TDB
ADVISORY

Airports' Submissions on Commerce Commission's Input Methodologies Process & Issues and Draft Framework Papers

A cross-submission report prepared for BARNZ

3 August 2022
www.tdb.co.nz

TDB Advisory Limited
L5, Wakefield House
90 The Terrace
P.O. Box 93
Wellington
New Zealand

Email: info@tdb.co.nz

Contacts for this report:

Phil Barry
phil.barry@tdb.co.nz
021 478 426

Maitland MacFarlan
maitland.macfarlan@tdb.co.nz
022 137 7986

Disclaimer

This report has been prepared by TDB Advisory Ltd (TDB) with care and diligence. The statements and opinions given by TDB in this report are given in good faith and in the belief on reasonable grounds that such statements and opinions are correct and not misleading. However, no responsibility is accepted by TDB or any of its officers, employees, subcontractors or agents for errors or omissions arising out of the preparation of this report, or for any consequences of reliance on its content or for discussions arising out of or associated with its preparation.

Introduction

This report comments on submissions on the Commerce Commission's Part 4 IM review. We focus on the submissions of the airports, notably from the NZ Airports Association (NZAA) and from Auckland International Airport Limited (AIAL), Wellington International Airport Limited (WIAL) and Christchurch International Airport Limited (CIAL) individually.

On the whole, the airports support the current IM methodologies, see little need to undertake substantive changes in these, and advocate evidenced-based approaches to adjusting the key WACC parameters. They do, however, take up the issue of the asset beta (AIAL proposes a beta of 0.8 compared with the current 0.6), argue for dropping the 0.05 downward adjustment in beta, and consider asymmetric risks and how the Commission addresses these. They also propose changes in some of the more technical and judgemental aspects of the current IM methodologies.

We believe it is important for the Commission to remain focused on the forward-looking aspects of the IM review. We are concerned, in particular, by the suggestion that the Commission should put much weight on beta estimates for the Covid period. We believe the high beta estimates provided by AIAL are heavily influenced by the impact of Covid on financial markets, especially over 2020 and 2021. If accepted, these estimates would in effect be providing airports with ex-post compensation for Covid-related losses. In line with the ex-ante nature of the IM methodologies, we encourage the Commission to focus on a largely post-Covid environment, where financial pressures and risks facing airports and airlines return to more 'normal', pre-Covid levels.

Asset and equity betas

The analysis presented by AIAL yields an average asset beta for airports of 0.77 over the last two five-year periods, compared with 0.66 in the previous IM review. AIAL's estimate remains unchanged if the comparator company ("compco") sample is adjusted to add and drop several airports that have been listed and delisted, respectively, and rises to 0.79 if two non-airport companies are removed from the sample.

These averages calculated by AIAL are based on equal weightings of the previous two 5-year periods. Normally, that would be a reasonable approach to take. In the current extraordinary circumstances, however, airports, airlines, and the rest of the global economy have been dealing with a situation that has been widely termed as a one-in-one-hundred year event – namely the Covid-19 pandemic. We would argue that, in this exceptional situation, there is a good case for either disregarding the abnormal Covid- affected period (especially 2020-21), or for significantly underweighting this period relative to the 'normal' pre-Covid period. This approach would be consistent with the forward-looking emphasis of the IM review.

In this regard, we note that the Australian Energy Regulator (AER), as part its draft 2022 Review of the Rate of Return Instrument[1], made a 'judgement call' *not* to adjust the equity beta for the industries it regulates, despite recent evidence (covering the Covid-affected period) suggesting a lower beta. Assessing this decision, a recently published Independent Panel Report on the AER's Review commented:

"*The AER identified macro and non-macro factors as potentially responsible for the reduction in the recent beta estimates and has concluded the change in beta is an anomaly. In the Panel's view the AER's consideration of potential anomalies in the beta estimates is appropriate (but could be improved by inclusion in the ES [Explanatory Statement] of beta estimates for APA [the APA group.]*

In general, if the more recent data suggests that a parameter estimate should be modified, there should be an expectation that the reasons for the variation would be fully investigated before any

[1] https://www.aer.gov.au/publications/guidelines-schemes-models/rate-of-return-instrument-2022/draft-decision

change would be implemented. This is consistent with the view that there should be an appropriately high bar for changing variables that are expected to be stable over the long term." [2]

We suggest that the evidence presented by AIAL of a recent increase in the (asset) beta should equally be viewed as an anomaly, and does not overcome the "high bar" needed for changing this variable going forward.

