OFFICES OF THE MINISTERS
OF TRANSPORT AND COMMERCE

The Chair
CABINET POLICY COMMITTEE

COMMERCE ACT REVIEW: AIRPORTS

PROPOSAL

1 This paper makes recommendations on the regulation of airports in response to submissions made on the review of Parts 4 and 4A of the Commerce Act.

EXECUTIVE SUMMARY

2 Many airports, particularly the larger international airports, have strong natural monopoly characteristics. A regulatory regime is required to encourage them to price their services in a manner consistent with the outcomes of a workably competitive market.

3 The current regulatory regime for airports is very light-handed, comprising information disclosure (though with no guidance on input methodologies and no independent monitoring), a requirement to consult, a statutory right to 'set charges as they see fit' under the Airport Authorities Act, and the threat of price control under the Commerce Act. Airports and airlines have made submissions to Ministers over the past few years with airlines arguing for a stronger regime and airports defending the current regime.

4 In the context of the review of the Commerce Act (see companion paper), the international airports (Auckland, Wellington and Christchurch), Air New Zealand, Virgin Blue, BARNZ (Board of Airline Representatives) and IATA made extensive representations on the regulatory regime. The airports argued in favour of the current regime, while other parties advocated a more robust regime with information provided by both parties on evidence or the lack of evidence of excessive pricing.

5 Although an independent review of the claimed over-charging has not been undertaken, given the Commerce Commission's findings relating to market power of major international airports in its 2002 inquiry, a requirement for airports to consult only, and the power of airports to set charges unilaterally, there is a case for strengthening the current regime. The need for a robust regime is pressing given the current overseas interest in acquiring greater shareholding in Auckland airport.

6 We consider that the current regulatory system for the three major international airports is inadequate. Consequently we are recommending that the current weak information disclosure system should be replaced with meaningful disclosure requirements along with active monitoring of the disclosed information by the Commerce Commission.

7 We are also recommending that consultants should be engaged in 2008/09 to report on whether further regulation is warranted for airports, and whether the coverage of regulated airports should be widened (including the option of a negotiate/arbitrate regime). Any resulting legislative change would be implemented in time for the next five year pricing period due to commence on 1 July 2012.

BACKGROUND

8 MED has undertaken a review of the regulatory control provisions in Parts 4, 4A and 5 (sections 70-73) of the Commerce Act 1986. An accompanying paper details the review and seeks approval of recommended changes to the Act.

9 The objectives of the review are to provide a credible regulatory regime to address markets where competition is not possible, improve certainty, timeliness and predictability for businesses, and provide for incentives for efficient investment in infrastructure.

10 The primary changes include:

- providing for a wider range of regulation (including information disclosure, negotiate/arbitrate, and a default/customised price-quality path) in addition to conventional price control;
- a more conventional, qualitative test, with quantification where possible, for when regulation may be imposed;
- a requirement that the Commerce Commission set "input methodologies" (how to determine the weighted average cost of capital, value assets, allocate common costs etc) as an upfront and stand-alone process, to improve certainty and predictability for businesses; and
- providing for limited merits review of Commission decisions on input methodologies.

11 The three major international airports and the airline sector were active in making submissions on the review. Submissions were received from Air New Zealand, Auckland International Airport Limited (AIAL), the Board of Airline Representatives in New Zealand (BARNZ), Christchurch International Airport Limited (CIAL), the International Air Transport Association (IATA), Peet Aviation, Virgin Blue and Wellington International Airport Limited (WIAL). There were no submissions from airports other than Auckland, Wellington and Christchurch or from those small domestic airlines, which are not represented by BARNZ. Sector participants have also been active in the media on these issues.

Structure of the paper

12 The following sections of this paper:

a consider the purpose of economic regulation of airports;

b consider the problems with the current regime; and

c consider the options for introducing a more robust regulatory regime for airports.

Objectives of economic regulation of airports

13 The over-arching objectives of economic regulation of airports are to:

- provide a credible regulatory regime to address markets where competition is not possible;
- constrain the scope for exercise of substantial market power by airports;
- protect consumers from prices that would not be consistent with those in a workably competitive market;
- improve certainty, timeliness and predictability for businesses, and
- provide for appropriate incentives for efficient investment in infrastructure, taking into account the benefits to end-users.

Current regulatory regime

14 Many airports, particularly the larger and international airports, have strong natural monopoly characteristics. This potentially enables them to set prices above those that would prevail in a workably competitive market and/or to provide inferior service. Accordingly, most OECD countries subject larger airports to a regulatory regime aimed at preventing monopoly pricing.

15 The current regulatory regime in New Zealand comprises:

- an information disclosure regime under the Airport Authorities Act (AAA) which requires airports to disclose specified financial and performance information, and for specified airports to disclose specific financial information relating to aeronautical related activities. The disclosure requirements do not specify input methodologies or pricing principles for the preparation of this information
- consultation with substantial customers[1]: Airports are required to consult with every substantial customer before fixing or altering charges. Those with revenues over $10 million per year are also required to consult with substantial customers on capital expenditure plans at least every five years;
- the power for airports 'to set charges as they see fit' under the Airport Authorities Act 1966 (the AAA); and
- the threat of price control under the Commerce Act 1986.

1 Airports are required to consult with every substantial customer before fixing or altering charges. Those with revenues over $10 million per year are also required to consult with substantial customers on capital expenditure plans at least every five years. Joint venture airports are regulated under the Civil Aviation Act.

Previous reviews

16 Between 1999 and 2002 the Commerce Commission undertook an inquiry into AIAL, WIAL and CIAL. It recommended control of AIAL (and WIAL, if charges were raised significantly[2]). The Commission estimated that Auckland Airport was earning excessive returns of $4.5 million in 2001, with excess returns of $27 million expected over the next six years if the regulatory regime remained unchanged. Notably, for the purposes of the Commission's forecasts, revaluation gains were not considered, thus these figures would likely have underestimated excess returns.

17 In the event the Minister decided not to impose control because net public benefits (overall efficiency) were negative (the benefits of regulation in terms of efficiency gains did not outweigh the costs) and benefits to consumers were relatively low (at only about 40 cents per passenger). At that time the only regulatory option available under the Commerce Act was full price control.

18 A review in 2001 by Arthur Andersen, for the Ministry of Transport found that the lack of clarity and specificity under the current information disclosure regime meant that none of the disclosures would allow an interested party to understand the price setting process to such an extent as to make a meaningful assessment of the appropriateness of cost allocations.

Problems with Current Regime

19 After considering information from previous reviews, and submissions from the three major airports and airline interests on the Commerce Act review, we have identified the following problems with the current regulatory regime:

- the information disclosure regime is ineffective. The absence of guidelines or methodologies limits transparency about regulatory issues and disclosed information tends to be largely of the nature of general purpose financial statements. They do not provide a robust basis for assessing whether there is monopoly pricing. In addition even if there were meaningful disclosure, no government agency actively monitors the information;

- the statutory requirement is to consult, not to negotiate. Because airports have the right to make investment decisions and set charges unilaterally (after consultations) it is inevitable, absent an independent dispute resolution mechanism, or credible and timely threat of heavier handed regulation, that airports will tend to make decisions in their own interests. Again the lack of pricing principles and binding input methodologies mean that these are a major source of contention between larger airports and airlines, along with the outcomes of consultation; and

- the current threat of regulation is weak. The Commission is not funded to undertake an inquiry on its own initiative, it does not undertake price monitoring of airports, and there is likely to be Government reluctance to undertake a new inquiry within a few years of the last one. Furthermore, inquiries and decision-making (and appeals) take many years, and even if price control is eventually imposed it is not able to recover past excess profits.

