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.