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Infratil Response to the Commerce Commission's draft Input Methodologies Review 2023

1 Infratil appreciates the opportunity to comment on the Commission's draft decision on the 2023 Input Methodology (**IM**) review.

2 Infratil has wide-ranging expertise in managing essential infrastructure assets. We are a publicly listed firm, based in Wellington, with a market capitalisation of NZD $8.3 billion today. We have international infrastructure investments across multiple infrastructure sectors including digital (CDC Data Centres, One NZ and Kao Data Centres), Energy (global renewable development platforms and Manawa Energy) and healthcare (Retire Australia, RHCNZ and Qscan). Of note we manage the majority stake in Wellington International Airport Ltd (**Wellington Airport**).

3 As locally based, long-term investors we take pride in our track record of investing in the essential infrastructure that underpins the economic prosperity and wellbeing of our communities and understand the responsibilities that fall upon the owners of such essential assets.

4 Infratil fully supports the objectives of the Commission's IM review – to provide incentives to innovate and invest, to improve efficiency and quality, to share with consumers the benefits of efficiency gains, and to limit the ability of regulated entities to extract excessive profits.

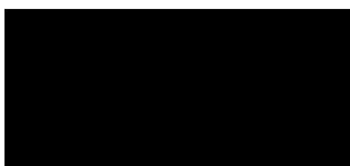
5 However, we believe that the changes to the Commission's approach to determining the asset beta for airports (as applied in the recent draft IM decision) are not methodologically sound, harm incentives to invest, and detract from New Zealand's historically stable regulatory climate, increasing regulatory risk for investors.

6 If the proposals outlined in the draft IMs are adopted in the final decision, we believe the Commission will significantly reduce the attractiveness of New Zealand for infrastructure investors, harming Kiwi consumers in the long run.

7 In the submission below we outline some of the key issues with the approach adopted in the draft decision and implore the Commission not to depart from its well-established approach without a robust, evidence-based, case for change.

8 We would welcome the opportunity to discuss these issues, and the impact they have on incentives to invest, in more detail with the Commission.

Yours sincerely



Jason Boyes – Chief Executive, Infratil Limited
Chief Executive – Infratil Limited

APPENDIX: INFRATIL SUBMISSION ON COMMISSION'S DRAFT IM DETERMINATION

Robust, predictable and stable regulatory decisions promote efficient infrastructure investment

9 Infrastructure investors, such as Infratil, take a long-term view when making investment decisions. In this context the predictability and stability of a fair regulatory regime underpins our ability to make investments in the essential infrastructure that supports end consumers' way of life.

10 The Part 4 regulatory regime explicitly recognises this by providing that:

10.1 the purpose of the IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation;[1] and

10.2 the purpose of Part 4 is to promote outcomes consistent with outcomes produced in workably competitive markets, such that suppliers of regulated services have incentives to innovate and invest,[2] while being limited in their ability to extract excessive profits (amongst other things).[3]

11 Infratil fully supports these objectives. However, we are concerned that the Commission's departure from its standard approach to determining asset beta will cause irreparable harm to incentives to invest, damage the credibility of New Zealand's regulatory environment, and contribute to New Zealand's growing infrastructure deficit.

Impact of Covid on the return on equity required by investors

12 The pandemic has materially changed the investment landscape for raising equity capital for airports, with investors pricing in the risk of a pandemic event. In practice, the spectre of the pandemic reflects a systemic risk which was historically under-valued but is now priced into airport investments. In this context it is commercially implausible or the Commission's asset beta estimate in 2023 (post-covid) of **0.55** to be materially below the estimate it reached in 2016 of **0.65** (prior to the decrement), and the estimate it reached in 2010 of **0.65**.

13 The implication of the Commission's draft decision is that in raising equity to fund investment in regulated assets, investors consider that the underlying risks to airport assets are lower despite the evidence provided through COVID-19. This is plainly incorrect, our practical experience shows that there were significant challenges in operating through a global pandemic, where air travel came almost to a stand-still for periods and predicting travel flows was impossible.

14 As shown in the figure below, the impacts of the pandemic have had a significant, observable uplift on asset betas with the average asset beta for the broad sample of airports spiking to over 0.85 during the pandemic to stabilise at a sustained level well above 0.8.

