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## **WELLINGTON INTERNATIONAL AIRPORT LIMITED – SUBMISSION ON 2023 INPUT METHODOLOGIES REVIEW DRAFT DECISIONS**

### **Introduction and summary**

- 1 This is Wellington International Airport Limited's (WIAL's) submission on the Commission's draft decisions in the 2023 Input Methodologies (IM) Review. We enclose an expert report prepared by HoustonKemp.
- 2 We have reviewed and support the NZ Airports Association's submission and the accompanying expert report prepared by CEG.
- 3 The Commission has, in its draft decision, given insufficient regard to the importance of certainty and predictability, and has not presented a clear and well-evidenced justification for departing from its previous approach. The Commission's draft decision is unsupported by expert evidence, insufficiently explained and justified and – as demonstrated by the expert reports provided by CEG and HoustonKemp – deficient in almost every respect.
- 4 The draft decision conflicts with the approach previously endorsed by the High Court and does not apply the Commission's own decision making framework.
- 5 The Commission has made two significant changes to its approach to estimating asset beta:
  - a) abandoning the large comparator sample it has used from 2010 onwards in favour of a smaller sample of allegedly more comparable airports; and
  - b) using a pre-COVID estimate of asset beta and then making a small upwards adjustment, rather than taking the average of the two five year periods and reflecting the impact of COVID in the asset beta.
- 6 These are substantial changes that will result in regulated airports being significantly undercompensated relative to their true cost of capital. We are concerned that the Commission's draft decision is not well justified and evidenced, does not reflect best regulatory practice, and is inconsistent in its implementation.
- 7 Proceeding with the draft decisions would have a significant adverse effect on regulatory certainty, the predictability and stability the Commission itself acknowledges is an important feature of the IMs, and

the confidence of investors that the regulatory framework will fairly reflect changes in market risk over time. We therefore support retaining the Commission's current approach to estimating asset beta.

8 However, we consider that there could be a reasonable basis for the Commission to extend the time period over which the beta is estimated, from 10 years to 15 years. This would serve to mitigate the immediate impact of asset beta increases, while preserving investment value over time.

9 We welcome the Commission's acceptance that the previous 0.05 downward adjustment is not supported by evidence; we agree.

### **Context for the Commission's asset beta decision**

10 Prior to 2020, every day approximately 17,500 passengers travelled through Wellington Airport, following its highest annual growth in a decade for domestic travellers. International travellers were set to reach 1 million per annum for the first time, and the Airport planned substantial capital investment through its 2040 Masterplan<sup>1</sup> to cater for the next 20 years of growth.

11 COVID-19 seriously impacted the entire aviation industry and Wellington Airport was no exception. The national lockdown in March 2020 ended all but essential travel, and restrictions continued for the next two years. As a result, passenger numbers dropped to 1% of normal levels in April 2020, and recovered to only 48% for the year to April 2021. While domestic growth slowly picked up over the next year, international passengers were only 49,000, just over 15% of pre-COVID levels. Overall, COVID-19 has set back our passenger growth forecasts by approximately 5-6 years, and the recovery is very much ongoing.

12 We acted quickly to resize as the pandemic emerged, making the very difficult decision to inform 30% of staff their roles were being made redundant. We also immediately reprioritised capital expenditure to essential maintenance only, and restructured bank and bond finances to withstand the pandemic period. This included securing waivers of lender covenants and putting in place a \$75.8 million shareholder support agreement with both Infratil and Wellington City Council. Shareholder dividends were foregone for two years. We have undertaken three bond issues since this time to extend and secure efficient long term funding.

13 The short point is that COVID-19 was an unprecedented shock to the global aviation industry and unquestionably influenced the systematic risk faced by regulated airport operators in New Zealand. WIAL (and other regulated airports) anticipated that this change in systematic risk would be reflected in the Commission's estimate of asset beta. And, in fact, had the Commission retained the methodology it has used since the inception of the current regulatory regime in 2010, asset beta would have moved from 0.65 to 0.79 (per CEPA's analysis).<sup>2</sup>

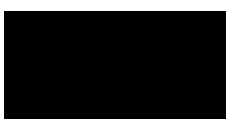
14 That is intuitively the right result given the shocks to the aviation sector over the past several years. However, the Commission has instead adjusted its methodology, which results in an asset beta that is lower than the asset beta in the 2016 IM Review (from 0.65 to 0.55). That is to say: the Commission's position is that systematic risk has reduced since 2016 despite the impact of COVID-19.

15 That is not a credible position, and therefore risks undermining confidence in the regulatory framework. As we describe below, providing an ex ante expectation of real Financial Capital Maintenance (FCM) entails a commitment to maintaining the predictability and stability of regulatory WACC settings over

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1 Attached to this submission.

2 Discounting the 0.05 downward adjustment which the Commission has now, correctly in our view, ceased.



the long-term (i.e. multiple regulatory periods) given the timeframe over which investments in long-lived assets are recovered. Investors reasonably expect that a s 52A-compliant approach to setting the regulatory WACC will result in allowable returns tracking changes in market conditions, including in the systematic risk faced by suppliers of the regulated service. The Commission's draft decision undermines that reasonable expectation. That has practical consequences for investors' willingness to invest, and also fails to achieve the s 52A purpose statement.

- 16 The Commission's determination of asset beta and Weighted Average Cost of Capital (WACC) also have practical consequences for regulated airports' consultations with airlines on landing charges. Under the ID regulation framework, the Commission's setting of these parameters has two primary applications for regulated airports:
- a) the estimated midpoint benchmark WACC informs the target return proposed by airports during their individual price setting events (PSEs); and
  - b) the WACC estimate underpins consultation between individual airports and airlines on landing charges. Consultation may incorporate a range of factors that differ from the Commission's underlying assumptions, thereby resulting in outcomes that may differ substantially from the Commission's estimates.
- 17 The adoption of the Commission's revised approach is likely to undermine effective consultation with airlines as it will increase the need for airports to determine and consult on bespoke asset beta and WACC estimates during each individual PSE. This is due to the sample used by the Commission being less reflective of New Zealand airports, leaving airports to determine how their own asset beta might differ from the Commission's sample.

### **The Commission must give effect to the s 52A purpose statement**

#### *The statutory purpose*

- 18 Section 52A directs the Commission to make decisions that promote the long-term benefit of consumers of airport services by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of airport services—
- a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets;
  - b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands;
  - c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
  - d) are limited in their ability to extract excessive profits.
- 19 The purpose of IMs, per s 52R, is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation of airport services.
- 20 The Commission has adopted its three key economic principles to guide its decision-making under Part 4. Relevant for present purposes, the Commission's ex ante real FCM principle provides that regulated suppliers should have the ex ante expectation of earning their risk-adjusted cost of capital (i.e. a 'normal' return), and of maintaining their financial capital in real terms over timeframes longer than a single regulatory period. Real FCM is essential to achieving the outcome in s 52A(1)(a) because, absent an expectation of maintaining financial capital in real terms, investors are not incentivised to



invest in the regulated service. Equally, real FCM is consistent with achieving the outcome in s 52A(1)(d) because it ensures that suppliers earn no more than their risk-adjusted cost of capital, and are therefore limited in their ability to extract excessive profits.

- 21 The Commission gives effect to real FCM in the context of the WACC IM by, amongst other matters, adopting an asset beta that is the best estimate of the systematic risk faced by airport operators. If the Commission's asset beta is too low relative to the actual systematic risk, airport operators will not have the opportunity to earn a normal return.<sup>3</sup>
- 22 The Court in *Wellington International Airport Limited v Commerce Commission* accepted that the s 52A purpose statement does not create an explicit hierarchy between the several outcomes set out in paragraphs (a) to (d).<sup>4</sup> The Commission is required to determine IMs that best achieve each of the outcomes in s 52A. But the Commission has recognised that, in certain circumstances, the purpose statement is best achieved through a focus on a particular outcome in s 52A. As regards the balance between paragraph (a) (incentivising investment) and paragraph (d) (restraining excessive profits), the Commission has observed that the benefits to consumers are generally greater from promoting dynamic efficiency rather than static allocative efficiency. For example, in the EDB-GPB Reasons Paper the Commission said, in relation to WACC percentile:<sup>5</sup>

*...the Commission is acknowledging that where there is potentially a trade-off between dynamic efficiency (i.e. incentives to invest) and static allocative efficiency (i.e. higher short-term pricing), the Commission will always favour outcomes that promote dynamic efficiency. The reason is that dynamic efficiency promotes investment over time and ensures the longer term supply of the service, which thereby promotes the long-term benefit of consumers (consistent with outcomes in workably competitive markets).*

- 23 That approach was endorsed by the High Court in *Wellington International Airport Limited v Commerce Commission*.<sup>6</sup>
- 24 In the 2016 IM Review the Commission observed that, if suppliers are already at or past the optimal level of investment there is no benefit from incentivising increased investment. Consequently, in its 2014 WACC percentile decision the Commission did not reiterate its earlier view that it would always favour dynamic efficiency considerations over allocative efficiency.<sup>7</sup> However, as HoustonKemp notes,<sup>8</sup> all three New Zealand airports are undertaking expansion programmes to meet future demand growth, which supports a continued focus on dynamic efficiency. Wellington Airport's Masterplan demonstrates that the international terminal is unable to cater to demand growth in the near future, and is already significantly congested; moreover, available apron space is unable to cater to growth in aircraft movements and particularly to the introduction of more Code E (large) aircraft types and the future proliferation of electric aircraft. Wellington Airport works hard to invest in time for growth, and

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<sup>3</sup> Commerce Commission, *Input Methodologies (Airport Services) Reasons Paper 2010*, December 2010 at E1.24.

