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SUBJECT: CROSS-SUBMISSION BY IATA – TARGETED AMENDMENTS TO THE COST OF CAPITAL INPUT METHODOLOGIES (IM) FOR AIRPORTS

IATA welcomes the opportunity to respond to the submissions made by the New Zealand Airports Association and individual airport operators, including their commissioned expert reports. This cross-submission contains no confidential information and may be treated as public.

The airport parties advocate for a higher asset beta based on three principal themes:

- Concerns regarding the Commission's methodology, particularly its implications for regulatory certainty and potential effects on investment incentives;
- The proposition that pandemic-related risks should be incorporated into the assessment of systematic risk; and
- Alternative estimation approaches such as those based on longer time horizons and broader datasets that yield higher beta estimates.

This cross-submission evaluates these arguments and explains why they do not provide a sufficient basis for departing from the Commission's Draft Decision.

Regulatory Certainty and Stability

The submissions of the airport parties (along with Transpower and Electricity Networks Aotearoa), place significant emphasis on the importance of regulatory certainty, asserting that the Draft Decision represents an unjustified and abrupt shift in methodology following the 2023 Input Methodologies (IM) review and subsequent merits appeal. They suggest that the Commission has departed from established expectations by replacing, rather than refining, the 2023 approach, thereby undermining predictability and investor confidence. From IATA's perspective, this characterisation overstates the role of methodological continuity and understates the Commission's obligation to ensure that its estimates remain robust, evidence-based, relevant and forward-looking.

While regulatory certainty under section 52R is an important consideration, it does not oblige the Commission to rigidly adhere to a particular methodology in perpetuity. The purpose of the IM framework is to provide clarity around the principles and approach that will be applied, rather than to preclude the Commission from refining or revising its methods where appropriate. The High Court has affirmed that the Commission has discretion to exercise judgement and is not bound by previous methodologies if better approaches become available.

In this context, the airports' interpretation of "certainty" as necessitating strict methodological continuity is misplaced. Rather, certainty is better understood as the consistent application of sound economic principles, not the preservation of specific analytical techniques irrespective of their continued suitability of performance. Viewed through this lens, it may also be timely for the Commission to consider the merits of assessing regulated airports under a Single Till framework to deliver a more balanced consumer outcomes.

Further, the suggestion that the Commission has "simply changed its mind" without evidential basis does not accurately reflect the context of the Draft Decision. The Commission is responding to identified coding errors in the 2023 IM and is considering how best to ensure that the resulting asset beta estimate is analytically robust. The availability of additional post-COVID data also appropriately invites reconsideration of the estimation approach. In these circumstances, it would be insufficient for the Commission to merely correct the coding errors without examining whether the broader methodology remains reliable and conceptually sound. A process of reassessment is both reasonable and consistent with good regulatory practice. A failure to update methodology in the presence of new evidence or identified errors would itself undermine regulatory credibility and long-term certainty.

Moreover, reliance on the 2023 IM as a benchmark for "stability" is unpersuasive. The 2023 IM itself introduced significant methodological changes relative to the 2016 IM, including the incorporation of pandemic-related adjustments. It is therefore inconsistent for the airports to contend that change in 2023 was justified, while further refinement in 2026 is inherently problematic. This position appears to reflect a preference for particular outcomes rather than a principled commitment to methodological stability. The relevant question is not whether an approach aligns with the 2023 IM, but whether it produces the most reliable estimate of forward-looking systematic risk, consistent with the Commission's objectives.

Incentives for Investment

The airport submissions assert that methodological changes, and in particular, a lower asset beta, will undermine investor confidence and deter capital investment. However, in practice, Aotearoa New Zealand's major airports continue to access capital markets and undertake substantial investment programmes. There is no indication that financing constraints or elevated borrowing costs have arisen as a result of changes to the IM framework.

More fundamentally, the argument reflects a misunderstanding of how regulated investment incentives operate in practice. The purpose of the IM framework is not to guarantee a particular level of returns, but to provide a reasonable opportunity for efficient firms to earn a normal return that commensurate with their systematic risk. Provided that the cost of capital is estimated on a sound and unbiased basis, efficient investment decisions will remain viable. A lower asset beta does not imply under-compensation if it more accurately reflects the true level of systematic risk faced by airports. It is substantiated in capital market observations.

It is also important to distinguish between the level of returns and the presence of investment incentives. Airports operate as regulated monopolies with relatively stable demand fundamentals and long-lived asset bases. Their investment decisions are therefore shaped by a combination of demand requirements, regulatory expectations, and long-term strategic objectives, rather than short-term variations in allowed returns. Airports should continue to invest in capacity expansion, resilience, and service enhancement in a timely and efficient manner, in line with their masterplans and aligning with evolving user requirements, supported by meaningful and transparent consultation with stakeholders.

If the airports' argument were accepted at face value, that investment is materially sensitive to relatively small changes in allowed returns, then it would imply a potential misalignment with Part 4 objectives, as investment timing could be strategically adjusted in response to regulatory settings rather than driven by efficient demand fulfillment.