Market evidence also points to the strong and secure outlook that financial market participants have for the airport sector. We note, for example, that the sale of Sydney Airport was concluded in early-2022 at a share price that reflected a significant premium over the price before takeover offers emerged in mid-2021, and at a price that came close to its pre-Covid peaks, with an overall market capitalisation that was substantially higher than before Covid arrived. We also observe the ongoing development plans confirmed for Auckland airport in 2021, including a new $1 billion-plus domestic hub. These developments were confirmed by the airport while the country was still largely shut off from the rest of the world and with domestic restrictions still in place. Overall, we suggest that such evidence signals the strong recovery and outlook expected for the airport sector, and is consistent with forward-looking asset betas that have not diverged significantly, if at all, from those of the pre-Covid period.

The airports argue that the discretionary 0.05 percentage point reduction the Commission applies to the estimated asset beta should be dropped. This argument is based mainly on the evidence presented by AIAL suggesting that aeronautical activities do not appear to be less risky overall that non-aeronautical activities. AIAL argues instead, at least based on its own operations, that "airport retail and car parking have either similar or lower systematic risk than aeronautical activities."

We do not consider that the empirical evidence presented by AIAL is sufficiently clear and compelling to warrant a change in the Commission's 0.05 downward adjustment in the asset beta. In particular:

- as elaborated below, we have several comments and questions about the most appropriate compco sample to use in such analyses;
- in its regression analysis of asset betas on the (non-)aeronautical till, LJK Consulting (LJK) finds nothing of significance in the 2011-16 period. We wonder whether the stronger findings for the 2016-21 period reflect broader anomalies connected especially with the Covid-influenced period rather than some more meaningful relationship; and
- in regard to LJK's analysis of AIAL's own business activities, we have doubts about the merits of regressing non-aeronautical income per passenger against passenger volumes, and are not surprised to see a negative correlation arise between the two measures. We also don't see a rationale offered for including time in the regression analysis, an important omission given that the inclusion of this variable appears necessary to get results that aren't weak or conflicting.

Looking at the underlying issues, we suggest that airlines face a strong incentive to maintain some degree of service even during difficult times, as we have seen during the pandemic. This then provides a buffer for airports' core aeronautical services, providing a layer of protection for these that doesn't apply to the same degree to their non-core services such as retail and parking. As a result, we still think that the inherent volatility of core services would be lower than non-core, and that the 0.05 downward adjustment remains reasonable.

The comparator airport ('compco') sample

In its background analysis, AIAL recommends removing two companies, Airport Facilities Corporation (AFC) and GMR Infrastructure, from the compco set for the 2023 IM review. In the 2016 IM review, the Commission mentioned that AFC and Japan Airport Terminal would both be considered for removal,

---

[2] https://www.aer.gov.au/system/files/Independent%20Panel%20Report%20-%20AER%20Draft%20Rate%20of%20Return%20Instrument%202022%20-%20July%202022.pdf p.39

given they are airport service providers as opposed to airport owners. If AFC is to be removed from the compco set, then it is only reasonable that Japan Airport Terminal also be removed for the same reason. With regards to GMR, GMR Infrastructure is identified in AIAL's submission as having volatile airport revenues over the last decade, with its share price reflecting a portfolio of activities (roading, energy and airports) rather than the airport business in isolation. The airport share of revenue has varied over the last decade but in the 5-year period (2016 to 2020) pre-Covid airport revenues were largely stable at around 70% of operating revenues. Of note is the fact that on 31 December 2021 GMR Infrastructure demerged into three separate entities with GMR Infrastructure Limited now listed as India's first pure-play airport owner. There is not a strong argument for GMR to be excluded from the compco set going forward.

