Air NZ Limited

Submission to the Commerce Commission on the "Draft report to the Ministers of Commerce and Transport on how effectively disclosure regulation is promoting the purpose of Part 4 for Wellington Airport"

Commerce Act 1986, Part 4

Section 56G Review of Wellington International Airport

30 November 2012

Introduction

1. The Commerce Commission (**Commission**) is conducting a review, pursuant to section 56G of the Commerce Act (**Act**), of how effectively information disclosure regulation is promoting the purpose of Part 4 of the Act in respect of Wellington Airport (**WIAL**).

2. A separate review of Auckland Airport is underway and a further review of Christchurch Airport will commence following Christchurch Airport's Price Setting Disclosure required by the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010.

1. On 2 November, the Commission released its draft report (**report**) relating to WIAL. The Commission is seeking submissions on this report by 30 November. Air New Zealand's contact person for this submission is:

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3. The Commission's report concludes that:

   a) Information disclosure regulation has not been effective in limiting WIAL's ability to extract excessive profits

   b) It has not been possible to determine the effectiveness of information disclosure regulation in respect of:

      - Operational expenditure
      - Investment; and
      - Sharing the benefits of efficiency gains

   c) Information disclosure is effectively promoting the Part 4 purpose in respect of:

      - Innovation;
      - Quality; and
      - Pricing Efficiency

4. Air New Zealand (**Air NZ**) agrees with the Commission's analysis in respect of the ineffectiveness of information disclosure in limiting WIAL's ability to extract excessive profits. Air NZ also agrees with the Commission's assessment that the major issues driving WIAL's excessive profitability are the airport's use of its own asset valuation methodologies without fully accounting for revaluation gains, and its targeting recovery of a cost of capital well in excess of what would be expected in a workably competitive market. These two issues have historically been, and continue to be, the major source of disagreement between airlines and airports in respect of pricing.

5. While agreeing with the Commission's conclusion that WIAL will extract excessive profits, Air NZ considers the Commission, through focussing on the 75th percentile WACC, has significantly understated the extent of those excessive profits.

6. The Commission notes that "information disclosure regulation is likely to have the greatest impact on Wellington Airport's incentives to earn excessive profits, and to share efficiency gains with its consumers. This is because of the relatively weak incentives on Wellington Airport in this area without regulation, and because information disclosure under Part 4 is particularly effective at highlighting issues in this area, which heightens the credible threat of further regulation. 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." [1]

7. Given this expectation, and the Commission's conclusions in respect of WIAL's excessive profits and the inability to determine whether it is sharing efficiency gains, it is therefore clear that the current information disclosure regime has failed. The fact that WIAL proceeded to set the charges it did, notwithstanding the knowledge of the new Part 4 regime, highlights a fundamental lack of any sort of credible threat which, in theory, is supposed to lie at the heart of the airport pricing information disclosure regulatory regime. WIAL's unwillingness to acknowledge the relevance of the Part 4 regime to pricing demonstrates without any doubt the failure of the current regime. As the Commission itself notes, "if it is effective, information disclosure should have its greatest impact in promoting the profitability based objectives in s52A(1) and so its ineffectiveness at limiting excessive profits is of significant concern."[2]

Excessive Profits

8. The Commission, in reaching its conclusion that WIAL will extract excessive profits, focuses its assessment on the 75th percentile WACC. The Commission bases this approach on the notion that:

   > "in trade-offs between assessing outcomes that promote dynamic efficiency (eg, incentives to invest) and static allocative efficiency (ie, higher short-term pricing) under Part 4, we generally favour outcomes that promote dynamic efficiency."[3]

9. Air NZ notes that the Commission's focus on the 75th percentile is inconsistent with its intended approach as stated in the Input Methodologies (Airport Services) Reasons Paper:

   > "In the case of Airports, for information disclosure, the Commission considers it appropriate to take a range between the 25th to 75th percentiles. In

[1] Commerce Commission, *Draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport*, 2 November 2012, para. 2.10 {Draft Report}
[2] Draft Report, para. 3.3
[3] Draft Report, footnote 171, pp. 101-2

> assessing profitability for the Airports an appropriate starting point for any assessment is the 50th percentile (mid-point) on the range."[4]

It is also clear that the Commission, in reaching this conclusion, had sound reasons to do so:

> "The Commission has tested the estimate of the post-tax WACC of 8.1%[5] for airport services produced using the IM against a range of other information to ensure those estimates are reasonable and commercially realistic.
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> …
>
> The conclusions from this comparative analysis are that the estimate of the post-tax WACC using the IM is reasonable and commercially realistic for suppliers of regulated airport services."[6]
>
> "On balance, the Commission considers this information supports the conclusion that the IM produces reasonable and commercially realistic estimates of the post-tax WACC for the regulated services of Airports."[7]

10. It is of considerable concern that the Commission appears now to be adopting a different approach to its assessment of profitability than was established in the Input Methodologies and what the Commission defended in the input methodologies appeal recently. Air NZ's support for the Commission's WACC IM was in part predicated on its adoption of the mid-point in the 25th-75th percentile range as the appropriate point for assessment. A change in position in such a critical aspect of the information disclosure regime is contrary to the intended purpose of Part 4 and the desired certainty sought for suppliers and consumers.

