AIR NEW ZEALAND

Submission

Ministry of Business, Innovation & Employment

The Effectiveness of Information Disclosure as a Regulation for Major International Airports

05 December 2014

Executive Summary

i. Air New Zealand (Air NZ) welcomes the opportunity to participate in the Ministry of Business, Innovation and Employment (the Ministry) consultation process regarding the effectiveness of information disclosure (ID) regulation for major international airports.

ii. Air NZ applauds the Ministry for undertaking this consultation on an evidential basis and in response to the Section 56G process. It is important to the credibility of the industry, regulator and indeed the legislation itself that appropriate responsive actions are continuously pursued in relation to important economic issues such as monopoly regulation.

iii. Air New Zealand notes that the Board of Airline Representatives New Zealand (BARNZ) is also submitting on the Ministry's consultation document. This highlights that the issues associated with the airport pricing regime is a sector wide challenge for both domestic and international carriers.

Air New Zealand

iv. Air NZ, as the New Zealand based and largest airline customer of all the major airports holds a specific historical knowledge of how the current regime came into being and is most heavily and directly impacted by that regime's outcomes.

i. Air NZ is the largest airline customer of all the major international airports in New Zealand, comprising 48% of Auckland International Airport Limited (AIAL), 33% of Christchurch International Airport Limited) and 60% of Wellington International Airport Limited (WIAL). Aeronautical charges levied on Air NZ by these three airports, which are subject to the ID regime, amounted to $166 million (AIAL $105m; CIAL $19 m and WIAL $42 m) in FY14. Revenues subject to ID paid to these three airports have seen a 44% increase over the past 5 years.

ii. Because New Zealand is our home market, excessive airport charges in New Zealand impose a proportionally greater detriment on Air NZ than on any other airline, impacting our cost competitiveness in a highly competitive industry noted for thin profit margins.

Key themes

iii. This submission should be read in the context of three key themes.

a) Firstly, Air NZ and the airports have a workable relationship at operational levels. Difficulties generally only arise when an issue has a commercial dimension. The commercial relationship is generally acrimonious due to the significant imbalance of power (in favour of the airports). These difficulties arise from the flawed legislative regime. Air NZ makes no judgement on the airports' management behaviour in operating as commercial entities and recognises that, being responsible to their shareholders with a profit maximisation objective, they have to take all opportunities presented to them.

b) Secondly, Air NZ challenges the legislative regime and the unjust regulatory environment it creates because it is based on unsound economic principles.

The purpose of monopoly legislation is to reproduce as far as possible, the conditions that exist in a competitive market by balancing monopoly power with firm, credible regulation. The current legislative regime has failed and will continue to fail to reproduce these conditions unless appropriate action is taken by legislators.

c) Finally, because the regulation is inadequate, it has a significant and negative impact on the New Zealand economy including the inefficient use of capital, underperformance of the tourism sector and ultimately the detriment of the end consumer; the public.

Summary of key positions:

iv. The light-handed constraints thought to exist upon the privatisation of airports have been robustly disproved, not by debate, but by real outcomes.

v. The current regulatory regime is not in the true sense 'regulation' but is in fact the absence of regulation and is totally inadequate to constrain airports as has been amply demonstrated for more than 20 years of airports acting as "commercial undertakings" and setting charges "as they see fit".

vi. Historical governmental omissions to fully confront this issue have resulted in the debate becoming so distorted that stakeholders have lost sight of the fact that ID is not based on economically sound principles in either its scope or detail.

vii. Air NZ notes that the Ministry of Transport is undertaking a review of the Airport Authorities Act 1966 (AAA) as part of the wider Civil Aviation Act 1990 review. Air NZ strongly supports the Ministry of Transport's recommendation as part of that review to repeal key provisions of the AAA in relation to airport pricing.

viii. Air NZ notes that that enduring resolution of airports' pricing requires a two stage process; removal of the AAA provisions (namely Section 4 (a)) and the activation of firm regulation in the Commerce Act 1986 by allowing the Minister to act more effectively.

ix. Provisions in the Commerce Act envisaging a negotiate / arbitrate regime (at Section 53(G-J) are already in existence. Their implementation will allow ready resolution of this issue if they replace ID which has failed and will continue to fail to achieve positive outcomes under the current, ineffective regime.

x. By employing firmer regulation New Zealand will see fairer pricing outcomes affecting consumers and the wider economy. Removing the antagonism created by unfair pricing will allow additional benefits in the development of the tourism sector through significantly more constructive collaboration between Air NZ and all the major international airports.

This submission:

xi. Air NZ has broken this submission into several which includes:

a) A summary of the economic basis for airport regulation and a history of the current regime's evolution in New Zealand;
b) Specific answers to the Ministry's questions in the consultation document, to be read in the context of the submission as a whole;
c) A summary on both the impact the regime has, and could have on the New Zealand economy; and
d) An outline of Air NZ's preferred (and regulatory sound) position of negotiate / arbitrate regulation.

xii. Air NZ would welcome the opportunity to comment further on the issue under consultation and would support the Ministry holding an open forum for participants to speak to and expand on their submissions.

xiii. Should the Ministry require further information or points of clarification in relation to this submission, please contact:

Nick McDonnell,
Manager Regulatory Affairs
Government & Industry Affairs

Mobile: **+64 273346105**
Email: **nick.mcdonnell@airnz.co.nz**

Air New Zealand Submission on The Effectiveness of Information Disclosure as a Regulation for Major International Airports.

Introduction

1. This submission, in addition to answering the specific questions posed by the Ministry in the consultation document will address wider issues associated with ID and its impacts and includes the following:

    a. General discussion on the need for and purpose of the legislation and why the major gateway airports of AIAL, WIAL and CIAL are unique in this sense;

    b. A history of how the industry has arrived at this point in order to highlight the protracted nature of the regulation debate, whether the intention of Parliament has been (or is likely to be) achieved and the considerable impact it has had on the industry and wider economy;

    c. An overview of the rationale to regulate airports as economic units. In relation to this Air NZ has commissioned Dr Mike Trethaway of InterVISTA (Vancouver) consulting group to undertake a review of ID as a regulatory regime. In this document (attached as Attachment I), Dr Trethaway explores the nature of light handed (and alternate) regulatory tools, together with international comparisons and concepts of credibility in regulatory regimes.

    d. We pose a fundamental question, unique to airports, challenging the separation of income streams from activities subject to ID and those that are not. Air NZ explores the nature of revenue generated from monopoly activity that is not subject to ID and the impact these activities should have on the regulatory environment and outcomes for airport users;

    e. A discussion of the economic benefits both on a consumer and macro level, driven by certainty, innovation, investment and stemming from credible effective regulation. Air NZ has commissioned an analysis of AIAL[1] market performance (attached as Attachment II), which emphasises the highly concerning outcomes the legislative environment is currently permitting. This is particularly so when combined with the detrimental impact the extraction of their profits have on the wider economy, market development and innovative re-investment.

    f. Finally, Air NZ offers access to negotiate / arbitrate provisions already in existence in the Commerce Act 1986 as a solution for the industry. This firm form of regulation is complemented by existing ID regulation and the concept of the Input Methodologies. In an industry with sophisticated commercial entities this option puts the onus back on the participants to reach negotiated agreements and incentivises the avoidance of regulatory intervention.