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[2] WIAL subsequently increased its charges by 27 percent.

20 In sum, the current regulatory regime is not a credible or robust regime for constraining the scope for exercise of airports market power.

21 The recent interest by overseas investors in Auckland airport means there is some urgency for clarity as to the nature of the regulatory regime going forward. In the absence of a robust regulatory regime there is a risk that either:

a Overseas investors will pay a discounted price for ownership based on the expectation that a robust regime will be put in place for New Zealand's major international airport. If such a regime does not eventuate, and high returns continue, there will be a transfer of monopoly rent out of New Zealand, which is a loss to New Zealand, or:

b Overseas investors will expect that the regulatory regime will remain as it is. Any subsequent Government action to introduce a tougher regime might be perceived as aimed at foreign owners, with a consequent reputational risk for New Zealand. Furthermore, if they initially over-pay for assets (in the light of their unrealised expectations about continuation of the current regime), it may be difficult to subsequently reduce the asset base to a reasonable level.

Options for action

22 This section considers the main options available to Ministers. In summary they are:

- One: Take no further action at this stage, but let the proposed amendments to the Commerce Act take effect;
- Two: Do further work (either an independent consultancy study or a Commerce Commission inquiry) to identify whether there is a problem and the best solution;
- Three: make a decision to improve the information disclosure regime and undertake price monitoring for major international airports, with further work undertaken in 2008/09 on whether further regulation is warranted;
- Four: make a decision to impose a robust information disclosure regime and a negotiate/arbitrate regime under the revised Commerce Act;
- Five: make a decision to impose price control under the current Commerce Act on major international airports;

Option One: take no further action and let the proposed amendments to the Commerce Act take effect

23 This option is predicated on the view that there is insufficient independent and credible evidence that there is a problem with the current regulatory regime and that the proposed revisions to the Commerce Act provide (a) increased credibility of the threat of regulation by introducing new options for regulation (information disclosure and negotiate/arbitrate in addition to conventional price control) and (b) specify appropriate net benefit tests for whether regulation should be introduced.

24 Major airports (AIAL, WIAL and CIAL) maintain that the current regulatory regime is largely satisfactory. They say that consultation requirements are taken seriously with airports making adjustments to their proposals (both in terms of input methodologies, proposed capital expenditure and charges) as part of this. Judicial review also provides a check on consultation processes.

25 Major airports also state that they take the threat of price control under the Commerce Act very seriously, and that their prices are not excessive and that their charges are generally mid range compared to international airports overseas.[3]

Airline views

26 The airlines (BARNZ, Air Zealand, Virgin Blue) and IATA, on the other hand, argue that New Zealand's regulatory regime lacks credibility. They argue that the information disclosure regime lacks rigour and value because there are no guidelines or methodology specified and the consultation process is unsatisfactory. The statutory power for airports to set charges as they see fit appears to be unique and as a result of the regime's current design, the airports can and do make unilateral decisions on investments and set charges as they see fit.

27 Airlines also point out the absence of guidelines or binding input methodologies is a major source of dispute and means that consultation processes are time-consuming and costly.

28 Overall, airlines argue that the threat of price control under the Commerce Act is weak[4], and as a result the larger airports have been charging excessive prices.[5] According to Air New Zealand, it is also unable to obtain service level agreements from particular airports – a situation which would not happen in a competitive market.

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[3] Airports also claim that some airlines, and in particular Air New Zealand, oppose investments in new facilities required to attract new entry by competing airlines and that this is to the detriment of the travelling public. Airports have also expressed the view that the ability to set charges as they see fit provide a "circuit breaker" when it does not prove possible to reach agreement. This enables the airports to get on and make investments.

[4] This is largely for the reasons set out in paragraph 18.

[5] For example:

- [withheld due to confidentiality];
- [withheld due to confidentiality];
- PricewaterhouseCoopers, for Air New Zealand, estimates that AIAL's excess returns for all activities (not just airfields) for the year to June 2006 were $90m. It also calculates that total shareholder returns for AIAL for the last seven years (excluding recent share price rises as a result of takeover speculation) have been 30 percent per annum compounding;

29 We (Ministers of Commerce and Transport) are of the view that there is sufficient evidence that the current regulatory regime is deficient and this option is not adequate in addressing concerns about the current regulatory regime pertaining to the major international airports.

Option Two: Further work

30 This option would involve either (a) commissioning an independent review by a consultancy firm on whether airports are over-pricing and whether there would be net benefits in introducing further regulation (and the best type of regulation), or (b) requesting the Commerce Commission to undertake another inquiry under the Commerce Act.

31 An independent consultancy review could cost less than a Commerce Commission inquiry and be quicker but this would depend on the specification of the terms of reference. Funding would need to be appropriated.

32 A further inquiry by the Commerce Commission could take 18 months to two years and cost up to $2m. It could be started under the current Act and then transfer to the revised Act (allowing recommendations to be made on alternative forms of regulation).

33 Treasury's preferred option is to undertake an independent review of problems with and potential solutions to, the exercise of market power in airport services markets. This would be a measured response to the concerns raised during the Commerce Act review, is consistent with good regulatory process and ensures that Ministers have a sound basis of information from which to make judgements on the efficacy of the framework.

34 However, should the Government wish to take a more active response to current concerns, Treasury considers there is value in implementing enhanced information disclosure and requiring the Commerce Commission to monitor information supplied by airports, reporting on the state of markets for airport services. A record of information on market performance would usefully inform later analysis of whether there might be any need for further regulatory interventions, such as a negotiate/arbitrate regime.

35 Treasury considers that this option would satisfy policy objectives and would be a measured response to the concerns raised during the Commerce Act review.

36 We (Ministers of Commerce and Transport) consider that there is sufficient evidence that the regulatory regime needs to be strengthened, particularly with respect to the current information disclosure regime. A further study on this particular issue would be unlikely to yield materially new information and would simply postpone a decision on a well-traversed and pressing issue (particularly in the light of overseas interest in acquiring AIAL).

Option Three: make a decision to improve the information disclosure regime and undertake price monitoring.

37 This option involves requiring the Commerce Commission to (a) develop guidelines and methodologies, including pricing principles, for information disclosure and (b) undertake price monitoring (with published analysis). The costs of the regime would be recovered by levy on the regulated companies. The specifications of the information disclosure regime are set out in the accompanying paper (paragraphs 43-44 and section F of Appendix B);

38 There is sufficient information available from the 2002 Commission inquiry and submissions made by the aviation section relating to the market power at AIAL, WIAL and CIAL to justify introducing enhanced information disclosure and price monitoring for these airports. There is insufficient information available to make such a decision for other airports. As such this option considers applying information disclosure and price monitoring to AIAL, WIAL and CIAL only.