In AIAL's analysis, AENA, Bologna Airport and Airports Corporation of Vietnam are added to the compco set. These are comparable airport companies and could be included in the Commission's asset beta sample set going forward. It is worth noting though that, as all three were listed between 2015 and 2016, only the last 5 years can be observed for the asset beta calculations.[3] We agree that SAVE should be removed as it was delisted in 2017. AIAL removes Sydney Airport from the bulk of its analysis as Sydney Airport was delisted in February 2022, with the delisting falling within AIAL's revised timeframes of year-end March 2017 to March 2022. This timeframe used by AIAL however does not align with the Commission's two most recent time periods for calculation (2011-16 and 2016-21). Hence, Sydney Airport should remain in the current IM review but be removed thereafter.

The table below compares the asset beta estimates provided by LJK and the Commission for the period 2011 to 2016.[4] The results for fifteen compcos for the period 2011 to 2016 feature in both LJK's and the Commission's reports.

[3] The Commission in its analysis take the weekly and 4-weekly asset beta values over the two latest 5-year periods in determining an overall average for the compco set.

[4] The Commission's estimates we have taken as the average of the weekly and 4-weekly 2011 to 2016 asset betas from the 2016 IM review.

Comparison of LJK Consulting's and the Commission's estimates of asset beta values, 2011 to 2016

	LJK 2011-2016	ComCom 2011-2016	Difference (+/-)
Serbia		1.16	
Airports of Thailand		1.15	
Xiamen		1.06	
Malaysia	0.92	0.97	-0.05
Guangzhou		0.96	
Shenzen		0.95	
Japan Airport Terminal	1.03	0.91	0.13
Meilan		0.87	
Shanghai		0.83	
ASUR (Mexico)	0.73	0.72	0.01
Auckland	0.74	0.71	0.03
Malta	0.75	0.67	0.09
OMAB (Mexico)	0.71	0.66	0.05
GAPB (Mexico)	0.63	0.63	0.01
Airport Facilities Co.		0.59	
Zurich	0.72	0.59	0.14
GMR Infrastructure		0.46	
Fraport	0.46	0.41	0.05
A de Paris	0.49	0.41	0.08
Beijing	0.53	0.40	0.13
Copenhagen	0.38	0.33	0.06
TAV		0.32	
Vienna	0.35	0.27	0.08
Sydney	0.29	0.23	0.06
SAVE		0.23	
Toscana Aeroporti	0.24	0.22	0.03
Average (15 compcos with aero/non-aero split)	*0.60*	*0.54*	*0.06*

Source: *AIAL IM submission (11 July 2022), Commerce Commission 2016 IM review*

We have concerns about the results presented by LJK, as summarised in the table above. Aside from Malaysia, for all the regression comparators LJK has calculated higher asset beta values in the 2011 to 2016 period than the Commission's estimates. On average, across the fifteen companies where a comparison can be made, LJK finds the regression sample to have an average asset beta of 0.60 while the Commission results have an average of 0.54.

The inclusion of Japan Airport Terminal also warrants further consideration. JAT is an airport-service provider rather than an airport owner and in the AIAL study it has the highest non-aeronautical percentage. There is uncertainty however as to how much of the "facilities-management" segment for operating revenue includes aeronautical revenue that would be relevant for the regression analysis.

Tax-adjusted market risk premium

The NZAA supports setting the tax-adjusted market risk premium (TAMRP) for airports at the 7.5% level as determined in the IM Fibre review in 2020. As we discussed in our earlier report[5], our concerns in regard to the TAMRP focus on the rounding issue: why round to 7.5 when the actual mean and median are 7.3? We continue to believe that either staying with the 7.3 direct estimate, or rounding to the nearest 0.25 – i.e., 7.25 – would lead to a more reasonable and defensible change in the TAMRP and therefore the WACC.

Asymmetric risks

The airports' submissions consider the issue of asymmetric risks and how the Commission views these. NZAA notes that "The Covid -19 pandemic has demonstrated a real and material asymmetric risk that has always existed for airports." But the NZAA also "acknowledges the Commission's position that the WACC does not usually compensate for non-systematic risk" (and the same should be said for asymmetric risk.) WIAL goes a bit further, citing earthquake risk in particular: WIAL suggests that such a risk "is not well-fitted to the current risk allocation methods contemplated by the IMs, but perhaps could be better addressed through, for example, a WACC uplift."

