Air NZ Limited
Submission to the Commerce Commission

Commerce Act 1986, Part 4

Section 56G Review of Auckland International Airport

AIR NEW ZEALAND

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Public Version

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1 Introduction

1. Air New Zealand Limited (**Air NZ**) welcomes the opportunity to participate in the Commerce Commission's (**Commission**) report, pursuant to section 56G of the Commerce Act 1986 (**Act**), on how effectively information disclosure regulation is promoting the purpose of part 4 of the Act in relation to Auckland International Airport Limited (**AIAL**).

2. Air NZ's contact person for this submission is:

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3. Air NZ notes at the outset that it is involved in the merits review of the Commission's input methodologies determination and has proposed an alternative approach to valuation than the Commission determined. For the purposes of this s 56G review, Air NZ is relying on the input methodologies (**IMs**) as determined by the Commission in its Decision No. 709.[1] For the avoidance of doubt, none of the views expressed in this submission in any way change Air NZ's belief that the methodologies it is espousing in the merits review are "materially better" than the Commission's in meeting the purpose of Part 4 of the Act.

[1] Commerce Commission, Decision No. 709 – Input Methodologies Determination Applicable to Specified Airport Services pursuant to part 4 of the Commerce Act 1986 (22 December 2010) (**Final Airports Determination**).

2 Executive Summary

4. Air NZ considers that the major areas of focus for this review are:

- WACC – where AIAL has adopted a post-tax target WACC return of 9.16% as the basis for its calculations; and
- Asset valuation – where AIAL's refusal to engage on the issue of the treatment of revaluation gains at the next PSE, when the current moratorium expires, coupled with its stated views as to the appropriate valuation methodologies to apply for pricing, means these will inevitably become a point of contention in future.

5. The Commission, in the course of the Wellington Airport Conference held on 7 August 2012, referred to the need for "an assessment of two worlds"[2] approach in determining the effectiveness of ID. In its post-conference submission Air NZ supported this approach:

> "If, for instance, the behaviours and outcomes are substantively similar with respect to the final price-setting event subject to AAA disclosures and the first subject to Part 4 information disclosure regulation, then the Commission will be able to conclude with confidence that Part 4 information disclosure regulation has had no appreciable impact on the promotion of Part 4 outcomes (as measured in part by the expectations set in the Commission's previously determined input methodologies)." [3]

6. Applying this test, Air NZ considers AIAL's second PSE clearly demonstrates that ID has been ineffective in promoting the purpose of Part 4. This is evident in AIAL's adoption of a WACC significantly in excess of the value determined by the Commission to be sufficient to ensure continued incentives to invest and in the continuing uncertainty around asset valuation methodologies. Analysis undertaken by BARNZ during the course of the consultation highlights the extent of the excess profits which AIAL will generate as a result of its pricing decision. These excess profits result almost entirely from AIAL's self-determination of a WACC target significantly in excess of what is appropriate for a business of its nature. As has been the case for a number of years, while acknowledging the constructive working relationship with AIAL particularly at an operational level, the major area of concern for Air NZ with AIAL's performance and behaviour remains pricing outcomes which fail to appropriately balance the objectives of s 52A(1) of the Act.

7. Air NZ made extensive submissions to the Commission as part of its complementary s 56G report process in relation to Wellington International Airport Limited (**WIAL**). Air NZ considers those submissions are equally valid to the Commission's consideration of AIAL –

[2] Transcript at 119, lines 30-34

[3] Air NZ Limited, Post-conference Cross-submission to the Commerce Commission, Commerce Act 1986 Part 4,Section 56G Review of Wellington International Airport Limited, 17 August 2012, pp.8-9, paragraph 24

"Air NZ believes that ID has failed to promote the purpose of part 4 of the Act…" [4]

"The IMs have also been ineffective in promoting certainty for consumers …."[5]

"Further, Air NZ strongly believes that ID regulation by itself – even a new and improved version – would not be truly effective in promoting the purpose of Part 4. We have set out the three main ways that the regulation of airports could be improved to better promote the purpose of … Part 4:

(a) implementing negotiate/arbitrate regulation alongside ID, including the removal of the airports' statutory right to charge as they see fit;
(b) adopting a "single till" approach; and
(c) determining a pricing methodology for specified airport services." [6]

"Interpreted against the purpose of Part 4, ID regulation must be intended to promote specific regulatory outcomes consistent with s 52A(1) and an express requirement of s 56G. Pressure on airports to adjust investment, pricing and recovery behaviour is precisely the legislative intention…" [7]

8. In respect of valuation, AIAL in its 14 September 2011 letter to substantial customers, stated:

"Auckland Airport's position, on the basis of its review of relevant literature and professional advice, is that MVEU (or MVAU plus land conversion costs) is the appropriate methodology for valuing land assets." [8]

And

"Auckland Airport advocated to the Commerce Commission that a current ODRC valuation was a materially better methodology than an ODRC valuation based on carrying values, derived from 30 June 2006 valuations rolled forward for additions, disposals and revaluations….

Auckland Airport has commissioned Opus to provide valuations as at June 2011 for specialised buildings and infrastructure.

The Opus valuations will be a crucial input for pricing purposes should Auckland Airport proceed with current valuations of specialised assets for pricing." [9]

9. While AIAL accepted the need to maintain the moratorium approach it adopted in 2007, it is clear from these comments and from AIAL's unwillingness throughout the consultation process to commit to an outcome when the moratorium ends,

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[4] Air NZ Limited, Submission to the Commerce Commission, Commerce Act Part 4, Section 56G Review, 29 June 2012, p. 14, paragraph 42

[5] Ibid

[6] Ibid

[7] Air NZ Limited, Cross-submission to the Commerce Commission, Commerce Act 1986, Part 4, Section 56G Review, 20 July 2012, p.11, paragraph 3.4.3

[8] AIAL 14 September 2011 Letter to Substantial Customers, Firt Information Pack Part B – Asset Valuation, p. 2

[9] Ibid

that the valuation issue will remain a major point of contention in the future, notwithstanding the IMs.

> "…Auckland Airport considers that it would be unreasonable for its customers to have any specific expectations regarding the duration of the Moratorium and/or approaches to be taken if or when the Moratorium is lifted, including how revaluation gains or losses might be treated." [10]

10. AIAL's 2 August 2012 Price Setting Disclosure makes the claim that its approach to WACC "is consistent with the Commission's WACC methodology for information disclosure,…"[11] but then proceeds to identify 5 areas in which the inputs it has adopted are different to those which the Commission adopts. In all cases the inputs adopted by AIAL are higher than those determined by the Commission, resulting in a significantly overstated WACC target.

11. Auckland Airport considers that its WACC range/target is necessary to "enable [it] to source suitable debt and equity funding from global capital markets".[12] However, in then determining to set prices at a level resulting in a forecast negative NPV outcome, AIAL demonstrates that its WACC target of 9.16% is in excess of what is required for it to secure "suitable debt and equity funding". Given that AIAL's "effective return" of 8.475% is approximately 1% higher than the 75th percentile value identified by the Commission in its 30 July 2012 determination[13], this is hardly unexpected.

12. AIAL's approach to both asset valuation and WACC highlight the continuing uncertainty and instability inherent in airport approaches to pricing, even with the current Part 4 ID regulation in place. The airports continue to ignore or disregard expectations of pricing behaviour set by the ID regime (including the input methodologies for asset valuation and cost of capital). The airports purport to justify this approach on the basis of their "right" to set prices as they see fit pursuant to the Airport Authorities Act. This purported justification does not promote the long-term benefit of consumers, as required by the Act, and cannot achieve this purpose until the airports are effectively incentivised to engage with the expectations set by the Part 4 information disclosure regime.

