PART 4 INPUT METHODOLOGIES REVIEW 2023

SUBMISSION ON PROCESS AND ISSUES PAPER

11 July 2022

INTRODUCTION

1. This is a submission by the NZ Airports Association ("**NZ Airports**") on the Commerce Commission's paper - Part 4 Input Methodologies Review 2023: Process and Issues Paper ("**Process and Issues Paper**").

2. Auckland, Wellington and Christchurch Airports have contributed to this submission.

3. We have focussed on the topics raised by the Commission that are priorities for NZ Airports. We will engage on other topics raised by the Commission if and when it becomes apparent that the Commission is proposing to consider changes that could have implications for airports.

4. For completeness, we note that we have not separately submitted on the Draft Framework Paper. We have reviewed that paper and the Commission's decision-making framework has informed our views in this submission (where relevant we have expressly referred to the Draft Framework Paper).

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EXECUTIVE SUMMARY

6. NZ Airports believes that the Input Methodologies Review ("**IM Review**") should be tightly scoped with a streamlined process given that:

   (a) many of the challenges airports and their customers are facing in light of the COVID-19 pandemic and decarbonisation can be addressed via consultation and pricing decisions, rather than changes to the input methodologies ("**IMs**"); and

   (b) the information disclosure regime is effective, and airports continue to promote all aspects of the Part 4 purpose statement.

7. The IM Review can therefore focus on updating relevant WACC IM parameters, using the Commission's established methods. This includes:

   (a) **Asset beta:** Updating the comparator sample and re-estimating asset beta using the average of weekly and monthly data from the most recent two five-year periods, which will appropriately reflect pandemic risk. NZ Airports continues to believe the 0.05 downward adjustment should be abandoned because there is no evidence that aeronautical operations are less risky than the airport as a whole.

   (b) **Tax adjusted market risk premium ("TAMRP")**: TAMRP should be updated to 7.5%, consistent with the Commission estimate for other regulated sectors (noting that TAMRP is an economy-wide estimate).

   (c) **Cost of debt:** The Commission should consider whether the five-year estimate for the debt premium remains appropriate in light of evidence of airports' actual longer debt tenor positions. We support the Commission's proposal to review the credit rating, as the average credit rating for airports has reduced since the A- rating was set.

8. In response to the Commission's questions about asymmetric risk, it is clear that airports face real and substantial asymmetric risk (pandemics being a key example) that are not compensated for by the WACC IM. It is therefore appropriate for airports to consider and consult on mechanisms to allocate this risk in their pricing consultations – amendments to the IMs are not required.

PROCESS AND DECISION-MAKING FRAMEWORK

9. NZ Airports appreciates the opportunity that the Commission has provided for stakeholders to help the Commission to define and prioritise topics, issues, risks and opportunities to be addressed by the IM Review. We also support the Commission's approach of letting the review process be informed by the issues that are identified.

10. NZ Airports believes that the IM Review process for airports can be tightly scoped, with a streamlined process. This reflects that:

    (a) the IMs are, on the whole, well-established and understood; and

    (b) being subject to information disclosure only, the information disclosure regime provides an ability for airports and their customers to appropriately respond to new risks and issues in pricing decisions, while being guided by applicable IMs and/or information disclosure tools (eg the carry forward adjustment).

11. Put another way, many of the significant challenges airports and their customers are dealing with now, and will deal with in the future, do not need to be addressed by specific changes to the IMs.

12. However, to ensure that the IMs establish benchmarks for an expectation of reasonable returns, it will be important for the IM Review to focus on updating relevant aspects of the WACC IM in a manner consistent with the approach adopted under the 2016 IM Review. We believe that if the Commission applies its established methods for updating the relevant parameters (eg asset beta), then that will promote outcomes consistent with the Part 4 purpose statement, and take proper account of the significant risks and challenges presented by the Covid-19 pandemic and/or decarbonisation.

13. It will then be important for the Commission to have an open mind to considering approaches that airports might adopt in price-setting decisions to appropriately allocate asymmetric pandemic risks that would not be fully addressed by the WACC IM. Where relevant, we have included views on such matters, with the objective of demonstrating that any such asymmetric risk-sharing approaches would be in addition to the Commission appropriately updating relevant WACC parameters, so that together:

    (a) the benchmark WACC appropriately reflects investors' changed risk perceptions in relation to airports; and

    (b) airports and their customers have an ability to consider pricing approaches that better allocate the very real and material asymmetric risks faced by airports.

