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

Christchurch International Airport Limited (**CIAL**) thanks the Commerce Commission (the **Commission**) for the opportunity to make a submission in relation to the Commission's draft decision (the **Draft Decision**) in its 2023 input methodologies review (**IMs Review**).

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

The primary purpose of this submission is to endorse the findings made in the CEG Report, and to comment on certain specific matters in relation to the Commission's decision on asset beta that are particularly relevant from CIAL's perspective.

This submission is accompanied by an independent expert report by Incenta Economic Consulting.

Information disclosure regulation

As a starting point, CIAL submits that the Commission should keep front of mind the framework in which airports set their prices. Not being subject to price-quality regulation, airports' pricing is subject to (a) the requirement to consult with substantial customers before setting prices,[1] and (b) information disclosure requirements.

This structure, which is unique to airports, relies on both the airports and their substantial customers having complete information available to support a commercial discussion about the appropriate level of prices. That includes a clear view of the true cost of capital faced by airports. This means it is critical that the asset beta properly reflects the actual systematic risk of regulated airport services.

In an environment where costs are generally rising, it may be tempting for the Commission to revisit other building blocks (such as asset beta) to offset the impact of interest rates and inflation. The Commission should bear in mind that it is not responsible for setting prices in the airport industry and negotiations between CIAL and its customers are most efficient when they each have the most accurate information available.

The regulatory framework for airports permits airports to set prices based on their own view of their true cost of capital and then justify that departure from the regulated WACC in their price-setting event disclosures. But we prefer not to have to rely on that safety valve as it shifts the focus of airline

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1 Airport Authorities Act 1966, s 4A.

consultations away from expenditure and investment in airport services, and requires significant time and resources. But if either:

- the regulatory WACC diverges too significantly from market participants' view of the true WACC, or

- the regulatory WACC varies principally because of changes in the Commission's estimation methodology rather than changes in market risk,

then that puts the onus on airports to spend more time and resources preparing evidence to support consultations and disclosures on cost of capital issues.

The Commission's revised methodology requires a delineation between airport comparators that are more or less closely comparable to the regulated airport in question. As CEG's and Incenta's advice shows, that is a fraught exercise as a matter of principle. In the context of a price-setting event, it invites airports and airlines to form their own view of what comparator set is truly comparable to the airport that is setting prices, and then defend that view to the Commission. We are concerned that the Commission's departure from its traditional approach will therefore render every price-setting event an exercise in arguing about which firms should or should not be in the sample used to set the WACC for that particular airport and that regulatory period. That would be a significant backwards step given the relative consensus over WACC that has emerged since 2010.

Airport-wide asset beta assessment
Despite the different risk profiles of the three airports, when setting IMs in 2010, the Commission decided to set an industry-wide, rather than firm specific, asset beta.

In its 2010 Reasons Paper, the Commission explained that it is not possible to directly observe asset or equity betas. Therefore, these must be estimated. In some instances, it would be possible to estimate firm-specific betas off traded securities, however:[2]

> … even when traded returns are available, firm-specific betas are often statistically imprecise. To help overcome these problems, the Commission estimates a regulated service wide equity beta using individual beta estimates of a portfolio of comparable businesses.

The Commission reached this view despite all submitters associated with the airport sector disagreeing with an airport service-wide cost of capital. Submitters argued that there are differences in each Airport, relating to risk profiles, customer base, pricing structures and leverage.[3] The Commission rejected these submissions on the basis that estimating asset betas for an industry (or specific service) is inherently imprecise and involves a significant degree of judgement. Estimating supplier-specific asset beta would require an even greater degree of judgement.[4]

This approach only makes sense to the extent that a large enough sample is used to provide a more accurate estimate of the systematic risk of the regulated service as a whole. As the CEG Report explains, with a large sample size the noise in each comparator's asset beta tend to cancel out and the average asset beta is much more stable, and likely to better estimate the systematic risk of the regulated service at any given point in time.

Even assuming that a more limited sample of more comparable airports can reasonably be determined (and CEG's report shows this is not straightforward) the more limited sample size forgoes the benefits of the large sample but does not necessarily result in a better estimate of the true asset beta. If the sample size is not large enough to cancel out the noise and provide a stable asset beta, then the benefits of an industry-wide asset beta falls away.