13. This continuing ability for airports to ignore the expectations set for suppliers and consumers undermines the stability of the regulatory regime. Pricing outcomes established by price-setting events can vary on little more than a whim, and with very little advanced notice (as demonstrated by changes to the various proposals throughout the pricing process). This compromises the certainty that the regulatory regime, and in particular the input methodologies, is intended to promote. In these circumstances, the resulting pricing and performance outcomes cannot credibly be considered to be consistent with competitive market outcomes.

14. AIAL's Price Setting Disclosure refers to a presentation from Air NZ to the AIAL Board at which the Board was advised that Air NZ was "largely comfortable with"

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[10] AIAL, Initial Pricing Proposal, 19 January 2012, section 3.4.4, p.41

[11] AIAL, Price Setting Disclosure, p.24

[12] AIAL, Price Setting Disclosure, p.5

[13] Commerce Commission, Cost of capital determination for information disclosure year 2013 for Transpower, gas pipeline businesses and specified airport services (with a June year-end) [2012] NZCC20, 30 July 2012

pricing, although Air NZ "considered the WACC being proposed by Auckland Airport was excessive and not consistent with the Commission's Determination."[14] The Commission should not underestimate the significance of the WACC issue as a concern to Air NZ. While Air NZ considers the continuation of the valuation moratorium and the pricing structure adopted in this PSE to be appropriate, as highlighted in this submission, WACC is the major driver of Air NZ's conclusions regarding the appropriateness of AIAL's pricing and consequently the (lack of) effectiveness of information disclosure in promoting the section 52A(1) purpose statement.

[14] AIAL, Price Setting Disclosure, 2 August 2012, pp.36-7

3 Process and Scope

15. Air NZ commented, in section 4 of its 29 June 2012 Submission to the Commission on matters of process and scope raised by the Commission as part of its preliminary work on the s56G review of WIAL. Those comments remain valid in the context of the Commission's review of AIAL.

16. Air NZ commented at that time that it was disappointed at the delay to the process the Commission proposed for WIAL. Air NZ is equally disappointed that the Commission has now pushed the Conference for AIAL out to sometime in February 2013 (indicatively) which will clearly have an impact on the timing of the draft report and subsequent stages of the process. Delays such as this do nothing more than prolong the period that customers are subject to excess prices.

17. Air NZ repeats the conclusions of that submission in relation to the process and scope of the Commission's assessment:

> "ID has revealed how ineffectively the current regulatory regime is promoting the purpose of Part 4, but it has not promoted the purpose of Part 4. In its report, the Commission should distinguish between the limits of the current ID regime (i.e., how could ID regulation be improved) and the limits of information disclosure in general. Even a flawless ID regime would struggle to promote the purpose of Part 4 in the context of the airports' anomalous "right to charge as they see fit" under s 4A of the AAA, the decision to regulate on a dual till basis and the absence of a negotiate/arbitrate model."[15]

[15] Air NZ 29 June 2012 Submission, pp. 33-34, paragraph 137

4 Questions relating to AIAL (Attachment 1)

Has information disclosure had any impact on AIAL's performance and in understanding AIAL performance relative to the first price setting event (PSE), and why?

18. Information disclosure has had no impact on AIAL's performance. Disclosures made pursuant to the Part 4 disclosure regime have provided greater transparency of AIAL's performance than previously available, relative to forecasts at the time of the first PSE.

Has information disclosure had any impact on the effectiveness and scope of consultation as part of AIAL's second PSE relative to the first PSE, and why?

19. Information disclosure had no impact on the effectiveness and scope of consultation as part of the second PSE. As AIAL has commented "…the airport's obligation is to consult under the Airport Authorities Act."[16]

20. A further contributing factor to this lack of impact is AIAL's requirement that the consultation process for the second PSE, as with previous consultations, be conducted completely confidentially. As such, there is no provision for parties which are not Substantial Customers as defined by the Airport Authorities Act to gain a full understanding of the airport's proposals as these are developed through the consultation process.

What aspects of performance and conduct should we focus our efforts on for this review for AIAL?

21. Air NZ considers the Commission should focus its assessment of AIAL on two issues:

- WACC
- Asset valuation at the expiry of the second PSE

WACC

22. AIAL adopted a post-tax WACC of 9.16% as the appropriate target return for the second PSE and has used this to calculate its NPV outcome over the pricing period. This compares to the mid-point post-tax WACC for airports determined by the Commission at 27 April 2012 of 7.06 (subsequent to AIAL's decision, the Commission determined a mid-point post-tax WACC of 6.49% as appropriate for AIAL).

23. The major inputs driving the differences in value are:

- Cost of debt – 7 years versus 5 years
- PTMRP - 7.5% versus 7%
- Asset beta – 0.65 versus 0.60
- WACC range – 75th-85th percentile versus 25th-75th percentile

[16] Auckland Airport, Auckland Airport – Section 56G Cross Submission, 17 August 2012, p.3

24. BARNZ, on behalf of its members, sought advice from Futures Consultants Limited on whether there was any valid justification for AIAL departing from the Commerce Commission WACC IM developed for the purpose of information disclosure, when setting charges. Futures Consultants concluded that "*…there is no justification for AIAL, when setting charges, adopting parameter estimates using a different approach from what the Commission has set for AIAL for information disclosure purposes. Should AIAL use Uniservices' WACC estimates in order to set charges for its regulated services, without making offsetting adjustments in one or more of the other components it uses for this purpose, it will be seeking very significant excess returns compared with the level the Commission considers to be appropriate.*"

25. Notwithstanding the views of airlines, AIAL proceeded to use over-stated inputs when setting its charges pursuant to the Airport Authorities Act, targeting a return almost 1.5 times the level considered appropriate using objective market data.

Asset Valuation

26. AIAL's initial position on valuation was that the regulated approach to asset valuation had changed and therefore the moratorium it voluntarily entered into in 2007 no longer applied. Following strong feedback from airlines AIAL decided to proceed on the basis of the moratorium. As such, the issue of revaluations and in particular the treatment of unforecast revaluations, was not a source of contention during this pricing consultation.

27. Of particular concern however is the seeming continuing reliance by AIAL on advice from NERA in respect of revaluations:

    "In terms of practical application for the upcoming price reset, it would be consistent with the principles we have outlined for Auckland Airport, starting from a current valuation for its specialised assets, to:
    - Obtain unbiased forecasts of expected changes in value for those specialised assets over the pricing period, and treat any expected revaluations as income over that pricing period; and
    - At the end of that pricing period, obtain unbiased revaluations of its specialised assets, with no wash-up… [17]

    The same approach was advocated by NERA for land assets.[18]

28. Air NZ, during the course of the consultation, sought commitment from AIAL to a principled approach to revaluations consistent with the Commerce Commission IM's, i.e. any revaluations should be reflected in income to the extent that these have previously been recognised in AIAL's pricing models. No such commitment was given and rather:

    "Auckland Airport continues to hold the view that it is inappropriate to form a view relating to its pricing consultation in 2017 now.

    Auckland Airport therefore reserves its views on revaluations generally until the next pricing round. However, Auckland Airport wishes to make it clear to

[17] NERA, Airport Asset Valuation Principles Auckland Airport, 13 September 2011, section 3.3, p.7
[18] Ibid, p.8

its Substantial Customers that there can be no expectation that Auckland Airport's approach to the revaluations in 2012 will be followed in future pricing consultations. [19]

29. It is therefore readily apparent that the treatment of unforecast revaluation gains remains a significant outstanding issue which will inevitably become a point of contention in the future. Given that AIAL's 2011 disclosure identifies some $75.4 million revaluation gains for Specified Airport Activity assets in the period since 30 June 2006 this is of major concern to Air NZ.

Is AIAL earning an appropriate economic return over time?

What is an appropriate level of target return for AIAL, and why is the level appropriate?

30. Air NZ provided general comment on this issue in section 5.4.1 (paras 153-165) of its 29 June 2012 Submission to the Commerce Commission in relation to Wellington International Airport. The Commission is referred to those comments which are attached at Appendix A.

