Targeted Amendments to the Cost of Capital Input Methodologies for Airports: Cross Submission

A report prepared for BARNZ

BARNZ
VOICE OF THE AIRLINE INDUSTRY

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Introduction and summary

1. TDB Advisory welcomes this opportunity to comment on the submissions made in response to the Commerce Commission's draft decisions reasons paper regarding its proposed Targeted amendments to the Cost of Capital Input Methodologies for Airports.

2. Despite the extensive airport protestations, we consider that the Commission has used a pragmatic and reasonable approach to estimating the most appropriate IM parameters for the current regulatory period. Compared with using a longer period of pre-covid and post-covid data, drawing on a three-year period of recent post-covid data is in line with the Commission's statutory objectives and with the forward-looking nature of this exercise.

3. In considering the various influences that can affect equity betas, we also think it is appropriate for the Commission to assume, implicitly, that the sorts of "routine" economic, political, natural and other developments that had an impact on beta during the estimation window may be a reasonable guide to what may apply in the coming years.

4. Considering airport share price developments, we note that the generally positive trend in AIAL's share price since covid may, amongst other things, reflect greater confidence amongst investors in the ability of vaccine technology, policy measures and other responses to mitigate the impact of future pandemics. The associated growth in airport valuations can indirectly lower equity betas. We also note that the unattributed expressions of investor concern cited by the airports don't appear to be reflected in recent share price trends. Moreover, the WACC resulting from the proposed IM parameters continues to provide airports with an overly generous rate of return for monopoly providers of essential infrastructure. As we noted in our earlier report, the RAB multiple of close to 2 for AIAL that is implied by the proposed IM parameters indicates returns for the regulated entity that are well in excess of the market's required returns.

5. While the airports dispute the Commission's starting point of February 2023 for its post-covid estimation window, we think a date of or close to February 2023 can be justified on several grounds. These include the prolonged lockdowns in NZ over the covid-affected period, including in comparison with most overseas experiences; the delayed opening of international borders; the slow recovery of international traveller numbers; and the significant volatility evident in asset betas over the covid period.

6. Moreover, with the estimation period it has chosen, the Commission is, appropriately, most likely to be capturing financial market sentiment that has largely moved on from the covid shock and is more focused on the issues, risks and opportunities that may be relevant for the rest of the current regulatory period.

7. Despite airport claims, the estimated asset beta of 0.62 is not by any means abnormally low. The asset beta trended down toward this level after the GFC, and observing a similar pattern after covid doesn't appear to be unusual or unreasonable. Moreover, an asset beta of 0.62 is not far off the 10-year beta average of 0.64 (excluding the covid affected period.)

8. We think that the airports' concerns of regulatory uncertainty arising from the Commission's proposed amendments are overblown. The Commission has always based its estimates on a recent period of relevant data. That basic principle is maintained in its latest draft decision, even if the period is shorter by necessity to avoid covid effects. Barring unforeseen developments, we would expect this same approach to be used in future IM reviews, when a longer span of post-covid data is likely to be available.

9. In line with the relatively narrow focus of the proposed IM amendments, we don’t see the Commission as being required to update the filters used to derive the 2023 comparator set. We do however recommend that Airports of Thailand (AoT) be removed from the comparator set: as demonstrated in our earlier independent report on the proposed IM amendments, the post-covid data presented by the Commission show AoT to be a clear outlier in terms of its asset beta and leverage estimates, indicating that AoT faces a quite different operating environment compared with the other airport operators.

Some overall perspectives

10. We begin by summarising what we see as some of the key underlying points that should frame the assessment of the Commission's draft decisions.

    a. The Commission's central goal is to re-determine the most appropriate values of equity beta and leverage for the current regulatory period (or at least the remainder of it.) The Commission is therefore forward-looking in its focus; it is not expected or required to compensate airports for past losses.

    b. The need for these amendments arose from acknowledged errors made by the Commission in its application of the Flint methodology to estimate cost of capital parameters in the original 2023 IM decision.

    c. The Flint approach was adopted in the first place because of uncertainty, following a period of elevated betas when the covid pandemic first hit, about what the systematic impact of these observations might be for the remainder of the regulatory period. Evidence on that issue is now available. But, as we understand the matter, it was never the Commission's intention that a covid-type uplift to asset betas would be applied "in perpetuity", as some have argued.

    d. The Commission's focus in the current IM amendment is relatively narrow (compared, for example, with a full IM update): re-estimate the erroneous parameters in an analytically sound, relevant and appropriate manner; but don't open up other aspects of the 2023 IM determination that, while still disliked by some parties, we would view as reasonable. The amendments are indeed 'targeted.'

    e. In determining revised cost of capital parameters, the Commission is not required to follow to the letter any previous methodology. In its Draft decision reasons paper (para. X4), the Commission echoes the arguments it made in the course of the 2025 Merits Appeal that a purely mechanical correction to the errors in the 2023 IMs would not be appropriate. But, in bringing its best judgement and discretion to this exercise, the Commission would be expected – as in all previous IM determinations – to place considerable weight on a relatively recent period of relevant evidence as a guide to what, in the minds of investors, may most likely lie ahead.