<sup>4</sup> *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 at [684] and [685].

<sup>5</sup> Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper 2010*, December 2010 at H1.31.

<sup>6</sup> At [243] to [244].

<sup>7</sup> Commerce Commission, *Input Methodologies Review Decisions: Framework for the IM review*, 20 December 2016 at [141] to [142].

<sup>8</sup> HoustonKemp, *Comment on the Commerce Commission's draft asset beta methodology: Report for Wellington International Airport Ltd*, 19 July 2023 at section 2.2.1.



we are proud of the services we are able to maintain on our constrained site, but the Airport is certainly in need of significant investment in the near term.

- 25 It should also be noted that one of the most effective ways for airports to keep per-passenger price increases down is to encourage growth in traffic by investing in new capacity. While incumbent airlines do not necessarily endorse this approach, it leads to better outcomes for consumers by promoting airline competition and spreading fixed costs over a larger passenger base.
- 26 HoustonKemp's opinion is that the asset beta proposed in the draft decision is likely to result in dynamic efficiency losses. This is because: (i) the lower midpoint WACC directly reduces the incentive for investors to finance investments by the airports, and (ii) the disproportionately large impact arising from the unexpected exercise of regulatory discretion reduces investment certainty and confidence in the Commission's application of the framework.
- 27 Moreover, the potential for allocative efficiency gains from reduced airport landing charges assumes that airlines pass through reductions in landing charges to passengers, which in turn depends on competition in the air passenger services market. As discussed by HoustonKemp,<sup>9</sup> the evidence of pass-through by New Zealand airlines is weak, which suggests the Commission's reduction in the WACC will simply result in a wealth transfer from airports to airlines, with no allocative efficiency impact. It will, however, reduce incentives to invest, resulting in a loss of dynamic efficiency.

#### *Commission's decision-making framework*

- 28 The Commission has developed and published a decision-making framework to guide its IM Review. The decision-making framework explains how the Commission gives effect to the statutory purpose statements in the context of reviewing the IMs. Suppliers submitted on that decision-making framework and have relied on the Commission's indication that it will apply it in its draft and final decisions.
- 29 The Commission states that the overarching objectives of the IM Review are to:<sup>10</sup>
- a) promote the Part 4 purpose in s 52A more effectively;
  - b) promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); and
  - c) significantly reduce compliance costs, other regulatory costs, or complexity (again, without detrimentally affecting s 52A).
- 30 We support those objectives.
- 31 The Commission has set out the factors it will take into account when deciding: (i) whether or not to review an IM, and (ii) whether or not to change an IM.<sup>11</sup> In deciding whether or not to review and change an IM, the Commission explained that it would consider, amongst other matters:
- a) whether the objective of the IM is still valid and consistent with s 52A;

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<sup>9</sup> At section 2.2.2.

<sup>10</sup> Commerce Commission, *Part 4 Input Methodologies Review 2023: Framework paper*, 13 October 2022 at [3.12].

<sup>11</sup> *Ibid*, at [3.21] et seq.



- b) whether there is evidence the current IM is no longer promoting s 52A, or that a change would better promote s 52A; and
- c) whether external circumstances have changed in a way that disrupts the assumptions underlying the original policy decision, or means the IM is no longer achieving its policy intent; for example, changes in the industry or economic theory or practice.

32 The key point that emerges from that description is that the Commission does not change an IM simply because it now prefers a different choice amongst the several options that were reasonably available to it when it made its original decision. In order to change the IMs, the Commission must be satisfied that the change is justified with reference to a shift in policy, effectiveness, evidence or external circumstances. In this case, the Commission appears to have simply changed its mind in the absence of any new evidence or change in circumstances, and without rigorously assessing its proposed methodology or its implications.

***Regulatory certainty, predictability and stability are critical to the achievement of the s 52A purpose***

33 Central to the principle of financial capital maintenance is that regulated suppliers should have the ex ante expectation of earning a normal return over the life of the assets.<sup>12</sup> Airport investments are long-lived, and the Commission's adopting of linear depreciation over the life of commissioned assets means regulated suppliers and their investors make investment decisions in light of their expectations of what the regulatory framework will deliver over the long-term, not over a single regulatory period.

34 While the Commission rejects the concept of a "regulatory compact"<sup>13</sup>, the Commission's approach to determining the return of capital (via depreciation) and on capital (via the WACC) in any given regulatory period assumes that regulated suppliers will continue to have the opportunity to return capital and earn a normal return in future periods. Put another way, applying the FCM principle in a given regulatory period requires that regulated suppliers have an ex ante expectation of maintaining their financial capital in real terms over the course of that regulatory period *and all subsequent regulatory periods*. Absent that expectation, suppliers will not be incentivised to invest in the regulated service. This entails a commitment on the part of the Commission to maintaining the predictability and stability of those settings over the long-term.

35 The Commission and the courts have at various points acknowledged the importance of regulatory certainty, predictability and stability in incentivising investment and therefore achieving the s 52A purpose statement, including the need for predictability and stability over multiple regulatory periods.<sup>14</sup> In its decision-making framework paper, the Commission observed in a number of places that certainty and predictability are important to the achievement of the s 52A purpose.<sup>15</sup>

36 The importance of certainty and predictability in maintaining investment incentives, and therefore achieving the s 52A purposes statement, extends both across regulatory periods, and across IM review periods. That is to say, while the Commission's septennial IM reviews require a comprehensive review of the IMs, an IM Review does not constitute a 'clean slate'. Inasmuch as certainty, predictability and stability across multiple regulatory periods are critical to incentivising investment, they are equally

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<sup>12</sup> Ibid, at [4.7].

<sup>13</sup> Ibid, at [4.27].

<sup>14</sup> See, for example, *WIAL v Commerce Commission* at [213] to [221] and [687].

<sup>15</sup> *Part 4 Input Methodologies Review 2023: Framework paper*, at [X23], [2.14], [2.23] and [4.4].



critical across septennial IM reviews. This follows naturally from the nature of the investments (long-lived) and the fact that real FCM is only achieved over the long-term.

37 We interpret the Commission's decision-making framework as consistent with that general proposition. The Commission does not approach the IM Review as an exercise in determining the IMs de novo. Rather, the Commission's decision-making framework emphasises that the Commission will only make changes where the policy intent underpinning the IM no longer achieves the s 52A purpose, the IM as currently drafted no longer achieves the policy intent, or external evidence or changes in circumstances warrant reconsideration. That general approach preserves regulatory certainty by requiring that the Commission *justify* changes in its approach, as opposed to simply preferring a different choice at subsequent IM reviews.

38 The position is well summed up in the Commission's decision-making framework paper:<sup>16</sup>

*2.23 It is clear that Parliament saw the promotion of certainty as being important to the achievement of the purpose of Part 4. This is to an extent implicitly inherent in section 52A (for example, providing regulated suppliers with incentives to invest in accordance with section 52A(1)(a) requires recognition of the role that predictability plays). It is also expressed in the section 52R IM purpose, in section 52T, and in other aspects of the regime.*

*2.24 When considering proposed IM changes, we must therefore be mindful of the importance of:*

*2.24.1 predictability, which plays a role in providing suppliers with incentives to invest in accordance with section 52A(1)(a); and*

*2.24.2 the IMs' role in promoting certainty.*

39 We acknowledge that a consistent application of the Commission's tried and tested method would lead to an increased asset beta estimate. This should not be viewed as creating instability or unpredictability; on the contrary, such an outcome promotes the certainty of investors that they will achieve a normal return as market conditions change. The asset beta must reflect actual levels of risk, and it is entirely appropriate that this has increased in the wake of the pandemic.

