

Air NZ Limited
Submission to the Commerce Commission

Commerce Act 1986, Part 4

Section 56G Review



AIR NEW ZEALAND

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1 Executive Summary

1 Air New Zealand Limited (**Air NZ**) welcomes the opportunity to participate in the Commerce Commission's (**Commission**) report under s 56G of the Commerce Act 1986 (**the Act**).

2 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 Commerce Act.

3 We have serious concerns that Information Disclosure (**ID**) regulation has been ineffective in promoting the s 52A(1) purpose statement. As a light handed form of regulation, ID regulation only promotes the purpose of Part 4 if the disclosure of information to interested persons affects the behaviour of the regulated supplier (particularly in relation to price setting decisions).

4 The purpose of Part of the Act is set out in s 52A(1):

The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
- (d) are limited in their ability to extract excessive profits.*

5 Yet the recent Final Price Document (**FPD**) of Wellington International Airport Limited (**WIAL**) shows a complete disregard for ID regulation and the underlying IMs. WIAL's comments during the price setting process reveal the negligible effect of ID regulation and the lack of consideration given by WIAL to acting in a way that would promote the purpose of Part 4. WIAL expressly rejected the suggestion that the WACC IM, published by the Commission to support ID regulation and promote the purpose of Part 4, was appropriate or applicable to its pricing decision.

6 Consequently, the purpose of s 52A(1) is not being achieved. Air NZ, on behalf of its customers, forecasts an additional \$85 million in additional charges from WIAL over the next five years. These excess prices will be a drag on the regional and national economies as they increase the cost of conducting business while decreasing demand.

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**).

- 7 The average price per customer will increase by up to 127% while WIAL extracts revenue and profit of at least \$117 million over the five year period, in excess of those expected under the IMs for asset valuation (including revaluations) and WACC.² WIAL itself notes that real prices per customer will increase by 3.6% per annum while real operating costs per customer decrease by 2.2% per annum. WIAL is therefore not sharing efficiency benefits with customers.
- 8 This submission addresses all of the questions raised by the Commission in its process and issues paper. But we think it is important to emphasise in this executive summary the gulf between the outcomes that would promote the Part 4 purpose and the actual outcomes as set out in the FPD.
- 9 We have set out what we consider the seven most substantial aspects of the FPD of WIAL which show the ineffectiveness of ID regulation in promoting the purpose of Part 4.
- 10 Simply put, if ID regulation was effective, then these would not have happened.

#1: WACC

- 11 Through a comprehensive assessment, the Commission calculated an appropriate WACC to be applied to returns from the supply of specified airport services. In consultation with WIAL, Air NZ supported the use of the Commission's WACC during the most recent Price Setting Event (PSE), but this was emphatically rejected by WIAL. WIAL instead determined a WACC of 10.51%, disregarding the Commission's WACC figure of 7.06%.³ The revenue impact of this decision, even considering the "concession" later offered by WIAL, is approximately \$13 million per annum over the five year term, compared to the Commission's WACC.

*For WIAL, the Commission has determined (...) a mid-point estimate of post-tax WACC of **7.06%** for the five year period commencing on the first day of disclosure year 2013 (ie 1 April 2012).*

The Commission⁴

*WIAL has **applied its own WACC** based on advice from expert advisors Sapere. (...) WIAL considered whether it was appropriate to apply the WACC Input Methodology published by the Commission for the Commerce Act ID regime. WIAL concluded that this was not appropriate(...)*

WIAL⁵

#2: Land Valuation

² See Appendix II

³ Mid-point post-tax figure, to apply for the five year period commencing on the first day of disclosure year 2013 (i.e. 1 April 2012), as determined in Commerce Commission, "Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services" [2012] NZCC 10 at 2.

⁴ Commerce Commission, "Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services" [2012] NZCC 10 at 2 (**April 2012 Cost of Capital Determination**).

⁵ WIAL, *Final Pricing Document* (1 March 2012) at 48 (**WIAL FPD**).

- 12 WIAL has increased valuations via changes in valuation methodology, and adopted an MVEU valuation approach in absolute and deliberate contrast to the MVAU adopted in the asset valuation IM. This increased the RAB by \$99 million⁶, and has a revenue impact of approximately \$10 million per annum.

*The valuation is required to be performed as if the land were to be put to its highest and best alternative use. This valuation approach is termed **MVAU**. (...) the valuer must **exclude conversion costs**.*

The Commission⁷

Land to be valued at MVEU being MVAU plus airport conversion costs... MVAU plus holding costs is the most appropriate methodology to derive an MVEU valuation which is reflective of a replacement cost for land.

WIAL⁸

#3: Failure to take recent revaluations to income

- 13 WIAL has increased the RAB through significant revaluations. While some revaluations were treated as income (as required under the IMs), a revaluation gain of approximately \$79 million from the just-ended pricing period was not taken to income. WIAL offered a modest “concession” in respect of this revaluation, but continued to emphasise the non-binding nature of IMs. WIAL treated its own decision to change the asset valuation methodology from a zonal basis (not consistent with the IMs) to MVEU (MVAU + conversion, and also inconsistent with the IMs) as justification for denying the wash-up and for not treating the revaluations as income. This has a revenue impact of approximately \$10 million per annum.

⁶ WIAL, PED at 68

⁷ Commerce Commission, *Input Methodologies (Airport Services) Reasons Paper* (December 2010) at [X19] (**Airports Final Reasons Paper**)

⁸ WIAL FPD at 59-60.

- 14 Worse still, in the FPD to apply from 2012 to 2017, WIAL has decided not to include any wash up mechanism for actual revaluation gains or losses compared to those forecast.

*If regulated suppliers were permitted to increase their prices to reflect a change in replacement cost, without the revaluation gain being treated as income, regulated **suppliers would not be limited in their ability to extract excessive profits**. In the context of information disclosure for airports, such a **revaluation (without appropriately treating the revaluation gain as income) could mask the existence of excessive profits**. This would be unlikely to be consistent with s 52A(1)(d), or with the purpose of information disclosure in s 53A.”*

The Commission⁹

No asset revaluation wash up applies in respect of the prior 2007 consultations. However, WIAL has provided a commercial concession for this wash up of \$14.5m in the FPD. (...) **WIAL has not included in the FPD any wash up mechanism for actual revaluation gains or losses compared to those forecast**

WIAL¹⁰

4: Increased RAB through attributing regulatory uses to non-regulated assets

- 15 WIAL has increased the value of the regulatory asset base by allocating a greater portion of terminal space to regulatory assets versus non-regulatory assets. For example, in the first PSE, WIAL removed the main terminal central hall from the aeronautical asset base but in the second PSE treated this as a common space. Given the basis of cost allocation a greater proportion of aeronautical assets will result in a greater apportionment of costs to the aeronautical cost centre.

Since higher regulatory valuations result in a higher estimate of the level of capital costs in future, the higher the valuation, the higher the prices a business would be allowed to charge in future before profits appeared excessive (...) the IM Determination requires Airports to 'unwind' the previous asset allocation and apply the cost allocation IM (...) to establish the initial RAB value for each non-land asset

The Commission¹¹

*WIAL maintains the view that the Main Terminal Central Terminal Hall is used by passengers waiting for flights in addition to being used as a food consumption area. WIAL is recognising this shared use by **allocating the area as a common space** for the next pricing period*

WIAL¹²

#5: Failure to share efficiency gains

- 16 One of the purposes of Part 4 is that suppliers of specified airport services share with consumers the benefits of efficiency gains in the supply of these services, including through lower prices. There have been some efficiency gains – albeit

⁹ Airports Final Reasons Paper, at v.

¹⁰ WIAL FPD at 76, 78.

¹¹ Airports Final Reasons Paper at 66, 173.

¹² WIAL FPD at 29.

largely driven by airlines – but these are not being shared with consumers. Rather, WIAL revenues and profits have been rapidly increasing – a trend continued in the FPD.

Competition helps ensure consumers are supplied with a choice of goods and services at the quantity and quality they demand, at an efficient price. Suppliers share efficiency gains with consumers over time by supplying goods and services at prices lower than they would be without competition, through improving the quality of existing goods and services, and through an expanded selection of goods and services.

The Commission¹³

*"[financial results] included a good financial outcome based on excellent performance from the Airport's provision of services to passengers. Five years ago the Airport's transport retail and advertising activities provided average earnings of \$4.10 per passenger, last year that had **risen to \$5.65 per***

Infratil¹⁴

#6: Disregard for the IMs

- 17 The AAA gives WIAL (and other regulated airports) a statutory power to charge for its services as it sees fit; a power that is unprecedented, to our knowledge, among natural monopolies worldwide. ID regulation, in the light of the consultation requirements in the AAA, was intended to provide an indirect incentive on airports to consider the IMs in the price-setting process. During the price-setting process, however, WIAL clearly and repeatedly refused to apply the IMs.

*It is in combination with each other, and with other requirements in the s 52P determination for information disclosure regulation, that **IMs provide incentives for regulated suppliers to act in a manner consistent with the Part 4 Purpose.***

Commission¹⁵

*WIAL considered whether it was appropriate to apply the WACC Input Methodology published by the Commission for the Commerce Act information disclosure regime. **WIAL concluded that this was not appropriate** (...) BARNZ continues to submit that WIAL should apply the Commission's input methodology for asset valuation. WIAL does not agree that this approach is appropriate.*

Infratil¹⁶

#7: Inefficient international subsidisation by domestic customers

- 18 The FPD subsidises international customers by imposing substantial price increases on domestic customers, following recent investment in international terminal assets. Historically, WIAL has calculated the costs of international and domestic terminal assets separately then allocated these costs to the users of each terminal. In the 2012 FPD WIAL has chosen to aggregate the costs of all terminals and charge them out at a standard rate per customer to all users.

¹³ Airports Final Reasons Paper at [1.2.3].

¹⁴ Infratil Limited, *Annual Report* (2011) at 32-33 (**Infratil 201 Annual Report**).

¹⁵ Airports Final Reasons Paper at 10.

¹⁶ Infratil 2011 Annual Report at 32 - 33.

- 19 This approach imposes a significant cross-subsidy, to the detriment of domestic customers. It harms efficiency by compelling domestic passengers to pay for international terminal assets that do not reflect their service requirements. Domestic passengers will pay considerably more, in an attempt to satisfy WIAL's international aspirations.

The way that costs are allocated between regulated and/or unregulated activities has an important bearing on monitoring how efficiency gains are shared with consumers of regulated services over time, as well as the extent to which investment by regulated suppliers in the provision of other goods or services is unduly deterred.

The Commission¹⁷

The terminal charges have been set at the same level for all passengers (...)
WIAL does not consider current usage patterns to be a strong basis for establishing an efficient pricing structure for the future, i.e. by trying to attribute specific fixed costs to each area based on predominant or exclusive use by one type of passenger or another. WIAL notes that the current charges were in fact based on this type of approach, but WIAL no longer considers this to be either efficient or equitable."

WIAL¹⁸

- 20 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.
- 21 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 Airport Authorities Act 1966 (**AAA**) and the decision to regulate on a dual till basis.
- 22 Information disclosure regulation needs to be stronger, and regulation needs to be stronger than information disclosure.

¹⁷ Airports Final Reasons Paper at Table 1.

¹⁸ WIAL FPD at 19, 109.

2 Introduction

- 23 This submission is in relation to the s 56G review of how effectively ID regulation is promoting the purpose in s 52A(1) of the Act in respect of specified airport services regulated under Part 4 and provided by WIAL. Air NZ thanks the Commission for the opportunity to participate in the Commission's report. As New Zealand's largest airline, WIAL's largest customer, and an active participant in the ID, IMs and PSE processes, we consider that we are able to offer a unique perspective on the effectiveness of ID regulation to date.
- 24 The Commission has asked some specific questions and invited other comment generally. We will initially present our view on the central question of the review—how effectively ID regulation is promoting the purpose in s 52A(1) in respect of specified airport services—and then provide answers to the Commission's specific questions.
- 25 In 2007, Air NZ made submissions on the regulatory control provisions in the Act. It was noted in those submissions that:¹⁹

Consumers are currently being denied significant welfare benefits through the lack of a credible and timely (e.g. months, rather than years) regulatory threat over monopoly infrastructure providers. Given the significance of key infrastructure facilities to the economy, these inefficiencies are felt throughout the economy.

Monopoly infrastructure providers remain free to set their own rules in valuing their asset bases and in failing to treat revaluations as income for the purposes of setting prices.

The absence of any regulatory scrutiny over asset valuation for pricing purposes can be abused by monopoly infrastructure providers to suppress real rates of return, inflate user prices and to reap unjustified gains.

The absence of independent and timely scrutiny over asset valuations acts as a serious impediment to commercial relationships between monopoly infrastructure providers and their users.

- 26 Air NZ went on to state:²⁰

The statutory right in the Airport Authorities Act for airport companies to "charge as they think fit" is totally inappropriate in the context of profit maximising natural monopolies and must be removed as part of any amendment to provide for a higher quality regulatory regime for airports.

- 27 These comments were made in 2007 when consumers had already borne more than six years of excess monopoly prices at airports. They foreshadowed the ineffectiveness of light handed regulation which has been proven in this WIAL

¹⁹ Air NZ, Review of Regulatory Control Provisions in the Commerce Act 1986, *Submission to the Ministry of Economic Development* at 31.

²⁰ *Ibid.* at 69.

pricing decision. We expect that airports will submit that more time should be allowed to evaluate the effectiveness of Part 4 legislation. Our submission will demonstrate that the legislation has clearly failed to achieve its purpose and must be amended immediately to prevent further damage to consumers and the economy.

- 28 We note that ID is a “light handed” form of regulation and to be effective it requires suppliers to voluntarily apply the IMs that form part of the ID pricing regime. In its 2012 FPD, the most recent decision of its kind, WIAL makes several indicative comments which demonstrate the ineffectiveness of ID including:

WIAL notes, however, that the Government, in determining the new ID regime for airports, intended the approach to be a light-handed regulation, including [...] provision in the Commerce Act that the airports are not required to apply a Commission cost of capital input methodology.²¹

WIAL considered whether it was appropriate to apply the WACC Input Methodology published by the Commission for the Commerce Act ID regime. WIAL concluded that this was not appropriate....²²

- 29 We further note that this disregard of ID was in the full knowledge of the s 56G(1) review which could have been expected to modify WIAL’s behaviour. Should this review fail to result in more effective regulatory control we expect that WIAL would be encouraged to further disregard the intent and purpose of Part 4 of the Act.
- 30 Throughout this submission and indeed the overall review, it should constantly be kept at the forefront of the discussion that the prices set by WIAL contain *real price increases* during a period of passenger growth and low capital expenditure.
- 31 This is a public version of a submission provided to the Commission which contained some confidential information. That confidential information has been removed from this version and its position is marked by {curly brackets}.
- 32 Air NZ would welcome the opportunity to discuss these issues further with the Commission, and looks forward to participating in the conference and consultation process ahead. Our contact person for this submission is:

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²¹ WIAL FPD at 22.

²² Ibid. at 48

2.1 Overview of pricing structure changes

- 33 The following information may assist with this submission and the WIAL FPD generally. It includes an overview of previous and new pricing structures and a comparison with current charges to the 2016 charges.