CONTEXT

Covid-19 Pandemic

14. The Commission has acknowledged that the airport sector is in a period of change, particularly in relation to the impacts of climate change, the transition to a low carbon climate-resilient economy, and the ongoing impact of COVID-19.[1]

15. Airports have responded to the extreme challenges presented by pandemic in a way that strongly demonstrates their actions are consistent with all aspects of the Part 4 purpose statement. For example:

(a) Wellington Airport explained the following in its cross submission on the PSE4 Price Setting Review:

> The Covid pandemic has had a significant impact on WIAL as well as our airlines. As noted in our earlier submission we resized our operations due to the sharp reduction in passenger numbers and ongoing uncertainty of the pandemic. At the onset of the pandemic in April 2020 our traffic reduced to under 7,000 passengers for the month which was 1% of their pre Covid level and for the year ended 31 March 2021 passengers reached almost 3 million, which was 48% of their pre Covid levels. In addition to a 30% reduction in staff, operating and capital expenditure was significantly reduced. WIAL also undertook a range of measures to enhance its liquidity and overall financial resilience, including securing covenant waivers with banks and other lenders, increasing bank facilities from $100 million to $170 million and issuing retail bonds totalling $225 million. Our shareholders also provided equity commitments totalling $75.8m, giving confidence to our lenders and enabling us to proceed with essential operations and targeted investment.
>
> Finally, we made a number of concessions to support airlines through this period, recognising the impact on our customers, including:
>
> a. holding prices flat through FY21, which resulted in a substantial reduction in cashflow in that year; and
>
> b. proposing a concessionary price path to minimise PSE4 price increases and defer a substantial amount of PSE4 revenue into PSE5. This results in an effective WACC for pricing assets for PSE4 of 5.43%.

(b) Auckland Airport's annual regulatory disclosure in October 2021 noted that international traffic remained extremely low (FY21 international passengers were down by circa 95% versus pre-COVID-19 and domestic passengers were down by circa 39%) and that Auckland Airport continued to reset its business for the new operating environment. This included:

(i) Prioritising health and safety, controlling costs and supporting business partners. Net of reversing some prior period over-provisions for capex related losses, operating costs were 50% less than forecast when prices were set.

[1] Process and Issues Paper, at paragraph X5.

(ii) Collaborating with border agencies and airlines on design of risk-based quarantine free travel systems, which involved splitting the international terminal into two areas, one for processing quarantine free arrivals from Australia and certain Pacific Islands, and the other for MIQ bound arrivals.

(iii) Rapid reprioritisation and recalibration of the extensive capital works programme. Some projects had been permanently cancelled, others were suspended and preserved, while others (such as runway slab replacement and roading) were accelerated to take advantage of low traffic conditions (all in consultation with customers).

(iv) Providing $12.8 million of relief that financial year from various aeronautical charges.

(v) In acknowledgement of the devasting impacts of COVID-19 on passenger numbers, airline financial performance, and the extreme uncertainty of the 'building blocks' forecasts required to set a five-year price path, Auckland Airport consulted with airlines and BARNZ on freezing prices at FY22 levels for the first year of PSE4.

(c) Similarly, Christchurch Airport's disclosure in November 2021 explains that in light of significantly reduced traffic, the following was observed:

(i) Reductions in operating expenditure reflected a cessation of discretionary expenditure and reduced terminal and airfield operating costs (which was offset to an extent by higher than forecast rates and insurance).

(ii) Operating efficiency was a particular focus with a strategy centring on proactive asset maintenance works and energy efficiency.

(iii) Quality survey scores remained high despite the unprecedented impact of the pandemic.

(iv) Using a COVID-19 working group allowed Christchurch Airport to focus on understanding and managing the risks relating to the pandemic, oversee the changing situation, and to work closely with border agencies.

16. In summary, in the face of significantly reduced revenues, the regulated airports have innovated, focussed on efficient investment, controlling operating costs, and delaying aeronautical price increases while continuing to provide high quality services in extremely challenging times.

Decarbonisation

17. NZ Airports wishes to emphasise that the risks and challenges presented by decarbonisation are not isolated to the energy sectors under Part 4. They are real for airports too, particularly as large-scale users of energy. In addition to airports' own scope 1 and 2 decarbonisation initiatives, airports will need to accurately forecast the timing of airlines' decarbonisation initiatives. Airport decarbonisation plans will include:

(a) Transitioning away from gas. Among other things, that will require secure and affordable electricity supply.

(b) Providing vehicle charging infrastructure, and electrifying ground services and terminal functions.

(c) Facilitating sustainable aircraft. Air New Zealand has publicly outlined its journey to net zero emissions by 2050 including sustainable aviation fuel ("**SAF**") and zero emissions aircraft. In addition to SAF, there are plans to electrify the smaller domestic fleet (Sounds Air aim to transition from 2026) and Air New Zealand proposes to transition the bulk of their domestic and short haul to hydrogen fuel.