40 In the particular context of the asset beta, maintaining certainty and predictability, investors' expectations of ex ante real FCM, and thus incentives to invest, requires that changes in the beta principally reflect changes in market data rather than changes in the Commission's methodology. If the beta from period to period is principally the result of the Commission revisiting methodological choices, or making evaluative judgments, then investors cannot have confidence that changes in systematic risk faced by airports will be properly reflected in the asset beta adopted from time to time. This undermines investors' expectations of real FCM over the long-term, which in turn undermines incentives to invest in long-lived regulated assets. That is not to say that the Commission is prohibited from revisiting its methodology, but where it considers changes to its approach to estimating the asset beta:

a) it should give due regard to the importance of certainty and predictability over multiple regulatory periods in achieving the s 52A(1)(a) purpose; and

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<sup>16</sup> Ibid, at [2.23].



b) require a clear and well-evidenced justification for departing from its current approach.

41 The Commission has, in its draft decision, given insufficient regard to the importance of certainty and predictability, and has not presented a clear and well-evidenced justification for departing from its previous approach. The Commission's draft decision is unsupported by expert evidence, insufficiently explained and justified and – as demonstrated by the expert reports provided by CEG and HoustonKemp – deficient in almost every respect.

### **The Commission has departed from its long-established approach to estimating asset betas**

42 The regulatory challenge for the Commission is to determine an estimate of the cost of capital for the provision of airport services that is consistent with the cost of capital faced by suppliers in workably competitive markets; i.e. neither too high, nor too low, such that airport operators are both:

a) incentivised to innovate and invest (per s 52A(1)(a)); and

b) limited in their ability to extract excessive profits (per s 52A(1)(d)).

43 At the outset of the current regime, in 2010, the Commission considered whether to determine a single asset beta for the regulated service, or individual asset betas for each supplier. On advice from its panel of external experts, the Commission determined that a single service-wide beta was preferable to estimating supplier-specific betas.<sup>17</sup>

44 The Commission's task is therefore to determine an asset beta that fairly represents the systematic risk faced by all three regulated airports, even though the three airports differ in various ways. With that background in mind, the Commission's usual approach of using a large comparator sample is appropriate, as it incorporates a broad range of airports, with varying characteristics, and is therefore a good measure of industry-wide systematic risk. Conversely, a small sample is likely to be more volatile, influenced by variances in individual comparator airports, and therefore a less reliable estimate of systematic risk for the regulated service as a whole.

45 We summarise below the Commission's approach to estimating asset beta from 2010 onwards.

### **2010 IMs determination**

46 The Commission's draft determination identified a comparator sample of 10 airport companies, which resulted in an average asset beta of 0.65.<sup>18</sup> Several submitters argued that the Commission should adopt a larger comparator sample for the purposes of estimating the asset beta.<sup>19</sup> In response, the Commission undertook further analysis to identify comparable firms, defining "comparable" as meaning firms with similar exposure to market risk, including overseas firms that operate airports.<sup>20</sup>

47 The Commission excluded from its sample of overseas airport operators:

a) any firm with insufficient history as a listed entity and small firms with thin trading volumes;  
and

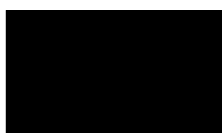
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<sup>17</sup> *Input Methodologies (Airport Services) Reasons Paper 2010*, at [E8.7] to [E8.13].

<sup>18</sup> *Ibid*, at [E8.15].

<sup>19</sup> At [E8.19] to [E8.29].

<sup>20</sup> At [E8.41] et seq.





b) any firms which the Commission did not consider were sufficiently comparable.<sup>21</sup>

48 The Commission's primary measure of comparability was the mix of services provided by the firm. The Commission therefore included, as comparable firms, 24 airport operators providing services similar to those services provided by regulated New Zealand airports.<sup>22</sup> Relevant for present purposes, the Commission both accepted: (i) that a large comparator sample was preferable to its initial – smaller – sample, and (ii) that it was generally not appropriate to refine the sample further. Instead, the Commission considered whether there was a case to make adjustments to the unadjusted average asset beta of a comparator sample.<sup>23</sup> The Commission determined that it was appropriate to apply a downward adjustment to account for the different systematic risk of an airport operator's regulated and unregulated businesses, but did not make adjustments to account for differences in the form of regulation.

49 The Commission applied a similar approach to estimating asset beta for EDBs and GPBs, increasing the size of the comparator sample between draft and final decisions to include a wide range of firms offering similar services to regulated New Zealand suppliers.<sup>24</sup>

### **Endorsement by the High Court**

50 The Commission's approach to estimating asset beta was challenged in the High Court, including the choice of comparator sample.<sup>25</sup>

51 Counsel for CIAL argued that the Commission's use of a broader comparator sample did not result in a materially better IM relative to the narrower sample used in the draft decision. CIAL argued that a better estimate of asset beta would have excluded a number of airports, including all Mexican and Chinese airports on the grounds that these were "developing countries" and therefore:

*... the different institutional and market environment in those countries compared to New Zealand means that there can be less confidence that the relationship between the economic returns to an airport in a developing country and the market as a whole is a good proxy for the relationship that would exist in New Zealand.*

52 The Court held that the narrower comparator sample advocated for by CIAL would not result in a materially better cost of capital IM. The Court was not persuaded that screening out certain countries from the Commission's broader comparator sample was likely to result in a better estimate of asset beta.<sup>26</sup>

*Having considered that evidence, we are not persuaded that WIAL/CIAL's proposed asset beta would produce a materially better Airports cost of capital IM. We find PwC's "developing country" argument unpersuasive. Mexico has, after all, been a member of the OECD for almost 20 years and to classify China's economy as "developing" may be true, but says little beyond stating the obvious. Moreover, the range of sample information commented on by PwC itself in its report (for example Europe Economics'*

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<sup>21</sup> At [E8.44].

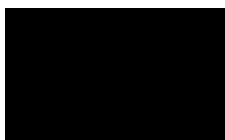
<sup>22</sup> At table E18.

<sup>23</sup> At [E8.72] et seq.

<sup>24</sup> *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper 2010*, at [H8.37] et seq.

<sup>25</sup> *WIAL v Commerce Commission*, at [1561] to [1569].

<sup>26</sup> At [1568].



*sample compared to that of the Commission) shows, in our view, that the Commission's sample took something of a middle ground in terms of those that were advocated before it.*

### **2015/16 IMs Review**

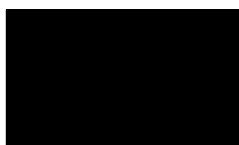
- 53 The Commission largely retained its 2010 approach in the 2015/16 IMs Review. The Commission's comparator sample was primarily determined with reference to the activities of the comparator firms. The Commission's only adjustments to the comparator sample were to:<sup>27</sup>
- a) exclude several firms that had been acquired or did not appear to hold airport assets; and
  - b) include a number of firms that either operate airports or hold airport assets.
- 54 In the course of explaining its approach to asset beta for EDBs and Transpower, the Commission reinforced the benefits of the large sample approach, as opposed to making significant refinements to the comparator sample, as suggested by some submitters.
- 55 The Commission explained that using a large sample is preferable because:<sup>28</sup>
- a) it limits the need to make subjective judgement calls regarding which firms should be included or excluded. The Commission observed that any refinement to comparator sample would mean clarifying the criteria and evidence to support inclusion or exclusion, and then to exercise judgement with regard to those criteria and evidence; and
  - b) it maintains consistency and stability with the approach used when setting the original IMs in 2010. This reduces the risk of large swings between reviews based on a change in methodology, rather than a change in asset beta data.
- 56 TDB, on behalf of Contact, argued – as it has again in the 2023 IMs Review – for a refined comparator sample reflecting firms that TDB argued were more comparable to the regulated suppliers in New Zealand. The Commission rejected that approach, amongst other reasons, because:<sup>29</sup>
- a) the approach to excluding firms from the comparator sample required significant subjective judgement; and
  - b) applying the refinements proposed by TDB would result in what the Commission described as “a relatively small sample of eight companies”. Notably, the Commission's draft decision on the airports asset beta would also rely on a small sample of only eight firms.
- 57 Prior to the 2023 IMs Review, the Commission's approach to estimating asset beta therefore emphasised:
- a) the need to determine an asset beta reflecting the systematic risk of the regulated service as a whole, rather than individual suppliers;

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<sup>27</sup> Commerce Commission, *Input Methodologies Review Decisions - Topic paper 4: Cost of capital issues*, 20 December 2016 at Attachment C.

<sup>28</sup> At [277].

<sup>29</sup> At [311] et seq.



- b) the benefits of using a large comparator sample to estimate the systematic risk of the regulated service as a whole, including with reference to airport operators/owners in a range of other countries;
- c) that “comparable” in the context of identifying the comparator sample is principally determined with reference to the mix of services undertaken by the firm, rather than by its country of origin, form of regulation, etc;
- d) that, if necessary, adjustments can be made to the (unadjusted) average of the comparator sample if there are reasons to believe the comparator sample produces a result that is misaligned to the circumstances of regulated airports in New Zealand. But, for transparency, those adjustments should be made to the result of the comparator sample, rather than by refining the comparator sample itself;
- e) that, for reasons of consistency and stability, changes in the asset beta from period to period should principally reflect changes in market conditions rather than changes in estimation methodology; and
- f) that refinements to the comparator sample, based on considerations other than mix of services, are not appropriate because they inevitably require an exercise of subjective judgement on the part of the regulator.

