TDB
ADVISORY

NZ Commerce Commission: Part 4 Input Methodologies Review 2023

Process and Issues and Draft Framework Papers, May 2022

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1 Introduction

TDB Advisory Ltd (TDB) welcomes the opportunity to comment on the Commerce Commission's Process and Issues and Draft Framework papers surrounding the forthcoming Part 4 Input Methodologies Review. In this report, we focus in particular on the airports sector.

We agree with much of the content of the Process and Issues and Draft Framework papers and welcome the intended continuity in much of the Commission's approach to this review.

In our report we identify several issues that may come up in in the course of the upcoming review and which, we think, will require careful consideration. These include whether or how the IM review should handle the impact of the Covid-19 pandemic and its consequences.

In addressing these issues, we focus on the underlying principles that, we believe, should continue to guide the Commission in its decision-making processes. We pay particular attention to the principles-based approach for estimating the cost of capital, especially equity, in an analytically sound, consistent, and robust manner.

2 Discussion

The Commerce Act sets out the ground rules that enable businesses to compete on their merits. One of these rules is a prohibition on firms with substantial market power misusing that market power to harm the competitive process – s36 of the Commerce Act.

2.1 Should the estimated cost of equity be increased because of Covid-19?

In TDB's view, the Commission should maintain its principles-based approach to valuing the cost of equity. In particular, we think the Commission should resist pressures that might arise from airports for "compensation" for the effects of the Covid-19 pandemic, whether through increases in the TAMRP or in the equity and asset betas. We draw on several arguments in support of this view.

The Commission has maintained from the outset of its IM approach that it would not accommodate adjustments to the cost of capital for unsystematic or asymmetric risks. In its IM Reasons paper of December 2010, the Commission explicitly ruled out adjusting the cost of capital for risks such as pandemics. It based this view in part on the difficulties of quantifying these risks, determining the implied adjustment in the cost of capital, and guaranteeing to customers that increased revenues suppliers might receive from such an adjustment were "ring fenced" for self-insurance against asymmetric risk rather than used for other purposes. We suggest that these arguments continue to hold.

Other regulators are following a similar approach. For example, in its recent Airport Monitoring Report 2020-21 (June 2022), the Australian Competition and Consumer Commission (ACCC) addresses the impact and aftermath of Covid-19 as follows. *"The ACCC considers that the APPs* [Aeronautical Pricing Principles] *preclude an airport from increasing aeronautical prices to make up for lost profits or previously unrecovered costs. This also means that.....the APPs do not allow an airport to include unrecovered costs into its asset base for negotiation of prices in future ASAs* [Aeronautical Service Agreements (between airports and airlines.)] *The ACCC is likely to have serious concerns if any*

airports engage in 'catch-up pricing' and would likely consider such actions as evidence of exercise of market power." We suggest that the same views should prevail during the forthcoming IM review for New Zealand.

We note that while the pandemic has had deep and relatively prolonged effects on some sectors, including travel and tourism, its impact on overall economic and financial market activity has been much milder and shorter-lived than initially feared. For example, GDP growth in most economies, including New Zealand, has held up much better than initially forecast, with the more recent slowdown driven predominantly by events other than Covid. Partly reflecting these real trends, after plunging in early-2020 as pandemic concerns took hold, stock markets around the world (including in NZ) quickly recovered, regained previous highs well before the end of 2020, and continued to climb strongly until recently.

As a result, the conceptual "well balanced" equity portfolio that underpins the IM approach to valuing equity will have provided sufficient diversification to largely compensate investors for the more prolonged weaknesses in some specific sectors, without the need for additional adjustments. Furthermore, in line with its intended focus on *ex-ante* market returns, the Commission should be looking at what is essentially a post-Covid world rather than considering adjustment to the cost of equity that might be attributed to Covid.