11. BARNZ, on behalf of its members, commissioned Future Consultants Limited (FCL) to comment on the Commission's use of the 75th percentile as the focus for its analysis.[8] FCL's conclusion on this point is that:

    > "If the Commission wishes to indicate the uncertainty around the estimates of WACC then I believe a preferable approach is to show both the 25th and 75th percentiles along with the estimated midpoint. It should note that the midpoint calculated using the Brennan-Lally model and monthly data is likely to be an overstatement of the true midpoint."

12. This conclusion is based on three factors:

    - WIAL derives significant revenues from un-regulated ancillary businesses which are critically dependent on passenger flows. As a consequence WIAL has incentives over and above its "regulated" returns to invest (thereby satisfying dynamic efficiency outcomes).

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[4] Commerce Commission, *Input Methodologies (Airport Services) Reasons Paper*, 22 December 2010, para E11.2, p326. {Reasons Paper}
[5] The Commission's estimate of the mid-point WACC in the 25th – 75th percentile range at that time.
[6] Reasons Paper, para. E13.7-E13.9, pp. 346-7
[7] Reasons Paper, para. E13.45, p. 354
[8] Futures Consultants Ltd, *Report to BARNZ on the Commerce Commission's Draft 56G Report on WIAL*, 27 November 2012

- Three of the four non-parametric sources of uncertainty used in estimating WACC will tend to lead it to overstate WACC estimates.

- Biasing estimates in favour of airport dynamic efficiency will impact negatively on airline innovation and dynamic efficiency.

13. Air NZ endorses FCL's conclusions.

14. This issue was also considered by Europe Economics in a 2008 report to the UK CAA relating to Heathrow and Gatwick airports:

> "We believe it is appropriate to aim up within a given range because of a mild asymmetry of costs to consumer welfare between outcomes in which prices are too high, and hence consumer surplus is lost in the short term, and those in which investment is too low, and hence consumer surplus is lost in the longer term. We don't believe that the function of aiming up is to eliminate all reasonable possibility of a cost of capital that is "too low" …" [9]

15. And:

> "In our view, the purpose of drawing ranges for regulatory decisions to be based on is connected to the function of the "aiming up" notion. We believe it is appropriate to aim up within a given range because of a mild asymmetry of detriments to consumer welfare between outcomes in which prices are too high, and hence consumer surplus is lost in the short term, and those in which investment is too low, and hence consumer surplus is lost in the longer term. Estimating the statistical higher and lower bounds, and selecting a figure at 90th percentile, as suggested by Prof Schaefer, would imply that the function of the aiming up is to eliminate all reasonable possibility of setting a cost of capital that is "too low". We do not believe that is appropriate.
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> Further, in our view, there could be two main reasons for "aiming up". First, it could be done to acknowledge uncertainty or possible errors in estimation. Second motivation could be to allow for the possibility that the market cost of capital might evolve during the price control period. However, taking an extreme case, once one is in the worst possible state of the world, one is in *the worst possible* state of the world. It would be a mistake to think that it was appropriate, having realised an unexpectedly bad outcome, one should then aim off further, as if things could get even worse than the worst possible case. Clearly, the current state of the world is not *the worst possible*, but nonetheless, the lesson to be drawn from the above is that the degree of aiming up, if any, should be less in acknowledged bad states of the world than in "normal market conditions".
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> At the risk of labouring the point, and to put it one more time, there is an element of double counting if we find ourselves in the bad state of the world against which we insured by aiming up from measurements conducted in more normal times, and then, on the basis of measurements conducted in the bad state of the world, aim up again."[10]

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[9] Europe Economics, *Advice to CAA on Aspects of Cost of Capital for the Final Q5 Price Control Decisions*, 4 March 2008, para. 2.45, p.12

[10] Ibid, para. 2.78-2.80, pp. 20-21

16. As we have submitted in the past (and as referred to by FCL), Air NZ considers the Commission's WACC IM already provides a measure of upward bias in favour of the airports and as such adopting the mid-point of the range determined (i.e. the 50th percentile in the 25th – 75th percentile range) will provide more than sufficient incentive for investment. As Europe Economics note, adopting conservative inputs as a means of "aiming up" in the range, and then adopting the top of that range will result in double counting.