**2023 IMs Review draft decision**

- 58 In the 2015/16 IMs Review the Commission flagged several issues that it proposed to re-examine at the 2023 IMs Review:
- a) the Commission indicated that it would use the intervening period to “collect more detailed data on each of the companies so that it can further refine its decisions on whether they should be included or excluded”,<sup>30</sup> and
  - b) specifically would consider excluding Japan Airport Terminal and Airport Facilities on the basis that an insufficient proportion of their revenue was associated with the provision of airport services.<sup>31</sup>
- 59 In the Process and Issues Paper at the outset of the 2023 IMs Review, the Commission again notified participants that it intended to revisit the inclusion of JAT and Airport Facilities, as it had signalled in 2016.<sup>32</sup>
- 60 However, the Commission’s draft decision goes significantly beyond the matters it identified in 2016 and flagged in the Process and Issues Paper. The draft decision represents a dramatic change in approach that is not justified with reference to the Commission’s prior reasoning or expert advice.
- 61 The Commission refers to the “potential problem” identified by TDB that the large sample “may include firms that differ markedly from domestic operators”.<sup>33</sup> The Commission also observes that regulators

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<sup>30</sup> At [319].

<sup>31</sup> At FN 356.

<sup>32</sup> Commerce Commission, *Part 4 Input Methodologies Review 2023: Process and issues paper*, 20 May 2022 at [6.41].

<sup>33</sup> Commerce Commission, *Part 4 Input Methodologies Review 2023 - Draft decision: Cost of capital topic paper*, 14 June 2023 at [4.32].



in other jurisdictions tend to use smaller comparator samples to estimate asset betas and concludes that using a large sample is “not standard practice and we do not support that approach”.<sup>34</sup>

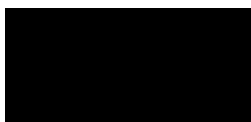
- 62 The Commission’s draft decision is to instead remove from the comparator sample:
- a) firms that operate in markets that are substantively different to New Zealand, with reference to the FTSE Equity Country Classification and MRP as indicators;
  - b) firms that have “unusually variable” asset beta estimates;
  - c) firms that have unusual business financing structures that create anomalies when converting the observed equity betas to asset betas; and
  - d) firms that have business characteristics that are not comparable to a major airport operating in New Zealand.
- 63 The consequence of the Commission’s revised approach is an asset beta based on the average of only eight comparator firms, as opposed to the 26 firms used to estimate the asset beta in 2010 and 2016.
- 64 In addition, in 2010 and 2016 the Commission derived the benchmark asset beta by calculating the same average asset beta observed over the last two five-year periods, and then taking the average of the two. Adopting the same approach for this review would ensure that the asset beta reflects the impact on systematic risk of the COVID-19 pandemic. However, the Commission’s draft decision is to start with a long-term pre-COVID-19 average asset beta estimate of 0.53 and apply a premium of 0.02 to account for the expected impact of future COVID-19 type events, resulting in a benchmark asset beta of 0.55.

#### **Problems with the Commission’s draft decision**

- 65 The Commission’s draft decision is deficient in a number of respects:
- a) the Commission has failed to apply its own decision-making framework in deciding to review and change the methodology for estimating the asset beta;
  - b) the reasons advanced in support of the change are not persuasive and do not meet the threshold for a change in approach;
  - c) the draft decision conflicts with the approach endorsed by the Court;
  - d) the Commission’s approach fails for the reasons it has itself advanced over several prior IM review processes;
  - e) the weight of expert opinion continues to favour the current approach;
  - f) the Commission’s draft methodology does not result in the best estimate of airport betas;
  - g) The resulting asset beta is not commercially realistic; and

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<sup>34</sup> At [4.41].



- h) the Commission's approach renders asset beta a subject for ongoing debate at future reviews, in airports' consultations with airlines and as part of airports' PSEs, undermining certainty, predictability and stability.; and
- i) the Commission has undermined regulatory certainty and the progress achieved over the last 13 years;
- j) the Commission's approach will significantly impact investment decisions for WIAL and other New Zealand airports, and will result in a wealth transfer to airlines with little benefit to end consumers.

66 We elaborate on these points below. We also must note that these failures in both process and substance, and the failure to follow established precedent or take the views of the New Zealand Courts into account, expose the Commission to no small legal risk if its draft decision is not reversed. We urge the Commission to seriously reconsider its approach.

**The Commission has failed to apply its own decision-making framework**

67 The reasons offered by the Commission for changing its approach to estimating the asset beta fall short of the requirements of its own decision-making framework. In amending its approach, the Commission has relied on:

- a) TDB's observation that the current comparator sample may include firms that differ from domestic operators; and
- b) the assertion that regulators in other jurisdictions have tended to use smaller comparator samples.

68 Relevant for present purposes, the Commission's decision-making framework explains that the Commission will only consider changing an IM if:<sup>35</sup>

- a) the policy intent behind the IM is no longer relevant and appropriate;
- b) the current IM is no longer achieving that intent, or if amended would better achieve that intent.

69 The Commission's original decision to adopt a large comparator sample was justified on the basis that:

- a) a large sample was appropriate for the purpose of estimating an asset beta for the regulated service as a whole, rather than individual suppliers;
- b) in the absence of a sufficient selection of listed domestic operators, the Commission looked to international operators (and even potentially listed suppliers in analogous industries) to identify a statistically significant sample size;
- c) in light of that objective, and the statistical benefits of a large sample, the principal criterion for determining comparability was mix of services.

70 Paragraphs 3.24-3.27 of the Commission's decision-making framework paper set out the questions the Commission will address when determining whether the original policy intent remains relevant and

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<sup>35</sup> *Part 4 Input Methodologies Review 2023: Framework Paper*, at [3.22].



appropriate, and whether the current IM is achieving that intent. The Commission does not appear to have engaged in any significant way with those questions. For example:

- a) the Commission has not discussed its original rationale for adopting the large comparator sample, which was reaffirmed in 2016, and why that rationale no longer holds. The reasons the Commission has pointed to now were equally valid considerations in 2010 and 2016, and yet the Commission made a deliberate choice to prefer a larger comparator sample. It then defended that rationale (successfully) in the High Court. The Commission's draft decision makes no serious attempt to grapple with its original reasoning and explain what has changed since 2016;
- b) the Commission has not identified or sought any evidence that the current IM results in an asset beta that does not represent the best estimate of systematic risk faced by airport operators in New Zealand. The Commission obtained independent expert advice on cost of capital matters in the course of determining the original IMs and again in 2016. That advice either endorsed, or did not raise concerns with, the Commission's approach. The Commission has not obtained any independent expert advice to support the change it is making now. It relies principally on TDB, which addresses the issue in three short paragraphs in its report supporting BARNZ's submission on the Commission's Process and Issues Paper. TDB offers no evidence or analysis in support of its position, simply noting that "the Commission's selection raises questions about the trade-offs between using a larger sample that may include firms that differ markedly from domestic operators, and a smaller sample of more similar firms". Qantas, whose methodology the Commission has adopted, similarly offers no evidence that its approach results in a better estimate, other than an assertion that "it is necessary to consider a comparator sample that draws on airports similar to those operating in New Zealand";
- c) the Commission has referred to international regulatory practice, which we separately address below. But it has not identified any change in economic theory suggesting that its approach prior to this point is out of step with economic theory; and
- d) the Commission has also not identified any changes in external circumstances, for example in market conditions, that disrupt its original policy position.

71 In the 2016 IMs Review, the Commission indicated that it would reconsider the inclusion of JAT and Airport Facilities, and that it would also use the intervening period to gather data on the companies in the comparator sample in order to determine whether further refinements were appropriate. But it does not appear to have done that. Instead, it has comprehensively revised its approach, but without reference to new evidence or advice.

72 As described above, regulatory certainty demands that, when the Commission changes an IM, particularly an IM that is central to investment incentives, it properly justifies the departure with reference to changes in policy, evidence or circumstances that warrant a revised approach. Conversely, the Commission shouldn't change an IM simply because it now prefers a different option amongst the options that were reasonably available to it when it made its original decision. That is what the Commission appears to have done here. The Commission says that it is "balancing the risk of having a small sample with the risk of including firms that are poor comparators, while acknowledging that there is inherent error in measuring correlations across erratic share-market data".<sup>36</sup> But that is precisely the question it addressed in 2010 and resolved in favour of a broader sample. It reaffirmed its preference for a broader sample in 2016. It is not that the circumstances, evidence, or advances in

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<sup>36</sup> *Part 4 Input Methodologies Review 2023 - Draft decision: Cost of capital topic paper*, at [4.44].



economic theory now require a new approach, but rather that the Commission has simply changed its mind on the balancing question. That is not a sufficient basis for a change that has such significant implications for investment incentives, and falls short of the thresholds articulated by the Commission in its decision-making framework.

