Cross-submission on Commerce Commission's Review of AIAL's PSE4

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

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Disclaimer

Introduction

1. TDB Advisory Ltd (TDB) welcomes the opportunity to comment on submissions on the Commerce Commission's review of Auckland Airport's 2022-2027 Price Setting Event. In our comments below, we argue that in reviewing Auckland International Airport Ltd's (AIAL or the Airport) selection of input parameters for its target WACC, the Commission is fully justified in assessing these parameters against its own updates to the airport comparator set and associated parameters that were used in the Commission's IM 2023 review. These updates represent the Commission's best estimate of how investors, market analysts and companies would currently assess the WACC for airports looking ahead.

2. Alternatively, if the Airport had wanted to avoid uncertainties that could arise (and have arisen) regarding the most appropriate parameter updates, it could have followed the Commission's "standard expectation" that parameters already in place from the 2016 IM review, notably for beta and leverage estimates, continue to be used. This approach was used by Christchurch Airport just shortly before Auckland's review and was deemed reasonable by the Commission. In view of new questions that have been raised regarding the IM 2023 decisions, and the forthcoming merits review, we remain of the view that this approach remains the better option to use for the PSE4 review. In other words, the Commission's Scenario 1 – which uses the beta and leverage estimates from the 2016 IM review, along with updates to the risk-free rate (RFR) and the tax-adjusted market risk premium (TAMRP) – remains a "safer" and more predictable option for assessing the Airport's PSE4 compared with Scenario 2, which draws on parameter updates from the 2023 IM review.

3. We also consider whether the Airport's WACC should be adjusted to reflect asymmetric risks. While not denying that such risks may occur, we agree with the Commission that there are a number of practical and conceptual difficulties in trying to take them into account through a WACC adjustment. It is uncertain, for example, whether funds raised through an uplifted WACC for some form of self-insurance against exogenous shocks would actually be used for that purpose. And we understand that a WACC adjustment for asymmetric shocks would need to be service-wide (e.g., covering all regulated airports), even if the type, scale, and impact of shocks potentially facing different entities were quite different.

Selection of WACC parameters

4. The submissions of NZAA and AIAL (supported by their advisors at CEG) have a common theme of defending the rationale and results of the updates to the 2016 IMs that favour AIAL and that were incorporated in Auckland's PSE4, while questioning the relevance (at least for PSE4 purposes) of the Commission's sample and certain parameter updates that were part of the 2023 IM decision.

5. We acknowledge that AIAL faced a timing dilemma in its selection of parameters for PSE4. It could either follow the Commission's "standard expectation" that the Airport continue using the equity beta and leverage estimates from the 2016 IM review, even though these estimates were nearing the end of their expected lifespan and arguably did not adequately capture the impact of more recent events (notably the pandemic.) Or AIAL could choose to update the parameters using whatever methodology it deemed appropriate, knowing though that at much the same time the Commission was engaged in its own updates in the context of the 2023 IM review.

6. While AIAL's choice of the latter strategy – pursuing its own updates – is understandable, that does not imply that its results should prevail. Instead, in reviewing the PSE4 proposals, the Commission should be expected to – and does – apply its own updated methodologies and judgements to gauge how investors and others would assess the Airport's WACC over the PSE4 period. The fact that the Commission's methodologies and judgements differ from the proposals in PSE4 is not to say that the latter are wrong, but rather that the Commission's updated approach – one we largely agree with – incorporates its latest assessment of factors relevant to the WACC going forward. These include the most suitable set of airport comparators, the associated beta and leverage estimates, and the potential systematic impact of exogenous shocks (such as pandemics) going forward.

7. To illustrate the tensions that arise in this context, CEG argues that, for the purposes of PSE4, updates to the asset beta estimate to take into account pandemic risks should be done using the airport comparator sample that was used in the 2016 IMs, not the updated 2023 sample. CEG argues that changes in the sample were for "reasons unrelated to updating the parameters for revealed pandemic risks."[1]

8. There is some point to CEG's argument in a narrow, technical sense: as CEG notes, the updated sample is used only to estimate the pre-covid asset beta and is not used in the estimated pandemic uplift.