31. In summary, Air NZ considers that the work undertaken by the Commission in developing the WACC IM was comprehensive and sound and the resulting IM reflects the best advice of experts in the field.

32. Returns consistent with the WACC mid-point calculated pursuant to the WACC IM are an appropriate level of target return, representing a balance between the objectives of s 52A(1)(a) and (d). As discussed in our 29 June submission, the dual till approach adopted by New Zealand airports already provides additional incentives to invest in aeronautical facilities given the airports are able to rely on the WACC return associated with the aeronautical business plus the incremental non-aeronautical revenues accruing from additional passengers using the airport. And indeed, AIAL acknowledges this in its 2012 Annual Report – "The improved financial results were largely fuelled by growth in passenger numbers across our airport interests."[20]

33. Further, as noted in para. 164 of our 29 June submission "The Commission's use of comparator airports to derive the WACC, most of which are single till and therefore include the higher cost of capital figure associated with non-aeronautical revenues, only underscores the need for the Commission to be conservative in its application of the cost of capital. In fact, for airports who have an even higher proportion of non-aeronautical revenues than WIAL (such as AIAL), it may be more appropriate to apply a cost of capital below the mid-point for assessment purposes."[21] Assessment against the mid-point is therefore favourable to AIAL.

34. This point is reinforced when considering AIAL's performance on an overall business basis. Set out below are graphs which present the return on shareholder funds and investment (net assets). The analysis is presented in three forms:

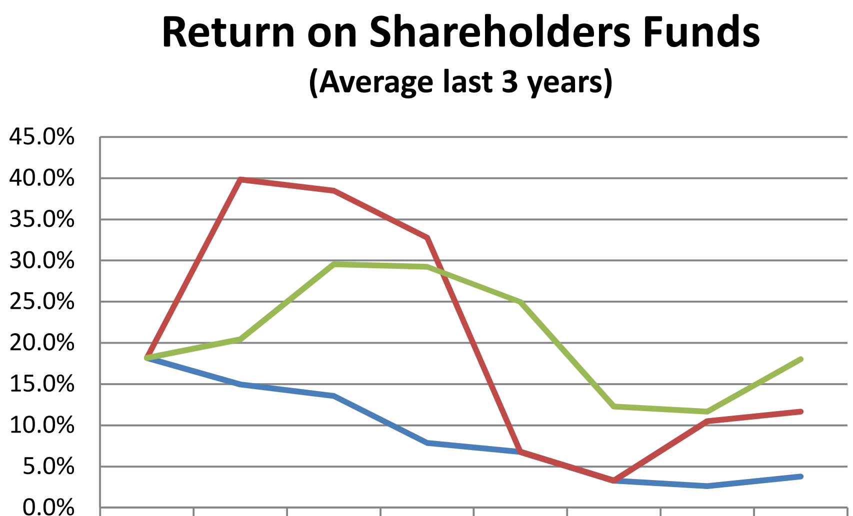
[19] AIAL, Reasons Paper, Pricing Decision on its Aeronautical Charges, 7 June 2012, section 3.2.2., p.26

[20] AIAL, Wider Ambition, Annual Results 2012, p.1

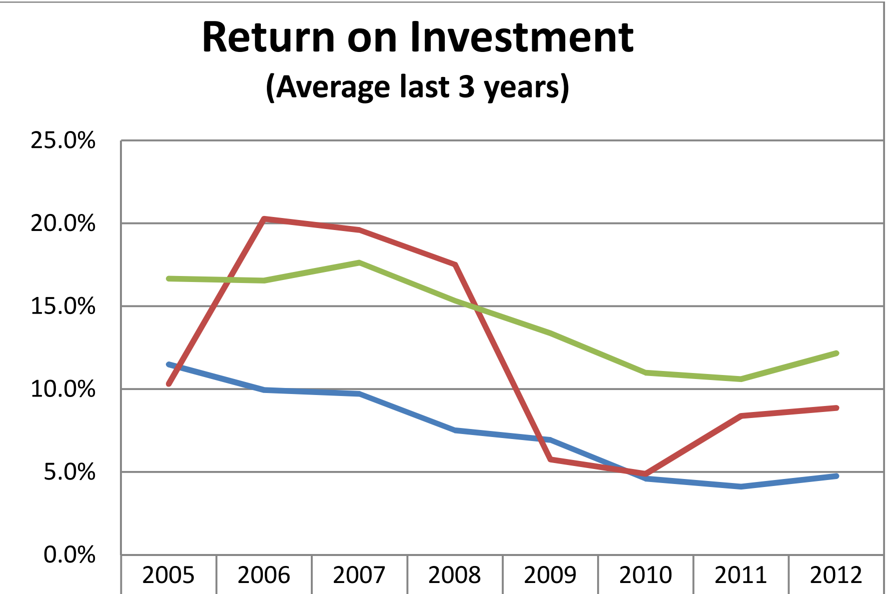
[21] Air NZ 29 June Submission, p.39, paragraph 164

- As per accounts
- Revaluations post 2002 included in profit and loss
- Revaluations post 2002 excluded from shareholder funds and investment

The analysis (which has been performed over the last 10 years) has been presented as three year moving averages from 2005. This approach has been taken to remove the sharp spikes when revaluations are taken to the earnings statement,



	2005	2006	2007	2008	2009	2010	2011	2012
As per accounts	18.2%	14.9%	13.6%	7.9%	6.8%	3.3%	2.6%	3.8%
Reval in P&L	18.2%	39.8%	38.5%	32.8%	6.8%	3.3%	10.5%	11.7%
Post 2002 BS Revals excluded from equity and profit	18.2%	20.4%	29.6%	29.2%	25.0%	12.3%	11.7%	18.0%



	2005	2006	2007	2008	2009	2010	2011	2012
As per accounts	11.5%	9.9%	9.7%	7.5%	6.9%	4.6%	4.1%	4.8%
Reval in P&L	10.3%	20.3%	19.6%	17.5%	5.8%	4.9%	8.4%	8.9%
Post 2002 BS Revals excluded from equity and profit	16.7%	16.6%	17.6%	15.3%	13.4%	11.0%	10.6%	12.2%

35. This analysis clearly illustrates the level of excess returns being enjoyed by AIAL overall. A monopoly such as AIAL should on average, earn a 7-8% return on investment and a 10-12% return on shareholder funds. If post 2002 revaluations are removed, the 2012 return on investment is 13.6%, while the return on shareholder funds is 28.2% (compared to the reported 5.8%) – both far in excess of what could be justifiably achieved. It should also be noted that returns in the past three years would have been suppressed as a result of AIAL's investment in North Queensland and Queenstown airports.

What is an appropriate level to reflect normal performance, and why?

36. See discussion below.

What is an appropriate level to reflect superior performance, and why?

37. Air NZ provided comment on this issue in section 5.4.1 (paras 152-165) of its 29 June 2012 Submission to the Commerce Commission in relation to Wellington International Airport. Air NZ considers the comments are also relevant to AIAL's performance. The Commission is referred to those comments which are attached at Appendix A.

38. Air NZ also refers the Commission to its comments above regarding the need to ensure that the assessment takes into account total business performance and as such a cost of capital below the mid-point may be an appropriate measure of "normal" performance. As discussed in our 29 June submission, "..attempts by regulated airports to rely on the WACC upper bound should be viewed as likely to

permit airports to extract excessive profits overall to the detriment of consumers of airport services."[22]

Have there been any wash-ups, discounts or other discretionary adjustments to the forecast revenue requirements. If so, how should these be dealt with for assessing profitability?

39. Air NZ is not aware of any such discretionary adjustments to the forecast revenue requirements in the second PSE.

How reasonable is AIAL's revenue forecast for the second PSE compared to the first PSE forecasts, and why?

40. Air NZ considered AIAL's revenue forecasts for the first PSE, as per its prices set pursuant to the Airport Authorities Act in 2007, to be excessive. The major drivers of this excessive level of charges were the WACC being targeted by AIAL and its failure to properly account for previous unforecast revaluation gains.

