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Hristina Dantcheva
Head of Price Quality Regulation
Commerce Commission
Via: infrastructure.regulation@comcom.govt.nz

Wellington International Airport Limited – Cross-Submission on Airports Cost of Capital IMs Amendments

This is WIAL's cross-submission on the Commission's draft decision on *Targeted amendments to the cost of capital IMs for Airports – equity beta and related parameters*. No part of this submission is confidential.

We have reviewed and support the NZ Airports Association's cross-submission and the accompanying report prepared by CEG.

The simplest and best approach remains the Commission's pre-2023 method

WIAL's position remains, per our ongoing appeal, that a materially better IM is one that includes an equity beta derived using a large and geographically diverse set of airports and an estimation window of at least ten years (without adjustment), as it did prior to 2023.

Airports have consistently argued this approach is: (i) not only more likely to produce an estimate that is closer to the 'true' asset beta than the various alternatives the Commission has explored, but (ii) preferable because it avoids highly subjective decisions about which airports to include or exclude, and what estimation window to adopt.

The complexity the Commission has introduced from 2023 onwards has resulted in the current impasse. This draft decision, and the response from submitters, only serves to emphasise the weaknesses of the Commission's current path, which requires a series of highly subjective and contestable choices about comparator selection, estimation windows and pandemic adjustments. None of those choices the Commission is now considering were required under the pre-2023 approach, which was simple, durable and limited the scope for argument.

In WIAL's view, the Commission's repeated methodological changes and goal-seeking for what it considers "reasonable" answers have added fuel to the fire in airport/airline pricing debates, rather than neutralising those debates with well-reasoned regulation. The Commission only has itself to blame for the complexity that has emerged and the antagonism evident in the submissions. If not corrected in the final decision, we will remain at an impasse where regulatory inputs are contested at every pricing event rather than settled.

The airlines' argument to exclude Airports of Thailand (AOT) illustrates the point. The airlines have argued, opportunistically, that AOT should be excluded on the basis that its asset beta is an outlier that distorts the sample average upwards. They have declined to acknowledge that, if the filters are to be re-applied, consistency would demand that other airports currently excluded are included.

Airports cautioned the Commission, in 2023 and again in the High Court, against opening the door to this type of opportunism. In any event, as CEG has demonstrated, it is only on a highly selective reading of the data that AOT can be considered an outlier.

The Commission's preference for 'recent' data misunderstands the role of the equity beta in the IMs

Airlines have supported the Commission's selection of an estimation window that privileges the most 'recent' data on the basis that this is more likely to reflect current conditions. Our earlier submission and the expert reports demonstrate that the Commission's approach proceeds from an incorrect premise: that asset beta estimates 'incorporate' the systematic risk of events that predate the estimation window. We have seen no serious reasoned argument in support of the Commission's analysis in either the airline submissions or the Commission's own reasons papers.

But, moreover, the preference for an asset beta that reflects 'current' conditions misunderstands the role of the equity beta in the IMs. The WACC IM contains some parameter values that are estimated at the point of price-setting (e.g. the risk-free rate) and others that are fixed at each septennial IM Review and are intended to provide certainty for price-setting for longer periods. The equity beta has always been in the latter category because:

- the equity beta is not expected to change significantly over the short or medium term (in contrast to the risk-free rate); and
- in acknowledgement of that fact, the Commission used a long estimation window that minimised volatility and therefore delivered an equity beta that was plausibly relevant for up to seven years.

Since the present regulatory framework commenced in 2010, the WACC IM has been remarkably successful in minimising arguments between airports and airlines about the appropriate return on capital in the context of price-setting events. At least in part, that is because the Commission has adopted WACC parameter values at periodic IM Reviews that remained reasonable estimates for price-setting events that occurred in the seven years between IM Reviews.

The method in the draft decision, in contrast, is highly volatile and time-sensitive. The resulting asset beta is very sensitive to the exact estimation window that is adopted, and the filters used to select comparator airports are also time-sensitive. The consequence is that even if one were to accept that the asset beta in the draft decision is a reasonable estimate for mid-2026, it is unlikely to be a reasonable estimate for 2027 or later, when airports are setting prices.

