

16 March 2016

Keston Ruxton
Manager, IM Review
Regulation Branch
Commerce Commission
Wellington

Dear Keston

IM Review – Professor Yarrow report and emerging views on the airport WACC percentile

Christchurch International Airport Limited (CIAL) is pleased to comment on the expert advice of Professor Yarrow (Yarrow Report) recently published by the Commerce Commission (Commission), and the Commission's emerging views on the airport WACC percentile. Thank you for the opportunity to do so.

CIAL endorses the submission made by NZ Airports, including:

- The Yarrow Report and the Commission's emerging views provide a sound platform for considering how the WACC IM should be used in information disclosure regulation;
- The central insight is that excess profits cannot be identified by simply comparing returns (forecast or actual) to a WACC estimate. Professor Yarrow advised the Commission that it "cannot be over-emphasised" that a comparison of returns with estimated cost of capital, taken out of context, cannot be the basis for a judgment that there will be or have been excess returns. A broader, contextual analysis is required;
- In making this change, the key risk is that in practice the current de facto price control simply moves to the Commission's mid-point estimate of the cost of capital. It will be important that the Commission avoid this scenario by publishing clear statements that any divergence between returns and cost of capital estimates does not indicate a presumption of excess returns, acknowledging a role for assessing the asymmetric risk of forecast error when estimating the cost of capital, and by taking care with any public guidance as to the factors relevant in assessing the performance of airports.

We wish to emphasise in particular that a change will be required from the Commission to give more emphasis to actual returns.

Professor Yarrow emphasised the importance of analysing both forecast and actual returns. Both are needed if the Commission is to give to consumers and other stakeholders a complete analysis of airport returns in context.

The Commission's approach to date of equating the airport's target WACC with intended airport returns is contrary to Professor Yarrow's advice. The focus on target WACC has also been a key contributor to the way in which the information disclosure regime has operated in practice as price control.

We know that in our business, target WACC is only one indicator of our expected returns. Other relevant factors include our uncertainty over our cost and demand forecasts, which can vary depending on the forecast and the market context at the time. Also relevant to our expected returns are any incentive arrangements we negotiate with our airline customers. These are often negotiated after prices are set, and so influence expected returns at the time of price setting in a material but uncertain way.

For these reasons, an airport's track record of actual returns is also a powerful indicator of expected returns going forward. By excluding actual returns from an assessment of airport performance there is the real possibility that consumers are presented with a picture that may at best be only half the story. We urge the Commission to follow the lead of Professor Yarrow and place weight on both forecast and actual returns when reporting to consumers on airport performance.

We would be happy to discuss any aspect of this submission with you, and we look forward to working with the Commission on the implementation of this new approach.

Kind regards

Yours sincerely



Michael Singleton

GENERAL MANAGER LEGAL AND CORPORATE AFFAIRS

DDI: (+64 3) 353 7046

Email: michael.singleton@cial.co.nz