18. Airports' building blocks forecasts used to set future aeronautical prices will need to accurately encompass capital expenditure to deliver new airport infrastructure required by airlines to enable their decarbonisation plans, plus associated airport operational changes.

19. Airports will need to consider how they are placed with respect to onsite renewable energy generation capability and how they can partner with others that share the same decarbonized aviation vision (eg airlines, airline manufacturers or other support ancillary businesses.

COST OF CAPITAL

20. We consider that the following topics are relevant to reviewing the airport WACC IM:

(a) asset beta;

(b) TAMRP; and

(c) cost of debt issues, including credit rating for airports.

21. As a general observation, we note that COVID-19 will have an enduring impact on airports' WACC – which will continue beyond recovery from the immediate effects of the current pandemic. As noted by the UK Civil Aviation Authority ("**UK CAA**"), there has been a shift in investors' long-term perception of the risk exposure of airports due to the possibility of future pandemics. There is also a residual or "tail" effect – as there is still uncertainty regarding the recovery trajectory, and the impact will vary for different airports.[2]

22. Nevertheless, we do not think this translates into a requirement for the Commission to change its estimation approaches from the previous IM review in 2016, as discussed further below in relation to asset beta.

Asset beta

23. In considering the method for estimating asset beta, in accordance with the Draft Framework Paper the Commission must have regard to:

(a) providing regulatory certainty in accordance with the purpose of IMs; and

(b) whether it can be established that there is a problem with the existing method and, if so, whether an alternative approach would better achieve the policy intent.

24. The Commission's use of a wide range of comparator airports to estimate asset beta is robust and transparent. The method was established in 2010 and used again in 2016. NZ Airports expects the Commission to use the same approach under the IM Review. That is,

[2] UK CAA, Economic Regulation of Heathrow Airports: H7 Final Proposals (June 2022), at paragraphs 9.9 to 9.11.

we do not believe that there is evidence that could justify the adoption of any change to the method for estimating asset beta.

25. In particular, as the Commission knows, asset beta has been an important focus in airport pricing decisions since the 2016 IM Review (where it was established that airports have the ability to justify an airport specific WACC that departs from the WACC IM benchmark). Following engagement with the Commission on those decisions, there is now a clear understanding of the Commission's methodology for estimating asset beta. In the interests of certainty, NZ Airports considers it is important to retain that approach following this IM Review.

Comparator sample

26. We expect that the Commission will update its comparator sample (as it did in the 2016 IM Review).

27. Some of the comparator airports will need to be removed because they are no longer listed, and others should be removed where evidence shows that they are not true airport comparators. There are likely to be new listed airports to add.

28. NZ Airports understands that Auckland Airport will provide some initial analysis to the Commission regarding potential updates to the comparator set. We look forward to further engaging with the Commission on principled refinements to the comparator set as it progresses the IM Review.

Updated asset beta estimate

29. In the 2016 IM Review, the Commission explained why it placed "greater weight" on the two most recent five-year periods. While it had also identified estimates for the two prior five-year periods, the Commission in fact ignored those entirely in calculating its unadjusted airport asset beta average estimate of 0.65 (by calculating the average only of its weekly and four weekly data for the two consecutive five year review periods ending on 31 March 2011 and 31 March 2016). In referring to Professor Aswath Damodaran, the Commission noted that there was a trade-off when choosing a time period. A long period provides more observations but may be offset by changes in circumstances. Bearing in mind that the objective is to obtain the best forward-looking estimate, the Commission decided that the best balance to the trade-off was obtained by placing "greater weight" on the two most recent five-year periods. Per the above, the Commission placed exclusive weight on the two most recent five-year periods.

30. The Commission repeated this reasoning and approach when it determined an asset beta estimate for fibre services in October 2020.[3]

31. In response to the Commission's questions at paragraph 6.22.2 of the Process and Issues Paper, we do not see any reason why the Commission should now consider changing this approach of averaging weekly and four weekly data from the two most recent five-year periods (eg ending 31 March 2023). Doing so would be out of step with its approach for other sectors. By repeating its past estimation approach, NZ Airports believes that the impact of COVID-19 on investors' perception of risk today (which will be enduring going

[3] Fibre Input Methodologies: Main Final Decisions Reasons Paper (13 October 2020) at paragraph 6.411 onwards. The asset beta estimate was determined following the onset of the COVID-19 pandemic, and the Commission indicated it would consider whether the IMs needed to be "re-opened" once the impact of the pandemic was better understood. The Commission subsequently decided not to re-open consideration of the cost of capital IM in light of COVID-19 (letter to stakeholders dated 31 March 2021).

forward) will be appropriately reflected by the inclusion of circa seven years of pre-COVID-19 data, and circa three years of COVID-19 impacted data.