As CEG explains, the Commission's sample contains firms that are not particularly comparable to New Zealand airports. CEG shows that the most relevant comparator for New Zealand is AIAL, and therefore a reasonable methodology would produce betas that tend to converge to AIAL's beta. The Commission's methodology does not achieve this. From CIAL's perspective, this is particularly concerning because CIAL is likely exposed to greater systematic risk than AIAL given the characteristics of its business. There remain significant differences between each of the three regulated airports in terms of their risk profiles, customer base, pricing structures and leverage. When the individual characteristics of each of the

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2 Commerce Commission *Input Methodologies (Airport Services) Reasons Paper* (December 2010) (**2010 IMs Reasons Paper**) at [E8.5].
3 IMs Reasons Paper at [E8.8].
4 IMs Reasons Paper at [E8.10].

airports are taken into account, CIAL is likely to be considered one of the riskier airports in New Zealand. Accordingly, given the Commission's methodology likely understates the systematic risk faced by AIAL, it significantly understates the risk faced by CIAL.

Comparator firm sample

Finally, we would like to highlight the following points raised in the NZAA submission and the CEG Report, which we support, relating to the inappropriateness of the comparator firm sample proposed by the Commission. This is demonstrated by the point, made in the CEG Report, that the asset betas in the Draft Decision suggest that New Zealand airports have lower systematic risk profiles than Heathrow Airport – one of the busiest airports in the world.

We support the following points made in the NZAA submission:

- the existing asset beta IM provides the most reliable estimate of asset beta. This has been applied since 2010 and has been subject to very little debate over the years;
- the proposed asset beta uses a very poor comparator sample for New Zealand airports. It includes the largest and lowest risk airports in the world, which are not comparable to New Zealand airports. This will provide a less robust and more volatile estimate;
- if the Commission is not willing to move away from its proposed asset beta, CIAL submits that at a minimum, the changes described in NZAA's submission as its alternative proposal should be made;
- as a matter of commercial common sense, it is unreasonable to suggest that systematic risk for airports has decreased following the Covid-19 pandemic;
- on a number of occasions, the Commission has rejected suggestions that it should decrease its sample size. Its reasons were because a large sample limits the need to make subjective judgement calls and maintains a consistency and stability of approach;[5] and
- most importantly, the Commission has not sought independent expert advice on how the comparator sample is compiled. For a decision of this magnitude, it would have been appropriate for the Commission to seek and rely on independent advice.

In addition, CIAL considers that, as Auckland International Airport Limited (**AIAL**) is the most similar comparator firm to both CIAL and Wellington International Airport Limited (**WIAL**) it should be weighted more heavily in the sample.

Process concerns

We also support NZAA's submissions on the application of the Commission's process and decision-making framework. The proposed change to the asset beta IM is a fundamental change with potential for significant impact. Despite this, the Commission has not made overt attempts to apply its decision-making framework. It has not explained why its proposed asset beta IM is likely to meet one or more of its objectives.

Additionally, there is limited or no evidential basis for the Commission's decision. There is no new evidence before the Commission to demonstrate that (a) the existing asset beta IM is not achieving its intent of producing the most reliable and least volatile estimate off asset beta for airports; and/or (b) the proposed new asset beta IM produces a more reliable or less volatile estimate.

COVID uplift

The Commission's approach to the COVID uplift attempts to quantify the expected value of a COVID-like event in any given regulatory period. That approach assumes that the Commission can accurately quantify the probability of such an event and its impacts. It also implies a commitment to keeping that uplift in the beta for perpetuity. It is difficult to rely with any confidence on the Commission's method for quantifying the expected value of a COVID-like event. In any event, the Commission does not appear to have properly applied the method used by the UK Civil Aviation Authority.

We could accept a degree of uncertainty if the Commission had no practical alternative, but it does. The better alternative is to simply retain the Commission's current approach and allow the asset beta to reflect the impact of significant events as they arise. Under that approach, the true impact of low probability high impact events will be accurately reflected in the asset beta from time to time.

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5 Commerce Commission *IM Review 2016: Final Cost of Capital Topic Reasons Paper* at [277].

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

Yours sincerely

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Tim May
Chief Financial Officer