumstances when undertaking a full contextual analysis of profitability (for example, is there evidence that airports have exercised market power?). However, it is not possible to draw any generalised conclusions, in advance, that consultation dynamics make it more appropriate to use the mid-point to assess profitability. As with dual till considerations, we ask that the Commission provides evidence to support its position (in the event it seeks to confirm its views).

50. For completeness, we note that if undue prominence was given to the mid-point in the framework for assessing acceptable returns, there is a risk that this will create false expectations in consultation that a mid-point percentile return is appropriate regardless of the context of the investment, rather than encouraging customers to discuss with the airports the value they place on varying service levels.

IV. The way forward

51. NZ Airports considers that Professor Yarrow's advice is consistent with the approach we have been advocating since the introduction of the Part 4 ID regime. That is, the WACC range is one relevant factor among many that should inform *ex ante* and *ex post* assessments of airport performance. Crucially, WACC should not be conflated with the question of what an acceptable level of return is. In addition to that distinction, actual and forecast returns will further differ from the WACC on a case by case basis for a variety of legitimate reasons.

52. NZ Airports encourages the Commission to fully adopt the approach advised by Professor Yarrow. Important in that respect is avoiding an undue focus on the use of a benchmark figure as being presumptive of acceptable returns, above which airports will need to justify their returns as being not excessive. As noted earlier, the core theme in the Yarrow Report is that excess profits should not be identified and assessed by comparing returns to a WACC estimate. Rather, broader contextual analysis is required. The airports are keen to facilitate and be involved in such assessments.

53. At this stage, we think the Commission and interested parties should focus on establishing common ground on some key principles for contextual profitability assessment. If appropriate principles can be established, further guidance may not be necessary (particularly given the overarching need to take a proportionate approach and to avoid undue prescription for ID regulation).

54. In our view, those key principles should include:

(a) The WACC IM mid-point estimate will not be treated as a bright line benchmark of acceptable airport returns in profitability assessment (both ex ante and ex post) - above which all returns will be presumed to be "excessive" unless they can be justified.

(b) As discussed above (including in the enclosed Sapere WACC v ROR Report) and in the Yarrow Report, there are numerous reasons why the WACC IM is not capable of providing a robust benchmark of acceptable returns, (including):

(i) the conceptual distinction between WACC and rates of return and that, in practice, returns typically differ to (and are higher than) WACC estimates;

(ii) the level of quality, risk and option values inherent in forecasts;

(iii) estimation error in the WACC model;

(iv) estimation error in the WACC model parameter;

(v) truncation in the distribution of returns; and

(vi) the asymmetric social costs of underinvestment arising from a failure to recognise factors such as the above.

(c) Instead, a contextual analysis taking account of a full range of airport specific and market factors, as well as reference to the Part 4 Purpose, will be undertaken. Without that analysis, it would be arbitrary to reach a judgement that returns higher than the WACC are excessive.

(d) As part of such analysis, it is most important to understand the rationale and reasons for airport conduct.

(e) It is also important to consider impacts of performance on all types of consumers.

(f) Airports should focus on providing an account of the "relevant causal factors or reasons" for their target and actual returns, which could be airport specific (eg cost of debt).

(g) These factors are likely to be different depending on whether the assessment is taking place on an ex-ante or ex-post basis. As Professor Yarrow observes, great caution is required for ex ante assessment, where forecasts are necessarily relied upon.[56]

(h) Any potential finding of the exercise of market power would need to be justified by evidence beyond a numerical comparison of returns to WACC.

Questions for stakeholders

55. The Commission has asked the following specific questions to inform further analysis:

> *What are the specific factors that should (or should not) allow an airport to target returns that diverge from the mid-point* WACC *estimate? These factors should be differentiated between:*
>
> *a)* Factors that result in airports estimating a different mid-point WACC from that estimated using the WACC methodology specified in the IMs.
>
> b) Factors *that result in an airport targeting returns above (or below) their mid-point WACC estimate.*

56. As discussed above and consistent with the attached Sapere WACC v ROR Report, there could be various reasons why target returns are lower or higher than the Commission's WACC mid-point estimate. We accept that it is appropriate for airports to explain why they consider their targeted returns to be acceptable in the relevant circumstances, to assist with a proportionate contextual analysis applying the principles set out above.

57. However, as discussed above, it needs to be recognised that the mid-point is an inevitably flawed proxy for returns that are consistent with the purpose of Part 4. Accordingly, for the reasons set out in this submission, we encourage the Commission to confirm that there will not be a presumption that returns above the mid-point are excessive.

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[56] Yarrow Report, pp.5 -6.

58. Airports may use a different WACC in pricing due to specific airport circumstance which affect matters such as asset beta and cost of debt. In addition, airports might, as Professor Yarrow suggests, assess some projects to be riskier than others and accord projects a differing WACC.[57] That said, we are not sure why the Commission has sought to focus discussion on why a pricing WACC may be different than the WACC IM and/or why airports may use higher than their mid-point pricing WACC estimate. Consistent with the principles above (and Professor Yarrow's advice), airports should explain the rationale for their choice of WACC, but the fact that it may be different to the WACC IM is unlikely to be evidence of AEEMP in itself. The Commission has previously been clear that airports are not required to apply its IMs in pricing, and that a combination of alternative methodologies can promote the Part 4 purpose. We think that is the right approach.

59. We note that whatever WACC is used by the airports as an input into pricing, there are a multitude of other decisions on pricing inputs that will impact on the target return for the pricing period. In our view, it is the full contextual assessment of target returns that is most important - not the pricing WACC itself.

60. The Commission has also asked for views on the relevance of asymmetric social costs under the framework proposed in the Emerging Views Paper. Our views are provided in paragraph 37 to 41 above but, in summary, our response to that question is that the Commission ought to recognise the impact of asymmetric social costs, as a framework matter, under ID regulation (which, as Sapere's advice indicates, are higher than for energy). That recognition should be confirmed by the Commission (during this IM Review process) as being relevant to airport ID. It should not be left to a case-by-case assessment when airports set prices.

[57] Yarrow Report, pp 6-7.