2.2 Previous pricing structure

- 34 Prior to the 2012 FPD WIAL had a simple pricing structure with charges per arriving AND departing passenger of:

Table 1: Previous pricing structure

| | Per Passenger |
|---------------|---------------|
| International | \$11.78 |
| Domestic Jet | \$10.73 |
| Turbo-prop | \$ 6.03 |

- 35 In addition there was a \$25 (including GST) departing passenger charge paid by International departing passengers and Air NZ paid an annual rental for check-in space of \$250,000 per annum which is subsumed into the new pricing structure.
- 36 An estimate of the cost per passenger and cost per aircraft movement for aircraft operated by Air NZ prior to the 2012 FPD, based on a 75% load factor shown below in Table 2:

Table 2: Estimated aeronautical costs by aircraft²³

| | Total cost Per Passenger | Total cost Per Aircraft |
|---------------------------|-----------------------------|----------------------------|
| A320 International | 22.70 | 2860 |
| A320 Domestic | 10.78 | 1382 |
| B737 | 10.78 | 1075 |
| ATR72 | 6.08 | 310 |
| Dash 8 | 6.08 | 228 |
| B1900 | 6.08 | 87 |

2.3 New pricing structure

- 37 The 2012 FPD contains many new elements. These specifically include:
- (a) Aircraft Movement charges for Airfield usage (Prices vary according to whether the flight is Peak, Shoulder or Off-Peak);
 - (b) Terminal Charges per passenger;
 - (c) Parking charges for time greater than standard turnaround times;

²³ Air New Zealand calculations.

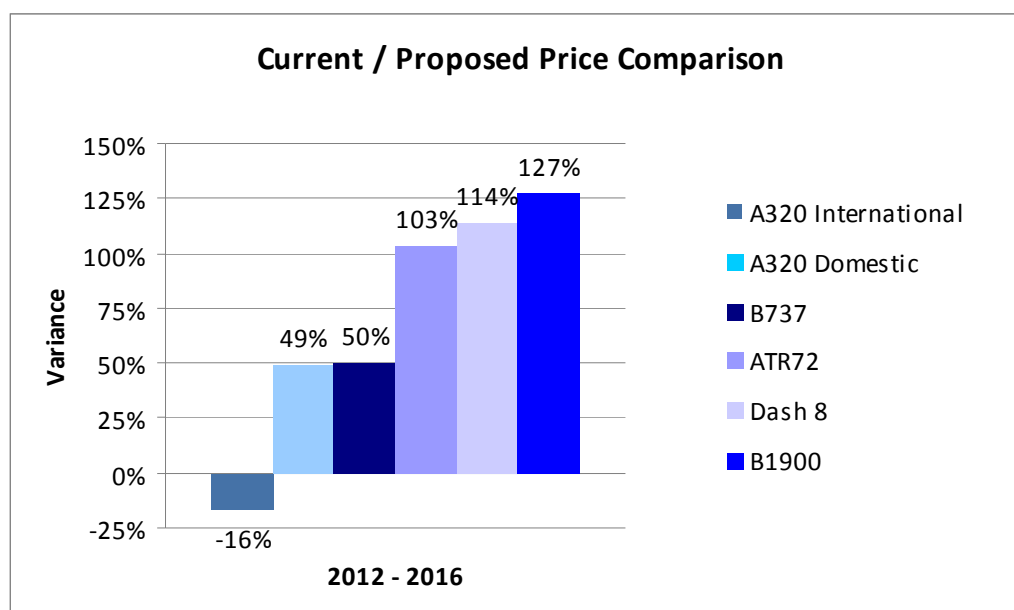
- (d) Charges per hour for use of check in counters; and
- (e) Lumins charges for investments in district plan noise related requirements.

38 The FPD is forecast to lead to substantial revenue growth over the pricing period, both on a total and per-passenger basis. While international charges will decrease slightly, domestic and (particularly) turbo-prop charges will increase significantly.

2.4 Comparison of 2012 (current) prices with 2016 prices

39 Chart 1, below, gives a comparison between current prices and those for 2016 based on a 75% load factor:

Chart 1: Current / proposed price comparison²⁴



40 We estimate that while WIAL's overall revenue is forecast to increase by 54% over the pricing period, the impact on Air NZ, WIAL's largest customer, is close to a 75% increase in cost (Table 3) below.²⁵

Table 3: Estimated effect of WIAL's charges on Air NZ²⁶

| \$ m | Previous | 2016 | % Change |
|----------------------------|-------------|-------------|------------|
| International | 6.4 | 6.6 | 3% |
| Domestic Jet | 22.1 | 38.1 | 73% |
| Domestic Turbo-prop | 8.9 | 20.4 | 129% |
| Total | 37.4 | 65.2 | 74% |

41 Information disclosed during the 2012-2017 pricing consultation and FPD differs slightly from that included in the Pricing Event Disclosure (PED).²⁷ We have attempted to reference information sources where possible.

²⁴ Air NZ calculations (detailed data contained in Data Sheet attached).

²⁵ International prices currently include the International departure fee currently paid by passengers. 2016 costs include Lumins charges and exclude incentives.

²⁶ Air NZ calculations.

²⁷ To form our view in relation to WIAL it has been necessary to compute information. This has been harder than anticipated in the ID environment. WIAL provided its statutory PSE Disclosure. It also provided airline customers information in conjunction with its FPD. The information is different, due to inclusions of leased assets which are not part of the Pricing Asset Base. As we have more detailed information from the FPD, we have used that information. The differences between the information sources would not materially change any conclusions.

3 Summary of effectiveness of ID

3.1 Overview

- 42 Air NZ believes that ID has failed to promote the purpose of part 4 of the Act, as set out in s 52A(1). This submission will illustrate, with reference to WIAL's recent FPD, that under ID regulation WIAL:
- (a) has minimal incentives to innovate
 - (b) has minimal incentives to improve efficiency
 - (c) is not providing services at a quality that reflects consumer demands;
 - (d) is not sharing with consumers the benefits of efficiency gains in the supply of services regulated under the Act; including through lower prices
 - (e) is not limited in its ability to extract excessive profits.
- 43 The IMs have also been ineffective in promoting certainty for consumers (contrary to their purpose under s 52R), as demonstrated by WIAL's decision to essentially ignore the IMs and establish its own methodologies during the most recent PSE.
- 44 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 the 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.

3.2 Information Disclosure has not resulted and is unlikely to result in innovation, or improvements in efficiency

- 45 Regulated airports providing specified airport services are commercial entities with a profit maximisation objective. As a commercial entity, facing minimal competitive pressure, WIAL will inherently be incentivised to increase the value of its assets (either through investing in additional assets or simply revaluing its assets) wherever it can make a return at, or above, its cost of capital. Consequently and as expanded below, WIAL is not incentivised to undertake activity that does not increase investment and is not incentivised to ensure that investment is efficient.
- 46 As highlighted in paras 223 - 225 below, and as reflected in WIAL's disclosure for the year ended 31 March 2011, most innovation at airports in New Zealand is airline-led, with airports generally only responding to airline requests (for example, by providing for dual boarding of aircraft). Where airports lead the process, such

as in relation to the proposed baggage hall extension, the solutions are more often than not more expensive than required. WIAL's initial proposal involved a major building expansion but did not proceed as Air NZ was able to put forward a solution which utilised technology and innovation to deliver a more efficient and productive investment and operational outcome.

- 47 Similarly, airline suggestions that efficient pricing would involve discrete charging for boarding bridges and the baggage system—meaning airlines could choose to utilise bridges or not, and that charges would only be applied in respect of passengers who utilised the bag system—were ignored by WIAL.
- 48 In a workable competitive market, demand impacts would provide a constraint on raising prices. The demand for airport services is derived from the demand for passenger and freight services. Airport costs only make up 5-10% of a total ticket price. Hence a doubling of airport prices, which would double WIAL's regulated revenue, only makes a 5-10% difference in the overall ticket price meaning that airports are largely immunised from demand impacts as a result of excessive prices, and acting rationally they will raise prices to the greatest extent possible.

3.3 What increases profit in an Input Methodology regulatory regime?

- 49 The IMs give a general expression of revenue expected by a regulatory supplier as:²⁸

$$\begin{aligned} & \text{Regulatory Asset Base} \times \text{Cost of Capital} \\ & + \text{Depreciation} + \text{Operating Expenditure} + \text{Tax} - \text{Revaluations} - \text{Other income} \end{aligned}$$

- 50 Under this methodology there are several ways WIAL can increase its regulatory revenue. It could:
- (a) Increase the value of the Regulatory Asset Base;
 - (b) Apply a higher Cost of Capital;
 - (c) Increase depreciation rates;
 - (d) Reduce actual tax vs. regulatory tax;
 - (e) Not include revaluations in income; or
 - (f) Inflate operating costs.
- 51 In a workably competitive environment creating efficiencies is a core element of competition. However, in the current environment where airports remain free to price under the AAA, investment is favoured over innovation. For example, if a 10% increase in passengers can be accommodated via more efficient use of the existing terminal or increased capital expenditure, WIAL maximises profit by the increased expenditure, rather than improving the efficiency of the existing asset.

²⁸ Standard building block methodology.

- 52 In the same vein, if WIAL does improve the efficiency of its existing assets, it receives no benefit that translates into profit from doing so. Where it invests in new assets, it faces limited incentives to do so in an efficient way. For example, if an airport elects to invest in monumental architecture in its terminal construction, there is no evidence that customers value this in relation to the increased cost it imposes, but the airports receive a return on the investment regardless of whether it is valued or efficient.
- 53 WIAL's FPD clearly demonstrates profit maximising behaviour without consideration of the intended "sunlight" effect of ID regulation, the IMs or the purpose statement in s 52A(1). This submission discusses this ineffectiveness in detail, including the most egregious decisions to:
- (a) Increase its asset valuations via changes in valuation methodology, and adoption of an MVEU valuation approach in absolute and deliberate contrast to the MVAU approach determined by the Commission;
 - (b) Increase the value of the regulatory asset base by allocating a greater portion of terminal space to regulatory assets over non-regulatory assets;
 - (c) Use a WACC of 10.51%²⁹ versus the latest Commission WACC for WIAL of 7.06%,³⁰ and
 - (d) Exclude revaluations of approximately \$65 million during the previous pricing period by not including as regulatory income.
- 54 Consequently WIAL has demonstrated ID and the IMs are unlikely to create incentives to innovate, improve efficiency or provide service at a level that reflects customer demands. In a broader sense this would continue to be true even if WIAL was applying IMs in line with the Commission's directions.
- 55 Rather than improve efficiency, the FPD has distorted customers' incentives in ways that reduce efficiency. As one example, consider WIAL's introduction of aircraft parking charges for occupation of aircraft gates for periods longer than standard turn-around times. The economically efficient response, from the airlines' perspective, is to tow the aircraft away from the gate to avoid the charge – even when there is an over-supply of gates and no demand for the use of that gate. As a result, most of Air NZ's tows are now done solely to avoid the gate parking charge. This increases costs, requires additional engineers and other labour and creates an additional risk of aircraft damage – a vastly disproportionate consequence of the perceived problem of gate scarcity.
- 56 The inherent and unavoidable inconsistency between the objective of profit maximisation and the purpose and intent of Part 4 of the Act, combined with WIAL's undisputed power in a market where there is little or no competition and little or no likelihood of a substantial increase in competition, manifests in WIAL's disregard of the IMs. WIAL's ability to disregard Part 4 is due entirely to the

²⁹ Subject to an arbitrary concession.

³⁰ April 2012 Cost of Capital Determination.

inconsistency between the Act's regulation and the AAA pricing regime which bestows on WIAL (notwithstanding its market power) an unfettered ability to establish charges.

3.4 Information Disclosure has not resulted and is unlikely to result in services at a quality that the customer demands

57 There is undoubtedly an incentive to invest which permeates WIAL's commercial behaviour and business decisions. However, the incentive to innovate is present only where that innovation involves increasing investment. Where this innovation involves improving efficiency and lowering investment there is simply minimal incentive to innovate.

58 Consequently, no obvious link exists to providing service at a quality that the customer demands. It appears there is a presumption that the quality demanded is at least that currently provided, and that there should be incentives to ensure that investment maintains or improves this quality.

59 A structural presumption, which we believe to be misdirected, suggests that WIAL is best placed to determine this quality, as it alone has control of the capital investment which primarily determines the quality level. We will evaluate the issue of quality demanded below and also comment on the quality measures in ID.

What quality does the customer demand?

60 The Act caters for consideration of consumers; the direct customer (primarily airlines) and the indirect or end-user customer (primarily passengers) who consume regulated services.

61 For end-user consumers, the airport is part of an overall travel experience. These consumers have no ability to purchase specified airport services separately or to purchase varying levels of quality of the airport experience.

62 Air NZ has information about product attributes that customers value when making Domestic and Trans-Tasman journeys; including those using WIAL.³¹ This data shows the significance of price as a key decision criteria which is traded against quality factors.

63 Airlines are the major direct consumer of regulated services. While recognising that price is important to the majority of customers, airlines also recognise that a basic quality level is also important and that many customers demand a higher quality level. As a result, competition between airlines is often based on quality and airlines are therefore well placed to make quality or price tradeoffs on behalf of their customers. We believe that there is merit in making all quality investments subject to demand from airline customers on behalf of the end users. Airports would likely argue that this will result in falling quality standards as airlines would value cost reductions above quality. The evidence is to the contrary. Airlines invest heavily in quality to meet customer demand where it exists. Products such as

³¹ See Table 16 below (Key Decision Criteria Domestic and International Passengers).

lounges, inflight entertainment and, inflight meals are all examples of quality investment led by airlines. Within the airport environment quicker check-in and dual boarding are examples of airline-led quality and efficiency investments.

3.5 Information Disclosure has not resulted and is unlikely to result in sharing the benefits of efficiency gains

64 In trying to establish whether the objectives of Part 4 of the Act have been achieved, in relation to WIAL sharing the benefits of efficiency gains, we have attempted to review historical performance as well as the information from the most recent FPD. The current pricing decision is forecast based and can be assessed to form a judgement on whether WIAL intends to share the benefits (if any) with consumers.³²

65 The Act's ID regime provides no information on the performance of complementary non-regulated businesses. The PED provides information on forecast events, but does not provide the same information on historical events. It is therefore difficult to establish the extent to which efficiencies have occurred and whether the benefits have been shared with consumers. Air NZ has used best endeavours to develop the necessary information.

Where have efficiency gains occurred?

66 To understand whether efficiencies have been shared with customers we must assess where efficiencies have occurred.

67 In its Reasons Paper on Input Methodologies (Airport Services), the Commission specifically referred to efficiency gains from economies of scale and scope, the allocation of common costs and the nature of demand complementarity.

68 WIAL operates extensive complementary non-regulated businesses which share common costs with the regulated airport businesses, gaining the scale and scope benefits from those regulated business.

69 Air NZ strongly encourages the Commission to consider how ID regulation could be made more effective by requiring airports to disclose the efficiencies achieved in regulated services as a result of complementary non-regulated services operated by the regulated supplier.

70 It has become clear to Air NZ that ID regulation alone does not provide sufficient information to assess whether the purpose of Part 4 in being promoted in relation to specified airport services. ID regulation, in its current form, does not show whether airports have incentives to improve the efficiency of specified airport services by sharing common costs, utilising economies of scale and scope and leveraging demand complementarities with their non-regulated services.

³² Actual results will vary from the forecasts so an examination of actual results is required to assess whether the benefits have actually been shared.

- 71 Further, to the extent that airports are improving efficiency, ID regulation does not disclose how these efficiency gains from non-regulated services are being shared with customers.
- 72 As a result, while our ability to understand the performance of the complementary businesses is limited by information available, the below (Table 4) outlines our estimations. This information was computed by:
- Commencing with the "Total" information from WIAL 2012 Annual report
 - Removing the subvention payment, which is effectively a distribution of profit to a subsidiary of Infratil
 - Inserting known costs of the aeronautical business from the FPD spreadsheet
 - Allocating other costs based on the split of Aeronautical and Non-Aeronautical assets
- 73 The information is approximate, but it indicates that substantial returns are being made in the non-aeronautical WIAL business. In the absence of any information to the contrary, Air NZ believes that the efficiency benefits are not being shared with consumers. Table 4 also illustrates the difference between higher returns achieved from non-aeronautical business activities, compared to aeronautical.

