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Part 4 Input Methodologies Review 2023 – Draft Decision – Cost of Capital Topic Paper

The Commerce Commission (Commission), on 14 June, published its Draft Decisions on the 2023 Input Methodologies Review. Air New Zealand (Air NZ) welcomes the opportunity to submit on the Draft Decisions. Overall, Air New Zealand supports the Draft Decisions and the proposed amendments to the Specified Airports Input Methodologies Determination.

Air NZ engaged Castalia to review and comment on the Commission's Draft Decisions relating to the cost of capital. Castalia's report is appended to this submission. BARNZ, on behalf of member airlines, engaged TDB Advisory to also review and comment on the Draft Decisions. This submission incorporates comments from both Castalia and TDB Advisory.

Air NZ confirms that nothing in this submission is confidential.

Specific comments on elements of the Cost of Capital topic paper are set out below.

Cost of Debt

The Commission is proposing to continue with its use of a prevailing risk-free rate versus moving to a trailing average. Air NZ agrees with the continued use of a prevailing rate as it better reflects expected market conditions and better promotes investment incentives.

Matching the term of the risk-free rate to the regulatory period remains a valid approach as it provides compensation for risk faced during the regulatory period.

Annual updating of the risk-free rate is not supported as this would introduce volatility and, in any case, suppliers can hedge against volatility.

Air NZ agrees that the current approach to calculating the debt premium is appropriate, with the 5-year averaging period effectively replicating costs associated with debt with staggered terms to maturity. This approach also reduces complexity and administrative burden.

Air NZ agrees with maintaining the Commission's 2016 decision not to provide for a Term Credit Spread Differential for airports. As the Commission notes, airports are only subject to Information Disclosure regulation and this issue can be, and is, addressed during reviews of airport pricing decisions.

The Commission has maintained its approach of a 20-bps annual allowance for debt issuance costs, comprising 8-10bps for direct issuance, 4bps for swaps and 7-9bps for "other" costs. Air NZ considers this allowance is reasonable.

Air NZ supports the Commission's draft decision to maintain a notional long-term credit rating for airports of A-, noting that Christchurch Airport's credit rating was raised to A- in December 2022. As noted by the Commission, this is an issue which can be addressed as part of individual reviews of airport pricing decisions.

Cost of Equity

Air NZ agrees that use of the same risk-free rate for the cost of equity as for the cost of debt ensures consistency in estimating debt and equity allowances and with the term of the regulatory period. Use of a term longer than the regulatory period, where prices will be reset at the end of the period, would compensate suppliers for a risk they do not bear. Use of government bonds as a proxy for the risk-free rate remains appropriate.

As the Commission notes, the IM's specify the equity beta of regulated suppliers. The equity beta is derived from observed equity betas of comparator sample companies, adjusted for leverage to calculate the asset beta.

The Commission has adjusted its comparator sample of airports based on cogent analysis by TDB and Qantas identifying a sample of airports operating in broadly similar markets and with similar characteristics to a major airport operating in New Zealand. Such an approach is consistent with international regulatory practice. This has reduced the comparator sample from 26 airports to 8 airports. Air NZ agrees with this approach and considers it produces a more robust and reliable outcome. Castalia concurs with the updated sample, with the exception of Beijing Capital International Airport, which it considers should be removed on the same basis as the other Chinese airports given its operations are in China. Removal of Beijing from the sample would reduce the estimate of asset beta by a further 1bp.

The Commisson's updated comparator sample, along with the premium applied to reflect the period impacted by the pandemic, results in an asset beta estimate of 0.55, reflecting also the updated leverage implied by the comparator sample.

Even at 0.55 it could be argued that the estimated asset beta is generous to airports. As noted by TDB in its report prepared for BARNZ,

> "…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)."

The Commission is proposing not to apply a downwards adjustment to the asset beta for airports as per previous practice, reflecting the difference in risk between aeronautical and non-aeronautical services. In our opinion, the change to the comparator company set has resulted in a beta estimate that more appropriately reflects a purer aeronautical business.

Air NZ agrees with the Commission's approach to estimating the TAMRP, with multiple methodologies being used recognising the strengths and weaknesses of each approach. The 7.0 estimate arrived at is reflective of current evidence and consistent with estimates used by market practitioners in New Zealand.

The Commission is proposing to maintain its current approach for airport ID regulation of publishing only the mid-point estimate of WACC along with the standard error of that estimate. Airports, as part of the Commission's review of PSEs, are required to justify any departure from that mid-point estimate. This approach has worked well, with the Commission showing preparedness to accept departures where appropriately justified.

Reasonableness checks

The Commission has taken a variety of approaches to assess the reasonableness of its mid-point WACC estimate for New Zealand airports, including looking at historic and expected New Zealand market returns, the range of New Zealand-sourced post-tax WACC estimates for airports, and international regulatory precedent, with most weight being given to New Zealand-sourced estimates. The conclusion, after assessing these comparators, is that the mid-point estimate of WACC is reasonable. Air NZ considers this conclusion is appropriate, if not generous to airports, as evidenced by the further check undertaken looking at RAB multiples.

The Commission notes that RAB multiples provide a useful indicator of whether the allowed rate of return has been set at a level sufficient to adequately compensate investors for putting their capital at risk, with a multiple above 1 suggesting that this would be the case. The Commission's survey of analysts resulted in estimated RAB multiples of 1.3 (UBS) and 1.9 (Forsyth Barr) for Auckland Airport, suggesting that the market perceives regulatory settings and the resulting cost of capital to be generous to airports.

As Castalia notes:

> "We do note that following the publication of the draft decision the Auckland Airport share price (and presumably the implied RAB multiple) did not materially shift. This suggests at least anecdotally that the decision was not viewed by the market as materially impacting Auckland Airport's expected future profitability."

The Commission has noted that there may be a range of factors influencing RAB multiples. In the case of Auckland Airport's observed estimations, it can be surmised that the presence of the non-regulated, non-aeronautical till is likely a key factor in perceived (out)-performance. Having a relatively stable and guaranteed regulated income stream underpinning the ability to achieve superior returns in the non-regulated parts of the business would provide significant comfort to investors.

Draft Airport Services IM 2023 Amendment Determination

Air NZ confirms that it is comfortable that the Draft Amendment Determination reflects the proposed changes to the Airport Services Determination and that these proposed changes are appropriate.

Air NZ looks forward to the Commission confirming its Draft Decisions. Please contact [redacted] if you have any queries relating to this submission.

Yours sincerely

[redacted]

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