AIR NEW ZEALAND

11 October 2006

The Commissioner
Productivity Commission
PO Box 80
Belconnen
ACT 2616
AUSTRALIA

Dear Sir

Please find attached Air New Zealand's response to the Productivity Commission's ("the Commissions") 2006 Draft Report entitled "Review of Price Regulation of Airports Services".

While offering Air New Zealand's viewpoint on several of the Commission's draft recommendations, the following response also attempts to provide the Commission with insights into the difficulties associated with the current "light handed" regulatory regime in New Zealand. It is hoped that these insights highlight some of the key areas in which improvement is required and, using the New Zealand situation as an example, highlight the consequences of not doing so.

Please contact the writer if you have questions in relation to this material or require further information.

Yours sincerely

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KEY POINTS

- ***Don't agree that continuation of a dual till approach is appropriate***
- ***Agree that price monitoring should continue***
- ***Agree that future asset revaluations should not provide a basis for higher charges***
- ***Submit that an effective dispute resolution mechanism is an unavoidable requirement if realistic commercial negotiations are to occur with what are otherwise monopoly suppliers***

INTRODUCTION

As noted in the Commission's draft report, only New Zealand and to a much lesser extent the UK have pursued the sort of light handed regulatory approach for major airports adopted by Australia. Many distinctions can be drawn between the New Zealand and Australian experience. In New Zealand, the lack of a price monitoring regime[1], the lack of a statutory equivalent of Part IIIA of the Trade Practices Act, and the existence of a statutory entitlement for airports to "set such charges as they think fit" means that the shortcomings of the "light handed" regulatory regime are more pronounced than is the case in Australia. Some would argue that the New Zealand regulatory regime is practically non-existent.

That said, the shortcomings of the existing "light handed" approaches on both sides of the Tasman, have tended to manifest themselves in the same way:

(a) charges at the main capital city airports have increased significantly relative to changes in actual costs;

(b) Auckland and Wellington airports have both re-determined the financial value of their aeronautical assets leading to increases in charges and very large associated windfall gains;

(c) the lack of clarity and specificity around the aeronautical information disclosure regime has tended to mask the performance of the airports' aeronautical activities rather than expose instances of monopoly abuse; and

(d) the imbalance of bargaining power between the airlines and airports has resulted in protracted price "consultation" events at the conclusion of which airlines have been left in the unenviable position of repeating their concerns as airport companies inexorably move on to set charges. This imbalance is reinforced by airports' statutory entitlement to "set such charges as they think fit" – an entitlement quite without precedent in any other regulatory regime that we can think of (let alone a regime designed to curb the exercise of monopoly power).

The "light handed" approach in New Zealand was founded on the following key assumptions:

(a) airlines possess significant countervailing power;

[1] The only price monitoring that is done is by BARNZ on behalf of the airlines. Neither the Ministry of Transport nor the Commerce Commission routinely monitor the airport pricing situation.

(b) the existence of an information disclosure regime and the provision of a “consultation” process would strengthen user’s countervailing power and expose instances of monopoly abuse; and

(c) the threat of re-regulation would impose sufficient constraints on monopoly abuse.

However, as is the case in Australia, the New Zealand Commerce Commission has generally accepted that users have little or no countervailing power particularly at major airports and experts agree that the lack of specificity around the information disclosure regime has concealed (rather than unmasked) monopoly pricing[2].

The ineffectiveness of “consultation” is of particular concern. The process was described by the New Zealand Court of Appeal in the following terms”

> *“If the party having the power to make a decision after consultation holds meetings with the parties it is required to consult, provides those parties with relevant information and with such further information as they request, enters the meetings with an open mind, takes due notice of what is said, and waits until they have had their say before making a decision, then the decision is properly described as having been made after consultation”.*

The outcome of course is that airports are now careful about process, as opposed to outcomes, and trying to demonstrate an “open mind” but ultimately all parties know that at the end of the process, and in accordance with the legislation, the airport will “set such charges as it from time to time thinks fit”. Modifying unreasonable proposals under the guise of having had an open mind doesn’t in itself produce reasonable proposals. While consultation might be an appropriate concept in the public sector, we are not aware, as noted above, of any other commercial environment where it is mandated or considered to be a viable way of protecting the interests of consumers and driving economic efficiency.