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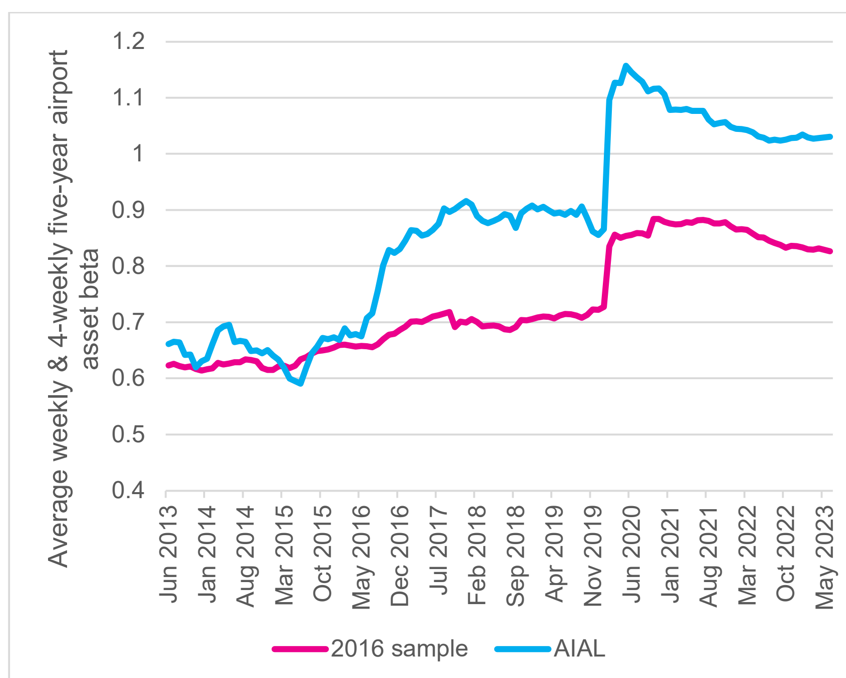
[1] Section 52R of the *Commerce Act 1986* (**Act**).

[2] Section 52A(1)(a).

[3] Section 52A(1)(a).

Five year asset beta over the last decade for Auckland Airport and 2016 IM sample[4]



15 The Commission's draft decision does not reflect the commercial reality of the changes to the investment landscape post-covid which harms incentives to invest.

The Commission's standard approach to determining asset beta has delivered regulatory certainty

16 For over a decade the Commission has applied a reasoned and consistent approach to determining the comparator set using a broad, geographically diverse, sample of international airports, including Auckland Airport. This approach was endorsed by the High Court following the introduction of the IMs,[5] and has been used by the Commission to determine the asset beta for airports since, with only minor modifications to update the sample set.

17 The standard approach adopted by the Commission has two key benefits:

17.1 **First**, the approach of adopting a broad set of comparators, reduces volatility in the sample and reduces the risk of under or over-estimating the beta. By using many data points this approach reduces the effect of any bias in any particular beta estimate (upwards or downwards) with any single comparator receiving only approximately a 3-4% weighting in the overall average. This reduces the risk that the asset beta will be set too high (enabling airports to extract excessive profits) or too low (which harms incentives to innovate and invest). It also removes the subjectivity from the selection of comparators, with such subjectivity a recipe for endless econometric debates about 'comparability' of international airports[6], and reduces the risk of biases in the sample selection.

17.2 **Secondly**, the application of this approach in a consistent and predictable way, over time, gives investors certainty to invest in New Zealand businesses subject to information disclosure (light handed regulation). To the extent that the sample under or over-estimates the beta in a regulatory period, the consistent application of the approach over time helps provide investors with confidence that they can invest and will receive a required rate of return commensurate with regulatory and commercial risks and be 'made whole' over the long term.

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[4] Applying the 2016 IM sample up to September 2017, then switching to CEPA's updated sample from Oct 2017 onwards.

[5] *Wellington International Airport Ltd and others v Commerce Commission* [2013] NZHC 3289 (**IM Appeal Decision**).

[6] For example refer to the arguments made by CEG on the patent dissimilarities in risk profiles comparing large capacity constrained European hub airports such as AdP, Fraport or Heathrow with NZ Airports, arbitrariness associated with the exclusion of Shanghai and inclusion of Beijing, and the importance of incorporating Asia-Pacific airports.

18 This approach of drawing upon a wide range of diverse airport stocks, and applying a consistent approach over time, reflects how Infratil as an investor in airport assets assesses the relative risk of airport investments compared with a diversified market portfolio. This principled and consistent approach provides Infratil with confidence to invest in the sector.

