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WELLINGTON INTERNATIONAL AIRPORT LIMITED – CROSS-SUBMISSION ON 2023 INPUT METHODOLOGIES REVIEW DRAFT DECISIONS

Introduction

1 This is Wellington International Airport Limited's (WIAL's) cross-submission on the Commerce Commission's (Commission's) draft decisions in the 2023 Input Methodologies Review. We enclose an expert report prepared by HoustonKemp. No part of this cross-submission or the enclosed report are confidential.

2 We have reviewed and support the NZ Airports Association's cross-submission and the accompanying report prepared by CEG.

3 Please see also the attached appendix which outlines arguments made in airline submissions, and where these have been addressed in airport submissions to date.

4 In our original submission we expressed our concern that the Commission's draft decisions on the WACC IM were unsupported by evidence – either in the Commission's own reasons papers or in the form of expert advice. No substantive new evidence has been provided by airline submitters in support of the Commission's draft decisions.

5 In fact, those submissions illustrate our fundamental concern with the draft decisions: that the Commission has been tempted into a series of unsound subjective judgement calls and, in doing so, has lost sight of the empirical foundation for the asset beta estimate. The airline submissions tend to reinforce this problem by encouraging the Commission to make further subjective judgements, based on assumption and supposition rather than data and statistical rigour.

6 No compelling rationale or evidence has been offered to depart from the long-standing status quo. And as CEG and HoustonKemp have pointed out, the Commission's implementation of its methodology is inconsistent and does not reflect its own reasoning.

7 This is a very concerning to WIAL and our shareholders. The WACC methodology is critical both to investor returns in future periods and to overall confidence in the regulatory framework. Given the centrality of the WACC IM to the regulatory framework, we reasonably expected the Commission would justify any changes with reference to sound theory and a robust evidence base. The Commission has not provided adequate justification for its proposed changes.

8 A theme of the regulatory environment from 2010 onwards has been the Commission's commitment to maintaining the core tenets of its WACC methodology so that the WACC from period to period reflected changes in market conditions rather than methodological choices. In practical terms, this has principally meant that investors have had to accept a low WACC in a persistently low interest rate environment from 2010 to present on the basis that the WACC methodology was 'settled' and the Commission was going to let changes in market data flow transparently through the methodology.

9 Investors had therefore reasonably assumed that increases in systematic risk and a higher interest rate environment would equally be reflected in the WACC as the Commission would show fidelity to its method. Instead, the WACC is materially lower than it would have been under the Commission's usual methodology. If the Commission continues on its present course, investors will have to assume that future returns are subject to regulatory caprice, and this will affect their willingness to invest in New Zealand regulated assets.

Areas of consensus

10 The estimation of the asset beta is a technical area of applied finance, regulatory economics and econometrics. This requires the Commission to weigh up, and give deference to, the substantial body of expert evidence before it.

11 The overwhelming weight of expert advice provided to the Commission does not support the Commission's position. Castalia and TDB endorse the Commission's approach in broad terms, but the reasoning they offer is not persuasive.

12 However, there also appear to be several points of consensus between the various experts. The discrete points of broad consensus include the following:

a) there is no basis for any downward adjustment for alleged differences in risk between aeronautical and non-aeronautical components of an airport business;

b) the COVID-19 pandemic, and possible future pandemics, reflect systemic risks affecting the asset beta of airports;

c) the Commission's method to account for the pandemic is mathematically incorrect;

d) estimating the likelihood of low-probability, high-impact events is inherently uncertain, subjective, speculative and difficult;

e) it is invalid as a matter of finance theory to exclude airports which have 'unusually variable asset beta estimates'; and

f) it is invalid as a matter of finance theory to rely on market risk premium (MRP) to exclude airports on the basis that they are operating in 'substantially different' markets.

13 We briefly elaborate on these points below.

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No basis for downward adjustment

14 In the Draft Decision, the Commission concluded that 'a downward adjustment to the asset beta is not justified',[1] citing the evidence of Dr Tom Hird of CEG,[2] and LJK Consulting,[3] which demonstrated that there is 'no statistical evidence of a positive relationship between asset beta and proportion of revenue that is non-aeronautical (based on the LJK data)'.[4]

15 There is broad expert consensus on this point. This consensus includes CEG,[5] HoustonKemp,[6] LJK Consulting,[7] and Castalia. [8] Notably Castalia, engaged by Air New Zealand, provides that: [9]

> We support the Commission's draft decision to accept the findings by LJK Consulting and CEG that there is no basis for a downward adjustment to asset beta to reflect any potential difference in risk between aeronautical and non-aeronautical services.

