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2023 INPUT METHODOLOGIES REVIEW – CROSS SUBMISSION ON THE COMMERCE COMMISSION'S DRAFT DECISIONS

This is Christchurch International Airport Limited's (**CIAL**) cross-submission on the Commission's draft decisions (the **Draft Decisions**) in the 2023 Input Methodologies Review (**IMs Review**).

CIAL has contributed to and supports the cross-submission made by NZ Airports Association (**NZAA**), together with the report attached to that submission from Dr Tom Hird of Competition Economics Group (the **CEG Report**).

This cross-submission is accompanied by an independent expert report by Jeff Balchin of Incenta Economic Consulting.

No part of this cross-submission is confidential.

No substantial new evidence in airline submissions

We have reviewed the submissions made by Air New Zealand, Castalia (for Air New Zealand), A4NZ, BARNZ, TDB (for BARNZ), Dr Martin Lally, IATA and Qantas. Our overall conclusion is that there is no substantial new evidence in those submissions supporting the Commission's draft decisions. We note that Dr Lally has identified essentially the same flaws in the Commission's approach to Covid uplift that were outlined in CEG's report attached to NZAA's submission.

The limited amount of new evidence or analysis presented in those submissions in support of the Commission's draft decisions is unpersuasive, as we explain in more detail below.

As we observed in our own submission, the Commission has not obtained any independent expert advice supporting its proposed approach to asset beta (despite opportunities to do so). In fact, the Commission instructed Cepa to re-run its 2016 asset beta methodology but *not* to comment on the methodology itself. The Commission's own long-time expert – Dr Lally – does not agree with the Commission's approach to asset beta.

On the other hand, there is a substantial body of expert evidence pointing out the conceptual and empirical weaknesses of the Commission's proposed approach and, conversely, the merits of retaining the Commission's usual approach of estimating asset beta based on a large sample and two five-year periods of data. CEG, Incenta and HoustonKemp have also explained that the Commission has failed to consistently apply its own reasoning, resulting in an approach to asset beta that is essentially arbitrary.

Given the significant impact the Commission's proposed changes will have on airport returns on capital, we would expect the Commission to provide a solid justification and evidential foundation. That foundation is lacking.

Airline submissions reinforce the highly subjective nature of the Commission's proposed approach to asset beta

In our submission we explained that the Commission's proposed approach to both the comparator sample and the Covid uplift abandons statistical rigour in favour of a highly subjective exercise in judgement. That is not an appropriate basis for estimating the asset beta for the regulated service, as it means the regulatory settings are influenced more by the Commission's judgements at each IM Review, rather than changes in market conditions. Airports and investors invest in long-lived assets in the expectation that the regulatory framework will deliver an appropriate return on capital over multiple regulatory periods. Central to that expectation is that changes in market conditions will flow through into the WACC, so that investors are appropriately compensated over the life of the investment. The durability of the Commission's WACC methodology over multiple periods is one of the strengths of New Zealand's regulatory framework. The Commission's draft decisions undermine the predictability and stability that is required to preserve incentives to invest in long-lived infrastructure assets.

Airline submissions reinforce the highly subjective nature of the Commission's draft decisions on asset beta. It is notable that Castalia and TDB do not seek to support the Commission's approach with empirical evidence or economic theory. Rather, they endorse the Commission's methodology with unfounded assertions. For example:

- Castalia argues that the Commission is right to exclude airports from emerging markets because, in emerging markets, capital movements are restricted in idiosyncratic ways, governments are more likely to behave arbitrarily, and airports are more likely to be affected by arbitrary government action. First, no evidence is offered in support of these propositions, or that they are relevant to the estimate of asset beta. Second, restrictions on capital movements are already addressed by the Commission's liquidity filter. Third, examples of government action disproportionately affecting airports in emerging markets (e.g. China) can equally be met by examples from mature economies (e.g. New Zealand, which closed its borders to international travel for two years).

- BARNZ and TDB argue that the Commission's approach to addressing the impact of Covid on asset beta is appropriate because Covid-type events will be "rare" in the future and the impact of Covid-type events will be mitigated due to "lessons learned" by policy-makers. That provides no answer to the fundamental challenge that the Commission has no reliable basis on which to estimate the likely frequency or severity of future events. In fact, it reinforces that the Commission's approach rests on an assumption about the expected frequency of future shocks.

The Commission's proposed approach to estimating asset beta opens the door to endless arguments about which countries or airports are more or less comparable to New Zealand, as well as the likely timing and severity of future shocks to the aviation sector. Not only does this approach lack a sound theoretical or empirical foundation, but – as we explained in our submission – it will undermine the integrity of future airline consultations on airport charges.

Comparator sample

Castalia has argued that the Commission is right to exclude developing economies from its comparator sample, although its reasoning differs from that of the Commission. As discussed above, Castalia offers no evidence to support the relevance of its submissions to asset beta. As CEG explains, the Commission's country filters tell us nothing about the characteristics of the relevant airports and their comparability to New Zealand regulated airports.