That suggests the asset beta the Commission adopts through this process is unlikely to settle the debate for upcoming price-setting events. That, in turn, calls into question the utility of this exercise. If the Commission had, instead, chosen to amend its 2023 decision via a correction of the Flint method – as we had understood was the intention – the resulting equity beta would be much more likely to credibly guide price-setting until the next IM Review.

The airlines appeal to 'reasonableness' rather than analysis or evidence

The airlines support the Commission's historically low asset beta and even argue for a lower asset beta. They offer no substantial theoretical or empirical analysis to support that view other than an appeal to what they regard as a commercially reasonable outcome.

Reasonableness checks are not a substitute for a credible estimation method. The asset beta must be determined by applying a coherent methodology and may only then be sense-checked against

WLG | Wellington Airport
Main Terminal
PO Box 14175
Wellington 6241 | Te Whanganui-a-Tara
New Zealand | Aotearoa
PH: 04 385 5100
mail@wellingtonairport.co.nz
wellingtonairport.co.nz

relevant external indicators. The airline submissions propose reversing that sequence by relying on the application of additional checks, including:

- other regulators' estimated asset betas: Qantas proposes the use of other regulators' estimated asset betas, which it states support its proposed asset beta of 0.54 on the basis that it reflects "a level of business risk consistent with how other regulators assess comparable airport infrastructure". But those regulators are undertaking a different exercise. Qantas provides no explanation as to why it views these regulators, or the underlying businesses for which those regulators are estimating an asset beta, as comparable to the Commission and Commission's task of determining an asset beta for regulated New Zealand airports; and
- RAB multiples: As the Commission has itself acknowledged, including the 2023 IM review, RAB multiples over 1x do not necessarily indicate that the regulated rate of return is too high.[1] For example, it can equally indicate that the market expected the company to out-perform relative to the allowed cashflow or other model assumptions used in the regulatory determination. The Commission has described RAB multiples as a "secondary indicator of whether the allowed rate of return has been set at a sufficient level to adequately compensate investors for putting their capital at risk".[2]

For the most part, airlines simply assert that aeronautical services are less risky than the regulatory WACC suggests and that airports are consequently overcompensated. IATA, for example, suggests that aeronautical services are more comparable to electricity lines or gas pipeline services, both of which have demonstrably lower elasticity of demand. If proof were needed that investors in airports face significant risks to returns, look no further than the Covid pandemic, in which airport cashflows fell precipitously as a result of border closures and lockdowns. Electricity and gas services do not risk comparable events.

The post-Covid beta estimate does not support the conclusion that systematic risk has declined in the wake of the pandemic

TDB argues that "the fact that the pandemic has not led to a systematic premium on equity betas, as originally envisaged, is all the more reason to pursue the Commission's proposed approach". As CEG and Dr Lally have explained, the difference between pre- and post-Covid estimates is not statistically significant given the degree of error in the estimates.

More generally, all the experts have explained that asset beta estimates are extremely noisy. The only way to generate a reasonably reliable estimate is to use a long estimation window. CEG and HoustonKemp have demonstrated the statistical unreliability of the Commission's estimate based on a three-year window. The airline submissions have ignored that issue.

All plausible methods converge on an asset beta of 0.71 or higher

The draft decision asset beta of 0.62 is historically low and unjustified for the reasons we, the other airports and NZ Airports raised in our submissions. In contrast, the analysis provided by the airports demonstrates that, of the wide range of approaches that could plausibly be adopted, all converge on an asset beta of approximately 0.71 or higher. This happens to also be consistent with

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1 Commerce Commission *Part 4 IM Review 2023 Draft Decision – Cost of capital topic paper* 14 June 2023 at [6.78], [6.90], [7.46] and [7.53].

2 *Part 4 IM Review 2023 Draft Decision – Cost of capital topic paper* at [7.15].