16 TDB Advisory, engaged by BARNZ, appear also to endorse the Commission's finding that there is no empirical basis for the downward adjustment. TDB Advisory state that they are 'comfortable a fresh look is being taken at this issue' and contend that 'definitive conclusions can't be drawn' on whether a positive relationship exists between asset beta and the proportion of non-aeronautical revenues.[10]

17 Given the weight of the expert evidence on this issue, and supporting views from airports,[11] the Commission should retain this aspect of its draft decision in its final decision.

Pandemics are a systemic risk and the perception of this risk has increased post-COVID

18 The Commission's draft decision states that 'it is likely that COVID-19 provided new information that had not been included in the market's assessment of the airport asset beta'[12] thereby finding that the pandemic reflects a systemic risk measured by the asset beta.

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1 NZCC Draft Decision at paragraph 4.80.

2 NZCC Draft Decision at paragraph 4.77.

3 NZCC Draft Decision at paragraph 4.76.

4 NZCC Draft Decision at paragraph 4.78.

5 Dr Tom Hird, Competition Economists Group, Asset beta update for the 2023 IMs, August 2022, section 4; Dr Tom Hird, Competition Economists Group, NZCC Comments on Asset Beta Estimates for Airports, dated February 2023 (**CEG February Report**) at section 2 at pages 8 to 22.

6 Houston Kemp submission at page i, stating that 'we agree with the Commission's finding that there is no evidence to support the 0.05 downward asset beta adjustment' (**HoustonKemp Report**).

7 Attachment A to Auckland Airport submission.

8 Castalia submission at page 8 (**Castalia Report**).

9 Castalia Report at page 8.

10 TDB Advisory submission at pages 6-7 (**TDB Advisory Report**).

11 See also NZ Airports Association cross-submission, and Wellington International Airport Limited, *Submission on 2023 Input Methodologies Review Draft Decisions,* July 2023 (**WIAL July Submission**).

12 Paragraph 4.67 of NZCC Draft Decision.

19 There appears to be broad consensus on this point including from CEG,[13] HoustonKemp,[14] and Castalia.[15] Castalia provide that 'a large portion of the risk created by the COVID-19 pandemic, and any possible future pandemics, is clearly systemic,'[16] and Castalia reject the options for the averaging period which exclude the pandemic estimates as 'untenable' and 'problematic' as such options 'ignore' the systemic aspects of the pandemic.[17]

20 Given the weight of the expert evidence on this issue, and supporting views from airports[18] and airlines,[19] the Commission should maintain its uncontroversial finding that the COVID-19 pandemic, and any future pandemics, reflects systemic risks affecting airports.

COVID-19 adjustment is mathematically incorrect

21 The expert material before the Commission which addresses the mathematical application of the COVID-19 adjustment is limited to CEG and the submission of Dr Lally.[20] Both CEG[21] and Dr Lally contend that the Commission has made errors in its implementation of the methodology used by the UK CAA in its Heathrow determination.

22 Dr Lally expressly confines his analysis to the 'mechanics' of the COVID adjustment, and notes that 'the underlying assumptions' implicit in the Commission's calculation may both be false,[22] and correcting for this would result in a COVID specific uplift in asset beta from 0.53 to 0.59.[23] This reflects an increase in the uplift from 0.02 to 0.06, indicating that Dr Lally considers the Commission has understated the uplift by 3x. Dr Lally explains that, given the issues with this approach, the preferable approach is to weight the empirical results to generate a single estimate, which is consistent in methodology to CEG's preferred approach (which implicitly applies a 100% weighting to pre and post-covid estimates to produce a single estimate).[24]

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13 Dr Tom Hird, Competition Economists Group, *Critique of 2023 IM Draft Decision on Asset Beta for NZ Airports,* dated July 2023, (**CEG July Report**) at para 363 and 379.

