18 August 2016

Keston Ruxton
Manager IM Review
Commerce Commission New Zealand

By email: regulation.branch@comcom.govt.nz

Dear Keston,

SUBJECT: CROSS-SUBMISSION ON DRAFT DECISION PAPERS AND REPORT ON THE IM REVIEW

The International Air Transport Association (IATA) represents some 265 airlines comprising 83% of total air traffic. Air New Zealand and other major scheduled airlines operating to the three major international airports in New Zealand are members of IATA.

IATA welcomes the opportunity to provide its comments for consideration by the Commerce Commission in response to the submissions made by airport operators and NZ Airports Association.

Based on the dual-till framework applied in New Zealand, we outline below the impact of operating in a dual till scheme on the WACC, investments and incentives and considerations to take into account. IATA's comments are from an international perspective and are based on the requirements of, and practices in, international civil aviation.

1. Underinvest risk unlikely to materialize due to WACC being set at mid-point

Referring to the submissions made by NZ Airports Association (para 112 -150), Auckland Airport (page 15), Christchurch Airport (para 12 – 15) and Wellington Airport para 58 – 71 relating to the rationale for an uplift to the regulatory WACC.

The appropriate regulatory framework should mimic a competitive market providing incentives for efficiency and investments at the airport, efficient prices for consumers as well as reasonable returns to reflect the WACC. In a competitive market charges are set in a way that profit on both commercial and aeronautical reflect the WACC – and not more. It is IATA's position that single till reflects the pricing mechanism airports would apply if they were under real competition. It is therefore the fairest mechanism of charging. A single till benefits both airlines and their passengers and ultimately airports, allowing airports to earn a competitive rate of return on their activities, provided they are operating efficiently.

In the New Zealand context where dual till framework is applied at the major airports, a strong and objective approach is needed. The Commission's proposal to use the mid-point as the baseline for assessing an airport's profitability will unreservedly ensure a more appropriate rate of return on invested capital in airports and help prevent excessive profits being generated at the expense of users and the broader economic growth of New Zealand.

International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666

The mid-point is the value with the highest probability of occurrence. As such, it would be overly conservative to assess the existence of excessive returns from a starting point higher than that of the mid-point. In fact, the utilization of a dual till approach suggest that the WACC could be targeted to a value lower than the mid-point.

Summary point 1: Increasing the target WACC, above the mid-point estimate, is not an appropriate remedy for incentivizing the needed level and quality of aeronautical investments.

IATA agrees with the view that under investment or misguided investment in needed aeronautical services can have major adverse consequences. However, IATA does not see this realistically materializing as a result of using the mid-point WACC. Nor does IATA consider a remedy for misguided investment or under investment to come from increasing the target WACC to above the mid-point estimate.

Summary point 2: Under-investment in appropriately timed capacity enhancing aeronautical activities will not materialize due to positive synergies that exist with non-aeronautical revenues.

Under normal market conditions, in a dual till framework even in a light touch regime, under-investment in appropriately timed capacity enhancing aeronautical activities will not materialize. Any reasonable potential underestimate in the WACC target rate is likely to be more than offset by the positive synergies that exist with non-aeronautical revenues. Nonetheless, there may be other reasons (not related to underestimating target WACC) that may lead to timely and needed investments not being realized. For example, an airport with market power may engage in strategic behavior that distorts investment. Increasing the target WACC above the mid-point estimate is not an effective mechanism through which to counteract this threat.

Summary point 3: There is a risk that some, but not all, non-capacity enhancing investments may be neglected by the airport but increasing the target WACC is not an effective remedy. Instead, airports need to be mandated to engage in closer consultation with airlines, backed-up with a robust regulatory framework.

There is a legitimate concern that in a dual till and light touch regulatory regime, such as the one employed in New Zealand, there is a risk that needed non-capacity enhancing aeronautical investment may be neglected by an airport. Although even here there is some evidence to suggest that some non-capacity investments may also have a positive relationship for non-aeronautical revenues[1]. IATA has not yet had an opportunity to review this specific piece of evidence but based on our experience we think it is likely that a positive passenger experience in the airport can have a favorable impact on non-aeronautical revenues. Therefore, it may be that non-aeronautical revenues can also be favorably impacted by non-capacity enhancing aeronautical investments if those are channeled appropriately. Nevertheless, there may still be instances when airports choose to neglect

---

[1] http://www.aci.aero/News/Releases/Most-Recent/2016/08/08/ACI-releases-new-research-paper-analyzing-the-influence-of-customer-service-quality-on-airports-nonaeronautical-revenue

International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666

non-capacity boosting investments or wish to pursue misguided investments due to their insulation from market forces as a result of their market power.