41. While the revaluation issue was not a factor in the second PSE, due to AIAL maintaining the moratorium on revaluations it voluntarily entered into in 2007, AIAL's target WACC (9.16%) continues to be an issue, and results in a disclosed forecast negative NPV outcome which is overstated. As discussed above, Air NZ considers the mid-point WACC determined by the Commerce Commission as an appropriate, if generous, target return given the nature of AIAL's overall business. Air NZ notes that the Commission's WACC determination for the 2013 financial year (mid-point 6.49%) was made after AIAL's pricing decision, and is approximately 1% less than the determination for the 2012 financial year.

To what extent did actual results for the first PSE differ from forecasts, and why?

42. Differences in the asset and activity groupings forming the base for the first PSE forecasts and information disclosed under the previous Airport Authorities Act disclosure regime, coupled with the hiatus in disclosure resulting from the transition to the new Commerce Act disclosure regime make it difficult to generate a direct comparison between forecast and actual outcomes.

43. Nevertheless it can be determined that AIAL's revenue from the three main aeronautical charges – airfield MCTOW, PSC and TSC – were all less than was forecast in 2007, reflecting lesser international passenger volumes and overall aircraft movements. It can also be determined, from AIAL's 2011 disclosure and 2012 annual results, that actual capital expenditure was less than forecast, as a result of deferrals due to weaker growth and changes in priorities.

44. The 2011 disclosure also highlights that operational expenditure during the period was higher than forecast - although a significant portion of this is attributable to the inclusion of activities (aircraft and freight, and leased areas) not included in the first PSE activity base. As highlighted by AIAL the single largest item contributing to the higher than forecast operational expenditure was AIAL's decision to commit significantly more resources to route development initiatives and to allocate these costs to the aeronautical cost centre.

[22] Air NZ 29 June submission, p.38, paragraph 165

To what extent is the difference between forecast revenue and actual revenue disclosed under ID for 2011 and 2012 different due to changes in demand and what is the dollar value difference in each year due to the changes in demand?

45. Changes in demand will inevitably have driven part of the difference between forecast and actual revenue (e.g. forecast MCTOW in 2011 was 6.584m tonnes versus actual disclosed of 5.690m tonnes). The actual total revenue impact of these differences are not readily apparent to Air NZ given the different MCTOW charge categories (albeit noting that international MCTOW revenue in 2011 would appear to be approximately $9.2m less than forecast in 2007). Given this, and that AIAL's 2012 disclosure has not yet been made, this question will need to be addressed by AIAL.

How do the asset values used for the second PSE pricing purposes reconcile to the asset values disclosed under ID?

46. The asset values used by AIAL for the second PSE are, due to the moratorium applied by AIAL for the 2008-12 and 2013-17 pricing periods, based on the asset values adopted for pricing in 2007. The pricing asset base reflects capital expenditure and depreciation since 2007 but does not incorporate any further asset revaluations.

47. In contrast the asset values disclosed under ID reflect the Commission's IM determination and therefore incorporate CPI indexation and a mid-price period asset revaluation.

48. A further difference, as outlined by AIAL in its 2012 Price Setting Disclosure, is the inclusion in ID disclosures of assets relating to activities which are not part of the pricing asset base.

49. Air NZ considers that AIAL is best placed to provide a detailed reconciliation of the different asset base values.

What differences (including dollar value effects) are there between cost allocation methodologies and cost categories used for ID disclosure and the second PSE price-setting?

50. Air NZ understands that AIAL has attempted to provide consistency between the methodologies and categories used for ID disclosure and price-setting but that there will be differences due to the wider set of activities included in ID disclosure.

51. AIAL is best placed to respond to this question.

How reasonable are AIAL's asset valuations, and why?

52. Air NZ refers to its earlier comments regarding asset valuations and the Merits Appeal.

53. In terms of the actual valuations adopted by AIAL in the first PSE (which form the basis of valuations for the second PSE), Air NZ refers the Commission to work undertaken on behalf of BARNZ during consultation on the first PSE which highlighted, as the main area of difference, the overly aggressive approach taken by AIAL's valuers to the ODRC valuations of the terminal and civil works. Air NZ considers that these valuations should not form the basis of the starting point values under the Commission's IMs.

54. Air NZ refers the Commission to the analysis undertaken for BARNZ in respect of the 2011 valuations.

What is the appropriate treatment for pricing purposes of assets held for future use?

55. Assets held for future use should as a matter of principle not be included in the asset base for pricing purposes. As these are not currently used to provide services to consumers it would be inappropriate to include them within the cost base on which current charges are set. While AIAL has excluded the Northern Runway and Northern Runway approach land from its cost base for current Standard Charges, it believes such an approach is "inappropriate"[23], consistent with its approach to pricing during the first PSE when 56% of the northern runway land was included in the pricing asset base.

56. Air NZ considers that including such assets within the pricing asset base would amount to a form of pre-funding as users are effectively paying for an asset which is not currently in use and for which they derive no current benefit. Air NZ commented on this issue in its 27 October 2011 response to AIAL's First Information Package:

> "Airlines have traditionally been opposed to pre-funding due to difficulties associated with ensuring monies collected are used for the purpose intended, and with the intergenerational inequity associated with pre-funding i.e. today's users paying for investment which they do not use today and which they may not use in the future.
>
> It is noted that the International Civil Aviation Organisation, in its *Policies on Charges for Airports and Air Navigation Services*, does acknowledge that pre-funding may be acceptable in certain circumstances:
>
> *"The Council considers, notwithstanding the principles of cost-relatedness for charges and of the protection of users from being charged for facilities that do not exist or are not provided (currently or in the future) that, after having allowed for possible contributions from non-aeronautical revenues, pre-funding of projects may be accepted in specific circumstances where this is the most appropriate means of financing long-term, large-scale investment, provided that strict safeguards are in place, including the following:*
>
> *i) Effective and transparent economic oversight of user charges and the related provision of services, including performance auditing and "benchmarking" (comparison of productivity criteria against other similar enterprises);*
>
> *ii) Comprehensive and transparent accounting, with assurances that all aviation charges are, and will remain, earmarked for civil aviation services or projects;*
>
> *iii) Advance, transparent and substantive consultation by airports and, to the greatest extent possible, agreement with users regarding significant projects; and*

[23] AIAL, Price Setting Disclosure, 2 August 2012, p. 21

iv) Application for a limited period of time with users benefitting from lower charges and from smoother transition in changes to charges than would otherwise have been the case once new facilities or infrastructure are in place."[24]

If AIAL were to apply such an approach, it is therefore incumbent on it to provide details of the proposal, in terms of timeframe, pricing profile, and governance arrangements under which the funds will be earmarked for the intended purpose. If the ICAO policy is a guide to behaviour it is also a good indicator that some form of negotiation concluding with agreement is necessary to underpin pre-funding. Notwithstanding the perceived inability of the New Zealand approach to consultation to deliver rational outcomes in airport pricing Air New Zealand urges AIAL not to proceed with the investment, or a pre-funding methodology, without agreement from users.

Air New Zealand notes that there are options for pricing of large-scale investment which have been used at other locations whereby a longer-term view of profitability is taken, such as Dublin Airport, whereby the investment is recovered over the long-term through growth. In that case the regulator rejected the concept of pre-funding under the guise of over building. Such mechanisms are acknowledged by Estina where it notes:

"*Airports operating in a competitive market, and facing successive investments in capacity steps would not show constant economic profits of zero, but instead would;*

- *Experience periods of under recovery (particularly so just after an investment in increased capacity, while utilisations are relatively low);*
- *Alternating with periods of over recovery (particularly so just before an investment in increased capacity, while utilisations are relatively high).*"

The issue is not about the airport achieving NPV=0, it is instead about the period over which the NPV is calculated, i.e. an assessment of the appropriate period over which to recover the cost of a significant and long-lived asset and the extent to which this can be funded through activity growth rather than (simply) unit price increases."