### **The reasons advanced for the change are not persuasive**

- 73 The reasons advanced by the Commission for changing its approach are not persuasive.
- 74 The Commission describes TDB's advice as identifying a "problem" with the Commission's current approach to estimating asset beta: that there is a trade-off between using a larger sample, which averages across potentially more and less comparable operators, and a small sample, which may include more comparable operators but is more volatile. But the issue identified by TDB is not new; it is the very issue the Commission considered and resolved in 2010. The Commission's draft decision in 2010 adopted a smaller comparator sample of airport operators that the Commission considered were most comparable. But in its final determination, the Commission reasoned that a larger sample was more likely to be representative of the systematic risk faced by the regulated service in New Zealand. The Commission characterises TDB's advice as raising a new issue that warrants consideration, whereas in fact it has been central to the Commission's analysis throughout.
- 75 Moreover, TDB raised essentially the same issue – on behalf of Contact – in the 2016 IMs Review and on that occasion the Commission rightly rejected TDB's proposed alternative.
- 76 The other rationale for revisiting the comparator sample is the Commission's assertion that "evidence from other regulators indicates a preference to have a sample of relatively close comparators".
- a) The Commission's analysis of overseas regulatory precedents is not persuasive: the UK CAA is engaged in a fundamentally different exercise as it is attempting to estimate supplier-specific betas, rather than an industry-wide beta. The CAA's task is therefore to identify a smaller sample of airports that are most similar to Heathrow, rather than a sample that reflects the systematic risk faced by all three regulated New Zealand airports;
  - b) the AER excludes international firms because they have different characteristics to regulated "pure play" Australian energy businesses. The Commission also recognised in its 2010 and 2016 decisions that multi-divisional firms would include businesses with higher risk than the regulated service, but has historically addressed that by making an adjustment to the average of the comparator sample. Furthermore, the AER has expressed concern about the small comparator sample that it currently relies on and has indicated its intention to consider a broader sample, including international firms, at its next reset.<sup>37</sup> It is therefore not accurate to suggest that a small sample reflects regulatory best practice; and
  - c) the ERA similarly, in its 2022 decision, expressed concerns with the narrow comparator sample it had historically relied on and, as part of its review, decided to include international firms.<sup>38</sup> Accordingly, the trend in the international precedents relied upon by the Commission is towards larger samples rather than smaller samples.

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<sup>37</sup> Australian Energy Regulator, *Rate of Return Instrument: Explanatory Statement*, 24 February 2023 at pages 19 and 179

<sup>38</sup> Economic Regulatory Authority, *Explanatory Statement for the 2022 final gas rate of return instrument*, 16 December 2022 at [922] to [923], [1000] to [1006] and [1039] to [1043].



77 Other international regulatory precedents also do not align with the Commission’s reasoning in the draft decision:

- a. the Queensland Competition Authority commented, in its 2021 Rate of Return decision, that the point of establishing a “pure play” sample is to identify comparators with a sufficiently similar (ideally identical) level of systematic risk. Commenting on the AER’s approach, the QCA observed that introducing additional comparators into a sample otherwise consisting of “pure play” comparators would introduce bias and therefore may not be desirable. However, that assumed that a sufficient sample of “pure play” competitors existed in the first place.<sup>39</sup> Consistent with the acknowledgements of both the AER and ERA in their most recent reviews, the QCA considered there was not a sufficient sample of pure-play competitors available for the purposes of its review. Given the AER and ERA’s established practice of using smaller samples consisting of firms that the respective regulators have determined to be “pure play” comparators, their approaches are less relevant to the New Zealand position;
- b. the AER and ERA decisions referred to by the Commission relate to comparator samples for regulated energy providers, rather than regulated airports. This is relevant because energy providers tend to supply similar products, such that a provider’s size is less likely to translate to materially different systematic risks compared to other sized energy providers. In comparison, the systematic risks relevant to different airports vary materially depending on the type of and proportion of products transported, the size and the status of the airport (as a “hub” or “spoke”). The consequence of the relative homogeneity of systematic risks as between regulated energy suppliers, compared to airports, is that it is more appropriate to use a smaller sample of comparators for energy suppliers on the basis that:
  - i. it tends to be easier to identify comparators with systematic risks that closely match that of the benchmark provider; and
  - ii. the inclusion of less comparable providers in a sample is relatively immaterial, even if their inclusion does introduce bias, because the systematic risk is still relatively homogenous.

For these reasons, the approaches adopted by the AER and ERA are less relevant to the Commission’s consideration of the airport comparator sample.

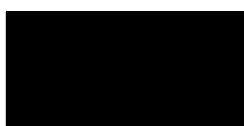
- c. Finally, the Commission’s characterisation of the international precedents suggests that a preference for small comparator samples reflects an update to regulatory best practice. However, the regulators the Commission refers to were also using smaller comparator samples when the Commission confirmed its preference for a large sample in 2016. The international precedents therefore do not represent a change in circumstances that warrants a revised approach in this IM Review.

### **The draft decision conflicts with the approach endorsed by the Court**

78 The High Court had the opportunity in 2013 to opine on the relative merits of a smaller versus a larger comparator sample. The Commission defended the larger comparator sample it had used in its final decision as the best estimate of systematic risk faced by airports in New Zealand. The appellants argued that the smaller comparator sample used in the draft decision was a materially better IM.

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<sup>39</sup> Queensland Competition Authority, *Rate of Return Review: Final report*, November 2021 at page 69





- 79 The Court held that the larger comparator sample resulted in a materially better IM.<sup>40</sup>
- 80 It is particularly relevant that the Court was considering the very issue the Commission has now revisited in this IM Review: the size and composition of the comparator sample. The Court's decision confirms that the adjustments made by the Commission between its draft and final decisions in 2010 resulted in a materially better IM, and specifically:
- a) the larger comparator sample (26 firms) compared to the 10 firms used for the draft decision; and
  - b) the undesirability of excluding airports from certain countries on the basis of perceived differences in market risk.
- 81 The Commission cannot now lightly depart from the position endorsed by the Court. If it is to do so, it must at least point to changes that render the present context distinguishable from the circumstances that pertained when the Court determined the matter. The Commission has not done so. In fact, it has failed to acknowledge that the size and composition of the comparator sample is a matter on which the courts have opined. If the Court were to again consider the matter, in the absence of any new evidence or justification supporting a change in approach, it is difficult to see how the Court could depart from its 2013 endorsement of the large sample approach.
- 82 Courts in other jurisdictions have also endorsed the Commission's 2016 IM approach and questioned the validity of smaller comparator samples. For example, the Supreme Court of Western Australia in *Perth Airport v Qantas Airways* favoured the Commission's 2016 IM comparator sample and approach over a smaller comparator sample. The Court was asked to consider an approach very similar to what the Commission is now proposing, and unequivocally rejected it. The Court was unpersuaded by Qantas' expert's argument that:<sup>41</sup>

the small sample of comparators identified were in fact "best" comparators; and

comparators must come from places with similar country risks to the benchmark firm have similar country risks.

### **The Commission's approach fails for the reasons it has advanced over several reviews of the IMs**

- 83 In the 2016 IM Review the Commission again considered the merits of adopting a smaller comparator sample and rejected that approach. The Commission set out several reasons why refinements to the comparator sample were not desirable. The Commission's draft decision in the 2023 IM Review does not address or even refer to its earlier reasoning. The Commission's draft decision is flawed for precisely the reasons the Commission has previously rejected refinements to the comparator sample.

#### ***Refining the comparator sample requires subjective judgement calls***

- 84 The Commission has always identified comparable firms on the basis of the mix of services they provide. In the 2016 IM Review, the Commission observed that any refinements to the comparator sample, beyond an assessment of the mix of services provided, would require the Commission to:

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<sup>40</sup> *WIAL v Commerce Commission*, at [1568].

<sup>41</sup> *Perth Airport Pty Ltd v Qantas Airways Ltd [No 3]* [2022] WASC 51 at [262] to [267].



- a) clarify the criteria used to exclude firms (and justify those criteria as likely to result in a better estimate of asset beta than including those firms);
- b) identify the evidence that would support the application of those criteria; and
- c) then to exercise judgement regarding the application of those criteria in light of the evidence.

85 Those steps would entail the exercise of a significant amount of ultimately subjective judgement. Both the selection of the criteria and the evaluation of the criteria and evidence are inherently subjective. Reasonable decision-makers could reasonably disagree as to whether the criteria are appropriate, the evidence sufficient, or a proper evaluation of the criteria and evidence support including or excluding a firm from the comparator sample. In the 2016 IM Review the Commission acknowledged that this approach was not likely to result in a materially better IM than its current approach of using a larger sample defined principally with reference to the mix of services.