Specifically, it would imply that airports have both the ability and the incentive to adjust the timing of investment in response to periods of higher or lower regulatory returns. This would suggest the potential for behaviour consistent with monopoly optimisation, whereby investment is accelerated during periods of favourable regulatory settings and deferred when returns are perceived to be less attractive, in order to maximise overall returns.

We also note that the airport submissions do not provide any empirical threshold at which investment would be affected, nor do they demonstrate that the Draft Decision falls below such a threshold. Without evidence of a binding financing constraint or a demonstrable shortfall between allowed returns and market-required returns, the claimed link between the Draft Decision and reduced investment remains unsubstantiated.

For these reasons, there is no credible basis to conclude that the Draft Decision will discourage efficient investment. On the contrary, ensuring that the asset beta is estimated accurately and without upward bias is essential to maintaining a regulatory framework that supports both efficient investment and the long-term interests of consumers.

Treatment of Pandemic Risk

The preposition that pandemic-period data must be explicitly incorporated into the asset beta, either directly or through adjustment mechanisms such as the Flint methodology, is not compelling when assessed against the conceptual foundations of CAPM and principles of regulatory estimation. Asset beta is intended to measure systematic risk through observable covariance with market returns. It is not designed to capture exposure to rare, extreme, or episodic events in isolation.

Pandemic-related data presents particular challenges in this regard. By definition, such events are low-frequency and high-impact. Their inclusion in relatively short estimation windows can result in disproportionate weighting of outcomes that may not be representative of long-run conditions. Conversely, their exclusion can produce estimates that do not reflect extreme market stress conditions. This asymmetry is precisely why reliance on such data, whether through inclusion, exclusion, or reweighting, introduces a high degree of subjectivity. The difficulty lies not in recognising that pandemics affect airport returns, but in determining how such effects should be scaled relative to their uncertain probability and duration in the future. Any adjustment that embeds these effects into the asset beta therefore necessarily relies on assumptions that are not directly observable in market data.

In addition, embedding pandemic-related adjustments into asset beta risks departing from a consistent and transparent estimation framework. The Flint methodology, for example, requires assumptions regarding the frequency, duration, and severity of pandemic-like events, as well as judgments about the appropriate weighting of affected observations. These assumptions are inherently uncertain and may vary significantly depending on the analyst. Incorporating them into the cost of capital introduces a level of discretion that is difficult to validate and may reduce the predictability of the regulatory framework over time.

Importantly, the expert evidence presented by the airport parties acknowledges that observed increases in beta during the pandemic do not, in themselves, demonstrate a change in underlying systematic risk. Rather, they reflect the mechanical impact of an extreme observation within the estimation period. As has been demonstrated, the presence of a rare event within an estimation window can cause estimated betas to increase, while its absence can cause them to decrease, even if the "true" beta remains unchanged. As such, elevating such temporary effects into a permanent uplift in asset beta risks overstating forward-looking systematic risk – it tends then to perpetuate this risk as it sets a new starting point by including such rare events as part of the calculation.

More fundamentally, the assertion that pandemic risk should result in a higher asset beta reflects a misapplication of CAPM principles. Exposure to extreme downside outcomes is not, in itself, equivalent to systematic risk. The relevant question is whether such events increase the degree to which airport returns covary with overall market returns in a consistent and forward-looking sense. While the pandemic affected both airport revenues and broader market outcomes, there is no robust empirical evidence that they have resulted in a sustained structural increase in this covariance. With the absence of such evidence, there is no basis for adjusting the forward-looking beta upward.

There is also an important distinction between investor awareness of risk and the manifestation of that risk in beta estimates. Even if investors now assign greater probability to pandemic-like events following COVID-19, this does not automatically imply a higher measured or expected beta. If the perceived probability of pandemics remains relatively stable over time, this risk may not manifest in measured beta despite being recognised by investors. Attempting to impose this risk onto beta through adjustments therefore risks double counting or introducing elements that are not captured through observed market behaviour.

From a regulatory perspective, it is therefore preferable to maintain a clear separation between systematic risk captured through asset beta and broader forms of uncertainty or tail risk, which are more appropriately addressed through other mechanisms. These include demand forecasting, investment staging, financial resilience, and risk sharing arrangements. Embedding such risks into the asset beta would result in compensation levels that exceed those required by capital markets for systematic risk, leading to higher allowed returns without a corresponding increase in underlying economic risk.

Asset Beta as a Measure of Systematic Risk Under CAPM

The airport submissions appear to rest on the premise that investors must be compensated through the regulatory WACC for all forms of risk faced by the business, including peculiar risks and exposure to extreme downside events. This interpretation is not consistent with the conceptual foundations of the CAPM framework, which underpins the Commission's cost of capital framework. Under CAPM, investors are compensated only for systematic risk, that is, the extent to which returns covary with the market portfolio. Risks that are specific to an individual firm, or that can be diversified away through portfolio selection, do not attract a return premium and therefore should not be reflected in the asset beta.