39 The advantages of this option are that it significantly improves the value and relevance of information disclosed, and provides guidelines that would be taken into account by airports in their consultations. Furthermore, by providing more useful regulatory information on airport pricing, and an explicit monitoring role for the Commerce Commission, it improves the credibility of the threat of regulation if prices are excessive.

40 Specification of binding input methodologies for information disclosure would also remove one of the biggest sources of contention under the current regime which could mean that commercial settlements are reached quicker and there are greater incentives to improve commercial relationships. There may be litigation on the first set of input methodologies but this is likely to be no more so than under the current regime. Over time, however, with binding input methodologies there should be fewer disputes and litigation over these matters.

41 The input methodologies required for robust information disclosure (such as asset valuations, revaluations, and allocation of common costs) would be binding, while methodologies such as pricing principles and how to calculate WACC (which are required for monitoring and analysis) would be in the form of guidelines.

42 With regard to pricing principles, we propose that the Commission develops a set of high-level pricing principles. The Australian Government has published some pricing principles for assessing airport performance. The Australian Government gives regard to these principles when monitoring prices, and a consistent failure to produce results consistent with these principles may trigger more detailed scrutiny and potentially more regulation. Along the same lines, we propose that the Commerce Commission monitors airports having regard to the principles it develops and the prices of services supplied in markets where the airports have high degrees of market power.

43 Notably under the revised Commerce Act, input methodologies developed by the Commission would be subject to industry consultation and merits review. This would provide ample opportunity for parties to feed into the final approach to input methodologies that would apply to major international airports. There are also processes for reviewing and amending input methodologies to allow these to evolve as appropriate over time.

44 Provision of pricing principles, including guidelines on WACC, and binding input methodologies will remove the flexibility for regulated companies to 'set prices as they see fit.' However, this is a critical part of addressing issues relating to constraining the scope for natural monopolies to exercise market power, and a crucial part of the proposal to enhance the regime.

45 Without pricing principles and binding input methodologies there will be little or no regulatory value of information disclosure. We also note that to some extent, there are already guidelines on input methodologies for airports, in terms of the methodologies used by the Commission in its 2002 inquiry. These have largely been an area of contention with uncertainty about whether they should be used or not and when. Thus, if input methodologies are non-binding, this would be akin to the status quo, which is unsatisfactory.

46 The main cost (levy-funded) would be a one-off cost for the preparation of input methodologies of $1.4 million[6] and an on-going cost for price monitoring, estimated at an average of $400,000 a year.[7] Overall regulatory compliance costs for airports and airlines are likely to be lower than currently as a result of reducing the areas for dispute.

47 This type of regulatory regime is similar to the price monitoring regime for larger airports in Australia. However, the Australian regime differs in a few respects in that:

a airport asset values were frozen this year by the government at 1 July 2005 levels for pricing purposes. This takes one of the main areas of contention (asset valuations and treatment of asset valuation gains) between airports and airlines off the table. We propose instead that binding input methodologies be developed and set by the Commission in consultation with the industry, as consistent with the proposals relating to the regulatory control provisions of the Commerce Act.

[6] Commission's cost estimates – the costs of input methodologies would be spread over two years.
[7] These costs are Commission estimates. Officials are of the view that price monitoring may be able to done for a lower sum.

b the Productivity Commission undertakes a comprehensive review of the Australian price monitoring regulatory regime every five years. The Australian Minister of Transport will also be required to consider annually, on the basis of an ACCC price monitoring report, whether to ask airports to "show cause" why they should not be regulated.[8] These two triggers for potentially re-imposing price control on airports are likely to be important in ensuring a timely and credible threat in constraining the scope for exercise of airports' market power. We also propose that the Commerce Commission would be required to undertake periodic reviews after airports set charges, starting from the price reset in 2012, on major international airports' compliance with its pricing principles, the effectiveness of the price monitoring regime and whether further regulation is warranted.

48 The other benefit of enhanced information disclosure and price monitoring is that additional regulation (or removal of regulation) could also be identified and considered in a timely manner.

49 Treasury considers that this option would satisfy policy objectives in responding to current concerns and the need for further information before considering additional benefits in additional interventions. There is value in implementing enhanced information disclosure and requiring the Commerce Commission to monitor information supplied by airports, reporting on the state of markets for airport services. A record of information on market performance would usefully inform later analysis of whether there might be any need for further regulatory interventions, such as a negotiate/arbitrate regime.

50 An enhanced information disclosure regime as set out above could be provided for either under the Commerce Act 1986 or the AAA.

51 On balance, MED and MOT consider that an enhanced information disclosure regime would be best introduced under the proposed revised Commerce Act to provide cross-sectoral consistency, rather than amend the AAA. Providing for regulation of major international airports under the revised Commerce Act also has the advantage of having direct reference to a regulatory specific purpose statement that would provide guidance on appropriate regulatory outcomes as well as processes and criteria for removing airports from price monitoring or subjecting them to further regulation. There are no such provisions under the AAA.

52 Given all of the arguments set out above, we (Ministers of Commerce and Transport) are of the view that introducing enhanced information disclosure and price monitoring for major international airports under the Commerce Act is the preferred option. We consider that input methodologies (excluding WACC) should be binding and merits reviewable. We also consider that the Commerce Commission should be required to develop pricing principles and guidelines on WACC to assist in its evaluation and reporting of airport performance.

53 Whilst we propose that the information disclosure regime for the major international airports be moved from the AAA to the Commerce Act, we consider that the requirement to consult as set out in the AAA be retained and continue to apply to the major international airports. We expect that an enhanced information disclosure regime together with the proposed requirement that the Commerce Commission

[8] This 'show cause' cause is still being developed by Australian officials.

monitor compliance and report on whether further regulation is needed would provide useful regulatory information and would influence how consultation processes are undertaken.

Option Four: make a decision now to impose a robust information disclosure regime and a negotiate/arbitrate regime (for international airports) under the revised Commerce Act.

54 This option involves deciding now to replace the current regime for airport pricing in the Airport Authorities Act and the Civil Aviation Act (for joint venture airports[9]) with:

- An enhanced information disclosure regime for airports above a $2 million threshold[10]; and
- A negotiate/arbitrate regime for major international airports (AIAL, WIAL and CIAL).

55 The specifications for these regimes are provided in the companion paper on the proposed amendments to the Commerce Act as follows:

- information disclosure (paragraphs 43-44 and section F of Appendix B); and
- negotiate/arbitrate (paragraphs 45-48 and section G of Appendix B).

56 The costs of the option would be similar to those for the previous option with regard to information disclosure. In addition there would be the costs of any arbitration. This is hard to estimate because it will depend of the scope of any arbitration. An estimate however is an average of $300,000 per arbitration. This allows for 40 days[11] for an arbitrator at $3000/day, plus $100,000 for specialist assistance, plus $80,000 for travel, accommodation, administration and sundries.

57 The benefits of a more robust information disclosure regime (with pricing principles and binding methodologies) are covered under the previous option (paragraphs 40-42).