While the threat of regulation is meant to act as a constraint on airports, Air NZ agrees with the passage quoted by the Productivity Commission from NERA’s report for Qantas that because the line between acceptable and unacceptable changes in charges is not known, and the process of implementing re-regulation is not clear, open and transparent, the threat of re-regulation lacks credibility.

It is for these reasons that Air NZ has considerable interest in identifying ways in which to overcome the imbalances inherent in the current regulatory regimes on both sides of the Tasman.

In the following document, Air NZ sets out its views on:

(a) the appropriateness of “dual till”;

(b) asset valuation and the treatment of revaluations; and

(c) the need for dispute resolution mechanisms.

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[2] Arthur Andersen conducted a review of the disclosure regime back in 01/02 for the Ministry of Transport and concluded (this quote is from an internal Ministry of Transport report) “…the disclosures did not achieve the intent of the Regulations and in particular, noted that none of the disclosures would allow an interested party to understand the price setting process to such an extent as to make a meaningful assessment of the appropriateness of such allocations. Arthur Andersen suggested that this may, to some extent at least, have been the result of the Regulations’ lack of clarity and specificity.”

SINGLE TILL VERSUS DUAL TILL

The relative merits of a "single till" versus a "dual till" approach to pricing has been the subject of longstanding debate. That said, there is no dispute that almost all non-aeronautical revenues are complimentary to the aeronautical activities. The economics of complementary revenues is not particularly contentious.

We do not propose to restate the arguments for and against either approach except to say the following:

(a) we do not accept that airports are likely to 'reward' airlines for additional passenger throughput in recognition of demand complementarities between aeronautical and non-aeronautical services. In New Zealand, this has been borne out by actual experience - recognition of the value of passenger throughput is not a feature of airports' pricing structures. It is important to note that in New Zealand, the "dual till" approach is not legislated for but, over time, has tended to have been developed by the airport companies as they have exercised pricing freedom;

(b) we agree with the arguments put forward by NERA on behalf of Qantas that "…the potential loss in non-aeronautical revenues resulting from aeronautical service charge increases is likely to be small…[and that, as a consequence]…the financial gains from increasing aeronautical charges are likely substantially to outweigh any potential loss in net revenues from non-aeronautical services";

(c) while we agree with the Commission's assertion that, in principle, the increasing importance of non-aeronautical revenues would be expected to constrain the extent to which airports might consider using market power to raise charges for aeronautical services, in practice there is little evidence to suggest that airports (at least those not operating in competitive environments) understand the impact of price changes on passenger volumes because:

   a. in the short term they are insulated from such price increases by the airlines' revenue management systems which will generally attempt to preserve volumes in the first instance by reducing average yields; and

   b. in the longer term, the negative effects of cost increases (in terms of reduced airline schedules and/or passenger numbers) can be simply offset by resetting charges off reduced volumes at the next price reset (the average length of pricing arrangements are typically far less than average asset lives and, furthermore, the building blocks pricing methodology currently used by airport operators typically determines prices at levels that ignore the existence of surplus capacity in existing or new assets);

(d) we submit that dual till could actually discourage investment in aeronautical services for two important reasons:

   a. allowable returns on aeronautical assets will invariably be constrained relative to returns on the latter due to the fact that non-aeronautical activities don't bear the stand-alone costs of operation but can price at levels reflecting stand alone costs; and

b. the hurdle for investment in aeronautical services may be set at an unnecessarily high level. For example, a project may not be feasible on the basis of its projected aeronautical income but may become feasible if combined with projected non-aeronautical returns. Such investments may be deferred unnecessarily if the case stands or falls on the level at which aeronautical charges are struck;

(e) the allocation of common joint costs is an oxymoron – single till dispenses with the requirement to make purely arbitrary cost splits;

(f) the New Zealand experience (particularly at Auckland Airport) is that airports exploit the dual till concept as, in the absence of specific pricing principles, considerable opportunities exist for the airport to unfairly load both capital and operating costs on the aeronautical business (and for the reasons set out in (b) above, there is insufficient constraint or "measurables" around their ability to do so); and