[1] AIAL has been analysed due to its listing on the NZX and therefore the availability of accurate financial information. It can be reasonably assumed based on our estimates and the outcomes of the Section 56G reports that the same, if not proportionally higher, outcomes exist at WIAL and CIAL.

What is Air New Zealand's clear position and why?

2. From the outset it is important to understand, unambiguously Air NZ's position. Air NZ does not seek rate based price control as airport regulation. Air NZ does however, vigorously oppose the current airport pricing regime because the outcomes it produces are fundamentally unjust and economically inefficient.

3. The current regime (ID) is not actually effective light-handed regulation, but is in fact the absence effective regulation due to the lack of a trigger mechanism.[2] This means that a firmer regulatory regime could still reasonably be considered light-handed. Air NZ is open to the potential of other forms of regulation provided they are based on sound economic pricing principles. The ideal, in any regulatory context, is to have firm-handed regulation where the legislation itself plainly provides for enforcement, escalation and certainty.

4. As is developed later in this submission, Air NZ supports a move to firmer regulation of negotiate / arbitrate already provided for in the Commerce Act but not yet applicable to airports. This approach promotes the sophisticated commercial participants involved in the regime to come to agreement while at the same time incentivises the avoidance of regulatory interference.

Airports as monopoly enterprises.

5. To understand why Air NZ has this view the fundamental attributes associated with airports must be clearly recognised and understood.

6. Airports are locational (i.e. natural) monopolies. For most of the services they offer they have no practical competition and no threat of competition. Unlike other monopolies, airports are unique in their natural inoculation from competition. Gas services for example, are at least subject to some market forces such as commodity prices and alternate and competing power sources (electricity) exist for consumers.

7. Airports however, enjoy unbridled monopoly status. There is no alternate place for airline customers to conceivably land aircraft (except in cases of emergency or disruption).

8. Airports enjoy further unique characteristics as monopolies, as opposed to utilities (for example), related to the benefits they enjoy through economies of scale and scope.

9. In its Reasons Paper on Input Methodologies (Airport Services), the Commission specifically referred to efficiency gains from economies of scale and scope.

[2] Dr. M Trethaway, InterVISTAS, Issues Reagrding Regulation of New Zealand's Gateway Airports, December 2014.

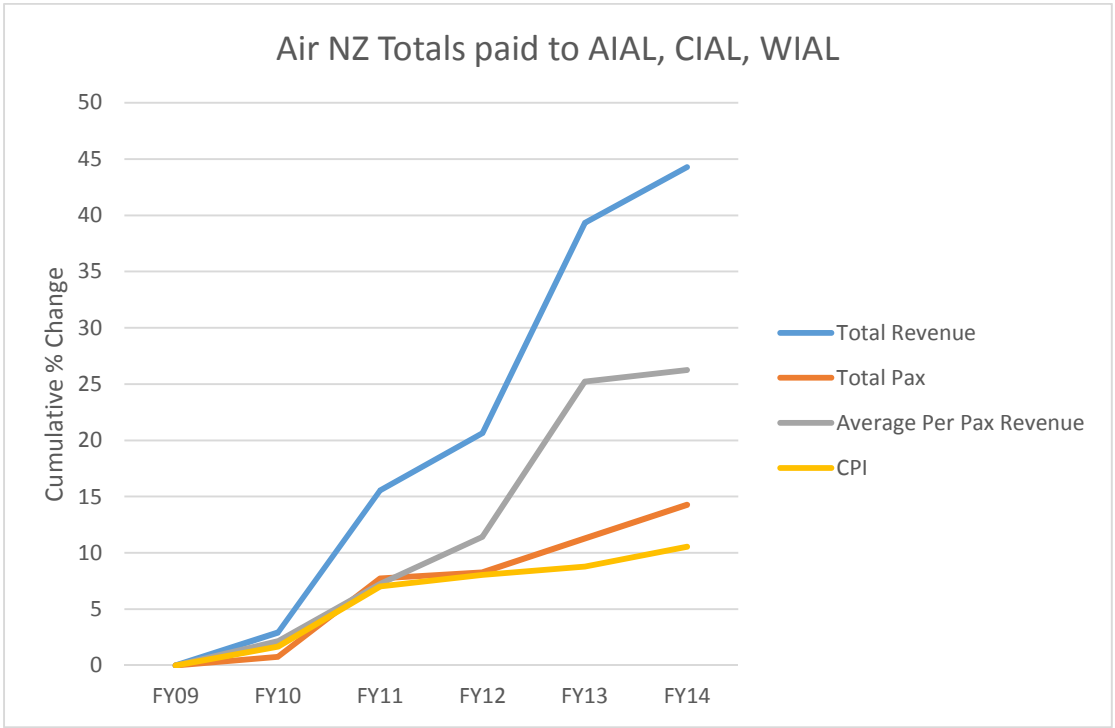
10. The airports operate extensive complementary monopoly businesses that are not subject to ID and which share common costs with the activities that are subject to ID, gaining the scale and scope benefits from those activities.

Economies of Scale

11. Economies of scale result from growth, when fixed costs remain the same or grows at a slower rate than the overall growth. Unit costs fall significantly with the growth. Businesses subject to market conditions ordinarily pass on these scale efficiencies to consumers through, for example, lower prices.

12. A good example of scale efficiencies can be seen in Air NZ's unit cost for its high volume jet operations as opposed to regional operations. The larger the plane (jet), the more passengers there are to spread the fixed costs. Therefore unit costs decrease and these are passed onto consumers through lower airfares. Where smaller aircraft operate a route, compared to jet operations, higher prices are typical as there are fewer passengers to spread the fixed costs across.

13. One could expect an airport to operate in the same way. As the traffic volumes (i.e. aircraft and passenger movements) increase, the overall unit cost should decrease as the fixed costs are spread over more users. For example, there has been no new runway built in the past 60 years; the locational monopoly asset has remained essentially the same and enjoyed significant volume increase in usage. Unit costs however have not only not decreased, they have increased significantly.



Economies of Scope

14. Economies of scope result from the creation of additional revenue streams at a cost far lower than the actual cost of provisioning those services.

15. Air NZ's website is an industry example of the economies of scope. In addition to providing the critical service of online flight bookings, the website includes other services that passengers can access (rental car bookings, insurance etc.), which provides the airline with additional, ancillary revenue. The website is already established and necessary for bookings and these other services 'piggy back' on the website without the need for their own overheads (e.g. domain names, maintenance, advertising costs).

16. Airports have considerable potential for (and have capitalised on) significant economies of scope. The following table shows the extent to which airport related activities not subject to ID make up total revenues in the 2014 financial year:

$m	AIAL	WIAL	CIAL
Airport activities subject to ID	$248	$70	$57
Airport activities not subject to ID	$226	$41	$83
Revenue – TOTAL	$474	$111	$140
% Not subject to ID	48%	37%	59%

17. For airports, the creation of a runway is fundamental to the creation of other revenue streams. Obviously, without a runway, there can be no airport and certainly no airport retail stores.

18. Putting aside car parking services and terminal rents (which in most other jurisdictions form part of the single till), taxi services offer the clearest example of the exploitative approach airports take to economies of scope. All the major airports have had, or continue to have, issues with taxi companies. Like airlines, taxis have no viable alternative location to pick up or drop off their airline passengers.