58 A negotiate/arbitrate regime could provide an independent circuit breaker if the parties are unable to negotiate a commercial agreement. This in turn could provide much stronger incentives than otherwise for the parties to reach a commercial settlement to avoid the costs and risks of an arbitrated arrangement.

59 If this regime was put in place, decisions would be needed on matters such as the scope of airport services to be regulated in this way and the parties to be represented at the negotiations, how parties other than incumbent airlines are represented, the timetable for negotiations, procedural matters, the form of arbitration and the like. These are all quite complex design issues.

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[9] Joint venture airports have part government ownership. The Minister of Transport sets their prices.

[10] Adjusted periodically for inflation

[11] Indicative timeline only for the purposes of cost calculations.

60 Airlines favour the introduction of a negotiate/arbitrate regime. The airports on the other hand consider that negotiate/arbitrate amounts to heavy-handed regulation and is unnecessary. They also argue that it would create gaming problems, delays, and stall investment. Airlines dispute this, arguing that they share an interest in upgraded airport facilities and noting that an arbitrator (not airlines or airports) would make decisions on investments in the event of an inability to reach a commercial agreement.

61 We (Ministers of Commerce and Transport) are of the view that any model based on negotiation would require further work on the costs and benefits of additional regulation before a decision could be made. Enhanced information disclosure and price monitoring (option three) and the real possibility of introducing additional regulation could deliver outcomes consistent with a more workably competitive market.

62 We therefore propose that MED lead work to be undertaken in 2008/09 on whether the scope of regulation should cover more airports or services and whether additional regulation is required.

Option Five: make a decision to impose price control on major international airports under the current (or amended) Commerce Act.

63 This option would move the major international airports straight to price control under Part 4 of the Commerce Act, as recommended by the Commerce Commission in 2002 for AIAL, and WIAL if it increased its prices (which it subsequently did).

64 Departments consider that price control should not be considered without a full inquiry. It is a relatively high cost option, and, unlike information disclosure (and negotiate/arbitrate), does not encourage the parties to seek a commercial agreement.

Conclusion

65 We (Ministers of Transport and Commerce) consider that the current regulatory regime is unsatisfactory. In our view it does not lend itself to outcomes that would be sustainable in a workably competitive market. The incentives on the airports to negotiate are weak because only consultations are required and the airports may set charges unilaterally. Critically, the threat of heavier handed regulation being imposed is weak. Although we recognise that independent analysis has not been done of the claims by airlines about over-charging by the international airports, our current regulatory regime lacks credibility and robustness.

66 We also consider it important to make timely decisions given the interest of overseas investors in Auckland airport. It is important that investors have certainty about the regulatory regime, that the regime is more mainstream internationally and that it protects New Zealand's long term best interests.

67 In our view, enhanced information disclosure with price monitoring now would provide a considerably more robust regime for airports in a timely and cost effective manner.

68 We also propose that further work be undertaken in 2008/09 on whether the scope of airports coverage should be widened and whether further regulation is desirable. Ideally the Commerce Commission as the expert regulator could be well placed to undertake such a review. However, given the substantial workload for the Commission relating to implementing proposed amendments to the Commerce Act, it would be preferable to commission an independent consultant to undertake this review.

Other airport companies

69 At present all airport companies are subject in varying degrees to the existing information disclosure requirements. In addition, the Airport Authorities Act allows them to set charges as they see fit. Although the smaller airports are, strictly speaking, natural monopolies, few if any have market power. Most only have one airline customer (Air New Zealand) which has substantial countervailing negotiating power. Therefore, the issues are somewhat different. If anything, the balance of power between Air New Zealand and the smallest airports favours the former.

70 The discussion document did not address or invite comment on smaller airport issues and nor were any comments received. Consequently, we do not have any reliable information on the nature and size of any problems, options or solutions. Therefore, we recommend that MOT be asked to carry out work on these matters and report to the Minister of Transport by 30 June 2009.

TRANSITIONAL ISSUES

71 Implementation of the proposals in this paper requires amendment to the Commerce Act 1986. It is proposed that a Commerce Act Amendment Bill will be passed by mid 2008.

72 The following transitional arrangement is proposed:

a The Commerce Commission to develop and prepare generic input methodologies and pricing principles to apply to airports to be ready by December 2009;

b The Commerce Commission to specify the information disclosure requirements by December 2009 and for the information disclosure requirements to take effect from then;

c Disclosure from the regulated airports would be three months after the end of a financial year;

d Until input methodologies and information disclosure regime specification are finalised, the current information disclosure regulations under the AAA will apply;

CONSULTATION

73 This paper has been prepared by MOT and MED in consultation with Treasury. DPMC has been advised of the paper.

74 A discussion paper on the broader Commerce Act review was released in April with a 3 month consultation period. Submissions were received from 45 parties. These included AIAL, WIAL, CIAL, Air New Zealand, Virgin Blue, BARNZ, IATA and Peet Aviation. No provincial or regional airports made submissions. The discussion paper did not specifically refer to a change in the regime for airports, or to amendments to the Airport Authorities Act.

75 There is a risk that given the major international airports were not consulted on changes to the airport specific regulatory regime under the AAA, and the proposals involve requiring AIAL, WIAL and CIAL to fund the costs of an enhanced information disclosure regime that will apply to them, that these companies will react negatively to these announcements.

FISCAL IMPLICATIONS

76 It is proposed that airports be levied to fund:

- the Commission in preparing input and information disclosure methodologies and specifications for the disclosure regime at a cost of $1 million in 2008/09 and $400,000 in 2009/10; and
- the ongoing costs of price monitoring. Costs will be $200,000 in 2009/10 and $400,000 in 2010/11 and out-years.

77 It is also proposed that the Crown provide funding of $200,000 to cover the costs of further work to consider whether:

- additional airports to those set out in recommendation 5 below should be subject to regulation under the Commerce Act; and whether
- other forms of regulation should apply to regulated airport companies under the Commerce Act

HUMAN RIGHTS

78 There are no human rights, gender or disability implications arising from this paper.

LEGISLATIVE IMPLICATIONS

79 The companion paper recommends amendments to Parts 4, 4A and 5 of the Commerce Act, and notes that the Ministers of Commerce and Energy propose to recommend that the legislation be introduced and passed in 2008.

80 If the decisions set out in this paper are confirmed, it is proposed that an additional part be added to the Commerce Act covering airports (paralleling the sections on electricity lines and gas pipelines). This is expected to be a relatively short part which:

- Applies the generic information disclosure regime proposed for Part 4 to AIAL,WIAL and CIAL;
- Makes transitional arrangements;

- Provides powers to levy the regulated airports for the costs of preparing input methodologies and the ongoing costs of administering the information disclosure regime;

- Makes consequential amendments to the Airport Authorities Act and the Civil Aviation Act.

REGULATORY IMPACT ANALYSIS

81 A RIS was prepared and the Regulatory Impact Analysis Unit considers the analysis and the RIS to be adequate.

PUBLICITY

82 It is proposed that Ministers make announcements regarding the decisions on this paper at the same time as decisions on the broader Commerce Act review.