The draft decision materially harms regulatory certainty and incentives to invest

19 Notwithstanding the Commission's well-established approach to determining the comparator sample, in the absence of any rigorous analysis, or a clear case for change, the Commission's draft decision makes radical changes to reduce its sample to just eight airports. Once the Commission's cull is applied, the Commission is left with a narrow sample which is dominated by Europe's largest hub airports, with the expected consequence that the average asset beta for the sample reduces drastically from 0.79 to 0.63, which along with the Commission's other changes delivers an asset beta of just 0.55.

20 This radical change from the Commission's standard approach will blunt incentives to invest and is inconsistent with good regulatory practice, as:

20.1 it materially under-compensates airports for the efficient costs of providing regulated airport services;

20.2 the change of approach without strong evidence for change, undermines the predictability of the regime and adds regulatory uncertainty; and

20.3 it introduces subjectivity and potential bias into the Commission's determination of the asset beta.

The Commission's draft decision does not compensate for the efficient costs of providing regulated airport services

21 A feature of any regulated pricing regime is to set prices such that providers can recover their efficient costs including a reasonable return on their investments commensurate with the commercial risks of that investment. It is common ground that prices that allow for the recovery of efficient costs (including the cost of capital) promote the purposes of Part 4 by providing incentives to innovate and invest, while limiting the ability of businesses to extract excessive profits.

22 When investors do not receive a return that compensates them for the cost of capital, it blunts incentives to invest in infrastructure, strangles investment and exacerbates the infrastructure deficits that weigh on the New Zealand economy.

23 These fundamental principles are even more important in a context where the global aviation industry and airports sector are recovering from the profound effects, of the covid pandemic. We acknowledge the Commission's established approach will lead to a increase in asset beta. This reflects the increase in the risk of airport investments that has been revealed by the pandemic and appropriately compensates investors for this risk.

24 As explained in more detail in WIAL's submission, the Commission's draft decision on asset beta will not adequately compensate regulated NZ airports for their costs of equity.

The change to approach departs from regulatory good practice and undermines confidence

25 Infratil recognises that regulation should not be static. Good regulatory practice requires that regulations have scope to evolve in response to changing circumstances or new information on the regulatory system's performance.

26 However, a bedrock principle of good regulatory practice is that regulators have processes that produce predictable and consistent outcomes for regulated parties. [7] This requires that material changes to a

[7] New Zealand Treasury *Government Expectations for Good Regulatory Practice* April 2017.

methodology must be proportionate and tailored to an identified problem and supported by robust analysis in support of the changes.[8]

27 The Commission's draft decision has not defined a clear problem with its standard approach and the evidence relied on in support of the change falls significantly short of the standard necessary to justify such a material change. The evidence base, strikingly, is primarily based on a five page letter from Qantas which offers no third-party substantiation for its proposed position. This does not pass muster in circumstances where the Commission has previously rejected arguments for a narrower sample size, when market evidence supported a higher asset beta if the narrower sample was applied.

28 The Commission's analysis of suitability of individual comparators in its draft reasons paper is limited to a single column, in an appendix to the paper.[9] This is in stark contrast to the detailed expert evidence provided by CEG and others, and indeed the detailed reasoning provided previously by the Commission itself in 2010 and 2016, in support of the standard approach.

29 This change to a well-established approach to determining asset beta, without a problem and justification, undermines confidence in the regulatory regime and harms investor confidence.

Introduces subjectivity and potential bias into the Commission's determination of the asset beta

30 The proposed approach of narrowing the comparator sample puts the Commission in the position where it needs to apply a subjective assessment of the business environment, relative risk, and robustness of comparable airports.

31 This introduces the inherent risk of regulatory error and bias in the sample selection, as illustrated by deviation between the draft decision comparator sample and the actual observed asset beta for Auckland Airport. Put simply, it is implausible to suggest that a methodology that estimates that AIAL's 'actual' asset beta is 0.55 (as per the draft decision), when its actual observed asset beta is persistently over 0.8, is a reliable or reasonable methodology.