17. On this basis, WIAL's forecast excessive profits based on the Commission's modelling at the mid-point WACC, amount to approximately $40 million over the 2013-17 period.

18. In assessing the likely range of excess profits the Commerce Commission has also disregarded a number of other issues highlighted by BARNZ in its submissions duing the consultation process, including in relation to the reasonableness of the MVAU valuation. In the absence of any further detailed investigation of the evidence the Commission should conclude that that the upper end of range of excess profits will be in excess of the $60 million implied by its modelling.

The revenue-profit relationship

19. The Commission, as required by the statutory framework, focuses on the excess profits WIAL will extract as a result of its pricing. What should not be lost sight of is the fact that the excess revenues WIAL will extract from the economy in order to secure those excess profits will be substantially more than the figures identified by the Commission.

20. The Commission illustrates in Table H16 of its report the different revenue outcomes resulting from application of the different inputs. Air NZ considers the actual revenue outcomes of the different pricing scenarios are a relevant and important consideration given that these represent the actual impact on consumers of the excessive prices being charged by WIAL. The following table illustrates the actual revenue impact of the different scenarios:

	Revenue 2013-17	Excess Revenue
WIAL Forecast	$ 407,658,000	
CC 75th %ile	$ 369,365,000	$ 38,293,000
CC 50th %ile	$ 338,504,000	$ 69,154,000
CC 25th %ile	$ 307,735,000	$ 99,923,000

21. In summary, the Commission's modelling indicates that WIAL's pricing will result in it extracting from consumers $69 million (with a range of $38 million to$100 million) more than it requires to fund its operations over the 2013-17 period. This represents a significant deadweight on the regional and national economies which could drive substantial gains if it were directed towards more productive activities.

22. Air NZ, in a previous submission to the Commission,[11] and based on WIAL's own assessment of regional economic contribution, highlighted the economic detriment of WIAL's pricing decision ($50 million reduction in economic growth per annum and a loss of 375 potential jobs). Air NZ notes that the methodological approach used to assess this detriment is supported by the New Zealand Airports Association.[12] In its submission on the Qantas/Emirates alliance the NZAA estimated that a fare increase of 5% on Tasman services alone would result in passengers paying an additional $1b in airfares and an additional economic loss of $1b in visitor spend. The Association's concerns are equally applicable to increases in airfares due to excess prices charged by airports.

23. It should be noted also that the Commission's analysis will understate the excess returns (and profit) being extracted by WIAL given various other inputs it has used. For example, the Commission has conducted its analysis on the basis of WIAL's total Specified Airport Activities which includes revenues and costs associated with leased assets and LUMINS costs and revenues.

24. WIAL states in its PSE Disclosure that "Revenues from leasing activities are obtained following commercial negotiation and a WACC was not applied in the negotiations."[13] It also notes that "WIAL forecast a NPV below zero for the Pricing Period for its leased property assets not included in the pricing asset base."[14]

25. Given that WIAL's returns from its leasing activities presumably reflect the return it can receive in a (semi) competitive marketplace – which is consistent with the outcome sought under Part 4 - it is therefore inappropriate that the Commission's analysis potentially allow for WIAL to be compensated through charges derived from its pricing activity asset base for any supposed shortfall in these returns.

26. Similar considerations apply with respect to the LUMINS activities, which as WIAL notes in its PSE Disclosure has been established as a separate activity and modelled separately in order to determine the standalone charges for the noise mitigation activity. As indicated previously, the airlines are engaged with WIAL in order to come up with a suitable commercial solution to cater for this discrete activity.

27. Air NZ submits that the Commission ought to highlight that its excess profit analysis is likely to understand the actual excess profit WIAL will receive.

Sharing of Efficiency Gains

28. A further significant area of concern arising from the Commission's report relates to its conclusion that it is unable to determine whether information disclosure is being effective in respect of WIAL sharing efficiency gains with consumers. Given the Commission's conclusion in respect of profitability it is somewhat

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[11] Air NZ, *Submission to the Commerce Commission, Commerce Act 1986, Part 4, Section 56G Review*, 29 June 2012, para.326, p.65

[12] NZAA uses a similar approach to assess the potential impact of the proposed QK/EK Alliance in its submission on that Alliance Application to the Minister of Transport – NZ Airports, *Submission to the Minister of Transport on the Application for Authorisation of the Qantas and Emirates Master Coordination Agreement*, 19 October 2012, p5.

