REVIEW OF CHRISTCHURCH AIRPORT'S 2022-2027 PRICE SETTING EVENT

SUBMISSION ON CONSULTATION PAPER

24 October 2023

INTRODUCTION

1. This is a submission by the NZ Airports Association ("**NZ Airports**") on the Commerce Commission's ("**Commission**") Consultation Paper – Review of Christchurch Airport's 2022-2027 Price Setting Event ("**Consultation Paper**").

2. There is no confidential information in this submission, and it can be published in full on the Commission's website.

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EXECUTIVE SUMMARY

4. The Consultation Paper is a positive endorsement of Christchurch Airport's ("**CIAL**") performance. Christchurch Airport is working within the bounds of an effective information disclosure regime and promoting the long-term benefit of consumers.

5. The Commission's assessment approach is consistent with past pricing reviews. While the consistency is appreciated, NZ Airports would like to see the pricing reviews provide a fuller picture to the public on how airports are promoting all aspects of the Part 4 purpose. The heavy focus on profitability suggests that the Commission is focussed on the short term, and not the long-term benefits of consumers.

6. We support the draft conclusions that:

    (a) CIAL's WACC estimate of 6.65% and target return of 6.26% are reasonable. In our view, it would have been reasonable for CIAL to have updated the 2016 IM asset beta estimate, which was considerably out of date at the time it set prices, and to have applied a higher WACC estimate than 6.65% when establishing its PSE4 target return as a result.

    (b) Using a TAMRP of 7.5% (and not the IM value of 7.0%) is reasonable.

    (c) Using CIAL's actual credit rating and a higher debt premium only has a marginal impact on WACC.

7. The following briefly elaborates on aspects of the Consultation Paper's reasoning that we consider are important for the Commission to apply consistently across all pricing reviews.

EXPECTED PROFITABILITY

Draft Conclusions

8. The Consultation Paper focusses on expected profitability and notes that "[o]ur focus on profitability does not cover all outcomes reflected in the Part 4 purpose."[1]

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[1] Commerce Commission *Review of Christchurch Airport's 2022-2027 Price Setting Event – Consultation Paper* (26 September 2023) at [18] [**Consultation Paper**].

9. The Consultation Paper's starting point for assessing profitability is the Commission's 1 April 2022 WACC determination, which was the most recent determination prior to CIAL's price setting on 23 June 2022.[2]

10. On that basis, the Consultation Paper's estimate of an airport-wide WACC is 6.32%, which compares to CIAL's airport-specific estimate of 6.65%.

11. Under its assessment framework, the Commission appropriately accepts that there can be legitimate reasons for airports to target returns that are different to its mid-point WACC estimate. For each WACC parameter, the Commission considers:

   (a) what reasons and evidence has the airport provided to justify the departure?

   (b) is the size or quantum of the departure justified by evidence?

12. CIAL's only departures from the WACC IM were for TAMRP and credit rating (which we separately address below).

13. Overall, the Consultation Paper concludes that CIAL's WACC estimate of 6.65% is reasonable. Further, the Consultation Paper concludes that CIAL's target return of 6.26% is reasonable.

NZ Airport's views

14. NZ Airports agrees that CIAL's WACC and target return are reasonable.

15. We emphasise that it remains open to each airport to separately identify and justify departures from the WACC IM when determining their airport-specific WACCs and target returns. That is, the draft conclusions for CIAL do not constrain what other airports may seek to justify in their pricing decisions. Broadly speaking, airports could depart from the WACC IM for the following reasons:

   (a) There are airport-specific circumstances that make it inappropriate to apply a sector-wide benchmark WACC parameter to that airport. For example, the Commission has accepted that an airport-specific cost of debt or asset beta could be justified.

   (b) A parameter is out of date at the time prices are set. We elaborate on this in the TAMRP section below.

16. NZ Airports is concerned that the Consultation Paper continues a trend of pricing reviews having a rather mechanical focus on assessing profitability, and therefore a heavy focus on limb (d) of the Part 4 purpose statement (limiting excess profits).