14 HoustonKemp Report at section 4.1.

15 Castalia Report at page 2 states that:

> We agree that COVID-19, as the first global pandemic event of this scale in the time of mass air travel, likely fundamentally shifted market perceptions of pandemic risks. We also agree that by now markets will have priced in pandemic risk, and this is reflected in the actual betas of listed companies, including airports.

16 Castalia Report at page 2.

17 Castalia Report at page 3.

18 WIAL July Submission at [13]-[14]:

Auckland Airport submission at page 3.

New Zealand Airports Submission at [7].

19 See for example, A4ANZ, *Part 4 Input Methodologies Review 2023 – Draft Decision,* July 2023 at page 2.

20 Submission of Dr Martin Lally, *The impact of future covid scenarios on beta* dated 22 June 2023 (**Dr Lally Submission**).

21 See CEG July Report at [94]-[95].

22 Dr Lally Submission at pages 3-4

23 Dr Lally Submission at pages 3-4

24 Dr Lally Submission at page 5

23 CEG conclude that Dr Lally's contribution is consistent with its preferred approach.

24 Given this expert material, the Commission should:

a) apply an approach which gives consistent and transparent weight to the pre- and post-COVID empirical estimates; and

b) give weight to CEG's proposal which addresses Dr Lally's mathematical concern.

COVID-19 adjustment is fundamentally speculative and uncertain

25 There is consensus that any attempt to predict the frequency and magnitude of future Covid-type events is inherently uncertain, subjective, speculative and complex. This consensus includes CEG,[25] HoustonKemp,[26] Incenta,[27] Castalia,[28] and Dr Lally. This point is made by Dr Lally in the following terms:

> The merits of applying such treatment to selected events are contentious, especially when the probability of a recurrence of the event is so hard to estimate and any such recurrences may be materially more or less severe'.[29]

26 Given this expert material, the Commission should apply CEG's and HoustonKemp's preferred approach of not changing the averaging period. This avoids the subjectivity, speculation and complexity associated with attempting to predict the likelihood and magnitude of similar events and, if applied consistently through time, exactly predicts the actual measured effect on the asset beta of similar low probability-high impact events.

Excluding 'volatile' estimates is invalid

27 The Commission's draft decision proposes to 'remove firms that have unusually variable asset beta estimates'.[30]

28 There is broad consensus that the proposed 'unusually variable estimates' has no theoretical or empirical basis. This consensus includes CEG,[31] Incenta,[32] and Castalia.[33] Castalia provides that 'we

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[25] CEG February Report section 3 and Appendix B; CEG July Report at section 9.

[26] HoustonKemp Report at pages iv, 28.

[27] Incenta Economic Consulting, *Airport Comparator Sample Selection: Christchurch International Airport Limited*, dated July 2023, (**Incenta Report**), para 15 and para 37.

[28] Castalia Report at page 3 (emphasis added):

> Ultimately, **the difficult challenge** for the Commission is to estimate how much of an impact perceived pandemic risk will have going forward—not how much it has had in the past.

[29] Dr Lally Submission at page 1.

[30] NZCC Draft Decision at paragraph 4.43.2.

[31] CEG July Report at section 6.1.2; CEG February Report section 4.2.

[32] Incenta Report at pages 8-9, and 2-3.

See also section 2.4.

[33] Castalia Report at page 5.

are not aware of any theoretical or empirical grounding for improving the accuracy of beta estimation by excluding potential comparator firms from a sample based purely on measures of beta volatility'.[34]

29 Given this expert material, the Commission should not apply its proposed 'unusually variable estimates' filter in its final decision.

Excluding airports operating in countries based on MRP is invalid

30 The Commission draft decision states that it has used market risk premium as one of two indicators to remove airports operating in markets that are 'substantively different' to New Zealand. The Commission says it 'consider[s] the market risk premium is useful as an indicator of countries that may have a materially different risk profile, and therefore trading environment, to New Zealand'.[35]

31 There is broad consensus in the expert evidence that MRP is an invalid indicator for this purpose. This consensus includes CEG,[36] Incenta,[37] and Castalia.[38] Castalia advises:[39]

> 'CEG correctly notes that the systemic risk of emerging markets is accounted for in the market risk premium of the relevant market, and does not therefore feed into the beta. We therefore agree with CEG that, in isolation, higher market risk premiums seen in emerging markets should have no bearing on the Commission's decision of whether to retain a firm from the sample.''