2.1.1 Adjustments in beta

As part of the argument outlined above, we think that the Commission should resist Covid-related arguments for adjustments in the equity or asset betas. We note that the beta estimates reflect the fact that airports' sensitivity to systematic risk is less than that of the market as a whole. Such estimates are inherently made over a lengthy period of time. There is also some indication that asset betas across the airport comparator sample may have either plateaued on average, or possibly declined, in the period leading up to the previous IM review (2011-16) compared with the preceding period (2006-11).

We have seen over the last couple of decades several "extraordinary" events that caused significant disruption to airline and airport performance. These include 9/11 and its aftermath and the 2010 volcanic eruption in Iceland that led to a prolonged suspension in north Atlantic air travel. In addition, airports are affected by a range of more "routine" disruptions, including from fog, hurricanes and so on.

We note too that while the future scale and nature of pandemics is unknown, the risk of pandemics is not a surprise. Pandemics have long been cited among the natural disasters and other catastrophic events that potential investors are alerted to in bond or equity offerings by airport owners and operators. For example, in the prospectus accompanying its share offer in 2010, Auckland Airport noted that "Future pandemics… may reduce passenger volumes at very short notice and, depending on the severity of the outbreak, may depress passenger volumes for an indefinite period which could adversely affect Auckland Airport."[1]

Risk episodes, when they actually happen, are almost by definition a shock and surprise. That has also been the case with Covid-19. But whether or not any specific risk eventuates, airports' cost of capital determinations implicitly reflect their possibility. These risks, among many other factors, are built into the airports' beta. To pursue further *ex-post* adjustments in equity or asset betas to compensate for risk events (like Covid) that have actually arisen would in effect be double counting the risk assessment elements in the cost of capital methodology.

2.1.2 Adjustment in the TAMRP during the GFC: a precedent?

The Commission made a discretionary adjustment in the tax-adjusted market risk premium (TAMRP) in 2010 during the Global Financial Crisis (GFC) – notably the increase from 7 to 7.5 percent for 2010-11. This adjustment was based on a range of views that the crisis had likely led to at least a temporary increase in perceptions of equity market risk. We would argue however that the GFC should not be

[1] Auckland Airport Simplified Disclosure Prospectus January 2010. See also the prospectuses for Infratil's bond offers of 2006 and 2013, and Wellington International Airport's retail bond offer in 2019, for references to pandemic risks.

viewed as a parallel for Covid-induced circumstances, and that the GFC adjustment is not a valid precedent for changes that might be considered currently. In particular, the GFC was induced and exacerbated by financial market events, including the Lehman Brothers collapse, with the downturn in the real economy following as a result. In contrast, the short-lived financial market downturn during Covid was driven by concerns the health pandemic would have on the real economy, and these real concerns generally persisted much longer than financial ones.

Furthermore, at the time the Commission made its decision to raise the TAMRP in 2010, financial markets appeared to be recovering but had not yet regained their pre-crisis levels of 2007. At the time of making its adjustment in 2010, the Commission referred to lingering uncertainties facing the real economy and financial markets, noting that "This [adjustment] cannot be interpreted to imply that the Commission is stating that the effects of the GFC will be over a particular time."[2]

We suggest that the 2010 context was quite different from current circumstances, where (we hope) Covid-induced uncertainties on the real economy and financial markets are largely behind us and markets are more focused on other developments. We also note that the Commission decided not to open the Fibre cost of capital IM in 2021 to take account of Covid-19. In reaching this decision, the Commission referred to the share market recoveries around the world since early 2020, and to academic observations that some of these market reactions can be associated with "a sharp increase and then relatively quick correction of the Market Risk Premium to normal levels." [3]

2.2 The recent TAMRP increase and the rounding question

In its October 2020 decision for Fibre Fixed Line Access Services, the Commission increased the TAMRP from 7.0 to 7.5 percent. This decision was subsequently extended to the Gas Pipeline sector in 2022. The Commission based its 2020 decision mainly on re-estimates of the TAMRP using several methodologies, applying updated historical and forward-looking evidence. The Commission also claims that the revised TAMRP is consistent with the range of estimates used by NZ market participants, including investment banks.