(g) the risk that single till pricing will stifle innovation and development is significantly overstated. As is the case in any other environment, provided it is clear that new investment will be incorporated into any monitored asset base then future investment is unlikely to be discouraged. In a competitive environment, the operator(s) offering the most effective product at the lowest cost win. Success can only be achieved in such an environment by viewing the business as a single economic unit. By way of illustration, Infratil (owner of Glasgow Prestwick Airport, which operates in a competitive environment), stated in its Infrastructure Bonds Investment Statement that "…because airline charges are kept low, to attract throughput, profitability has to come from retail concessions, ground transport activities, and providing other services for passengers." This statement not only provides a strong indication of how pricing decisions would made outside of the artificial construct of "dual till" but Infratil's further comments suggest that investment is not deterred by this fact. For example, Infratil further states that ""…while Infratil is progressing investment into other European airports, Infratil's main European interest is Glasgow Prestwick Airport…";

(h) there is an economic incentive for airlines to have development and further investment occur at airports. However, the "dual till" concept tends to scuttle any opportunity for effective bi-lateral negotiation by opening up endless opportunities for airports to set prices above marginal cost or even average cost.

For these reasons, Air NZ does not support Draft Recommendation 5.1 that the new price monitoring regime should continue on a dual till basis.

CONTINUATION OF PRICE MONITORING

In the event that Draft Recommendation 5.1 remains unchanged, Air NZ is supportive of continued price monitoring and welcomes Draft Recommendation 5.2 that the Australian Competition and Consumer Commission should separately monitor charges for car parking and other landside vehicle services at the major airports.

Air NZ also supports Draft Recommendations 4.1 and 5.5.

The recommendation that the monitoring process be reoriented to put much greater emphasis on seeking and reporting the views of stakeholders is a most welcome development. The Australian practice of holding a scheduled review of the regulatory regime relating to airports every five years also has the advantage that it keeps the airports on notice that their behaviour and actions will be subject to scrutiny. This discipline is sadly lacking in New Zealand.

In our view, a light handed regulatory regime backed by the possibility of more intensive forensic scrutiny if significant concerns arise, and pre-scheduled periodic reviews go some way to reducing any uncertainty as to whether and when there will be a scrutiny of behaviour. The Australian practice of having the review undertaken by a body other than the regulator and by a body which reviews regulatory structures across all sectors is also appropriate.

Notwithstanding the above, if the New Zealand experience is anything to go by, the line between acceptable and unacceptable changes in charges must be as clearly defined as possible to be effective. Air NZ accepts that price monitoring is intended to provide some latitude so as to encourage commercial negotiation, however, it is our view that "commercial negotiation", absent balanced bargaining positions[3], is rarely possible.

The New Zealand experience has been one of broken promises. As noted above, one of the pillars of the regime was the threat of regulation. In 2002 and Airfield Pricing Inquiry ("the Inquiry") was undertaken by the New Zealand Commerce Commission and the opportunity arose to send a clear message to airport monopolies regarding the credibility of the threat. Notwithstanding the fact that the Inquiry was very limited in scope, it was still recommended that Auckland Airport become subject to price control. Unfortunately, the finding was not acted on by the Government, a periodic review of the situation was not scheduled and the threat of regulation lost all credibility.

The result, to date, of the combined effects of a dual till approach, a lack of clarity around the acceptability of revaluations, and the lack of a credible threat around re-regulation has been that at Auckland Airport alone:

(a) share capital is almost entirely made up of asset revaluations;

(b) asset revaluation reserves increased by NZ$281 million in 1999, a further NZ$169 million and a staggering NZ$1.385 billion in 2006. Total revaluation reserves are now NZ$1.875 billion or 72% of the total carrying value of fixed assets (i.e. over 3.5 times their actual cost);

(c) EBITDA margins are almost 80% (EBITDA margins on the so-called "contestable" non aeronautical activities were 88% in 2005);

(d) if revaluations are excluded from the asset base on the basis that they have not been included in income, ***post tax*** returns on net operating assets in 2005 (before any asset optimisation) were approximately:

    a. 19% - Group (the New Zealand Commerce Commission considered a mid-point WACC of 8.4% was appropriate in respect of airfield activities in its 2002 report);

    b. 35% - Non-Aeronautical;

    c. 11% - Aeronautical (where the aeronautical till is loaded with non-aeronautical assets such as roads);

[3] Airlines have no direct substitutes and there is no symmetry of loss in the event of an impasse between the airlines and the airport.