32 Given this consensus amongst the experts, the Commission should not rely on MRP as a basis to exclude airports operating in 'substantively different' markets.

Comparator sample

33 It is important that the Commission keeps sight of the purpose of setting the equity beta for New Zealand airports in the IMs.

34 The equity beta component of the WACC compensates equity investors for the systematic risks of investing in businesses providing regulated services. It estimates the extent to which the company's returns fluctuate *relative to* the equity returns in the stock market as a whole.[40]

35 Thus, the purpose of estimating the benchmark airport beta is to compensate airport equity investors systematic or 'non-diversifiable' risks associated with the investment. If the Commission's estimate of the equity beta is too low, equity investors will not be sufficiently compensated for the systemic risks of the investment and will invest elsewhere with adverse effects on incentives to innovate and invest. On

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[34] Castalia Report at page 5.

[35] NZCC Draft Decision at paragraph 4.43.

[36] CEG July Report at section 6.1.1; CEG February Report section 4.3.

[37] Incenta Report at page 3, see also at paragraph 13(b), and paragraph 31-34::

> "*Secondly, with respect to the MRP filter that the Commission applies, we agree with CEG that there is no valid reason why markets with higher MRPs should be excluded.*

[38] Castalia Report at pages 5-6.

[39] Castalia Report at pages 5-6.

[40] New Zealand Commerce Commission, *Input methodologies review decisions*, Topic paper 4: Cost of capital issues, 20 December 2016, para 48.

the other hand, if equity beta is set too high, equity investors will be over-compensated for the systemic risks of the investment and the firm may not be sufficiently constrained from earning excess profits.

36 For listed airports, the empirical equity beta can be measured by assessing the extent to which the listed stock is correlated with movements in the market as a whole. However, unlisted airports do not have observable market data to determine an empirical estimate of equity beta. Accordingly, an estimate of the beta for such companies needs to be derived from empirical data available for other airport stocks.

37 In large markets, such as Europe, where there are a large number of listed airports operating with similar characteristics in similar markets, it may be appropriate to undertake this exercise by reference to a narrow sample of close comparators with similar characteristics to the airport that the beta is being estimated for. For example, when determining the equity beta of Heathrow it may be appropriate to have primary regard to other large European global hub airports such as Charles De Gaule and Frankfurt.

38 Unfortunately, New Zealand does not have this luxury. The Commission’s task is to measure the risk faced by *New Zealand* airports, of substantially different scale, proportion of international and domestic passengers, and with a far greater degree of dependency on fewer large airline customers than the large European hub airports. These factual idiosyncrasies create inherent difficulties in finding close comparators for New Zealand airports. It follows that regulatory precedent from European jurisdictions that adopt a narrow sample set has limited application in a New Zealand context.

39 To address this difficulty, the Commission’s established approach adopts a wide geographically diverse sample relying on a broad range of empirical data. This produces a stable and predictable estimate of the systematic risk faced by airports – that is, the relative risk of airports against the markets in which they operate – and dilutes the impact of any individual comparator.

40 The Commission’s established approach is broadly supported by economic theory, data and statistical analysis, including evidence and reasoning the Commission has developed over the course of the Part 4 regime.

41 CEG, HK and Incenta have provided additional evidence, including independent expert evidence, supporting the Commission’s established approach.

Narrower sample

42 In contrast, there is a notable paucity of evidence that supports the narrow sample advocated by airlines. Airlines have provided no new persuasive evidence supporting the adoption of a narrow sample set in submissions on the Commission’s draft decision.

43 Rather, the submissions by airlines on the appropriate comparator sample reinforce the subjective nature of the exercise the Commission has embarked upon and highlight the risks associated with selecting a narrow sample of comparators, rather the neutrality and statistical stability associated with a broad sample set.

44 For the reasons set out below, we consider that the Commission should place no or little weight on the submissions by Castalia, Qantas and IATA.

