PART 4 INPUT METHODOLOGIES REVIEW 2023

SUBMISSION ON COMMISSION'S LETTER OF 8 DECEMBER 2022 AND CEPA REPORT

3 February 2023

INTRODUCTION

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

   (a) the report by Cambridge Economic Policy Associates Pty Ltd ("**CEPA**") on aspects of the cost of capital input methodologies, dated 29 November 2022 ("**CEPA Report**"); and

   (b) the Commerce Commission's ("**Commission**") accompanying letter, dated 8 December 2022, which included some specific matters which the Commission has sought views on ("**Commission Letter**").

2. The Commission has invited views on specific matters relevant to CEPA's report, including asset betas. In response to this invitation, NZ Airports requested Dr Tom Hird of Competition Economists Group ("**CEG**") to review the CEPA Report and the Commission Letter and to provide independent expert advice on asset beta matters ("**CEG Report**"). The CEG Report is **attached** and referred to in this submission where relevant.

3. This submission focuses only on asset beta matters. However, NZ Airports reserves its position to comment on other aspects of the CEPA Report and the Commission Letter in the context of future consultation, including feedback on the Commission's draft decision.

4. Auckland, Wellington and Christchurch Airports have contributed to this submission.

5. NZ Airports' contact for this submission is:

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SUMMARY

6. Thank you for the opportunity to provide feedback. NZ Airports is concerned about the following aspects of the Commission Letter:

   (a) The Commission is continuing to entertain applying a downward adjustment to the average asset beta from the comparator sample, but only in respect of the airport sector. The Commission continues to adopt this view on the presumption that the asset beta for aeronautical services is likely to be lower than the asset beta for non-aeronautical services.[1]

   (b) The Commission is considering whether the comparator sample, again, only in respect of the airport sector, should be reduced by excluding airport companies which:[2]

      (i) operate in countries that have a market risk premium that is "substantially different" to New Zealand's market risk premium; and

[1] Commission Letter, at paragraph [7].
[2] At paragraph [8].

(ii) have a large variance in estimates based on daily, weekly and four-weekly data (on the basis that those companies do not have a stable estimate of asset beta and may therefore not be suitable comparators).

(c) The Commission is considering departing from its standard approach of using only asset betas from the two most recent five-year period and is instead "considering whether we should use a term for airports that is either longer or shorter than the last two five-year periods", ostensibly because "the economic consequences of COVID have resulted in an increase in asset betas for airport services". Similar to the two points above, the Commission states that it is only considering a different approach for the airport sector, not the energy sector, because "there does not appear to be a need to vary the sampling timing we used last time".[3]

7. For the reasons set out in this submission and the accompanying CEG Report, NZ Airports does not consider any adjustments to the Commission's existing methodology, adopted in its 2016 IM Review, are justified, or required. NZ Airports sets out its specific concerns on the above matters below. However, as an overarching point, NZ Airports is concerned that these ad hoc adjustments are aimed at delivering a lower asset beta exclusively for airport companies.

8. NZ Airports strongly rejects any proposal which would see the Commission creating a WACC input methodology for the airport sector that has numerous differences and adjustments compared to other regulated sectors. This is especially in the context of the technique used to estimate asset beta which should be common across companies and sectors. We consider that a predictable and stable regulatory environment for all regulated entities over the long term would be undermined with such an approach and is contrary to the purpose of Part 4 of the Commerce Act. Such an approach would be detrimental to investor confidence and regulated entity confidence to make critical infrastructure capital investment. Accordingly, NZ Airports cautions the Commission against pursuing these adjustments, which would risk delivering systematically skewed WACC estimates over the long term, unless a raft of yet to be determined upwards adjustments were made going forward to future asset beta data (that is not regarded as being influenced by COVID-19 or other economic shocks) so as to deliver the correct underlying long-term asset beta estimate.