(e) a staggering NZ$741 million has been returned to shareholders in the past five years. Over the same period the airport has invested NZ$353 million in airport-related infrastructure. Total shareholder returns have been in excess of 25% compounding per annum.

It is so easy to do nothing while leaving airlines, in the words of the Australian Competition Tribunal, in the unenviable position of relying on costly "…legal proceedings, media campaigns and lobbying for regulation…[which we see as]… relatively weak bases of countervailing power which are generally related to, and dependent upon, the regulatory environment."

While improvements in the monitoring regime in Australia are welcome, absent a dispute resolution mechanism, it is our view that airports will continue to systematically dominate negotiations with users in respect of any issue that has not otherwise been "taken off the table" either as a result of the present inquiry or as a result of continued ACCC involvement.

ASSET VALUATION

Air NZ agrees that, given its experience in New Zealand, the issue of asset valuation is inhibiting productive negotiations on charges and is a major barrier to the further development of commercial relationships between airports and airlines.

Air NZ agrees that the Commission's assessment of revaluation of assets for the purposes of setting prices represents a return on assets for which no outlay has been made and for which no regulatory or commercial risk is involved. It is interesting to note that while the total level of upward aeronautical asset revaluations by Australian airports exceeds $1 billion, Auckland Airport alone has revalued its aeronautical assets by an amount in excess of $450 million since 1999 and has recently announced a further increase of NZ$1.385 billion (or a doubling in the value of the existing asset base).

Air NZ agrees with the conclusion reached by the Commission that, in practice, the theoretical efficiency benefits of employing opportunity cost/replacement cost valuations for land and other aeronautical assets are unlikely to be large.

However, if the concept of opportunity cost was to be mooted further by the airports, it is Air NZ's view that for pricing purposes:

(a) specialised aeronautical assets should be valued at optimised depreciated replacement cost (ODRC);

(b) airfield land should be valued at historic cost (if using a nominal WACC) or indexed historic cost (if using a real WACC).

If the opportunity cost of airfield land is deemed to be a relevant consideration for reasons of allocative efficiency (and we agree with the Commission that such an approach has theoretical rather than practical merit) then Air NZ is of the view that opportunity cost must:

(a) take into account the 'restitution' costs associated with converting the airport back into bare land; and

(b) reflect the estimated impact of converting land into non-aeronautical uses on the carrying value of the airport's aeronautical and non-aeronautical assets.

In other words, the opportunity cost must reflect the value impact of abandoning many assets (including many specialised assets). As a consequence the asset base for pricing purposes will always be the higher of historic cost plus new investment (at cost) less depreciation (if any) or true opportunity cost as described above.

The unhappy situation gaining increasing momentum in New Zealand (absent any meaningful regulatory constraints) is that airports are setting prices at levels commensurate with a hypothetical current market price for the land (which they themselves determine), the optimised depreciated replacement cost of existing infrastructure assets (i.e. the specialised assets are assumed to retain value notwithstanding the fact that the land is valued on the basis that it is available for urban or industrial development) and the "brown-fields" cost of building new infrastructure (i.e. the asset base for pricing purposes is keyed off the cost that a new entrant would face if building all the infrastructure over again even if parts of the infrastructure are sub-optimal in design).

As a consequence:

(a) charges are set off asset bases that include the impact of highly subjective and often flawed valuations of very large parcels of land which take no account of economic efficiency;

(b) users are meeting the costs of replacing assets before they are, in fact, replaced and then again when the real investment actually incurs due to the fact that, in the case of assets that are depreciable, revalued amounts are being depreciated without an adjustment being made to reflect implicitly lower previous depreciation charges or, alternatively, an adjustment being made to include the revalued amounts in income for pricing purposes.

Air NZ agrees with the Commission that revaluations should be netted out of the asset base used to monitor rates of return and that, absent the agreement of customers, future asset revaluations should not provide a basis for higher charges.

Air NZ supports Draft Recommendation 6.1.