57. Air NZ continues to hold that position.

Is AIAL operating and investing in their assets efficiently?

Where and when do capacity constraints occur at AIAL, and is additional investment necessary to address these constraints?

58. There are currently capacity constraints in parts of both the domestic and international terminal and apron facilities for limited periods during peak times at AIAL. This is not uncommon for large infrastructure assets as it is inefficient to construct these to cater for absolute peak demand resulting in significant excess capacity for large periods of time. Nevertheless, Air NZ agrees that there is a need to address this at AIAL and the second PSE capital expenditure forecast includes allocations to address these.

[24] ICAO's Policies on Charges for Airports and Air Navigation Services, Doc 9082, Eighth Edition, 2009 p. 10

59. For the longer term, AIAL is engaging with airlines regarding the development of a new domestic terminal facility which is not reflected in current pricing. AIAL has indicated[25] that following consultation on the capacity solution, it will consult on an "investment charge" and that this may be set during this pricing period. Development of a sustainable commercial solution to the funding of this development will be a key factor in assessing any such charge.

What factors outside AIAL's control have contributed to the capex and opex forecast for the second PSE and to changes in expenditure since the first PSE?

60. The major factors outside AIAL's control are increased insurance and local authority rates costs. While there has also been an element of increased regulatory cost, the extent of this latter cost category is able to be controlled by AIAL, e.g. in terms of the extent to which consultants and advisors have been engaged to undertake valuation and other exercises, and the extent to which AIAL participates in the merits review proceedings.

How reasonable are AIAL's opex and capex forecasts for the second PSE, and how do these compare to forecast and actual expenditure from the first PSE?

61. AIAL's operational expenditure forecasts for the second PSE appear to be reasonable, declining in both real and nominal per passenger terms over the period. This is to be expected due to the economies of scale able to be captured through growth. Air NZ does have a concern however that the starting point for the operating expenses incorporates a significant uplift in per passenger expenses towards the end of the first PSE, e.g. total operating expenses in 2012 disclosed in the 2013-17 pricing model were approximately 13% higher than forecast in 2007. A stand-out item included in the operating expense forecast is AIAL's merits review costs which Air NZ considers should not be included in aeronautical costs.

62. Air NZ considers AIAL's forecast capital expenditure for the second PSE to also be reasonable. The process undertaken by AIAL in determining its capital expenditure priorities for this period was robust, transparent and inclusive and the resulting programme included in the forecast is a good reflection of customer requirements during the second PSE. It should be noted that consultation is ongoing regarding future domestic terminal facilities and Air NZ remains fully engaged in this process.

To what extent does the demand forecast presented by AIAL as part of the second PSE accurately reflect expectations of future demand, and why?

63. Air NZ considers the passenger demand forecasts used by AIAL as part of the second PSE are an accurate reflection of future expectations of demand.

64. Air NZ's confidence in these forecasts is based on the work it commissioned from international consulting company InterVISTAS Consulting as part of the initial consideration of AIAL's Integrated Terminal Facility proposal. InterVISTAS conducted a rigorous econometric analysis to develop its forecasts and applied Monte Carlo simulation to address uncertainty, resulting in a robust long-term passenger forecast for AIAL's total market.

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[25] AIAL, Price Setting Disclosure, 2 August 2012, p.43

How reasonable is AIAL's demand forecast for the second PSE compared to the forecast from the first PSE?

65. Air NZ considers the demand forecasts for both the first and second PSEs to have been reasonable based on available information when they were made.

What role did information disclosure regulation play in negotiations concerning AIAL's expenditure forecasts?

66. Application of ID regulation did have an impact on the basis on which AIAL allocated the cost of roading on the airport precinct resulting in a lesser allocation of main roads to the aeronautical cost centre (albeit that this represents only approximately 0.5% of the land allocated to the Pricing Asset Base). With this one exception, ID had no role in the consultation on AIAL's expenditure forecasts.

What impact has information disclosure regulation had on the efficiency of AIAL's investment and operational expenditure?

67. Air NZ does not consider information disclosure regulation to have had any impact on the efficiency of AIAL's investment and operational expenditure.

Is AIAL innovating where appropriate?

How does the level of innovation at AIAL compare to innovation at other airports both domestic and international?

68. AIAL has in recent years engaged comprehensively with airlines and other stakeholders through the Lean 6 Sigma forum and consequently through the Collaborative Operations Group in an effort to improve operational performance and passenger service quality.

What research and development (R&D) or innovation activities have been undertaken or are forecast to be undertaken by AIAL and what was the outcome of these activities (if they have been undertaken), or the expected outcome?

69. Air NZ has been the major driver of innovation in New Zealand, with its self-service offerings highlighting the potential to increase the productivity of existing check-in assets and defer the need for capital-intensive expansion of infrastructure. AIAL is intending to build on Air NZ's example through a commitment to look at options for introducing common-use self-service check-in facilities.

How receptive is AIAL to innovation activity led by airlines?

70. AIAL has (and continues to) demonstrated a receptivity to suggestions from airlines for new and more efficient means of operating the airport. One example of this was the airport's introduction of ground power units at the international terminal.

How does the level of R&D and innovation activities compare now to activities prior to the introduction of information disclosure regulation?

71. As noted above, recent years have seen an increase in AIAL's focus on improving operational performance. This would appear to be a change in focus of management which would have happened regardless of the introduction of information disclosure regulation.

What innovation has occurred in other airports in New Zealand or overseas in recent years?

72. Air NZ provided comment on this issue in section 5.6.3 (paras 222-225) of its 29 June 2012 Submission to the Commerce Commission in relation to Wellington International Airport. The Commission is referred to those comments which are attached at Appendix B.

Is AIAL providing services at a quality that reflects consumer demands?

What changes in quality have occurred since ID regulation was introduced?

73. Recent years have seen increased attention by AIAL to matters impacting on on-time performance, particularly in respect of timely response to interruptions to air bridges. It is not clear whether this is a result of ID regulation or a change in AIAL management priorities that would have occurred regardless. Interruptions to runway and airbridge services, and baggage handling systems were previously disclosed as part of the AAA disclosure regime.

What, if any, aspects of quality do you think should or could be improved (or potentially lowered) at AIAL?

74. Air NZ is currently engaged with AIAL regarding refurbishment of the existing domestic terminal facility to enhance the service quality offering for domestic travellers and to cater for anticipated growth in activity over the period to 2020. Air NZ is also engaged with AIAL regarding longer term domestic terminal facility solutions.

What consultation was undertaken on aspects of service quality during AIAL's second PSE? How does this differ from consultation on quality at the first PSE?

75. Service quality was not a subject of detailed consultation during the second PSE process, except insofar as particular capital expenditure projects were aimed at addressing aspects of service provision. Service quality issues have historically tended to be addressed through operational fora at the airport with "fixes" requiring additional capital or operational expenditure considered separately by airlines through the TSC process or through discrete consultations on significant capital projects. While the TSC Agreement is no longer applicable to AIAL's pricing structure, there is engagement between AIAL and airlines regarding the appropriate forum to provide ongoing oversight of the capital expenditure plan and to address interim requirements during the pricing period.

What role did information disclosure play in negotiations concerning service quality during AIAL's second PSE?

76. Information disclosure did not have a role in consultations regarding service quality during the second PSE.

Do the current ID requirements capture the right measures of quality?

77. Air NZ provided detailed comment on this issue in section 5.7.5 (paras 233-249) of its 29 June 2012 Submission to the Commerce Commission in relation to Wellington International Airport. The Commission is referred to those comments which are attached at Appendix C.

Is AIAL sharing the benefits of efficiency gains with consumers, including through lower prices? Do the prices set by AIAL promote efficiency?

How do the prices set by AIAL reflect previous efficiency gains? How did the prices set by AIAL for the first PSE reflect previous efficiency gains?

