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3 February 2023

IM Review team
Commerce Commission
Wellington

By email: im.review@comcom.govt.nz

To whom it may concern,

2023 INPUT METHODOLOGIES REVIEW – SUBMISSION ON CEPA REPORT ON ASPECTS OF THE COST OF CAPITAL

- Christchurch International Airport Limited (**CIAL**) thanks the Commerce Commission (the **Commission**) for the opportunity to make a brief submission in relation to matters that were raised in the Commission's letter to stakeholders dated 8 December 2022 titled, ***"CEPA report on aspects of the cost of capital Input Methodologies for the 2023 review".*** [1]

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

- The primary purpose of this submission is to endorse the findings made in the Competition Economics Group (**CEG**) report in response to the "specific matters" that the Commission requested stakeholder feedback on.

- The CEG Report is well grounded in the principles that it establishes. Together with the empirical evidence that CEG has assembled, CEG presents a strong case in relation to all three key issues raised in the Commission's Letter.

- Where possible, we also wish to draw your attention to further corroborating evidence to support CEG's analysis and recommendations.

- CIAL's views are informed by work it has previously undertaken as part of its PSE4 pricing consultation and work undertaken by Incenta Economic Consulting on its behalf.

[1] Commission, *CEPA report on aspects of the cost of capital Input Methodologies for the 2023 review* (8 December 2022) which references the CEPA *Review of Cost of Capital 2022/2023 – Final report* (29 November 2022)

The three issues are, in turn:

There is no evidence to support a 0.05 decrement in the estimated asset beta based on the idea that non-aeronautical revenue bears greater risk than aeronautical revenue

The CEG Report presents a compelling case that there is no evidence to suggest that non-aeronautical operations at airports bear greater systematic risk than aeronautical operations. CEG's analysis includes both statistical evidence of the relationship between (total) airport asset betas and the extent of non-aeronautical activities, as well as corroborating information on how the most recent macro-economic shock (Covid-19) affected the revenue and profit for these different activities.

In our view, CEG's results are quite intuitive. The principal non-aeronautical activities at airports are typically:

- concessions within airports (i.e., food and beverage and other retail activities), and
- industrial and commercial property.

In terms of the former, the rentals charged for concessions are typically a function of turnover, and so have a similar driver to aeronautical activities, although these contracts typically provide for a minimum rental payment, which lowers the risk of these activities. These activities have similar risk to aeronautical activities.

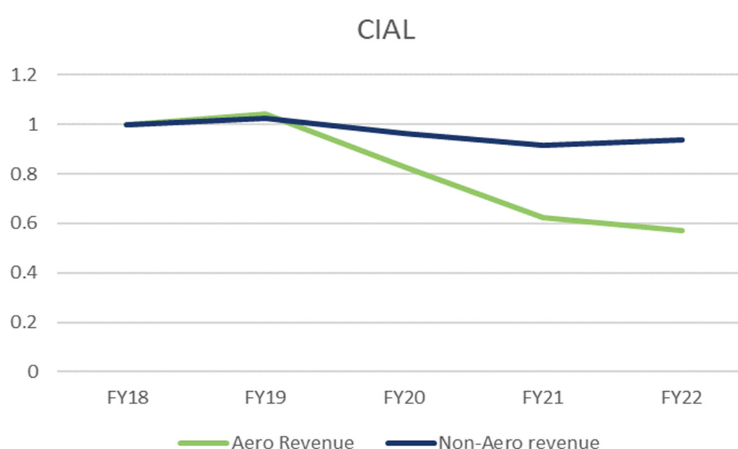
In contrast, however, the long-term leasing of commercial and industrial property has a direct equivalent outside the airport sector, and these activities tend to have relatively low asset betas.

In support of the "event study" approach applied by CEG, we have undertaken a parallel analysis for CIAL during the same period of the pandemic. In CIAL's experience, where 2018 revenue is compared with 2020 and 2021 revenues respectively:

- aeronautical revenue fell by **17 per cent** per cent (2020) and **38 per cent** (2021), and
- non-aeronautical revenue fell by only **4 per cent** (2020) and **8 per cent** (2021).

Presented graphically below, the relative revenue trends demonstrated by CIAL's revenue during the Covid-19 pandemic are similar to those CEG presented for the Commission's sample of comparator airports.