DISPUTE RESOLUTION

Air NZ understands the concerns expressed by the Commission that the existence of a dispute resolution mechanism poses a risk that arbitration is seen as a default option thereby curtailing incentives to reach negotiated outcomes. However, if it is accepted that the bargaining position of airports and airlines is imbalanced (and a substantial body of evidence now exists in support of this proposition) then commercial negotiations cannot in fact take place absent a mechanism designed to redress such imbalances. To quote NERA's report to Qantas once again:

> *"As a general principle, 'commercial negotiation' will lead to efficient pricing outcomes in circumstances where the bargaining power is relatively equal between airports and airlines."*

In other words:

(a) if relatively equal bargaining power is a prerequisite for efficient pricing outcomes capable of being commercially negotiated; and

(b) if the bargaining positions of major airports vis a vis the airlines are imbalanced; then

(c) commercially negotiated, efficient pricing outcomes cannot be achieved. A dispute resolution mechanism designed to redress the imbalances then becomes an unavoidable feature of any environment that is designed to mimic what might otherwise be achieved in a competitive, commercial environment.

While Air NZ thoroughly endorses the Commission's recommendation to take asset valuations "off the table" (this unarguably reduces the negotiating divide between airports and airlines) it doesn't address the fundamental imbalance in bargaining power and information asymmetry that stands in the way of effective commercial negotiations.

The observations of the Australian Competition Tribunal mirror the New Zealand experience when its stated that:

> *" [given] the manner in which SACL is contemplating imposing further charges, these revenue issues are likely to be resolved by SACL exercising monopoly power to impose upon the airlines a level of revenue growth which would not be open to it in a competitive environment. While these issues are outstanding, and where the airlines have no recourse to independent arbitration and determination, there remains the opportunity for SACL to impose higher and additional charges upon the airlines which would be unlikely to be accepted in a more competitive environment."*

This is consistent with the view of one of the world's leading economists familiar with the industry, Alfred E Kahn who, in an "Appraisal for the Review of New Zealand Airport Regulation" in 1995 stated that:

> *"…the notion that a mere requirement that such monopolists provide more information than they have been willing to provide in the past or to "consult" with their customers more wholeheartedly than they have in the past seems utterly vapid. So long as the market power is on one side of the bargaining table alone, with the monopolists under instruction otherwise only to do what any ordinary commercial enterprise with a monopoly would do seems to me singularly futile – in the absence of an "agency competent to assess such conflicting claims and with authority to impose a just or efficient settlement" that I contended the public interest required".*

There may be no dispute resolution mechanism that fully accommodates the Commission's desire to maintain strong incentives for all parties to negotiate while also providing a means for resolving irreconcilable disputes. Unfortunately, there is an unavoidable tension between these two objectives. However, we would emphasise that users do have an incentive for airports to invest in appropriate infrastructure and that, as current ambiguities around pricing principles are progressively addressed, neither airports nor airlines will have a great deal of appetite to engage in costly, arbitrated outcomes. Air NZ believes that "Final Offer Arbitration" certainly acts as a disincentive to those that would otherwise use traditional methods of arbitration to gain ground in traditional "compromise-style" outcomes.

The Commission expressed two reservations about this approach:

(a) that if bargaining power is skewed, then it is not clear to the Commission why the incentive for the party in the weaker position to reach a negotiated outcome would be greatly increased; and

(b) limiting the arbitrator's choice to the two final offers removes the prospect of countenancing possibly superior alternatives.

As noted above, Air NZ submits that, as regards the first point, the great advantage of the approach is that there is no incentive to go to arbitration in the expectation of gaining incrementally in a compromise – each party simply wins or loses its case on the merits. To further moderate any appetite for arbitration of this sort, it is suggested that the loser pays the costs of both parties and the arbitrator.

As regards the second point, Air NZ believes that this style of arbitration, by its very nature will drive the parties as close together as they are likely to get in a commercial negotiation given the desire to minimise the considerable potential risks associated with going to arbitration and losing. It may not always produce the same outcome as that which may have been favoured by a regulator but it is likely to reflect a commercially negotiated result and this, at its core, is the objective of “light handed” as opposed to “heavy handed” regulation.

For these reasons, Air NZ has a strong preference for this method of dispute resolution.