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Castalia

45 Castalia submits that, in developing countries, capital movements are restricted in idiosyncratic ways, and that airports are disproportionately affected by arbitrary government action. However, Castalia's submission does not offer any evidence or underlying analysis in support of these assertions.[41]

46 Castalia asserts that the balance of power in any conflict between a firm and a government entity in a non-developed market is likely to be more in favour of the government than in a developed market and that airports, as essential infrastructure, are disproportionately affected by these factors. Castalia cites, by way of example, international airports operating in China that were adversely affected by the Chinese Government's response to COVID-19. Castalia does not provide any evidence that this impacted the beta for Chinese airports, as compared to other countries. Counterexamples are also readily available – the clearest being New Zealand's response to COVID, which was particularly onerous for the aviation sector. The New Zealand government's decision to close the border for two years effectively eliminated international travel for that period. Lockdowns and other restrictions on domestic movement also severely impacted domestic passenger air services. New Zealand's response to COVID-19 was, in terms of restraints on freedom of movement and therefore adverse effects on airports, amongst the most onerous in the world.

Qantas

47 Qantas submits that a market diversification filter should be applied and that Auckland Airport should be excluded from the sample on the basis that Auckland Airport's share of the NZX50 index distorts its equity beta estimate and introduces an upward bias.

48 The argument that Auckland Airport's share of the NZX50 "*distorts its equity beta estimate and introduces an upward bias*" is false. As explained in section 4.1 of HoustonKemp's report, the greater the representation of a stock in a benchmark index, the more the estimate of equity beta for that stock will tend towards the market average of systematic risk, being 1. It follows that, given Auckland's observable asset beta has been persistently higher than 1, the estimate utilised by CEPA, if anything, underestimates the actual equity beta for Auckland Airport. In any event, Qantas offers no analysis in support of the proposition that Auckland Airport's approximately 6% share of the index is sufficiently large to render its asset beta an unreliable measure.

49 A close analysis of Qantas' arguments illustrates the risk of relying on assertions from airlines that are not underpinned by robust evidence.

50 The diagrams set out at figure 1 do not support Qantas' argument. Rather, they simply plot the various equity betas for various comparator airports. This simply illustrates that the only observable equity beta for a New Zealand airport (Auckland) is materially higher than the comparators adopted by the Commission, which indicates that the Commission's approach in its draft decision materially under-estimates the equity beta for New Zealand airports as a whole.

51 Notwithstanding this, Qantas seeks to exclude the only NZ Airport on the basis of an erroneous assumption that Auckland Airport's share of the NZX50 index distorts its equity beta estimate and introduces an upward bias.

52 Putting Qantas' empirical errors to one side, the suggestion to exclude Auckland altogether strains credibility. Qantas' submission that the Commission should estimate the equity beta of New Zealand airports without reference to the sole listed New Zealand airport but rather to European hub airports

41 We note that the author of the Castalia report is not disclosed.

and Sydney serves to illustrate the type of opportunistic gaming and subjectivity that is introduced with an approach that requires the Commission make an evaluative judgement about which firms are more or less comparable to New Zealand airports.[42] Qantas' submission demonstrates that, once you start introducing subjective judgements to exclude firms, the exercise collapses into selection bias and loses all empirical rigour.

IATA submission

53 IATA advances the curious proposition that large European hub airports with the benefit of a substantial hub European airport operation combined with substantial airport operations in other capital city hub airports, reflecting a fully diversified airport portfolio means that they are fundamentally different from New Zealand airports to argue for a *downward* adjustment for the large European hub airports.

54 CEG refer to this point as a strong basis to conclude that such fully diversified global airport stocks are fundamentally lower risk, and inapt comparators, to CIAL, WIAL and AIAL.

55 Once a 'narrow' approach is adopted, either airport stocks are 'good comparators' or they are not. To the extent that IATA's submission is contending that large European hub airports with substantial global portfolios are inapt comparators to New Zealand airports, WIAL agrees that such large capacity constrained hub airports in Europe are inapt comparators.

56 To the extent that this submission is contending for a bespoke downward adjustment to the inapt European comparators for alleged heightened risks (notwithstanding greater diversification), such an argument is unsubstantiated, inconsistent with finance theory, and further underscores the arbitrariness associated with relying on a narrow sample of inapt comparators.

