31 October 2006

Wild at Heart™
WellingtonAirport

Inquiry into Price Regulation of Airport Services
Productivity Commission
P O Box 80,
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ACT 2616,
Australia

By email: airportpricing@pc.gov.au

Dear Sir

Review of Price Regulation of Airport Services: Air New Zealand's Submission

Wellington International Airport Limited ("WIAL") is an interested observer of the Productivity Commission's inquiry proceedings, although the Commission's Terms of Reference ("TOR") do not apply either to WIAL or other New Zealand airports.

However, WIAL was not particularly surprised to read Air New Zealand's submission dated 11 October 2006 on the Commission's Draft Report setting out its superficial criticisms of the New Zealand airport environment relating to aeronautical charges. Air New Zealand has been conducting a long running campaign in the New Zealand media and with various New Zealand Governmental agencies to belittle the New Zealand airport regulatory environment and to demonise the behaviour of Auckland and Wellington International Airports, leading up to, and continuing through, aeronautical pricing consultations with these airports. It seems to WIAL that Air New Zealand is seeking to use the Commission's inquiry as yet another forum to pursue its New Zealand campaign albeit in the context of Air New Zealand's claim of "*shortcomings of the existing "light handed" approaches on both sides of the Tasman*".

WIAL is nevertheless concerned to ensure that the Productivity Commission is aware that the criticisms made by Air New Zealand do not represent a correct or balanced view of the New Zealand environment. WIAL therefore wishes to make the following comments. We confine these only to specific references by Air New Zealand to the New Zealand environment and its operation and not to issues concerning the Australian regulatory environment. We use the same main headings as Air New Zealand used in its submission.

1. Introduction (Section 1 of Air New Zealand's Submission)

1.1 *The claimed "shortcomings" of the New Zealand "light handed" regime (First paragraph)*

Air New Zealand's comment that New Zealand's regulatory regime is "*practically non-existent*" is absurd. New Zealand Airport Authorities are subject to an industry specific regime under the New Zealand Airport Authorities Act 1966 and Regulations. This regime includes statutory consultation obligations for the setting of aeronautical

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charges (the consultation regime being consistent with current ICAO Principles promoting a consultative approach) and detailed financial disclosure obligations for the major airports in respect of their aeronautical activities.

The use of aeronautical price setting powers and related processes are subject to New Zealand's robust judicial review supervision. Significantly, there is a substantial history of judicial review litigation between Air New Zealand and WIAL in which the nature and scope of WIAL's statutory obligations and constraints regarding its market position, and aeronautical pricing conduct in particular, have been extensively judicially interpreted to the point that settled principles exist. WIAL's approach has invariably been upheld by the Courts, which is perhaps the source of Air New Zealand's dissatisfaction. As noted later in this letter, aeronautical pricing is also frequently set under commercial agreements with the airlines as a result of consultation processes. Those processes can, by agreement, also include referral of one or more issues to arbitration (as has occurred between WIAL and Air New Zealand).

In addition, the provisions of the New Zealand Commerce Act not only constrain restrictive trade practices and monopoly conduct relating to pricing, but also provide for direct price control of any airport services under the generic industry provisions of Parts 4 and 5 of the Act if considered warranted by the New Zealand Government. Whatever charges may be set under the Airport Authorities Act, by airports or by agreement with airlines, price control may be imposed on those charges under the Commerce Act. Accordingly, and most significantly, charges made by airport companies are already, unlike most New Zealand industries, subject potentially to two statutes.

1.2 *Increases in New Zealand Airport Charges (Second paragraph, subparagraph (a))*

Air New Zealand states that airport charges have increased significantly relative to changes in actual costs. This comment is correct only if one defines costs purely as recurring operating costs and ignores costs of capital. It is true that Wellington Airport is one of the most efficient in the region and that we have managed our costs very effectively. However Air New Zealand's statement is simplistic – increases in charges have been substantially driven by much needed (and quite popular) airport investment. In WIAL's case, for example, a major new passenger terminal was opened in 1999 to replace a set of buildings that were considered an embarrassment to Wellington and New Zealand (a situation quite similar to Adelaide's recent terminal development and pricing changes). Wellington Airport's charges have not increased since 2002.

1.3 *Alleged "windfall gains" by WIAL from "re-determined assets values" (Second paragraph, subparagraph (b))*

Air New Zealand's claim is confusing and wrong. In WIAL's case, its charges were last set as at 1 July 2002 and we have only recently opened statutory consultations for prices to apply from 1 July 2007.

WIAL's existing charges are based on aeronautical asset methodologies, upheld by independent binding arbitration between WIAL and the major airlines in New Zealand. These same charges (and their underlying components) were determined by the Government not to warrant price control under the Commerce Act. Indeed,

Air New Zealand withdrew litigation initially brought against WIAL in respect of these same charges and entered into an agreement with WIAL. That agreement is still in place.