9. NZ Airports wishes to reiterate that for the Commission to adjust its methodology in relation to asset beta, the Commission must be satisfied that the adjusted WACC IM will be "materially better" than the current WACC IM in meeting the purpose of Part 4 (promoting the long-term benefit of consumers) and the purpose of the IMs (promoting certainty for suppliers and consumers).[4] To ensure that the IMs establish benchmarks for an expectation of reasonable returns, the Commission's review should therefore focus on updating relevant aspects of the WACC IM in a manner consistent with the approach adopted under the 2016 IM Review. If the Commission does this, then that will not only promote outcomes consistent with the Part 4 purpose statement, but also the purpose of IMs.

10. It is worth noting that the Commission has previously applied a high threshold to justify airport-specific asset betas in pricing decisions, rejecting such adjustments due to insufficient evidence having been provided. NZ Airports submits that the Commission must apply that same evidential standard to any adjustments it is seeking to make to the comparable company asset beta sample set, or the sample period.

[3] Commission Letter, at paragraph [4].

[4] Commerce Act 1986, s 52Z.

11. As a reminder, NZ Airports is not seeking *ex-post* compensation for the impact of COVID-19 by seeking a change to the Commission's asset beta methodology. 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.

COMMENTS ON POSSIBLE ADJUSTMENTS TO ASSET BETA

Any adjusted WACC IM must be "materially better" than the existing IM

12. It is useful, as a starting point, to summarise briefly the Commission's legal framework for amending an IM. As identified by the Commission in its Decision-Making Framework paper, published on 13 October 2022, the Commission recognises that:[5]

> Amendments to the IMs, like the initial IMs, are subject to merits appeals, where a court considers whether there is a **materially better** alternative than the IM we have determined in light of section 52A, section 52R, or both.
>
> [Emphasis added]

13. The Commission has further explained that it will "only propose changing the IMs if this appears likely to meet one or more of the three overarching objectives", which are to:[6]

(a) promote the Part 4 purpose in section 52A more effectively;

(b) promote the IM purpose in section 52R more effectively; and

(c) significantly reduce compliance costs, other regulatory costs, or complexity,

without (in respect of (b) and (c) above) detrimentally affecting the promotion of the section 52A purpose.

14. Importantly, the Commission describes its approach as ensuring that the section 52R IM purpose and the impact of a decision on certainty is a "mandatory consideration".[7]

15. This approach reflects the High Court's judgment in *WIAL & Ors v Commerce Commission,*[8] which concluded that:

> S 52R purpose of certainty is conceptually subordinate to the s 52A purpose of the long-term benefit of consumers. We say that because promoting the long-term benefits of consumers in accordance with s 52A is the central purpose of Part 4 as a whole. IMs must be designed with that in mind. Subject to that, **a materially more certain IM is to be preferred to a less certain IM**.
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> [Emphasis added]

16. It is also relevant the regulated airports are only subject to information disclosure. The information disclosure regime provides an ability for these airports and their customers to appropriately respond to new risks and issues in pricing decisions, while being guided by applicable IMs and / or information disclosure tools.

[5] Commerce Commission, Part 4 Input Methodologies Review 2023: Framework paper (13 October 2022) at paragraph [2.62].
[6] At paragraph [3.12].
[7] At paragraph [3.17.1].
[8] *WIAL & Ors v Commerce Commission* [2013] NZHC [11 December 2013] at [165].

17. In relation to cost of capital IMs specifically, the Commission recognises that:

> a proposed change to the IM(s) for one parameter will not meet the above overarching objective(s) if it reduces the extent to which the package of parameters as a whole do so.

Previous NZ Airports submissions

18. NZ Airports submitted late last year that there is no basis for the Commission to depart from its established methodology for updating the asset beta.[9] This view was supported by independent economic expert, Dr Hird of CEG, who concluded, in the CEG report on asset beta updated for 2023 IMs which was published in August 2022 ("**August 2022 CEG Report**"), that:[10]

> 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 (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.