Increasing the target WACC above the mid-point estimate would **not** be an effective way to align airport investments with needs of the user community and will almost certainly lead to worse outcomes for users. To adequately address the investment needs of the user community, closer consultation is needed with airlines that is backed-up with a robust regulatory framework. If airports do not need to agree their investment plans with regulators and airport users, there is increased risk that these investments don't adequately address or are not aligned to the service-level needs of airport users. Closer consultation can help identify opportunities to better exploit airport-airline operational efficiencies ensuring that solutions are delivered in the most cost effective way. In the absence of regulation, the prevalence of market power by airports over airport users means that the consultation process over investment choices is unlikely to be balanced or effective.

Delay of investment in the UK not attributed to any potential under targeting of the WACC

The experiences referenced in South East UK in the Bush & Earwaker paper relied upon by NZ Airports Association have little (or no) relevance to the issue of over or under estimating the target WACC.

Delays in investment in runway capacity in South East UK has had severe adverse impacts on users and the wider UK economy. However, the reason for such delays should not be attributed to any under targeting of the WACC. The reason for the delay is primarily explained by political indecisiveness around planning issues. However, academics and observers of the UK air transport sector have indicated that past strategic behavior of common airport ownership in South East UK may have contributed to the lack of political will. They claim that this may in part explain why BAA saw further runway expansion in southeast as less urgent than the regulatory authorities. If this assertion is true, we see it is more likely that any BAA decision not to actively advocate for runway expansion was likely motivated by a desire to increase utilization of aeronautical assets at their less congested airports in the London area. The common ownership of airports in the London area would have created an incentive for BAA to divert demand from congested to less congested airports.

Summary point 4: Delay in investments in runway capacity in South East UK is currently and in the past likely explained by political indecisiveness, although (mis)incentives that existed under common ownership of airports may have in the past contributed to the lack of political will.

In the latest public effort to identify the best location for runway capacity expansion in South East UK, the Airports Commission faced no shortage of interest for allowing investment in runway capacity. To our knowledge, all major airports in and near the London area, either directly or indirectly, were vying for permission to make substantial increases to runway capacity[2]. The Airport Commission has made a recommendation for expansion. However,

[2] https://www.gov.uk/government/publications/long-term-options-proposals-received-by-the-airports-commission

International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666

no planning permission has been given and needed government decisions have continued to be postponed on what appear to be largely non-technical considerations.

Summary point 5: The combination of common ownership of airports and political indecisiveness have in the past had adverse impacts on terminal investments in South East UK

In terms of terminal investments, when airports in London area were under common ownership they intentionally distorted quality of service provision by exploiting market power endowed to them through common airport ownership network effects. This combined with planning permission issues are in our view the leading contributing factors that explain why historically needed aeronautical investments at terminals have not materialized in South East UK in a timely fashion.

2. Interdependency between passengers airlines transport to airport and non-aeronautical revenues at airports is widely recognized and directly reflected in airport charge policies across the world

Referring to the submission made by NZ Airports Association para 125 – 133 rejecting the Commerce Commission's view that the presence of complementary revenue streams reduces the risk of under-investment.

IATA strongly supports the single till principle under which airport commercial revenues are taken into account to offset the charges cost base. The single till is justified because there is an interdependency between the passengers airlines transport to airports and the non-aeronautical revenues (e.g. retail, car parks) they generate for airports. A dual till may result in higher aeronautical charges and may not only negatively impact the development of air traffic, but additionally create the need for difficult and detailed cost and asset allocation between aeronautical and commercial tills.

Since airlines bring in passengers who use airport commercial facilities and contribute to their profitability, it is reasonable that airlines should also benefit from economic benefits of airport commercial activities. A single till benefits both airlines and their passengers and ultimately airports, allowing airports to earn a competitive rate of return on their activities, provided they are operating efficiently. IATA would also like to dispel the notion that airport non-aeronautical revenues are subsidizing airlines if a single till approach is used. Our views on this matter are detailed in Appendix A.