9. But CEG again seems to be missing the bigger point. The updated sample, along with its parameter estimates, represent part of the Commission's clearly articulated objective of coming up with its best estimate of how investors, market analysts and companies would assess the WACC for airports looking ahead. When faced with changing economic circumstance, including an unprecedented exogenous shock, the development and application of such updates become all the more important.

10. Reflecting the approach and methodology it actually adopted, the Commission notes that "*An alternative interpretation was that COVID-19 was, at least in part, a systematic event and the pandemic provided new information about the relative risk of investing in airports that can be affected by government responses and consumer behaviour associated with a pandemic*."[2] Note the use of the term "***a***" pandemic; not "***the***" pandemic. The Commission is not just aiming to come up with best estimates of beta through the covid-affected period, but the best estimates

[1] *Treatment of Systemic and Asymmetric Risk in NZCC PSE4 Consultation Paper,* CEG 2024, para 26.
[2] Cost of Capital Topic Paper, para 4.87, Commerce Commission, December 2023.

for future years when the likelihood of another pandemic, although not zero, is (we hope and expect) much reduced.

11. In effect, CEG is asking the Commission to cast a blind eye to any updates to the comparator sample that would form part of these best estimates going forward. The Commission's IM Decision Paper sets out clearly the reasons why its updated comparator sample is more appropriate than the 2016 sample – including by taking into account the potential impact of future pandemics or other shocks. For example, in deciding to exclude potential comparators with negative leverage, the Commission notes that negative leverage may be a signal of broader business risks facing the airports concerned.[3] These risks could make such comparators less relevant when it comes to estimating the systemic risks facing New Zealand airports – now and into the future.

12. In other words, whether in the context of PSE4 or the IM review more generally, if investors and others are considering the most appropriate return to be expected from airports in the post-pandemic world, they would surely want to base such estimates on the most useful set of comparators, along with the associated updates to numerical estimates of the asset beta and other key parameters. It is this forward-looking aspect of the Commission's findings that does not appear to be adequately reflected in CEG's analysis.

13. Much the same point applies as regards AIAL's argument for using a TAMRP of 7.5 percent in both of the Commission's scenarios for the WACC. A TAMRP of 7.5 percent is appropriate for inclusion in Scenario 1 along with the other established WACC parameters; it has, for example, been "correctly" applied by Christchurch Airport in this context. But a TAMRP of 7.0 percent is part of the Commission's updated view on how investors and others should view airport returns going forward. It would be remiss of the Commission not to reflect such views in its assessment of PSE4.

14. We note CEG's claim that there are coding errors in the Commission's application of the "Flint method" for estimating an appropriate asset beta adjustment to reflect the systematic impact of the pandemic. We will leave it to the Commission to address these points as the claimed errors cannot apply to TDB's analysis which was Excel-based and did not involve coding.

What scenario to use?

15. All in all, the claims of errors in the asset beta calculation, along with the forthcoming merits review of the IM 2023 decision, raise further questions about whether the updated parameter estimates in the Commission's Scenario 2 should be used for AIAL's PSE4 review. In view of these concerns, we continue to argue that Scenario 1 should be used in the PSE4 review: as we noted earlier, this Scenario is consistent with the Commission's standard expectation that the prevailing beta and leverage estimates be used; this approach can be applied consistently through time (e.g., when an overall IM review is not taking place and updated estimates are not available); and it follows the precedent set by and deemed reasonable for Christchurch Airport recently.

[3] op. cit. para's 4.135-136.

