

3 February 2023

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**Re: CEPA Report on Aspects of the Cost of Capital Input Methodologies for the 2023 Review**

### Introduction

BARNZ welcomes the opportunity to comment on the report prepared by Cambridge Economic Policy Associates Pty Ltd (CEPA) on aspects of the cost of capital input methodologies. Our comments focus on CEPA's analysis and findings regarding airport services.

We give particular attention to the updated estimates that CEPA provides for the asset beta for airports. In that regard, we have little disagreement with the underlying analytical framework used by CEPA to derive updated beta estimates and the "raw" results of this analysis. We propose, however, a modified approach that, in our view, provides a more appropriate weighting on the beta estimates over recent years where results have been distorted by the impact of Covid-19. In the attachment to this report, we provide independent expert analysis by TDB Advisory Ltd (TDB) of how a suitably modified approach would affect the estimated asset beta for Auckland International Airport Ltd (AIAL). We suggest that this approach should be extended to the comparator sample as a whole.

### Asset beta updates

In its 2016 IM review, the Commerce Commission (the Commission) arrived at an asset beta estimate for regulated airport services of 0.60. Using the same approach, CEPA estimates an updated asset beta of 0.74. This is based on the two most recent five-year periods (2012-17

and 2017-22); updates to the comparator set and estimates of leverage; and the 0.05 downward adjustment to the “raw” estimate of 0.79 from the sample periods used.

Figure 4 in the CEPA report illustrates the sharp jump in the airports’ asset beta as Covid-19 took hold in early 2020. Breaking down its recent estimates into a pre-Covid period of 2018-20 and a Covid-affected period of 2020-22 (up to end-February), CEPA finds that the average asset beta rose by around 0.14 from the first period to the second – from 0.70 to 0.84 after the 0.05 adjustment. The most recent data suggest, however, that a modest downward trend may have emerged in 2022.

The significant and probably exceptional nature of the Covid shock suggests that recent estimates of beta need to be viewed with extreme caution when they are used as a basis for forward-looking assessments of the cost of capital. In particular, we think that the Covid-affected period and its associated jump in beta need to be down-weighted in the Commission’s current Input Methodology review to better reflect the airports’ prospective cost of capital in more normal times that should prevail going forward. While a potential recurrence of pandemic-like events cannot be disregarded, public authorities will be able to draw on lessons learned during Covid-19 to mitigate the economic consequences of their future policy responses. The downward trend noted above in the asset beta among the airports’ comparator group may reflect some reassessment of the risks of future disruption.

A recent report by the Flint Group,<sup>1</sup> prepared for the U.K. Civil Aviation Authority, offers what we think is a very useful approach for reflecting the impact of Covid-like events in an appropriate manner. Using the pre-Covid period as a baseline, Flint develops forward-looking beta estimates over a comparator group for Heathrow Airport. In particular, Flint simulates the effects of Covid-like events occurring at different frequencies – e.g., from once every 5 to once every 100 years. Flint finds, for example, that for Covid-like events occurring between one in 20 and one in 50 years, the appropriate Covid adjustment to the baseline would be in the range of 0.04 to 0.14. The lower bound in this range assumes that future Covid-like events continue to affect betas for 17 months (analogous to the Feb. 2020 – June 2021 period), while the upper bound assumes an impact over 30 months. In comparison, the actual impact of Covid -19 on beta over 2020-21 appears to have been over 0.20 for the comparator group.

As detailed in the attachment to this covering report, TDB has replicated the Flint methodology in estimating an updated asset beta for AIAL. Overall, we find that an event similar in nature and impact to Covid-19, occurring at a frequency between once in 20 and

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<sup>1</sup> “Support to the Civil Aviation Authority: Estimating Heathrow’s beta post-Covid-19”, Flint, August 2021.

once in 50 years, would increase the beta estimate for AIAL by between zero and 8 basis points, compared to recent pre-Covid observed values.

As a basis for looking forward and reflecting the impact of Covid-like events appropriately, we suggest that an approach such as this – extended to the full airport comparator set – would lead to more reasonable estimates of beta than those derived from the heavily Covid-affected raw data for 2020-22 as used by CEPA.

### Standard errors

CEPA finds that the standard errors around the beta estimates have increased since the last review. Drawing on these updated estimates, CEPA notes that “(t)he uncertainty interval is incredibly wide” (pg. 16.) As illustrated in Figure 4 (p. 17) of the CEPA report, the 95% confidence interval around the average asset beta estimate ranges from a lower bound that is generally around 0.0 to 0.2, to an upper bound of about 1.2 to 1.4.

We agree with CEPA’s advice that the Commission “consider the standard error estimation procedure and implications of this carefully” (p. 16). We note that such results highlight the substantial level of judgement and discretion surrounding the Commission’s determination of the most appropriate asset beta to use in the current IM review, as the point estimates are so imprecise.

### Comparator airport set

CEPA has updated the Commission’s 2016 airport comparator set, dropping six airport companies – mainly because they have been delisted (including Sydney Airport), have had a change in ownership structure, or have little or no involvement in relevant aeronautical services – and adding three companies that appear to be genuine airport operators.

We think it is important that the comparator set comprise entities whose primary focus and activity is in providing relevant aeronautical services, even if this means using a smaller group of comparators. It is unfortunate that Sydney airport has been delisted and therefore excluded – as it is a relevant dataset for the Asia Pacific region. In general, we would encourage the inclusion of airports from comparable economies to New Zealand.

### Credit ratings

Only five airports in the updated comparator sample have long-term credit ratings from S&P or Moody’s. All of these airports have investment grade ratings of A- or above (including AIAL at A-). CEPA also notes that these credit ratings have been relatively stable since 2016 and,

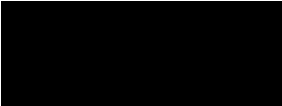
even with downgrades in two of the comparators during the Covid-19 period, their ratings remain comfortably above the investment grade threshold.

On this basis, we consider there is little reason to change the Commission's use of a notional A- credit rating in the current IM review.

#### The downward 0.05 adjustment in beta

CEPA notes and applies the downward 0.05 adjustment in the asset beta estimates, but does not address the pros and cons of this adjustment. In BARNZ's view, the arguments for this adjustment remain valid. As we have argued previously, there is likely to be lower inherent volatility in the earnings of airports' core aeronautical services compared with non-aeronautical activities like parking and retail services. This difference is appropriately reflected in the discretionary downward adjustment in the asset beta estimates.

BARNZ is happy to take questions on this submission.



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