Downward adjustment

32. NZ Airports believes that the Commission should remove its downward adjustment of 0.05 to asset beta, made to account for a perception that the aeronautical business is less risky than the airport business as a whole.

33. As the Commission is aware, NZ Airports has opposed this downward adjustment since inception, and the matter was considered most recently in the 2016 IM Review. We nevertheless invite the Commission to consider new information that supports our view that the policy for the adjustment is not appropriate because it is not supported by empirical evidence or other regulatory decisions.[4]

34. We note that a downward adjustment was not applied by the Supreme Court in the Perth Airport case. There, expert evidence was provided that there was not a strong case for the adjustment, and if the Commission's logic was accepted, there should be an upwards adjustment for airports with high-risk aeronautical operations.[5]

35. The Commission has accepted in the past that the adjustment involves judgement, and the quantum of the adjustment is not calculated using numerical techniques.[6] The Commission has applied a high threshold for empirical evidence to justify airport-specific asset betas in pricing decisions. It has rejected airport-specific adjustments because it believed that insufficient evidence had been provided. NZ Airports submits that the Commission must apply that same evidential standard to any adjustment it wishes to make to the asset beta derived from the comparator sample.

36. We refer to Auckland Airport's analysis in its separate submission, which demonstrates that there is no evidence that its aeronautical business is less risky than the remainder of its business. In particular:

    (a) The COVID-19 impact on aeronautical revenue was broadly in line with the total company impact.

    (b) Analysis of airline traffic, retail. and car parking revenues suggests that retail and car parking have similar or lower systematic risk than aeronautical activities. In particular:

        (i) there is greater ability for an airport to maintain retail revenue via lease arrangements (albeit significant rent relief was provided);

        (ii) car parking was assisted by domestic traffic; and

        (iii) property revenue is not directly related to aeronautical demand and were not impacted in a significant way.

    (c) Analysis of the comparator sample suggests airports with higher non-aero shares may have lower asset betas.

[4] We refer to paragraph 3.22 to 3.25 of the Draft Framework Paper regarding the appropriate considerations for revisiting IM policy decisions.

[5] *Perth Airport PTY Ltd v Qantas Airways Ltd* [No 3] [2022] WASC 21, at paragraph 204.

[6] Input Methodologies Review Decisions, Topic Paper 4: Cost of Capital Issues (20 December 2016) at paragraphs 482 and 483.

TAMRP

37. As the Commission notes, TAMRP is a market-wide parameter that should not vary by sector, service or company. The Commission has used the same approach to TAMRP for Part 4 and Part 6 regulation, and for other sectors.

38. We agree with the approach of setting TAMRP in the IM, and only updating the TAMRP estimate at each scheduled IM Review. This provides regulatory certainty.

39. The Commission updated the TAMRP to 7.5% when setting IMs for fibre services in 2020. It applied this update to gas pipelines when amending IMs for that sector in April 2022.

40. It follows that the TAMRP for all Part 4 regulated sectors, including airports, should be updated to 7.5% as part of this IM Review. We therefore agree with the Commission's proposal to use its 2020 estimate of the TAMRP, noting an expectation that TAMRP should be relatively stable over time.[7]

Cost of debt issues

Debt premium

41. The Commission uses a five-year estimate for the original term of the debt premium in its benchmark approach to cost of debt.

42. In reviewing Wellington Airport's PSE4 pricing, the Commission noted that issuance of longer-term debt may benefit consumers due to reduced refinancing risks. It accepted that the longer tenor of debt may imply a higher debt premium than the mid-point estimate provides for. Accordingly:

> We agree in principle that additional compensation may be appropriate for the additional debt premium that can be incurred from issuing debt with a longer original term than the five-year regulatory period.[8]

43. Originally, the IMs included a TCSD to compensate airports that issue debt with an average initial tenor of more than five years (albeit it resulted in a cashflow adjustment rather than a change to WACC). It was removed in the 2016 IM Review due to is complexity and lack of effectiveness. NZ Airports does not advocate for a return of the TCSD.

44. As demonstrated by the review of Wellington Airport's pricing, it should be possible for airports to use a debt premium in their pricing WACC that is different to the benchmark in the WACC IM, if that better reflects their actual debt tenor.

45. Nevertheless, we would support the Commission reviewing whether the five-year estimate remains an appropriate benchmark in light of evidence of the regulated airports' actual debt tenor positions.

