TDB ADVISORY

NZ Commerce Commission: Part 4 Input Methodologies Review 2023 – Cross Submission

A report prepared for the Board of Airline Representatives New Zealand Inc.

August 9, 2023

www.tdb.co.nz

TDB Advisory Limited
L5, Wakefield House
90 The Terrace
P.O. Box 93
Wellington
New Zealand

Email: [redacted]

Contacts for this report:

Phil Barry

Maitland MacFarlan

Disclaimer

This report has been prepared by TDB Advisory Ltd (TDB) with care and diligence. The statements and opinions given by TDB in this report are given in good faith and in the belief on reasonable grounds that such statements and opinions are correct and not misleading. However, no responsibility is accepted by TDB or any of its officers, employees, subcontractors or agents for errors or omissions arising out of the preparation of this report, or for any consequences of reliance on its content or for discussions arising out of or associated with its preparation.

1 Introduction and summary

TDB Advisory Ltd (TDB) welcomes the opportunity to comment on the submissions to the Commerce Commission on its Draft Decisions Paper on the 2023 Input Methodologies (IM) review.

Our general observation is that, despite the voluminous comments by NZAA, CEG, and others on the proposed comparator sample, the COVID-19 uplift and associated regulatory changes, these submissions have little or nothing to say on the overall results of the draft decision. As indicated in our earlier submission on this draft decision, we consider the Commission's updated parameter estimates for the WACC to be largely consistent with the current evidence available. Indeed, the reasonableness checks that the Commission applies to the proposed WACC indicate that, if anything, the WACC is still somewhat overestimated.

In our comments below, we focus on some of the main points addressed in the cross submissions, especially those from the airports and their advisers. We note in particular that:

- The Commission is well-justified in limiting its sample of comparator airports to those based in developed countries. By a range of economic and governance indicators, the operating environment in these countries not only comes closest to that facing regulated airports in New Zealand, but it also differs markedly from the circumstances facing airports in less developed countries.

- We disagree with the direct comparison that CEG draws between the asset betas for Auckland Airport and Heathrow as an indicator of the relative riskiness of these two airports. The asset beta is not a measure of absolute risk but of systematic risk relative to the overall capital market these entities operate in. We would argue that the capital markets within which Auckland and Heathrow operate are quite different.

- We also suggest that it is not as clear-cut as CEG and others imply, that Heathrow faces lower inherent systematic risks than Auckland. Auckland has no competitor airports nearby, whereas Heathrow does.

- We question CEG's assertion that the long-run asset beta for the comparator sample should track that of Auckland Airport. This point might have some validity if Auckland's operations already emulated those that might arise in a competitive environment, but we doubt this is the case. Instead, Auckland's generally strong share market performance, its high RAB multiples, and other indicators suggest that Auckland has fared relatively well as a lightly regulated entity.

- We disagree with the concerns expressed by CEG and others surrounding regulator certainty, including how the Commission will approach future IM reviews. Predictability and consistency in the regulatory framework are certainly important, but these attributes need to be tempered by the Commission's judgement in taking into account and adapting to changing circumstances. Otherwise, blind adherence to a mechanistic approach to estimating betas and other WACC parameters would likely lead to estimates that are increasingly at odds with the realities surrounding each review.

- As we stated in our comments on the Commission's Draft Decision Paper, we fully support the Commission's approach to the 2023 IM review – retaining the methodologies from previous IM reviews where they remain appropriate; updating and refining its methodologies where necessary; and adopting an innovative approach to addressing the

extraordinary circumstances that arose during part of the latest review period, notably through the COVID-19 pandemic. We have every confidence that the Commission will continue to use this balance of consistency, pragmatism and judgement in future reviews.

- We note that the Flint/TDB approach to estimating the potential systematic effect of COVID-19 on the asset beta receives support from Dr. Lally. The estimated uplift under the Flint/TDB methodology is consistent with that proposed by the Commission.

- We also note and agree with IATA's argument for not removing the 0.05 downward adjustment in the estimated asset beta based on the lower volatility of aircraft movements relative to passenger numbers and spend.