TDB agrees with the Commission's approach but offers no further evidence in support of it. We also note, however, that the Commission's draft decisions differ from the approach that TDB originally advocated for. TDB now endorses the Commission's approach, but does not explain why it has changed its view since its earlier report.

Qantas argues that the Commission should have applied a market diversification filter to recognise that AIAL is overweighted in the index. Qantas does not explain why AIAL's share of the index (which varies over time) is sufficiently large that it would distort the estimate of asset beta. And the fact that a comparator firm represents a significant share of the index is not a reason by itself to exclude it. Rather, if AIAL's share of the index (and therefore the correlation of its returns to total market returns) results in

a high beta, then that merely signals that investors require a commensurate return. In any event, Qantas' preferred solution – to remove AIAL from the comparator sample – is not credible. AIAL is the only New Zealand listed airport stock and therefore the most comparable firm for purposes of estimating an asset beta for the regulated service.

Covid uplift

Castalia argues that Covid exhibits elements of both systematic and unsystematic risk. The implication appears to be that the Commission is right to discount the impact of Covid on asset beta on the basis that some part of the risk is diversifiable. But it is not clear to us why that would influence the Commission's approach to estimating asset beta. To the extent the risk is systematic, it will be captured in the Commission's WACC methodology. But any part of the risk that is non-systematic is presumably not compensated for in the WACC. Per the Commission's usual approach, that non-systematic risk, if it is allocated to airports, must be compensated through some other (e.g. ex post) mechanism.

Castalia argues that the Commission's usual approach of using the average of two five year periods (including the impact of Covid) should only be used as an upper bound estimate. To the contrary, for the reasons set out by CEG, Incenta and HoustonKemp, the Commission's usual approach results in the best estimate of asset beta as it accurately reflects the timing and severity of major shocks to the regulated service.

Reasonableness checks

Airline submitters have pointed to a number of other cross-checks as supporting the Commission's position.

TDB argues that suppliers that are "largely focused on providing/using core economic infrastructure tend to have lower asset betas than those…dependent on discretionary consumer-driven preferences". TDB refers to analysis comparing utility betas (electricity, gas, water, etc) to asset betas in the recreational sector.

TDB's argument assumes that airports are more similar to electricity or gas than they are to services with a higher income elasticity of demand. If anything, the reverse is true. In an economic downturn, consumers are unlikely to materially decrease their electricity consumption, but are likely to defer travel. In any event, the best evidence that airports have a higher asset beta than traditional utilities is that the Commission's comparator samples for energy firms and telecommunications consistently result in lower asset betas than it airport sample.

TDB also refers, with approval, to the Commission's reliance on RAB multiples as a reasonableness check. RAB multiples are, at best, a lagging indicator of the financeability of regulated suppliers under current regulatory settings. They don't support the conclusion that the Commission's draft decisions (which reduce the WACC) will equally enble regulated suppliers to attract capital. The available data points are also too limited to be of use. There is only one example of a transaction involving a regulated supplier (Eastland) and the RAB multiple in that case can equally be explained by the acquirer's expectation that Eastland can out-perform its expenditure allowances. The remaining data points are analyst estimates of only two firms – Vector and AIAL – and therefore of limited relevance.

Other issues

A number of submitters support the Commission's decision to exclude pecuniary penalties and legal costs associated with appeals from the definition of operating costs. We agree that it is appropriate to exclude pecuniary penalties. If consumers are required to reimburse suppliers for pecuniary penalties then those penalties will not have the necessary deterrent effect. However, it is inappropriate to deter regulated suppliers from pursuing their legitimate rights of appeal. The opportunity to appeal is included in the Part 4 framework by design, to ensure that the Commission is accountable for the quality of its decisions. Costs associated with pursuing an appeal are properly part of the regulated service. Excluding appeal costs from regulatory accounts punishes suppliers for exercising their rights.

IATA argues that a number of other costs should also be excluded from the definition of operating costs. Again, these costs are all properly part of the regulated service.

IATA has also argued that the Commission should impose obligations to consult with substantial customers on cost allocation. Obligations to consult with substantial customers are provided for in the Airport Authorities Act and are not properly part of information disclosure under Part 4. Airlines do have an opportunity to comment on cost allocation via:

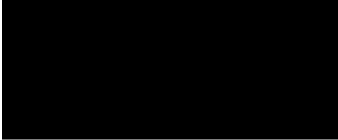
- airport consultation on charges, which includes substantial information about how operating costs and assets have been allocated, to support a fully informed consultation process; and

- the Commission's consultation process following a price-setting event disclosure.

Finally, IATA argues that airport land should not be subject to revaluation because there is no "market" for these assets. Revaluation is available to airports at their discretion and allows them to maintain the value of their financial capital in real terms, should they choose to do so. Revaluations are treated as income, and therefore while the profile of cashflows differs depending on whether land is revalued, the NPV=0 principle is maintained in either case.

If you would like to discuss any aspect of the contents of this submission, please feel free to contact me.

Yours sincerely



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