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GETTING THE BALANCE RIGHT IN THE AVIATION SECTOR

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1. INTRODUCTION

Auckland International Airport has once again been judged the most profitable airport in the world.[1] What's more, it looks set to continue in this profitable vein having announced a record half-year result in February 2003 up 13.1% on the previous year.[2] At the same time the airline industry is in the middle of a crisis. The global recession, combined with a general reduction in people flying due to the threat of terrorist actions, wars and the outbreak of SARS have had a cumulative effect which has led to the world's airlines making losses estimated at over US$30 billion.

How is it that one part of the aeronautical equation, the airports, can continue to make record profits while the other players, the airlines, are losing so much money?

Airlines operate in one of the most intensely competitive industries in the world. Prices are set by the market. Airlines are not able to simply pass on costs imposed by monopoly service providers. Airports on the other hand set prices so as to recover all costs and provide a return on assets.

In 1997 as the New Zealand Government prepared for the sale of its share in airports, it made amendments to the Airport Authorities Act 1966 to "protect against the possibility of monopoly pricing by airport companies and to protect consumers' interests"[3]. The airport companies thought the amendments went too far and were an abuse of their right to run a business without interference while the airlines felt the amendments did not go far enough. The Government interpreted the level of disagreement as suggesting it had "got the balance right".[4]

Six years later, with three major consultation processes[5], three High Court proceedings[6], an arbitration and a Commerce Act Part IV Inquiry by the Commerce Commission[7]

[1] Transport Research Laboratory, *Review of Airport Charges and Airport Performance Indicators*, 2002 (London).
[2] http://www.auckland-airport.co.nz/SixMonth2002/report.html.
[3] NZPD 19 November 1997 5485 per Hon Maurice Williamson (on behalf of the Minister of Transport); 6 March 1997 728 per Hon Jenny Shipley (Minister of Transport) during the second and third readings of the Airport Authorities Amendment Bill.
[4] NZPD 19 November 5487 per Hon Maurice Williamson (on behalf of the Minister of Transport) during the third reading of the Airport Authorities Amendment Bill.
[5] AIAL: October 1999 till August 2000; CIAL: August 1999 till January 2001; WIAL: October 2001 till February 2003.

having taken place, it is appropriate to examine the regime introduced in 1997, assess how it has worked in practice and ask whether the balance is right.

This paper is divided into four main sections –

- An overview of current airport regulation
- An examination of how this regulation has worked in practice since it came into force in 1999
- An assessment of whether the balance is right between the interests of the airport companies, the interests of airlines and the interests of the ultimate users – the travelling public of New Zealand and visitors to New Zealand
- A discussion of possible options for restoring the balance.

2. OVERVIEW OF CURRENT AIRPORT REGULATION

New Zealand operates a light handed regulatory regime. Like most sectors of the New Zealand economy, regulation of airports is achieved primarily through the Commerce Act, New Zealand's generic light handed competition framework.

Supplementary legislation specifically for airports is provided for in the Airport Authorities Act 1966. This legislation requires airports to operate as a "commercial undertaking"[8] and gives each airport company the right to set such charges as it thinks fit for the use of the airport[9], subject to the obligation to first consult with major users over the proposed charges[10] as well as over any capital expenditure worth more than 20% of the current value of the aeronautical assets of the airport.[11] In addition, airport companies are required to disclose certain financial information on an annual basis.[12]

Broadly speaking, the restrictions on the ability of New Zealand airport companies to charge are threefold:

- Ø The requirement to consult with substantial customers in relation to aeronautical charges such as landing, terminal and departure charges
- Ø The requirement to disclose information under the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999

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[6] *Air New Zealand Ltd v Auckland International Airport Ltd*, M1634-SD/00; *Wellington International Airport Ltd v Commerce Commission*, CP151/02, High Court Wellington, Wild J; *Wellington International Airport Ltd v Air New Zealand Ltd*, CIV-2003-485-194.
[7] Commerce Commission, Airport's Inquiry Final Report, 1 August 2002.
[8] Section 4(3) Airport Authorities Act 1966.
[9] Section 4A(1) Airport Authorities Act 1966.
[10] Section 4B Airport Authorities Act 1966.
[11] Section 4C Airport Authorities Act 1966.
[12] Section 9A Airport Authorities Act 1966 and Airport Authorities (Airport Companies Information Disclosure) Regulations 1999.

- The restrictions contained in general competition law, as expressed in the Commerce Act 1986, including the possibility of stronger action through the introduction of control under Part IV of the Commerce Act

This regime can be compared with a three-legged stool – if any one of the legs becomes wobbly or breaks, the stool falls. If any one of the consultation, information disclosure or general competition law provisions fails to work properly, the whole regulatory regime surrounding airports becomes weakened and unable to properly prevent monopoly pricing and protect consumers.