Table 4: WIAL non-aeronautical returns³³

| 2012 | | | | | |
|--|----------------|----------------|----------------|------------------|---|
| Wellington International Airport | Units | Total | Aeronautical | Non-aeronautical | |
| Investment Base | | | | | |
| Non-current assets | \$ '000 | 781,503 | 445,811 | 335,692 | Per FPD spreadsheet |
| Current Assets | \$ '000 | 13,180 | 7,519 | 5,661 | Pro rata on Non-Current assets |
| Current Liabilities | \$ '000 | -25,591 | -14,598 | -10,993 | Pro rata on Non-Current assets |
| Net Investment | \$ '000 | 769,092 | 438,732 | 330,360 | |
| Income and Expenses | | | | | |
| Total operating revenue | \$ '000 | 99,467 | 55,744 | 43,723 | Per FPD spreadsheet |
| Revaluations | \$ '000 | 83,608 | 47,694 | 35,914 | Pro rata on Non-Current assets |
| Investment property revaluation increase | \$ '000 | 922 | | 922 | Non Aeronautical |
| Operating expenses (incl. employee remuneration) | \$ '000 | -24,002 | -15,892 | -8,110 | Per FPD spreadsheet |
| Depreciation | \$ '000 | -17,553 | -13,434 | -4,119 | Per FPD spreadsheet |
| Amortisation of fair value of ineffective hedges | \$ '000 | -4,380 | -2,499 | -1,881 | Pro rata on Non-Current assets |
| Net profit before tax | \$ '000 | 138,062 | 71,613 | 66,449 | |
| Amortisation of fair value of ineffective hedges | \$ '000 | 3,836 | 2,188 | 1,648 | Pro rata on Non-Current assets |
| Comprehensive income | \$ '000 | 141,898 | 73,801 | 68,097 | |
| Pre-tax ROI (NPBT / net investment) | % | 18.0% | 16.3% | 20.1% | Excludes interest bearing liabilities, net interest expense and fair value movements of derivatives |
| Total comprehensive income - pre-tax ROI | % | 18.5% | 16.8% | 20.6% | |

- 74 We also note that Infratil Limited, the majority shareholder of WIAL, in its 2011 Annual Report commented that the year's result:³⁴

³³ Air New Zealand calculations.

included a good financial outcome based on excellent performance from the Airport's [WIAL] provision of services to passengers. Five years ago the Airport's transport retail and advertising activities provided average earnings of \$4.10 per passenger, last year that had risen to \$5.65 per passenger.

- 75 The same report (in Table 5) also highlights the fact that WIAL's EBITDAF has grown by \$22 million (44%) per annum over the 2007-2011 period, while aeronautical income rose by 36% and passenger service income rose by 53%. Operating costs rose by 29%. There is therefore no evidence that operating efficiencies have been shared with consumers over the historical period.

Table 5: WIAL earnings details³⁵

| Year ended 31 March | 2011 | 2010 | 2009 | 2008 | 2007 | 5 year change |
|--------------------------|--------------|--------------|--------------|--------------|--------------|---------------|
| Domestic passengers | 4,479,651 | 4,491,260 | 4,645,402 | 4,416,097 | 4,060,211 | +10% |
| International passengers | 654,576 | 626,646 | 610,996 | 603,344 | 575,500 | +14% |
| Aeronautical income | \$57m | \$55m | \$53m | \$49m | \$42m | +22% * |
| Pax services income | \$29m | \$26m | \$24m | \$22m | \$19m | +38% * |
| Property/other income | \$8m | \$8m | \$8m | \$8m | \$6m | +33% |
| Operating costs | (\$22m) | (\$20m) | (\$20m) | (\$18m) | (\$17m) | +29% |
| Earnings EBITDAF | \$72m | \$68m | \$65m | \$60m | \$50m | +44% |
| Investment spend | \$15m | \$23m | \$23m | \$32m | \$35m | |
| Infratil cash income | \$27m | \$24m | \$23m | \$19m | \$19m | +42% |

* on a per passenger basis

- 76 Further evidence that efficiency gains are not being shared is included in the WIAL PED. WIAL notes that real operating costs per passenger will decrease by 2.2% per annum.³⁶ Further, it notes that real revenue per passenger will increase by 3.6%.³⁷ This is not consistent with the purpose of Part 4 of the Act.

Table 6: WIAL operating costs³⁸

| \$000 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|--|--------------|--------|--------|--------|--------|--------|
| Total Expenses \$000 | 15,892 | 16,638 | 16,068 | 17,721 | 18,103 | 18,415 |
| Nominal Expenses per Passenger | \$3.05 | \$3.14 | \$2.96 | \$3.17 | \$3.13 | \$3.10 |
| Real Expenses per Passenger | \$3.05 | \$3.07 | \$2.82 | \$2.94 | \$2.84 | \$2.74 |
| Annual Change in Real Costs per Passenger 2012-2017 | -2.2% | | | | | |

- 77 In the most recent pricing decision we see similar trends coupled with an increase in the percentage of terminal space/cost allocated to regulatory activity versus non-regulatory activity. This also indicates that WIAL is not sharing efficiency

³⁴ Infratil 2011 Annual Report at 32-33.

³⁵ Infratil 2011 Annual Report at 32-33.

³⁶ WIAL, *Price Setting Event Disclosure for the Pricing Period 1 April 2012 to 31 March 2017* (30 April 2012) at 40 (**WIAL PSE Disclosure**).

³⁷ WIAL FPD p 9.

³⁸ Ibid.

benefits with consumers. In essence, WIAL is acting to maximise profits by allocating additional cost to regulatory activity.³⁹

- 78 Under its 2007 pricing decision, WIAL allocated approximately \$13 million of assets associated with the main terminal retail hall to “commercial”. In the most recent PED, this area was reclassified as “terminal common space” with approximately 75% of the value allocated to the aeronautical cost centre.
- 79 This results in an additional \$1 million of revenue, approximately, being recovered from aeronautical users of the terminal, as compared with the previous pricing structure.
- 80 The above makes apparent that ID and the IMs have not resulted in WIAL sharing with consumers the benefits of efficiency gains in the supply of regulated goods, including through lower prices. It has also not resulted in outcomes consistent with those produced in workably competitive markets.
- 81 Rather, the disproportionate raising of prices on turbo-prop aircraft is inefficient. It punishes airlines for the use of smaller aircraft, even when these are the most efficient given passenger numbers.

3.6 Information Disclosure has not limited and is unlikely to limit WIAL’s ability to extract excessive profits

- 82 One of the purposes of Part 4 of the Act is to prevent WIAL from extracting excessive profit. While the IMs provide very clear guidance on expectations of normal returns for providers of specified airport services, as outlined in this section, ID has not achieved that purpose.
- 83 In order to form a judgement on whether excessive profit is being extracted, it is first necessary to form a view on what normal profit is. While the reference in the legislation is to profit, it must necessarily include Return on Investment (**ROI**).
- 84 This section considers a number of different measures for assessing whether profits are excessive (and by extension, how to determine a normal profit). The most important, in the context of ID regulation, is to consider the IMs. We have also considered WIAL’s profits by:
- (a) comparing the profit with the actual investment of capital contributed
 - (b) comparing the profits against WIAL’s overall business;
 - (c) comparing the results with companies in similar businesses in New Zealand;
 - (d) comparing results against outcomes in workably competitive markets;
 - (e) comparing the profit against market expectations; and

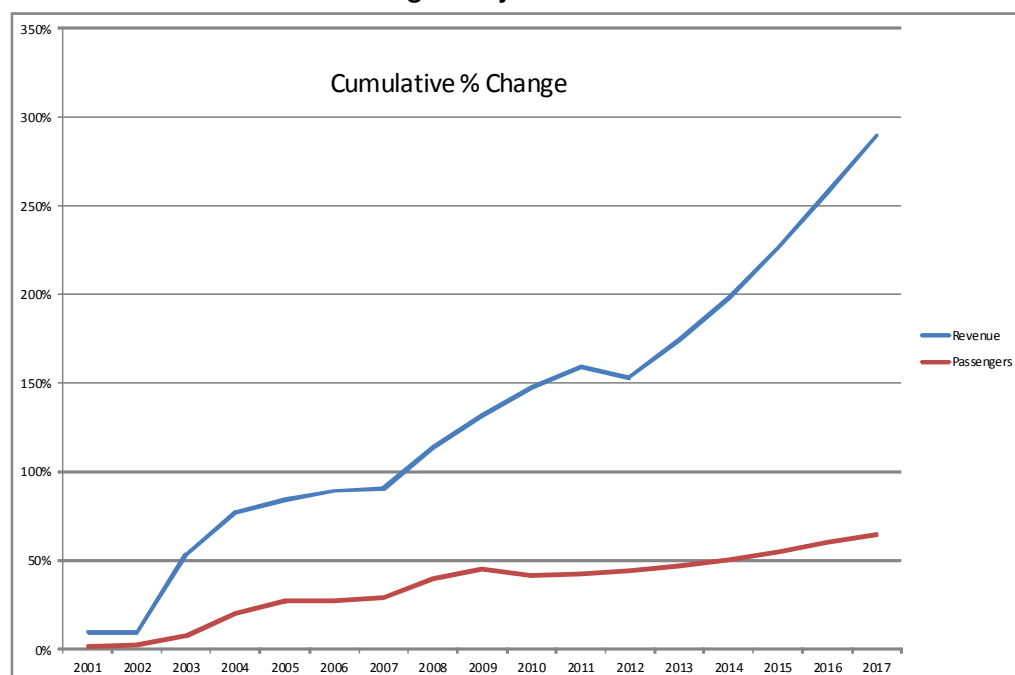
³⁹ WIAL PSE Disclosure at 23 (notes that percentage of Land and Other Assets allocated as aeronautical in the 2012-17 period).

(f) comparing WIAL, as a monopoly supplier, with other suppliers in the same value chain.

85 Section 52 A(1)(d) of the Act states that the purpose of Part 4 is to, among others, promote benefits such that suppliers of regulated goods and services are limited in their ability to extract excessive profits.

86 Excessive price increases and revenue growth were apparent prior to ID regulation and continue under the ID regime. This is demonstrated in the following graph of WIAL's regulatory revenue growth.

Chart 3: Growth in WIAL's regulatory revenue⁴⁰



Excessive profits compared to the IMs

87 The IMs set very clear parameters for assessing returns. As detailed in its disclosure, WIAL has elected to disregard the IMs. Some of the most substantial effects of this decision are set out in Table 7 below.

Table 7: Effect of WIAL disregarding IMs⁴¹

| Input Methodology | Commerce Commission | WIAL | Revenue Impact |
|-------------------|------------------------|---------------------|-------------------|
| Land valuation | MVAU | MVEU (+\$67m) | \$10m p.a. |
| WACC | 7.06% | 9.51% ⁴² | \$17m p.a. |
| Revaluations | All included in income | Partially included | \$10m p.a. |

⁴⁰ Air NZ calculations as shown in attached Data Sheet

⁴¹ Air NZ summary based on WIAL PSE Disclosure (detailed data contained in Appendix II).

⁴² Following a commercial "concession".

- 88 Compared to the IMs approach to land valuation and WACC, WIAL is forecasting earning excessive revenue of at least \$23 million per annum. This is further evidence that the ID regime, including the IMs, while successful in demonstrating WIAL's behaviour, has clearly been ineffective in limiting the ability of the supplier to extract excessive profits. The ID regime as a means of influencing behaviour is ineffective and in the absence of effective regulation via legislation, it is clear that excessive profits will not only continue, but increase.
- 89 It should be noted that in the most recent FPD, WIAL adopted a WACC of 10.51% but applied a rate of 9.51% after what WIAL refers to as a "commercial concession". It is important to note that this concession is nothing more than WIAL removing the 1% margin for "model error" recommended by its advisers. The inappropriateness of such a margin was traversed in depth during the Commission's development of the IMs, and choosing not to apply it can hardly be termed a "concession". These so called concessions are outlined further at paragraph 309 below, however the assumption should be avoided from the outset that such concessions would continue once WIAL was satisfied that ineffective legislation would be allowed to stand.

Excessive profits against incremental investment

- 90 WIAL's recent FPD (Table 8 below) shows that between 2012 and 2017 the revenue from customers will increase by \$30.1 million per annum and the regulatory earnings after tax will increase by \$25.5 million per annum. For the same period the capital employed will increase by \$58.8 million. The 2017 after tax return on incremental investment is therefore 43.5%. This plainly demonstrates excessive profit within the regulated business.

Table 8: WIAL's increasing revenue⁴³

| TOTAL SPECIFIED AIRPORT SERVICES | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|--|---------------|---------------|---------------|---------------|---------------|---------------|
| REGULATORY EARNINGS | | | | | | |
| Other Revenue | 200 | 205 | 210 | 215 | 221 | 226 |
| Revenue | 55,744 | 60,303 | 65,686 | 71,918 | 78,706 | 85,850 |
| Asset Management and Airport Operations | 12,930 | 13,589 | 12,923 | 13,974 | 14,235 | 14,922 |
| Asset Maintenance | 2,314 | 2,384 | 2,462 | 3,048 | 3,151 | 2,756 |
| Corporate Overhead | 648 | 666 | 682 | 699 | 717 | 737 |
| Operating Expenses | 15,892 | 16,638 | 16,068 | 17,721 | 18,103 | 18,415 |
| Consultation Wash Ups for the Rock and Valuation | - | 5,661 | 6,199 | 6,788 | 7,434 | 8,140 |
| Operating surplus / (deficit) | 40,052 | 49,531 | 56,027 | 61,201 | 68,258 | 75,801 |
| Depreciation | 13,434 | 12,846 | 13,511 | 15,441 | 16,704 | 17,297 |
| Revaluation | 10,761 | 10,927 | 11,270 | 11,914 | 12,206 | 12,268 |
| Regulatory Earnings Before Tax | 37,379 | 47,611 | 53,786 | 57,674 | 63,760 | 70,773 |
| Operating Tax | 7,429 | 8,827 | 10,543 | 11,669 | 13,366 | 15,262 |
| Regulatory Earnings After Tax | 29,950 | 38,784 | 43,243 | 46,004 | 50,394 | 55,511 |
| CAPITAL EMPLOYED | | | | | | |
| Specified Airport Services Regulatory Investment Value | 445,811 | 456,145 | 476,032 | 495,062 | 502,242 | 503,602 |

Excessive profits within the overall business of WIAL

- 91 The analysis in Table 9 (below) looks at the overall return of WIAL in 2012 in relation to the capital contributed by the owners of the business. To assess the

⁴³ Spreadsheet attached to WIAL, FPD, Building Block Model.xls, tab: Aero Actives

profit we have taken the FY12 Net Surplus and added back the subvention payment made to a subsidiary of Infratil; effectively a distribution of profit.

Table 9: WIAL's overall return in 2012⁴⁴

| Wellington International Airport | Units | FY00A | FY01A | FY02A | FY03A | FY04A | FY05A | FY06A | FY07A | FY08A | FY09A | FY10A | FY11A | FY12A |
|--|--------|-------|--------|--------|----------------|--------|--------|--------|----------------|--------|--------|--------|---------|----------|
| Return on equity analysis | | | | | NZ GAAP | | | | NZ IFRS | | | | | |
| Net profit before tax (excl. revals) | \$'000 | | 2,319 | 3,408 | 9,292 | 18,429 | 19,243 | 6,676 | 6,966 | 12,128 | 16,057 | 7,555 | (1,000) | (909) |
| Subvention payments | \$'000 | | - | - | - | - | 6,102 | 19,427 | 19,348 | 18,678 | 23,287 | 23,675 | 27,245 | 30,137 |
| Shareholder's equity (excl. reval. reserves) | \$'000 | | 24,966 | 23,128 | 25,443 | 37,707 | 53,969 | 53,783 | 51,016 | 52,284 | 40,062 | 44,573 | 26,672 | (15,364) |
| Before tax ROE | % | | 9.3% | 14.2% | 38.3% | 58.4% | 42.0% | 12.4% | 13.3% | 23.5% | 34.8% | 17.9% | (2.8%) | (16.1%) |
| Return on equity excl. subvention | % | | 9.3% | 14.2% | 38.3% | 58.4% | 55.3% | 48.5% | 50.2% | 59.6% | 85.2% | 73.8% | 73.7% | 516.9% |

Note: \$101.1m revaluations were reclassified as retained earnings in charge IFRS in 2007. These have been treated as revaluations
Note: WIAL Parent company only. Excludes isle subsidiary

92 To assess the capital contributed, we have excluded the revaluations noted within the accounts and the revaluations which were reclassified as retained earnings during the 2007 transition to IFRS.