1.4 *Information Disclosure Regime (Second paragraph, subparagraph (c))*

Air New Zealand refers to the "*lack of clarity and specificity*" around New Zealand's Information Disclosure Regime. In fact the Regulations are detailed and WIAL, as with the other New Zealand airports, ensures that its disclosures meets these requirements.

WIAL's compliance is reviewed by the New Zealand Ministry of Transport ("NZMOT") and has been audited by an external adviser on behalf of NZMOT. Any deficiencies in annual disclosure reporting are remedied when advised by NZMOT. Moreover, despite claims about the adequacy of the information disclosure regime by Air New Zealand and the airlines' association, BARNZ, over several years, no changes have been deemed necessary by the Government.

More fundamentally, major New Zealand airports are required to provide comprehensive information to airlines as part of their consultation obligations. This arises from judicial interpretations of the Airport Authorities Act. This disclosure extends well past the boundaries of the disclosure regulations and includes full details of revenue and expenditure forecasts as well as asset valuation and return assumptions. Expert reports obtained by the airports on asset valuation, WACC and forecasting issues are provided to the airlines as well as the detailed workings behind the airport's pricing assumptions. The process involves the detailed testing of all assumptions and exchanges of expert views.

2. Single Till versus Dual Till (Section 2)

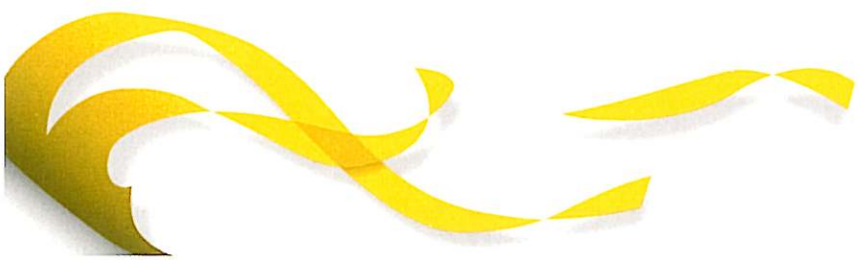
As a preliminary comment, WIAL is not even sure Air New Zealand's comments on single till are relevant to the Commission's considerations. The Australian Government's Review Principles set out under paragraph 2(a) of the Productivity Commission's TOR specifically incorporate a "*dual till*" approach. We also understand that the Australian Government's "*dual till*" approach is consistent with its Directive of 20 April 2001 to the ACCC in respect of the ACCC's review of SACL's aeronautical charges.

2.1 *Rewarding Airlines for Passenger Throughput*

Air New Zealand is quite wrong to state that pricing approaches in New Zealand do not reward airlines for passenger throughput. First, passenger forecasts are a fundamental input to pricing consultations. Generally, the higher the passenger throughput, the lower prices can be set. This provides fertile ground for agreements and trade-offs between airlines and airports. A range of innovative approaches have been explored in the past.

Second, many airports have agreements with airlines. These agreements are generally confidential. We can only assume that Air New Zealand's comment relates only to published charges at airports.

Contrary to Air New Zealand's assertions, our desire to see passenger growth is an important consideration in our dealings with airlines, and we independently invest with tourism agencies to promote passenger growth.



2.2 *The claim that the use of Dual till in New Zealand was developed by airports alone (Second paragraph, subparagraph (a))*

Air New Zealand is quite wrong to state that "*dual till is not legislated for in New Zealand but, over time, has tended to have been developed by the airports as they have exercised pricing freedom*". In fact, a "*dual till*" approach is effectively recognised under the pricing setting, consultation and related disclosure provisions under the Airport Authorities Act 1966. This Act prescribes the distinct activities that comprise the aeronautical business and in respect of which WIAL must disclose separate information, consult with the airlines and set charges.

Furthermore, the airlines sought reconsideration of this issue by the Commerce Commission in its Inquiry into Airfield Activities under the Commerce Act. The Commission specifically took no account of non-aeronautical revenues as an offset against allowable aeronautical prices in its inquiry assessment. Indeed, it endorsed the building block approach as the primary approach to aeronautical pricing in accordance with airport practice internationally.