2 Discussion

2.1 The comparator sample

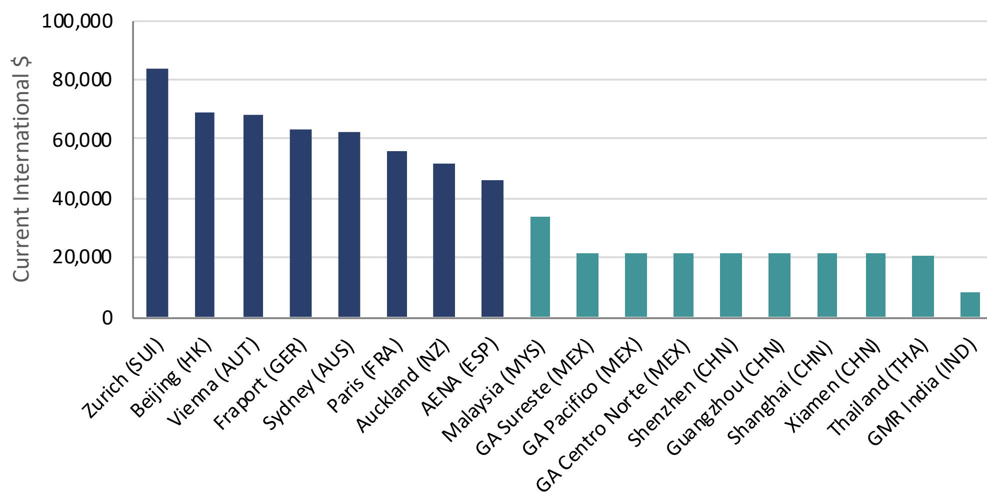
1. The submissions from the airports and their advisers criticise at significant length the Commission's proposed comparator sample set. TDB believes the Commission is well-justified in its proposed selection, which retains eight comparators from its previous sample and excludes the rest.

2. We note first that the Commission's use of a liquidity filter to exclude several airport operators is generally accepted, including by CEG and Incenta. We also agree with this filter, and in the analysis and charts below we exclude the four airport operators that the Commission cites as being of concern on this front.

3. The main reason the Commission uses to include or exclude the remaining comparators is whether they operate in markets that are substantially similar to or different from New Zealand. We fully support the Commission's use of a market comparability filter. Use of such a filter is both standard practice and best practice. As we discuss below, market comparability extends beyond just economic and financial measures, also affecting governance and other dimensions of activity that can affect how airports and other entities function in the markets concerned.

4. In that regard, we support the Commission's decision to limit the comparator sample to entities based in developed countries. Its use of the FTSE Equity Country Classification is fully appropriate for this purpose: this classification is soundly and transparently constructed, readily available, regularly updated and widely used by international investors and others. As a simple illustration of the differences involved, there is a significant gap between GDP per capita in the developed countries whose airport operators the Commission retains, and the less developed countries whose operators are excluded (Figure 1).

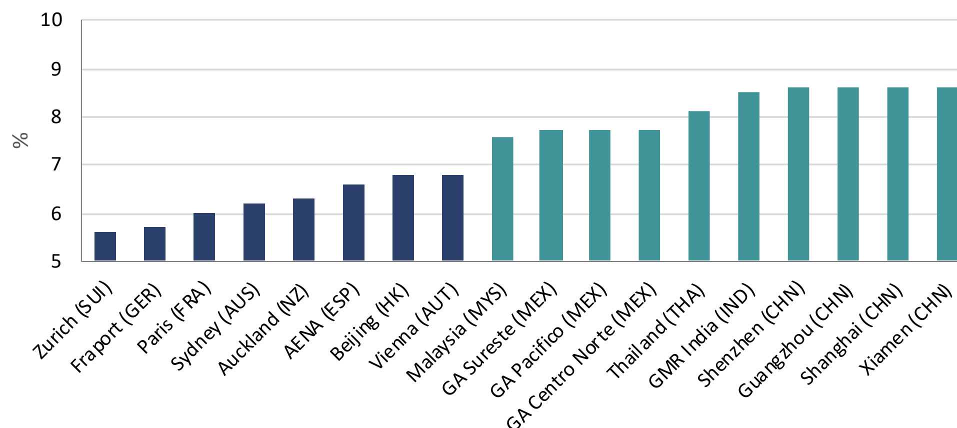
Figure 1: GDP per capita of comparators, 2022, current international $



Source: World Bank.

5. The Commission refers also to the market risk premium (MRP) of the countries concerned, noting the high correlation between this measure and the FTSE classification. This is illustrated below (Figure 2). What is striking is not only the consistently lower MRPs for the eight developed countries that are bases for the operators the Commission retains, but also the significant gap between these MRPs and even the "best" across countries with the excluded entities (i.e., the jump from Austria to Malaysia.) There is no indication of a steady gradient in these measures or of a smooth spectrum of results where marginal calls may come into play.