32 The subjectivity of the approach is non-exhaustively illustrated with the unusual result that Shanghai is excluded whereas Beijing is included due to a subjective assessment that these major Chinese airports do not operate in 'comparable markets'. Further, the Commission's approach results in WIAL's asset beta being assessed with reference to a sample dominated by the largest and lowest risk airports in Europe including AdP (owner of 23 airports including Charles de Gaulle) and Fraport (owner of 31 airports including Frankfurt) whilst excluding most Asia-Pacific airports on the dubious basis that they do not operate in a 'developed' country – an argument that was explicitly rejected by the High Court as 'unpersuasive'.

33 While the Commission could improve its sample by rigorously assessing the relative risk of NZ Airports to the comparators, the inherent issues with such an approach cannot be avoided.

Sensible cross-checks illustrate the Commission's error

34 In addition to the technical and economic arguments against the Commission's draft decision, standing back and applying sensible cross-checks illustrates that the Commission's new approach plainly under-estimates the asset beta for New Zealand airports.

35 As explained by the High Court in the IM Appeal Decision, the most helpful comparative material as a cross-check will be independent assessments in the New Zealand context.[10] It follows that the observed estimate of Auckland Airport provides the best cross-check on the reasonableness of the asset beta determined by the Commission using its sample of comparators.

36 The fact that the actual, observed, asset beta for Auckland Airport (which is plainly the closest comparator for Wellington and Christchurch) is materially higher than the asset beta determined in the Commission's draft decision illustrates that the draft methodology is unsound.

[8] New Zealand Treasury *Government Expectations for Good Regulatory Practice* April 2017.

[9] Commerce Commission *Cost of Capital Topic Paper* 14 June 2023 - Attachment A: Airport comparator sample (Cost of capital Equity beta).

[10] See paragraph 1213.

Given this objective fact, it is unclear how the Commission can reconcile its draft decision with the requirement that the IMs provide incentives to innovate and invest.[11]

37 It is implausible that an asset beta that sits significantly lower than the ***actual*** observed beta for New Zealand's only listed airport could adequately promote incentives for New Zealand airports to innovate and invest.

Implications of reducing investment incentives

38 The impacts of underinvestment in airport infrastructure cause significant harm to end-consumers over the long-run.

39 Whilst the Commission's revised approach will lead to lower aeronautical charges paid by airlines, such reductions in charges are rarely passed through to end-consumers' pockets by airlines.[12] Accordingly any end-consumer gain resulting from any allocative efficiency benefit is, at best, uncertain.

40 In stark contrast, the dynamic efficiency detriments from underinvestment in airport infrastructure are likely to cause significant harm to end-consumers over the long-run. Since the inception of the Part 4 Regime, the Commission has acknowledged, as a fundamental regulatory principle, that the consequences of underinvestment in infrastructure vs higher prices are asymmetric, with the consequences to consumers, over the long term, of under-investment more harmful than short term price increases.[13]

41 New Zealand's well documented infrastructure deficit is a direct result of short-sighted investment by owners who have not taken a long-term view. [14] We support the Commission's objective to provide incentives to innovate and invest but are concerned that material reduction in the asset beta, resulting from dubious and subjective judgment calls with respect to the sample and the treatment of the pandemic, will not adequately compensate airports for the cost of capital and will perpetuate the infrastructure deficit.

42 We believe an effective, objective, and balanced regulatory regime can promote efficient investment in infrastructure and improve consumer outcomes. To ensure that the risk of regulatory error is mitigated, preserve New Zealand's reputation as a stable regulatory environment, and protect investor confidence in the regulatory regime, we consider it appropriate that the Commission reconsiders its draft decision and ensures that it does not depart from its standard approach without a robust, evidence-based, case for change.

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[11] Commerce Act, section 52A(1)(a).

[12] By way of example the Australian Productivity Commission's report on the economic regulation of airports, from June 2019, determined that airlines have weak incentives to pass reductions in aeronautical charges onto passengers in Australia's concentrated aviation market (see pages 305-306). The report noted that the Qantas Group had 'acknowledged that increasing aeronautical charges would not lead to higher ticket prices, and the reverse is also true – lower aeronautical charges would not be automatically passed through to lower airfares.' It follows that in New Zealand's even more concentrated domestic aviation market, that changes in aeronautical charges are even less likely to be passed on to consumers.

[13] See, for example, Commerce Commission Draft Decision – Cost of Capital Topic Paper – 14 June 2023, at paragraph 2.9.2.

[14] See, for example, the report for New Zealand Infrastructure prepared by Sense Partners in October 2021, accessible here.