RECOMMENDATIONS

83 It is recommended that the Committee:

1 Note that an accompanying paper makes recommendations for amendments to Parts 4, 4A and 5 (s 70-73) of the Commerce Act, including providing for information disclosure and a negotiate/arbitrate regime;

2 Note that airlines, related bodies and the Auckland, Wellington and Christchurch airport companies were active in making submissions on the above review;

3 Note that the current information disclosure regime for airports does not specify pricing principles or binding input methodologies and as a result does not provide any useful information on regulatory matters relating to whether airports are charging excessive prices;

4 Note that binding input methodologies can provide a valuable input into assessing whether there is evidence of abuse of market power by natural monopolies, and under the current regulatory regime for airports are currently a major source of contention between parties;

Major International Airports

5 Agree to the following changes to the regulatory regime for airports:

5.1 That the regulatory regime for aeronautical charges at Auckland, Wellington and Christchurch International Airports should be provided for in the Commerce Act instead of the Airport Authorities Act;

5.2 That Auckland, Wellington and Christchurch International airports should be subject to the proposed information disclosure regime under the amended Commerce Act;

5.3 That the Commerce Commission develops:

5.3.1 binding input methodologies (excluding weighted average cost of capital) for the information disclosure regime; and

5.3.2 non-binding guidelines covering pricing principles and weighted average cost of capital for monitoring and analysis purposes;

5.4 That the Commerce Commission undertake periodic reviews of the disclosed information against its pricing principles, after airports set charges and starting from when airport charges are reset in 2012, to assess the efficacy of the price monitoring regime, and whether further regulation is warranted;

5.5 That the costs of the regimes should be met by levies on Auckland, Wellington and Christchurch airports;

6 Note that there are currently no powers to levy airports for the costs of the regime;

7 Agree that Ministry of Economic Development will lead further work in 2008/09 to consider whether:

7.1 Additional airports to those set out in (5) should be subject to regulation under the Commerce Act;

7.2 Other forms of regulation should apply to regulated airport companies under the Commerce Act;

8 Invite the Minister of Transport and Minister of Commerce to report back to Economic Development Committee on the outcome of the work undertaken in (7) by 30 June 2009;

Smaller airports

9 Note that no work has been carried out to date in relation to the regulation of smaller airport companies and their major customers;

10 Invite the Minister of Transport to report back to Cabinet Economic Development Committee on the nature and scope of any issues, along with any recommended changes, by 30 June 2009;

Financial

11 Agree to increase funding to develop input methodologies and specifications for information disclosure, for the ongoing costs of price monitoring and to fund further work on the regulation of airports with the following impact on the operating balance:

	$m – increase/(decrease)				
Vote Commerce	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12& Outyears**
Operating Balance Impact	-	0.200	-	-	-
No Impact	-	1.000	0.600	0.400	0.400
Total	**-**	**1.200**	**0.600**	**0.400**	**0.400**

12 Approve the following changes to appropriations to put into effect the changes in recommendation 11:

	$m – increase/(decrease)				
Vote Commerce Minister of Commerce	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12& Outyears**
Departmental Output Expense: Policy and Purchase Advice – Business Law and Competition Policy (funded by Revenue Crown)	-	0.200	-	-	-
Non-Departmental Output Expense: Enforcement of General Market Regulation	-	1.000	0.600	0.400	0.400
Total Operating	-	1.200	0.600	0.400	0.400

13 Note that the increase in the Non-Departmental Output Expense: Enforcement of General Market Regulation has no impact on the government's operating balance because the funding will be recovered through levies on regulated airports;

Legislation

14 Note that the proposals in this paper, if confirmed, would be implemented as part of the proposed amendments to Parts 4, 4A and 5 of the Commerce Act;

15 Note that the Ministers of Commerce and Transport will be seeking a legislative priority to enact the proposals in this paper, in the 2008 Legislative Programme.

16 Invite Parliamentary Counsel Office to prepare drafting instructions based on the recommendations in this paper;

Publicity

17 Invite the Ministers of Commerce and Transport to announce the decisions in this paper;

18 Agree that this paper may be made public on the website of the Ministry of Economic Development and the Ministry of Transport.

Hon Annette King
Minister of Transport

Date signed: _____

Hon Lianne Dalziel
Minister of Commerce

Date signed: _____

ANNEX 1

INTERNATIONAL REGULATORY REGIMES APPLYING TO AIRPORTS

Australia – Price Monitoring Regime

In 2002, the Australian Government removed price cap regulation and price notification with respect to airport services for all Australian airports, following recommendations made by the Productivity Commission.[34] Instead, a price monitoring regime was introduced for major airports.[35]

The current price monitoring arrangements provide for the Australian Competition and Consumer Commission ('ACCC') to monitor the prices, costs and financial returns relating to the supply of aeronautical and related services.[36] Prices and profits earned by an airport from services such as retailing, corporate parks and factory outlets or from the renting space for the provision of such services by third parties are not monitored. The ACCC is also required to report to the Minister on service quality at the monitored airports.[37]

The ACCC does not make recommendations or draw conclusions from the monitored information and cannot initiate an inquiry of its own volition. The information informs Ministerial judgements of whether further investigation (via an inquiry) is required.

A set of overarching principles (including pricing principles) specified by the Government provides guidance to parties on the appropriate outcomes under the monitoring regime. In 2007 the Government introduced additional pricing principles to the regulatory regime that:

- prohibited further asset valuations as a basis for increasing airport charges, freezing assets values as at 1 July 2005;
- specified that parties should negotiate in good faith to achieve outcomes consistent with the principles; and
- provided for a reasonable sharing of risks and returns between airports and their customers (including those relating to productivity improvements and changes in passenger traffic).

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[34] 2002 Australian Productivity Commission Report on Airport Price Regulation

[35] Initially, in 2002, seven airports (Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney Airports) were monitored under these arrangements. Following the 2006 Australian Productivity Commission Report, Canberra and Darwin were removed from the monitoring regime.

[36] The monitored services are aircraft movements; passenger processing, including security; the provision of landside vehicle access to terminals; transport to and from an airport (e.g car parking); and aircraft maintenance.

[37] Sydney Airport must also notify the ACCC if it intends to increase charges for aeronautical services to regional airlines using the airport with a regulatory direction limiting the increases in average charges to these airlines to no more than CPI.

The triggers for further investigation/inquiry into monitored airports or a change in the regulatory regime for airports are:

- A 'show cause' clause where the Minister for Transport and Regional Services, having regard to monitoring information will, each year be required publicly to indicate whether a monitored airport should 'show cause' why their conduct should not be subject to more detailed scrutiny. The show cause clause is intended to ensure that the threat of re-imposition of price control is credible. This is currently being developed by Australian officials.

- An inquiry by the Australian Productivity Commission which tends to occur every five years, assesses the effectiveness of the regime against the review principles, and whether further regulation is warranted.

- Airport users can also use the national access regime available under Part 3A of the Trade Practices[38] which addresses third party access to services of facilities of national significance through services being 'declared' and for parties to negotiate terms and conditions of access.[39] The aim of this part of the Act is to encourage competition in upstream or downstream markets. Decisions under this Part of the Act are subject to merits review by the Australian Competition Tribunal.