We agree with the need to re-estimate the TAMRP from time to time, especially if there are significant changes in the economic and financial outlook relevant for the review horizon. We also agree that several methodologies should be used in this task, given the acknowledged strengths and weaknesses in each individual approach.

Using this range of methodologies, the Commerce Commission's point estimate for the TAMRP in the 2020 exercise was 7.3 percent. This was the mean and median rate estimated using 5-year risk free rates, which are the appropriate ones for this purpose, and also the median 5-year rate using other (global) markets. The Commission then rounded up this estimate of 7.3 to reach its decision point TAMRP of 7.5 percent.

We do not consider that rounding the TAMRP estimate is necessary or appropriate. This approach has artificially inflated an actual estimated TAMRP change of 0.2 (from the previous median of 7.1 to the new estimate of 7.3), to an actual change of 0.5 (7.0 to 7.5). As was noted at the time[4], this further adjustment in the TAMRP led to the WACC estimate increasing by 0.3 percentage points, despite the median TAMRP estimate only changing by enough to justify a 0.12 percentage point increase in the WACC.

With a RAB of around $2b in the case of Auckland International Airport, each 0.1 point increase in the TAMRP implies an increase in "regulatory" revenues of over $1m per year. This would mean a revenue increase of nearly $6m associated with a TAMRP move from 7.0 to 7.5, whereas the increase implied

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[2] Commerce Commission Input Methodologies determination 2010 E7.120

[3] Cf *The Impact of the Covid-19 Pandemic on the Cost of Capital Input Methodology for Fibre*, Commerce Commission March 2021

[4] See BARNZ submission to the 2020 Fibre review, as cited in the Commission's decision paper.

by the median change from 7.1 to 7.3 would be more of the order of $2.4m. This is a not inconsequential difference, with the consequences growing over time as the asset base rises.

We also suggest that it was a stretch for the Commission to claim in 2020 that the new TAMRP was consistent with the estimates used by NZ investment banks and analysts. Of the data shown in Table 6.13 of the Commission's 2020 decision paper, only one of the six participants cited had a TAMRP above 7.4, and four of the six were in the range of 6.5 to 7 (implying a median estimate of 7 and mean of 7.1.)

In our view, the median estimate from the range of methodologies deployed should be the TAMRP used by the Commission. Although not perfect, the median is nevertheless a logically coherent way of smoothing out the potential weaknesses in the individual estimation methodologies and hence the best point estimate that is available. The approach of then rounding this median to the nearest 0.5 percent adds an unnecessary further layer of approximation and artificiality to the TAMRP estimate.

If, however, the Commission insists that some rounding is necessary, we suggest that the nearest 0.25 would be better than 0.5. In the circumstances discussed above, this approach would have resulted in a TAMRP rising from 7.0 to 7.25, which is much closer to the actual change implied by the median estimates.

2.3 WACC percentile for airports

In TDB's view, the WACC percentile for airports should be no higher than the mid-point (50th percentile.) By definition, the mid-point represents the best estimate of a normal return on investment going forward. Moving to a higher percentile could be justified only if there were clear, compelling, and causative evidence that such a move would provide long-term benefits to consumers – notably through incentives for investment and innovation that would not arise through other means. TDB suggests that such evidence is unlikely to be forthcoming, at least in the case of airports.

Previous discussions of the WACC percentile for airports have noted that, in addition to the investment incentives for core aeronautical services implied by the mid-point, airports face the prospect of increased returns from complementary airport services such as parking and retail activities. These services provide a lucrative revenue stream to airports. As these revenues certainly increase with growth in passenger numbers, along with those who assist them to and from the airport, operators already face strong incentives for investment and innovation to support growth in core services.

Several factors also combine to reduce the risks of under-investment in aeronautical services. One is the likelihood of public and airline pressure if there were a drop-off in the quality and efficiency of airport services – as evidenced, for example, through increased delays in airline departure and/or arrival procedures, or increased congestion in airport terminals (such as meeting and greeting areas.) In addition, airports face statutory requirements to provide adequate facilities for a range of public and official services. These include Customs and MPI activities, and a wide range of safety and security requirements regulated through domestic and international authorities. There is minimal risk of under-investment in such areas.

