

MEMORANDUM TO CABINET

## **REGULATORY CONTROL INQUIRY INTO AIRFIELD ACTIVITIES**

### **PROPOSAL**

1 The purpose of this paper is to inform Cabinet of my intention to make a decision on the Commerce Commission recommendation that control be imposed on airfield activities provided by Auckland International Airport.

### **EXECUTIVE SUMMARY**

2 The Commerce Commission found that the criteria in section 52 of the Commerce Act 1986 have been met for airfield activities supplied by Auckland International Airport (AIAL). The Commission recommends that I should recommend that regulatory control be imposed on AIAL in the interests of the airlines (and indirectly air passengers). Section 52 provides that control may be imposed if competition in the market in which the services are supplied is limited and that the imposition of control results in net benefits to acquirers of the services.

3 I am satisfied that these minimum criteria have been met for airfield activities supplied by AIAL. However, I may take into account a wider range of matters than the Commission in making my decision on whether to recommend to the Governor-General that control should be imposed.

4 My officials have also advised me on whether I may recommend control for airfield activities supplied by Wellington International Airport (WIAL). The Commerce Commission did not recommend that control be imposed on WIAL, but noted that if the current consultation round resulted in a significant increase in charges it may be satisfied that control may be imposed. WIAL recently increased charges by 77.7%, of which 27.6% related to airfield activities.

5 The Commission did not recommend that control should be imposed on Christchurch International Airport.

6 I consider that this inquiry has identified some problems with the legislation and the matters that the Commerce Commission and I may consider in making our decisions. I will be requesting my officials to carry out a review of these provisions.

### **BACKGROUND**

#### **Regulatory and Commercial Environment for Airports**

7 The three airports that are the subject of my decision are Auckland, Wellington and Christchurch International Airports. The following table briefly outlines the ownership arrangements for each airport.

Airport	Ownership
Christchurch	CIAL was incorporated in July 1988, with 75% of its shares held by the Christchurch City Council and 25% by the Crown. The Christchurch City Council has first option and Ngai Tahu has second option to purchase the Crown's shares on sale.
Wellington	WIAL was incorporated in October 1990. The airport company is currently owned by Infratil, holding 66%, and Wellington City Council, holding the remaining 34%.
Auckland	AIAL was incorporated in April 1988 and its shares trade on the New Zealand and Australian stock exchanges. Substantial security holders include Auckland local authorities <sup>1</sup> and institutional investors.

8 The airports are subject to the Airport Authorities Act 1966, which requires airports to operate as commercial undertakings. The Act and regulations also include provisions to address competition concerns and enhance the countervailing market power of airlines. These provisions include a requirement for airports to consult with substantial customers when setting charges and on capital expenditure, and to disclose specified financial and operational information to the public. In addition to this relatively light-handed regime, airports are subject to the Commerce Act 1986, including the threat of regulatory control.

9 Each of the airports provide a range of services to customers, broadly categorised as airfield activities, passenger terminal activities, and other activities such as car parking, conference facilities, concessions, etc. My decision relates to airfield activities only.

### Control Inquiry

10 Parts 4 and 5 of the Commerce Act 1986 provide for the control of specified goods or services. Goods or services subject to control can only be supplied subject to terms and conditions set by the Commerce Commission. These terms and conditions may relate to price, revenue or quality standards. The last good or service to be subject to regulatory control by the Commission was the supply of natural gas and the control order was repealed in March 1993.

11 The Commerce Act provides that the Governor-General may declare goods or services subject to control following a recommendation from the Minister of Commerce. Before making this recommendation the Minister of Commerce may request the Commission to carry out an inquiry to advise the Minister whether the statutory criteria in section 52 of the Commerce Act for control to be declared have been satisfied.

12 In 1998 the National / NZ First Government initiated a Commerce Commission inquiry into airfield activities provided by Auckland, Wellington and Christchurch International Airports. The decision to initiate the inquiry was related to the Crown's decision to sell its shares in AIAL and a concern that privatisation of important infrastructure may result in competition concerns.

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<sup>1</sup> The Auckland City Council is in the process of completing the sale of its 25% shareholding. Manukau City Council continues to own 9.6%.