Figure 1: Revenue time series for aero and non-aero (FY2018=1)



Source: CIAL financial data

Hence, CIAL's experience provides further corroboration for CEG's conclusion that there is no evidence to support a 0.05 decrement in the estimated asset beta based on the idea that non-aeronautical revenue bears greater risk than aeronautical revenue.

There is no case for the Commission to change its comparator selection methodology to reflect such factors as instability of beta estimates or the size of country market risk premiums (MRP)

CEG makes a strong case, supported by empirical evidence, that beta estimates contain substantial statistical noise, and the best way to address the problem is to construct a large sample of comparators. Attempting to filter or select comparators based on the extent of variability in beta estimates risks undermining the benefits achievable by constructing this large sample of comparators. Moreover, CEG also provided compelling evidence that different plausible measures of beta instability will create a different ranking of comparators, implying that any exclusion of comparators based on "instability" is likely to have a material arbitrary element, which is not consistent with good regulatory practice.

We also agree with CEG's findings that there is no empirical evidence to suggest that asset betas are likely to be related to the MRP in the relevant comparator's home market. CEG explains how the existence of such a relationship is inconsistent with finance theory (where by definition the equity beta of every market is 1) and supports this with empirical evidence as to the relationship between beta and two measures of the home country MRP for the airport sample. Lastly, CEG also shows that, even putting this aside, removing airports from the highest MRP countries – again, applying two measures of the relative MRP – is unlikely to materially affect the asset beta estimate.

All information should be applied when estimating the asset beta, and a change to the current approach is required to ensure all years are weighted equally

In our view, CEG provides a good discussion of the difficulties with trying to remove effects of infrequent, large events in a manner that is unbiased over time – noting that some compensation is required but will be over-represented in the immediate aftermath of the event. CEG's preferred route is to allow all events simply to flow through so that the consequences of events even out over time, which we consider to be a well-principled position.

CEG also raised a related concern that the current approach – whereby asset betas are set in the IMs using 10 years of data and with the IMs reviewed at a frequency of no more than seven years, but pricing periods are five-year terms – results in different years being weighted materially differently in the asset beta estimate. As an example, again under the current approach, the year to 31 March 2022 (the year in which the Covid-19 recovery commenced) would have three times the weight as 2021 (the year of the Covid-19 market collapse).

In addition, the current approach also results in quite dated information being applied when prices are set. As an example, the applicable IMs for CIAL's PSE4 pricing decision that was made in June 2022[2] were the current IMs,[3] the asset beta for which was based on information to 31 March 2016, implying that six years of market information were not factored into the PSE4 prices.

[2] CIAL, *Disclosure relating to the reset of aeronautical prices for the period 1 July 2022 to 30 June 2027* (11 August 2022).

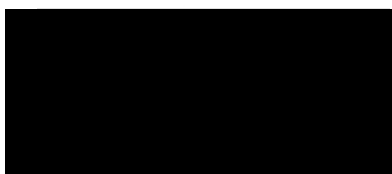
[3] Airport Services Input Methodologies Determination 2010 (consolidated as of 20 December 2016).

CEG's preferred response is to re-estimate asset beta at the start of each pricing period, applying a method – rather than a value – that is prescribed in the IMs. The objective of re-estimating the asset beta in this manner would be to ensure that an equal weight is applied to each year in the asset betas that are applied for pricing purposes rather than arbitrarily weighted depending on when prices must be set, compared to when the IMs review falls.

The issues CEG has raised about the differential weighting of years when estimating asset betas are important. CEG makes a strong case for change from the current approach. CIAL is also open to changing the approach to one where the IMs prescribe a method for estimating the asset beta, but with a new estimate being derived just prior to the commencement of each pricing period. One issue that we would raise, however, is that to achieve the objective of applying an equal weight to all years when estimating the asset beta, it may be necessary to apply a slight variation across airports in how past periods are weighted (for example, a transitional arrangement) when estimating the asset beta given the different timing of the airports' pricing decisions. Initial analysis suggests that a reasonably simple modification to CEG's main proposal will address the circumstances of CIAL, and CIAL proposes to address this matter further in future submissions.

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

Yours sincerely



Tim May
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