17. It is not clear to us how and when the Commission assesses airport performance against the other limbs of the Part 4 purpose statement, and the overall purpose of promoting the long-term benefit of consumers. It would be helpful for the public to receive a fuller picture of how airports are promoting the Part 4 purpose.

18. Since the inception of Part 4, NZ Airports has consistently adhered to the view that the overall purpose of promoting the long-term benefit of consumers is paramount. Assessing whether this purpose is being promoted requires consideration of the interaction between all

[2] Consultation Paper, at [42]; citing Commerce Commission *Cost of capital determination for disclosure year 2023 for information disclosure regulation – Electricity distribution businesses and Wellington International Airport* (3 May 2022).

four limbs of the Part 4 purpose statement. We remain concerned that focussing too much on profitability at the expense of the other limbs means that a balanced assessment of airport performance will not be provided to interested persons.

19. For example, particularly when airports are facing capacity and quality challenges that require significant investment, the assessment framework should consider profitability against the requirement to promote incentives to invest, and the potential impacts of underinvestment on the long-term benefit of consumers. Put another way, a focus on profitability considerations might benefit consumers in the short-term, but could be at the expense of consumer benefits in the long term if an airport's ability to invest in capacity and quality is constrained.

20. Further, in considering whether airports are promoting the long-term benefit of consumers, the minimal impact on consumers from an airport earning above the benchmark WACC IM should be carefully measured against the potentially material adverse impact on consumers where an airport does not have sufficient incentives to invest. The impact of each limb of the Part 4 purpose on the long-term benefit of consumers is asymmetrical. This asymmetric effect should be considered by the Commission in its pricing reviews when considering if airports are meeting the purpose of Part 4.

21. In the long term, the cost to the consumer of under-investment is significantly greater than the cost of excess profits. This is because airport charges only impact the consumer to the extent that those charges result in higher airfares charged by airlines, and setting airline airfares is a product of competition (not airport charges):

    (a) If airport capacity is not delivered in time to meet demand, due to market constraints airfares can rise by far more than the impost of airport charges. This is because the consumer pays for airport services through airfares, of which aeronautical charges make up a small portion of the ticket price.

    (b) If an airport earns excess profits but does invest in capacity in time to support demand growth, the impact on the final airfare will be far lower than if airport capacity is constrained.

    (c) There is limited competition in the New Zealand domestic air travel market. Most routes are monopoly routes – meaning that benefits from lower aeronautical charges are unlikely to flow through to end consumers, but rather support airline profitability.

22. For example, the significant change in the asset beta proposed in the draft IM Decision would amount to a reduction in aeronautical charges of around $1.80 to $2.60 per passenger. This impact is minimal compared to the increases in airfares that can result when seat capacity exceeds demand, with domestic airfares having increased by an average of $65 (or 33%) while international airfares increased by an average of $255 (or 36%) in real terms since the pandemic.[3]

23. This demonstrates that underinvestment in airport capacity so that it cannot meet future demand is likely to have a much greater detrimental impact on the long-term benefit of consumers compared to any assessment of excess airport profitability.

24. In conclusion, we would like to see the Commission take into account the materiality (or lack thereof) of the impact on the long-term benefit of consumers when assessing departures

[3] See NZ Airports *Part 4 Input Methodologies Review 2023 – Submission on Draft Decision* (19 July 2023) at [24]–[27].

from the mid-point WACC estimate. Keeping in mind that airports are careful to justify any such departures and are not intending to target excess profits, the Commission should weigh the (small) impact of its mechanical calculation of profitability against the potential (large) detrimental impact to consumer benefit in the long-term if its calculations are incorrect and lead to underinvestment.

TAMRP

Draft Conclusions

25. The Consultation paper notes that CIAL has departed from the WACC IM parameters by using a TAMRP of 7.5% instead of 7%.