Estimation of equity beta

11. Estimation of the equity beta raises important conceptual as well as practical questions, including the appropriate time period over which the beta is estimated, the particular shocks and other events that might (or might not) arise over this period, and the past, present and future risks that might be in investors' minds and where perceptions may change over the period considered. It is not clear to us that there is any one time period that is distinctly better than any other – including the 10-year period that tends to be favoured by the airports – for taking into account the appropriate shocks, other developments and changing risk perceptions.

12. As a result, we consider that the Commission has room for judgement in determining what period is most appropriate for estimating the appropriate forward-looking beta to apply for the current regulatory period. While the chosen three-year period is shorter than that used in the past, leading to higher variance in the estimates, there is a trade-off in this case between lower variance versus higher relevance. We see good reason to opt for greater relevance, as the Commission has done.

13. Moreover, in anticipating what may influence investors' reactions and perceptions over the rest of the regulatory period, we consider it is reasonable for the Commission to assume that there would be no major shocks or disasters over this period. Such events are (we hope) few and far between. In contrast, the Commission can reasonably assume a continuation of the more "routine" economic, political, natural and other developments that influence equity markets even in relatively benign times.

14. We note that the equity beta over the chosen 2023-26 estimation period was 0.87: this "relatively quiet" period was not devoid of influences that moved airport equities in a closely (but not perfectly) correlated way with markets. Again, that baseline may provide a more relevant guide as to what could reasonably be expected over the rest of the regulatory period than a baseline with major shocks or other exceptional developments.

15. In that regard, we note CEG's simulations of beta estimation over many years of "pandemic-free times" – where the equity beta is close to zero -- and fewer years affected by pandemic shocks, which lead to a positive overall beta. While we accept that their scenario is presented just for illustrative purposes, it does risk obscuring the fact that even in relatively calm, shock-free periods, there may still be numerous market-moving events that lead to positive beta estimates.

Links with share price developments

16. CEG (para.78 et seq.) observes that airport equity betas may be affected indirectly through variations in airport valuations. CEG notes, for example. that if valuations decrease as a result of investors increasing their estimates of the expected costs of a pandemic, the percentage change in valuations from random non-pandemic shocks would be higher and that would raise the equity beta. We largely agree with this observation, but we suggest these indirect impacts on beta may work both ways (not just raising the equity beta, as CEG argues.) For example, pandemics – along with many other potential shocks – have long been part of airport risk scenarios and hence embedded, at least implicitly, in investors' share assessments and valuations. To the extent that investors have taken some comfort from the recent covid experience and have greater confidence in the ability of vaccine technology, policy measures and other responses to mitigate such risks in the future, the associated downside influence on share prices and valuations may have diminished. If airport valuations are higher as a result, the indirect impact may be to lower equity betas.

17. In line with the preceding argument, we note that airport share values do not appear to have suffered long-term damage as a result of the pandemic. In the case of AIAL, for example, apart from a short period of elevated prices in mid-2019, the share price is now well above pre-covid levels, having recovered rapidly from the covid shock. While we acknowledge that many other influences will affect airport share values, this observation of rising share prices also appears at odds with HoustonKemp's argument that investors may respond to pandemic-related risks by paying a lower price for airport stocks, signalling an increase in perceived systematic risks.

18. In AIAL's submission, the airport provides several unattributed comments from investors expressing concern about the Commission's draft IM proposals. As noted above, these concerns do not appear to be reflected in AIAL's recent share price performance. It is also notable that no evidence has been cited of a deterioration in the airport's ability to raise debt finance.

19. Indeed, it is not clear to us that there should be such concerns. As TDB noted in our earlier report, even with the new IM parameters proposed by the Commission, the implied WACC appears to provide an overly generous return on capital to monopoly providers of essential infrastructure. We agree with IATA's comments in that regard – notably that the "proposed asset beta of 0.62 remains elevated when assessed against the underlying economic characteristics of regulated aeronautical service." We also agree with IATA's suggestion that the Commission should at some point consider "(e)xpanding the comparator set to include other regulated infrastructure sectors subject to Part 4."