COVID uplift

57 In our submission on the Commission's draft decisions we explained that:

a) the Commission's approach of excluding Covid-19 affected data from the asset beta sample and instead applying an uplift was inherently subjective, unreliable, and implied a long-term commitment to the uplift that suppliers couldn't be confident about;

b) the uplift method is unnecessary given the Commission's standard approach is a readily available alternative, and more accurately reflects in the asset beta the impact of high impact/low probability events as they arise; and

c) the Commission's implementation of the Flint/UK CAA method was flawed.

58 Dr Martin Lally, who provided much of the advice to the Commission on WACC from 2010 onwards, agrees that the Commission's method results in much uncertainty. Dr Lally says:

> The merits of applying such treatment to selected events are contentious, especially when the probability of a recurrence of the event is so hard to estimate and any such recurrences may be materially more or less severe.

59 We agree. Moreover, a number of the other submissions on the Commission's draft decisions reinforce the inherently subjective and uncertain nature of the exercise. BARNZ and TDB, for example, argue (in

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42 In contrast, for example, to some European airports which have a number of listed airports with similar characteristics.

support of the Commission's approach) that Covid-type events will be rare in future and less impactful because of the "lessons" learned by policy-makers from this event. BARNZ submits that future pandemics are less likely to result in border closures because governments have "learned much from their experience" and therefore the impact on aviation will be less severe.

60 There is simply no evidential basis for that assertion. As Dr Lally emphasises, we do not know the probability of future Covid-type events and we have no basis to estimate their severity. There is also no reason to think that governments in future will be less likely to close their borders in the face of pandemics. Closing New Zealand's borders prevented the introduction and spread of Covid-19 during a period in which no vaccines or effective treatment were available and the health system lacked the capacity to manage a widespread outbreak. That decision not only created the time and space necessary to prepare for the inevitable outbreak of Covid-19 in New Zealand, it also allowed New Zealanders to live relatively normal lives while other countries were struggling to identify effective strategies to manage their epidemics and experiencing significant death tolls. If anything, the lesson from Covid-19 is that closing borders and limiting domestic movement is an effective pandemic management strategy for a country like New Zealand.

61 However, the point is not whether or not a future government would close New Zealand's borders again, but rather that the probability cannot be estimated with any reliability. Without a reasonable basis for estimating the frequency and severity of future Covid-type events, the Commission's approach lacks any quantitative rigour and amounts to not much more than a plausible guess. It is notable that submitters seek to support the Commission's approach with arguments based on equally contestable assumptions.

62 Happily, there is a quantitatively rigorous alternative, which is simply to let the impact of Covid-19 (and future shocks) flow through the beta estimate as and when they occur. This avoids the need to estimate the frequency and severity of future events and does not require a long-term commitment to the uplift.

63 BARNZ argues that this approach would make the impact of Covid-19 "permanent" in the asset beta. It would not. Rather, retaining the Commission's customary approach would mean that the impact of high impact/low probability events is accurately reflected in the asset beta as and when those events occur.

64 If the Commission believes that taking the average of the last two five year periods overweights the impact of Covid-19 in the asset beta for the next period, the alternative – we have submitted – would be to take the average of 15 years, which would give a longer-term view and lessen the impact of Covid-19 in this sample.

65 If the Commission considers it should persist with its proposed approach, it must at least correct the errors in its implementation (as described by CEG in its report enclosed with NZAA's submission). Dr Lally has also pointed out errors in the Commission's implementation of its preferred approach.

Downward adjustment

66 The Commission has previously applied a downward adjustment of 0.05 on the theory that non-aeronautical activities result in higher asset betas than is the case for airports whose revenue is predominantly aeronautical. The Commission has now undertaken further analysis and agrees with AIAL, LJK Consulting and CEG that there is no statistical evidence of a positive relationship between asset beta and proportion of revenue that is non-aeronautical.

67 We agree that there is no basis for the downward adjustment. Castalia (for Air New Zealand) and TDB (for BARNZ) also agree, which is significant.

68 Qantas, on the other hand, argues that the evidence does support a correlation between percentage of non-aeronautical revenue and asset beta. That analysis conflicts with the more detailed evidence provided by AIAL, LJK and CEG. In addition, as HoustonKemp and CEG explain, Qantas' analysis contains material errors, the relationship it purports to have identified is not statistically significant, and Qantas' estimate of aeronautical revenue is unreliable.