86 The Commission's draft decision falls afoul of exactly these problems. TDB and Qantas have each offered differing criteria for refining the comparator sample. The Commission has drawn on those submissions but developed its own approach which differs again. The Commission does not offer any justifications or reasons in support of its choice of criteria. The application of those criteria to the facts is also highly contestable, as is evident from the expert reports provided by CEG and Houston Kemp. The result is that the beta estimate relies heavily on the exercise of subjective judgement by the Commission. That is not a methodology in which suppliers or investors can have confidence, or against which they can make decisions to invest in long-lived assets.

***The larger sample maintains consistency and stability over time***

87 In the 2016 IM Review, the Commission explained that the larger sample maintains consistency and stability over time. Maintaining the current methodology maintains consistency and stability in two ways:

- a) it supports regulatory certainty and predictability because regulated suppliers can know with reasonable certainty how the asset beta will be estimated in future periods, and how it will respond to changes in market conditions; and
- b) it reduces the risk of large swings in the beta between reviews based on a change in the methodology rather than a change in asset beta data.

88 This second concern is particularly relevant to the draft decisions given the impact the Commission's change in methodology will have on the asset beta. Despite the severe impacts of COVID-19 on the aviation sector over the past several years, the Commission's estimate of asset beta is lower than the result in 2016. This is not because the asset beta data supports the same result. Rather, it is the Commission's change in the methodology that principally drives the outcome. This is exactly what the Commission cautioned against in 2016.

***Refining the sample results in relatively small comparator samples***

89 Finally, the approach advocated for by TDB in the 2016 IM Review would have resulted in a comparator sample of just eight firms, which the Commission criticised as a relatively small sample from which to reliably estimate the asset beta.

90 The Commission's draft decision would also result in the asset beta being estimated from a comparator sample of just eight firms. The Commission has not acknowledged its earlier concern in



2016, or sought to explain why eight firms is a sufficient comparator sample now when it was deemed insufficient in 2016.

### **The weight of expert opinion continues to favour the current approach**

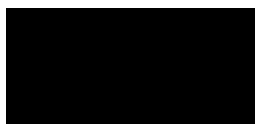
- 91 A number of submitters have provided expert reports supporting the current approach. CEG and HoustonKemp have provided extensive analysis supporting the Commission's 2010 and 2016 approach to estimating the asset beta.
- 92 Conversely, other than TDB's relatively brief discussion of the merits of a smaller comparator sample, there is no expert advisor support for the Commission's draft decision. The Commission has not explicitly sought expert advice assessing the respective merits of larger versus smaller comparator samples. To the extent the advice the Commission obtained from CEPA and Bela is relevant to this question, the Commission has disregarded that advice.
- 93 One of the key concerns identified by CEG and HoustonKemp is the internal inconsistency of the Commission's proposed approach. The Commission's methodology does not achieve its stated objectives, and its implementation is inconsistent, both including and excluding airports apparently contrary to the criteria it has established. That is the unfortunate consequence of attempting such a significant change to the methodology for estimating asset betas without due consideration and detailed analysis.
- 94 Both CEG and HoustonKemp strongly support retaining the 2010 and 2016 approach to estimating asset beta. But, in addition, they explain the type of analysis that would be required to support a change in approach. The Commission has not undertaken that detailed analysis and, in its absence, going ahead on the basis of the draft decision would be unjustified and unsafe.

### **The Commission's methodology does not result in the best estimate of airport betas**

- 95 We have instructed Houston Kemp to review and opine on the Commission's draft decision on asset beta and have also had the benefit of considering CEG's report prepared for NZ Airports. The findings of Houston Kemp and CEG indicate deficiencies in the Commission's approach to calculating regulated airports' asset betas in the draft decision, particularly the Commission's method for determining the comparator sample and to adjust the asset beta for COVID-like events.

#### ***Selection of comparator sample***

- 96 HoustonKemp explains that the issue of whether a country filter should be applied involves a trade-off between bias and variance. A smaller sample of comparator firms is likely to generate estimates with lower bias provided the comparator firms closely match the systematic risks of the benchmark airport, but these estimates are likely to be volatile because they are sensitive to idiosyncratic shocks that affect individual comparator airport. Conversely, a larger sample may introduce bias if it includes firms with systematic risks that are less comparable to the benchmark airport, but the estimates tend to have less variance and better reflect the "true" parameter estimates over shorter time periods.
- 97 This is the trade-off that TDB's advice pointed to, but without explaining what analysis would resolve that trade-off. The Commission similarly has not provided any analysis supporting its preference for the small sample. HoustonKemp's advice explains how the Commission should resolve that question and why a larger sample is therefore preferable.
- 98 The trade-off between bias and variance associated with applying different filters is likely to vary across industries. One important consideration is whether the industry exhibits systematic risks that are uniform or diverse. The adoption of filters (such as a country filter) is reasonable for industries



where there are a large number of firms for which the systematic risks are fairly uniform. This is because it is easier to identify potential comparators with systematic risks that closely match that of the benchmark efficient firm.

- 99 But airports, by comparison, exhibit diverse systematic risks. The systematic risks faced by airports can differ materially depending on a wide range of factors (e.g. depending on the types and proportion of products transported, airport size and status as a “hub” or “spoke”).
- 100 Where filters, such as country filters, are applied across firms for which systematic risks are diverse, the result is a small comparator sample that:
- a) generates more volatile estimates across regulatory periods since fluctuations in the estimates for individual companies will be less likely to offset one another overall; and
  - b) increases the influence of outlier firms on the final parameter estimate.
- 101 In the case of airports, where beta estimates are more likely to vary substantially, the marginal benefits of reducing the variances of the asset beta and gearing estimates through obtaining a larger sample that does not apply a country filter are likely to outweigh the marginal costs of potentially introducing additional bias from including firms operating in markets that may differ substantively from New Zealand.
- 102 Furthermore, the benefits (in terms of lower bias) of a smaller sample are predicated on accurately identifying firms that are closely comparable to New Zealand regulated airports. If those firms are not closely comparable, then the small sample will exhibit both bias and variance. The Commission has not provided any detailed analysis demonstrating that the characteristics of the individual airports in its smaller sample make them more appropriate comparators for the three regulated New Zealand airports. Indeed, the evidence tends to show that the airports in the Commission’s smaller comparator sample are not closely comparable to New Zealand regulated airports.
- 103 Houston Kemp also demonstrates that the smaller comparator sample is more sensitive to additions and removals of individual firms compared to an updated 2016 IM sample. When removing the comparator with the largest asset beta in the sample versus removing the comparator with the smallest asset beta:
- a) the average asset beta differs by 0.04 to 0.05 on average for the updated 2016 IM sample, depending on the time period;
  - b) the average asset beta differs by 0.07 on average for the 2023 draft IM sample; and
  - c) if Beijing Airport, Sydney Airport and Vienna Airport are removed from the 2023 draft IM sample the average asset beta differs by 0.11 to 0.12 on average, depending on the time period.
- 104 CEG similarly considers the draft decision marks a significant departure from well-established regulatory precedent, observing that the effect of the Commission’s departures from regulatory precedent is to reduce the final asset beta by more than 25% compared to the compensation for systematic risk that would have resulted from maintaining established regulatory practice (0.55 vs 0.76). CEG’s evidence shows that the Commission’s approach is poorly explained and justified, conceptually flawed, inconsistent with international best practice, and internally inconsistent in its application.
- 105 CEG explains that a fit-for-purpose comparator sample requires similar risk to New Zealand airports. This effectively requires the sample average to, in the long run, provide a reasonable approximation to



Auckland Airport's asset beta (given Auckland Airport is the best proxy for an airport with an operating environment similar to that which exists in New Zealand).

106 If the comparator sample: (i) does not provide an average similar to the estimated asset beta for Auckland Airport in the long run, and (ii) includes comparators that have, on average, demonstrably lower or higher asset betas compared to Auckland, the sample should be amended in one or more of the following ways:

adding more comparators to the sample until (i) and (ii) above are no longer true;

giving more weight to AIAL than other comparators in the sample. This is consistent with Bela's advice to the NZCC; and

applying an uplift to the sample average to correct the bias apparent in (i) and (ii).

107 CEG's view is that a large sample of comparators which, in the past, have had similar asset betas to the best comparator(s) is common and good practice. A larger sample size means the noise in each comparator's asset beta tend to cancel out and the average asset beta is much more stable. This allows for the use of shorter estimation windows (10 years or less) that capture industry trends but which avoid the volatility that would be associated with a small sample (even if that small sample was comprised of the best comparators).

108 Based on its analysis, CEG considers that the wider 2016 IM sample is the preferred option as it demonstrates better tracking with AIAL over time, reduces noise compared to only using AIAL, and offers increased statistical accuracy and precision compared to the NZCC draft decision sample.