19. When airports levy and increase taxi charges, they are charging for access to the airport, in essence, access to the monopoly asset. Unconstrained and historically encouraged by regulation, the airports are free to charge with the full force of a locational monopoly. However these airport activities, their charges and the significant revenues they generate are not subject to ID, or any regulation, or third party scrutiny. They are treated separately (and therefore artificially) from other airport activities. This is the unsound, artificial and questionable practice (in this context) of dual till accounting. This ignores the fact that the airport is a single economic unit.

20. Furthermore, as activities subject to ID are charged out to the airlines, but (for example) no new runway is built, the revenues generated from this first till are used for other purposes in the second till. This includes the development of the forecourt area, which the airport then charges the taxi company to access.

21. It has become clear to Air NZ that ID regulation alone does not provide sufficient information to assess whether the purpose of Part 4 is being promoted in relation to airport activities subject to ID. ID does not show whether airports have incentives to improve the efficiency of services by sharing

common costs, are utilising economies of scale and scope and are leveraging demand complementarities with their activities not subject to ID.

22. To the extent that airports are improving efficiency, ID regulation does not disclose how these efficiency gains from activities not subject to ID are being shared with customers.

23. The Act's ID regime provides no information on the performance of complementary airport activities from the second till not subject to ID. It is therefore difficult to establish the extent to which efficiencies have occurred and whether the benefits have been shared with consumers.

Purpose of Monopoly Legislation.

24. Parliament, as in many developed economies, understands the plain fact that the airports are monopolies and has legislated in recognition of this. The purpose of monopoly legislation is ultimately to replicate the conditions present in a contestable market.

25. The New Zealand legislation, at 52A of Part 4 of the Commerce Act, outlines this purpose:

> *"[Promoting] the long-term benefit of consumers … by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services-*
>
> *a. have incentives to innovate and to invest, including in replacement, upgraded and new assets; and*
> *b. have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
> *c. share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
> *d. are limited in their ability to extract excessive profits."*

26. These are the correct principles of monopoly legislation. However, a more fundamental question needs to be asked – what activity is taken into account when seeking to measure the effectiveness of the legislation in promoting these principles? An airport, as a single economic unit, where its 'commercial' activity is inextricably linked to its monopoly asset (the runway) must not be separated into and treated as separate economic units for the purpose of measuring total economic performance.

27. At the very least, the existence and performance of the airport activities not subject to ID should impact the true cost of capital the airport faces given their interaction with the monopoly asset's ability to significantly lessen risk.

28. The impact of the airport's total economic performance as one unit is critical given its impact on the cost of capital. In competitive markets, an industry over time will earn its cost of employed (spent) capital. When dealing with a locational monopoly that has no competition or prospect of competition, a regulatory objective would be to allow the monopoly to earn its cost of employed capital, but no more.

29. To achieve this outcome, there is a pooling of costs (including the cost of employed capital) from which revenues (excluding landing charge) are deducted. The difference is the landing charges to be paid by Airlines. A relatively simple, but economically sound concept.

30. Successive Governments have failed to give effect to the economic reality that in order to produce outcomes of a competitive market, the airport needs to be treated as the single economic unit it is.

History of airport pricing regulation

31. Airport pricing is freely determined by airports themselves exercising the statutory powers in the Airports Authorities Act 1966 (AAA).

32. The AAA was established in order to provide for the ownership mechanisms and operation of airports, essentially allowing local authorities to operate as airport authorities, expressly empowering these airport authorities to establish, improve, maintain, operate, or manage airports. This was subject to the consent of and in accordance with any conditions imposed by the Crown.

33. Under this framework, there was no real focus on airports as commercial businesses, with fairly rudimentary pricing and costing procedures; revenues were gained by a simple percentage charge on airline revenues and weight charges, costs were not allocated in any detailed way and there was no special effort to measure returns. Airports were considered to be key infrastructure supporting the regions within which they were located.

34. The focus on economic efficiency from the mid-1980's resulted (via a 1986 amendment) in changes to the AAA to allow airports to become limited liability companies under the Companies Act. This process involved establishing a valuation for each airport, determining the respective shareholdings of the Crown and relevant local bodies and appointing a board of directors. At this time, shareholders in an airport company were to be limited to the Crown, local authorities and the Airways Corporation.

35. Along with the new governance framework, the 1986 amendment also created the pricing authority for airports, such that following consultation, they were able to set charges for the use of their services and facilities as they saw fit. The only guidance given regarding the basis on which prices should be set was that an airport should operate as a "commercial undertaking".

36. Further amendment to the AAA in 1988 removed the constraint on ownership opening the way for the Crown to sell its shareholdings in the airports to private interests.

37. At first, single till was the standard mode of price-setting post corporatisation. However, once airports began to appreciate that (in the absence of legislation) their monopoly powers were not constrained, they proceeded to exclude activities not readily identifiable with the runway (non-airside activities).

38. At that time, a review of the regulatory framework considered that:

a. There was little competition between airports;
b. There were considerable forces acting against the exercise of monopoly power by the airports, with the most important of these being the countervailing power of the airlines as the main customers of the airports;
c. The threat of regulation acted as a constraint on the airports' exercise of market power; and
d. Section 36 of the Commerce Act should be sufficient to prevent most discriminatory activities by airports.

39. Monopoly infrastructure assets were corporatised and mandated with maximising returns subject only to:

    a. a requirement to consult with their customers, but with the ultimate right to make pricing decisions;
    b. a belief that airlines' "countervailing power" would provide some check on exercise of monopoly power; and
    c. rhetoric concerning the threat of regulation if airports were found to be exercising monopoly power.

40. This "light-handed" framework (for now self-evident reasons) had no precedent in other jurisdictions around the world. As discussed below, each of these "restraints", for various reasons, proved unsuccessful in moderating airports' pricing behaviour.

Consultation

41. Early consultations under the new regulatory framework were subject to significant disputes between airlines and WIAL in particular[3], resulting in a series of judicial challenges to pricing outcomes over the decade following passage of the 1986 amendment.

42. This judicial action resulted in a body of established jurisprudence regarding the requirements on airports when setting charges as they saw fit. In effect, this confirmed that the only basis on which airport pricing decisions could be challenged was if the airport had failed in its duty to consult. Pricing outcomes themselves could not be challenged on the basis of inefficiency or consumer outcomes. As a result, airports have become extremely proficient at the "consulting" process which inevitably concludes with a simple unilateral decision from airports that does not reflect the nature of the consultation or the evidence presented in it.

43. Consultation has become a box ticking exercise conducted by the airports and a process to point to when attempting to avoid criticism.

44. Consequently, the first leg of the regulatory regime – the requirement to consult – has consistently been demonstrated as incapable of protecting consumer interests.

[3] AIAL and CIAL entered into MOUs with their respective airline customers, with AIAL confirming a profit ceiling of 10% after tax on shareholders' funds the airfield and terminal cost centres, and 5% after tax on shareholders' funds on the rescue fire cost centre. CIAL confirmed a profit target of 10% after tax on shareholders' funds on the airfield and terminal cost centres.

Countervailing market power by airlines

45. The Government undertook a further review of the regulatory regime in 1995, starting with the premise that "current legislation provides insufficient protection for airport users against potential abuse by airports of their monopoly power". The review was essentially guided by two principles – the promotion of efficient pricing and the desire for optimal investment. These key principles are still relevant today but are notably absent twenty years on.

