NZ AIRPORTS ASSOCIATION

# PART 4 INPUT METHODOLOGIES REVIEW 2023

# CROSS SUBMISSION ON PROCESS AND ISSUES PAPER

**3 August 2022**

## INTRODUCTION

1. This is a cross submission by the NZ Airports Association ("**NZ Airports**") in relation to 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 cross submission.

3. We have reviewed the submissions by Air New Zealand, A4ANZ, BARNZ and Qantas ("**airline submissions**"). We have also reviewed the report by TDB Advisory ("**TDB Advisory Report**"), as commissioned by BARNZ and referred to in all of the airline submissions. This cross submission makes some brief comments on relevant topics raised in the airline submissions and TDB Advisory Report.

4. NZ Airports requested Dr Tom Hird of Competition Economists Group ("**CEG**") to review the TBD Advisory Report and to provide independent expert advice on asset beta and asymmetric risk matters ("**CEG Report**"). The CEG Report is attached and referred to in this cross submission where relevant.

5. Overall, it appears that NZ Airports and the airlines are relatively aligned on most matters relevant to the IM Review. In particular, airports recognise that airlines have also suffered significant hardship due to COVID-19. Responding to these unprecedented events has required extensive collaboration between airports and airlines.

6. A key theme throughout the airline submissions is that airports may now seek ex post compensation for the impact of COVID-19 by seeking a change to the Commission's asset beta methodology. This is not the case. Rather, NZ Airports is simply seeking that the Commission applies its tried and tested methodologies to update key WACC IM parameters and avoids introducing new regulatory uncertainty in difficult times by seeking to change its methods.

7. NZ Airport's contact for this cross submission is:


Kevin Ward
Chief Executive
kevin.ward@nzairports.co.nz
04 384 3217


## ASSET BETA

### Incorporating the risk of pandemics

8. The airline submissions argue that there should be no adjustment to the asset beta to provide ex post compensation to airports for the impact of COVID-19.

9. NZ Airports agrees. As set out in our submission on the Process and Issues Paper ("**Submission**"), we encourage the Commission to apply its established methodology for updating the asset beta. We anticipate this will involve:

   (a) updating the comparator set (e.g. to remove unlisted companies or add newly listed companies, or to remove companies where new information suggests they are not truly airport service providers); and

(b) as at a date as close as possible to the time that the IMs are determined following this review, re-estimating asset beta using the average of weekly and monthly data from the most recent two five-year periods.

10. The CEG Report provides views on how the comparator set should be appropriately updated using the Commission's methodology and concludes that 0.83 is a reasonable estimate (noting that the Commission will update its analysis at a later date).

11. Following the Commission's established approach will appropriately incorporate pandemic risk into the asset beta estimate. We therefore endorse the following statement made by BARNZ:[1]

> As the TDB report highlights, the Commerce Commission has been consistent in maintaining that it would not factor in adjustments to WACC for unsystematic or asymmetric risks throughout its management of the IM approach. We agree this approach needs to be maintained, and that the covid pandemic does not provide a sound reason for departing from it.

12. It is not clear from its submission, but A4ANZ appears to imply that the Commission should depart from its established methodology for estimating asset beta. A4ANZ urges the Commission to maintain asset beta at 0.6, without any consideration of whether this figure would be produced by the Commission's established estimation methodology.

13. A driver of the airlines' position appears to be that the impact of COVID-19 is now historic, so any increase in asset beta would effectively compensate airport investors for risk they no longer bear. Putting aside that NZ Airports is simply asking the Commission to follow its established methodology for updating its asset beta estimate, we disagree with the notion that pandemic risk is historic, such that it does not need to be reflected in asset beta estimates. As stated in our Submission (where we referred to the statements by the UK Civil Aviation Authority), COVID-19 will have an enduring impact on airports' WACC, and therefore needs to be appropriately incorporated into forward-looking asset beta estimates.

14. On this topic, the CEG Report concludes:[2]

> In my view, there is a strong case for the NZCC to continue to apply its existing methodology (i.e., it will appropriately incorporate the impact of COVID-19) given:
>
> - The NZCC’s current methodology provides the correct estimate of asset beta risk on average over time. This is because the rolling estimation windows ensures that every event that occurs (e.g., a pandemic, a global financial crisis, historically high inflation, a war in Ukraine etc.) will be weighted in the long run average IM asset beta according to the frequency with which that type of event actually occurs.
>
> - Any attempted change in methodology to seek to incorporate specific risk events would almost certainly result in too high or too low average asset beta over time. This is because it is impossible to accurately estimate the parameters necessary for incorporating the impact of such events.
>
>   - Noting that any change in methodology to seek to reduce the estimated impact of the pandemic in the 2018 to 2023 window

---

[1] BARNZ Submission on Process and Issues Paper at [4].

[2] Dr Tom Hird *Asset beta update for the 2023 IMs* (Competition Economists Group, August 2022) ("**CEG Report**") at [81].