[9] NZ Airports, Cross Submission on Process and Issues Paper (3 August 2022), at paragraph [16].
[10] Dr Hird of CEG, Asset beta update for the 2023 IMs (August 2022), at paragraph [81].

19. In terms of the specific matters raised in the Commission Letter, NZ Airports also submitted last year that:[11]

(a) A proposed 0.05 downwards adjustment should be abandoned because there is no evidence that aeronautical operations are less risky than the airport as a whole. **NZ Airports' position has not changed.** Rather, the analysis conducted by Dr Hird in the CEG Report, which demonstrates empirically that there is no evidentiary basis for reaching this conclusion, has confirmed to NZ Airports that the Commission's proposed approach would be wrong, as explained further below.

(b) There is no basis for departing from the established methodology for compiling and updating the comparator sample, and certainly no basis for adjusting it in a way which results in a smaller or narrower set, given the better approach is to use as large a comparator set as possible to mitigate the risk that noise associated with individual company estimates will skew the estimate. **NZ Airports' position has not changed**. In response to the latest proposal to reduce the size of the comparator sample, the CEG Report explains that this makes the ultimate estimate less reliable, not more reliable, and indicates that shrinking the sample size in this way would result in primary weight being given to AIAL's estimated asset beta.

(c) There is no reason why the Commission should change its approach from using the two most recent five-year periods, and if it did, this would be out of step with its approach for other sectors (e.g. the Commission's approach in determining an asset beta estimate for fibre services). **NZ Airports' position has not changed.** The CEG Report highlights concerns with changes to the estimation window and suggests that while it may be reasonable to extend the estimation period to 14/15 years, this would require the Commission to retain that extended estimation window for all future IMs and price setting events and may introduce asymmetric regulatory risk (in investors' minds regarding the stability of New Zealand's economic regulation for airports).

20. NZ Airports briefly describes aspects of CEG Report which support these views below.

The Commission's downward adjustment proposal is not valid

21. In the August 2022 CEG Report, Dr Hird summarised that:[12]

> 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.

22. Despite this expert view, the Commission Letter indicates that the Commission is continuing to consider a downwards adjustment to the average asset beta from the comparator sample, and still based on the unsupported presumption that aeronautical activities have lower systematic risk and asset beta than non-aeronautical activities. NZ Airports has always maintained that the Commission does not have evidence to support this position,[13] and absent

[11] See NZ Airports' Submission on Process and Issues Paper (11 July 2022) and Cross Submission on Process and Issues Paper (3 August 2022).

[12] August 2022 CEG Report, at paragraph [97].

[13] NZ Airports, Cross Submission on Process and Issues Paper (3 August 2022), at paragraph 17.

any such evidence, NZ Airports does not consider that the Commission would have grounds to apply the proposed downward adjustment.

23. To put the matter further beyond doubt, however, NZ Airports asked Dr Hird to conduct a conceptual and empirical examination of the relative risk of aeronautical and non-aeronautical revenues. The results of this assessment are contained in section 2 of the CEG Report.

24. In summary, the CEG Report concludes that not only is there no conceptual basis for the Commission presuming aeronautical operations are lower risk than non-aeronautical operations, "the available empirical evidence strongly supports the opposite conclusion."[14] That is, the empirical evidence actually indicates that non-aeronautical operations are lower risk than aeronautical operations, and this is based on CEG's analysis that:

    (a) measured asset betas are lower the larger the share of non-aeronautical revenues;

    (b) aeronautical profits were much more sensitive to COVID-19 than non-aeronautical profits; and

    (c) aeronautical revenues were near universally also more sensitive to COVID-19 than non-aeronautical profits.

25. In light of this new and compelling empirical evidence, NZ Airports submits that the evidential burden for making a downward adjustment to the average asset beta estimate is clearly not met.

Attempts to reduce the comparator sample are arbitrary and risk distortion

26. NZ Airport maintains that it is important to have a large and diversified comparator sample to mitigate the risk that "noise" associated with individual company estimates will skew the estimate.