Dating the post-covid period

20. The airports dispute the Commission's chosen starting point of February 2023 for estimating the post-covid asset beta. CEG, for example, suggest that covid-affected betas may have ended in late-2020, based on structural break tests and observations by Flint (2023). We have some concerns, however, about CEG's application of the Chow tests, viewing their approach as somewhat unorthodox and suboptimal with unreliable results. Beyond that, and as a practical matter, we would find it hard to argue that the broader effects of covid on the aviation sector, financial markets and the economy generally were largely over by the end of 2020. New Zealand was still experiencing extensive lockdowns well into 2021; international borders weren't fully reopened until mid-2022; and, even at end-2022, international arrivals were still under 70 percent of pre-covid levels. The significant volatility in annual asset beta estimates over this period is illustrated in Table 3.3 of the Commission's report and in figure 5.1 in CEG's submission. Moreover, the observations of Flint and others need to be treated with some caution in view of the varying experiences and policy responses of different countries over the covid period. For both practical and empirical reasons, we think therefore that the Commission is justified in using its chosen starting point for the estimation window.

21. Dare we suggest that there may be too great a pre-occupation with covid and its aftermath in some of the airports' submissions? Without doubt, the covid pandemic created an enormous shock to the aviation sector, and to the global economy and society as a whole. The exceptional nature of this shock warranted the special treatment of data from this period in the 2023 IMs, as noted in 10c above. But markets, and their surrounding economic and societal context, have largely moved on. As noted above, we suggest there is greater confidence both in vaccine technology to curtail future pandemic risks, and in policy-makers to handle such risks with much lower economic and societal disruption than before. Moreover, financial market participants may be mainly focused on new issues, risks and opportunities. While no period is ideal, the Commission's chosen baseline may be the most useful and appropriate period for capturing these post-covid sentiments for its forward-looking parameter estimates.

The estimated asset beta is not abnormal

22. The airports and their advisers make much of the observation that the Commission's proposed asset beta of 0.62 is at the low end of the historical probability distribution of 3-year asset betas. That may be the case, but asset betas around this level are certainly not unprecedented: similar values can be seen at times over the 2013-2015 period as betas showed a steady decline after the GFC. Observing a similar decline and reaching a similar value for beta after covid doesn't appear unusual or unreasonable. Moreover, the 10-year asset beta (excluding covid) of 0.64, or even the corrected pre-covid beta of 0.65 from the 2023 IMs, are relatively close to the 0.62 estimate. In contrast, the airports' preferred asset betas of 0.71 and up appear to be well out of line with these pre- and post-covid estimates.

Regulatory certainty

23. The Airports and their advisers claim that the estimation approach the Commission has chosen for its targeted amendments will increase regulatory uncertainty. HoustonKemp, for example, suggests that this is the third approach the Commission has taken to estimating asset beta in the last 10 years. We think such concerns are significantly overblown. As noted in point 10e above, the Commission has always based its beta estimates on what it considers to be the most relevant period of recent data. In 2010 and 2016, a 10-year period was used; in 2023, a slightly longer period was used to establish a pre-covid baseline, with the Flint-type adjustment added because of uncertainty about the potential systematic impact of covid on beta during the regulatory period; and a three-year period of post-covid data is used in the proposed amendments. As foreseen in the High Court decision of December 2025, we would expect that – barring exceptional circumstances – the Commission would continue to rely on an appropriate period of post-covid data in future asset beta estimates. The time frames may differ, but the underlying principle remains the same – use the baseline period that is most relevant for the task at hand. In reaffirming this principle, the Commission may have increased regulatory certainty rather than diminishing it.

The comparator set

24. As noted in 10d and 10e above, in issuing its draft proposals we don't see the Commission as being obliged to open up and relitigate issues that were settled in the 2023 IM decision and then reaffirmed in the High Court judgement on the Merits Appeal. That includes the selection of the comparator sample, where the airports want to see substantial changes to the 2023 sample. The Commission is not required to update the filters used to derive the 2023 sample as part of its narrower goal of correcting the erroneous beta estimates.

25. TDB acknowledges that we, along with Air New Zealand, Qantas and IATA, are recommending that Airports of Thailand (AoT) be removed from the comparator set. This view though is not based on a broad re-assessment or re-application of the filters, but more directly on the post-covid data presented by the Commission. These data show AoT to be a clear outlier in terms of its asset beta and leverage estimates. Such differences indicate that AoT faces a quite different operating environment, including its surrounding economic and political context, compared with the other comparators that all have advanced economy listings.