109 The comparator airports included in the Commission's narrower sample are not comparable to New Zealand airports because they have lower risk operating environments:

a) five of the seven non-Auckland airport companies in the draft decision sample have lower risk regulatory environments where prices are reset more frequently (and/or are updated automatically for changes in demand) and where there is passenger volatility risk sharing;

b) all seven of the non-Auckland airport comparators have much lower exposure to passenger demand volatility than New Zealand airports due to:

high levels of capacity constraints such that excess demand from these central airports tends to be served by secondary airports. The result is that, when there is a fluctuation in overall demand, this is felt primarily by the secondary airports and not the central airport; and

greater diversity of passenger traffic. These airports are served by a variety of airlines as well as being paired with variety of origin and destination locations. New Zealand airports are more heavily impacted by a single shock compared to these comparators.

c) two of the seven airport comparators (Fraport and AdP) are dominated by airport operations outside their home countries resulting in their measured asset betas relative to their home country stock indexes being likely to be materially biased downwards, relative to comparators operating in a single country.



### *Adjustment of the asset beta for COVID-like risks*

- 110 The Commission's draft decision applies a premium of 0.02 to the long-term pre-COVID average asset beta estimate (which the Commission calculates to be 0.53) to account for COVID-like events occurring in the future.
- 111 Houston Kemp observes that the application of this uplift is at odds with the Commission's earlier views stated in its fibre IMs, where it observed that ex-ante compensation is difficult to measure and may require additional ex-post compensation even after ex-ante compensation has been provided.<sup>42</sup>
- 112 In addition:
- a) The Commission has misapplied the CAA's approach: the Commission's approach of taking the weighted average of pre-COVID and COVID-affected asset beta estimates differs from that proposed by Flint in its advice to the CAA, and produces an uplift that materially understates the expected impact of future COVID-like events; and
  - b) ultimately relies on an arbitrary assessment of the probability and impact of a future COVID-like event. The Commission does not explain what evidence supports the assumptions that underpin the analysis. This is consistent with Flint's acknowledgement in its advice to the CAA that its analysis regarding future COVID-like events is speculative.
- 113 The Commission's approach also creates regulatory risk. Implicit in the Commission's approach is that the COVID uplift must be applied in perpetuity (as it reflects the long-term expected impact of COVID-like events). But it is not clear from the draft decision whether the Commission intends that the adjustment be applied in perpetuity, removed in future regulatory periods and/or the future circumstances in which a similar adjustment would be applied. Even if the Commission was prepared to clarify these points, it would not be bound by them in future regulatory periods. This raises regulatory risks for the regulated airports if investors are concerned about the risk of the Commission modifying or removing the uplift in future IMs, which in turn will make it more difficult for the regulated airports to raise capital for investments in line with the Part 4 purpose.
- 114 Houston Kemp's opinion is that the Commission's 2010 and 2016 approach is to be preferred as it does not require the NZCC to generate estimates about the expected length, frequency and impact of future COVID-like events, or to apply an uplift in perpetuity. Rather, COVID-like events are reflected in asset betas as they occur.
- 115 CEG similarly opines that an adjustment for COVID is not necessary or desirable. Like Houston Kemp, CEG proposes adopting the 2016 IM methodology which effectively allows systematic shocks:
- that actually occur to be captured in the asset beta estimates;
  - to be assigned an impact that matches the actual severity of the particular shock; and
  - to receive the exact correct weight based on actual frequency over time.

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<sup>42</sup> Commerce Commission, *Fibre Input Methodologies: Main final decisions – Reasons paper*, 13 October 2020 at [6.1017.1] to [6.1017.2].



### **The Commission's methodology does not result in a commercially realistic estimate of asset beta**

- 116 The draft decision applies a midpoint airport asset beta of 0.55, compared to the previous airport asset beta of 0.60 in the 2016 IMs, reflecting a decline by 0.05 between 2016 and 2022. This difference increases to 0.10 when comparing the proposed asset beta against the 2016 IM estimate prior to the 0.05 downward adjustment.
- 117 Both Houston Kemp and CEG explain that this is implausible given the impact of COVID-19 in the intervening period.
- 118 Further, the Commission's estimates of the asset betas of Auckland Airport (being the only regulated airport in New Zealand that is publicly listed) from the last 15 years are materially higher than the 0.55 asset beta proposed in the draft decision suggesting the Commission may have underestimated materially the asset beta of the benchmark efficient airport.

### **The Commission's approach renders asset beta a subject for ongoing debate**

- 119 Between 2010 and 2023, the Commission defined the comparator sample principally with reference to the mix of services supplied by firms, adjusting only for thinly traded stocks. That approach was stable, transparent and relatively free from controversy.
- 120 The Commission's draft decision introduces several new criteria, the choice of which is not clearly explained. In introducing these new criteria, and failing to identify a demarcation principle that justifies the selection of these criteria (and not other criteria), the Commission has opened the door to endless debates about the criteria that best define the group of airports that is most comparable to New Zealand airports.
- 121 The consequence is that future IM Reviews will inevitably see submitters presenting new or additional criteria that, they will argue, better model the systematic risk faced by New Zealand airports. That has three consequences:
- a) first, the Commission and submitters will be required to devote substantial resources to evidencing their preferred choice of comparator firms; and
  - b) second, the asset beta from period to period will reflect whatever set of criteria – and therefore comparator firms – prevails at each IM Review, rather than reflecting changes in asset beta data (and therefore systematic risk faced by airports). This will reduce predictability and stability, undermine investor confidence in the regime, and therefore reduce incentives to invest; and
  - c) third, pricing consultations take place against the background of the Commission's WACC IM, but with an acknowledgement that airports may legitimately target a different return on investment reflecting their specific circumstances. The Commission's signal that the appropriate asset beta is a matter of selecting for the most comparable airports will inevitably result in debates about asset beta during pricing consultations between airlines and airports, as all participants will have their own view of what comparator selection best reflects the systematic risk of the particular airport.
  - d) Further, the narrower sample set produces a sample which is demonstrably un-like New Zealand airports. Airports will now have little choice other than to seek an uplift from the IM position by distinguishing themselves from the comparator set, requiring an immense amount of expert input and analysis at each price setting event with no certainty of whether the Commission will accept this analysis when it comes to its review.



## **The Commission's approach has undermined regulatory stability and the progress achieved over the last 13 years**

- 122 WIAL has reiterated our view for some time that the regulatory regime for airports has become increasingly mature and settled. We welcomed the certainty and stability this provided. The difference between the 2010 and 2016 IM processes was stark, with much less debate and contention in 2016. Airports' respect for the Commission's methodology and views has increased, and we have appreciated the greater collaboration and understanding developed between airlines, airports and the Commission over time.
- 123 This is demonstrated in WIAL's PSE4 pricing proposal issued in 2019, which was provided to the Commission in its PSE4 review:<sup>43</sup>

*Since the introduction of ID requirements in 2010, extensive time and effort has been put into the refinement of the regulatory regime by airports, airlines and government agencies. Though there are still areas of debate between airports and their airline customers (and between airlines with different priorities), the regime has demonstrably matured and common ground has increased.*

*There are aspects of economic regulation which remain challenging to WIAL. Despite this, it is our intention to approach pricing consultation in the best possible faith and to work within an approach that will be acceptable to the Commerce Commission following review. WIAL has paid careful attention to the Commission's reviews of Christchurch and Auckland Airports' PSE3 pricing and has applied much of the Commission's logic to its own approach.*

...

*WIAL has been through three price-setting events since the introduction of the ID regime. The experience and institutional knowledge developed through these events, combined with IM and ID reviews, and ongoing interaction with the Commission and airline customers, has equipped the airport sector with an increasingly finely-tuned series of regulations.*

*We also welcome improvements made through the 2016 IM review which have increased transparency and flexibility. These include aspects WIAL has applied in this IPP such as the transparency of carry forward adjustments to the opening & closing RAB; flexibility in CPI forecasting; and an improved process for calculating internal rate of return.*

*WIAL also expects and looks forward to ongoing refinement of the regulatory regime through future IM reviews. WIAL is also watching with interest the outcome of the Australian Productivity Commission review of airport regulation, and note the draft 14 report's finding that the existing light-touch regulation in Australia benefits the community and is fit for purpose.*

- 124 The Commission's draft decision undermines this progress. Whereas to date we have relied on our expectation that changes in market risk would be reflected in the asset beta, the Commission's draft decision – and particularly the absence of any serious justification for the change in approach – means airports and investors must now proceed on the assumption that the asset beta will principally reflect the Commission's methodological preferences from time to time. WIAL is dismayed that while the Commission had the opportunity to refine a successful regime, it decided to fundamentally alter its

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<sup>43</sup> WIAL Initial Pricing Proposal, 2019.





approach in a way that is likely to be contested in price setting events and further IM reviews for years to come.