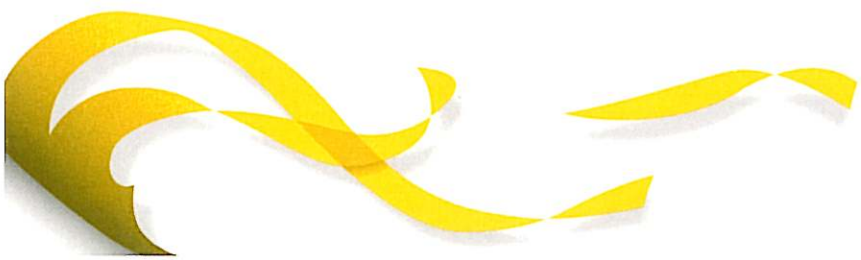
The dual till approach has therefore not been "*developed*" unilaterally by the airport companies.

2.3 *Air New Zealand's example of Glasgow Prestwick Airport (Second paragraph, subparagraph (g))*

Air New Zealand's use of Infratil's Glasgow Prestwick Airport to demonstrate the benefits of *"single till"* is a poor choice at best. Infratil statements make it clear that there are distinct lines of business that are assessed in their own right (freight and military aircraft activities, commercial activities as well as passenger services). Investment in each of those areas relies on the returns available from those activities. While Infratil is obviously proud of Glasgow Prestwick Airport and positive about its potential, at this stage the passenger facilities at that airport are quite different to other airports with stronger passenger revenues. Indeed, Glasgow Prestwick would not be alone among UK airports in focusing its investments in areas where it can earn a return, while deferring or avoiding investments in other areas. Certainly Glasgow Prestwick has not announced a terminal investment programme similar to Wellington and other mature airports operating under a dual till system and with a strong focus on passenger services.

2.4 *Airline incentives relating to investment at airports (Second paragraph, subparagraph (h)*

Air New Zealand says airlines have an economic incentive to encourage investment in airports. However this has not always been WIAL's experience of Air New Zealand. As the dominant New Zealand airline player, its actual behaviour at Wellington Airport has raised competition concerns. WIAL's new passenger terminal, enabling the more neutral allocation of gates and passenger facilities, was substantially opposed by Air New Zealand before settlement was achieved with WIAL in 1997. More recently WIAL is, or has proposed, undertaking improvements to its facilities and these have been supported by other airlines, but not Air New Zealand. Indeed, Air New Zealand has been very critical of investment projects on occasions, even when those investments are supported by other airlines.



3. Continuation of Price Monitoring (Section 3)

3.1 *The claimed lack of a credible threat in New Zealand (paragraphs 3, 5 and 6)*

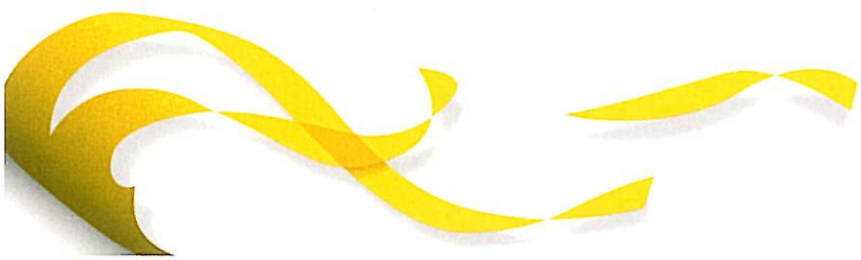
Air New Zealand supports price monitoring and periodic reviews as a means of maintaining a credible threat, and contends that this threat does not exist in New Zealand.

Apart from the obvious difference of compulsory periodic consultation requirements, Air New Zealand's perspective is certainly not shared by airports. New Zealand airports are critically aware of Air New Zealand's Government ownership and, in addition, the existence of potential price control under the Commerce Act. In New Zealand, inquiries leading to the imposition of price control by the Government may be initiated either by the Commerce Commission or the Minister of Commerce. In addition, the New Zealand Government can review, at any time, through any review mechanism it wishes, whether to impose a more restrictive regulatory environment. This is what Air New Zealand has been campaigning for over many years and especially since the Government declined in 2003 to impose price control on airfield activities following the Commerce Commission inquiry.

Air New Zealand state that the Government did not implement the Commerce Commission's recommendation to impose price control on Auckland Airport and comment that the threat of regulation has lost all credibility. The Commission (by a majority) also recommended control of WIAL. This recommendation was not in respect of WIAL's pricing as it stood at the time of the inquiry, but in relation to future increases in charges as a result of the 2001-2003 consultation that was still underway at that time . However the recommendation was critically dependent on certain key factors that were contested, notably highly contentious and unprecedented valuation methodologies and numerical errors. These factors had the effect of substantially (and artificially) reducing the prices the Commission assessed as appropriate. In addition, the recommendation was not followed by the New Zealand Government, in part on the advice of the New Zealand Ministry of Economic Development ("NZMED"), which differed on the key factors and noted that the Government was able to take wider economic considerations into account in considering price control.

