

31 August 2001

The Chairman
Commerce Commission
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AIRFIELD PRICING INQUIRY

Air New Zealand, as a “substantial customer” of Auckland, Christchurch, and Wellington international airports, the subjects of the Commission’s inquiry, has paid close attention to the submissions of interested parties and the responses to the Commission’s Draft Report. Air New Zealand has been closely involved in the various submissions of the Board of Airline Representatives of New Zealand (BARNZ) and has a long and deep experience of the principal issues involved.

To this point, the Inquiry and the views of participants have necessarily been focussed mainly on assessing whether the requirements of section 52 of the Commerce Act are met, i.e. the nature of the market for airport services and the need or desirability for remedies, including the possibility of “price control” in its various forms.

A significant component of the Commission’s Draft Report is devoted to an empirical assessment of airport market power and associated economic inefficiencies. On balance, Air New Zealand believes the Commission’s empirical results are consistent with both the Commission’s competition analysis and Air New Zealand’s experience in price setting forums with these airports.

Inevitably, empirical exercises can lead to considerable disagreement between various parties over the value of key parameters used within the model. The modelling undertaken by the Commission has proved to be no exception, with many participants disputing the underlying assumptions and key parameter values. This is particularly so with the analysis in Chapter 14.

In common with decisions based on reasoned argument, there will always be disagreement between the various parties affected. Indeed, the re-working of the Commission’s empirical modelling by many participants essentially represents the mathematical interpretation of the basic views of each party as to whether the airports in question have abused their market power.

At best, such an exercise provides an apparent precision to something which is an art more than a science. And the attempt to quantify the impact of the exercise of market power and the cost to those affected remains only one of a number of factors that the Commission would need to consider in determining whether price control should be imposed. The robust competition analysis undertaken by the Commission is of much greater importance.

The Commission has not yet covered in depth its own judgements on potential solutions to problems associated with market power. However, chapter 12 of the draft Report did note some important options. One important aspect that Air New Zealand would like to focus on is the question of solutions that might be jointly agreed between airports and airlines.

In the view of Air New Zealand, the principal problem with the current pricing system is that the power to determine the outcome of consultation is fundamentally unbalanced, with one party holding the ultimate ability to set prices. This ultimate authority to set prices means that the airports have – understandably, where shareholders with an emphasis on maximising returns are involved – limited incentive to engage in securing negotiated (lesser) outcomes. While airlines have the ability to challenge adherence to the law, such challenge is generally only possible in respect of the process, rather than issues of principle which are generally at the heart of differences between the parties. Furthermore, challenging the process may result simply in a requirement to remake the process rather than produce a meaningful outcome. Such action is costly for all concerned and avoids the fundamental problem.

In our view, it is possible nevertheless that airports and airlines will recognise that their best interest *over the long term* lies in developing an agreed method of negotiating – not consulting, but negotiating – over pricing changes, if the Commission is prepared to indicate that such a step is the only alternative to formal price regulation.

Air New Zealand is willing to work to develop such arrangements. We believe that, if the Commission maintains its view that airfield services are offered in a market characterised by limited competition and that there is good reason to be concerned about the current system sustainably protecting the interests of consumers in the longer term, the Commission may wish to consider asking airports and airlines to provide an indication of whether they are interested in attempting to develop such negotiating parameters.

The Commission advanced at paragraph 12.64 a framework for negotiation. Air New Zealand is interested in further exploring this framework, with the airports.

The objective of the new structure should be to provide an environment in which the current imbalance of power is addressed, i.e. replacement of the “consultation” model with a “negotiation” model. The key output flowing from such a structure should be a contract between the airport and airline for the supply of aeronautical services, consistent with outcomes observed

in competitive markets. The structure must then be capable of being recognised in legislation, in a manner capable of addressing the fundamental imbalance currently created by legislation.

Air New Zealand believes two necessary components of a structure capable of encouraging effective price negotiation are:

- ? Specification and clarification of key financial parameters, particularly a set of required land valuation techniques and the basis for setting a WACC. This would form the basis for price negotiation, rather than set prices in a mechanical fashion by multiplying and adding the relevant financial parameters; and
- ? An appointed arbitrator or similar person, with the ultimate ability to determine charges. However, as neither the airport or airline should have a clear incentive to seek an arbitrated decision instead of a negotiated outcome, the arbitrator's power may need to be limited.

The Commission's Draft Report has set out (tentatively) a number of principles and guidelines which address to some extent the issues of land valuation and WACC. Clear establishment in the Final Report on these matters would be invaluable guidance to setting a negotiating framework.

As noted, the asset base is a key parameter in considering appropriate prices for airfield services. In this regard it is critical that the asset base is established at a level reflecting users' requirements. To do otherwise is to build in inefficiency and create an unrealistic expectation on the part of shareholders in terms of anticipated return on that investment. Today's users should not have to bear the cost of past unrealistic or inappropriate valuations, or investments. Similarly, users should have the ability to determine if a currently unused asset is nevertheless 'useful' in the sense that its disposal would hinder future utilisation of the airport.

Air New Zealand endorses the Commission's view that the appropriate opportunity cost of land is that of market value in its alternative use. This is the only justifiable approach to determining the value of the opportunity foregone by a land-owner, i.e. the opportunity of using that land for an alternative purpose.

Air New Zealand also strongly supports the concept that greater than normal returns earned by an airport must be justified by customers' views that the airport provides an above-normal service. As a rule, however, there should be a recognition that in a market such as that for airfield services, a reasonable WACC return represents the highest return that shareholders can expect.

The Commission's ability to provide clear guidance on principles such as these would be particularly useful in assisting the parties develop a negotiating framework.

The negotiating framework solution to pricing issues is likely to be a unique solution to a unique problem amongst infrastructure providers. It reflects the special nature of airports. Airports are multi-product firms covering businesses which are in part exposed to the need for regulatory oversight; and in part not. This complication is reflected in the dispute that can arise in attributing costs to particular areas of the airport businesses. The option to use a negotiating framework approach can also only arise where, as occurs on airports primarily, the consumer can be represented by an informed party which shares its interests.

I would be happy to expand on the question of a negotiating framework for the future, at your convenience.

Yours faithfully,

Peter Harris
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