69 TDB argues that, while it is "comfortable" with the Commission's draft decision, a downward adjustment would still be appropriate because, TDB says, suppliers that are "largely focused on providing/using core economic infrastructure tend to have lower asset betas than those…dependent on discretionary consumer-driven preferences".

70 TDB refers to analysis that purports to compare the asset betas of suppliers in the utilities sector with sectors such as retail, restaurants and dining, recreation and entertainment. TDB's argument appears to be that airports are more akin to electricity, water or telecommunications than to discretionary sectors because airports utilise infrastructure.

71 First, the best evidence that airports asset betas differ from electricity and other inelastic utilities is the difference in asset betas that result from the Commission's energy, fibre and airport samples. That comparison demonstrates that airports have significantly higher asset betas than utilities such as electricity (0.59), gas (0.68) and fibre (0.5).

72 Second, that outcome is intuitively right given the differences between the types of low-beta utility services that TDB points to and airports. Demand for energy and telecommunications is significantly less elastic than demand for aviation services (and therefore for airport services). In that sense, airports are much closer to the type of sectors that TDB identifies as "discretionary" than utilities services.

Reasonableness checks

73 The Commission considers that its methodology produces a reasonable estimate of WACC, having regard to the reasonableness checks discussed at paragraphs 7.5 and 7.6 of its Reasons Paper. However, the Commission has failed to have regard to the two most significant reasonableness checks:

a) the Commission's proposed WACC IM implies that the systematic risk faced by regulated airports in New Zealand has declined since the 2016 IMs Review, despite the intervention of Covid-19. That is not a credible result.

b) the Commission's estimates of the asset betas of Auckland Airport (being the only regulated airport in New Zealand that is publicly listed) from the last 15 years are materially higher than the 0.55 asset beta proposed in the draft decision suggesting the Commission may have underestimated materially the asset beta of the benchmark efficient airport.

74 TDB argues that the Commission should place greater weight on evidence of RAB multiples above 1.0. In our view, the Commission's discussion of RAB multiples is not persuasive as a reasonableness check.

75 First, there are very limited data points to draw on. The Commission is drawing on only one transaction involving a regulated supplier (Eastland) and a handful of analyst estimates for Vector and AIAL. That is insufficient data from which to draw any conclusion.

76 Second, as the Commission acknowledges, RAB multiples do not necessarily indicate that the regulated rate of return is too high. It can equally indicate that the market expected the company to

out-perform relative to the allowed cashflow or other model assumptions used in the regulatory determination. In the case of Eastland, the only transaction in the Commission's dataset, it is also likely that the acquirer's valuation model assumed some efficiencies could be achieved through the integration of Eastland into the First Gas Group, or that the acquirer had other strategic priorities that drove its bid.

77 Third, the RAB multiples referred to by the Commission reflect the regulatory settings that applied between 2016 and the present, rather than the Commission's draft decisions, which propose to significantly reduce the WACC relative to the WACC that would have applied had the Commission retained its usual approach. Evidence of RAB multiples that pre-date the Commission's draft decisions tell us nothing about the financeability of regulated suppliers under the regulatory settings the Commission now proposes.

Exclusion of appeal costs from definition of operating costs

78 IATA supports the Commission's draft decision to exclude pecuniary penalties and legal costs associated with appeals from the definition of operating costs. We agree that it is appropriate to exclude pecuniary penalties. But the Commission's proposal to exclude the costs associated with appeals deters regulated suppliers from pursuing their legitimate statutory rights. Part 4 of the Commerce Act expressly affords regulated suppliers a right of appeal. Legal costs associated with pursuing an appeal are amongst the costs of the regulated service. The alternative is that appeals must be funded by shareholders directly (i.e. out of earnings), which precludes suppliers from exercising their rights. Deterring appeals also undermines the quality of the Commission's decision-making by eliminating a key source of accountability.

CONCLUSION

79 It is vital for the future of airport investment and continued recovery from the pandemic, that the Commission reaches its decisions based on robust inputs and sound process. Airline submissions on the draft Input Methodologies have not offered any persuasive evidence in favour of the Commission's position, and the bulk of evidence supports a thorough overhaul of the draft. We urge the Commission to take this evidence into account and remain open minded to revising its original decisions.