

Paul Lindwall
Presiding Commissioner
Economic Regulation of Airports
Productivity Commission

6 September 2018

Dear Paul

Re: Economic Regulation of Airports

1. Air New Zealand is pleased to submit to the Productivity Commission with respect to its review of the price monitoring regime in Australia. We were also pleased to meet with the Commissioners to discuss the review in August 2018, and to compare the regulatory settings of New Zealand with those in Australia.
2. In the hope that it will assist the Commissioners, Air New Zealand's submission focuses on the similarities and differences in the regulatory settings for airports in New Zealand and Australia, where we see strengths and weaknesses, and what the results of these settings have been in New Zealand. We consider that these are 'matters relevant to the terms of reference'. We would be happy to answer any questions the Commission may have as they complete their enquiry.
3. Air New Zealand is also party to submissions made to the Commission by the Board of Airline Representatives of Australia (BARA) and by Airlines for Australia and New Zealand (A4ANZ). We are supportive of the submissions of these organisations, both of which answer specifically the questions raised by the Commissioners in the Issues Paper.
4. Air New Zealand operates to Sydney Melbourne Perth, Brisbane, the Sunshine Coast, Adelaide, Cairns and the Gold Coast. Flying on the Tasman is a fiercely competitive environment. Like all airlines in this market Air New Zealand is sensitive to costs, and looks for high levels of service from airports so that on-airport need are met and customers experience seamless service.

Regulatory Regime in Australia

5. Air New Zealand observes that there is currently a price monitoring regime in place in Australia, and that contracts are required to be negotiated between airports and airlines. The price monitoring regime replaced the price cap regime in 2002, and is 'light handed regulation' similar to New Zealand's information disclosure regime. Price monitoring applies to Brisbane, Perth, Melbourne and Sydney. Additionally, second tier price monitoring applies to Canberra, Darwin, Gold Coast and Hobart.

6. The ACCC delivers annual reports for those airports subject to the price monitoring regime. From time to time, the Australian Government refers the subject of airport regulation to the Productivity Commission. The Productivity Commission is directed to review the regulatory settings, and the terms of this review are set by the Treasurer under the Productivity Commission Act. The findings of the Productivity Commission are then delivered to the Australian Parliament.

Regulatory regime in New Zealand

7. New Zealand also operates light handed regulatory regime for what are known as specified airports. Auckland, Wellington and Christchurch airport companies are currently included in the regime.
8. The specified airport companies are required to make annual disclosures, reporting on metrics specified by the Commerce Commission. The airport companies must set prices at least every five years. Following the price setting event, the Commerce Commission reviews prices as set, though any findings of the Commission are not binding on airports.

New Zealand – Australia: airport regulatory regime comparison

9. Below is a comparison of key metrics of the regulatory regimes in each country, as observed by Air New Zealand. Naturally, we defer to the national competition regulators with respect to each regime; though every effort has been made to ensure factual accuracy.

Australian regulatory environment for airports	New Zealand regulatory environment for airports
<p>Airports are largely privately owned and operate in a dual till environment</p> <p>The ACCC operates a price monitoring regime which includes the collection of data on the provision of aeronautical services, including car parking and landside access.</p> <p>A voluntary price monitoring regime exists for some regional and capital city airports.</p> <p>The ACCC does not regulate other 'second till earnings' arising from services offered by the airport companies including retail or commercial lease outside terminal and tarmac.</p>	<p>Airports are largely privately owned and operate in a dual till environment.</p> <p>The Commerce Commission does not regulate prices, but rather regulates aeronautical services offered by specified airports via information disclosure These include terminal and tarmac services.</p> <p>The Commission does not regulate 'second till' earnings arising from services offered of the airport company including retail, commercial lease outside the terminal or tarmac, car parking, landside access for taxis or public transport</p>
<p>Four major airports are subject to price monitoring: Sydney, Brisbane, Perth and Melbourne Airports</p>	<p>Three airports are specified airports and are currently regulated by information disclosure: Auckland, Wellington and Christchurch airports.</p>
<p>No airport specific WACC is published by the ACCC</p>	<p>An airport specific WACC is published annually by the Commerce Commission but is not binding</p>
<p>Airports will target their own cost of capital but the parameters for setting the WACC, and the inputs to WACC may be different per airport.</p>	<p>Airports nominate their own cost of capital, using specified parameters, but may vary these parameters to suit their 'unique circumstances'.</p>
<p>The ACCC collects and publishes data on ROI, capex and opex, airside and landside services, quality and cost. These results are published annually, and the ACCC may make comment on performance.</p>	<p>The Commerce Commission collects data from specified airports on ROI, capex and opex and service metrics, provided audited and certified by airports.</p>