3. EXPERIENCE OF CURRENT REGIME IN PRACTICE

3.1 CONSULTATION EXPERIENCE

Airport companies are obliged to consult with substantial customers before setting aeronautical charges such as landing or terminal charges paid by the airlines or departure charges paid directly by passengers.

The essence of consultation is the communication of a genuine invitation to the consulted party to give advice and a genuine consideration by the consulting party of that advice. Consultation does not require that there be agreement and it cannot be equated with negotiation.[13]

The airlines have now participated in major consultations over charges with Auckland, Wellington and Christchurch airports. The charges set have amounted to a substantial increase in revenue for each airport, or in costs for airlines. WIAL had by far the largest increase imposing a huge 78% increase in its charges while AIAL increased its charges by 12.5% despite the airlines producing clear evidence in both cases that these increases were not justified. These increases represent millions of dollars of extra costs for the airlines and the travelling public. The extra costs at Wellington alone amount to more than $14m per annum.

Different circumstances applied at the different airports and it is not the purpose of this paper to describe in any detail the process of consultation or the particular differences in the approaches taken by each airport. However, a number of key issues recurred at each airport:

- *A reluctance to provide necessary information and an insistence on the airlines entering into strict confidentiality agreements thereby seeking to prevent the airlines publicly raising these issues.*

  For example, one airline which refused to sign a confidentiality agreement was not provided with any further information other than the proposed increases until three months later when it signed the confidentiality agreement.

[13] *Air New Zealand Ltd v Wellington International Airport Ltd* CA 23/92, 24 September 1992 at page 45, partially reported at [1993] 1 NZLR 671.

- *The use of a weighted average cost of capital which is above that which is reasonable for the environment the airport is operating in and the risk which the airport faces.*

  For example, both Wellington and Christchurch airports use a pre-tax cost of capital of more than 15%.

- *The valuation of assets at a rate significantly higher than their worth*

  For example, Wellington has valued its land at a rate per hectare almost double that of the Commission.

- *The inclusion of assets in the asset base which are not used and useful*

  For example, Auckland airport has included seabed land which it currently values at more than $7m. Christchurch airport has included future terminal developments of $30m in its asset base despite the fact these have not been consulted over and are not programmed to occur until 2006.

- *The lack of any efficiency mechanism in operating costs, with costs increasing faster than inflation*

  All three airports failed to include any efficiency mechanism when setting charges and vigorously disputed a suggestion by the Commerce Commission that efficiency savings of 1% of operating costs were achievable.

New Zealand airport companies use a model known as the building block formula to calculate charges. Under this model a rate of return is sought on every dollar of asset allocated to the aeronautical business and every dollar of operating cost, depreciation and tax is passed on. The higher the rate of return and the greater the value attributed to the assets, the higher the resulting charges and the greater the revenue to the airport. There is therefore an incentive on an airport to include all possible assets and costs, to value assets as highly as possible and to have a high required return. Issues such as cost of capital, asset valuations, which assets ought to be included and cost allocation are therefore key to determining the level of charges.

In the case of all three airports, possession of information, the knowledge that accompanied the analysis of that information, and the right to make submissions to the airports, did not provide the airlines with sufficient power to prevent prices being set which contained monopoly rents. The airport companies have proved to be very conscious of their unique statutory power under section 4A of the Airport Authorities Act to “set prices as [they] think fit” and for the most part were not receptive to the airlines’ submissions.

3.2 INFORMATION DISCLOSURE

The Airport Authorities (Airport Companies Information Disclosure) Regulations 1999 require the three largest New Zealand airports to disclose financial information relating to identified airport activities. This is intended to provide ongoing annual disclosure of financial and operational information by airports. The Government’s philosophy was that this would assist in guarding against monopoly pricing and would help to better inform the consultation process.[14]

The regulations require high level segmented reporting in respect of airfield, terminal and freight activities of an airport. They also require disclosure of WACC calculations and of an airports most recent valuation reports. Certain statistical measures must also be provided.

There have now been three years of disclosures. The disclosure regulations have proved useful in certain respects, for instance in requiring valuation reports to be provided, but in other respects, they fall short. Critically, the regulations do not provide guidelines or rules regarding the key questions of rate of return, asset valuation methodology or allocation of costs or assets. Furthermore, they do not require a breakdown of assets by type for each activity, making it virtually impossible to reconcile asset values between years.