93 The analysis shows that WIAL are earning 70% excluding revaluation gains on the Capital that has been contributed.

Excessive profits compared to market expectations

94 First New Zealand Capital issued a research note on Infratil Limited on 7 March 2012. Entitled "Eye Watering Price Reset" the note included the following market perspectives on the WIAL FPD:⁴⁵

The new pricing structure is highly controversial as WA has chosen to ignore the Commerce Commission (ComCom) input methodologies established in 2009/2010 following extensive consultation with interested parties. The methodologies for valuing the regulatory asset base (RAB) and guidelines on calculation of appropriate returns (WACC) have been established by the ComCom as a consequence of the information disclosure regime for international airports being transferred from the Airport Authorities Act to Part 4 of the Commerce Act. International airports are required to disclose returns under the methodology prescribed by the ComCom, though they are not currently compelled to use these principles in setting aeronautical prices.

Our view has been that WA may have to reduce prices under the new regime in the forthcoming price reset given the reduction in RAB (due to requirement to use MVAU for land) and lower cost of capital. Accordingly, in our earnings model and valuation we had factored in a 5% reduction in prices in FY13, with no further change to prices out to FY17.

Excessive profits compared to similar businesses in New Zealand

95 In seeking to find comparator companies we considered the nature of WIAL's assets and business and excluded other listed airport companies because these are subject to the same regulation as WIAL.

96 We considered other infrastructure companies, such as electricity and gas providers, but concluded that WIAL's assets were primarily land and buildings, whereas gas and electricity companies primarily owned specialised assets. The

⁴⁴ Air New Zealand calculations.

⁴⁵ First New Zealand Capital, *Research Note - Infratil Limited* (7 March 2012).

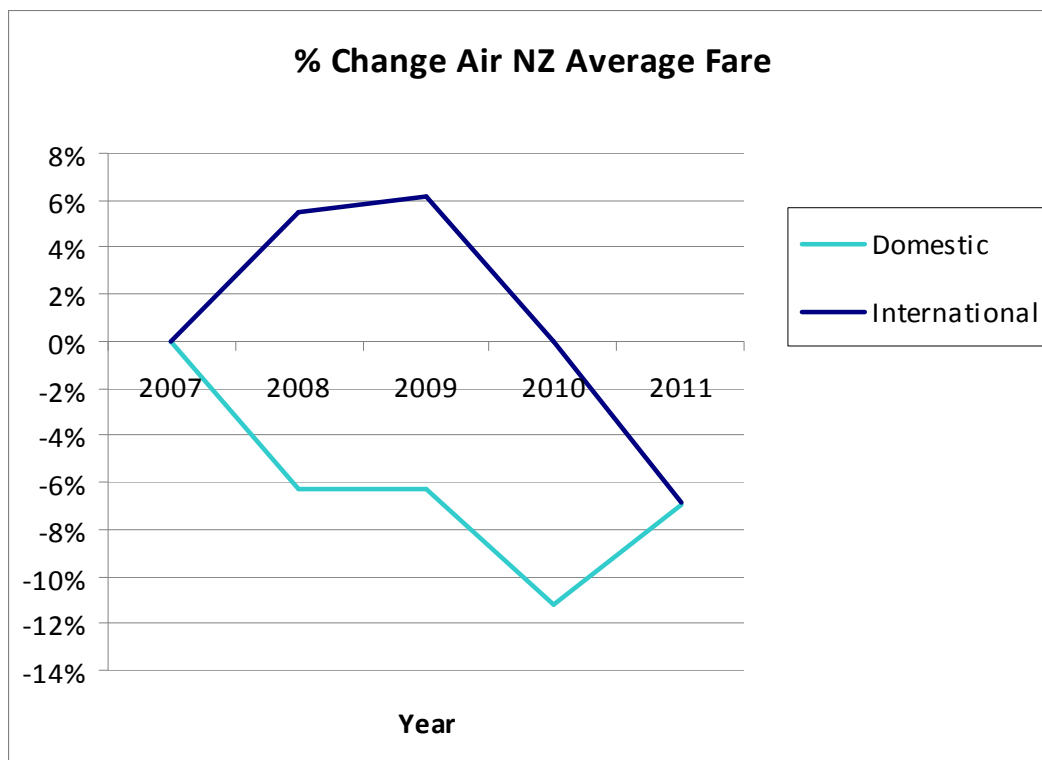
most direct comparison was with listed property companies as detailed in the attached Data Sheet.

- 97 That data compares after tax returns excluding revaluations with capital contributed. We believe this is the comparison best reflecting results that would be achieved in workably competitive markets.
- 98 This varies from the approach taken in the asset valuation IM, where revaluations are included in income and assets/equity. The reason for adopting this calculation is that historical revaluations have not all been taken to income.
- 99 While there are not any markets that are directly comparable with WIAL's business, this analysis suggests that the returns in workably competitive markets are much lower than those that are achieved and forecast by WIAL and that excessive profits are being extracted.

Excessive profits compared to the Value Chain

- 100 In workably competitive markets intermediate consumers will have a degree of influence over supplier prices. Where the intermediate supplier is unable to make adequate returns based on prices end-user customers are prepared to pay, they will aggressively negotiate with competitive suppliers to reduce prices and returns.
- 101 In the past five years the returns of WIAL and Air NZ have been on opposite trajectories. This reinforces the observation that WIAL has been able to earn excessive profits at the expense of its customers. During this period Air NZ has aggressively negotiated costs with other significant suppliers resulting in cost reductions, in contrast to constantly escalating costs at WIAL.

Chart 4: Air NZ average fare



- 102 In the 2007 to 2011 period average fares paid by Air NZ domestic and international passengers fell by 7% while WIAL revenue and profits continued to rise.

Excessive profits compared to outcomes in workably competitive markets

- 103 Infratil Limited also owns airports in Glasgow and Kent in the United Kingdom. These airports operate in competitive markets with a number of alternative airports in their respective catchment areas. During the five year period, encompassing the Global Financial Crisis, these airports steadily increased their losses. This highlights that the WIAL outcome is markedly different to those its own parent company is achieving in competitive markets (Table 11) and has resulted in Infratil seeking to exit its holdings in those airports.

Table 11: Infratil UK Airports Financial Summary⁴⁶

| Year ended 31 March | 2011 | 2010 | 2009 | 2008 | 2007 |
|-----------------------------|--------------|--------------|--------------|-------------|-------------|
| Passengers | 1,556,655 | 1,718,070 | 2,748,184 | 3,003,874 | 3,085,797 |
| Freight (tonnes) | 38,312 | 48,582 | 42,012 | 64,359 | 56,445 |
| Aeronautical income | £12m | £13m | £17m | £22m | £21m |
| Pax services income | £6m | £7m | £8m | £8m | £8m |
| Property/other income | £3m | £4m | £4m | £6m | £7m |
| Operating costs | (£26m) | (£27m) | (£37m) | (£37m) | (£35m) |
| Earnings EBITDAF | (£5m) | (£4m) | (£7m) | £1m) | £0m) |
| Depreciation, interest, tax | (£2m) | (£0m) | (£2m) | (£5m) | (£7m) |
| Revaluations | (£16m) | (£16m) | | | |

3.7 WIAL's decisions have not promoted certainty for consumers

- 104 Section 52R provides that the purpose of IMs is to “promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part.”
- 105 Yet the only certainty evident in WIAL's pricing decisions is that under ID regulation WIAL does not feel the need to apply the IMs and that the prices consumers face will therefore remain above the reasonable expectations of the Act.
- 106 With reference to s 52R of the Act, the Commission has stated that promoting certainty is “an important contributor to fostering an environment in which regulated suppliers have the appropriate incentives to invest, innovate and improve efficiency”.⁴⁷ In our view, the most effective way that the IMs could promote certainty would be for WIAL (and other regulated airports) to consider and take into account the IMs during each PSE, giving airports and airlines a common ground for consultation. Through the pricing process, Air NZ encouraged WIAL to consider and take into account the IMs determined by the Commission. This position was clearly rejected by WIAL.

⁴⁶ Infratil 2011 Annual Report at 30-31.

⁴⁷ Airports Final Reasons Paper at [2.2.6].

107 Consistency with best established regulatory practice in respect of the IMs promotes certainty for consumers and suppliers in terms of s 52R. An unjustified departure from clearly established IMs, as WIAL has done, promotes considerable uncertainty in respect of the treatment of IMs and the effectiveness of ID regulation.

108 In particular WIAL have not applied IMs relating to valuation and cost of capital, which clearly was not the expectation of the Minister when amending the Act.⁴⁸

“A major improvement to the current regime is the proposal that we will require the Commerce Commission to develop as a matter of priority the rules, requirements, and procedures, collectively called input methodologies, for regulation. Businesses have complained about a current lack of certainty and predictability in the rules on crucial matters, like how to calculate the cost of capital, to value assets and to allocate common costs.”

109 The Commission also expected an increase in certainty that has not materialised.⁴⁹

The Commission also considers it will promote certainty for suppliers and consumers if the capital is set out in an IM.

110 The excessive price increases and lack of any IMs relating to pricing principles also leads to a high degree of uncertainty for airline investors. This pricing decision has led to price increases exceeding 100% for some aircraft types operated to Wellington while other prices have decreased. Investment in aircraft is highly uncertain in this environment and the current light handed regime will undoubtedly reduce investment in future capacity. Air NZ very recently made significant investments in turbo-prop aircraft, only for WIAL to severely increase turbo-prop charges in the FPD. These investments are now being re-evaluated.

111 Air NZ is of the firm view that WIAL’s most recent pricing decision has demonstrated the ineffectiveness of ID in promoting the stated outcomes of the Act. Not only has WIAL not applied the Commission’s asset valuation and WACC methodologies, the methodologies that WIAL has applied completely disregard the Commission’s IMs.

3.8 What would assist in achieving the purpose of Part 4 of the Act?

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 It is arguable that because 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

⁴⁸ Minister of Commerce, *Introduction to the Commerce Amendment Act* (March, 2008).

⁴⁹ Airports Final Reasons Paper at [2.8.13].

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.⁵⁰
- 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 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.

⁵⁰ See: Airports Final Reasons Paper at fn 124.

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 Paper⁵¹ and subsequently in its IM Emerging Views Paper⁵², decided that it was not necessary to set pricing methodologies for

⁵¹ Commerce Commission, *Input Methodologies Discussion Paper*, (19 June 2009) at [9.9] and [10.8].

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.⁵³ 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.

⁵² Commerce Commission, *Input Methodologies Emerging Views Paper*, (23 December 2009) at 22.

⁵³ Air NZ, *Submission to Commerce Commission on Input Methodology – Discussion Paper*, 31 July 2009, at 75 - 76.

4 RE: Commerce Commission Airport Services – s 56G Reports Process and Issues (31 May 2012)

4.1 Process and timings

- 130 We agree with the intention to commence a review of WIAL at the earliest opportunity and believe that the negative consumer impacts of the FPD demand urgent review and redress.
- 131 We supported the proposed process and indicative timeframes in clause 17 of the process and issues paper.⁵⁴ We are disappointed at the subsequent delay, which will prolong the period that customers are subject to excessive prices.

4.2 Scope and Approach for all Airports

- 132 We consider that the three airports are similar enough to allow the same approach as proposed in clause 18.
- 133 We agree with the interpretation of the task outlined in clause 19.
- 134 We make the following comments in relation to what the review will not consider stated in clause 20:
- (a) We agree that the Commission is “not required” to consider other types of regulation; and
 - (b) We highlight the Commission’s initial intentions in 2008:

In developing the Airports Report the Commission may consider whether negotiate/arbitrate regulation and/or price-quality regulation, (which have both previously considered as potential options for regulating airport services),¹⁴¹ may better achieve the regulatory purpose of the Act (section 52A). The Commission intends setting out its expectations as to how these types of regulation would operate in the context of airport services regulation prior to the development of the Airports Report.⁵⁵

- (c) We note however, that it did not proceed with this intention following submissions from Auckland International Airport Limited, which included comments such as:

Parliament's intentions for the regulation of airports are now clearly set out in two enactments. The Commission's (and Minister's) duty is to comply with and give effect to those intentions. If the Commission commences work on a form of regulation for airports not contemplated

⁵⁴ References to ‘clauses’ in this section reflect those used in Commerce Commission, *Airport Services – s 56G Reports (Process and Issues)* (31 May 2012) at 6.

⁵⁵ Commerce Commission, *Regulatory Provisions of the Commerce Act 1986 - Discussion Paper* (19 December 2008) at 144.

by Parliament (i.e. negotiate/arbitrate), it will leave itself open to legal challenge...

The Commission should therefore abandon any intentions to consider negotiate/arbitrate regulation, and focus purely on the design of an appropriate information disclosure regime⁵⁶

- (d) We note that the Commission can hold an inquiry on its own initiative under s 52H of the Act and that a s 56G review and a s 52 inquiry could be conducted in parallel.
- (e) We believe that there is already ample evidence that ID has been ineffective in promoting the objectives of s 52A(1) including statements by WIAL such as:

“The express provision in the Commerce Act that the airports are not required to apply a Commission cost of capital input methodology.”⁵⁷

- (f) We believe that the best remedy to the ineffectiveness of ID is alternative regulation and that MED and MOT officials should be undertaking work on this in parallel with the s 56G review. If the Commission has no certainty that this approach is being adopted by the MED and MOT then we believe the Commission should be commencing an inquiry in parallel to the review or the Minister should be directing the Commission to do so.

135 We agree that the Commission should take a wide approach to information sources including, but not limited to, those in clause 24.

4.3 Assessment approach

136 We agree with the assessment approach proposed by the Commission. Considering the airports’ recent and expected behaviour – particularly in relation to pricing – against the IMs, where possible, is the most effective method of assessing the effectiveness of ID regulation. As the Commission notes, the IMs are less suited to some parts of s 52A(1). We have considered information from other sources accordingly, and the Commission should do the same, but we do note that the necessity of doing so provides another illustration of the ineffectiveness of ID regulation.

137 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

⁵⁶ AIAL, *Submission to the Commerce Commission on the Regulatory Provisions of the Commerce Act 1986 Discussion Paper*, (16 February 2009) at 14.

⁵⁷ WIAL FPD at 22, 49.

4A of the AAA, the decision to regulate on a dual till basis and the absence of a negotiate/arbitrate model.