46. As a result of this review, the Airport Authorities Amendment Act 1997 sought to modify consultation requirements on "specified" airport companies, created a specific requirement to consult on capital expenditure over a specified level, and provided for the creation of an ID regime for larger airports, focussed on so-called "identified airport activities". During the Third Reading of the Amendment Bill, the Hon. Maurice Williamson (on behalf of the Minister of Transport), stated:

> *The objective of this Bill is to protect against a possibility of monopoly pricing by airport companies and to protect consumers' interests…*
>
> *Achieving that objective will ensure that airport companies provide their services efficiently and investment in new airport facilities reflects the growing demands for air travel and air freight.*

47. However, airports retained the right to set charges as they saw fit (under the AAA), and the regulatory framework still lacked any guidance as to what considerations should underpin pricing. Consultation remained a process only exercise.

48. Following this amendment, the Minister of Commerce, in 1998, directed the Commerce Commission (the Commission) to report to him on the following matters:

> *Whether there is evidence that airfield activities provided by the three major international airports … are supplied or acquired in a market in which competition is limited or is likely to be lessened; and it is necessary or desirable for the prices of these goods or services to be controlled in accordance with the Act in the interests of users, or consumers, or as the case may be, suppliers; and*
>
> *Whether market conditions are such that the Commission believes that I should recommend to the Governor-General that he make an Order in Council under section 53 of the [Commerce] Act invoking price controls over charges for airfield activities at the three major international airports.*[4]

49. The Commission, in its 1 August 2002 Report to the Minister, noted that:

> *The current regulation of airports relies largely upon the countervailing power of airlines, the requirements on airport operators to consult with them before setting charges, and the threat of further regulation.*

[4] Commerce Commission Airports Inquiry Final Report, 1 August 2002, Appendix 1, p.334.

> *However, analysis suggests that meeting demand for flights is the overriding factor determining which airport an airline flies to, rather than the costs of doing so, and that airlines' countervailing power is generally limited…*[5]
>
> *The Commission's conclusion is that there are insufficient constraints on AIAL's, WIAL's and CIAL's ability to exercise market power in the supply of airfield activities compared to what would be found in a market where competition was workable or effective."*

50. The Commission concluded that control should be introduced for AIAL and that if WIAL proceeded with price increases it was proposing at the time, that control should also be introduced for WIAL.

51. The second leg of the regulatory regime – airlines' countervailing power – was accepted by the Commission to be an inadequate mechanism for restraining airports' pricing behaviour. This recognised the significant imbalance of power in the relationship. There would be no symmetry of losses between airport and airline in the event of disagreement; the latter losing millions of dollars per day were it not able to access the airport.

Credible threat of regulation

52. Unfortunately, the Minister declined to follow the Commission's recommendation on the basis that the costs of full price control (which was the only option available at the time) would likely negate any benefits to acquirers and in any event, from a total welfare perspective (rather than a consumer welfare focus which the Commission had considered), there would be no public benefit (transfers between suppliers and consumers being discounted).

53. Thus the remaining leg of the regulatory regime – a credible threat of further regulation – totally collapsed. Airports were therefore able to make pricing decisions with the knowledge that those decisions would be subject to no meaningful scrutiny by an independent third party.

54. A further review of the regulatory provisions of the Commerce Act in 2007 again resulted in confirmation that the regulatory regime was ineffective. The Ministers of Transport and Commerce, in a November 2007 report to Cabinet noted that in their view:

> *…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. … our current regulatory regime lacks credibility and robustness.*[6]

[5] Ibid p.18, para 24-25.
[6] Cabinet Report – Commerce Act Review: Aiports, p.12, para 65.

55. The airports' ID regime was consequently transferred to the new Part 4 of the Commerce Act. However, airport pricing remained subject to the existing requirements of the AAA.

56. It should be noted that concurrently with Parliament's consideration of the Commerce Act changes in 2008, Justice Wild, in a judgment on an action brought by Air New Zealand against WIAL, noted that:

> *Sections 4A to 4C[7] did not include principles that airports were required to adhere to in setting charges, nor did they provide for substantive review of charges, including components essential to setting them e.g. the valuation of an airport's assets. The airlines had sought both.[8]*

57. Wild J went on to conclude –

> *…there is no restraint on monopoly pricing in the Airport Authorities Act.[9]*

58. Further, he noted:

> *Testing WIAL's charges against the standard of "reasonableness" would not, in practical terms, be a different exercise from determining whether WIAL's charges breach s4A, because they result in monopoly profits. Both exercises would involve the Court undertaking a task which the case law establishes is for the Commerce Commission and not for the Courts.[10]*

59. At this juncture, Wild J confirms there is no credible threat of regulation under the light handed approach and that this is not an area for the Courts to consider. The normal protections afforded to participants are openly acknowledged to be non-existent. In essence, airports, unlike any other corporations have the ability to set their prices as they wish. This is akin to the privatisation of taxation

60. Inclusion of the airports in the Commerce Act Part 4 regime was intended to remedy these omissions, with the Commission instructed to review the effectiveness of the new ID regime in achieving the objectives of Part 4 following the first price resets by the airports under the new regime.

61. It is noteworthy that in both instances where the Commission has subjected airport pricing outcomes to scrutiny, it has determined that airports are exercising monopoly power, resulting in outcomes detrimental to consumer welfare.

62. Air NZ has included this brief chronology of the governmental reviews of the regime to highlight what has become a substantial and ongoing regulatory failure. The Commission, the government's own independent and semi judicial regulator has plainly stated the ineffectiveness of this experimental regulatory

---

[7] Inserted into the Airport Authorities Act by the Airport Authorities Amendment Act 1997

[8] *Air New Zealand Limited and Others v Wellington International Airport Limited*, HC, WN CIV 2007, 485 1756 (24 April 2008), para. 26.

[9] Ibid, para. 39

[10] Ibid, para 42

approach which relies on consultation, countervailing power and the credible threat of regulation. Unsurprisingly the regime is without international comparators. The third leg of that regulatory approach, the credible threat of regulation, which is largely the driver of the Ministry's consultation document, was simply the final part of the experiment to be disproved.

The Airport Authorities Act 1966 and Part 4 Commerce Act 1986

63. Air NZ recognises that an important factor in the ability of airports to overcharge its customers is the unfettered ability of airports to set prices as they see fit (under the AAA) and that this provision (among others) is proposed to be removed as part of the AAA review. Air NZ's wholly supports this move, the reasons for which are fully outlined in the submission made to the Ministry of Transport on the Civil Aviation Act 1990 and AAA review in October this year.

64. However it is important to recognise that should the AAA be amended (as the Ministry of Transport recommends) only part of the problem will be solved. The question becomes – what happens in the vacuum? As the above chronology illustrates, airports have enjoyed decades of unsound pricing principles and legislative exploitation. In the absence of meaningful regulation the only guidance after the AAA pricing power is removed, is still to act 'as a commercial undertaking' (as confirmed by the Court). Countervailing market forces or negotiated and agreed pricing levels will not suddenly appear with the AAA's repeal; the strong power of the locational monopoly remains.

65. It is therefore critical that the amendments (or repeal) of the AAA is complemented by firm regulation. The Commerce Act, with its existing regulatory provisions, is the appropriate legislative vehicle to fill the vacuum but the relevant provisions must be able to be activated by the Minister.