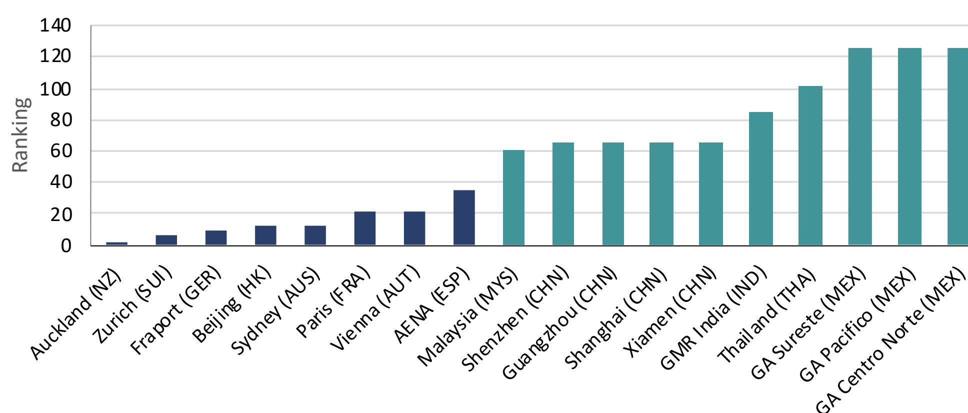
Figure 2: Market risk premium of comparators, 2023, %



Source: Fernandez 2023.

6. This pattern is also apparent in other measures. Going beyond economic and financial indicators, the figure below illustrates the corruption perceptions country rankings from Transparency International (Figure 3). Countries with the eight included operators stand out as a distinct group, with international rankings ranging from 2 (New Zealand) to 35 (Spain). Again, there is a significant gap to the "best of the rest" – Malaysia, with a ranking of 61 – with rankings for the remaining countries extending up to 126 (Mexico).

Figure 3: Corruption perceptions ranking of comparators, 2022



Source: Transparency International.

7. The Commission's use of "unreliable beta estimates" to exclude certain operators has been questioned by Incenta, CEG and others. While we accept that some variability may be expected across daily, weekly and monthly estimates of beta, we also think the Commission is on solid ground in questioning cases of unusual variability and using its judgement to exclude some operators as a result. We also note that of the 11 entities excluded under this criterion, the Commission cites only two (Malta and Malaysia) as not also excluded under at least one other filter and Malta itself has data limitations under the market comparability filter.

8. The Commission's use of unusual financing structures, notably negative gearing, as a reason for excluding some potential comparators has also been criticised by Incenta and CEG. Again, we think it reasonable for the Commission to question how and why such financing structures arise. We suggest that such outcomes might represent something more than the relatively benign circumstances cited by the airports' advisors. We note too that of the 4 firms excluded under this criterion, all are also excluded under at least one – and in 3 of the 4 cases more than one – of the other filters.

2.2 Asset beta estimates

9. Much attention is given in the CEG report, and echoed in airports' submissions, as to how Auckland Airport's asset beta compares with the betas of other airports, notably Heathrow. CEG argues, for example, that it is implausible for Heathrow to have an (unadjusted) asset beta that is only a few points lower than the benchmark the Commission arrives at for NZ airports. CEG also suggests that, after adjustment, the UKCAA and NZCC decisions would imply that "Heathrow is 12% riskier than NZ airports..." (CEG para. 24).

10. We argue that such comparisons are misleading and meaningless. The asset (and equity) betas are not absolute measures. They measure risk relative to the associated market as a whole. For example, an equity beta of 0.5 (or any other value) relative to the UK stock market – which is vastly bigger, more diversified and different in other ways – compared with the NZ stock market will almost certainly imply a quite different level of absolute underlying risk compared with the same beta within the NZ context.

11. That said, we suggest that it is not as clearcut as CEG and others appear to argue that Heathrow should have less underlying risk than Auckland Airport. We acknowledge that Heathrow faces capacity constraints and operates as an important hub airport in a major metropolitical area. But Heathrow also faces competition from other airports around the London area, in southern England, and indeed in the western parts of Europe. That stands in sharp contrast to the situation facing Auckland Airport, as well as Wellington and Christchurch Airports. For example, the straight-line distance from London to Paris is about two-thirds of that between Auckland and Wellington and about half of that between Auckland and Christchurch. Such distances, coupled with the more limited services available at these alternative NZ airports, tend to reinforce Auckland's monopoly position and reduce its inherent riskiness.