In October 2006, the Federal Court upheld the decision of the Australian Competition Tribunal (ACT) in December 2005 to declare the domestic airside service at Sydney Airport under Part 3A of the Trade Practices Act. The Productivity Commission stated that this could have the effect of lowering the threshold for a facility to be declared with negotiate/arbitrate becoming the operative/default form of regulation. This could undermine the light-handed regime for airports. In response the Australian Government announced that it would amend this provision to reinstate a higher threshold for declaration than the Federal Court's 2006 interpretation of these provisions.[40]

The United Kingdom

The broad objective of economic regulation of airports in the United Kingdom is to promote the efficient, economic and profitable operation of such airports, while furthering the interests of airports users and encouraging timely investment by airports.[41]

Regulatory oversight applies to airports which have had an annual turnover of £1million or more in two of three of its most recent financial years. 57 airports in England, Scotland and Wales[42] fall within the scope of this regulation, of which the main forms are price cap regulation for main city airports (discussed below) , and lighter handed regulatory oversight for other airports.

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[38] These criteria include that (increased) access to the facility would promote a material increase in competition in at least one market (other than the market for the service); it would be uneconomical to duplicate this facility and the facility is of national significance. (Part IIIA s44H of Trade Practices Act)

[39] For example, it covers access to electricity grids or natural gas pipelines.

[40] See http://www.treasurer.gov.au/tsr/content/pressreleases/2007/032.asp

[41] See 39(2) of Airports Act 1986 which sets out the CAA's duties.

[42] Airports in Northern Ireland are regulated under separate legislation. Airports currently excluded from regulation are those in the Isle of Mann and the Channel Islands, those owned or managed by the CAA or a CAA subsidiary and those managed by the Government.

Designated Airports – Price Cap Regulation

Currently, there are four 'designated' airports, which are subject to price cap regulation - Heathrow, Gatwick, Stansted and Manchester. The criteria for designation generally relate to an airport having the scope to exercise substantial market power, and the benefits of designation exceeding the costs and potential adverse effects of this.

Every five years the Competition Commission and the CAA review and reset the charges for designated airports going forward[43], including an analysis of the airports' conduct over the previous period, for evidence of behaviour that may not be in the 'public interest'. Action by the Competition Commission will normally be triggered by complaints by those affected. Where the Competition Commission makes an adverse finding the CAA must impose conditions to remedy or prevent the adverse effects of the conduct concerned. Airports at this time can be de-designated.

Price cap control terms are determined using a 'single till' approach where both aeronautical and non-aeronautical costs and revenues are taken into account when setting the appropriate level of airport charges.

Price Control Reviews

Currently, Heathrow and Gatwick airports are undergoing a five yearly review of their price control terms. The next five year regulatory period commences 1 April 2008.

Stansted and Manchester airports are currently subject to a government review of their designation status. Draft recommendations released in July 2007 suggest that both airports no longer meet the criteria for designation. This assessment is largely based on the level of competition that both airports now face, from other airports, and from rail and road.

Regulated Non-designated Airports

Airports with an annual turnover over in excess of $1 million, but are not designated, must apply to the CAA for 'permission' to levy airport charges. Once granted, a permission remains in place unless the CAA revokes it. Regulated airports must also provide the CAA with their annual statutory accounts, and schedules of airport charges.

The CAA can open an inquiry, of its own volition, into a regulated airport's conduct and the treatment (including the charging of) airport users by airports. As a result of an inquiry, the CAA can impose additional conditions on an airport, including further information to be disclosed. Complaints are investigated by the CAA with the Competition Commission being the appeal body.

[43] Airports are required to consult with airport users on a number of issues that feed into the CAA's analysis, such as traffic forecasts and capital investment plans. This is sometimes referred to as 'constructive engagement'.

European Union

In February 2007, the Council for the European Union issued a "Proposal for a Directive of the European Parliament and of the Council on Airport Changes" (Directive). The purpose of the Directive is to establish a common framework to regulate the essential features of airport charges and the way the way they are set, across the European Union. The Directive will only apply to airports above a minimum size.[44]

The specific objectives of the Directive include contributing to fair competition between EU airports by the introduction of common charging principles; the promotion of more transparent charging systems applicable to users of airport infrastructure; and the generation of sufficient revenues to maintain and complete airport infrastructure at an optimal level.

Context

At present the pricing of EU airport services is regulated at the national level. There is an inconsistent approach across many airports within the EU as to how airport services are priced and charged to users of airport services. The status quo has been considered inadequate. One indicator of this is that 14 out of the 25 most expensive airports are located in the EU, and the quality of service and capacity available is not reflective in the increase in costs.

[44] Small airports and their funding mechanisms are intended to be exempt from the Directive.

REGULATORY IMPACT STATEMENT

EXECUTIVE SUMMARY

1 Many airports have strong natural monopoly characteristics. A sound regulatory regime should enable the regulator to identify the extent of monopoly pricing which should encourage airports to price their services in a manner consistent with the outcomes of a workably competitive market. The current regulatory regime for airports fails to do this.

2 In the context of the review of the regulatory control provisions in the Commerce Act, some members of the aviation sector made a number of submissions on the regulatory regime for airports.[45] The key problems identified with the current regulatory regime for airports are, that airport companies are empowered to set prices as they see fit the lack of a credible and timely threat to constrain the exercise of substantial market power by major airports in setting airport charges. This problem has been exacerbated by the lack of guidelines on both the desired outcomes from the regulatory regime, and on appropriate input methodologies (how to value assets, calculate weighted average cost of capital) to provide guidance on desired regulatory outcomes.

3 To address the inadequacies of the current regime it is proposed that a decision be made now to provide for a strengthened information disclosure price monitoring regime for Auckland, Wellington and Christchurch airports under the Commerce Act. It is also proposed that further work be undertaken in 2008/09 on whether further regulation is required for other airports in New Zealand as well as in addition to the proposed regulatory changes for Auckland, Wellington and Christchurch.

ADEQUACY STATEMENT

4 The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the adequacy criteria.

OBJECTIVES

5 The over-arching objectives of economic regulation of airports are to:

a) provide a credible regulatory regime to address markets where competition is not possible;

b) constrain the scope for exercise of substantial market power by airports;

c) protect consumers from prices that would not be consistent with those in a workably competitive market;

d) improve certainty, timeliness and predictability for businesses; and

[45] Submissions were received from Air New Zealand, the Board of Airline Representatives of New Zealand, Virgin Blue, the International Air Transport Association, consultants Peet Aviation, and three airports, Auckland, Wellington and Christchurch

e) provide for appropriate incentives for efficient investment in infrastructure, taking into account the benefits to end-users.

STATUS QUO AND PROBLEM

6 The intention behind the 1997 introduction of the disclosure regulations for airports was to explicitly help guard against the possibility of monopoly pricing, and to help to better inform the statutory consultation process.[46] The current information disclosure regulations are ineffective in this regard.

