

**SUBMISSION TO**  
**The Commerce Commission**  
**on the**  
**Draft Report**  
**Price Control Study of Airfield Activities**  
**at**  
**Auckland, Wellington and Christchurch**  
**International Airports**

**By**

**FEDERATED FARMERS OF NEW ZEALAND (INC)**

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**SUBMISSION TO THE COMMERCE COMMISSION ON THE DRAFT REPORT – PRICE CONTROL STUDY OF AIRFIELD ACTIVITIES AT AUCKLAND, WELLINGTON, AND CHRISTCHURCH INTERNATIONAL AIRPORTS**

**EXECUTIVE SUMMARY**

- Although recognising that price control can potentially have a perverse impact on the incentives to invest and innovate (i.e. cases of 'market failure' can be replaced by 'regulatory failure'), the analysis in the Draft Report provides a strong case for price control based on the fact that the airfield services provided by the major airports in New Zealand are effectively natural monopolies, with strictly limited competition due to the high 'set-up' costs involved in entering the market.
- The Federation notes that the Report states that current inefficient pricing may be able to be removed without the need for price control. For example, the potential exists for airports to be required to “negotiate” over prices and services rather than to merely consult. As a general principle the Federation considers that airports and their users should reach negotiated agreements on price and quality of service wherever possible. In this respect, price control should generally be one of last resort. Nevertheless, given the nature of this particular market, there may be little effective alternative to price control.
- The Federation considers that the approach of The Report in respect to the valuation of land, specialised airfield assets on an historical basis, and the optimisation of land held for future development is fundamentally sound. Moreover, we consider that the Commission’s approach to asset valuation should also be applied consistently across other infrastructural industries where similar natural monopolies exist, such as electricity lines companies and port companies. The final determination of this particular case in respect to the valuation of airport assets could well have flow-on implications for pricing structures of other natural monopolies, such as electricity lines companies. The Federation is therefore supportive of the pricing principles outlined in The Draft Report.

## **1.0 Introduction**

- 1.1 Federated Farmers of New Zealand (Inc) welcomes the opportunity to make a submission to the Commerce Commission on the price control study of airfield activities.
- 1.2 Federated Farmers is an industry organisation that represents approximately 16,000 members and which has a long history of representing the interests of rural farming communities throughout New Zealand.
- 1.3 The rural sector is the backbone of New Zealand's economy and represents the underlying basis for our competitive advantage in international trade. The agricultural sector accounts for around 16% of GDP (once downstream processing is taken into account) and provides one in every eight jobs in New Zealand.
- 1.4 Airports play an increasingly significant role in the New Zealand economy. It is therefore important that they operate efficiently and that pricing structures represents fair returns on investment in the absence of competition. This is particularly so given that there may be incentives on local authorities to try and maximise returns from commercial investments in order to minimise general rates rises required to fund increased expenditure of local authorities. It is noted that as at August 2000, local authorities still owned over one-third of both Wellington and Auckland International airports, while the Christchurch City Council owns 75% of Christchurch International airport, with the Crown owning the balance.
- 1.5 Airports are a critical infrastructure for the rapid movement of perishable goods internationally. It is important that the regulatory environment in relation to airports reflects their importance to the wider economy.
- 1.6 Federated Farmers is generally supportive of the broad thrust of the Draft Report from the Commerce Commission ('The Report'), recommending that price control of Auckland International Airport Ltd (AIAL) is justified.

## **RECOMMENDATIONS**

Given the importance of airfields to the New Zealand economy, and given that the major international airports (Auckland, Wellington and Christchurch) are effectively natural monopolies, the Federation supports the Draft Recommendations contained in the Report. These being:

**“If the Commission were to report to the Minister today, its recommendation would be that:**

- **The requirement in section 52(a) of the Commerce Act is satisfied for all three airports. There is evidence that airfield activities (as defined in the Airport Authorities Amendment Act 1997) provided by AIAL, WIAL and CIAL are supplied or acquired in a market in which competition is limited or is likely to be lessened.**
- **The requirement in section 52(b) of the Commerce Act is satisfied for two airports. There is evidence that it is necessary or desirable for the prices of the airfield activities supplied by AIAL and CIAL to be controlled in accordance with the Commerce Act in the interests of the acquirers of airfield activities.**
- **Based on an assessment of the net efficiency benefits, the Commission’s preliminary view is that market conditions are such that only the airfield activities supplied by AIAL should be controlled.**

The Federation also **recommends** that:

**the Commission’s approach to asset valuation in respect to airport assets is applied consistently across other infrastructural industries where similar natural monopolies exist, such as electricity lines companies and port companies.**

## 2.0 Discussion

2.1 Although recognising that price control can potentially have a perverse impact on the incentives to invest and innovate (i.e. cases of 'market failure' can be replaced by 'regulatory failure'), there is strong justification for price control based on the fact that the airfield services provided by the major airports in New Zealand are effectively natural monopolies, with strictly limited competition due to the high 'set-up' costs involved in entering the market.