In its recent inquiry into airfield activities under Part IV of the Commerce Act 1986, the Commerce Commission concluded that, based on a post tax WACC of 8.5%, AIAL exhibited excess returns in relation to its airfield activities of $3.4m per annum.[15] By contrast, AIAL has included figures and values in its Disclosure Statements for the year ending 30 June 2002 that show it earning an after-tax return of less than 4% per annum on its aeronautical activities.[16]

The difference is largely attributable to the asset base; specifically, which assets are included and how they are valued. Auckland values its airfield assets $117m higher than the Commission.[17] This allows monopoly profits to be disguised and even portrayed as an under-recovery.

3.3 GENERAL COMPETITION LAW

The control provisions in the Commerce Act 1986 provide the only mechanism available in New Zealand for challenging prices on the ground they contain monopoly rents.[18] In 1997 the Government initiated an Inquiry into airfield activities under Part IV of the Commerce Act at the three international airports.

Over the next four years the Commerce Commission gathered evidence, called for submissions, carried out investigations and analysis, called for submissions, released a draft report, called for more submissions, held a conference, called for more submissions, and in August 2002 released its final report. The Government then called for more submissions.

[14] NZPD 19 November 5486 per Hon Maurice Williamson (on behalf of the Minister of Transport) during the third reading of the Airport Authorities Amendment Bill.
[15] Figures taken from Commerce Commission letter to Minister of Commerce dated 31 October 2002.
[16] http://www.auckland-airport.co.nz/StatutoryInfo/index.html.
[17] AIAL disclosed airfield activity assets of $335.238m in its Disclosure Statements for 2002. The Commerce Commission calculated an appropriate asset base for airfield activity assets in 2002 of $218.077m - refer page 399 of its Report to the Minister of Commerce, August 2001.
[18] *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385 at 308.

In its report, the Commission recommended that airfield activities at Auckland be controlled and noted that if WIAL proceeded to increase its charges by the levels it was then contemplating (which it subsequently did) then it would be likely to also recommend control at Wellington. The Commission's main conclusions were:

- At the determined WACC ranges, all three international airports exhibit excess returns of varying magnitudes[19]
- Airlines have insufficient countervailing power to prevent exercise or abuse of market power by airport companies[20]

In May this year, the Minister of Commerce announced that while she accepted the findings of the Commerce Commission, controls would not be introduced at either Auckland or Wellington. The Minister applied a test known as the net public benefit test, which looks at the benefit to the economy as a whole and disregards wealth transfers between suppliers and acquirers, and concluded that the benefit of control was too small to warrant the cost of imposing it. The Commerce Commission had focused on the specific users and suppliers in its report as Part IV of the Commerce Act does.

The implications of this decision extend far beyond airlines and airports. The potential for the imposition of control under the Commerce Act is a central component of the light-handed regulatory regime which operates in New Zealand. It is a regulatory bargain which every monopoly supplier in New Zealand had understood – behave in an appropriate manner and the Government will not interfere. Behave in a manner which exploits a monopoly position and the appropriate provisions in the Commerce Act will be utilised.

The Commerce Commission had concluded that AIAL would earn monopoly profits of $24m over a seven year period. This equates to pre-tax over-charging of more than $35m. The Government's decision to not impose control in the face of monopoly profits of this magnitude will seriously undermine the light handed regulatory regime which exists in New Zealand. It seems that a threshold has now been set under which New Zealand businesses can expect that the Government will turn a blind eye to monopoly pricing.

4. IS THE BALANCE RIGHT?

Quite clearly, the balance between the interests of the travelling public, the airlines and the airport companies is not right.

In practice, the statutory right given to airport companies by the Airport Authorities Act to set charges as they think fit, has set the monopoly power of the airports into concrete. While the airport companies go through the motions of consultation, they are very conscious of this right to set charges as they think fit and of the fact that they are only obliged to consult and not to negotiate or attempt to reach agreement.

[19] Commerce Commission, Airport's Inquiry Final Report, 1 August 2002, para 95.
[20] Commerce Commission, Airport's Inquiry Final Report, 1 August 2002, para 24-25, 3.101 – 3.119.

Airlines are in the unenviable position of being left repeating their concerns as the airport company inexorably moves on to set charges. In my mind, the power to set charges as the airport company thinks fit is at the heart of the airlines' inability to influence landing charges and ensure an economically efficient outcome.

While Disclosure Regulations can be a useful tool to enable monitoring of pricing behaviour of a monopoly supplier and can assist in providing a certain amount of transparency, the current Airport Authorities Disclosure Regulations allow airport companies to disguise monopoly profits behind a wall of unnecessary, unused and, in some cases, over-valued assets. Airport companies are able to do this to the extent that they can imply that there has been an under-recovery when in fact, monopoly pricing has been occurring. As such the Regulations do not guard against the possibility of monopoly pricing and require review and amendment.