13 On 1 August 2002 the Commerce Commission provided me with its final report on the outcome of its inquiry. The Commerce Commission recommended that the airfield activities supplied by:

- a Auckland International Airport should be subject to control;
- b Wellington International Airport should not be subject to control, but if the airport company imposes a significant increase in charges as a result of its current consultation with the airlines, the Commission would likely be satisfied that control would be in the interests of acquirers; and
- c Christchurch International Airport should not be subject to control.

### **Statutory Criteria for Making Decision**

14 [ ] my decision on whether to recommend control should be declared on any good or service requires a two-step analysis. Firstly, I must be satisfied that the goods or services meet the criteria for control to be imposed as set out in section 52 of the Commerce Act.

15 Section 52 provides that goods or services may be controlled if:

- a the goods or services (in this case, airfield activities) are supplied in a market in which competition is limited or likely to be lessened; and
- b it is necessary or desirable for those goods or services to be controlled in the interests of persons acquiring the goods or services. These acquirers are the airlines and indirectly the airlines' passengers.

16 The Commerce Commission has interpreted these matters as being a requirement that competition in the market for airport activities is limited and that control would result in sufficient net benefits to acquirers. The Commission has advised me on these matters and, in doing so, has taken into account the thresholds it has set under section 54 of the Act to assist me in assessing whether the criteria in section 52 are met.

17 Only if satisfied of the matters in section 52 can I then proceed to the second stage of the analysis to determine if I should recommend control. In making this decision I may have regard to a wider range of relevant matters than those considered by the Commission. Matters that I consider relevant include the purpose of the Act, any relevant international obligations, and alternative policy options for addressing the problem other than control. These matters are discussed in more detail below.

### **COMMENT**

18 I have considered the Commerce Commission's final report, submissions received on the Commerce Commission's report and advice from my officials. The following is a discussion of the submissions and my analysis for each of the airports.

### **Analysis of submissions**

19 I received submissions from 15 submitters, including from each of the airports, shareholders of the airports, Qantas, Air New Zealand and the Board of Airline

Representatives NZ (BARNZ). The submissions generally contested the Commission's analysis and its assumptions. However, there were no matters raised that would cause me to consider that the Commission has interpreted the section incorrectly or that its analysis is unreasonable.

20 The submissions identified two numerical errors in the Commission's analysis relating to the calculations for Auckland and Wellington International Airports. The correction of these errors did not significantly affect the Commission's analysis or its recommendations. The corrected figures are included in this paper.

21 The main new matter identified in the submissions is the outcome of WIAL's latest consultation round on charges following the expiry of the previous agreement in June 2002. This is discussed in more detail later in the paper.

### **Christchurch International Airport**

22 The Commission has concluded that competition is limited in the market for airfield activities supplied by Christchurch International Airport (CIAL), but that the net benefits of control for acquirers would be negative. As such, the Commission has advised that the criteria in section 52 of the Commerce Act are not satisfied for CIAL and I should not recommend control. I am proposing to accept the Commission's advice.

### **Auckland International Airport**

23 The Commission has concluded that the criteria in section 52 of the Commerce Act are met for airfield activities supplied by Auckland International Airport (AIAL) and that I should recommend control in the interests of acquirers. The Commission calculates net benefits to acquirers of control of approximately \$1.7 million per annum, within a range of –(\$1.0) to \$4.1 million.<sup>2</sup>

24 I am satisfied with the Commission's analysis that competition is limited and it is in the interests of acquirers to impose control. There are, however, other matters that I consider to be relevant before deciding whether to recommend that control should be imposed.

#### *Net Public Benefits of Control*

25 The purpose of the Commerce Act 1986 is to promote competition in markets for the long term benefit of consumers within New Zealand. [

Such a test looks at the net benefits of control to New Zealand as a whole.<sup>3</sup> It differs from a net benefit to acquirers' analysis, as it is neutral as to income transfers from suppliers to acquirers.

26 My officials advise me that the net public benefits of control are approximately –(\$0.7) million per annum, within an average range of –(\$1.1) and –(\$0.1) million. That

<sup>2</sup> The calculation of net benefits of control to acquirers is highly sensitive to the calculation of the weighted average cost of capital (WACC) for each airport. Given uncertainties associated with calculating WACC, the Commission has calculated a WACC range and estimated net benefits to acquirers across the WACC range and at the point estimate.