While it is possible for the ACCC to recommend a price inquiry into airports, they have not done so.	These are published on airport company websites and are published by the Commerce Commission. The Commerce Commission publishes compilations of these results so that metrics may be compared by port.
There is a documented contract between airports and airlines	There is no contract between airports and airlines
Contract lengths vary	Prices must be set by airports at least every five years
Pre-funding aeronautical assets is possible	Pre-funding aeronautical assets is possible
The Productivity Commission inquiry represents a form of regulatory threat, in that they may change the form of regulation	Current legislative changes to the Commerce Act may introduce a regulatory threat, providing a pathway to tighter regulation for services offered by specified airports.

10. Air New Zealand submits its own observations on these settings below. It encourages Commissioners to discuss these settings with agencies and policy makers in New Zealand, as well as Australia, as it continues its enquiry. New Zealand is currently at a regulatory and legislative crossroads when it comes to settings for airports, and bilateral observations will certainly be of interest to Commissioners.

Dual till environment

11. New Zealand and Australia both operate a 'dual till' regulatory environment for airports, though in Australia regulators also monitor additional services under the regulatory umbrella, such as landside access or car parking services offered by airports. It has been noted by IATA that the dual till model does not replicate a competitive market, brings cost allocation challenges, and poorly incentivises airports to invest in aeronautical infrastructure.¹
12. Earnings from airport companies from commercial tills and aeronautical tills are inextricably linked. Airport companies are incentivised to invest in retail and commercial leases while withholding investment in aeronautical assets. Nowhere is this more starkly played out than at Auckland International Airport Limited (AIAL) where the Commercial landholding in the airport precinct is extensive and well invested in, while the terminal assets have degraded. Now that AIAL is working towards a new integrated terminal, it is the retail spaces of that terminal which have been progressed, as earnings arising from these spaces are unregulated.

Return on investment – the question of WACC

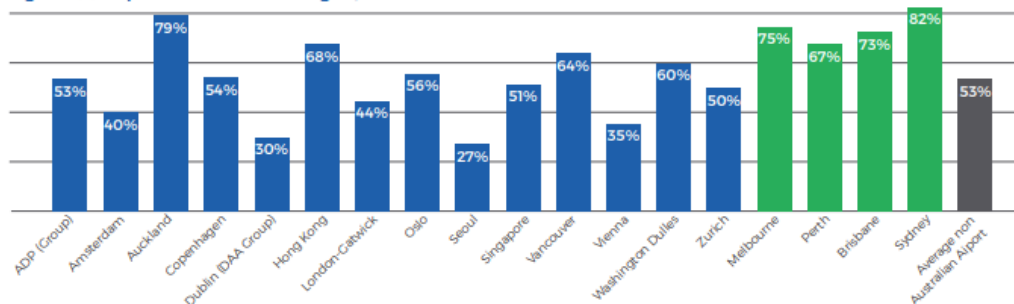
13. The dual till environment should, in theory, provide sufficient incentive for airports to invest in their facilities. Investment in aeronautical facilities should deliver increased passenger flow, and in turn deliver benefit to commercial tills. However, this does not appear to be the case in either New Zealand or Australia. We see airports like Auckland Airport investing in commercial landholdings, in retail options, and in car parking, while the aeronautical assets are left to sweat.
14. In the Australian environment, there is no regulatory WACC published, nor must airports follow a particular model for forecasting target returns when negotiating prices. This lack of transparency means that it is not always clear what returns are being targeted at the time prices are set, on what basis returns are targeted, or whether these returns are reasonable or otherwise.
15. In the New Zealand environment, the Commission publishes a regulatory WACC for airports based on parameters set in Input Methodologies. However, specified airports consider they are free to vary the inputs to the airport-specific WACC, and to base these on their own circumstances. They base this view on other legislation which currently exists in New Zealand – the *Airports Authorities Act 1966*. This piece of legislation, which has existed since before airports were privatised, contains a clause relied on by airports noting they may '*price as they see fit*'.² While it is not clear that this subverts the regulatory intention set out in New Zealand's *Commerce Act 1986*, it creates an unhelpful environment for clear regulatory settings.