[13] WIAL, *Price Setting Event Disclosure for the Pricing Period 1 April 2012 to 31 March 2017, 30 April 2012*, p. 33

[14] Ibid, p. 18

surprising that the Commission concluded that it was unable to determine whether efficiency gains were being shared. The fact that average aeronautical income per passenger increases by almost 15% over the 2013-17 period while average cost per passenger increases by only 7% suggests that rather than sharing any efficiency gains accruing from increased passenger throughput, WIAL is pocketing these in increased profits.

29. The relevance of this aspect of information disclosure to profitability, and the failure of information disclosure to influence WIAL's behaviour only serves to highlight the failure of information disclosure to achieve the purpose of Part 4.

Pricing Efficiency

30. The other main issue in the report which Air NZ wishes to comment on relates to the Commission's conclusion that information disclosure is effective in promoting pricing efficiency.

31. WIAL states in its Final Pricing Document that "A congestion pricing regime will encourage efficient use of WIAL's scarce runway, taxiway and apron resources." Air NZ does not dispute this principle. Air NZ does however consider that any analysis of the efficiency implications of WIAL's pricing structure should take into account its impacts on the efficiency of the national air transport network.[15]

32. Wellington plays a significant hubbing role within Air NZ's network, whereby passengers travelling between regional locations which are not large enough to sustain direct non-stop services transfer at Wellington between flights to the two points. The size of these regional markets (and the infrastructure available at the airports) is such that use of smaller aircraft means they can be sustainable. Consolidation of passengers from a number of smaller regional markets can also assist in the sustainability of main trunk routes.

33. As a consequence Air NZ's network is structured such that flights from smaller centres are timed to arrive in Wellington to connect with other, regional and trunk, flights to other centres. A key issue in designing the network is ensuring convenient and timely connections between flights so as to minimise overall travel time – an important factor for people travelling between two regional locations. Any movement of smaller aircraft out of the peak periods will increase connectivity times for travellers between regional centres[16] and reduce the utility of the air transport network for that portion of the market.

34. Of more significant concern are those elements of WIAL pricing structure which result in a greater and inappropriate proportion of costs being loaded onto smaller aircraft. WIAL is now levying a common Terminal Charge of $5.25 for all passengers. This common charge is being applied notwithstanding WIAL's own analysis identifying $33 million of assets allocated directly to international terminal activities. As BARNZ identified to WIAL, a charge per international passenger of approximately $9 [17] would be required to cover these direct costs,

[15] As discussed in a report from NZIER commissioned by Air NZ – NZIER, *Wellington airport congestion charging, Issues of congestion pricing and possible effects on airline network connectivity, Report to Air New Zealand*, 1 June 2011
[16] Which may have the effect of increasing WIAL's non-aeronautical revenues as travellers with more downtime spend more on food and beverage.
[17] BARNZ, *Assessment by BARNZ of WIAL Revised Pricing Proposal for Charges to Apply from 1 April 2012 to 31 March 2017*, 23 December 2011, p.20

let alone contribute to the costs of common and shared assets within the terminal. Clearly charges on domestic passengers are being used to subsidise WIAL's international activities.

35. This subsidy is highlighted in WIAL's own modelling which identifies a positive PV outcome of $13 million on terminal activities offsetting a negative PV outcome of $13 million on airfield activities. The airfield costs associated with larger aircraft – which are higher than those of smaller aircraft – are being met through passenger terminal charges with a proportionately larger impact on aircraft serving regional routes.

36. Clearly WIAL's pricing structure[18] is aimed at attracting additional international business – which drives higher non-aeronautical revenues for the airport – through pricing those services at a level below cost. This is allocatively inefficient and may also result in dynamic inefficiencies if further investment is triggered to cater for those markets in response to the additional traffic stimulated by the inappropriate pricing signals.

37. In the face of Airport company price increases at Wellington and Gisborne Airports Air NZ has increased airfares reflecting the cost increase and reduced services between Wellington and Gisborne effective 1 December 2012 reflecting the consequential demand decrease. As Wellington fees further increase during the term of this pricing period we expect an escalating number of similar cancellations.

38. The magnitude of these increases, the scale of the cancellations and the decrease in utility to customers is directly related to the pricing methodology adopted by WIAL and currently endorsed by the Commission. In particular the methodology charges turbo-prop passengers for a terminal that they do not use and applies a congestion pricing principle to a runway that is not yet congested. Air NZ does not disagree with efficient pricing principles where they are correctly applied, however the current application by WIAL does not result in outcomes that are consistent with the purpose of Part 4 of the Act.

39. Air NZ considers that the Commission's conclusion that prices based on WIAL's pricing methodology are more likely to promote efficiency than those previously in place is premature.

[18] In respect of both Terminal Charges and WIAL's incentive scheme.