<sup>3</sup> [

is, the direct and indirect costs of imposing price cap controls (CPI-x) on AIAL exceed the efficiency gains to New Zealand.

### *International Obligations*

27 New Zealand has entered into a number of international agreements that impose obligations relating to aeronautical charges. The agreement with the most detailed provisions relating to the level of charges is the Multilateral Agreement on the Liberalisation of International Air Transport (MALIAT), which came into force on 21 December 2001. Current parties to the MALIAT are New Zealand, Brunei Darussalam, Peru, Singapore, United States, Samoa and Chile.

28 The MALIAT requires that charges imposed on the other parties to MALIAT by a charging authority (e.g. any airport company) shall not exceed full costs, including a “reasonable return on assets”. If any excess charging is identified, the Government would be subject to legal risk if it failed to take action either under the Commerce Act or by other means. Accordingly, the MALIAT requirements are a relevant matter I have taken into account in arriving at my proposal.

29 In examining the “reasonable return on assets” standard under the MALIAT, it should be recognised that the application of this standard is not constrained by particular pricing and valuation methodologies that the Commerce Commission applied in their assessment of “excess returns”, which focused on an “efficient pricing” standard. In particular, the “reasonable return on assets” test could be applied with reference to a number of commercially and internationally accepted valuation methodologies and differing judgements about optimisation of the asset base.

30 Having considered the economic data submitted to the Commerce Commission, I have concluded that there is no information to suggest that current charges are inconsistent with the New Zealand’s obligations under the MALIAT. Accordingly, having considered the relevant international obligations, I have concluded that they do not require me to intervene to constrain airfield charges at this time.

### *Incentives on Investment*

31 The submitters recommend that I take into account the impact of a proposal to impose control on the incentives to invest in airports and infrastructure generally. AIAL is important to the New Zealand economy. Control is a relatively heavy-handed form of regulation and the investment risk associated with regulatory uncertainty and error could be significant. Alternatively if airports are able to earn unconstrained excess returns this could impact on returns and incentives to invest in airline infrastructure.

### *Availability of Other Policy Options*

32 A number of submissions discuss other policy options for addressing the problem of excess returns. The main options discussed relate to a review of the consultation obligations under the Airport Authorities Act 1966 to further enhance the countervailing power of the airlines. This could involve replacing the current “consultation” obligation with a “negotiation” obligation, adopting an alternative dispute resolution mechanism, or prescribing methodologies for the airports in setting charges.

33 The adoption of the Commission's pricing principles in the Airport Authorities Act 1966 is favoured by BARNZ and the airlines. This would be effectively a form of regulatory control with oversight by the courts rather than the Commission. It would require an assessment by Ministers that airports should charge efficient prices rather than what may be reasonable for a commercial undertaking.

34 The Ministry of Transport has put on hold a review of the information disclosure regulations and consultation requirements pending my decision on control. The priority, scope and timing of this review will be reconsidered following my decision and taking into account other government priorities. I consider that a decision on whether or not to recommend control should be made on its merits and any further work on other policy options should proceed independently.

#### *Net Benefits as a Proportion of Total Landing Charges and Net Profit*

35 The Commission suggested that I take into account the net benefits to acquirers of control as a proportion of landing charges paid by the airlines and of the net profit earned by AIAL per annum.

36 My officials estimate that control would result in a 3.1% net reduction in charges to the airlines. I consider this amount is not insignificant but it is relatively small. The Commission estimated that landing charges made up approximately 4.1% of domestic passenger ticket prices, and that the net benefits of control would be 3.1% of this. If the airlines passed on the full reduction in charges to passengers, my officials estimate that it would result in approximately a 35 cents reduction in the average price for a one-way trip.<sup>4</sup>

37 My officials estimate that control would reduce AIAL's net profit by approximately 7.9%. Macquarie Equities NZ recently stated that one of the big attractions of AIAL as an investment is that it is not hostage to just the airport related income which is the subject of the control inquiry. Approximately 73% of AIAL's revenue in 2001/02 is from sources other than airfield income. AIAL's recently announced 13.1% increase in its after tax surplus for the six months ended December 2002 is largely attributable to an 8.9% increase in total passenger numbers and a 32.6% increase in retail income. Airfield income had only a small increase of 3.3% for the six month period due to an increase in the average weight of domestic aircraft, even though the number of domestic aircraft movements declined.