2.2 The Federation endorses the analysis in The Report that there is often no, or at least strictly limited, alternatives to the use of a particular airport.

*“The competition faced by the airfield activities at airports from those at other airports may be of two kinds: the **existing** competition from other airports already operating, and the **potential** competition from prospective new entrants. The Commission’s preliminary view is that the nature of the investment in a major airport facility, such as those at Auckland, Wellington and Christchurch, is likely to be such that barriers to entry are high, and hence that competition from potential entrants is low. The extent of existing competition for airfield activities depends largely on the degree to which airports are substitutes for one another. The Commission’s preliminary view is that there is some scope for supply-side substitution for general aviation aircraft given the presence of small airfields in the vicinity, but not for large (commercial) aircraft. There are not substantial near entrants to compete effectively with the three large airports for domestic and international traffic.”*

2.3 The Report goes on to state that while there are requirements on airport operators to consult with airlines before setting charges, the airlines countervailing power is strictly limited. Meeting demand for flights is the overriding factor determining which airports an airline flies to rather than the costs of doing so.

2.4 The issue concerning pricing of airport services in which there is strictly limited competition from alternative providers, closely mirrors the potential for unfair pricing practices by electricity lines companies, unless assets are valued in a fair manner, providing a 'normal' rate of return on their use.

2.5 In this respect, in the absence of competitive markets for similar services, the assets of a company are the most logical way of determining what is a satisfactory rate of return on the use of those assets. The valuation of those assets is therefore crucial. The final determination in this particular case in respect to the valuation of airport assets could have flow-on implications for pricing structures of other natural monopolies, such as electricity lines companies in the future.

**Pricing principles (p.8)**

- 2.6 Federated Farmers endorses the broad pricing principles of a competitive market as outlined on pages 8 and 9 of The Report, particularly that the outcomes achieved by competitive markets are the benchmark against which to compare the outcomes for other types of markets. While it is not necessary to repeat those principles here, two particular ones which are crucial are that prices should allow for a 'normal' rate of return by the suppliers of services over the medium term, and secondly, prices should send appropriate signals for determining whether new investment (or divestment) would be efficient.
- 2.7 The Report notes that in a competitive market, prices determine the value of the assets. In other words, the higher the price of a good or service, generally the higher the value of the assets which are responsible for the production of those goods or services.
- 2.8 The difficulty arises where markets are not competitive (as can be argued with airfield services for the reasons outlined earlier). Here the valuation of assets is particularly relevant for the purposes of determining the price of airfield services. The higher the valuation of assets, the higher the prices of services required to generate the stream of income required in order to generate a normal rate of return on those assets.
- 2.9 The Federation strongly endorses the analysis in The Report, that in economic terms, the relevant costs on which to determine the asset base are the opportunity costs.

**Valuation of Airfield Land (p.10)**

- 2.10 The Federation endorses the principles outlined in The Report in respect to the valuation of airfield land.

*Valuing airfield land at opportunity cost provides appropriate signals to either continue operating the land in its existing use (as an airfield) or to put the land to alternative use and relocate the airport. It also provides the appropriate incentives for new investment.*

*Opportunity costs should be determined based on the highest alternative use value of airfield land. Hence, land value should not include the cost of getting the land to a stage where it could be used as an airport. Such costs are more appropriately included within the costs of any land improvements, such as runways, taxiways and aprons."*

**Valuation of Specialised Airfield Assets (Runways, Taxiways and Aprons)**

- 2.11 The Federation generally endorses the analysis in the Report in respect to the pricing of specialised airfield assets. Economically, most of the asset are in the form of “sunk costs” in that they have little, if any, alternative use.
- 2.12 While it could be argued that given the costs associated with specialised airfield assets are sunk costs and therefore of no value, the airport companies need to be able to cover the costs of, and obtain an acceptable return on, such assets, otherwise there will be no incentive to continue to invest and upgrade them.
- 2.13 The Report states that alternative approaches to deal with this issue are to make valuations of specialised assets either on a replacement or historic basis. The Commission’s preliminary review is that specialised airfield assets should be included in the assets base at historic cost.
- 2.14 The Federation strongly endorses the approach of the Commission in this respect. It would be totally inappropriate to include the replacement cost of the assets in forming the asset base as this would run contrary to the general principle that today’s users should only pay for the costs associated with today’s assets. Basing asset valuations on historical cost would still provide incentives to invest in specialised resources. Such an approach would result in prices being charged to today’s “users” of services reflecting the cost of providing those services, but would not involve paying for the (possibly) upgraded services supplied to tomorrow’s users.