[7] Process and Issues Paper, at paragraph 6.51.

[8] Commerce Commission, Review of Wellington Airport's 2019-2024 Price Setting Event: Consultation Paper (13 May 2022), at paragraph A111.

Credit rating for airports

46. The WACC IM sets a benchmark credit rating of A- for airports. As the Commission knows, each airport in fact has a different credit rating. Further, since the 2016 IM Review, the credit ratings for Wellington Airport and Christchurch Airport have changed.[9]

47. NZ Airports agrees that it is appropriate for the Commission to therefore consider whether the notional credit rating of A- should be updated.

48. We appreciate the Commission's acknowledgement that, when reviewing pricing decisions, it is able to take the airport-specific credit rating into account. This mitigates the materiality of the issue, but it remains the case that that the benchmark credit rating in the WACC IM needs to be the best estimate possible.

49. The Commission has presented two potential methods for determining a benchmark credit rating:

    (a) ***Comparator sample approach:*** Use the average credit rating of the airports in the asset beta comparator sample. This has been supported by submitters in the past but has not been adopted by the Commission.

    (b) ***Notional credit rating approach:*** Selecting a target credit rating through judgement to reflect an appropriate level of credit default risk. This would also have regard to the comparator set.

50. NZ Airports prefers the notional credit rating approach and expects that the Commission will give weight to the actual credit ratings of the regulated airports when determining an appropriate sector-wide level of credit default risk. The average movement in credit ratings for Wellington and Christchurch Airports has been downward, which suggests that any change to the benchmark rating would also be downward.

51. We also note that, as part of 2016 IM Review, the Commission observed that Bloomberg only reported long-term credit ratings for three of the airports in the comparator sample, which suggests that the comparator sample approach is not feasible for airports.

Adjusting the IMs to allow for a four-year regulatory period

52. The Commission proposes to consider changing the WACC IMs to allow the cost of debt and equity to match a four-year regulatory period for EDBs, Transpower, and GPBs. We understand changes were made under recent decisions to set a four-year price path for GPBs (matching the risk-free to the regulatory period and allowing additional debt issuance costs).

53. The Commission also states that it will consider whether equivalent changes are required for airports.

54. We are not convinced that the Commission needs to explore this topic for airports. On the one hand, it makes sense for the WACC IM to be consistent across all regulated sectors in this respect, and airports do have flexibility to choose a pricing period of less than five years. It may therefore appear desirable for the WACC IM to include flexibility so that the Commission's assessment of target returns using the WACC IM is matched to the pricing period. On the other hand, it is rare for airports to adopt a pricing period that is less than five

[9] Wellington Airport is currently S&P BBB (previously BBB+) and Christchurch Airport is S&P BBB+ (having been A- for a period of time).

years. If any airport chose to do so, the impact of that shorter period could be factored into the pricing WACC and subsequent review by the Commission, without amending the WACC IM as part of this review.

RISK ALLOCATION

55. At paragraph 5.61 of the Process and Issues Paper, the Commission asks some questions about pandemic risks. This section responds to those questions.

56. The COVID-19 pandemic has demonstrated a real and material asymmetric risk that always existed for airports. It is not a newly discovered risk. There has been a realisation of massive downside risk resulting from border closures and other health measures, with no commensurate upside risk.

57. The issue to be considered now is whether airports have been adequately compensated for bearing such risks, and how the risk may be better allocated going forward.

58. We acknowledge the Commission's position that the WACC does not usually compensate for non-systematic risk. That is why Wellington Airport submitted, in response to the Commission's open letter, that the Commission should be open to airports considering other pricing mechanisms to compensate for asymmetric risk that they are exposed to.

59. That is, the WACC IM (specifically the asset beta) will not fully capture the risk that investors now expect to face in the airports sector following COVID-19. This is aligned with the position of the UK CAA, which has stated that the asset beta (or broader WACC) does not incorporate the impact of asymmetric risks, because the CAPM assumes all risks are symmetrically distributed and therefore will not compensate shareholders for bearing asymmetric risks.[10]

60. We do not think that the IMs need to be reviewed or amended in response to the impact of the COVID-19 pandemic (as noted above, updating the asset beta in accordance with the Commission's established method will be sufficient).

61. The IMs and information disclosure requirements (particularly the carry forward mechanism) provide flexibility for airports to transparently disclose risk allocation mechanisms that they may adopt in pricing decisions following consultation.

62. However, NZ Airports believes it remains an important topic for the Commission to keep in mind because airports will need to consider appropriate risk allocation approaches in their future pricing decisions.

[10] UK CAA, above n 2, at paragraph 11.23.