12. We also question the merits and force of CEG's assertion that "(t)he most accurate sample has a long run average asset beta close to AIAL's long run average." (CEG p. 35). The purpose of the IMs is to simulate the opportunities and constraints that AIAL (and other regulated entities) would face in a workably competitive environment. These conditions are all the more important because, as argued above, Auckland Airport probably faces less inherent competition in its routine operations than most, and possibly all, of the overseas comparators.

13. If regulation were "perfect," in the sense that Auckland Airport's investment, pricing and other behaviours were perfectly aligned with those in a competitive setting, there may be a case for saying that AIAL's asset beta would also be better aligned with what would prevail under such competition. But, in addition to the fact that many other things besides the extent of competition are likely to influence the beta (such as the characteristics of local capital markets and, we would argue, the mix of aeronautical and non-aeronautical activities), the regulatory framework is unlikely to be perfect from the get-go: rather, it will evolve and hopefully improve over time. First-hand evidence of this comes from the reasonableness checks applied by the Commission, especially the RAB multiples: under previous regulatory settings, AIAL appears to have earned returns that more than adequately compensate investors for the risks they face. Furthermore, as we have indicated in earlier submissions, AIAL's beta is well above what one would expect from a provider of underlying economic infrastructure. The revisions proposed by the Commission in its draft decisions may induce AIAL to adjust its behaviours more towards those that might prevail in a more competitive environment and its beta may eventually reflect this. But AIAL still seems a considerable distance away from this point.

2.3 Future IM reviews

14. CEG raises the spectre of a "regulatory quagmire" arising from the approach the Commission proposes in its draft decision to estimate the asset beta. CEG questions, for example, how the Commission will approach the next IM review in 2030 and whether the proposed uplift to beta for the systematic effects of Covid will be applied forever.

15. We suggest that CEG is 'tilting at windmills' with these arguments and questions. These concerns appear to stem from their belief that the Commission should have stayed through thick and thin with a mechanistic approach to estimating beta, regardless of the broader circumstances and the associated market realities.

16. The estimation of beta and other WACC parameters is inherently a forward-looking exercise. As such, the Commission's judgement should always have greater weight than blind adherence to a mechanistic approach. At times, especially in more stable circumstances, the past may be the most reasonable guide to the future. That was the approach taken in the 2016 review. But, as we and others have argued extensively, this approach is not reasonable in the current review in light of the extraordinary impact of the COVID-19 pandemic, including on backward-looking asset beta estimates.

17. Instead, the Commission is fully justified in supplementing relevant data from the past with its estimates and judgement as to what the systematic impact of COVID-19 might be going forward. Doing less than that, or different from that, would not be doing justice to the role of the Commission's judgement in assessing the most appropriate beta estimate for the period ahead.

18. From the same perspective, we don't share the concerns of CEG and others surrounding the IM reviews in 2030 and beyond. By 2030, the Commission will have around eight more years of post-COVID-19 data to incorporate as appropriate in its determination of beta and other parameters for the subsequent period. These data should reflect any residual, systematic effects of COVID-19 and other intervening shocks. We agree that the previous approach of using two rolling five-year averages may still not be fully appropriate at that point (as COVID-19 would still be affecting the earlier data). But the more recent data, along with the Commission's judgement, is still likely to produce a more reasonable and valid beta estimate than a purely mechanistic approach.

2.4 The COVID-19 uplift

19. Dr. Lally in his submission points out a potential problem with the Commission's approach of weighting the COVID-19 and non-COVID-19 betas to arrive at an overall estimate. He notes though that the Flint/TDB approach of weighting returns rather than betas gets around this problem. The Commission acknowledges, however, that its approach is just an approximation and its results are consistent with those found by TDB using the Flint methodology. Hence, we think that the final result and the uplift proposed by the Commerce Commission remain valid. We also note that these results are consistent with those cited by IATA in its work with LHR.

2.5 The 0.05 adjustment in beta

20. We note that IATA supports arguments we have made for not removing the 0.05 downward adjustment in the asset beta. IATA observes that there is less variability in aircraft movements than in passenger numbers, so aeronautical revenues are less volatile than non-aeronautical. We agree with these points and suggest that the 0.05 adjustment should remain.