27. The Commission has previously highlighted the issues with relying on individual company estimates in the context of Auckland Airport's PSE3 pricing:[15]

> Although Auckland Airport's actual beta is a useful reference point, we consider that beta estimates for a single company and over shorter reference periods are unreliable. Asset betas are 'noisy' and there is a significant risk of estimation error when focussing on the observed beta for an individual company. For this reason, we have used a comparator sample approach when determining beta estimates in the IMs.

28. The Commission has also previously accepted that a larger comparator sample is preferable when estimating the asset beta to reduce the risk of measurement error, given the noise from the asst beta estimates:[16]

> …we consider that Contact's sample of six comparator firms is too small to be relied on when estimating asset beta. Given the level of noise in empirical asset beta estimates, our view is that a larger sample is required to reduce the risk of measurement error.

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[14] CEG Report, at paragraph [8(a)].

[15] Commerce Commission, Input Methodologies review draft decisions – Topic paper 4: Cost of capital issues (16 June 2017), at paragraph [315].

[16] Commerce Commission, Input Methodologies review draft decisions – Topic paper 4: Cost of capital issues (16 June 2017), at paragraph [315].

29. The CEG Report looks at two airports, Vienna and Copenhagen, to demonstrate that empirically estimated asset betas are by their very nature "noisy", and notes that:[17]

> Using a large sample will allow the noise in these individually empirically estimated asset betas to cancel out, giving a more reliable estimate of the true average asset beta for the sample. Using a small sample means this noise is less likely to cancel out.
>
> That is why I consider the NZCC 2016 IM methodology of adopting a large sample is best practice.

30. The CEG Report also considers the proposals in the Commission Letter which would have the effect of reducing the comparator sample size, discussed briefly below.

Exclusion based on country MRP

31. In relation to the Commission's consideration of whether to exclude companies from countries that have a market risk premium that is substantially different to the market risk premium for New Zealand, in addition to the issue around shrinking the comparator size, the CEG Report considers the following:[18]

> a. There is no reason to believe that the asset beta for an airport is affected by the country risk premium for the country in which it operates. In fact, the average equity beta in a country is, by mathematical definition, unaffected by the riskiness of the market (MRP). There is no reason to believe that airports in markets with high risk have high (or low) asset beta.
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> b. Even ignoring the fact that there is no conceptual basis for such an exclusion, excluding comparators based on their country MRP will involve adopting:
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> i. Arbitrary measures of country MRP; and
>
> ii. Arbitrary thresholds for what constitutes a “substantially different” MRP to NZ.
>
> (This is problematic in the same way that arbitrary measures of, and thresholds for, “stability” of asset beta estimates would be as discussed in section 4.2.2.)

32. NZ Airports agrees with the CEG Report's conclusion on these issues, that:[19]

> Ultimately, there is no way in which inclusions or exclusions from the sample can be rigorously determined based on such analysis. To attempt to do so will invite gaming by parties submitting to the NZCC and the risk that investors perceive the regulatory environment as unpredictable.

Exclusion based on "instable" asset beta estimates

33. In relation to the Commission's consideration of having a large variance in estimates based on daily, weekly and four-weekly data (on the basis that those companies do not have a stable estimate of asset beta and may therefore not be suitable comparators), the CEG Report highlights a number of issues with this approach, including the fact that all airports have (and

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[17] CEG Report, at paragraphs [152] and [153].
[18] At paragraph [129].
[19] At paragraph [146].

should be expected to have) unstable asset beta estimates. In particular, the CEG Report states that:[20]

> … there is no basis for believing that volatility in asset beta estimates is a sign of unreliability in asset beta estimates. Airports are volatile companies and volatile companies have noisy asset betas. That is why the NZCC practice has been to use 25 asset beta estimates for every company and to have a large sample.