(to reflect an estimated long run average frequency of pandemics) would, based on its own internal logic, need to be paired with an increase in estimated asset betas in all other (past and future) estimation periods unaffected by pandemics.

  - If done correctly, this should have zero effect on the long run average asset beta. However, because we simply do not know either the true frequency of these events or the impact on measured asset beta when they occur, then attempting such an adjustment will inevitably lead to over or underestimation of the asset beta in the long run.

- There would be a massive increase in the complexity of the IM process (both now and in future IMs) associated with attempting to ensure internal consistency across time; and

- The complexity would introduce scope for cherry-picking analysis and provide incentives for stakeholders to try and game the process by promoting approaches that were not internally consistent through time.

**Large comparator set is required**

15. We disagree with the TBD Advisory Report suggestion that a smaller or narrower set of "more comparable" airports should be used to estimate asset beta. Our understanding is that the Commission's established methodology uses the largest comparator set possible to mitigate the risk that "noise" associated with individual company estimates will skew the estimate. We believe it would encourage cherry picking and exercise of subjective judgement if the Commission was to now invite views on which companies should be included or excluded in the comparator set based on relative risk profiles. We refer to the CEG Report's advice that:[3]

> TDB does not identify which airports it considers fit these categories. As explained in the previous section, I consider that the NZCC is correct to rely on the largest possible sample of comparators of airport companies – provided that these companies are, in fact, airport companies subject to passenger demand risk.
>
> The evolution of the NZCC's methodology has been based on a preference for a broad sample of comparable companies rather than engaging in, inevitably, subjective analysis to try and identify a small sample of the most comparable companies. The NZCC has logically argued that the average estimated beta of a smaller sample, even if it was on some dimensions more comparable, may be less reliable due to noise in the individual asset beta estimates.

16. NZ Airports therefore sees no basis for the Commission to depart from its established methodology for compiling and updating the comparator sample. The TBD Advisory Report does not provide evidence that changing the methodology will better promote the purpose of Part 4.

*Aeronautical v non-aeronautical risk*

17. NZ Airports continues to believe the 0.05 downward adjustment to asset beta should be abandoned because there is no evidence that aeronautical operations are less risky than the

[3] CEG Report at [54]-[55].

airport as a whole. The policy rationale underlying the original decision to impose the downward adjustment is flawed. Removing the adjustment would better promote the Part 4 purpose statement, by ensuring that airport aeronautical returns are measured against a benchmark that is more commensurate with their risk profile.

18. The CEG Report supports NZ Airports' view. It analyses the conceptual challenges that the Commission has not grappled with in the past and points out that there is no empirical evidence to support the Commission's position. It concludes as follows:[4]

> In summary, I do not consider that there is a valid case for presuming that aeronautical asset betas are lower than non-aeronautical asset betas. This is because aeronautical cash-flows are more exposed to temporary economic shocks than non-aeronautical cash-flows and has average risk exposure to permanent economic shocks. If anything, this suggests higher risk for aeronautical activity than non-aeronautical activities.

**Compensation for asymmetric risk is a separate matter**

19. We also note that the CEG Report supports NZ Airports' position as set out in the Submission that it is appropriate for airports to separately consider mechanisms to allocate asymmetric risk. It explains that:[5]

    (a) A primary concern of investors is to be compensated for the actual cost of asymmetric risk events – i.e. catastrophic risk events such as earthquakes and pandemics; and

    (b) A separate and secondary concern is to ensure that non-diversifiable systematic risk is compensated via asset beta in WACC.

20. The CEG Report therefore concludes that:[6]

> It follows that the updating of the asset beta under the IM review is therefore a separate matter to, and does not impact on, any consideration airports might give to compensation for ex ante expected costs in pricing consultations.

21. In response to airlines submissions NZ Airports notes that if airports did adopt mechanisms as part of pricing decisions to better allocate asymmetric risk, then this would be in relation to future asymmetric risk events and would not be an attempt to seek compensation for past events.

**TAMRP**

22. The TBD Advisory Report argues against the Commission making a discretionary adjustment to TAMRP akin to the adjustment made for the GFC. We agree.

23. The TBD Advisory Report also suggests that the estimate of TAMRP should be rounded to 7.25%. We disagree.

24. We repeat our Submission that the Commission should follow a consistent approach for all sectors regulated under Part 4 of the Commerce Act and Part 6 of the Telecommunications

[4] CEG Report at [97].
[5] CEG Report at [24] and [29].
[6] CEG Report at [30].

Act and we endorse its proposal to use its 2020 estimate of 7.5% (which was applied to the gas sector earlier this year).

**AIRPORT CREDIT RATING**

25. The TDB Advisory Report states that the credit rating should remain at A-. As stated in our submission, we support the Commission considering whether the credit rating should be updated to reflect changes in the regulated airports' credit ratings.

26. Ultimately, however, the key concern for NZ Airports is that when reviewing pricing decisions the Commission will take the appropriate airport-specific credit rating into account.