Pulling these points together, a stronger argument could be made for a WACC percentile for airports that is below the mid-point, as risks of under-investment appear lower than those of over-investment. But there is clearly little case for an uplift above the mid-point.

2.4 Airports comparator sample

In estimating the cost of capital for airports, the Commission's sample of "comparable firms" – ie, those with similar exposure to market risks – comprises mainly a set of overseas airport operators, as Auckland Airport is the only listed domestic operator. These overseas firms appear to vary widely in terms of the scale, range and complexity of their operations, with some firms having a number of airports (eg, in France, Japan, Thailand, and Mexico) and some very large operators (eg, in Germany,

Japan, and China.) This variety is also indicated by the very wide range in asset beta estimates for the operators in the sample – from around 0.2 to 1.2 in the 4-weekly estimates for 2011-16.[5]

While we agree that overseas operators need to be included in the sample of comparable firms, the Commission's selection raises questions about the trade-offs between using a larger sample that may include firms that differ markedly from domestic operators, and a smaller sample of more similar firms. The larger sample should enable some smoothing across the more and less comparable operators, but if there is a disproportionate number of the latter – as we would argue is the case – then this smoothing loses some of its validity.

On balance, we would prefer that a smaller sample of more comparable firms be used. We suggest that, in the Commission's current sample, the smaller operators that have primary responsibility for just one airport are likely to be more similar to their NZ counterparts than the very large, and often regional or even national, operators that are also included in the sample.

2.5 Credit rating for airports

We suggest that the notional long-term credit rating for airports remain at A-. This would provide continuity and consistency with the Commission's past approach to this issue. We note that there have been several adjustments up and down in actual credit ratings over recent years – including Christchurch Airport moving to and then from an A- rating – with recent downgrades probably reflecting the impact of the Covid pandemic.

Overall, considering a largely post-pandemic outlook where prospects for airline and airport activities appear to be rapidly improving, we think that there is more upside than downside risk regarding credit-rating adjustments in the coming years. The debt positions of some airlines (e.g., Qantas) have already improved significantly, and it is reasonable to expect airports to be acting equally quickly to strengthen their balance sheets. As a result, we don't see a clear basis for changing the current notional rating to something lower. We also note that cost of capital differences that may emerge from an airport's actual credit rating differing from the notional target rate can be dealt with in the Commission's *ex-post* assessments of each airport's actual profitability.

We also support the Commission's "Option 2" approach to setting a notional credit rating – ie, "selecting a target credit rating though judgement to reflect an appropriate level of credit default risk, while also having regard to the results from the comparator set." We think that the "Option 1" approach of estimating the average credit rating of the airport comparator companies is likely to be less reliable and credible, especially in view of our comments above about the significant differences within the comparator set, and also because very few credit ratings appear to be available for the comparators.[6]

2.6 Risk-free rates

TDB supports the Commission's approach to estimating risk-free rates, notably in estimating these rates over a 3-month determination window rather than taking a longer historical average. The use of prevailing rates is much more in keeping with the *ex-ante* character and intent of the cost of capital estimates, allowing interest rates to reflect current conditions and expectations in financial markets. We agree that the 3-month determination window provides an appropriate balance between the increased volatility that can be associated with shorter averaging periods, including from hedging activities, and the greater stability that arises with longer windows.

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[5] Cf Table 33 in *Input Methodologies Review Decisions - Topic Paper 4: Cost of Capital Issues,* Commerce Commission December 2016

[6] The Commission reported in its 2016 Decision Paper that only 3 credit ratings were available for the airport comparator sample.

2.7 Review period

In its Process and Issues paper, the Commission reports that it will consider changing the cost of capital IMs to allow for regulatory periods shorter than 5 years for airports. While there are substantive arguments on both sides of this issue, on balance TDB would prefer to see the current 5-year regulatory period maintained. This would support continuity and stability in the IM process and would help to reduce the transactions costs associated with each review.