7 Many airports, particularly larger airports, have strong natural monopoly characteristics. This enables them to set prices above those that would prevail in a workably competitive market. Whilst other smaller airport companies are strictly speaking, natural monopolies, few if any have market power, and most only have one airline customer, Air New Zealand, which has substantial countervailing negotiating power. Also, the recent review of the Commerce Act did not receive any comment. Consequently we have limited information on the nature of and extent of the problem and possible solutions for the regulation of smaller airports.

8 The 2002 Commerce Commission inquiry undertook extensive analysis and found that Auckland Airport was earning excessive rents and if the regulatory regime remains unchanged this would continue. The Commission estimated that forecast excess returns would be $27 million over the six years from 2002.[47] These forecasts did not include any potential revaluation gains that may have occurred in relation to land. To the extent that there would have been revaluations, these excess returns are likely to have been understated.

9 The Commission also stated that while any countervailing power by airlines might constrain airport behaviour at the margin, it was unlikely to be sufficient by itself, to prevent exercise or even abuses of market power. The Minister of Commerce in making her decision not to impose control, at the time, based her decision on analysis that overall efficiency costs were negative and consumer benefits were relatively low. Notably, in assessing the costs of regulation the assumption was that the form of regulation was price cap regulation which is a high cost form of regulation, and the only form of regulation then available under the Commerce Act.

10 Since 2002, the regulatory regime for airports has not changed, and it is likely that the substantive analysis of market power undertaken in this inquiry is no less relevant.

[46] Hon Jenny Shipley, Minister of Transport during the second reading of the Airport Authorities Amendment Bill 6 March 1997, NZPD 729.

[47] The Commission also stated that the criteria for recommending control would also be met for Wellington Airport if prices were subsequently raised significantly.

11 The current regime lacks the requisite guidance around what information is required to facilitate effective negotiations between airports and users on the level of charges. This is likely to be a significant contributing factor (along with the lack of guidance) in the contention and litigiousness of the current regime.[48] The information provided is also generally insufficient to help the regulator or officials to determine whether excessive prices are being charged.

12 A 2001 review by Arthur Andersen Consulting for the Ministry of Transport found that the lack of clarity and specificity in the disclosure regulations meant that none of the disclosures would allow an interested party to understand the price-setting process to such an extent as to make a meaningful assessment for example, of the appropriateness of cost allocations.

13 The current disclosure regime does not specify enough level of detail to determine whether airports are over-recovering or not. Some of the crucial components in assessing whether airport user charges are excessive or not are the input methodologies relating to how the value of the asset base is calculated (including how asset revaluations gains are treated), and how common costs are allocated. The disclosure regulations do not specify any clear requirement in respect of the appropriate methodologies that should be used by airports. The lack of specificity also contributes to contention, for example which assets should be included in the asset base for aeronautical pricing purposes.

14 The statutory requirement is to consult, not to negotiate. Because airports have the right to make investment decisions and set charges unilaterally (after consultations) it is inevitable, absent an independent dispute resolution mechanism, or credible and timely threat of heavier handed regulation, that airports will tend to make decisions in their own interests. Again the lack of pricing principles and binding input methodologies mean that these are a major source of contention between larger airports and airlines, along with the outcomes of consultation.

15 Furthermore, the current disclosed information is not monitored or reported on at the departmental or regulator level. Thus, whether or not an airport is over-recovering based on the information disclosed is not compiled and presented by an independent body.

Status Quo

16 The option of taking no further action specifically on airport regulation, but let the proposals relating to the regulatory control provisions of the Commerce Act take effect was considered.

[48] In 1997 and again in 2002, following the setting of airport charges by WIAL, Air NZ and WIAL respectively took proceedings against each other. In 1997 Air New Zealand objected to WIAL's investment programme, and in 2002 Air New Zealand refused to pay the charges set by WIAL based on its revaluation of its assets. Again, following the latest round of pricing announcements earlier this year, Air New Zealand has sought judicial review of the process undertaken by both AIAL and WIAL and BARNZ has been active in calling for a Commerce Commission inquiry (under Part 4 of the Commerce Act) into WIAL's pricing.

17 This option does not resolve the problems discussed above associated with inadequate information. Also, when compared to the preferred option, it does not provide additional checks on the misuse of market power and will not help facilitate effective negotiation between airports and airport users.

18 The threat of further regulatory action under the Commerce Act is likely to be a weak vehicle for constraining airports' market power without an effective means of measuring and monitoring the information disclosed by the airport. Instead a costly inquiry would be needed to determine whether there are grounds for economic regulation.

ALTERNATIVE OPTIONS

19 In addition to the status quo there were four options considered for the regulation of airports:

a Do further work through an independent consultancy study or a Commerce Commission inquiry to identify whether there is a problem, and make recommendation on the best solution;

b Make a decision now to impose an improved information disclosure regime and a negotiate/arbitrate regime (for international airports) under the revised Commerce Act; and

c Make a decision to impose price control under the current Commerce Act on major international airports.

d Make a decision now to improve the information disclosure regime and undertake price monitoring, with further work to be undertaken in 2008/09 on whether additional regulation is required *(Preferred option);*

Option a: Do further work through an independent consultancy study or a Commerce Commission inquiry to identify whether there is a problem, and make recommendation on the best solution

20 The benefits of this option is that it provides for a full review process to consider the nature of the problem to be addressed, the magnitude of this, and the options available to address this. It would also be fully consistent with Government statements on quality regulation being based on evidence and rigorous analysis.

21 Commissioning an independent review by a consultancy firm or the Commission on whether airports are overpricing and whether there would be net benefits in introducing further regulation and the best type of regulation, would cost up to $500,000 and take around six months. A 'full blown' inquiry under Part 4 of the Commerce Act by the Commission could take about 18 months to two years and cost around $2 million.

22 While there are advantages of taking additional time to identify more evidence and undertake further analysis this will not necessarily lead to a different or better outcome. There is sufficient information from previous reviews, as well as in submissions made on the review of the Commerce Act, regarding the inadequacy of current information disclosure regime and thus it is unlikely that a full-blown review undertaken in the near future will reveal any significantly or materially different issues that have not been raised previously. Thus, it may just lengthen the process for making a decision for little further benefit. Therefore this option was discarded.

Option b: Make a decision now to impose an improved information disclosure regime and a negotiate/arbitrate regime (for international airports) under the revised Commerce Act.

23 The benefits of the improved information disclosure regime under this option would be the same as set out below in the preferred option (option d), though it can be argued that this would better facilitate effective negotiation.

24 A negotiate/arbitrate regime should provide incentives for parties to negotiate a settlement, and parties would be able to customise settlements to meet their own circumstances. As a result, it could improve relationships between suppliers and customers. The arbitrator/regulator is only involved if parties fail to agree – this reduces costs compared to an option such as price control. Also, over time, parties should get better at predicting arbitrated outcomes, which will again speed up settlement processes.

25 The risks of such a regime are that parties look to the end-game (i.e. arbitration) and position themselves to get the best outcome from the arbitration. This may not be conducive for constructive commercial negotiations. The design issues such as the process for invoking arbitration would be important in limiting vexatious and/or trivial requests for arbitration. Should arbitration be too easily invoked, it could become the default form of regulation, rather than a form of regulation only resorted to after constructive commercial engagement.