Asset Valuation and Monopoly Pricing

66. The single most contentious issue underlying current airport pricing behaviour is that of asset valuation and specifically the treatment of asset revaluations. In simple terms, the building block financial model underpinning airport pricing determines allowable revenue to be a function of a normal return on an appropriately valued asset base. As such, the larger the asset base, the larger the revenue allowed.

67. As noted in above, one of the initial steps in corporatising the airports was the establishment of a valuation for each airport. Over the intervening three decades, airports have periodically revalued their assets, to the extent that more than 50% of the respective asset bases of the three major airports consist of revaluations – effectively phantom assets created by accounting policies – rather than representing capital actually invested in the business. Annual revenues (charges) associated with only these revalued assets on average amount to more than $90 million per annum across the three airports.

68. The extent of revalued assets as a proportion of total assets is a function of the fact that land forms a large part of airport assets, unlike most other regulated sectors. Proximity to large urban centres means that valuing land at its opportunity cost (i.e. next best alternative use) results in these land holdings being valued in a mix of residential, commercial and industrial use. However,

the valuation approach taken by airports does not include the costs of restitution to convert the land to the next highest and best use. If this economically sound approach was adopted the valuation would seldom exceed historical or indexed cost. Accordingly, it is unlikely the revaluations would exist if well established and economically sound principles were employed.

69. While revaluation of assets to reflect opportunity cost (when done correctly and based on sound economic principles) is not of itself economically invalid. The Commission has previously noted that it is important to ensure consistency between valuation methodologies and revaluation gains for pricing purposes:

> "Where a business sets prices and/or claims depreciation on an inconsistent basis (e.g. on the basis of revalued assets, but does not account for revaluation gains as income), then the Commission should not use the same methodology as the company for assessing excess returns. In that case the Commission must make the assessment by applying either of the approaches (i.e. ODV or historic cost approaches) in a consistent manner.
>
> If a business changes its valuation and price setting methodology part way through the life of the assets, and does not treat revaluation gains consistently, then it might earn excess or deficient returns, or the assessment of such returns could be obscured. In the gas industry, some businesses have moved from an historic cost to ODV valuation method for statutory reporting purpose. Excess returns may also be disguised where historic cost valuations are based on transaction values (excess returns may be capitalised into the sale price)."[38]
>
> ...
>
> "The Commission notes that it is not unreasonable for businesses to have adopted ODV as the basis for valuing their assets. If businesses have set prices on the basis of ODV and have treated revaluation gains as income, then it would be appropriate for the Commission to assess their performance using the ODV methodology. The Commission remains concerned, however, that the move from historic cost to ODV valuation could obscure the earning of excess returns. This could arise, for example, if businesses based their prices and depreciation on asset values, but did not treat revaluation gains as income for price setting purposes, or if revaluations were undertaken prior to the assessment period."[39] [11]

70. The simplest solution to this issue is to ensure that any revaluations are treated as part of the return that accrues to the owners from holding and using the monopoly assets. Revaluations may be included in the asset base for pricing purposes only as and when the corresponding revaluation gains/losses are accounted for as income for pricing purposes. Including the holding gains or losses as income in any year will reduce or increase the level of cash income required from users to achieve the required rate of return in that year.

[11] Commerce Commission, Final Report, Natural Gas Inquiry (29 November 2004), paras. 8.24-25 and 8.43

71. A holding gain for a productive asset (as reflected in a revaluation) can only arise if there is an expectation of an increase in future cash flows. A holding gain for a monopoly asset can only be sustained if cash flows from providing services using the assets are to increase in the future. This implies price increases, volume increases and/or cost efficiencies. There may be debate about the extent to which the benefits from cost efficiencies should be shared between customers and owners, but the spiralling concept of simply raising prices to support a revaluation of assets and revaluing assets to reflect price increases cannot be sustained.

72. Free of any effective regulatory constraint the major airports have generally set their own rules in valuing their asset bases and in accounting for such revaluations for pricing purposes. The result has been substantial revaluations which have then been used to justify large price increases for consumers. Airports have not treated the majority of the revaluations as part of their return (particularly in respect of unforecast revaluations) yet insist upon pricing such that they generate a return on the revalued asset base. This lack of symmetry represents an ongoing distortion in favour of the monopoly asset owners.

73. Revenues associated with revaluations amount to more than $90 million per annum. Consumers are therefore paying significant sums of money for nothing. This acts as a real impediment when airports need to actually invest in new or upgraded assets as prices simply need to rise again. As illustrated in above, this revenue associated with revaluations as opposed to actual investment represents more than the aeronautical revenue collected by either WIAL or CIAL in the 2014 financial year. At AIAL, the revaluation reserve makes up 86% ($2.1 billion) of its shareholders' equity.

74. Air NZ is always willing for efficient money spent to be fairly compensated but not when revaluations are not taken to income and when investment decisions are not based on sound economic principles.

Why does it matter?

75. It is important to point out the significance of finding the right approach concerning airport regulation. The argument is often portrayed as a battle between large corporate entities fighting for their share of revenues with little impact on the public or wider economy; a simple case of profit or surplus shift from one corporate to another.

76. The matter of airports' regulation is not however about Air New Zealand's bottom line nor in fact any airline's bottom line. There are several key reasons why this debate and the outcomes these regulations produce have much wider importance.

Legislative equality between corporates:

77. A hazardous practice exists in the relationship between the airport suppliers and their airline customers due to the structural inequality the legislation (AAA) provides and the lack of regulation under ID.

78. In an ordinary commercial relationship corporate entities are free to negotiate on a level playing field. While there will generally be differing objectives, different strengths and weaknesses the fundamental concept of legal equality remains. One side can challenge the other and seek compensation should a negotiated agreement be breached. Arbitration is provided if the parties have pre-conceived a stalemate situation and access to the Courts for effective determination is available. These tools assist in creating the certainty needed for enterprise to flourish.

79. Because of the backing of the AAA and the lack of credible regulation under ID, there is a significant imbalance in power in the relationship. This imbalance also exists in relationships with organisations such as Met Service, but this commercial relationship is generally good. The key difference seems to be the commercial motivation of a private company (as opposed to a Crown entity) to exploit the imbalance in power for the benefit of its shareholders. Airports regard input methodologies (which underlie ID) as simply a compliance requirement in the consulting process with no influence on the pricing decisions.[12] This highlights why, in the absence of enforcement, the regulation permits this significant power imbalance.

Innovative investment in infrastructure:

80. Major airports are commercial entities with, rightly, a profit maximisation objective. As a commercial entity that does not face competitive pressure, the airports will inherently be incentivised to increase the value of their assets (either through investing in additional assets or simply revaluing existing assets) wherever they can make a return at, or above, their cost of capital. Consequently the airports are not incentivised to undertake activity that does not increase investment and are not incentivised to ensure that investment is efficient.

81. Most innovation at airports in New Zealand is airline-led, with airports generally only responding to airline requests. Where airports lead the process, the solutions are usually more expensive than required. Air NZ is often able to put forward solutions which utilise technology and innovation to deliver a more efficient and productive investment and operational outcome.[13]

82. In a workably competitive environment creating efficiencies, including through innovation, is a core element of competition. However, in the current environment where airports remain unconstrained, investment is favoured over innovation. For example, if a 10% increase in passengers can be accommodated via more efficient use of the existing terminal or via increased capital expenditure, airports maximise profit by the increased expenditure, rather than improving the efficiency of the existing asset.