**Optimisation**

- 2.15 The Federation is strongly supportive of The Report’s preliminary view that only those assets, which are currently “used and useful”, should be included in the asset base on which a rate of return is calculated. All other assets should be optimised out, including land.

*“While land acquired or held to provide airfield activities in the future is included within the statutory definition of airfield activities, it does not follow that it is required to be included in the asset base for determining today’s prices of airfield activities.*

*The Commission considers that a return should generally not be sought from airfield users on any land held for the development of airfield activities – that is, until it is “used or useful”. For this reason, land held for the development of airfield activities has been optimised out.”*

2.16 The Report then goes on to state:

*“The Commission’s preliminary view is that pre-funding of new investment is generally inappropriate – only “used of useful” assets should be included in the asset base. This should encourage airports only to undertake new investments that will be “used and useful.”*

2.17 The Federation considers that the approach of the Report in respect to the valuation of land, specialised airfield assets on an historical basis and the optimisation of land held for future development is fundamentally sound. Moreover, we consider that the Commission’s approach to asset valuation should also be applied consistently across other infrastructural industries where similar natural monopolies exist, such as electricity lines companies and port companies.

**Control Necessary or Desirable in the interests of Acquirers**

2.18 The Report notes that current pricing structures, particularly at the AIAL, are inefficient with the AIAL reaping monopoly profits.

2.19 The Report notes however, that price controls do have the potential to impose costs. This is simply through the fact that regulatory intervention is imperfect, and that ‘market failure’ in the case of monopoly pricing can be replaced by ‘regulatory failure’ if price control measures are not appropriately set.

*“...price control provides an imperfect substitute for competition for dealing with the inefficiencies and excessive returns in markets. The imperfect nature of price control is reflected in the costs of price control.*

2.20 Despite the above caveat, given the nature of the market for airfield services and particularly the natural monopoly position that many of the larger airports are in, the Federation supports the preliminary conclusions outlined in the report. These being that there are likely to be net benefits in price control over the airfield activities supplied by AIAL.

2.21 The Federation notes the conclusions that there would appear to be no net benefits in respect to controlling the airfield activities supplied by WIAL and CIAL. However, the Federation also notes that the analysis outlined in the Report did not factor in any future increases in charges that may come out of WIAL’s upcoming consultations.

- 2.22 Given the importance of our major international airports (Auckland, Wellington and Christchurch), and their status as natural monopolies, it will be important that the Commerce Commission keeps a close eye on their respective pricing structures, even if it decides that, at this stage that there is no justification for price controls in either Wellington nor Christchurch.
- 2.23 The Federation notes that the Report states that current inefficient pricing may be able to be removed without the need for price control. For example, the potential exists for airports to be required to “negotiate” over prices and services rather than to merely consult. As a general principle the Federation considers that airports and their users should reach negotiated agreements on price, and quality of service wherever possible. Price control should generally be one of last resort. Nevertheless, given the nature of this particular market, there may be little effective alternative to price control as there are strictly limited incentives on the major international airports to negotiate voluntary solutions.

## **RECOMMENDATIONS**

Given the importance of airfields to the New Zealand economy, and given that the major international airports (Auckland, Wellington and Christchurch) are effectively natural monopolies, the Federation supports the Draft Recommendations contained in the Report. These being:

**“If the Commission were to report to the Minister today, its recommendation would be that:**

- **The requirement in section 52(a) of the Commerce Act is satisfied for all three airports. There is evidence that airfield activities (as defined in the Airport Authorities Amendment Act 1997) provided by AIAL, WIAL and CIAL are supplied or acquired in a market in which competition is limited or is likely to be lessened.**
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The Federation also **recommends** that:

**the Commission's approach to asset valuation in respect to airport assets is applied consistently across other infrastructural industries where similar natural monopolies exist, such as electricity lines companies and port companies.**