We encourage the Commission to stay with its principles of not accommodating asymmetric or non-systematic risks within the IM approach. We are pleased to see that the NZAA is also not pressing for changes in the IMs in response to the impact of Covid in this regard, arguing instead that the "The IMs and information disclosure requirements…. provide flexibility for airports to transparently disclose risk allocation mechanisms that they may adopt in pricing decisions following consultation."

Cost of debt

The submission from WIAL, echoed to some extent in the NZAA submission, argues for a change in the IM approach to measuring the cost of debt. In particular, WIAL proposes that the regulatory WACC should more closely reflect airports' actual cost of debt rather than the notional benchmark cost as used at present. These actual costs would include the impact of an average debt tenor that is longer than the 5-year term used in the benchmark, and use of airports' actual credit ratings rather than the benchmark A- rating.

As we stated in our report for BARNZ on the WIAL PSE4 consultation[6], we believe that the current broad-based approach is preferable to a more company-specific approach. The former leads to a consistent WACC being applied across the sector, hence providing greater certainty and transparency to airports and their customers regarding expected returns. The current approach also places treasury-management risks in the hands of the airports, who are best placed and most directly able to assess and handle such risks. The alternative of allowing airports to apply their own cost of debt in their WACC would put the "burden of proof" much more on the airlines and, later, on the Commission to assess whether treasury policy was reasonable and appropriate.

The Commission has reiterated the rationale for the current approach in its recent Review of WIAL's 2019-24 Price Setting Event. The Commission notes in particular that *"We prefer to use a benchmark cost of debt estimate in the WACC estimate rather than Wellington Airport's actual debt costs. The relevant estimate of the cost of capital, including the cost of debt, is the market's view of the cost of capital for providing the service, not the debt costs of a firm which may or may not be efficient. This leaves the firm with the opportunity to out (or under) perform against the benchmark as long as that benchmark is reasonable."*

We believe the Commission should stick with these underlying principles in the current IM review, reserving its scope for judgement and discretion for the ID pricing review process. This approach has been recently demonstrated in the WIAL review, where the Commission permitted adjustments in the

[5] TDB report prepared for BARNZ: "NZ Commerce Commission: Part 4 Input Methodologies Review 2023: Process and Issues and Draft Framework Papers", 11 July 2022.

[6] TDB report prepared for BARNZ: "Review of Aspects of Wellington International Airport's Initial Pricing Proposal for PSE4", October 2019.

cost of debt to take into account WIAL's longer average debt tenor and lower credit rating compared with the benchmarks.

In the same context, NZAA claims that the term credit spread differential (TCSD) *"was removed in the 2016 IM Review due to its complexity and lack of effectiveness."* Our reading of the rationale for this decision is somewhat different. The Commission noted in the 2016 IMs review, and reiterated in the WIAL PSE4 review, that the TCSD was not needed because, for airports issuing debt with original tenor of more than 5 years, *"the decrease in debt issuance costs offset the debt premium increase from longer term debt".* This conclusion was based on an A- credit rating. The Commission acknowledges though that for the currently lower BBB+ credit rating for WIAL, if there were clear evidence of an average debt term longer than the 5-year norm, *"an additional adjustment... may be appropriate as a TCSD-type premium"* (cf, WIAL PSE4 Review). Hence, as we indicated in our report on WIAL's PSE4 review, the TCSD mechanism remains available to airports in their ID process if their bond tenors exceed 5 years on average.

Credit rating

The NZAA suggests that in light of recent downgrades for WIAL and CIAL, *"any changes in the benchmark rating would also be downward."* Consistent with our arguments in the preceding section, we think the benchmark credit rating should remain at A-. This would maintain consistency and continuity with the Commission's past approach and would also be appropriate in view of the current rapid improvement in airport and airline activity and the stronger outlook for these sectors. We note too that airports' credit ratings are primarily a consequence of the capital structure they choose to put in place. As generally low-risk entities, airports have more discretion over such matters than most other businesses. If they choose to be more highly leveraged, as many do, this may in turn be reflected in a somewhat lower credit rating. But that does not provide a reason for lowering the benchmark credit rating, which is intended to reflect what efficient operators would seek in more open, competitive markets.