83. This 'bricks and mortar' approach to airport investment does not reflect the smart transport systems and processes a developed economy should be

[12] Letter in response to Air NZ notification of delayed payment of increased charges, July 2012.
[13] For example the use of kiosks to replace check-in counters or the better utilisation of aircraft through increased capacity rather than increased frequency e.g. replacing the Boeing 737 with the Airbus A320.

striving for. To move towards innovation over investment (in the built asset base) does however, run counter to a cornerstone of the airports' business model.

84. A constant ability to revalue is a disincentive for necessary investment. The current system encourages airports to simply revalue their way to profit. There is a high risk of ultimately being in a situation where there is substandard infrastructure of increasing age, while at the same time paying the price for assets that do not, in reality, exist.

Detrimental impacts on tourism and transport sector:

85. As stated Air NZ's own estimates suggest that revenue of approximately $90 million per annum accrue to all three major airports through revaluations. Given the significant impact revaluations have on pricing levels, overcharging by airports over long periods results in hundreds of millions of dollars being extracted from the economy. These profits do not re-appear in the same industry. They are not re-invested by airports. They are charged to the airline, which either absorbs them or passes them onto passengers (or both).

86. If charges were lowered airlines could not retain the surplus obtained from these lower charges. Due to a combination of the intense competitive nature of the industry, the high visibility of air fare levels, public expectations and the critical re-investment component of the industry, profits such as these would simply be passed onto the end consumer or reinvested back into the business (including into airlines' airport operations).

87. This re-investment, particularly through enhanced customer experience, sustainability of operations or decreased airfares (in general or through targeted campaigns) means traffic volumes ultimately increase. This is crucial to New Zealand where, as stated, the cost of travel (and ultimately sustainability of services) largely depends on maximising the economies of scale through growth.

88. Airport charges at their historical, current and projected levels, do not only impede future growth but contribute to the deterioration of existing service levels. For example, in 2012 Air NZ reduced frequency between Wellington and Gisborne as airport companies at both ends of the route imposed the equivalent of a 50% combined price increase in landing charges. Air NZ's best option was to up gauge the aircraft servicing this route and reduce frequency to minimise landing fee costs. Consumers as a result had to accept the less convenient lower frequency.

89. In November 2014, Air NZ announced the complete withdrawal of services from several regional towns and the lessening of frequency to some others. Air NZ stops short of saying airport charges were the cause of this reduction, however they were and are a contributing factor to the marginal economic viability of some services.

90. Where services are challenged in the way that some of Air NZ's regional services are, increases in airport charges do not just make them more

challenging, they completely destroy the economics and sustainability of the service.

91. In essence, the current airport regulatory regime results in the significant destruction of wealth and the misallocation of resources in the economy. These outcomes are a result of the incentivised and inefficient use of capital either through the syphoning of significant profits (through dividend or capital returns) back to shareholders or through questionable “re-investment”. Ultimately this is to the detriment of the travelling public, cargo services, other end consumers and the economy in general.

Answers to the Ministry's consultation document.

Are there any reasons why the Commission's analysis should not be accepted?

92. Air New Zealand considers the Commission's reviews of the airports' pricing decisions have reached generally sound conclusions regarding the lack of effectiveness of ID in promoting the purpose of Part 4. The fact that the Commission identified that CIAL and WIAL were not limited in their ability to extract excessive profits, and that AIAL would be achieving an "above normal" return, confirmed the concerns airlines have had for decades regarding the pricing behaviour of New Zealand's major airports, including the mechanisms by which they were seeking to justify their inflated prices.

93. While WIAL has subsequently re-consulted and set prices which will deliver returns closer to the appropriate level as envisaged by Part 4 of the Commerce Act, and CIAL has sought to correct errors in its calculation of tax and improve the transparency of its disclosures. ID itself has proven to be ineffective in achieving the purpose of Part 4, as evidence by the fact that no change in pricing behaviours or outcomes were observed prior to, during or after the price setting event. Accordingly, the Commission's analysis remains appropriate.

94. There is a suggestion that an equivalent of a Section 56G report be held for each airport after every price setting event on a permanent basis; this somehow being stronger regulation. Air NZ would reject this approach as simply a continuation of the ineffective regulation. Not only is the Section 56G process a significant drain on time, resources and a financial burden for all participants (including the Commission) the outcome of the process lacks any enforcement capability. The Commission may report to the relevant Ministers, but it cannot make recommendations and may only consider the issues in such a narrow scope so as to avoid judicial review. As the Commission and Ministry have pointed out, the Section 56G reports were one-off events and therefore a legislative change is required to make these permanent. If the Ministry is prepared to open the legislative process to make this change, then surely a more robust change, future proofed and more likely (and in some cases proven) to produce the outcomes intended under Part 4 is the appropriate response.

Are there any matters that were not considered that you believe may have affected the Commission's conclusions?

95. Air New Zealand, in its 29 June 2012 submission to the Commission regarding WIAL's pricing decision, made the following submission:

    a. *During the process of developing the IMs the Commission, and indeed experts for all parties, were very mindful of the unique nature of airports and the demand complementarity between regulated and unregulated services. As such, the Commission noted that its ability to require these s 53D disclosures would address expressed concerns that the proposed cost allocation IM would not provide an accurate picture of the business performance.*[14]

[14] Airports Final Reasons Paper at fn 124.

b. *Air NZ submits that the current focus on a portion only of airports' businesses does not allow for a proper assessment of whether the purpose of Part 4 is being met. In many jurisdictions where effective regulation of airports is applied, prices for aeronautical services provided by airports are set after taking account of forecast revenues from non-regulated parts of the airport. In this way the overall return of the airport is taken into account when establishing prices for monopoly services. This reflects practice in competitive markets where a business owner, when assessing returns, will consider the overall performance of the business rather than the individual business units. Analysis of individual business unit performance will be important in ensuring that all are performing effectively but the overriding concern is the overall performance. Air NZ considers that the Commission must undertake such an analysis to properly understand airport performance, and require sufficient information to allow it (and other interested persons) to do so.*[15]

96. The Commission responded that in its view such an analysis was not within the scope of its review and therefore it would not be considered as part of the s 56G review process.

97. In Air New Zealand's view had the Commission undertaken such an analysis it would have undoubtedly impacted on the Commission's conclusions, particularly in respect of AIAL.

98. As highlighted in Cameron Partners' analysis (Attachment II), AIAL has clearly been able to leverage its monopoly position to extract overall returns well in excess of general market and comparator performance. This suggests that any efficiencies AIAL is achieving are not being shared with consumers, as would be expected in a workably competitive market, but instead are accruing solely to shareholders.

Are there any new matters or information that may affect any of the Commission's conclusions regarding the effectiveness of information disclosure for the three major international airports? If so, how?

99. As the Ministry has noted in its discussion document, the Commission in response to comments from the High Court has undertaken a review of its WACC IM in relation to the appropriate percentile to use in assessing price-quality regulation for electricity lines and gas pipeline businesses. The outcome of this review was to reduce the WACC percentile from the 75th to the 67th percentile, which is expected to deliver benefits to consumers in the order of $45 million per annum through lower prices.