26 Some airports also expressed concern that a negotiate/arbitrate regime would stall and frustrate investment, and pointed out that arbitration can be complicated where there are multiple services and parties. As a result, it could be difficult to get the agreement of all parties, which would mean that arbitration/regulation is inevitable.

27 To mitigate the risk of incumbent airlines refusing to pay for capital investment that would encourage or facilitate increased competition by new entrant airlines, it would be proposed that arbitration be required to consider the benefits to end consumers of investment in facilities reasonably required to improve competition among airlines. Arbitration under the Commerce Act would also be subject to guidance from a proposed regulatory specific purpose statement that explicitly refers to incentives to invest.

28 Additional costs of arbitration are difficult to estimate as it will depend on the scope of any arbitration. A rough estimate would be an average of $300,000 per arbitration. This allows for 40 days[49] for an arbitrator at $3000/day, plus $100,000 for specialist assistance, plus $80,000 for travel, accommodation, administration and sundries.

29 On balance, given the potential risks and costs associated with the negotiate arbitrate model it is considered that further work on whether an alternative regulatory regime to the proposed information disclosure regime is necessary.

Option c: Make a decision to impose price control under the current Commerce Act on major international airports

30 It is considered that price control sold not be considered without a full inquiry. It is a relatively high cost option when compared to the status quo and preferred option (option d). Also, unlike information disclosure does not have the benefit of the interested parties, who generally have better information about how best to run their business than the regulator, being able to negotiate the best outcome for both parties.

PREFERRED OPTION

Option d - Make a decision now to improve the information disclosure regime and undertake price monitoring, with further work to be undertaken in 2008/09 on whether additional regulation is required (preferred option).

31 This option would involve moving the regulation of Auckland, Wellington and Christchurch airports into the information disclosure and monitoring regulatory regime provided for under the amended Commerce Act. Under this provision, the Commerce Commission would be required to develop binding guidelines and methodologies, including pricing principles, for the information disclosure regime and to undertake price monitoring with published analysis.

32 This option would involve moving the regulation of Auckland, Wellington and Christchurch airports into the information disclosure and monitoring regulatory regime provided for under the amended Commerce Act. Under this provision, the Commerce Commission would be required to develop binding guidelines and methodologies, including pricing principles, for the information disclosure regime and to undertake price monitoring with published analysis.

33 This regime would be along similar lines to the Australian regime for larger airports whereby the Australian regime provides pricing principles, information disclosure, and price monitoring and reporting by the ACCC. In most other OECD countries, larger privatised international airports are subject to some form of price cap regulation.

[49] Indicative timeframes only for purposes of cost calculations.

34 The advantage of this option is that it significantly improves the value and relevance of the information disclosed. Providing for specification of input methodologies would provide better information to guide consultations between airlines and airports and pricing decisions. The proposed regulatory specific statement under the Commerce Act would also provide guidance on desired regulatory outcomes. This, together with providing an explicit role of monitoring and reporting by the Commission should also create a more credible threat of heavier-handed regulation if prices are shown to be excessive. Improved information disclosure will also allow the regulator to identify whether regulation should be removed.

35 Specification of binding input methodologies would also remove much of the contention under the current regime. This reduces the scope for dispute which could mean settlements are reached quicker, less costly and there are greater incentives to improve commercial relationships.

36 The input methodologies required for robust information disclosure (such as asset valuations, revaluations, and allocation of common costs) would be binding, while methodologies such as pricing principles and how to calculate WACC (which are required for monitoring and analysis) would be in the form of guidelines. This would allow airports and airlines and other customers to reach commercial agreements taking in to account efficiency, productivity, investment and other issues while providing clear guidance to assist commercial negotiations

37 The application of this regime can occur under either the Airports Authorities Act or the Commerce Act. On balance the preferred option is move the regulatory regime for the setting of airport charges by Auckland, Wellington and Christchurch airports into the Commerce Act. The regulatory provisions of the Commerce Act are specifically designed to address monopoly pricing issues and the proposed regulatory specific purpose statement will guide decisions about appropriate/desired regulatory outcomes. The Commerce Act will also provide for cross-sectoral consistency has processes and tests/criteria for further inquiries on whether more (or less) regulation is warranted.

38 The main one-off costs for the Commission to prepare input methodologies for information disclosure is estimated at $1.4 million with ongoing costs for administering the information disclosure regime of $400,000 per annum.[50] These costs would be able to be recovered by levy on the three relevant airports. Airports and airlines would continue to incur the costs of consultation and litigation. Costs for airports and airlines are likely to be lower than currently as a result of fewer disputes about methodologies.

IMPLEMENTATION AND REVIEW

39 Implementation of the proposals in this paper requires amendment to the Commerce Act 1986. It is proposed that a Commerce Act Amendment Bill will be passed by mid 2008.

40 The following transitional arrangement is proposed:

[50] Cost estimations provided by the Commerce Commission.

a. the Commerce Commission to develop and prepare generic input methodologies and pricing principles to apply to airports to be ready by December 2009;

b. the Commerce Commission to specify the information disclosure requirements by December 2009 and for the information disclosure requirements to take effect from then;

c. disclosure from the regulated airports would be three months after the end of a financial year; and

d. until input methodologies and information disclosure regime specification are finalised, the current information disclosure regulations under the AAA will apply.

CONSULTATION

41 Major airports and the airline sector were active in making submissions on the review of the regulatory control provisions in the Commerce Act, and specifically highlighted issues with the regulatory regime for airports. Submissions were received from Air New Zealand, Auckland International Airports Limited, the Board of Airline Representatives in New Zealand (BARNZ), Christchurch International Airport Ltd, the International Air Transport Association (IATA), Peet Aviation, Virgin Blue and Wellington Airport Limited (WIAL).

42 After meetings during consultation with AIAL, WIAL, BARNZ and Air New Zealand, these parties further submitted on questions posed, and on possible options for regulatory change.

43 Major airports (AIAL, WIAL and CIAL) maintain that the current regulatory regime is largely satisfactory. They say that consultation requirements are taken seriously with airports making adjustments to their proposals (both in terms of input methodologies, proposed capital expenditure and charges) as part of this. Judicial review also provides a check on consultation processes. They also state that they take the threat of price control under the Commerce Act very seriously, and that their prices are not excessive and that their charges are generally mid range compared to international airports overseas.[51]

44 The airlines (BARNZ, Air Zealand, Virgin Blue) and IATA, on the other hand, argue that New Zealand's regulatory regime lacks credibility. They argue that the information disclosure regime lacks rigour and value because there are no guidelines or methodology specified and the consultation process is unsatisfactory. The absence of guidelines or binding input methodologies is a major source of dispute and means that consultation processes are time-consuming and costly. The statutory power for airports to set charges as they see fit appears to be unique and as a result of the regime's current design, the airports

[51] Airports also claim that some airlines, and in particular Air New Zealand, oppose investments in new facilities required to attract new entry by competing airlines and that this is to the detriment of the travelling public. Airports have also expressed the view that the ability to set charges as they see fit provide a "circuit breaker" when it does not prove possible to reach agreement. This enables the airports to get on and make investments.

can and do make unilateral decisions on investments and set charges as they see fit.