78. It is not readily apparent that prices set reflect efficiency gains made by AIAL. As noted above, actual operational expenditure in the first PSE was significantly above forecast, and this actual expenditure forms the base level for future forecasts.

To what extent do changes in the pricing structure at AIAL at the second PSE better reflect efficient pricing principles (for example, are prices subsidy-free, do they have regard to service capacity, do they take account of consumers' price sensitivity) relative to the first PSE?

79. The major changes to pricing structure in the second PSE relative to the first PSE are:

- Introduction of a domestic passenger charge
- Introduction of an international transit passenger charge
- Spreading the international passenger charge to capture 2-12 year olds
- Introduction of an hourly charge regime for non-leased international check-in facilities

80. Setting aside the issue of the level of these charges, Air NZ considers that the implementation of these changes does reflect efficient pricing principles, creating a stronger linkage between the use of facilities and revenues associated with those facilities.

To what extent have airlines and other consumers of AIAL's services been able to make price-quality trade-offs that best meet their needs for the second PSE? How does this compare with the first PSE?

81. The significant price-quality trade-off included in the second PSE is AIAL's decision following airline feedback to defer construction of 2 additional contact gates on Pier B at a forecast cost of $38m and instead construct a "walk-on" facility at ground-level at the end of the existing Pier B at a forecast cost of $15m. Airlines considered an increase in bussing operations to be manageable and better value than AIAL's initially preferred option.

82. The price structure set by AIAL for the second PSE does not provide for price-quality trade-offs during the period.

83. The TSC mechanism did provide for some degree of price-quality trade-off during the first PSE as airlines were able to influence whether capital expenditure

covered by that Agreement did proceed or not, with the airport receiving a guaranteed return on any such expenditure.

To what extent do AIAL's prices promote certainty and stability? How does this compare relative to the first PSE?

84. The prices set for the second PSE do promote a degree of certainty and stability for airlines for the duration of that pricing period. The abolition of the TSC removes the variability associated with the annual wash-up mechanism, albeit that this was a relatively small portion of total revenue.

85. Conversely, the complete reliance on per passenger charges for terminal facilities for the forthcoming pricing period does create some additional uncertainty for AIAL as its PSC revenue is totally dependent on passenger movements. In the same manner, per passenger charges for both international and domestic terminals create an additional degree of uncertainty for airlines and do not allow for airlines to capture unit cost benefits through, for example, increased load factors as would be the case if terminal charges were seat-based.

86. In addition, AIAL's broader approach to pricing does not promote certainty or stability for any party. AIAL has refused to engage on medium term pricing issues, such as the treatment of revaluation gains in 2017, which have the potential to impact significantly on prices in future pricing periods from that time. AIAL's reliance on its "right" to price as it sees fit allows it to avoid establishing a principled approach to ongoing and anticipated issues in a manner that only favours itself, contrary to the purposes of Part 4 regulation.

How do airlines and other consumers of AIAL's services expect their demand to change in response to the prices set by AIAL in the second PSE?

87. AIAL will introduce, with effect from 1 July 2013, a new approach to allocating and charging for check-in facilities in the international terminal. This can be expected to have an impact on utilisation of these to the extent that airlines are able to consolidate their operations into a smaller footprint while maintaining service quality and schedule integrity.

88. At a more general level, to the extent that increased prices result in increased airfares, a reduction in demand can be expected in certain categories of traveller.

What impact has information disclosure had on the pricing methodology set by AIAL for the second PSE?

89. Air NZ considers information disclosure to have had no impact on AIAL's pricing methodology for the second PSE.

Comparator Airports

What airports provide a useful benchmark for assessing the performance of AIAL, and why?

90. As discussed in Air NZ's 29 June 2012 submission to the Commission on the review of Wellington International Airport, to be a useful benchmark a comparator airport would need to be in a workably competitive environment. We have not

been able to identify any airports which have similar characteristics as AIAL while operating in competitive environments.

What are the strengths and weaknesses of the current ID requirements?

What are the additional costs to AIAL of complying with information disclosure?

91. Air NZ is not aware of the actual costs to AIAL of complying with information disclosure. Air NZ does not consider that these costs should impose a significant additional impost over business as usual activities.

How much of the information disclosed during the recent price setting round would have been publicly disclosed, or disclosed to airlines, in the absence of information disclosure regulation?

92. Based on historical precedent of consultation by AIAL, there would have been little difference between the information actually disclosed **to airlines** as part of the recent price setting round and what would have been disclosed in the absence of information disclosure regulation. As the Commission is aware, AIAL does require strict confidentiality in respect of the information disclosed so this information was not (and has not in the past been) publicly available. AIAL's 2 August 2012 Price Setting Disclosure does provide a greater degree of public transparency regarding the price setting decision than has occurred in the past.

What are the benefits to AIAL, airlines and other consumers of AIAL's services of using the information disclosed?

93. The information disclosed will enhance the ability for airlines and other consumers to benchmark AIAL's forecast (and actual) performance against the objective measure established by the IMs. In the absence of an appropriate regulatory response to the disclosure, there will be no benefit to airlines and other consumers of AIAL's services.

What additional information (not captured in responses to the questions above) could be added to the current ID requirements that would better help you assess whether the purpose of Part 4 is being met?

94. Air NZ provided detailed comment on this issue in section 3.8 (paras 112-129) of its 29 June 2012 Submission to the Commerce Commission in relation to Wellington International Airport. The Commission is referred to those comments which are attached at Appendix D.

Appendix A – Target Return

153 The current approach of ID and IM has been to only consider the regulated returns of WIAL and we now respond in relation to that framework. The Commission has undertaken extensive work on calculating an appropriate WACC for WIAL. Through a comprehensive assessment, the Commission has calculated an appropriate WACC to be applied to returns from the supply of specified airport services. Air NZ believes this work is sound; it supported the use of the Commission's WACC during the most recent PSE, although this was emphatically rejected by WIAL.

154 As part of the WACC process, the Commission published a WACC range. The size of the range, combined with the size of the regulatory asset base, creates a wide range of possible full cost of service and required revenue ranges that reduces certainty for consumers and suppliers. This affects not only the consultations regarding an appropriate WACC for the PSE, but also the issue of utilising this WACC during information disclosures processes (such as this s 56G review).

155 We consider that returns consistent with the WACC mid-point (i.e., the 50th percentile) are an appropriate level of target return, notwithstanding our concerns with the dual till approach preferred by the Commission to date. This represents a balance between the objectives of s 52A(1)(a) and (d): in general, if returns exceed the 50th percentile, then these could be characterised as excessive and any accompanying improvement in investment incentives are unlikely to outweigh the harm to the long-term interests of end users caused by the excessive pricing.

156 Adopting the 50th percentile – balanced halfway between two extremes – also has a clear logical attraction, given the balancing exercise implicit in s 52A itself.

157 One of the objectives of the Act is that suppliers have sufficient incentives to invest. Airports have argued that this should be the primary concern of the Commission in developing IMs, particularly the WACC IM. As a consequence, the airports have pushed for the use of the 75th percentile estimate, at the extreme margin of the range determined by the Commission.[26]

158 This emphasis on investment, and claims that returns above the 50th percentile are necessary to incentivise investment do not reflect the strong investment incentives already embedded through the dual till approach. Where an airport invests to increase capacity then the airport will benefit through that increased volume of passengers consuming non-regulated services. The boost that dual till gives to incentives to invest in aeronautical services is well recognised internationally and academically (although

[26] NZ Airports Association, *Draft Input Methodologies Determination Submission (Specified Airport Services)* (12 July 2010) at 9.

these do not typically recognise the accompanying potential for excess profits).

159 A further argument against using a WACC figure above the mid-point is that the Commission's sample of relevant comparator firms contains a significant number of airports which are subject to single till regulation. The WACC for single till airports is typically higher, as it incorporates the cost of capital for aeronautical assets (which are generally low risk due to their monopolistic position, and therefore have a lower cost of capital) and non-aeronautical assets (which are riskier by comparison, due to the presence of competition, and therefore have a higher cost of capital).