¹ <https://www.iata.org/policy/Documents/single-till.pdf>

² Airports Authorities Act 1966, s.4A

16. Until recent years, New Zealand’s Commerce Commission published a WACC range. When specified airports set prices under such settings, they consistently set prices targeting the top of the Commission’s WACC range.
17. Cost of capital is at least a transparent parameter in the New Zealand environment, thanks to the requirements of Information Disclosure. Price consultation includes the building blocks of WACC, and the final decision on price setting is summarised in price setting disclosures, and then annually noted in information disclosures, where returns above or below target are noted.
18. However the total regulatory settings in the New Zealand environment have led to some airports making returns far above those targeted. These excess profits have been returned to airport company shareholders, rather than invested in infrastructure. Auckland Airport, for example, has a policy in place for 100% returns to shareholders. In addition, in the last five year price period AIAL made a special capital return to shareholders of \$454m – before beginning a price consultation with airlines in 2016 which covered the requirement for extensive investment in aeronautical assets, which airlines were required to pay for.
19. Air New Zealand observes that Australian and New Zealand airports make some of the highest returns for their shareholders globally, as light handed regulatory settings allow for monopoly profits to be extracted. Sydney Airport in fact has the highest EBITDA margins of global airports as set out by Frontier Economics in a paper for A4ANZ - with Auckland Airport running a close second. Airports operating under price monitoring in Australia all had EBIT margins above 67%-with Sydney enjoying margins at 82%.³

Figure 4: Comparison of EBITDA margins, 2008-2015^d



Source: Frontier Economics calculations 2018

Negotiated contracts

20. One of the principal differences in the Australian and New Zealand regulatory regimes is the existence or otherwise, of a contract for services at a price. In the New Zealand environment, specified airports set prices that airlines must pay. No contract exists for delivery of promised services or capital expenditure. In

³ https://www.a4anz.com/documents/A4ANZ_Report-The_Performance_and_Impact_of_Australia's_Airports.pdf page 9

Australia, contracts are negotiated at each airport, though subject matter and clauses vary at each.

21. In Australia, Air New Zealand allows BARA to make early contract negotiations with airport companies. Once negotiations have reached a certain point, we enter into individual discussions, and may or may not improve on terms reached by BARA. Contract negotiations vary in length and outcome. Air New Zealand does not consider that contracts negotiated are free commercial contracts. The monopoly power of airports is present in all negotiations, and any improvement Air New Zealand is able to gain in any particular port represents minor shift in generic contract terms.
22. It is difficult for Air New Zealand to compare terms offered between Australian ports, as terms are not aligned, and target returns are not clear. We draw Commissioners attention to the sample contract terms set out in the BARA submission. It is clear that the airlines are payers of monopoly rents thinly veiled in 'negotiated contracts'.

Regulatory threat

23. For any regulatory regime to be effective, there must exist a regulatory threat. From Air New Zealand's vantage point, it seems that the review of the Productivity Commission represents that regulatory threat in Australia's price monitoring environment. While the ACCC price monitoring reports summarise outcomes at airports subject to the price monitoring regime, these reports do not consider whether the price monitoring regime represents effective regulation. This is the question asked of the Productivity Commission, as set out in detail in the scope of inquiry.
24. In the New Zealand environment, current regulatory settings do not deliver a clear regulatory threat. Airports set prices and airlines must pay. Excess returns earned by airports may be returned to shareholders. Airports are strong performers on the New Zealand stock market – they deliver high returns at low risk. However, New Zealand's regulatory settings may be about to change.
25. The Commerce Act Amendment Bill, now before Parliament in New Zealand, makes clear a pathway to deeper regulation for airports which are found to target excess profits. If passed in its current form, these amendments will ensure that specified airports are able to be moved from light handed information disclosure regulation to either negotiate/arbitrate regulation, or to default price path regulation, both of which are already allowed for in New Zealand's Commerce Act.
26. Air New Zealand has submitted extensively on the current price review of Auckland and Christchurch Airports, and on the Commerce Amendment Bill, that negotiate/arbitrate regulation would improve outcomes for consumers, and would restrain airports from excessive profit taking.

27. The concept of negotiation of contracts against a regulated set of inputs as 'base outcomes' set by the regulator would drive both parties towards a 'best' negotiated outcome, as base outcomes would already be known. Base settings could include a regulatory WACC. If airports wished to outperform their regulated WACC, they would have to improve service offerings or actually deliver capex plans - rather than setting capex plans and then shifting delivery timelines to the right.

Further questions

28. Air New Zealand welcomes any further questions from the Commissioners as they continue their inquiry process

Regards,

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