WLG | Wellington Airport
Main Terminal
PO Box 14175
Wellington 6241 | Te Whanganui-a-Tara
New Zealand | Aotearoa
PH: 04 385 5100
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wellingtonairport.co.nz

the position the Commission adopted in WIAL's and AIAL's price-setting events as a proxy for the corrected asset beta.

The range of methods that support a 0.71 or higher asset beta include:

- the Commission's correction exercises in Attachments B and C of the draft decision, where:
  - correctly applying the 2023 methodology results in an asset beta of 0.71 (Attachment B); and
  - the pandemic adjustment is updated, resulting in a range of 0.69-0.73 (Attachment C), with a midpoint of 0.71;
- CEG's analysis results in an asset beta of 0.75, where the Covid end date is corrected and available data up to May 2026 is used;
- Dr Lally's analysis results in an asset beta of 0.76, using the last two five-year periods (including COVID data); and
- HoustonKemp's analysis results in an asset beta of 0.70 utilizing a standard five-year window.

Given that convergence, the Commission should have serious doubts about the credibility of the historically low asset beta it has proposed in the draft decision.

The Commission must consider and engage with the evidence

The Commission and airlines are simply wrong when they say post-Covid asset beta estimates incorporate the systematic risk associated with major events. This reflects a persistent misunderstanding of what asset beta estimates are measuring. CEG, HoustonKemp and Dr Lally have demonstrated this point with reference to academic literature, reasoned explanation and illustrative examples.

The airlines offer little in the way of analysis or expert evidence in expressing their support for the proposed approach in the draft decision.

The High Court's decision also does not support what the Commission is now proposing to do. To the limited extent the Court suggested the Commission could rely on post-Covid data, those statements were obiter and appear to be reflecting points the Commission developed principally in its oral submissions to the Court, rather than in its 2023 IM Review decisions. The Commission should now properly apply itself to the question and consider whether post-Covid data reflects the systematic risk associated with major events.

It is not enough to say, as the Commission has done so far, that it simply prefers TDB's view. It is also not sufficient to simply choose a number that reflects a compromise between the competing positions of airlines and airports without engaging with the evidence put forward in relation to those figures. We expect the Commission to demonstrably engage with that reasoning and evidence. If it prefers the airline view, we expect it to provide a properly reasoned response to the arguments mounted by airports.

Opportunity to respond to substantive matters raised in cross-submissions

If material evidence is provided by the airlines in the cross-submission phase, in response to airports' evidence and expert reports, we expect an opportunity to respond to that evidence. This is consistent with the Commission's approach to the CEG cross-submission during the 2023 IMs review, following which the Commission allowed other submitters the opportunity to address new

WLG | Wellington Airport
Main Terminal
PO Box 14175
Wellington 6241 | Te Whanganui-a-Tara
New Zealand | Aotearoa

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wellingtonairport.co.nz

materials introduced at the cross-submission phase. In that situation, absent an opportunity to fully engage with new materials introduced in cross-submissions, there is an issue of fairness.

Options available to the Commission

In light of the above, and consistent with our original submission:

- we remain of the view that the best option is to revert to the Commission's pre-2023 method of estimating the asset beta, utilising a large comparator set and taking the average of at least ten years of data;
- the second-best option would be for the Commission to undertake the correction exercise it stated to the Court it would undertake. This is effectively provided for in Attachments B and C of the draft decision; or
- as described in NZAA's submission, the Commission should adopt a final decision that:
    - correctly defines the end of the Covid period with reference to statistical breaks in the data, and extends the estimation window;
    - consistently applies its comparator set filters; and
    - sets the asset beta no lower than 0.71 – the minimum supported by the Commission's own corrected arithmetic.

We also reiterate our request that whatever the final outcome of this consultation, the Commission clarify its view on the applicable asset beta as at 31 March 2024, in order to inform WIAL's PSE6 pricing consultation and the carry-forward of revenue agreed in PSE5.

We look forward to the Commission's final decision.

Jenna Raeburn
GM Corporate Affairs

WLG | Wellington Airport
Main Terminal
PO Box 14175
Wellington 6241 | Te Whanganui-a-Tara
New Zealand | Aotearoa

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