In addition, many of the risks cited by airports are either diversifiable or can be managed through mechanisms outside the WACC framework. Investors in listed infrastructure assets such as airports typically hold diversified portfolios and are therefore not compensated for firm-specific volatility. Similarly, risks arising from demand uncertainty, traffic variability, or operational factors are routinely addressed through forecasting assumptions, pricing frameworks, regulatory consultation processes, and capital structure decisions. More extreme or tail risks may also be managed through balance sheet resilience, insurance, or staged investment planning. These mechanisms are more appropriate tools for addressing such risks than embedding them directly into the asset beta.

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Embedding non-systematic or tail-risk premia into the asset beta would result in an allowance for returns that exceeds the level required by capital markets for a well-diversified investor. In effect, this would compensate airport shareholders for risks that they are not expected to bear in a portfolio context. Such an approach would lead to systematically higher WACC estimates, increasing airport charges without a corresponding increase in underlying economic risk – giving a reward where none is expected nor justified. This outcome would be inconsistent with the objective of setting a cost of capital that reflects a normal return for the risks borne.

There are also broader efficiency implications If the asset beta is calibrated to include investors' compensation for risks beyond systematic risk. It may create distorted investment incentives, such as encouraging over-investment or the undertaking of projects with marginal economic value, as returns would exceed those justified by underlying risk.

For these reasons, it is important that the estimation of asset beta remains grounded in its intended role as a measure of systematic risk. A more appropriate approach is to ensure that such risks are addressed through other components of the regulatory framework, while maintaining a disciplined and theoretically consistent estimate of asset beta for the purpose of setting the cost of capital. This principle is well established in regulatory cost of capital frameworks internationally and underpins the Commission's longstanding reliance on CAPM.

Divergence from 2016 IM and 2023 IM

The alternative methodologies proposed by the airports, including a return to the 2016 IM or the retention of the 2023 approach with updated data, are not methodologically neutral. In practice, each of these approaches tends to produce asset beta estimates that are materially higher than those under the Draft Decision, typically falling within a range of approximately 0.69 to 0.79. These methodological choices consistently result in higher beta estimates. While each of these choices can be rationalised individually, their combined effect is to introduce an upward bias in the estimate, rather than to provide a more reliable measure of forward-looking systematic risk.

In particular, the preference for longer estimation windows warrants careful scrutiny. It is well-established that longer time series can reduce sampling variability and improve statistical precision. However, this comes at the cost of incorporating data that may no longer be representative of current or expected future conditions. The aviation sector has been subject to significant structural change, including the effects of COVID-19, evolving travel demand patterns, increased resiliency and changes in regulatory and financing environments. In such a context, placing substantial weight on data from earlier periods may dilute the relevance of more recent information and lead to estimates that are not reflective of forward-looking systematic risk.

The trade-off between variance and bias is therefore central. Shorter estimation windows may be more sensitive to recent conditions but can exhibit greater volatility, while longer windows may reduce volatility at the expense of incorporating outdated or less relevant information. Regulatory estimation requires balancing these considerations, rather than defaulting to a preference for longer datasets. It is not sufficient to argue that a 10-year window is inherently superior. Rather, the appropriateness of the estimation period must be assessed in light of its ability to capture forward-looking systematic risk, which the Commission has appropriately demonstrated in its draft decision.

Consumers Outcomes

It is notable that the airport submissions give limited weight to the implications for consumers. An increase in the asset beta directly raises the allowed cost of capital, and consequently, aeronautical charges borne by airlines and ultimately passengers. Under Part 4, the Commission is required to balance investment incentives with the long-term interests of consumers. Methodological choices that systematically inflate beta risk tilting this balance by transferring value from users to airport shareholders without clear empirical or conceptual justification. As risk and reward are clearly correlated in financial markets, we do not see an increase in risk which would justify an increase in reward.

Conclusion

In conclusion, the airport parties' arguments rely heavily on maintaining methodological continuity and asserting investor concerns. However, the evidence provided does not demonstrate that the Draft Decision understates forward-looking systematic risk or would adversely affect efficient investment.

The Commission has discretion to refine its methodology where appropriate, particularly in response to identified issues and updated data. Such refinement is consistent with maintaining a robust and credible regulatory framework. Ensuring that asset beta reflects systematic risk accurately is essential for balancing investment incentives with consumer outcomes. In this context, the Draft Decision represents a considered and evidence-based approach.

From our perspective, it is essential that the cost of capital reflects a disciplined application of CAPM grounded in observable market evidence. Where refinements are required to achieve this, they are not only appropriate but necessary to ensure outcomes that are consistent with the long-term interests of consumers.

IATA reiterates its support for the Commission's approach set out in the Draft Decision. We further submit that the Commission should address the residual upward bias in the estimation by making appropriate downward adjustments to reflect the exclusion of non-aeronautical risks, and by removing Airports of Thailand (AOT) from the comparator sample given its lack of comparability.

We remain committed to supporting the Commission's objective of delivering consumer-focused outcomes within a monopolistic market environment. We welcome continued engagement and constructive dialogue as the Commission progresses toward its Final Decision. Should you require any further information, please do not hesitate to contact me at [redacted].

Sincerely yours,

[redacted]

Matteo Zanarini
Area Manager South West Pacific
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cc Richard Tan, IATA Senior Manager Airport and ANSP Charges