5 Questions relating to WIAL (Attachment 1)

5.1 Has ID had an impact on WIAL's performance and in understanding WIAL performance and why?

- 138 ID has had no impact on WIAL's performance as, in respect of the significant building block inputs, i.e. asset valuations, the treatment of revaluations and the level of return sought, it has continued to apply its traditional approach without reference to the IMs developed by the Commission.
- 139 It could be said that ID has had an impact in terms of generating a better public understanding of WIAL's behaviour. This is through a comparison of the disclosure for the year ended 31 March 2011 with the PSE Disclosure for the Pricing Period 1 April 2012 to 31 March 2017 which highlights the disconnect between the value of the asset base disclosed as at 31 March 2011⁵⁸ and that disclosed in the PSE Disclosure as at the same date.⁵⁹
- 140 This also highlights the difficulty in accurately tracking changes over time given the asset base disclosed does not equate to the asset base used for setting prices. In particular, there are substantial differences in the inclusion of aeronautical leased facilities for which revenues are established by commercial negotiation rather than under the AAA, and the inclusion in the aeronautical asset base in this period of some assets that were previously allocated to the non-aeronautical business.
- 141 ID also highlights the difference between the WACC adopted by WIAL in setting prices (10.51%, subject to a "commercial concession" of 1.0%) versus that determined by the Commission under clause 5.1 of the IMs for the five year period commencing 1 April 2012 (mid-point post tax 7.06%).
- 142 In essence, ID has highlighted that WIAL's performance is inconsistent with what would be expected were it to adopt the IMs and that the WIAL performance is not consistent with the purpose of Part 4 of the Act. The issues, now that this has been illustrated are: first, how can ID regulation be made more effective, and second, to what extent is the effectiveness of ID regulation affected by broader statutory and regulatory factors.

5.2 Has ID had any impact on effectiveness and scope of consultation as part of WIAL's second Price Setting Event? Why?

- 143 Forecast performance information is now more widely and publicly available under ID. However, Air NZ has always had access to the material produced under the AAA (albeit subject to confidentiality). While this information is more accessible, it clearly has not had the desired impact.

⁵⁸ \$407 million.

⁵⁹ \$483 million.

5.3 What aspects of performance behaviour should CC focus efforts on for WIAL review?

- 144 The Commission has indicated its intention to consider the airports' performance behaviour against the IMs, where possible. The Commission also intends to look at variations by each airport from the IMs, and the airports' reasons for doing so. This approach, which Air NZ supports, suggests that the aspects of WIAL's behaviour which the Commission should focus on will be the departures from the IMs with the biggest impact.
- 145 Air NZ has outlined in the Executive Summary the seven key aspects of the FPD where WIAL has most significantly departed from the FPD. These should be at the top of the Commission's list. The seven issues were:
- (a) WACC;
 - (b) land valuation;
 - (c) treatment of actual (and future) revaluations;
 - (d) increased RAB through attributing regulatory uses to non-regulated assets;
 - (e) failure to share efficiency gains;
 - (f) disregard for the IMs; and
 - (g) inefficient international subsidisation by domestic customers.
- 146 WIAL's adopted approach in determining these issues and the manner in which it went about implementing its pricing outcomes in this PSE, highlight the inconsistency between the airport's approach and an outcome which could be expected in a competitive market, in line with s 52A(1).
- 147 In addition, the Commission should focus on WIAL's behaviour in reaching its FPD and the structure of charges it has established.

WIAL's Behaviour

- 148 Air NZ commented on a number of occasions during the consultation process that WIAL had not adequately demonstrated that it was, or would be, subject to a level of demand which required it to move at this time to implement its congestion pricing structure for runway, apron and terminal facilities.
- 149 Air NZ reiterated its willingness to work with WIAL to address any related issues there may be with constrained capacity or a desire to more efficiently utilise capacity. However, Air NZ submitted that these should be considered over a longer period and could be introduced at, for example, the next PSE.
- 150 WIAL provided no further information on this issue and moved to implement a fundamental change in pricing structures with one month's notice (its decision on pricing to apply from 1 April 2012 was notified on 1 March 2012). Experience since then has highlighted that this was a hasty move with difficulties developing around

the proposed check-in counter arrangements and the parking system introduced by WIAL

- 151 The impact of this haste on Air NZ has been a significant increase in administrative requirements to manage the systems and minimise the cost impact of the new structure. Had WIAL agreed to an orderly transition to a new system, in concert with its customers (as could be expected in a competitive market) this transition could have been managed much more easily to the benefit of both parties.

5.4 Is WIAL earning excessive profits?

5.4.1 What is an appropriate level of target return and why?

- 152 Air NZ provides detailed commentary on the appropriate level of profit above, at paragraphs 49 - 103.
- 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.⁶⁰

- 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 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.⁶¹ The Commission accordingly adjusted the asset beta for these comparator airports downwards,⁶² 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.⁶³
- 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.

⁶⁰ NZ Airports Association, *Draft Input Methodologies Determination Submission (Specified Airport Services)* (12 July 2010) at 9.

⁶¹ Airports Final Reasons Paper at [E8.81].

⁶² *Ibid.* at [E8.83].

⁶³ *Ibid.* at [E.8.91].

- 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 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.

5.4.2 What level reflects normal performance and why?

- 166 In addition to the comments made earlier in paragraphs 49 - 103, Air NZ makes the following comments.
- 167 To answer the question of superior performance it is necessary to consider:
- (a) What measures would distinguish between normal and superior performance;
 - (b) Whether the target return should be for WIAL or for the regulated services of WIAL; and
 - (c) How normal and superior performance relate to the purpose of Part 4 of the Act.
- 168 When considering normal and superior performance in competitive environments we generally look at ROI as the prime measure of performance, then other customer and operational measures to reflect on the sustainability of that performance. In the case of a monopoly asset, ROI will be most easily improved by increasing revenue. For New Zealand airports it has previously been recognised that there is no restraint on pricing,⁶⁴ so incentivising and judging performance on an ROI basis would most likely result in airports maximising monopoly prices to maximise ROI; in direct tension with the Purpose of Part 4 of the Act.
- 169 The primary purpose of Part 4 of the Act is to promote the long-term benefit to consumers. As demonstrated in paragraphs 229 - 251 below, the prime interest of consumers in relation to regulated assets is price. As long as reliable service and

⁶⁴ *Air New Zealand Ltd v Wellington International Airport Ltd* [2008] 3 NZLR 87 (HC) at [39].

basic quality is being provided, the majority of customers would consider superior performance to be that which delivers lower prices to customers.

- 170 Obviously lower prices can result in lower revenues and there are risks that an airport will not aspire to achieve superior performance if it results in lower ROI. Generally, we believe the best approach to superior performance (under the current AAA model) would be for the airports to be under a single till environment as discussed in paragraphs 117 - 119.
- 171 Essentially a single till approach would incentivise airports to innovate, but achieve the purpose of the Act by sharing the benefits with consumers over the long term.
- 172 In considering the approach above we have taken into account the interface between specified airport services and the unregulated goods and services provided by airports. Effective ID regulation of specified airport services requires that the IMs and ID not close their eyes to the strong effect that these unregulated services have on specified airport services. These effects flow through into each of the objectives under s 52A(1) for specified airport services. In relation to efficiency, for example, airports should have incentives to share with customers the scale and scope efficiencies achieved through demand complementarity. Further, ID regulation should provide sufficient information for interested persons to assess whether this is occurring.
- 173 An expanded terminal (for example) will likely lead to increases in aeronautical revenues; there will be more aircraft and more passengers. But there will also be more demand for car parking; more demand for retailers; more demand for advertising space.
- 174 An airport will accordingly consider its forecast aeronautical investments and revenue in the light of the non-aeronautical effects. An aeronautical investment that would be uneconomic viewed purely in terms of its benefits to aeronautical revenue may be considered viable when non-aeronautical benefits are taken into account.
- 175 The regulatory regime should similarly take into account the effects of non-aeronautical services. This does not constitute regulation of non-aeronautical services. Rather, it improves the effectiveness of the regulation of specified airport services. Just as importantly, doing so is consistent with sections 52A and 53A; it would show airports' realistic incentives to invest, and give interested persons sufficient information to make this assessment.
- 176 Airports are clearly distinct from other providers regulated under Part 4 in this respect. The ability to recover investment costs from non-aeronautical sources is much greater for airports, and the treatment of specified airport services, particularly in relation to investment incentives, should reflect this.
- 177 Air NZ considers that the most effective way for information disclosure to promote the purpose of Part 4 is to consider specified airport services in the light of unregulated services and their effects.

178 As an interested person, and one that frequently engages with WIAL and other regulated airports on proposed capital expenditure, Air NZ would see significant value in information that shows whether a proposed aeronautical investment satisfies a cost-benefit analysis on aeronautical grounds alone, or whether the financial viability of the proposed capital expenditure (with its associated rises in aeronautical charges) is dependent on accompanying increases in unregulated revenue.

5.4.3 How should CC assess profitability given use of inter-temporal use of wash-ups, discounts and other discretionary measures?

179 The Commission should assess profitability on the basis of actual performance in a disclosure period, considering both scenarios, i.e. one where the returns are not adjusted for any inter-temporal wash-ups etc, and one which reflects any such adjustments for the period.

180 This also highlights the need for the Commission to consider the overall business performance given that “discounts” or other discretionary measures for aeronautical services may provide enhanced performance in other parts of the business.

5.4.4 How reasonable is WIAL’s revenue forecast for the second PSE compared to the first PSE?

181 WIAL’s revenue forecast for the first PSE was overstated, with analysis by BARNZ highlighting that prices in place at 31 March 2007 should have been reduced to deliver total revenue over the period approximately \$100 million less than forecast by WIAL. WIAL instead applied a 2.85% annual increase to charges from 1 April 2008.

182 WIAL’s revenue forecast for this PSE is similarly significantly overstated, with advice indicating that WIAL will again recover approximately \$100m more than required over the five year period.

5.4.5 How reasonable is WIAL’s asset valuation, and why?

183 Air NZ wishes to note that neither the WIAL valuation, nor the approach adopted by BARNZ (consistent with the IMs), reflect Air NZ’s preferred approach, advocated in the Merits Appeal, that would deliver a “materially better” outcome than that developed by the Commission. For the purpose of this Review, and noting the current legislative position that the IMs remain in effect until overturned by any Merits Appeal, Air NZ is limiting its comments to an assessment of reasonableness as against the position adopted by the Commission.

184 WIAL’s asset valuation is not consistent with the asset valuation IM developed by the Commission. WIAL has adopted a 2011 MVEU land valuation and a 2011 ODRC of civil works and buildings. Neither of these valuations reflect a reasonable assessment of the underlying investment by WIAL in its facilities.

- 185 Regarding land valuation, WIAL initially assessed an MVAU valuation of \$153 million and added conversion costs of \$156 million, adopting an MVEU valuation of \$340 million.⁶⁵
- 186 However, later in the FPD, WIAL assessed an MVAU valuation of \$141 million and added conversion costs of \$99 million, adopting an MVEU valuation of \$273 million.⁶⁶ As the Commission rightly concluded during the process of developing the IMs and on a number of previous occasions, in a workably competitive market, land values will reflect the opportunity cost of the land in its next best alternative use. Land conversion costs will either be reflected in that value or have been recovered in the past. Consequently conversion costs and remediation expenditure must be excluded in an MVAU valuation.⁶⁷
- 187 Property Advisory Limited, for BARNZ, undertook an alternative valuation and concluded that the underlying land value of WIAL was in the order of \$98 million. This translated to a land value for the pricing asset base of approximately \$88 million at the commencement of the 2013-2017 pricing period. This compares to approximately \$186 million adopted by WIAL.
- 188 BARNZ also applied the approach adopted in the IMs to the valuation of civil works and buildings and produced slightly amended values for these asset categories.
- 189 BARNZ includes detailed commentary on this issue in its submission to the Commission on this review.

5.4.6 What role has ID played in discussions in the industry regarding target return on investment when setting prices?

- 190 ID has played a significant role in some parts of the industry and has been essentially non-existent in others. Unfortunately, it has had the least effect where it is most needed and the most effect where it is not targeted.
- 191 Air NZ's approach to ROI in respect of the three main airports in New Zealand has been to refer to the WACC Input Methodology on the basis that this reflects the considered outcome of experts in what is a highly technical field following a robust and comprehensive review of the issue during development of the IMs.
- 192 As discussed elsewhere in this submission (see paragraphs 53 and 87 - 89), WIAL has categorically rejected the relevance of the WACC IM as a target ROI while setting prices.
- 193 WIAL has settled on a post-tax WACC of 10.51% as being appropriate. The WACC proposed in its initial proposal was 11.27%.

⁶⁵ WIAL, FPD

⁶⁶ The land value included in the pricing asset base was amended during the consultation process, as detailed in WIAL FPD at 68.

⁶⁷ 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) at (7).

- 194 In contrast, smaller regional airports in New Zealand appear to consider the Commission’s WACC IM (and indeed other aspects of the IMs including the asset valuation IM) as generally appropriate, presumably because it supports large price and profit increases when applied to the regional airports. Price increases up to 100% have resulted. While these increases are indirect consequences of the ID regime, the indirect outcomes are clearly detrimental to the consumers and economies of these regions.

Table 12: Price increases by regional airports⁶⁸

| Airport | Increase |
|------------------|----------|
| Dunedin | 76% |
| Hawkes Bay | 100% |
| Palmerston North | 88% |

- 195 Dunedin Airport International Airport Limited (**DIAL**) for example noted:

The Commerce Commission was required to develop Input methodologies that produce outcomes consistent with those produced in workably competitive markets (the standard mandated by section 52A of the Commerce act)⁶⁹

We consider the workable competition standard to be a reasonable basis from which to make commercial pricing decision. Accordingly, in preparing this pricing proposal, we have been guided by the Commission’s Input Methodologies. Where we have departed from the Commission’s Input Methodologies, this has been to better reflect our commercial circumstances.⁷⁰

- 196 Further, PwC advised and commented on DIAL’s approach:⁷¹

DIAL has used the Commission’s preferred parameters for estimating the weighted average cost of capital input in the pricing model, and has used the midpoint estimate of the WACC.”

- 197 Hawke’s Bay Airport Limited (**HBAL**) also relied on input from PwC:⁷²

PwC has derived a WACC that is broadly consistent with Commission determinations in relation to price setting of regulated airport services under Part 4 of the Commerce Act 1986

PwC determined that HBAL’s cost of capital estimate based on a 75th Percentile Post-Tax WACC is 8.69% for the pricing period.”

⁶⁸ Air NZ Calculations

⁶⁹ DIAL, *Pricing Proposal Consultation Document*, (June 2011) at 8 - 9.

⁷⁰ DIAL, *Pricing Proposal Consultation Document*, (June 2011) at 8 - 9.

⁷¹ As noted by DIAL’s advisor PricewaterhouseCoopers, in its 14 June 2011 letter to DIAL.

⁷² HBAL, *Pricing Proposal* (21 September 2011) at 19.

- 198 Using these inputs, DIAL imposed a 76% increase in charges and HBAL an overall increase over the five year pricing period in excess of 100%.
- 199 Airports are clearly taking a very different view of the relevance of the Act's regime, depending on their particular circumstances. In the case of the regional airports, reliance on the ID IMs enables them to impose increases (under the AAA) which are significantly higher than the underlying viability of the business. Larger airports clearly consider the Act's framework does not provide them with sufficient returns and (also under the AAA) "individualise" the methodologies based on their own assessment of their circumstances.

5.5 Is WIAL operating and investing in assets efficiently and effectively?

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

- 200 Aeronautical capacity constraints at any airport are likely to occur within:
- (a) passenger terminal facilities;
 - (b) aircraft parking apron; and
 - (c) the airfield impacting runway and taxiways.

Details relating to each of these aeronautical spaces are contained in Appendix I.

- 201 It is Air NZ's view that WIAL has not satisfactorily demonstrated that capacity constraints exist at a runway and taxiway level that will materially limit their ability to accommodate growth over the pricing period which justifies the present level of investment proposed.

Table 13: Aircraft Movements⁷³

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|----------------------|---------|---------|---------|---------|---------|
| Domestic | 93,670 | 88,856 | 84,708 | 83,072 | 81,952 |
| International | 5,270 | 5,554 | 5,476 | 5,512 | 5,708 |
| Other | 12,330 | 15,268 | 12,834 | 12,112 | 13,249 |
| Total | 111,270 | 109,678 | 103,018 | 100,696 | 100,909 |

| | 2013 | 2014 | 2015 | 2016 | 2017 |
|----------------------|--------|---------|---------|---------|---------|
| Domestic | 82,396 | 83,819 | 85,392 | 87,142 | 89,267 |
| International | 5,730 | 5,882 | 6,180 | 6,452 | 6,590 |
| Other | 10,810 | 10,810 | 10,810 | 10,810 | 10,810 |
| Total | 98,936 | 100,511 | 102,382 | 104,404 | 106,667 |

⁷⁴

⁷³ See WIAL, *Annual Report 2012*, at 32.