26. In agreeing that CIAL had legitimate reasons for departing from the value specified in the IMs at the time of setting prices, the Consultation Paper notes that:[4]

(a) 7.5% was the TAMRP value estimated for the fibre IM decisions (November 2020) and gas transmission service IMs (March 2022);

(b) the Commission does not consider the draft TAMRP of 7.0% from the 2023 review of IMs to be relevant to this PSE review; and

(c) TAMRP is an economy-wide parameter and the latest estimate available when CIAL finalised its prices was 7.5%. It was reasonable for an airport operating in a workably competitive market to use the latest estimate when setting prices. Doing so is consistent with the Part 4 purpose (especially the s 52A(1)(d) requirement to limit ability of airports to earn excessive profits).

NZ Airport's views

27. NZ Airports fully supports the reasoning and draft conclusions in the Consultation Paper. It is reasonable and consistent with workably competitive markets for airports to use the most recent and up to date information when setting prices. Also, their decision-making must be judged by the information available to them at the time, meaning that subsequent developments, such as IM Review Draft Decisions, are irrelevant.

28. These are important principles that should be supported and applied consistently across the pricing review and future pricing reviews.

29. NZ Airport's position is that an IM being out of a date is a key reason why pricing decisions that depart from the prescribed IM are legitimate and justified. Given the five-year pricing cycle and seven-year IM review cycle, this is a matter that each airport is required to consider each time it sets prices.

30. This should not be controversial given that the Commission produces an annual WACC determination for this reason. For parameter values not fixed in the IM itself, the annual WACC determination updates input parameters which are relatively simple to measure (such as risk-free rate) to reflect the most recent and relevant information.

31. TAMRP is fixed in the IM and therefore is not subject to updates in the annual WACC determination. However, this does not change the principle that airports should be able to use the most recent value available.

[4] Consultation Paper, at [46]–[51].

32. Equity beta is an example of a parameter where similar considerations arise. The 2016 IM review established a precedent of updating the relevant comparator data for asset beta. It is therefore legitimate for airports, over 5 years later, to update the data when they set prices (though we note it appears that CIAL opted not to do so). During Auckland Airport's PSE4 aeronautical price consultation and in submissions on the 2023 IM review, Auckland Airport and NZ Airports found the Commission's 2016 IM review methodology would now produce an estimated asset beta of 0.81.[5] This estimate is materially higher than the Commission's 2016 IM review estimate of 0.65 — before the Commission's 5 basis points downward adjustment for the regulated aeronautical part of airport businesses, which it discontinued in the draft 2023 IM review decision.[6] NZ Airports believes that it would also have been reasonable for CIAL to update the Commission's 2016 IM review asset beta estimate when it set prices and, as a result, to have applied a higher WACC estimate for establishing its PSE4 target return.

CREDIT RATING

Draft Conclusions

33. CIAL used a BBB+ credit rating instead of the IM parameter of A-, which results in an associated higher debt premium. The Consultation Paper notes that CIAL based its decision on four arguments:[7]

(a) small size relative to airports in the comparator sample;

(b) exposure to leisure traffic;

(c) exposure to natural disasters, including pandemics; and

(d) its own credit rating is BBB+ and this was used in PSE3.

34. In response, in addition to noting a lack of evidence to support these points, the Consultation Paper states that:[8]

> We consider that the arguments relating to size, exposure to leisure traffic and exposure to natural disasters are not typically matters that are considered in relation to credit rating. To the extent that these matters are systematic they would be accounted for in the asset beta.

35. Regarding the perceived lack of evidence showing that CIAL's exposure is greater than for other airports, the Consultation Paper states:[9]

> This latter point is important because we assume the benchmark airport has characteristics similar to the average of the comparator sample. This assumption avoids exposing consumers to inefficient prices when the regulated firm is structured in a way that deviates substantively from the benchmark airport.

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[5] See NZ Airports *Part 4 Input Methodologies Review 2023 – Submission on Draft Decision* (19 July 2023) at [8].

[6] Commerce Commission *Input Methodologies review decisions – Topic paper 4: Cost of capital issues* (20 December 2016) at [473] and [486].

[7] Consultation Paper, at [52].

[8] Consultation Paper, at [53].

[9] Consultation Paper, at [55].