160 Single till comparator firms included in the Commission's WACC process included (non-exhaustively) Heathrow, Gatwick, Stansted and Dublin.

161 The Commission recognised the comparative firms had a mixture of regulated and unregulated activities.[27] The Commission accordingly adjusted the asset beta for these comparator airports downwards,[28] but determined that:

> *it is not feasible to: (a) adequately assess the structure of the regulatory regime that each of these airports is subject to; and (b) meaningfully compare those regimes against the one that applies to New Zealand Airports with sufficient precision to robustly inform the magnitude of an adjustment for differences in regulatory regimes. (…) The Commission's decision is to not make any adjustments for regulatory differences.*

162 The Commission expressly excluded any attempt to account for different regulatory regimes in its analysis.[29]

163 Notwithstanding the downwards adjustment to the asset beta, by blending comparatively high WACC single till airports with comparatively low WACC dual till airports, the Commission's final WACC mid-point for WIAL, when applied in a dual till environment, is likely to contain a buffer in favour of higher returns. It is therefore unnecessary, and inconsistent with s 52A(1), to apply a WACC any higher than the mid-point.

164 As discussed in Table 4 and paragraph 73, non-aeronautical returns can be significantly higher than aeronautical returns. The Commission's use of comparator airports to derive the WACC, most of which are single till and therefore include the higher cost of capital figure associated with non-aeronautical revenues, only underscores the need for the Commission to be conservative in its application of the cost of capital. In fact, for airports who have an even higher proportion of non-aeronautical revenues than

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[27] Airports Final Reasons Paper at [E8.81].

[28] Ibid. at [E8.83].

[29] Ibid. at [E.8.91].

WIAL (such as AIAL), it may be more appropriate to apply a cost of capital below the mid-point for assessment purposes.

165 As such, the Commission should resist permitting regulated airports from "double counting" any padding through enjoying the benefits of a conservative asset beta estimate as well as seeking to apply the upper bound of the actual WACC range calculated by the Commission. That is, in light of the well-grounded approach the Commission has taken to determining the WACC inputs, attempts by regulated airports to rely on the WACC upper-bound should be viewed as likely to permit airports to extract excessive profits overall to the detriment of consumers of airport services.

Appendix B – Innovation

222 Most innovation in airports is passenger related. Airports have generally not led innovation in any area; typically in New Zealand, airport innovation is led by airlines.

223 Where innovation is proposed by airlines airports are often reluctant and slow to adopt that innovation. Examples of this at WIAL include:

(a) WIAL's approach to the implementation and slow adoption of the Air NZ self service kiosk program which targeted enhancing the customer service experience and enabling consumers to make choices with respect to the services they wished to use. This innovation was 100% funded by Air NZ for its own component of investment and those of WIAL's infrastructure. It could be argued that this innovation is to Air NZ's benefit, WIAL has not however sought to replicate these facilities which provide facility optimisation and productivity opportunities for the airport.

(b) The implementation of dual door aircraft embarkation/disembarkation at WIAL. This process has the ability to shorten domestic aircraft turnaround times enhancing asset optimisation for airports. Air NZ was the proponent of this process.

(c) The recent departure baggage area expansion – initially proposed as a major building expansion by WIAL was eventually achieved within the existing footprint. This was through an Air NZ led solution that involved technology and innovation delivering a more efficient and productive investment outcome.

(d) The implementation of Smartgate was a joint airline/airport initiative with Air NZ also working closely with NZ Customs on the future vision beyond stage 1.

224 Similar self service innovation by Air NZ has occurred at other New Zealand airports on very similar terms to those imposed by WIAL (i.e. 100% funding by the airline). At one New Zealand location an additional premium access fee above market rental rates was charged by the airport to enable implementation of self-service by Air NZ.

225 Offshore airports introducing passenger related innovation include Sydney, Melbourne, Vancouver, Las Vegas, London Heathrow, Hong Kong and Montreal. Air NZ has interacted with all of these airports on innovation and participates at a Sub Committee level in the IATA "Simplifying the Business" program which seeks to optimise passenger and cargo services.

Appendix C – Measures of Quality

233 Section 52A(1)(b) of the Act refers to promoting outcomes that provide service at a quality that reflects consumer demand. To answer this question we must consider who the consumer is, what service is provided, what quality they demand and whether this quality is measured.

234 We consider that consumers are the direct consumers of airport services (primarily airlines) and the indirect consumers (primarily airline passengers).

235 The specified airport services that are subject to ID are aircraft and freight activities, airfield activities and specified passenger terminal activities.

236 For passengers the demand for airport specified services is derived from the demand for air travel. The passenger would not consume the airport service apart from their need to travel. We believe that most passengers would give little consideration to the quality of aircraft, freight or airfield activities and would not generally distinguish what specified passenger terminal activities are provided by the airlines and which are provided by WIAL.

237 In considering what quality passengers demand, we can refer to our own research in relation to customers' considerations when purchasing an air ticket and their satisfaction with their journey:

Table 15: Key decision criteria[30]

Domestic Key Decision Criteria		International Key Decision Criteria	
Market View	**Total**	**Market View**	**Total**
Price	41%	Price	56%
Flight Schedules	31%	Flight schedules	31%
Some body else decided	17%	Service reputation	23%
Service Reputation	15%	Frequent flyer programme	16%
Flights consistently depart on time	12%	Safety reputation	16%
Safety Reputation	11%	In-flight meals offered	15%
Frequent Flyer Programme	9%	In-flight entertainment offered	14%
Shorter flight / time to get to end destination	6%	Somebody else decided	13%
Company Policy	6%	Seat comfort	11%
Seat Comfort	5%	Flights consistently depart on time	11%
In-flight Meals Offered	4%	Shorter flight / time to get to end destination	9%
Travel Agent Recommendation	3%	Travel agent recommendation	9%
Ability to use the lounge	2%	Holiday package	7%

30 Air NZ's regularly updated statistics provided by TNS, Market Monitor.

Holiday Package	2%	Ability to use the lounge	3%
In-flight Entertainment Offered	2%	Company policy	2%
Other	19%	Other	9%

238 This research lists the key decision criteria that customers use when selecting a flight. Customers may consider more than one factor to be critical so the numbers total to more than 100%.

239 The research shows that customers hold price as critical, schedule (the time that the flight departs) as very important and service reputation importance declines for domestic (shorter) journeys. This implies that service factors are less important for shorter journeys than longer journeys.

240 Relating this research to specified airport services we conclude that the quality factors that airline passengers consider important are:

(a) Price:

The price that WIAL charges is a direct cost to the airline providing service. Assuming that long term, airlines can cover the cost of operations, WIAL prices will be reflected in the price that the customer pays.

(b) Flight schedules (i.e. the ability to access capacity at a preferred time)

Flight schedules will be determined by the capacity that the airport provides, and by the structure of charging for access to that capacity. The majority of our customers have some degree of trade off between price and schedule, with price being the most important factor.

(c) Service reputation:

Service reputation is an important criterion and along with price is one of the key competitive dimensions for airlines.

(d) On time operation and safety reputation:

On time operation and safety reputation are important to customers and the specified airport services provided by WIAL contribute to this.

241 WIAL's provision of airport services contribute to all of these to some degree.

242 We also research customer satisfaction post-flight. Data does not distinguish between that part of the experience that is specifically airline-provided versus that which is airport-provided. Within that research we have specific

questions on baggage collection and the airport departure lounge environment. Both of these questions generate high satisfaction scores (above 80 on a 100 point scale) and in both areas WIAL is within one point of the average

243 As discussed, passenger demand for specified airport services is derived from their demand for flights. For the majority of services consumed passengers will not distinguish between what is provided by the airline and the airport and the quality of all services will generally contribute to the service reputation of the airline. In some areas where service quality is central to customers, they are generally not equipped to assess quality levels (for example, safety).