⁷⁴ WIAL PSE Disclosure, 2012, Schedule 19. (WIAL aircraft movements are published with very different numbers in two of the final pricing spreadsheets. The "WIAL Building Block Model FPD" spreadsheet contains the numbers above. The "WIAL Pricing Structure Model FPD" spreadsheet contains completely different numbers for Domestic Jet Movements. We have used the former. A reconciliation of the difference is included in the spreadsheet provided by Air NZ to support this submission.

- 202 Schedule 19 of the PED provides information on the forecast Landings for 2012/17. This information is consistent with the Traffic Tab of the WIAL Building Block Model FPD. It should be noted that, even assuming WIAL's movement forecasts come to fruition, total movements forecast in 2017 are still 3,000 less than actual movements in 2009 and some 5,000 less than 2008 which the airport was able to accommodate.
- 203 Not only are the predicted movements less than 2008, but we believe that these are also significantly overstated relative to the passenger demand forecasts. During this period Air NZ will be replacing the majority of its B737 fleet with the A320 aircraft which has 28% more seats. It will also be adding ATR72 aircraft to the fleet, which at 68 seats are the largest turbo-prop aircraft and will allow addition of seats without an increase in frequency.
- 204 Overall we believe the domestic passenger growth forecast will be accommodated without any increase in frequency. If the forecast passenger numbers were accommodated on the forecast frequency numbers with the correct mix of B737 and A320 aircraft then Air NZ's domestic jet load factor would fall from 76% to 68%.⁷⁵ The profit impact of this would result in reductions of frequency back to 2012 levels.

5.5.2 What factors outside of WIAL's control have contributed to opex and capex forecasts for the second PSE and to changes in expenditure since the first PSE?

- 205 The major factor outside WIAL's control contributing to opex and capex forecasts are the impacts of a series of natural disasters in 2010-11 (earthquakes in Christchurch and Japan, and flooding in Australia) impacting on insurance costs and a heightened focus on building standards. To a lesser extent the new ID regime requiring changes to accounting and reporting systems has also impacted on forecast opex.
- 206 Air NZ does not consider that any of the capex forecast by WIAL is due to factors outside of its control and believes WIAL should be able to manage any regulatory compliance works in a more efficient manner than it appears to be intending to do.

5.5.3 How reasonable are WIAL's opex and capex forecast for the second PSE and how do these compare to the first PSE?

- 207 WIAL's opex forecasts for the two periods demonstrate an alarming trend of ever-increasing expenditure. It is also apparent that the opex forecasts are impacted by changes to asset allocations over time (e.g. in the first PSE, WIAL removed the main terminal central hall from the aeronautical asset base but in the second PSE treated this as common space) Given the basis of cost allocation a greater proportion of aeronautical assets will result in a greater apportionment of costs to

⁷⁵ Air NZ Calculation

the aeronautical cost centre. This highlights one of the difficulties in accurately tracking airport performance over time when only part of the business is being assessed and the airport changing allocations over time.⁷⁶

- 208 Air NZ considers the capex forecast to be reasonable with the exception of works being undertaken to support B777 aircraft operations and achieve compliance with ICAO Annex 14 standards.

5.5.4 To what extent does WIAL’s demand forecast as part of the second PSE, accurately reflect expectations of future demand and why?

- 209 Over the pricing period forecast growth rates are estimated to be:⁷⁷

Table 14: Forecast pricing growth rates

| | |
|----------------------------------|-----------------------|
| International passenger | 4.3% CAAGR per annum. |
| Domestic passenger | 2.7% CAAGR per annum. |
| International aircraft movements | 3.5% CAAGR per annum. |
| Domestic aircraft movements | 2.0% CAAGR per annum. |

- 210 The international forecasts are predicated on a new international B777 service, but we note that the CAGR for the next 5 years is very similar to the actual CAGR for the 2007-12 period, which was achieved without this stimulation:

“The relatively high international growth is a result of the introduction of direct international services from WIAL. These services capture traffic which would have otherwise travelled via Auckland and Christchurch and stimulate some new traffic to and from the Wellington catchment”⁷⁸

- 211 Air NZ advised WIAL in May 2011 that it considered the domestic passenger forecasts reasonable and in line with historic performance. In respect of international passenger forecasts, it was noted that these were predicated on route development plans WIAL had made available to Booz & Company and that Air NZ was not in a position to comment on plans or commitments made by other carriers.
- 212 Air NZ has, in a number of fora, indicated its scepticism regarding the viability of new long-haul services connecting Wellington with “South East Asia” in the medium term, given aircraft performance and the multiplicity of destinations required to be served to satisfy demand.
- 213 WIAL’s approach to this investment is speculative. A prudent investor generally times their investment to ensure a reasonable return can be achieved within a sensible period of time. In a competitive market the risks of speculation are typically borne by the investor and the rewards banked when speculation pays off.

⁷⁶ WIAL FPD at 30.

⁷⁷ The pricing period from FY2013 – FY2017 based on the numbers contained in the Booz & Company forecasts, and in WIAL’s FPD model.

⁷⁸ Booz & Company, *Annual Forecasts - WIAL 2011 Initial Pricing Proposal* (2011) at [4.1].

- 214 WIAL however, seeks to fund speculative development through its application of the AAA which has no constraints on such behaviour. In addition it is charging current consumers for that speculative investment in both capex and incentives with no certainty that the requirement for investment will ever materialise.
- 215 Air NZ did not comment on aircraft movement forecasts as it considered these should be considered in the context of a wider review of capacity which could lead to a pricing structure reflecting congestion pricing elements if this was warranted. WIAL had not demonstrated any pressing need to move to such a structure immediately.

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

- 216 The demand forecasts used in the first PSE, particularly in respect of initial changes to the domestic market, were significantly understated. Air NZ provides comments in relation to passenger forecasts used in the second PSE in paragraphs 209 - 215 above.

5.5.6 What role did ID regulation play in negotiations concerning WIAL's expenditure forecasts?

- 217 It should be recognised that that there is no negotiation involved when airports are establishing prices pursuant to the AAA. Negotiation requires a balanced relationship where the outcome of discussions results in an agreed outcome. This is not the case in respect of airport pricing where s 4A of the AAA enshrines the airports' right to charge as they see fit. The purpose of Part 4 was nullified in the shadow of the broader regulatory framework; another illustration of both the need for stronger ID regulation, and the need for regulation that is stronger than ID.
- 218 Air NZ strongly supported the use by WIAL of the IMs, but this was largely rejected by WIAL.
- 219 BARNZ did highlight its concern that WIAL appeared to have lost its traditional focus on improving cost performance. WIAL responded in its RPP that the divergence in recent years between forecast expenditure in 2007 and actual expenditure must reflect that it "under forecast" costs at that time and this needed to be reflected in future forecasts. Air NZ supports the alternate view that the BARNZ comment is correct and WIAL has indeed lost its focus on managing its operation.

5.6 Is WIAL innovating appropriately?

5.6.1 What R&D or innovation activities have been undertaken or are forecast to be undertaken by WIAL and what was the outcome or expected outcome of these activities?

- 220 Refer to comments below in the section.

5.6.2 How does the level of R&D and innovation activities compare now prior to the introduction of ID in January 2011?

221 Refer to comments below in this section.

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

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.

5.7 Is WIAL providing services at a quality that reflects consumer demands?

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

226 Air NZ is not aware of any changes in quality since the introduction of ID. However, the upcoming expansion in the southwest pier at WIAL is expected to deliver improvements in that area.

5.7.2 What, if any, aspects of quality do you think should or could be improved, or potentially lowered, at WIAL?

227 Improvements in quality for regional airline customers are necessary at WIAL. Air NZ provided a number of options for bypassing jet screened areas for consideration in November 2011. No further progress has been reported despite several requests.

228 A service quality improvement WIAL proposes is a monitoring centre to provide coverage for 24 hours which is a surprise for an airport that is curfewed.

229 The current gate allocation process that WIAL will assume control of is currently undertaken on behalf of WIAL under policies defined by WIAL on a nil cost basis. There are no known service quality issues in this area.

230 WIAL provides no commitment to service quality. Airlines will by 2017 spend over \$85 million per annum for services at WIAL and bear the risks of WIAL's non performance without any ability to be compensated for losses incurred.

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

231 Service quality was addressed in respect of consultations around forecast capex with specific projects being considered as a means of addressing congestion within different parts of the terminal. These are also addressed in separate discussions with WIAL on actual details of developments. The promotion of a different pricing structure, justified on the basis of encouraging more efficient use of the airport facilities, was also nominally about addressing service quality issues and enhances efficient investment in the airport.

5.7.4 What role did ID play in negotiations concerning service quality during WIAL's second PSE?

232 ID had no role in the limited consultations on service quality.

5.7.5 Do current ID requirements capture the right 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 criteria⁷⁹

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

⁷⁹ Air NZ's regularly updated statistics provided by TNS, Market Monitor.

- 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.⁸⁰
- 248 It further notes that this service will require three additional employees.⁸¹ 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

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.

5.8 Do prices set by WIAL reflect efficiency gains comply, to the extent feasible, with efficient pricing principles?

5.8.1 How do the prices set by WIAL reflect previous and future expectations of efficiency gains?

- 250 The prices set by WIAL contain real price increases during a period of passenger growth and low capital expenditure.

⁸⁰ WIAL PSE Disclosure at 51.

⁸¹ Ibid. at 34.

- 251 Growth in passenger volume forecasts provides a small mitigation to the overall increase and reflects only limited scale efficiency. There is no evidence that the scope efficiencies from the co-location of non-regulated businesses have been shared with customers (see 112 - 119 for impacts of WIAL's "dual till" approach).
- 252 As discussed in paragraphs 117 - 119 of this submission, considerations of efficiency are closely linked to the dual till/single till debate. The interdependency between the aeronautical and non-aeronautical services provided by the airports means that increases in capacity and throughput generally benefit both aspects of WIAL's business (whether these efficiency gains originate from airlines or from the airport). It is difficult for the Commission, or other interested persons, to assess whether WIAL prices reflect past or potential efficiency gains without acknowledging the important role of unregulated services in building those efficiencies – a task that is more challenging, but still possible, under a dual till model.
- 253 As discussed in paragraphs 161 - 168 above, the Commission is well within its powers to consider efficiency gains in unregulated services in relation to the consequences on specified airport services (and to require disclosure of sufficient information in relation to this). Not doing so harms the effectiveness of information disclosure – interested persons are less able to assess whether the purpose of Part 4 is being met in relation to specified airfield services.
- 254 Effective information disclosure relies on information being accurate, detailed, clear and relevant – "sufficient" – to allow interested persons to assess whether the purpose of this Part is being met. Where efficiency gains are the result of investment and an addition to the regulated asset base (and the airports are incentivised to ensure this is typically the case), then those efficiencies should be appropriately allocated between the regulated and unregulated activities.
- 255 The Commission should not assume that efficiency gains that relate to unregulated services will necessarily be shared with consumers through competition; while these unregulated services fall outside the definition of specified airport services, this by no means suggests that they operate in a workably competitive market.

5.8.2 *To what extent do changes in the pricing structure at the second PSE better reflect the efficient pricing principles? (e.g. cost effective, subsidy free, regard for service capacity, responsive to consumer demands?)*

- 256 We will address separately the key changes in pricing structure in the second PSE. We understand these to be:
- (a) introduction of peak pricing charges including a structure that increases the relative price per customer on smaller aircraft;
 - (b) incentives for new capacity which are entirely funded from aeronautical charges;

- (c) disaggregated charges including separate charges for counter space, ground handling equipment and aircraft parking, but not for aerobridges and baggage handling systems;
- (d) aggregated charges for terminal usage;
- (e) introduction of aircraft parking charges
- (f) changes to check in facility charges
- (g) reduction in MCTOW charging;
- (h) separate Lumins charges;
- (i) smoothed price path; and
- (j) concessionary price path.

Introduction of peak pricing charges including a structure that increases the relative price per customer on smaller aircraft

- 257 WIAL are introducing aircraft movement charges that introduce new and increasing fixed charges during peak and shoulder periods, decrease charges for international aircraft and increase domestic charges (with significant increases in turbo-prop prices).
- 258 Table 16 below shows the changes in aircraft movement charges (being the combination of the fixed, MCTOW and passenger charge) based on an 75% load factor for aircraft types that Air NZ operates at WIAL.

Table 16: Aircraft Movement Charges⁸²

| WIAL Aircraft Movement Charges per passenger (75% load factor) | | 1-Apr-12 | 1-Apr-13 | 1-Apr-14 | 1-Apr-15 | 1-Apr-16 |
|---|-------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| A320 International | Peak | 14.63 | 14.73 | 14.84 | 14.95 | 15.06 |
| | Shoulder | 14.63 | 14.42 | 14.30 | 14.19 | 14.03 |
| | Offpeak/we | 14.63 | 14.10 | 13.77 | 13.42 | 12.99 |
| A320 Domestic | Peak | 6.48 | 7.74 | 9.00 | 10.26 | 11.53 |
| | Shoulder | 6.48 | 7.45 | 8.49 | 9.54 | 10.57 |
| | Offpeak/we | 6.48 | 7.15 | 7.99 | 8.83 | 9.60 |
| B737 | Peak | 6.51 | 7.83 | 9.14 | 10.46 | 11.79 |
| | Shoulder | 6.51 | 7.51 | 8.59 | 9.67 | 10.73 |
| | Offpeak/we | 6.51 | 7.19 | 8.04 | 8.88 | 9.66 |
| ATR72 | Peak | 1.19 | 2.99 | 4.80 | 6.60 | 8.41 |
| | Shoulder | 1.19 | 2.62 | 4.13 | 5.63 | 7.10 |
| | Offpeak/we | 1.19 | 2.25 | 3.46 | 4.65 | 5.79 |
| Dash 8 | Peak | 1.38 | 3.46 | 5.53 | 7.60 | 9.68 |
| | Shoulder | 1.38 | 2.99 | 4.67 | 6.36 | 8.00 |
| | Offpeak/we | 1.38 | 2.52 | 3.82 | 5.10 | 6.33 |
| B1900 | Peak | 1.45 | 4.44 | 7.42 | 10.41 | 13.40 |
| | Shoulder | 1.45 | 3.52 | 5.68 | 7.84 | 9.95 |
| | Offpeak/we | 1.45 | 2.61 | 3.94 | 5.26 | 6.51 |

- 259 Over the pricing period changes range from a price increase of 823% (B1900 in peak) to a decrease of 11% (A320 international off-peak).
- 260 As discussed in paragraphs 200 - 204 above, airlines are managing congestion issues well in the absence of any price signals and that there is no immediate near term requirement for congestion charging.
- 261 The introduction of peak pricing charges is of particular concern, when airline responses to pricing signals would have real effects on consumers and communities. Many provincial cities will only support 19-seater services. If airlines respond to the WIAL price signal these customers will be denied prime time access to their capital and connections to other cities. It seems that the premature introduction of Peak/Congestion pricing is not consistent with promoting the long term benefit of consumers.
- 262 The nature of airline operations may make WIAL's charges inefficient and ineffective. Airport landing charges are a significant, but not the major part of a fare. The cost of not utilising an aircraft during the peak will far exceed the cost of the congestion charge. The airlines will still need to choose the best aircraft for their day round; year round, requirements and will still fly that aircraft into WIAL during peak times. As shown above, the airlines will increase the gauge of aircraft ahead of congestion requirements to best serve their business and customers' needs.

