NZ Commerce Commission: Part 4 Input Methodologies Review 2023 – Draft Decision

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

BARNZ
VOICE OF THE AIRLINE INDUSTRY

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Disclaimer

1 Introduction and summary

TDB Advisory Ltd (TDB) welcomes the opportunity to comment on the Commerce Commission's draft decision on the Part 4 Input Methodologies Review 2023. In this submission we focus on the draft decisions as set out and explained in the Cost of Capital Topic Paper, especially the decisions relating to airports.

As we discuss below, there is much in this paper that we agree with, including the bulk of the paper's analysis and the associated decisions. We congratulate the Commission for approaching the 2023 IM review with an open mind – retaining the methodologies from previous IM reviews where they remain appropriate; updating and refining its methodologies where necessary; and adopting an innovative approach to addressing the extraordinary circumstances that arose during part of the latest review period, notably through the COVID-19 pandemic.

We agree, for example, with the smaller set of comparator airports that the Commission proposes to use. We think the new sample provides a more uniform and reliable basis for comparison, with some of the anomalies and inconsistencies arising in the previous sample removed. We also support the Commission's approach to updating its asset and equity beta estimates. We think the proposed approach gives due recognition to the volatility of betas through the COVID-affected period, while incorporating the potential longer-term systematic impact of the pandemic in a way that reflects the infrequency with which such events are judged to recur.

We think the Commission's updated parameter estimates for the WACC are largely consistent with the current evidence available. If anything, though, the WACC may still be overestimated. This is indicated, for example, by the RAB multiples cited by the Commission, and by the very favourable views that the investment community appears to have of the airport sector, both in NZ and overseas. As a result, any reexamination of the WACC and its underlying parameters in the Commission's final decision should, we think, lead to a downward adjustment in the WACC.

2 Discussion

2.1 Cost of debt

2.1.1 The notional credit rating

We agree with maintaining the A- notional credit rating for airports in estimating the debt premium. This provides an appropriate investment grade rating for airports and is consistent with the international evidence that is cited from the comparator sample.

The principles the Commission should follow when setting the notional credit rating were well set out in the Commission's Review of WIAL's 2019-24 Price Setting Event. The Commission noted in particular that "We prefer to use a benchmark cost of debt estimate in the WACC estimate rather than Wellington Airport's actual debt costs. The relevant estimate of the cost of capital, including the cost of debt, is the market's view of the cost of capital for providing the service, not the debt costs of a firm which may or may not be efficient. This leaves the firm with the opportunity to out (or under) perform against the benchmark as long as that benchmark is reasonable."

We believe the Commission should stick with these underlying principles in the current IM review, reserving its scope for judgement and discretion for the Information Disclosure pricing review process. This approach was demonstrated in the WIAL review, where the Commission permitted adjustments in the cost of debt to take into account WIAL's longer average debt tenor and lower credit rating compared with the benchmarks.

2.1.2 The term credit spread differential

We support the Commission's draft decision to maintain its 2016 approach of not specifying a term credit spread differential (TCSD) for airports. As above, individual airport's circumstances can be addressed if necessary at each airport's Price Setting Event (PSE).

2.2 Cost of equity

2.2.1 The risk-free rate

We agree with maintaining the same risk-free rate for equity and for debt.

We also agree that there is insufficient academic and empirical evidence to support "convenience yield" arguments for using bonds other than government bonds to estimate the risk-free rate. Hence, the practice of using only government bonds to estimate the risk-free rate should be maintained.

2.2.2 The comparator sample

We strongly support the Commission's draft decision to use a smaller set of more comparable airport companies in its comparator sample. We agree that the comparators now proposed are squarely focused on providing core aeronautical services; that is their key role and identity.

Similarly, we agree with the Commission's rationale for excluding some of its previous comparators. As the Commission observes, some of these former comparators operate in quite different markets, have unreliable beta estimates, show unusual financing structures (leading to negative leverage in some cases), or have a low percentage of aeronautical revenues – and at times some combination of these concerns.

We also note and concur with the Commission's point that the approach it now proposes is consistent with international practice.

As we discuss in more detail below, the average asset beta that emerges from the proposed comparator group is in line with what we would expect from a sector providing core economic infrastructure and associated public services.

2.2.3 The impact of COVID-19

We fully agree with the approach the Commission proposes to take to estimate the systematic impact of COVID-19 on the asset beta for airports through the next regulatory period. As we and others have argued previously, the COVID-19 pandemic was an extraordinary event, including in its economic, social and public policy impact. While future shocks of this nature shouldn't be ruled out, we maintain the hope and expectation that these are relatively rare events and ones that would be met by policy measures that are informed by the experiences of recent years.

Consistent with this view, the Commission identifies the sharp jump in the airport asset beta average during the more intense phase of the pandemic, along with the subsequent decline in the average back towards its pre-pandemic level. We agree with the Commission's assessment that this pattern suggests there has been at most a limited systematic impact of the pandemic.

As a result, we think the Commission is fully justified in departing from its previous practice of estimating the asset beta mainly from the average for the comparator sample over the last two five-year periods. In the current context, that would involve fully factoring into the average the abnormally high betas over the COVID-19 period. As a result, the average would significantly overstate the likely systematic impact of the pandemic going forward. It would thereby provide a poor basis for estimating the beta and hence the overall cost of capital in the forthcoming regulatory period.

Instead, the Commission proposes adding a "premium" to the long-term pre-COVID average beta, the premium based on an assumed 20- to 50-year recurrence of Covid-like events and reflecting the systematic impact of the pandemic.

We strongly support this approach. Its rationale, methodology and findings are largely consistent with the approach and findings we reported in our replication of the Flint method used in the U.K., as cited by the Commission.