Summary point 5: Single till framework inherently recognizes the interdependency of passengers airlines transport and the non-aeronautical revenues. It provides strong incentives for efficiency and productivity improvements.

Examples of regulatory framework that use the single till approach to reflect this interdependency include South Africa and the UK.

South Africa

In South Africa, the regulating committee to ACSA and ATNS recognizes this in their approach to the 2015/16 – 2019/20 permission where it is outlined that there is a high degree of inter-dependence between aeronautical and non-aeronautical aspects of the business

International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666

and it should be acknowledged that there would be little or no non-aeronautical activity without the aeronautical activity. In their view the single till mechanism does not constrain the level of non-aeronautical revenues, instead it effectively uses any supernormal profits earned in providing the services and applies these to moderate airport charges, restraining monopoly privileges[3].

UK

In the UK, the competition commission advised that there is no evidence that single till has led to under-investments in aeronautical assets and dual till would not be likely to lead to better aeronautical investments in the future.

The jurisdictions that have deviated from the single till approach have done so by employing frameworks that take into account the interdependency between the passengers airlines transport to airport and non-aeronautical revenues. Singapore is such an example.

Singapore Changi Airport (SIN)

When SIN was corporatized in 2009, the Civil Aviation Authority of Singapore (CAAS) opted for a hybrid till framework. As the airport operator, Changi Airport Group (CAG) is required to use a percentage of its non-aeronautical economic profit to partially contribute to the cost of providing aeronautical services and facilities. This contribution percentage known as H% is set by CAAS before the start of each regulatory period. For the current regulatory period, H% has been set higher than 50% and is reportedly to be in the range of 70-80%.

As opposed to a dual till approach, this hybrid till approach (in the absence of a single till approach) will better ensure that aeronautical charges to airlines and passengers remain equitable through the recognition and contribution of non-aeronautical revenue while providing CAG with sufficient incentives to invest, innovate and operate efficiently.

In 2014, Changi Airport was among the top three airports in the world in terms of retail business performance. Sales at Changi Airport in 2015 hit a record high of $2.2 billion, on the back of growing passenger numbers.

Summary point 6: Any deviation from the single till approach must be accompanied by robust regulatory frameworks that take into account the interdependency between the passenger airlines transport and non-aeronautical revenues.

3. Treatment of pricing incentives

Referring to submission made by NZ Airports Association (para 254 – 259).

IATA favors a general reduction in the level of charges for all carriers rather than granting incentives to a limited number of users as no group of users should be given special treatment with regard to charges. Specifically in the case where the costs for providing the incentives to some carriers are included in the overall cost-base for charges and finally paid by all users, this means airlines who operate in a competitive environment are inappropriately required to fund incentives granted to their competitors.

[3] Source: Approach to the 2015/16 to 2019/20 Permissions, Regulating Committee for ACSA and ATNS, September 2014

International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666

This practice where costs associated with the incentives are also allocated to airlines who do not benefit from them can be considered as discriminatory and is not in line with ICAO's principles for safeguarding users against potential negative effects of rebates[4]. IATA therefore strongly objects to discounts and incentives that distort competition among the airlines.

We have seen examples in a dual till environment where the funding of incentives is ensured through commercial revenues and therefore not included in the cost base for airport charges - which avoids cross-subsidization from airlines not benefiting from the incentives. However any incentive scheme still needs to be in line with ICAO's policies on charges and applied in a non-discriminatory way, fairly available to all users and for a finite duration. Proper engagement with the airlines in a full consultation to review incentives schemes along with analysis of the operational impact and network effect on aviation stakeholders is needed.

Summary Point 7: IATA's position remains that a general reduction in the level of charges for all carriers should be favored over discounts and incentives that distort competition. Still, in the event that incentive schemes are implemented, these need to be applied in a non-discriminatory way, fairly available to all users and for a finite duration.

We respectfully request that our views expressed above be taken into consideration in arriving at a decision that would be in the interest of New Zealand airport users.