100. The Commission has indicated its intention to similarly review the appropriate WACC percentile to be used when assessing airport pricing outcomes. It has noted that a number of experts have indicated there are particular characteristics of the three major international airports, i.e. the impact

[15] Air New Zealand Limited, Submission to the Commerce Commission, Section 56G Review (29 June 2012).

of the dual till, which suggest that no uplift from the mid-point WACC is justified. It appears that the Commission is at least attempting to compensate for the existence of the flawed economic principles that underwrite regime's failure.

101. While the Ministry is technically correct in noting that any change to the appropriate WACC percentile resulting from this work is relevant to future price setting periods rather than the 2012 price resets, it can't be ignored that had the Commission applied a level below the 75th percentile for assessing future returns, rather than two airports being found to be targeting excessive returns, all three airports would have been found to be targeting excess returns. As it is, the Commission did conclude that AIAL would be achieving above a "normal return" at the level of pries it had set and estimated excess revenues (i.e. above the mid-point WACC) over the period of $72.1 million.

102. We have commented above on the implications of WIAL and CIAL acting to address concerns raised in the Commission's section 56G reports. As noted these actions do not affect the Commission's conclusions on the effectiveness of ID.

In areas where the Commission has been unable to draw a conclusion on the effectiveness of information disclosure, do you consider it likely that conclusions would be able to be drawn in future?

103. The areas where the Commission was unable to draw a conclusion related to incentives to invest, Incentives to achieve efficiencies in operating expenditure and incentives to share efficiency gains

104. Air New Zealand considers that in all these areas, the development of a time-series of information will assist in enabling conclusions to be made in the future.

105. It is of some concern that the Commission felt able to reach the conclusion it did regarding the effectiveness of ID in constraining AIAL's pricing when it was not able to identify any impact on operational or capital expenditure efficiency or on the sharing of efficiency gains.

106. As noted by the Commission in its section 56G report on AIAL (para. 2.23)

Given the incentives already in place, the most obvious additional incentives provided by information disclosure regulation are on Auckland Airport's ability to earn excessive profits, and on its sharing of efficiency gains with its consumers. This is because of the relatively weak incentives on Auckland Airport in these areas of performance without regulation. Information disclosure under Part 4 should be particularly effective at highlighting concerns about excessive profits (and therefore prices), which heightens the credible threat of further regulation.[20] It is also the area of performance that is most likely to lead to more heavy-handed regulation if the desired outcomes are not being achieved. Incentives from the threat of further regulation are therefore likely to be strongest in this area.[21]

16

107. Cameron Partners' analysis (Attachment II) highlights the fact that AIAL has not been sharing efficiency gains with consumers, but instead has been cycling excessive profits back to its shareholders. This would suggest that ID has been ineffective. Air NZ contends that no regulator could be satisfied that the current regulatory regime was meeting the intention of Part 4 (particularly in limiting the ability to extract excessive profits in 52A (d)) when faced with the striking information illustrated in the Cameron Partners' analysis.

What scope of future analysis by the Commission would ensure that sufficient information is readily available to interested parties to assess whether the purpose of Part 4 is being met?

108. The section 56G review process highlighted the necessity for detailed consideration of airport pricing decisions by an independent body in order for proper conclusions to be drawn as to the likely outcome of those decisions. The review process identified that there was significant complexity in the different frameworks and approaches adopted by the airports and that these differences could create real difficulties for interested parties in understanding those airport pricing decisions.

109. Future analysis along the same lines as pursued by the Commission during the section 56G reviews would go some way to ensuring sufficient transparency of airport pricing decisions and to allow interested parties to assess whether the purpose of Part 4 is being met. Air NZ notes however that under the alternate negotiate / arbitrate regime, there would be no need for this analysis as participants themselves understand the information.

Is information disclosure for major international airports working effectively to achieve the objectives in Part 4 of the Commerce Act?

110. ID, in and of itself, is not working effectively to achieve the objectives of Part 4. While interested parties have access to a broader range of information regarding airports' historical and expected performance, the availability of this information does not impact on airports' ability and willingness to use their AAA entitlement to set prices as they think fit.

[16] Commerce Commission, Final Report to the Ministers of Commerce and Transport on how effective information disclosure regulation is promoting the purposes of Part 4 (Commerce Act) at Auckland International Airport Limited (31 July 2013), para. 2.23

111. InterVISTAS discuss the effectiveness of ID alone as a regulatory mechanism:

> *…information disclosure is useful but unlikely to be able to constrain potential abuse of market power at New Zealand's gateway airports. Airport operators complying with information disclosure requirements, still have an ability to ultimately and unilaterally impose price increases. The power of information disclosure as a light handed constraint on airport market power depends on the credibility of the threat of imposing regulation. Australia has a credible threat of reregulating its airports as it previously regulated these operators and continues to have legislation and regulations in place to quickly re-establish regulation. This is not the case for New Zealand…Thus New Zealand needs an additional constraint on the potential exercise of pricing market power by its gateway airports.*[17]

112. As noted by InterVISTAS the key to an effective regulatory regime is the credible threat of negative consequences in the event of a regulated entity not acting in accordance with the intended objectives. This credible threat, and a simple mechanism to impose it, is missing from the New Zealand landscape.

How does the presence of information disclosure affect how prices are set under section 4A of the AAA?

113. The impact of ID on price setting is limited to determining how information is provided, i.e. the structure of financial models and categories in which information is grouped. Beyond this airports remain unconstrained in their ability to take comments on board, or not, as they see fit.

Vice versa, do the price setting provisions in section 4A affect how effective information disclosure is in promoting the purpose of Part 4 of the Commerce Act?

114. The price-setting provisions in section 4A of the AAA are totally undermining any effectiveness of ID in promoting the purpose of Part 4.

115. Airports remain required by the AAA to operate commercially and set prices as they think fit. As noted by Justice Barker in the 2002 WIAL arbitration award:

> *The requirement under the [Airport Authorities] Act is for the airport to act commercially and therefore to obtain the best possible return on its assets as permitted in law.*[18]

116. Barker J recognised that as commercial entities beholden to shareholders the airports are entitled to exploit legislative short-comings with a profit maximisation objective.

117. The input methodologies underpinning ID are relevant only to disclosure and airports are not legally required to comply with them when setting prices. In the absence of anything in statute setting out a framework or

[17] As above, n 2, 38.
[18] Final Award of Sole Arbitrator, the Hon. Sir Ian Barker, Q3 (23 September 2002) para. 191

expectation of the outcome prices are meant to achieve, and in retaining an absolute statutory right to set charges as they think fit, airports remain free to price however they please with no regard to consumer interests.

118. As Barker J also noted:

> *The root cause of the airlines' dissatisfaction may be the failure of the legislature back in 1986 (and again in 1997) (a) to institute anything other than the 'light-handed' regulatory regime outlined in this award; (b) to replace that regime with something more prescriptive such as a regulator or a dispute resolution process; or (c) impose some criterion for assessing charges, such as 'fair and reasonable'.*[19]

119. At present, achieving pricing outcomes which reflect the purpose of Part 4 of the Commerce Act is dependent on an airport's management and board reaching pricing decisions under section 4A of the AAA which are also consistent with the Part 4 purpose statement. There is nothing to prevent current or future managements and boards making decisions which are inconsistent with Part 4 of the Commerce Act.