34. CEG also observes that if the Commission were to ignore the advice and arbitrarily shrink the comparator sample and sought to define a sample that is "most similar" to New Zealand airports, "it is difficult to understand why such a change in methodology would not result in primary weight being given to AIAL's estimated asset beta".[21]

35. NZ Airports is concerned at the prospect of the Commission adopting such a selective approach, and agrees with the CEG Report's conclusion that:[22]

> it would be unwise and unprincipled to develop a regulatory methodology in which such arbitrary decisions would play a critical role. This is especially the case given that there is no sound conceptual basis for wanting to exclude comparators with "unstable" asset beta estimates.

Any alteration of the estimate window should be applied consistently

36. NZ Airports considers that the Commission repeating its two consecutive five-year periods average asset beta calculation gives an appropriate weighting to the COVID-19 elevated asset beta data since early calendar 2020 and can be justified in terms of investors' pandemic risk expectations going forward.

37. The Commission itself, in its 2016 IM Review, acknowledged that while there was a trade-off when choosing a time period, the objective is to obtain the best forward-looking estimate:[23]

> We recognise this trade-off, and in this context we consider that placing **greater weight** on the two most recent five-year periods provides an appropriate balance between the number of observations and the best reflection of beta for the future.

38. While the Commission concluded that the best balance to the trade-off was obtained by placing "greater weight" on the two most recent five-year periods, in practice, it placed exclusive weight on the two most recent five-year periods, ignoring the estimates for the two prior five-year periods. The Commission adopted this reasoning and approach in determining the asset beta estimate for fibre services in October 2020.

39. The CEG Report considers this matter extensively, and concludes that while there may be a reasonable basis for extending the estimation window, it must line up with the PSE period and must be applied consistently and permanently going forward:[24]

> Any methodology for setting compensation for systemic risk across multiple PSEs must seek to ensure that the estimated asset beta applied across PSE's will, over the long run, reflect the average systemic risks observed in equity markets for

[20] CEG Report, at paragraph [113].
[21] At paragraph [8(e)(ii)].
[22] At paragraph [127].
[23] Commerce Commission, Input Methodologies review decisions – Topic paper 4: Cost of capital issues (20 December 2016), at paragraph [300].
[24] CEG Report, at paragraph [95].

airports. The best, and likely only realistically manageable, way to achieve this is if:

- The asset beta is updated at the beginning of each PSE;
- Each update uses the same estimation window; and
- The estimation window is a whole number multiple of the length of the PSE (e.g., if the PSE is 5-years then the estimation window is 5, 10, 15 etc years).

Historically 10-years has been used to estimate the asset beta in New Zealand and, consistent with the second dot point, I consider that 10-years should continue to be used. If, nonetheless, a longer period (e.g., 15-years) was adopted it should continue to be applied in all future PSEs.

40. As noted more generally above, NZ Airports is concerned that this could be viewed as the Commission seeking ad hoc adjustments to achieve what it perceives to be the "right outcome". The CEG Report echoes this concern, noting that one of the numerous concerns about ad hoc changes in standard practice is that:[25]

> there is the potential for such a change to be perceived as an illustration of asymmetric regulatory risk. That is, an ad hoc change attempting to dilute a period of realised high risk when a period of realised low risk would be unlikely to elicit a similar response.

CONCLUDING COMMENTS

41. NZ Airports strongly believes that there is no evidence to warrant adjustments to the asset beta methodology as contemplated by the Commission and thinks that this approach would run counter to the purpose statements of Part 4 and the IMs. The risk of such an ad hoc approach contributing to an unpredictable regulatory environment and impacting investor confidence, at a time when investment in airport infrastructure is critical, is a very real one. Given the regulated airports are only subject to information disclosure, there is also scope to appropriately address asymmetric pandemic risks that would not be fully addressed by the WACC IM (recognising that it is not possible to perfectly address such risks in the WACC IM in any event). Accordingly, there is no legal or evidentiary basis for change at this time.

42. NZ Airports would be pleased to further engage with the Commission on these issues and would be happy to provide additional views and information as a part of this process.

[25] CEG Report, at paragraph [92].