- 125 The adverse impacts on investor confidence are relevant to the s 52A purpose statement. As discussed above, and as acknowledged by the Commission, predictability plays a role in incentivising investment, as required by s 52A(1)(a). While that does not prevent the Commission from changing its approach, it does oblige the Commission to do so only with sufficient justification and in a reasoned and considered manner. The Commission's draft decision falls well short of that standard.

**The Commission's approach will significantly impact investment decisions for WIAL and other New Zealand airports, and will result in a wealth transfer to airlines with little benefit to end consumers**

- 126 The draft decision will have real impacts on airports' business decisions.
- 127 As noted above, the existing regulatory framework was increasingly well-defined and settled. Neither airports nor airlines were entirely happy with the approach, but were mostly willing to accept prices consistent with what the IMs determine is a 'normal' rate of return. This is demonstrated in WIAL's PSE4 pricing proposals, and airline responses during consultation, which generally referred to the IMs as the best reference point for setting prices.
- 128 Despite this, WIAL faced real challenges under the 2016 IMs when setting prices for PSE4. This was expressed in our pricing proposal and in discussions with the Commission:<sup>44</sup>

*In order to enable this intergenerational programme of capital works, it is essential that regulatory settings encourage investment. This relies on both the stability of economic regulation, and the ability to take innovative approaches to funding longterm projects.*

*In WIAL's view, economic regulation is working to ensure airports consult thoroughly with airline customers, provide extensive transparency to interested parties, and set prices within known boundaries. The increased maturity and stability of the regulatory regime is also critical to WIAL's confidence to make long-term investment decisions.*

*However, WIAL has found investment decisions for PSE4 genuinely challenging. The scale of capital expenditure required to deliver future growth requirements, and the "lumpiness" of capital expenditure, leads to cash flow challenges for WIAL and potential price shocks to customers.*

- 129 These challenges were not insurmountable, but demonstrate that the 2016 regulatory settings walked a fine line between enabling airport investment and limiting profits. In the intervening period the investment environment for airports has only grown more challenging. As a matter of commercial commonsense, it is therefore unreasonable that the Commission has decided to further limit airports' return on their investments, reducing their incentives to invest. We anticipate major future challenges in funding much-needed investment at WIAL, which requires in the next 5-10 years significantly expanded apron space, a new international terminal, and substantial seawall investment. These projects are vital to cater to demand growth and improve the airport's resilience to climate change and weather events, both of which are in the wider interests of airlines and passengers.
- 130 We also note there is no evidence that airports are currently over-investing. WIAL works hard to invest just in time for development to meet passenger growth; however, there are areas of the airport that are in need of development to meet future growth, as identified by our 2040 Masterplan. In particular, the

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<sup>44</sup> WIAL PSE4 Initial Pricing Proposal, 2019, previously provided to the Commission.



international arrivals area offers sub-optimal levels of service and requires an upgrade. We also note Auckland Airport's facilities require substantial investment to cater to future demand. The exception is Christchurch Airport, which has a relatively new expanded terminal following the 2010-11 earthquakes.

- 131 As the Commission is aware, WIAL is about to commence pricing consultation for PSE5. The Commission's ID framework leaves it to airports, through consultation with airlines and price-setting disclosures, to demonstrate that their true WACC differs from the Commission's regulatory WACC. But it is obviously far preferable that the regulatory WACC reflects a reasonable estimate of an airport's true WACC, limiting the need to spend time and resources addressing that question during price-setting.
- 132 The 2016 asset beta of 0.60 demonstrably does not reflect the real levels of systemic risk faced by airports, as revealed by the post-pandemic data. We were therefore expecting the Commission's 2023 review to deliver an updated asset beta, reflecting current market conditions, via a continuation of the current methodology. Such an approach would have helped to guide and inform our pricing decisions. We are left in the very unsatisfactory position of needing to set pricing inputs for consultation based on our own best possible estimates of a reasonable post-COVID rate of return, with little assistance from the Commission's draft approach, given the level of contention this approach has created.
- 133 The Commission's draft approach has also caused us to delay our initial consultation meetings with airlines, as we review how the draft IMs, if enacted, will affect our capital investments in future. We make this point simply to reinforce to the Commission that its decisions have real consequences. Our investments in expansion and resilience projects cannot reasonably be delayed, but we are now grappling with a serious degree of uncertainty regarding the future return from those investments, which has caused the WIAL Board and shareholders major concern.
- 134 Compared to the Commission's prior methodology, the proposed IMs will reduce WIAL's returns by approximately \$100m per five-year pricing period. It is inconceivable that this would not have an impact on our shareholders' willingness to invest.
- 135 If the Commission continues with its approach, therefore, the impact on investment and confidence will be significant. This impact flows to our shareholders through reduced returns, and in particular will have a secondary impact on infrastructure investment by reducing the funds available to Wellington City Council to fund its infrastructure. This goes for every council in New Zealand that is dependent on airport dividends,<sup>45</sup> and is deeply concerning given the nationwide infrastructure deficit.
- 136 On the other hand, there is no discernible benefit from the Commission's approach other than a wealth transfer of hundreds of millions of dollars from airports to airlines, in an environment where airlines are already making record profits despite the impact of COVID-19. As HoustonKemp reiterates, there is no reason to believe this would result in any gain for end consumers. While the aggregate impact (and therefore impact on investment) is very large, the impact per passenger would be around \$2-3. It is highly unlikely this amount would be passed through to passengers by airlines, who set prices based on demand and capacity assumptions, and a wide range of cost inputs. We note that airline prices have risen steeply since the pandemic, making the impact of the Commission's IMs negligible on ticket prices.

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<sup>45</sup> While only WIAL, AIAL and CIAL are directly regulated under Part 4, many other airports follow the Commission's IMs to guide their own pricing consultation with airlines; a point reinforced by NZ Airports' submission.



## **The Commission has other levers to address the price impacts of increasing cost of capital**

- 137 We are conscious that any reasonable estimate of WACC in the present environment will result in higher prices. If this is the Commission's concern, we urge an upfront approach to setting out this problem, so airports and airlines can make constructive suggestions.
- 138 The starting point is that the regulatory WACC must properly reflect market risk. Airports have faced an actual, significant increase in cost of capital post-COVID. To the extent retaining the current methodology reflects that increase, that is an appropriate outcome rather than a problem to be solved.
- 139 The regulatory regime then offers other strategies to address the price impacts of that increase in cost of capital; for example price smoothing. When setting prices, airports do not only have regard to bald outcomes from the building block model, but also to airlines' ability to bear price increases. That is an important feature of pricing consultations between regulated airports and airline customers.
- 140 For example, when WIAL set prices in 2020, we recognised the outcome from a straight application of the building block model would be a large price increase. Given this, and the circumstances of COVID-19, we offered a deferral of revenue which was welcomed by airline customers:<sup>46</sup>

*WIAL has worked hard to mitigate the impacts of Covid-19 on its business and customers. Operating and capital costs have been significantly reduced, though essential projects have been able to continue with the support of capital providers. In addition to holding FY21 charges flat on a concessionary basis to reflect industry uncertainty, WIAL has provided a number of concessions in pricing and as set out in this proposal has provided two potential price paths for its customers to consider.*

...

*Part deferral is offered to minimise any price shock to airline customers while ensuring that WIAL maintains the financial resources and access to capital required to operate efficiently. This concessionary approach results in WIAL targeting a reduced average charge of \$15 per passenger by the end of the pricing period.*

- 141 The biggest driver of increased WACC in the current environment is the risk-free rate. Again, this simply reflects the increased cost of capital for airports given the economic circumstances. If the Commission is concerned that WACC is increasing (though this is a natural consequence of the established regulatory regime), it is misdiagnosing the problem by focusing on asset beta. We note the prevailing economic opinion is that the risk-free rate will trend toward more normal levels well before the draft IMs take effect in 2026, and WACC estimates will therefore trend back down.
- 142 However, if the Commission perceives it as a "problem" that asset beta (and therefore WACC) would increase if it retained its previous methodology, we suggest there are other ways to mitigate the impact on prices while avoiding destruction of hundreds of millions of dollars of value for airport investment. One possible way to achieve this would be to increase the estimation window for asset beta, from 10 years to 15 years. If this approach was maintained in future IM decisions, it would enable investors to achieve a normal return over time, while avoiding a shock in the immediate pricing periods following the pandemic.

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<sup>46</sup> WIAL PSE4 pricing reset document, December 2020, previously provided to the Commission.



143 Houston Kemp's analysis shows that this would reduce the asset beta estimate for now (based on CEPA's data) from 0.79 to 0.745. This approach could preserve the value of investments over time while mitigating the immediate impact of COVID-19 on asset beta and WACC.

### **CONCLUSION**

144 The approach taken by the draft IM decision is deficient in terms of both process and outcome. If not amended, it has serious consequences for investment in airport infrastructure and opens the Commission's approach to ongoing debate and significant legal risk. We urge the Commission to rethink its position prior to finalising the IMs and would welcome any chance to discuss this further.