244 Airlines are constantly balancing the customers' demand for price and quality with providing those offerings that customers demand. As seen in the information provided earlier on average fares, overall, the majority of customer demand has been for lower fares.

245 This should not be interpreted as meaning that customers are only interested in price. There are some customers who highly value service quality and airlines provide products to meet these customers needs; lounges and priority check in for example.

246 What is important, is that assessing quality in isolation of price would not reflect the trade-off that the customer is making when purchasing services. For this reason we conclude that the airlines are best placed to make judgements on quality and should also play a key role, on behalf of customers, in making service quality investments. Given the earlier comments that profit maximisation creates incentives for airports to over-invest, it may be that the purpose of Part 4 in relation to quality is best achieved by requiring airline (customer) agreement to investments in quality.

247 An example of why this would be of benefit is in WIAL's decision to take over the provision of gate allocation. It outlines these reasons as providing assurance to all airlines of appropriate gate access and achieving a more efficient use of its existing facilities.[31]

248 It further notes that this service will require three additional employees.[32] Consequently, this action is adding cost to solve a problem that doesn't exist (lack of appropriate access) and achieve an unclear and indistinct efficiency. In the meantime, Air NZ cannot escape the cost of these employees who are still required to co-ordinate the Airline's gate arrival functions

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[31] WIAL PSE Disclosure at 51.

[32] Ibid. at 34.

Conclusions on quality

249 The quality demanded by customers cannot be separated from the price that they wish to pay for that quality. In addition, the quality of the airport service ultimately affects and reflects on the airline's service reputation. In this sense, airlines have a significant interest in the delivery of the right level of service quality.

Appendix D – Additional Information

112 As discussed above, setting pricing using the IMs determined by the Commission would go some way to meeting the purpose of Part 4 in relation to limiting, but in no way eliminating, excess profiteering. Crucially however, ID regulation and the current IMs do not provide the incentives to innovate or improve the efficiency of regulated assets or to share the gains with consumers through lower prices.

113 As the airport owns contiguous, non-regulated businesses, where travellers consume profitable non-regulated services, there is an incentive for innovation and efficiency. In reality however, given the scale of potential returns, the profit maximising incentive is still to invest further in the regulated service, while enjoying the additional benefits from the unregulated businesses.

114 ID does provide information on the level of price increases that are being imposed by WIAL. However, no benchmarks exist for determining whether the benefits of efficiency gains are being shared with consumers. This is of particular concern where this efficiency is created through the ownership of regulated and unregulated assets contiguously, with efficiency gains and excess profits manifesting in the unregulated assets.

115 The IM approach is also necessarily focussed on inputs, whereas the purpose of Part 4 is related to outcomes. Measures such as WIAL's revenue per customer are key measures of whether the purposes in s 52(A) are being achieved.

116 Section 53D of the Act allows the Commission to require the disclosure of information in relation to unregulated goods and services supplied by a regulated supplier. This includes any of the information set out in s 52C, and does not need to be on a consolidated basis. However, current airports 52P determination does not require this information to be reported.

Single Till Approach

117 During the process of developing the IMs the Commission, and indeed experts for all parties, were very mindful of the unique nature of airports and the demand complementarity between regulated and unregulated services. As such, the Commission noted that its ability to require these s 53D disclosures would address expressed concerns that the proposed cost allocation IM would not provide an accurate picture of the business performance.[33]

118 Air NZ submits that the current focus on a portion only of airports' businesses does not allow for a proper assessment of whether the purpose of Part 4 is being met. In many jurisdictions where effective regulation of airports is applied, prices for aeronautical services provided by airports are

[33] See: Airports Final Reasons Paper at fn 124.

set after taking account of forecast revenues from non-regulated parts of the airport. In this way the overall return of the airport is taken into account when establishing prices for monopoly services. This reflects practice in competitive markets where a business owner, when assessing returns, will consider the overall performance of the business rather than the individual business units. Analysis of individual business unit performance will be important in ensuring that all are performing effectively but the overriding concern is the overall performance. Air NZ considers that the Commission must undertake such an analysis to properly understand airport performance, and require sufficient information to allow it (and other interested persons) to do so.

119 As WIAL has demonstrated, it is clear that where a single till methodology is not adopted, ID will not be effective without the mandatory application of IMs. This mandatory application would also require amendment of the AAA to remove the absolute discretion to set prices.

Negotiate / Arbitrate

120 ID regulation, on its own, has proven ineffective in promoting the purpose of Part 4. The belief that disclosing sufficient information for interested persons to assess whether the purpose of Part 4 was being met would be enough to lead to outcomes consistent with the Part 4 purpose statement has been discredited.

121 Air NZ strongly considers that in the absence of a regulatory back stop or circuit breaker, the unbalanced commercial relationship between airports and consumers means that ID regulation by itself will not be effective in promoting the purpose of Part 4.

122 Air NZ continues to maintain that the negotiate/arbitrate model is well suited to developing a more commercial and constructive approach directly between airports and consumers. If Air NZ's dealings with airports were to be subject to a negotiate/arbitrate framework based on the IMs and informed through effective ID regulation, Air NZ is confident that commercial agreements would be reached with all New Zealand airports, and that these agreements would better promote the purpose of Part 4.

123 Negotiate/arbitrate would work to immediately re-balance the commercial relationship between airlines and airports through addressing the lack of countervailing power airlines possess in negotiations with airports. By addressing contentious pricing issues in the IMs and articulating the criteria and policy objectives against which to assess the appropriateness of airport charges, future negotiations could be approached with far greater degree of certainty on both sides and, accordingly, outcomes would be much more likely to be consistent with s 52A(1).

124 The second prerequisite for an effective negotiate/arbitrate model, along with improved ID regulation, would be the removal of airports' unique and

unjustifiable statutory right to "charge as they think fit". Air NZ believes that a statutory power such as this is inappropriate in the context of corporatised, privatised, "for profit" natural monopolies. In Air NZ's experience to date with private arbitration with regulated airports, this right has shackled the ability of the arbitrator to resolve disputes in a way that would be consistent with s 52A(1), and a regulated negotiate/arbitrate model would be similarly constrained by the presence of this right.

Pricing Methodology

125 We believe that the Commission should reconsider its decision to not determine a pricing methodology at the current time. The excessive and inefficient nature of the FPD demonstrates that the lack of a set pricing methodology has hampered the effectiveness of ID as a form of regulation.

126 The Commission, in its IM Discussion Paper[34] and subsequently in its IM Emerging Views Paper[35], decided that it was not necessary to set pricing methodologies for airport services in order for the purpose of ID to be met. This decision was based on the view that interested parties were able to undertake their own analysis of efficiency of prices. The Commission noted, however, that it was not precluded from setting its own methodology at a later date if necessary.

127 At the time, the Commission's decision was consistent with the regulatory principle that regulation should be proportionate and imposed only where necessary. Consistent with our earlier submission, we also recognise the value in the Commission providing a pricing methodology for airports where appropriate.[36] WIAL's behaviour and decisions in relation to the FPD, however, demonstrates the potential for aggressive pricing, to an extent that was beyond our contemplation when we assessed the implications of the Commission's decision.

128 WIAL's pricing illustrates that for ID to be effective, the Commission needs to determine a pricing methodology in accordance with s 52T of the Act. In the absence of a pricing methodology (even one set at a principles-based level) it is more difficult to assess the disproportionate and unjustified price increases on certain sectors.

129 We submit that the Commission should take a principle-based approach in developing a pricing methodology for specified airport services.

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[34] Commerce Commission, *Input Methodologies Discussion Paper*, (19 June 2009) at [9.9] and [10.8].

[35] Commerce Commission, *Input Methodologies Emerging Views Paper*, (23 December 2009) at 22.

[36] Air NZ, *Submission to Commerce Commission on Input Methodology – Discussion Paper*, 31 July 2009, at 75 - 76.