⁸² Air New Zealand calculations.

263 The changes in cost per passenger are also very significant outside peak times. We consider that the increases in turbo-prop off-peak charges are inefficient. Customers travelling on off-peak services are primarily travelling for leisure; these customers are highly price sensitive and have the greatest access to substitutes (i.e. land transport).

Incentives for new capacity which are entirely funded from Aeronautical charges and will result in windfall gains to WIAL

264 WIAL has introduced an incentive scheme which provides incentives to airlines growing passenger numbers on Wellington services. In the case of international services, these incentives require a minimum of three services per week.

265 Air NZ considers that these incentives are inconsistent with the purpose of Part 4 of the Act in that they do not reflect workably competitive markets and do not share efficiency gains with customers. In workably competitive markets incentives do exist but not in the form that WIAL is proposing them.

266 While WIAL characterises the incentives as non-discriminatory, in fact they do discriminate between airlines that have no countervailing market power against the monopoly supplier.

267 Demand for airline seats to/from Wellington is limited by factors other than the supply of seats. Incomes, limits on annual holiday leave and business travel requirements are all examples of factors that limit demand. Any new capacity to Wellington will impact on the demand for the existing capacity.

268 WIAL is offering incentives up to 100% of cost to providers of new capacity. These incentives exceed the average profit margins of the airline industry, so the incentive effectively will allow one airline to operate profitably, while an incumbent airline with the same revenue could be operating at a loss.

269 In a workably competitive market WIAL customers would be able to use some countervailing market power to ensure that an incentive scheme was fair. An example of a fair scheme that operates in a competitive market would be one that rewarded all airlines with a discount when target growth volumes were achieved. A scheme which reflects a workably competitive market environment would be where:

(a) new competitors are not subsidised by suppliers to compete against existing customers; and

(b) discounts are proportional to customer volume and value.

270 It is also noted that the incentive scheme value of \$11 million is funded entirely by aeronautical (regulated) revenue, with no funding from WIAL's complementary non-aeronautical business. This is contrary to the purpose of Part 4 which promotes that efficiency gains are shared with consumers. In this case, WIAL benefits from the non-aeronautical spend of any additionally stimulated travel and does not share the gain (or the cost) with consumers.

271 Air NZ also believes that the structure of the incentive scheme means that when the forecast volumes are achieved (which would require three new additional services per week to a single destination by a single airline) it is highly unlikely that incentive payments will be made, meaning that including them in the pricing model will result in a significant windfall gain to WIAL. This is set out in detail in Appendix II, but at a high level this can be demonstrated as follows:

Table 17: International passenger movements⁸³

| | 2017 | 2012 | 2008 |
|--------------------------------|-------------------|-------|-------|
| International Passengers (000) | 837 | 718 | 603 |
| International Movements | TBC ⁸⁴ | 5,708 | 5,270 |

272 Between 2008 and 2012 growth of 115,000 passengers was accommodated with 438 additional movements (219 return services or 4.2 return services per week). These additional four services per week were across all three international airlines across all three routes (i.e. less than 0.5 services per week per route). Some of the growth was accommodated on larger aircraft.

273 Between 2012 and 2017 the incentive growth target is 119,000 passengers. If this was accommodated using a similar mix of larger aircraft and increased frequency then it would generate similar growth. If the growth was entirely accommodated on existing sized B737 and A320 aircraft it would require a total of approx eight return services per week. These eight services would be spread across three airlines and three existing routes meaning it is highly unlikely that any individual airline will qualify for the incentive.

274 The balance of probability is that international incentive payments exceeding \$5.7m included as costs in the WIAL revenue forecast are highly unlikely to be paid, and will be a windfall profit gain to WIAL.

275 It is also noted that the international incentive scheme is available for new capacity added during peak hours. While Air NZ acknowledges that Trans Tasman flights are unlikely to be added during peak hours, it notes that there is inconsistency in the pricing principles applied.

Disaggregated charges including separate charges for counter space, ground handling equipment and aircraft parking, but not for aerobridges and baggage handling systems

276 WIAL claims to have sent price signals to airlines to encourage more efficient use of assets by disaggregating components of the terminal charge.

277 The approach has not been consistent in that they have disaggregated check-in space and ground equipment parking areas, but not disaggregated aerobridges and baggage handling systems; the latter which could be achieved by charging on a per bag basis.

⁸³ WIAL Annual Report, 2012.

⁸⁴ To be calculated in subsequent paragraphs

- 278 Aerobridges⁸⁵ are a discrete investment and can be used or not used as part of a service offering. Price signalling in this area would allow for efficient investment and price quality trade-offs by consumers.
- 279 Baggage system⁸⁶ capacity requirements directly correlate to the number of bags processed. Airline fare structures have generally evolved to including bag charges, allowing customers to make discrete choices about the value of baggage.
- 280 WIAL has chosen not to apply efficient pricing principles in areas where they would allow customers and airlines to make discrete choices, yet have chosen to apply separate charges in areas where options for responding to price signals are relatively limited (such as ground service equipment). This approach is inconsistent and has the net result of turbo-prop services (relatively low users of aerobridges and baggage systems) effectively cross-subsidising jet services (particularly international jet).

Aggregated Charges and Cross-Subsidies for Terminal Usage

- 281 In contrast to disaggregating components of terminal services, WIAL has adopted a new approach to the allocation of terminal charges generally. WIAL recently developed substantial new international terminal assets (“The Rock”). Historically, WIAL has calculated the costs of international and domestic terminal assets separately then allocated these costs to the users of each terminal. In this PSE WIAL has chosen to aggregate the costs of all terminals and charge them out at a standard rate per customer to all users.
- 282 Air NZ considers that this pricing approach fails to promote the purpose of Part 4. Specifically, the aggregation of international and domestic customers means that WIAL is not providing “services at a quality that reflects consumer demands”. As BARNZ outlined to WIAL, domestic passengers have very different service requirements to international passengers.⁸⁷

Domestic passengers are much more straightforward and cheaper to process, not having the same border control or security requirements as international passengers and having a much shorter dwell time in the terminal. Significantly less space is required to process domestic passengers, and a much larger number of domestic passengers are able to be processed through an equivalent amount of space.

- 283 Increasing the terminal charges for domestic passengers to recover the costs of an investment (such as “The Rock”) which they do not need, derive little benefit from and rarely use is directly contrary to s 52(1)(b).
- 284 Similarly, in terms of s 52(1)(c), any benefits from efficiency gains have not been shared with domestic passengers. Instead, they face increased terminal charges.

⁸⁵ WIAL FPD at 12 - 13.

⁸⁶ Ibid.

⁸⁷ BARNZ, *Assessment by BARNZ of WIAL Revised Pricing Proposal for charges to apply from 1 April 2012 to 31 March 2017* (23 December 2011) at 20.

Even the price decrease afforded to international passengers is not from the sharing of efficiency gains – it is coming out of domestic passengers' pockets.

- 285 The flaw in WIAL's terminal pricing approach is even more evident when considering charges for transit passengers. As the main domestic hub airport, a significant proportion of domestic passengers simply transit from one aircraft to another en route to their final destination. These passengers do not actually "use" much of the terminal infrastructure, including the check-in hall, baggage system, arrival areas and baggage claim facilities. Nevertheless under WIAL's pricing structure airlines are being charged as if these passengers were enjoying full use of all the facilities. The current pricing represents a significant cross subsidy from transiting passengers to non-transiting passengers and does not reflect pricing principles that would be expected in a workably competitive market.
- 286 New aerobridges (purchased for jet services) have been designated as terminal assets and will be cross-subsidised by turbo-prop customers as a result of aggregated charges. The turbo-prop customers pay for aerobridge assets that they rarely use, in direct contravention of s 52(1)(b), and receive no benefit in efficiency, including through lower prices, in direct contravention of s 52(1)(c).
- 287 This approach essentially provides a cross-subsidy from domestic passengers to international passengers. It does not recognise the historic purpose of investment, the current use of investment or the relative dwell time (utilisation of investment) of customers.
- 288 In the FPD, WIAL states that:⁸⁸

Efficiency principles suggest that all customers should be charged at least their marginal cost, and a subsidy would arise in the event any customer faces charges below its marginal costs. Given the low marginal and high fixed cost nature of airport infrastructure provision, subsidies and cross-subsidies rarely arise.

- 289 When determining whether cross-subsidies are present, WIAL's focus on the marginal cost analysis only is misguided. In natural monopolies such as airports, cross-subsidisation can occur even where the costs charged to the user are higher than the marginal costs of servicing the user. Natural monopoly infrastructure often involves substantial up-front investment but a very low marginal cost. Realistically, the marginal cost of an additional passenger to an existing terminal is negligible. As the marginal cost is so low, this does not provide an appropriate basis against which to assess potential cross-subsidisation. WIAL do not appear to have taken this into consideration.
- 290 In contrast with the WIAL FPD which charges turbo-prop customers \$5.22 per arrival and departure for use of terminal facilities, Air NZ has built a separate regional terminal in Christchurch for turbo-prop customers. The cost per passenger for this brand new facility and the shared use of the adjacent brand new terminal will be approximately \$2.75 per arriving and departing customer.

⁸⁸ WIAL FPD at 13.

Introduction of aircraft parking charges

- 291 WIAL have introduced aircraft parking charges for occupation of aircraft gates for periods longer than standard turnaround times.
- 292 The theoretical basis for the parking charge is that gates are a scarce resource and that charging separately for gates will encourage airlines to better use the resource.
- 293 In reality gate parking charges are a small part of airline costs and the incentive to efficiently utilise the aircraft itself, far outweighs the gate parking charges. Wellington has three primary commercial airline customers and they are self-interested in freeing up gates to better utilise their aircraft. This motivation far exceeds the gate pricing charge.
- 294 However with the pricing charge in place, airlines will respond to the charge. The economically efficient response is to tow the aircraft from the gate to avoid the charge. Air NZ has commenced this since the charge has been in place. Towing the aircraft requires deployment of labour, and creates an additional risk of aircraft damage.
- 295 Some tows would have occurred regardless of the parking charge, but the majority are occurring in response to the gate parking charge. These are an inefficient outcome of the pricing structure as these charges are adding cost by incurring additional man hours of appropriately qualified engineers to handle the required towing, without creating any additional value.
- 296 WIAL attempted to justify the removal of the previous aerobridge charge⁸⁹ by contending that the cost was negligible and the operating costs marginal. The capital costs of aerobridges are in excess of \$1 million each.⁹⁰ Aggregating these costs into terminal costs generally is a clear cross-subsidy and does not send any pricing signal to ensure demands for future investment are accurate.
- 297 WIAL responded to the suggestion of disaggregated baggage charges by dismissing the idea because it did not know how the information could be collected.⁹¹ This is despite the baggage system reading each bag label for reconciliation purposes. In contrast WIAL proceeded with implementing parking charges and counter charges.
- 298 Post implementation, it has been established that there is no mechanism for monitoring counter usage or for establishing when aircraft were towed off gates. WIAL requested that airlines provide them with information for the purposes of charging.
- 299 We do acknowledge that where an airline did not have an economic use for its aircraft, it may be left on at the gate, blocking other potential use of the gate. The parking charge may theoretically mitigate this situation, but a more efficient

⁸⁹ WIAL PSE Disclosure at 54.

⁹⁰ Apron Drive models range from approximately \$1.1 to \$1.5 million.

⁹¹ WIAL FPD at 105.

mitigation would be to require aircraft to be towed when alternative use is required rather than generating large volumes of unproductive activity that ultimately result in increased fares without any real benefit or efficiency gains.

Changes to check in facility charges

- 300 Check in facility charges have historically been charged to airlines on a fixed lease basis. WIAL has introduced a per desk charge to replace this.
- 301 The theoretical basis for this charge is that it sends pricing signals which encourage efficient utilisation, and frees up space for alternative use.
- 302 During the pricing consultation, WIAL calculations assumed that check in facility charge revenue based on airlines current utilisation of check in facilities would be \$1.1 million of which Air NZ's share would be \$0.7 million. However, post price setting, it has been established that the space currently occupied by Air NZ's kiosks and bag drops, which is not available for use by any other carrier, would actually generate \$2.2 million under the new pricing structure. This highlights that WIAL should have taken greater heed of Air NZ's submission to work together to assess capacity issues and move to a pricing structure reflecting congestion pricing principles over a longer timeframe.
- 303 Similarly to the parking charges, the check-in charges would be efficient if the airport had alternative use for the resources that were freed up. The space freed up is more often not reused and is reclassified as "Aeronautical building common area". For example, Air NZ and WIAL have no use for a number of check-in counters (other airlines also have no need for them). This has come about as a result of self service kiosk check-in and bag drop. In theory these should be optimised out of the asset base. However, WIAL converts that space into "common area" and recovers its WACC against common costs in lieu of lease costs. It is actually a better outcome for WIAL because lease costs reflect market rates which may be lower than their asset value and WACC.
- 304 The net result is no reduction in cost, no increase in efficiency, but at times a potential reduction in quality as a result of the response to the pricing signal.

Separate Lumins charges

- 305 Air NZ agrees in principle with the approach to charging for noise and district plan (LUMINS) related costs. Air NZ is however disappointed that WIAL chose to implement this charging using its AAA charging powers and did not take up, at this time, the airlines' suggestion that this be dealt with through a separate commercial arrangement.

Smoothed price path

- 306 WIAL has elected to mitigate the 54% increase in aeronautical revenue via the adoption of a smoothed price path.
- 307 The smoothed price path mitigates demand shocks from the large increases in prices and reduces the public visibility of the total magnitude of price increases by

breaking them into smaller pieces. Applying an NPV = zero principle results in prices below the full cost of service in earlier years and above the full cost of service in later years.

- 308 We note that if the IMs were applied in accordance with the IMs determined by the Commission, then the level of increase would mean that consideration of a smoothed price path was a moot point.

Concessionary price path

- 309 WIAL has characterised a portion of its pricing approach as a “Concessionary Price Path”. These self-labelled “concessions” are in three broad areas:⁹²

- (a) Reductions in the cost of WACC:

The WIAL Full Cost of Service uses an after tax WACC of 10.51%. The *concession* reduces required revenue by the equivalent of 1% of WACC. The net result applied in pricing is therefore 9.51% versus the recently published Commission determination of WIAL WACC of 7.06%

In adopting MVEU valuations, WIAL applied a WACC of 12.53% for airport development. The *concession* is equivalent to applying 9.51%. The IM determination specified MVAU as the appropriate valuation method. As noted elsewhere, MVEU has increased valuation of the regulatory asset base by in excess of \$100 million when compared to the IMs.

- (b) Revaluation Wash Ups:

WIAL has partially applied wash ups of revaluations above forecast from the previous pricing period. As detailed elsewhere a full wash up is consistent with the IMs, yet WIAL has only applied \$14.5 million compared to the approximately \$65 million that would be applied by applying the correct approach endorsed in the IMs.

- (c) Smoothed Price Path

The smoothed price path is characterised as a concession, but in reality actually increases revenue by \$3.6 million.

5.8.3 To what extent have airlines and other consumers been able to make price-quality trade-offs that best meet their needs?

- 310 The practical responses to changes in the WIAL pricing structure have been discussed in section 525.8.2 above.

- 311 Peak pricing charges can be reflected in prices to airline consumers, allowing them to make price quality tradeoffs. Airlines will generally be driven by other economic efficiency outcomes which will outweigh responses to peak pricing.

⁹² WIAL FPD at 92.

312 There is limited ability to respond to disaggregated charges for counter usage and ground handling equipment storage.

313 Disaggregated charges for aerobridges and baggage handling systems were proposed by airline consumers but were not implemented by WIAL. These charges would have presented the greatest ability for price/quality trade offs.

5.8.4 How do airlines and other consumers of WIAL's services expect their demand to change in response to the prices set by WIAL in the second PSE, including the introduction of peak pricing?