It is pertinent to note at this point that immediately following her decisions in May 2003 not to impose control on AIAL or WIAL, the Minister of Commerce, Hon Lianne Dalziel, announced a review of Part 4 of the Commerce Act. The review was to address a concern that the criteria for control were poorly targeted. MED's preliminary view was that the initial price control test of "*limited competition*" in the relevant market was too low. Other concerns included the relationship between the additional net benefits to acquirers control test and net public benefits, and a more technical issue about the Commission's inability to consider what form of control it might impose

On 7 August 2006, the Minister of Commerce stated that the review of Parts 4 and 5 of the Commerce Act would "*clearly include considering whether any amendments to the Act are desirable to reinforce the Government's policy objectives on investment in infrastructure*". This has subsequently been confirmed in the TOR for the review. The Government anticipates that the review will be completed by the end of 2007 and that any legislative amendments will be introduced in 2008.



The Minister of Commerce has also issued a Government Policy statement to the Commission meantime under section 26 of the Commerce Act regarding "*Incentives of Regulated businesses to invest in Infrastructure*". This announcement and an accompanying Government Policy Statement issued by the Minister of Energy under the Electricity Act in respect of Transpower are seen as an interim signal of a growing Government recognition of infrastructure's net contribution to economic growth and transformation. Air New Zealand fails to mention these developments.

4. Asset Valuation

Air New Zealand has again in this section failed to mention highly relevant facts. In particular and as noted above, the Commerce Commission was not unanimous in respect of asset valuation methodologies. Nor has Air New Zealand mentioned that the Commerce Commission's conclusions were not followed by the NZ Ministry of Economic Development or the Minister of Commerce. We note that even Air New Zealand, in its submission to the Productivity Commission, has changed its position and endorsed the use of ODRC for improvements and Historic Cost or Indexed Historic Cost for land. This is in contrast to the preferred valuation methodologies of the Commerce Commission majority.

Even more fundamental is Air New Zealand's failure to mention the independent arbitration that was undertaken by WIAL and the airlines during WIAL's last consultation process. The arbitration concerned the appropriate asset valuation methodologies to be applied by WIAL. The arbitration was conducted by a retired Judge of the NZ High Court and it was undertaken after the Commerce Commission had issued its final report. The Commission's majority views were expressly considered and not followed by the Arbitrator.

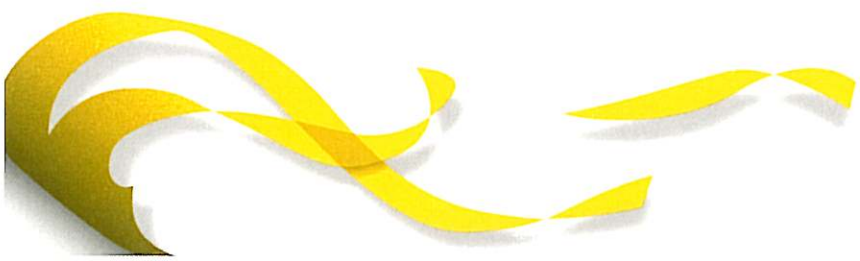
Of most concern to WIAL is that the parties to the arbitration including WIAL, Air New Zealand and Qantas agreed to be bound by the outcome of that arbitration. Air New Zealand has made no reference to this in its submission.

5. Dispute Resolution

Air New Zealand is strongly in favour of a commercial arbitration process but, as noted above, when this arbitration process has been followed and upheld, as with WIAL in 2003, Air New Zealand has not proved willing to accept the result. Its comments to the Productivity Commission therefore lack credibility.

WIAL, for its part, views the current regulatory process in New Zealand as providing an environment for the parties to seek a commercial outcome. The airports are statutorily required to act as commercial undertakings and the environment provides for a number of checks and balances that enable testing of the outcome if one party cannot accept it, whether this be agreed arbitration, judicial proceedings, Commerce Commission inquiry or regulatory review. All of these procedures have been followed in the New Zealand environment, especially in WIAL's case in the past 10 years and WIAL has yet to be found to be engaging in inappropriate conduct.

Finally we refer to Air New Zealand's comment that if bargaining power is not equal then "*commercially negotiated, efficient pricing outcomes cannot be achieved*". Interestingly, agreements have indeed been reached on many occasions. Agreement was reached in WIAL's past two five yearly consultations, with all airlines operating at WIAL in 1997, and with WIAL's major customer (Air New Zealand) in 2003. We are



also aware that the airlines agreed a 7 year commercial arrangement with Auckland Airport in 2000.

We are prepared to elaborate further on our comments if required. The writer can be contacted on +64 4 385 5105 or at mike.basher@wellingtonairport.co.nz.

Yours sincerely

Mike Basher
Chief Financial Officer