If section 4A of the AAA is removed for smaller airports, would this have an effect on price setting for major international airports? Should it be removed for larger airports also?

120. Section 4A of the AAA should be removed for all airports. If it were removed for smaller airports only, it would have no impact on price setting for major international airports as they would still be protected by the AAA provisions when setting prices.

How does the presence of information disclosure impact on the consultation requirements in section 4B of the AAA?

121. As noted above, ID has a limited impact on consultation in terms of providing a framework in which information is provided, including the structure of models and categories under which information is grouped.

Do you have any comments on how the requirement to consult on capital expenditure in section 4C of the AAA fits into the overall regulatory regime for major international airports?

122. The engagement mandated by section 4C is crucial to ensuring that airport capital expenditure proposals meet airport users' and consumers' needs and reflect the most effective and efficient outcomes, including in terms of innovation.

123. The requirement to consult on capital expenditure is therefore a critical feature of the regulatory regime for major international airports. Also, and as noted by the Ministry of Transport in its consultation document on the Civil Aviation Act and Airport Authorities Act, the requirement to consult is an

[19] Ibid, para 190.

obligation under International Civil Aviation Organisation policies and pursuant to some of New Zealand's Air Services Agreements. (p.145, E3, 53.1)

124. The necessity for consultation on capital expenditure also arises from the fact that the building block model under which airports establish prices, relies on increasing asset values to drive increased revenue requirements, hence increased charges. This consultation requirement provides some opportunity for users to note their support or objections to the extent of expenditure and consequent charges.

125. It is clear however that the current threshold for consultation (20% of identified airport assets) is inappropriate. In the case of AIAL, with identified assets in excess of $1 billion, this requirement is triggered only in respect of expenditure in excess of $200 million. Notwithstanding this, it is noted that AIAL currently voluntarily initiates consultation in respect of consultation well below this level.

126. This issue is currently being addressed in the context of the separate review by the Ministry of Transport of the Civil Aviation Act and Airport Authorities Act.

Do you see any issues in the interaction between the Commerce Act and the AAA for regulation of price setting at major international airports?

127. Lack of interaction between the Commerce Act and the AAA is the key impediment to developing an effective and efficient price setting regulatory regime for the major international airports.

128. At present the Commerce Act has no bearing on price setting as its consumer welfare objectives are subordinate to the AAA requirement ability to set prices as airports see fit, to act commercially and, in the words of Barker J, airports are required to "obtain the best possible return on … assets as permitted in law."[20] Given the absence of a legal framework underpinning the objectives of price setting and an untrammelled right to set charges as they think fit, airports are therefore incentivised to increase charges to whatever extent they consider desirable.

129. Development of an effective and efficient pricing regime for the major international airports which is focussed on achieving the outcomes sought by Part 4 of the Commerce Act requires removal of the AAA power of airports to set prices as they think fit and placing the Commerce Act Part 4 purpose statement front and centre in the price-setting process with the enforceability of a credible threat of regulation being the key enabler.

[20] Above n 15.

Negotiate / Arbitrate

130. Throughout this submission Air NZ refers to its preferred option of Negotiate / Arbitrate regulation as a way forward for airport pricing regimes. At this juncture, given the current state of the commercial relationship and the demonstrated failure of ID, employing negotiate / arbitrate is self-evident in the purpose section for the regime:

> 53G Purpose of negotiate/arbitrate regulation
>
> *The purpose of negotiate/arbitrate regulation is to encourage a supplier and its customers to reach agreement, through negotiation, on the supplier's prices and quality standards during a specified regulatory period, and to provide for binding arbitration if negotiation is unsuccessful.*

131. Other key reasons for Air NZ's preferred option of negotiate / arbitrate include:

a. Negotiate / arbitrate is a light handed form of regulation, unlike price control;

b. The provisions catering for negotiate / arbitrate already exist in the Commerce Act and are a logical (and promised) progression on the regulatory scale;

c. Negotiate / arbitrate, especially 'final offer arbitration' (as described by Dr Trethaway) requires parties to put their best offer forward at arbitration, where only one can be chosen. This stops 'gaming' the system and incentivises realistic and rationale outcomes. The "best offer" in arbitration is made with reference to the input methodologies that are based on sounds economic principles;

d. The regime provides certainty in the form of regulatory timeframes and ultimately, independent decision making;

e. Nothing in a negotiate / arbitrate regime prevents side deals or other agreements being made between an airport and different airlines;

f. Negotiation is the critical first step in the process and most matters are likely to be resolved at this juncture. In reality this means that sophisticated commercial entities such as airports and airlines (well-schooled in negotiation for mutual gain) can reach agreements without regulatory interference. Indeed, the success of an arbitration regime is measured by the infrequency of its use;

g. Open negotiation processes will naturally provide a forum for other areas of concern or opportunity to be jointly explored;

h. Long term commercial agreements where the airport makes an above normal return and the airline pays (and has to ultimately recover from

consumers) less than monopoly prices are likely, creating value for all participants;

i. There is the potential for a body of negotiated and arbitrated decisions to develop, creating a precedent value so that issues are not constantly re-litigated.

j. Sound economic principals are promoted by ensuring the outcomes achieved (commercially negotiated agreements) are consistent with outcomes produced in competitive markets

Conclusion

132. The potential exists in New Zealand to create a sophisticated aviation consortium that develops new offshore markets and promotes innovation. This would expand New Zealand's (and 'NZ Inc.'s) reach into key markets in South East Asia, the Pacific and other priority trade hubs. Inbound tourism and outbound connectivity are common industry goals.

133. The only way to create an effective grouping of industry participants is to have the largest participants in the tourism and aviation industry working together on projects of mutual benefit. While this goal seems possible, the toxicity of the airports' regulation debate and the related fundamental differences of participants driven by statutory incentives means that beyond operations, there is minimal co-operation between the biggest players.

134. Air NZ and airports are the most significant individual commercial organisations in the New Zealand tourism industry. There would be value in having highly aligned strategies, communications with customers and growth plans. Airports have developed a very supply side view of market development and are driven by a belief that increasing airline seat supply should be their primary objective. They have communicated their strategy effectively and developed a belief in its effectiveness, even while the sustainability of the results of the strategy seem questionable.

135. Air NZ is a highly successful airline, but its growth ambitions are not clearly understood and our questioning of the sustainability of the airports' approach has been perceived as protectionist. Attempts to engage with airports at a corporate level have improved communication but organisational strategies are not aligned or co-ordinated.

136. The only way to foster an environment of collaboration in the sector is to resolve the issue of pricing regulation in an enduring fashion and that resolution can only be achieved by legislation. As has been recognised for many years, airports are monopolies and effective regulation is necessary.

137. While effective regulation has been recommended and in some cases attempted, a brief historical summary of the issue shows plainly how a statutory power has been allowed to permeate through a commercial operation. The commercial imbalances and societal detriments this government omission and commercial opportunism creates are a severe constraint on collaborative growth of tourism and commerce.

Attachments:

Attachment I: InterVISTAS Report (Dr. Mike Trethaway) 2014

- Issues Regarding Regulation of New Zealand's Gateway Airports

Attachment II: Cameron & Partners Report (2014)

- Auckland International Airport Returns Analysis AIAL Returns Analysis