314 WIAL revenue will increase by 54% over the five year pricing period. We estimate the average cost per passenger will increase by up to 158% in the period to 2017 as illustrated in Table 18 below (note that commercially sensitive information has been removed (3 right hand columns):

Table 18: Estimated increases in costs per passenger⁹³

| (75% load factor) | Previous | 1-Apr-16 |
|---------------------------|----------|----------|
| A320 International | 22.70 | 19.02 |
| A320 Domestic | 10.78 | 16.04 |
| B737 | 10.78 | 16.15 |
| ATR72 | 6.08 | 12.34 |
| Dash 8 | 6.08 | 13.03 |
| B1900 | 6.08 | 13.80 |

315 The pricing methodology that underpins this structure appears to be explained by WIAL when it states that the assumption that the demand for international services as being less elastic than domestic services does not appear to hold true for Wellington traffic.⁹⁴

316 The customer surveys referred to above clearly show that price is the dominant factor taken into account by both domestic and international customers of WIAL.

317 The Tasman has proportionately less business customers than Domestic, and business customers are less elastic than leisure customers. However Domestic leisure customers have a much greater array of substitutes, which increases elasticity, and passenger numbers will be strongly impacted by these changes. Passengers also consider the total cost of the journey. For Tasman passengers the total cost of travel likely includes accommodation, Australian taxes and other holiday costs. Domestic travel frequently involves visiting and staying at friends and relatives, so the airfare is a much more significant portion of the total cost of travel and more price-sensitive accordingly.

318 Regardless of the reasons for the changes the outcomes are significant. This has major implications for customers and consumers. Air NZ has made A320 and ATR72 orders in anticipation that market growth would not be impacted by

⁹³ Air New Zealand calculations.

⁹⁴ WIAL PSE Disclosure at 9.

excessive prices. The demand impacts of these pricing changes and the overall level of price increases mean that Air NZ now has excess capacity available.

319 These changes in input prices will be reflected in changes to ticket prices by the airlines. The extent to which these changes remain in place will be influenced by competitive intensity. It can however, be presumed that over time airlines will seek to recover their costs and that average fares will reflect the cost increases.

320 WIAL is aware of price elasticity in its own market. In commenting on the proposed Air NZ and Virgin Blue Group alliance, WIAL recognises price impacts on individual passengers and stated that:⁹⁵

The applicants wish to avoid the competitive dynamic that creates public benefits and evade the competitive restraint...the Alliance would undoubtedly involve...a restriction of the supply or a raising of price. This will cut marginal passengers out of the market.

321 In the same submission, on a broader scale WIAL recognises the negative impact on the economy where it states:⁹⁶

...higher prices and reduced capacity can only damage Wellington's prospects of maintaining and growing the regional tourism industry it is developing...this will have knock on effects on the country's tourism industry as a whole and its contribution to the national economy.

322 Notwithstanding its own previous position, acknowledging the negative impacts of increased pricing and the limitations of price elasticity in the market, WIAL appears to be knowingly imposing costs that will see domestic price increases of {...}%. Consequently, the public good argument espoused by WIAL in the past and which underlies Part 4 of the Act, is treated as irrelevant.

5.8.5 What impact will WIAL's proposed prices, pricing structure and associated incentives have on demand on revenues?

323 It should constantly be kept at the forefront of the discussion and the review that the prices set by WIAL contain real price increases during a period of passenger growth and low capital expenditure.

324 In addition to its awareness of price increase impacts on demand, WIAL also has a good understanding of the impact its excess profits will have on the regional and national economy. Its website notes the vital role that the airport plays and its master plan estimates its economic impact:

⁹⁵ Key Wellington Stakeholders, *Submission to the Ministry of Transport on the application for authorisation of an alliance between Virgin Blue Group and Air NZ* (2 July 2010) at [212]. Note that WIAL constituted one of the parties represented by the Key Wellington Stakeholders' submission.

⁹⁶ *Ibid.* at [37].

- (a) Wellington Airport is a “vitaly important piece of national infrastructure providing a significant ongoing contribution to the region’s economy as well as delivering a return to the city and shareholders on the funds invested”⁹⁷
 - (b) WIAL’s forecast regional economic contribution is \$1.4b, with 9,866 jobs provided.⁹⁸
- 325 WIAL notes that its FPD results in real price increases of 3.6% over the pricing period. Air NZ believes that domestic fares will need to increase by {...}% in real terms to cover the WIAL price increases, with Tasman fares decreasing by {...}%
- 326 The net impact will be approximately a {...}% increase in real fares. Assuming that demand elasticity = 1, and accepting the regional economic contribution asserted by WIAL above, this would result in a reduction in economic growth over more than \$50 million per annum and a loss of 375 potential jobs.
- 327 These outcomes are compared to a zero real fare increase. With volume growth and low capital expenditure, WIAL’s real prices should be decreasing, meaning that the actual cost to the economy is greater.
- 328 Growth in passenger volume forecasts provide a small mitigation to the overall increase, reflecting some scale efficiency. There is no evidence that the scope efficiencies from the co-location of non-regulated businesses have been shared with customers.

5.9 Comparator Airports

5.9.1 *What airports provide a useful benchmark for assessing the performance of WIAL and why? Include benchmarking data if possible.*

- 329 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 WIAL while operating in competitive environments.
- 330 We note that the purpose of the IMs was to establish appropriate benchmarks and that the outcomes of the FPD against the IM benchmarks should be a central focus for the review.

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

5.10.1 *What are the additional costs to WIAL of complying with ID?*

- 331 WIAL is best placed to detail any additional costs of complying with ID. It should be noted however that WIAL does have some control over the extent of those costs. For example, the costs of additional valuation work is a result of WIAL’s insistence on applying different valuations for pricing and reporting purposes.

⁹⁷ WIAL, *Wellington International Airport – Corporate*, available online, at <http://www.wellingtonairport.co.nz/corporate/> (last accessed at 27 June 2012).

⁹⁸ WIAL, *2030 – The Master Plan* (January 2010) at 17.

5.10.2 How much of information disclosed during the recent PSE round would have been publicly disclosed to airlines, in the absence of info disclosure regulation?

332 Information disclosure has had little effect on the nature of the information disclosed to airlines during price setting consultations. The major difference, at least in respect of WIAL, is that the consultation process was conducted in a non-confidential manner with all information and submissions available for any interested parties to access via WIAL's website. In the past WIAL has required airlines to sign confidentiality deeds to gain access to the range of information it made publicly available in this process.

333 Such confidentiality deeds have proved a significant constraint to the effectiveness of previous disclosures during those consultations. We note that some airports (e.g., AIAL) continue to impose strict confidentiality restrictions, despite the introduction of ID regulation.

5.10.3 What are the benefits to WIAL, airlines and other consumers of services of using the information disclosed?

334 The major benefit of using the information disclosed has been to highlight the discrepancy between pricing which would reflect a supplier acting in accordance with the objectives of the Commerce Act and WIAL's actual pricing behaviour.

335 The new framework provides an objective measure against which to assess an individual airport's performance and also provides for easier comparison across airports.

336 The information disclosed does highlight however that under the current regulatory regime, and in line with the AAA there is no real constraint on airports to price as they see fit. The new ID regime has had no effect on this, at least in respect of WIAL.

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

337 The major omission in the current ID requirements relates to actual and forecast information on that part of the business not required to be disclosed, i.e. it is not possible to form a view on the performance of the overall airport business as a significant portion of it, while dependent on the performance of the aeronautical business, is not subject to disclosure.

338 Section 3.8 above describes the three main changes that would enhance the way specified airport services are regulated.

Appendix I: Summary of Aeronautical Services

1 Passenger Terminal facilities consist of:

- a) Passenger processing for the purposes of passenger and baggage acceptance:

Passenger processing areas currently contain a mix of self service and manned acceptance areas. As self service options grow as a percentage of through-put, Air NZ is of the view that the current passenger acceptance areas of WIAL's terminal will suffice for the next pricing period and potentially longer.

- b) Departure baggage and arrival baggage handling facilities:

Departure baggage facilities have been under stress for some time and WIAL is currently re-developing this area to accommodate changes in fleet mix and containerised handling. WIAL has committed to spend \$3.345 million in this pricing period to accommodate growth and anticipated additional security equipment requirements.

- c) Departure waiting and aircraft boarding areas (gate lounges) and "meet and greet" waiting areas:

Jet waiting and aircraft boarding areas are currently congested at peak times due to the use of segregated pre-board security screening processes. WIAL has proposed modifications to these facilities including expanding the southwest pier to improve waiting areas and separate unscreened passengers from screened passengers. Air NZ has contributed constructive feedback and has directly funded the development of more efficient and productive alternatives for consideration.

Runway/Taxiway Facilities

- 2 Air NZ supports reasonable and timely capital investment for capacity improvements. WIAL's determination in its Revised Pricing Proposal to defer investment of \$10.3 million of the planned \$16.6 million (in this pricing period) for runway/taxiway improvements is a positive move. However, little if any constructive consultation has occurred with users as to the reasonableness of WIAL's strategies with respect to taxiway and runway modifications originally proposed in the Initial Pricing Principle (IPP).
- 3 Of necessity consultation with substantial users/operators is required due to the implications on operational performance and safety procedures.
- 4 Introducing congestion pricing options based on runway requirements before sufficient analysis or review of options with key stakeholders can potentially result in over investment and low productivity at the expense of consumers.

5 In its Initial Pricing Proposal WIAL referred specifically to its runway capacity:

15.3.7 Runway Capacity

NZIER comments that runway capacity constraints were not demonstrated in the Sapere report. This is true, however, this was not the primary function of the Sapere report.

Runway capacity is determined from a variety of technical factors associated with aircraft performance and environmental conditions. WIAL cannot influence these factors in a manner that would lift the technical capacity. The airport has a single runway and, with its single parallel taxiway, can accommodate a practical maximum of 35 flights per hour in good weather conditions. In the morning and afternoon peak periods and in good weather conditions, this capacity is close to being fully utilised and in poor weather conditions the capacity is reduced and not all movements can be accommodated.⁹⁹

6 Air NZ agrees with WIAL that runway capacity is determined from a variety of technical factors associated with aircraft performance and environmental conditions. We do not agree with WIAL however that it cannot influence these factors in a manner that would lift technical capacity. Requests to WIAL for details of any investigations to enhance runway capacity undertaken that would support its assertions in this regard have been unsuccessful.

7 By comparison, in a number of congested and uncongested airports offshore there are Airport Capacity Enhancement programs underway seeking to achieve capacity improvements in the interests of efficient and productive investment outcomes. These programs are already well underway in Brisbane, Melbourne and Perth, with Sydney to follow shortly. Improvements in runway throughput are already being achieved in some of those airports.

8 Within New Zealand, Auckland Airport is in the early stages of planning for a similar program and key capacity gains have already been identified.

9 While capacity improvements at Auckland in visual conditions are clearly available the most gains will come through closing the gap between visual and inclement weather throughputs thereby improving operations robustness.

10 Further abroad, EuroControl is vigorously pursuing capacity enhancements at European airports using a similar process.

11 In all the locations noted above, the airport company, air space management provider and their airline partners are essential participants and stakeholders.

⁹⁹ WIAL, *Initial Pricing Proposal*, at [15.3.7].

- 12 At the congested airports there are a variety of levers applied to lift capacity or manage at peak hours. These can include schedule co-ordination, peak spreading, aircraft gauge changes and congestion pricing.
- 13 Schedule co-ordination is currently applied to international services primarily driven by international terminal processing constraints, and aircraft gauge changes occur in response to market demand. Peak spreading is applied to peak periods when capacity exceeds supply and typically after other possible capacity enhancements have been applied. Congestion pricing is typically one of the last levers to be applied.
- 14 In its IPP WIAL also outlined its intention to move towards compliance with ICAO requirements for runway/taxiway separation. This was ostensibly due to a directive from CAA that it would move to require ICAO compliance and a demand from scheduled Code E¹⁰⁰ aircraft airline operators. Notwithstanding WIAL's stated intentions to achieve compliance WIAL has also acknowledged that despite its planned investment it will not actually achieve full ICAO compliance.
- 15 WIAL currently holds a number of CAA authorised dispensations for Code C and Code D/E operations. It has been CAA policy for some time to authorise dispensations from ICAO and specific CAA requirements upon the provision of an adequate safety case prepared by the airport operator after consultation with airline operators. CAA has verbally confirmed to Air NZ that this remains its process.
- 16 The current dispensations relate to precision approaches and related runway strip width, plus Code E aircraft operations, both of which relate to separation of runway, taxiway, and obstacle clearances.
- 17 With respect to the runway strip dispensations, future GPS related technology will render precision approach based strip dimensions redundant and brings WIAL some level of compliance with capital expenditure falling directly to the airlines for aircraft based systems rather than the airport.
- 18 To support its capital plans WIAL has indicated that it has demand for scheduled operations by Code E operators and points to an average of 441 annual Code D/E aircraft movements over the last 21 years as additional rationale for its plans.
- 19 However, WIAL's March 2011 disclosure shows seven Code D/E aircraft landings or 14 movements in this category for the year. In reality WIAL has had no scheduled Code D/E aircraft operations in the last pricing period and currently none announced for this pricing period.¹⁰¹

¹⁰⁰ With respect to runway taxiway operations for Code E aircraft, the Boeing 777/747 and new B787 are Code E, the B767 is a Code D category aircraft. The categorisation is based on outer main gear wheel span.

¹⁰¹ Information on exact annual movements prior to ID by ad-hoc services is not available in the public domain.

Appendix II: WACC Data

This appendix sets out the workings behind prepared by Air NZ for this submission.

Revenue Scenarios – Table 7

1 WIAL FPD – MVEU and 9.51% WACC

Year end Assets as per WIAL Building Block Model – FPD, Sheet I9_FctRAB, Rows 681-684 and Total Revenue from WIAL Building Block Model – FPD, Exec Sum, Row 46.

Total Revenue = \$362.5m

2 WIAL FPD - Remove Conversion Costs and 9.51% WACC

Adjust Year end Assets as per WIAL Building Block – FPD, Sheet I9_FctRAB, Rows 681-684 by removing conversion costs (\$67.7m). Conversion cost apportionment based on percentage of total MVEU land value allocated to airfield and terminal activities for pricing as per page 68 of WIAL Final Pricing Document – 1 March 2012. i.e.

Airfield & Terminal Pricing Allocation = \$186,454
Total MVEU Land value = \$273,246

Airfield & Terminal Pricing Allocation = 68.24%

Airport Conversion Costs = \$99,233

Conversion Costs allocated to Airfield & Terminal Pricing = \$67,700

Total Revenue determined by Calculating 1Yr X Factor by Activity on WIAL Building Block Model – FPD, Exec Sum, Cell C9.

Total Revenue = \$313m = -\$49.5m

3 WIAL FPD - MVEU and 7.06% WACC

Year end Assets as per WIAL Building Block Model – FPD, Sheet I9_FctRAB, Rows 681-684 (Scenario 1 above).

WACC altered through manual input of 7.06 in WIAL Building Block Model – FPD, Sheet I1_WACC, Cell C23.

Total Revenue determined by Calculating 1Yr X Factor by Activity on WIAL Building Block Model – FPD, Exec Sum, Cell C9.

Total Revenue = \$279m = -\$83.5

4 WIAL FPD - Remove Conversion Costs and 7.06% WACC

Adjust Year end Assets as per WIAL Building Block – FPD, Sheet I9_FctRAB, Rows 681-684 by removing conversion costs (\$67.7m) (Scenario 2 above).

WACC altered through manual input of 7.06 in WIAL Building Block Model – FPD, Sheet I1_WACC, Cell C23.

Total Revenue determined by Calculating 1Yr X Factor by Activity on WIAL Building Block Model – FPD, Exec Sum, Cell C9.

Total Revenue = \$245.3m = -\$117m