36. Regarding the point that CIAL's actual credit rating is BBB+, the Consultation Paper states that it is more appropriate to use a benchmark cost of debt estimate in the WACC estimate than actual debt costs, because:[10]

(a) for an investor considering adding an airport to its portfolio, the market's view of the cost of capital is what counts, and not the debt costs of a particular firm; and

(b) if actual credit ratings were used, that could provide an incentive to increase leverage with adverse outcomes for consumers.

37. The Consultation Paper also explains that the Commission accepted BBB+ for Wellington Airport's PSE4 and CIAL's PSE3 because it was consistent with prudent level of debt financing and the benchmark credit rating used for regulated electricity lines and gas pipeline businesses. Accordingly, there were legitimate reasons for this departure from A- at the time. However, if the airport's actual credit rating is the same as the benchmark, then there was no case for an airport-specific adjustment.[11]

38. When setting prices for PSE4, CIAL's credit rating had a positive outlook and was then increased to be the same as Commission's benchmark of A- in Nov 2022. Accordingly, the reasons given for the BBB+ credit rating are not strong, but ultimately does not have a material impact on the overall WACC conclusions.[12]

NZ Airport's views

BBB+ is reasonable

39. NZ Airports supports CIAL's adoption of a BBB+ credit rating.

40. A theoretical view of what parameters an investor might use to estimate an airport's cost of capital is not relevant to the airport price setting process. CIAL is entitled to set prices to recover its efficiently incurred costs. There is no evidence to suggest that a BBB+ credit rating and associated debt premium is inefficient for an airport in CIAL's position. To the contrary, it has been accepted as efficient and prudent for airports in the past and for other sectors regulated under Part 4.

41. We can understand the Commission's position that an airport should not seek to use a lower credit rating than its actual credit rating. This is not the case for CIAL, where its credit rating only changed after it set prices. We see no reason why an airport should be expected to forecast its future credit rating (but not other WACC parameters).

Systematic factors

42. NZ Airports agrees that the size of an airport, its traffic mix and exposure to pandemics and natural disasters are relevant to its asset beta.

43. The current IM's large comparator set is best practice in terms of estimating asset beta for New Zealand airports:

(a) using a large sample will allow the "noise" inherent in individually estimated asset betas to cancel out, giving a more reliable estimate of the true average asset beta for the sample; and

[10] Consultation Paper, at [57]–[58].
[11] Consultation Paper, at [60]–[61].
[12] Consultation Paper, at [61]–[62].

(b) it is important to have a geographically diverse set of comparators because noise in the empirically estimate asset betas will often be geographically correlated.[13]

44. However, using a large and diverse sample does not remove the need for each New Zealand airport to consider whether there are good reasons to believe that their systematic risk profile is different to the average of the comparator set.[14] For example, while the 2016 IM provided the best measure of systematic risk factors at the time it was set, it has since been demonstrated to be out of date.

45. We therefore support CIAL's consideration of its specific risk exposures at the time it set prices and how they should impact on its WACC estimate.

PLEXIT

46. The Consultation Paper notes that CIAL has indicated that it is in discussions to purchase power and lighting assets from Airways, and that depending on the capital expenditure and operational expenditure involved it could look to reprice during PSE4.

47. NZ Airports notes that PLEXIT affects airports across New Zealand as Airways seeks to divest itself from its historical ownership and maintenance of power, lighting, and cabling assets on runways. We understand that many of these assets have not been maintained at optimal levels under Airways' ownership. As Airways negotiates transfers with airports, airports will be in a position where they need to evaluate the condition of these assets and in some cases invest in critical upgrades and updated annual asset management plans. This is important context for the Commission for the wider airports sector.

[13] See CEG *NZCC comments on asset beta estimates for airports* (February 2023) at [152]–[155].

[14] CEG emphasises that any relative risk assessment that justifies a departure from the large sample average should be achieved by adding or subtracting from the large sample average – and not by removing comparators from the sample. See CEG *NZCC comments on asset beta estimates for airports* (February 2023) at [153].