16. We note the comment in NZAA's submission that "*The use of the 2023 IM reflects a change in the Commission's position in the Issues Paper, where it stated that the IMs that apply to this review are the IMs that were in force at the time that Auckland Airport made its pricing decision on 7 June 2023. NZ Airports has always understood that pricing decisions would be assessed against the IMs in force at the time the pricing decision was made, given that the IMs are intended to guide pricing decisions*" (para. 63). While NZAA goes on to discuss the timing problems that then arise (as we also alluded to above), we consider that this underlying view is consistent with the Commission using Scenario 1 in its assessment of AIAL's pricing decision.

17. In much the same vein, we disagree with NZAA's argument that the Commission should adjust the 2016 IMs by removing the 0.05 downward adjustment in the asset beta and adding an uplift for pandemic risks, as these adjustments were not part of the IMs that were in force at the time of AIAL's pricing decision.

18. In view of its comments above, we think it is disingenuous for NZAA to argue that AIAL "*sought to apply and update the 2016 WACC IMs in its price-setting decisions, rather than depart from them*" (para.14), when it has departed from them in every parameter and by a substantial margin. Similarly, we would dispute NZAA's suggestion that AIAL's approach "*is consistent with the approach that all regulated airports adopt in their pricing decisions*" (para. 14). As noted above, the pricing approach of Christchurch Airport, conducted at much the same time as Auckland's, was much more in line with the Commission's expectations and has been accepted as such by the Commission.

Asymmetric risks

19. CEG, echoed in the submissions of AIAL and NZAA, discusses at considerable length the possibility of asymmetric risks in airport returns. CEG argues in part that such risks could be accommodated through an uplift in the WACC. We don't dispute that, in some circumstances, asymmetric risks may occur. In its past rulings, however, the Commission has recognized both the conceptual and practical difficulties of taking such risks into account and has explicitly determined not to adjust the WACC for them.

20. We focus here on what the Commission has labelled "Type I" asymmetric risks. These are "risks that are generally unrelated to the day-to-day operations of the firm, and arise through infrequent events that could produce large losses. Examples include natural disasters; pandemics; terrorist threats; or large, unexpected policy shifts… "[4] These risks appear more relevant for airports than Type II risks, which concern the possibility of new entrants to the market and asset stranding due for example to technological innovation.

21. The Commission cites several reasons for its decision not to make any adjustments to the cost of capital for Type I asymmetric risks. It notes for example that its benchmark cost of capital determinations are intended to apply to all suppliers of a regulated service. In that context, "If the Commission were to apply an ad-hoc adjustment to the service-wide cost of capital it would imply that all suppliers of a particular service are exposed to the same level of asymmetric risk. However, suppliers of a regulated service are exposed to different levels of

[4] Input Methodologies (Airport Services) Reasons Paper; Commerce Commission December 2010 para. E12.4

asymmetric risks and at possibly different time periods. If the IMs were to make an ad-hoc adjustment for asymmetric risks in the service-wide cost of capital it may over-compensate some suppliers and possible (sic) under-compensate other suppliers." [5]

22. The Commission goes on to note that, in practice, firms may not be able to obtain external insurance to cover all types of asymmetric risks, and the only option left to them may be to self-insure. While an uplift to the WACC could, in principle, provide funds for such insurance, the Commission argues that there is no assurance extra revenues would be used for that purpose. Furthermore, the Commission notes that, in contrast with firms in competitive markets whose only option may be some form of self-insurance, in the case of airports and other regulated entities "regulators are in the unique position of being able to make ex-post adjustments with the benefit of hindsight."[6]

23. The Commission also points out the difficulties in making provision for asymmetric risk by choosing a value for the cost of capital at the upper end of the plausible range of such estimates. They note that such an estimate would be "difficult to quantify and would risk becoming conflated with the unrelated issue of recognising the potential asymmetries arising from estimation uncertainty."[7]

24. We would argue that these questions and concerns the Commission has raised concerning compensation for asymmetric risk remain valid in the context of AIAL's PSE4. For example:

- is there any assurance that the "extra" returns the Airport would earn through an uplifted target WACC would be ring fenced for some form of self-insurance rather than, for example, distributed as additional returns to shareholders? We would argue that credible assurances have not been given in this regard; and

- what types of future service-wide (as opposed to AIAL-specific) risks are envisaged, and can they be satisfactorily quantified? We suggest that such identification and quantification is problematic. For example, Auckland may be more exposed to volcanic risks as opposed to the earthquake risks that Wellington and Christchurch face. But estimating in advance the impact of either and adjusting the WACC in a way that was reasonably "fair" across different shocks would be highly speculative. We suggest too that terrorism events or threats may tend to be focused on one rather than all airports.

25. We accept that the inflation risks cited by CEG would be an example of a system-wide event. However, we are not convinced that the past history of inflation risks or the inflation forecasts cited by CEG provide a robust and reliable basis for making a forward-looking adjustment to the WACC. Such forecasts are always uncertain and subject to change. Furthermore, if AIAL was convinced of the merits of an alternative inflation outlook from that of the RBNZ (or others), it could incorporate that track in its baseline projection and defend it accordingly. That would seem to be a more direct and straightforward course of action than seeking a questionable uplift to the WACC.

[5] Ibid para. E12.2
[6] Ibid para. E12.7
[7] Ibid E12.9

26. CEG draws on the asymmetric risk compensation that the UKCAA provides for Heathrow and develops associated scale and risk adjustments for AIAL's WACC. What is missing from this analysis, however, is recognition of the point above – that in the New Zealand context, the WACC, including any risk adjustments that might be made, is service wide, covering all the regulated airports and not AIAL alone. The scale and risk adjustments appropriate for Wellington and Christchurch airports would presumably be quite different from those for Auckland. As a result, we think that using CEG's approach to reach an adjusted WACC appropriate to all three would be problematic and speculative.

Other matters

27. CEG argues that AIAL should be able to target a mean return above the midpoint WACC because of an apparent rise in the Airport's operating leverage compared to the comparator sample. They suggest that the 65th percentile, as applied to the electricity sector, could be a "relevant point of comparison." We disagree with CEG's conclusions:

    i. The Commission's rationale for allowing a WACC uplift for the electricity sector (i.e. recognizing the severe economic impact of electricity blackouts) does not have a reasonable analogy in the airport sector, and so this comparison is not useful.

    ii. We find the broader argument for a WACC uplift on the basis of higher operating leverage somewhat circular in this case. AIAL's higher operating leverage is driven in part by its current investment programme, whose scale and merits have been disputed by the airlines and that is inherently part of the current PSE4 review. In these circumstances, it does not appear appropriate to "reward" the Airport further through a WACC uplift driven in part by a disputed investment programme.

    iii. In other work,[8] we find that the impact of capital expenditure on operating leverage and hence asset beta is not large (at least in the case of airports.)

    iv. Even to the extent that there is some impact of capital spending on operating leverage, most airports – including those in the comparator set – probably engage in major development projects from time to time. This would imply that how Auckland compares with others in the comparator set regarding operating leverage is likely to change through time as development projects come and go. Hence, current differences in this regard need not be systematic and would not provide a sound basis for a WACC uplift.

28. The NZAA submission argues that constrained airport capacity will have more impact on airline pricing than airport charges (cf. para 13d). The difficulty we find with this argument is that, as the airlines have argued, Auckland Airport's capacity doesn't show a material increase under AIAL's investment plans.

29. NZAA also objects to the Commission's use of 6.98 percent as a starting point for reviewing the WACC (paras. 26-27). We see this as much ado about nothing: the Commission makes very clear the rationale and basis for updating the WACC from this starting point, and how it reaches its new preferred range of 7.28-7.51 percent. The Commission cannot be held

[8] Review of Aspects of Wellington International Airport's Initial Pricing Proposal for PSE4, TDB Advisory October 2019.

accountable if journalists or others misunderstand the Commission’s analysis or choose not to read far enough into its report.