Yours sincerely,

Richard TAN
Regional Manager Airport, Passenger, Cargo and Security
Asia Pacific
tanr@iata.org

[4] ICAO Doc 9082 (ninth edition), paragraphs 3 iv) and 3v) of Section II

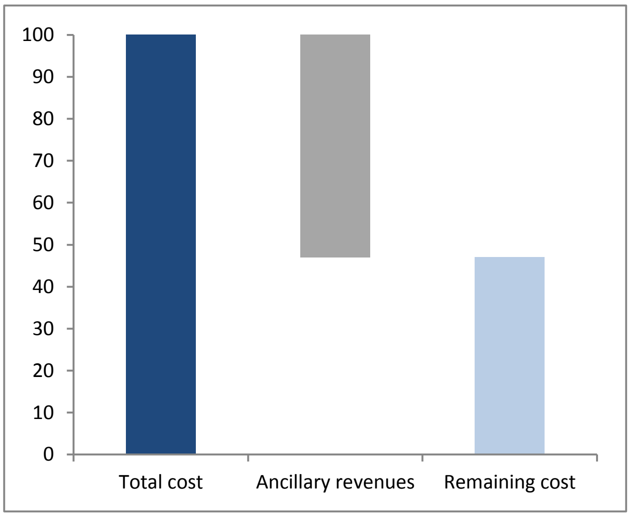
International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666

APPENDIX A

Airport non-aeronautical revenues are not subsidizing airlines

According to ACI, airports are subsidizing airlines as airport charges account for 47% of airport revenues in Europe only and airlines are therefore not paying the full cost of the infrastructure. In their view, using non-aeronautical revenues to offset airport costs is seen as a subsidy to airlines. This is wrong.

This argument is based on an artificial split of the airport business into an aeronautical and non-aeronautical segment, while in fact it is the same customer generating both at an airport. The airlines deliver consumers to the airport to both use aeronautical services, to shop and to pick up or park their car. This bundle of services jointly consumed is typical of many economic activities with large assets and fixed costs.



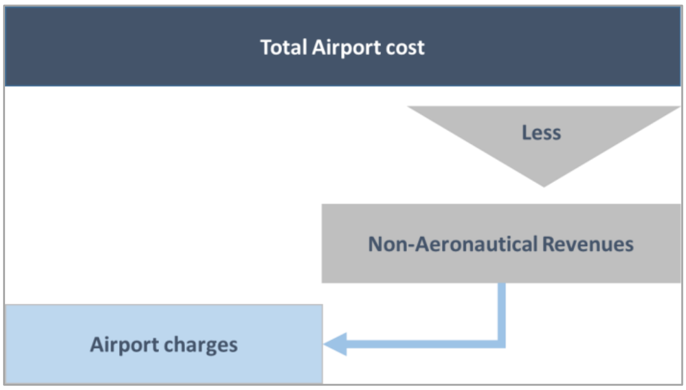
Business model under "Single Till"

The same business model to cover fixed costs is applied at Cinemas. The owner would need to incur high fixed costs in leasing/buying the infrastructure, the seats, equipment, etc. The core business would be for consumers to pay for a cinema ticket and be able to watch a movie. However, the cinema owner also offers additional services (selling of popcorn, beverages) to offset overall costs allowing to offer a competitive price for the ticket.

These ancillary revenues – generated by the same consumer who is buying the core product – help cover the fixed costs, which are common to supplying both the core and ancillary economic activity. These business models exist in highly competitive markets.

There are weak competitive pressures on airports placing them in a position of economic strength and endowing them with market power. Airports can use their market power to generate excess profits. Airport non-aeronautical services are exactly the same solution to covering fixed costs, as competitive markets have developed in industries such as restaurants, cinemas, sports venues, hotels and more. If there were strong competitive pressures on airports they would be disciplined by market forces to reduce their charges and improve their services in order to survive in the business. Airports would automatically utilize, what is called in the airport charges jargon, a "single till" mechanism.

International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666



Schematic Airport business model under "Single Till"

So in no sense can non-aeronautical charges be seen as 'subsidizing' an airport's aeronautical activities, unless it is meant in the same sense as beer sales at Emirates Stadium subsidizing the Arsenal football team, your massage treatment subsidizing your hotel stay, or the wine you buy at the restaurant subsidizing your meal.

The costs are common. The consumer is the same. This is not a subsidy and the same business model should be applied.

International Air Transport Association
111 Somerset Road, #14-05
Singapore 238164
Tel: +65 6438 4555
Fax: +65 6438 4666