We think that the resulting asset beta of 0.55, based on a 0.02 premium on the pre-Covid average of 0.53, provides an analytically sound and economically reasonable input for estimating the cost of capital in the regulatory period ahead.

2.2.4 The downward adjustment in asset beta

We note the Commission's draft decision to no longer apply a downward adjustment (currently 0.05) to the asset beta estimate for airports. We are comfortable that a fresh look is being taken at this issue.

The Commission bases its draft decision partly on the analyses of LJK Consulting and CEG, prepared for Auckland International Airport Ltd and NZAA respectively. From this work and its own findings, the Commission concludes that there is no statistical evidence of the asset beta for the compcos being driven up by the non-aeronautical proportion of airport revenues.

From a broader perspective, however, we continue to argue that economic entities that are largely focused on providing and/or using core economic infrastructure tend to have lower asset betas than those that are more dependent on discretionary, consumer-driven preferences. This argument is illustrated in Table 1 below – drawn from the international database compiled by Aswath Damodaran at the Stern School of Business NYU. While airports are not specifically identified, we suggest the core aeronautical service components of their activity would come closer in risk profile to the lower-beta utility and infrastructure providers (with asset betas in the range of 0.44 to 0.54) in the table, rather than the higher-beta retail and recreation service providers (with asset betas in the range of 0.73 to 0.99).

Table 1: Asset betas of industry sectors

Industry sector	Asset beta
Power	0.44
Utilities – general	0.45
Utilities – water	0.49
Telecom services	0.53
Railroads	0.54
Cable TV	0.61
Retail (general)	0.73
Restaurants/Dining	0.83
Recreation	0.99
Entertainment	1.10

Source: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html

The new comparator sample proposed by the Commission in its draft decision paper is still quite varied regarding the mix of aeronautical and non-aeronautical services within the group. Definitive conclusions can't be drawn about the relationship between these proportions and the associated asset betas. We do note, however, that the two airports with the highest proportion of aeronautical services (Frankfurt and Vienna) have asset betas that are well below average, while the two with the lowest share of aeronautical services (Beijing and Auckland) have asset betas that are above the average (see Table 2 below). Although the pattern is not totally consistent across the sample, this finding aligns with our expectations based on the evidence presented by Damodaran.

Table 2: Airports aeronautical services and asset betas

Airport	% Aeronautical	Asset beta 2012-17 (weekly)	Asset beta 2017-22 (weekly)
Beijing	32	0.50	0.83
Paris	36	0.41	0.85
Spain	57		0.79
Auckland	32	0.97	1.06
Zurich	48	0.54	0.86
Vienna	64	0.22	0.59
Frankfurt	76	0.34	0.57
Sydney	50	0.33	0.70
Average	49	0.47	0.78

Source: 2022 Annual Reports; Commerce Commission Cost of Capital Topic Paper 2023, Table A3

Overall, while the previous 0.05 downward adjustment in the asset beta may have been partially internalised in the beta average of the new sample (to the extent that this sample prioritises core infrastructure services), we think that further adjustment is appropriate to acknowledge the significance of retail and other such non-aeronautical services for certain operators in the sample.

2.2.5 The Tax-adjusted Market Risk Premium

We agree that a TAMRP of 7.0 reflects the current evidence available on this parameter and is consistent with estimates used by NZ market participants.

2.3 WACC estimate and reasonableness checks

We agree with the Commission's draft decision to continue publishing the midpoint WACC and the standard error. We also support the implication that the burden of proof will be on airports, during their respective PSEs, to justify deviations from the Commission's midpoint.

We note that the Commission arrives at a post-tax WACC estimate of 7.19%. This is up from the 6.29% in the 2016 IM review, mainly because of the higher risk-free rate (4.31% vs. 2.6%).

As the Commission notes, the estimate of 7.19% appropriately places the WACC between the yields on high-quality corporate bonds and the NZ share market as a whole. It is also within the range of NZ-based investment bank WACC estimates for airports. In both regards, the Commission correctly follows court guidance to rely mainly on NZ rather than overseas evidence in cross-checking the WACC.

However, we view the RAB multiples reported by the Commission as providing the most robust test of the reasonableness of its WACC estimate. The RAB multiples are the best market-based test of the reasonableness of the WACC estimate as they provide evidence on what return investors are willing to accept in reality when they put their money at stake. The Commission finds RAB multiples for airports are in the

1.3 to 1.9 range, indicating that investors are prepared to accept a significantly lower return than the Commission allows. Even the lower end of the 1.3 to 1.9 range of the RAB multiples cited by the Commission points to investors being more than adequately compensated for putting their capital at risk.

Although occurring in a different sector, the Eastland Network sale provides a recent direct market test of the Commission's overall regulatory framework and its implications. The fact that Eastland sold at a value of nearly 1.4 times the RAB confirms that investors were more than sufficiently compensated for the risks they faced.

We also note the long-term growth and strength in Auckland Airport's share price, now largely recovered from its pandemic-related downturn. In a different context and regulatory regime, Sydney Airport was sold in 2022 at a significant premium over its prior market value.

These last two observations are, we think, consistent with a broader view that the airport sector has been and probably remains an attractive proposition for the local and global investment community.

We suggest that an overestimate of the WACC may be contributing to these investor attitudes and reactions. If that is the case, the Commission may need to look again at some of the parameter estimates underlying the WACC. The focus should probably be on the more judgmentally-based estimates – notably the asset betas and the TAMRP. Although, as we have indicated above, the Commission's current estimates of these parameters appear to be in line with the relevant market evidence, if the debate on these issues is re-opened, any subsequent adjustments in the parameter estimates should be directed towards lowering the WACC.