#### *Other Forms of Control*

38 In order to estimate the net benefits of control to acquirers and the public the Commission based its estimate of the direct and indirect costs on a price cap form of control (i.e. CPI-x). However, Part 5 of the Commerce Act allows the Commerce Commission a wide discretion on the forms of price, revenue or quality controls it may impose.

39 The Commission estimates the direct and indirect costs of price cap regulation for airfield activities of AIAL of approximately \$2 million per annum on average. The

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<sup>4</sup> Based on figures provided by WIAL in the Dominion Post (1 March 2003) outlining AIAL's average charge across all passengers is \$11.46.

Commission suggested that I take into account the sensitivity of the recommendations to other less costly forms of control.

40 I consider that the Commission's analysis may not be that sensitive to other less costly forms of control. Less costly forms of control may be less effective in removing excess returns and thereby result in fewer benefits at the lower cost. The net effect may be minimal. Due to the uncertainty I do not propose to give great weight to this matter.

### **Wellington International Airport**

41 WIAL recently concluded its consultation on landing charges to take effect in July 2002. Landing charges increased by 77.7%, including a 27.6% increase in airfield charges. Only the increase in airfield charges is relevant to my consideration. A full reassessment of the impacts of this 27.6% increase on the criteria under section 52 of the Commerce Act would require recalculation of WACC and forecast returns over the revised price period. This would be a relatively involved process. My officials have done a simple analysis focusing on 2002/2003 only and estimate that the net benefits to acquirers of control would be in the order of \$0.4 million per annum.<sup>5</sup>

### **PARTS 4 AND 5 OF THE COMMERCE ACT 1986**

42 This inquiry has identified some problems with applying the provisions of Parts 4 and 5 of the Commerce Act. The criteria for when control may be declared are poorly targetted. In addition, the inability of the Commerce Commission to consider what form of control it may impose constrains its analysis and means that a further inquiry of potentially similar size would need to be undertaken to implement control. This seems inefficient. I propose to ask my officials to carry out a review of these provisions to ensure that the regime is appropriately targetted.

### **CONSULTATION**

43 The Ministry of Transport, the Treasury, the Ministry of Tourism, and the Ministry of Foreign Affairs and Trade were consulted in the preparation of this paper. The Department of the Prime Minister and Cabinet has been informed.

### **FISCAL IMPLICATIONS**

44 My decision on airfield activities supplied by the major international airports does not have fiscal implications for the Crown.

### **HUMAN RIGHTS**

45 The proposal in this paper is consistent with the NZ Bill of Rights Act 1990 and the Human Rights Act 1993.

### **LEGISLATIVE IMPLICATIONS**

46 This proposal does not have legislative implications.

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<sup>5</sup> This analysis assumes that the price increase applies for the full 12 month period, to allow an assessment of the implications of the increase going forward.

**REGULATORY IMPACT AND COMPLIANCE COST STATEMENT**

47 A regulatory impact and compliance cost statement is not required.

**PUBLICITY**

48 Publicity of my decision will need to take into account sensitivities with the public listing of AIAL on the New Zealand and Australian Stock Exchanges. I propose to issue a press release on my decision on Wednesday 21 May. I also propose to release this paper and my officials' advice papers, with any necessary deletions, at the same time.

**RECOMMENDATIONS**

49 I recommend that Cabinet:

- a **Note** that the Commerce Commission has advised me that I should recommend that regulatory control be imposed on airfield activities supplied by Auckland International Airport;
- b **Note** that I must make this decision under section 53 of the Commerce Act 1986, and that my decision may take into account a wider range of matters than those considered by the Commerce Commission;
- c **Note** that I will make a media release announcing my decision (taking into account share market implications); and
- d **Note** that I will be asking my officials to carry out a review of Parts 4 and 5 of the Commerce Act to ensure the regime is appropriately targeted.

Hon Lianne Dalziel  
**Minister of Commerce**