After an Inquiry which covered some four years the Commerce Commission found that monopoly pricing by New Zealand airports has been occurring and that the belief which Government officials have that airlines have sufficient countervailing power to control airport companies, is not true. Despite this, the Minister of Commerce has just determined that controls will not be introduced at any of the airports. In reaching this conclusion, the Minister has put to one side the monopoly profits which AIAL will be earning, which translate into $35m of extra charges over seven years. This decision leaves users of monopoly services with no avenue to address the issue of prices which include a monopoly element.

5. CAN BALANCE BE ACHIEVED?

There will always be an imbalance in the relationship between airlines and airports in New Zealand. Airports provide essential runway services. Airlines must access these in order to operate their aircraft and meet the needs of their passengers. New Zealand is too small for a competitive situation to develop as is occurring in some large overseas cities.

However, it is possible for the relationship between a monopoly supplier and a captive customer to reach a point of a mutual understanding and cooperation. If the customer is prepared to acknowledge that the monopoly supplier needs to be able to recover efficient operating costs and depreciation and earn a reasonable return on capital, and if the monopoly supplier is prepared to undertake to not earn more than this amount, then all parties should be able to work together.

5.1 TWO EXAMPLES WHERE BALANCE SEEMS TO HAVE BEEN ACHIEVED

The case of air traffic control in New Zealand provides an apt example of a monopoly provider which the airlines believe has managed to balance the interests of shareholders and users. New Zealand's air traffic control provider, the Airways Corporation, was corporatised in 1988. It was not given legislative authority for charging so has had to determine charges on a contractual basis with its customers. The airlines and Airways have agreed a memorandum of understanding which provides for full disclosure of information on a confidential basis between the parties, pricing on the basis of a 8.4%

return on capital and the sharing of any profits where there is positive economic value added.[21] All this has been achieved without the need for disclosure regulations, other regulatory intervention or litigation with major customers.

The Australian experience is also worth examining. The Australian privatised airport operators seem to be showing a greater willingness to embrace a reasonable commercial relationship with airlines, perhaps due to the strong regulatory regime implemented by the Australian Government as part of the airports privatisation process. The first airports privatised in Australia were required to price aeronautical services on the basis of a CPI-X price cap regime for four to five years, which was administered by the Australian Competition and Consumer Commission. In addition to determining efficiency factors, the ACCC established principles for adjusting charges to reflect necessary new investment by the airport operators. During this time the ACCC also undertook a detailed investigation of aeronautical charges at Sydney Airport, an exercise which further refined the basis for determining reasonable charges.[22]

At the expiry of the CPI-X regime in 2002, the airports have moved from price regulation based on CPI–X to a regime of price monitoring by the ACCC. However, the Government has clearly indicated that the airports' performance under the price monitoring regime will be monitored closely and, in the event that evidence of monopoly pricing emerged, the airports would be subjected again to price regulation.

Under this arrangement both the airlines and the airport operators understand that the ACCC pricing principles established under the CPI-X regime effectively represent an upper limit for future pricing purposes. Most capital city airports have agreed 5 year contracts with the airlines, the prices being negotiated by reference to the ACCC principles. The Australian operators who also operate to New Zealand airports certainly consider that these contracts represent a much better balance between the interests of the airport companies and the airlines than that achieved by the New Zealand airport legislation.

5.2 CHANGES NEEDED TO ACHIEVE BALANCE IN NEW ZEALAND

The New Zealand airports appear to have a fixation on earning ever increasing profits and are regarding their WACC as the minimum to be earned with the goal being to set charges to exceed this level. Despite airlines acknowledging that airports are entitled to earn a reasonable return on appropriately valued and useful assets as well as covering efficient operating costs and depreciation, airports have wanted more and have used various mechanisms to inflate the inputs into the pricing formula so as to earn above normal profits.

In the absence of the shareholder/customer balance which commercial organisations in the marketplace face, airports are focussing too much attention on their shareholder's demands for ever-increasing profits, and are disregarding their customers who have no option but to use the airport, however high the charges go.

[21] Airways NZ 2002 Annual Report, page 25.
[22] Http://www.accc.au/airport/f-s-air.htm

The lesson of the last six years is that while airports continue to have the statutory power to set charges as they think fit, the imbalance between the monopoly airport provider and the airlines is accentuated and balance will not be able to be achieved. The power to set charges as they think fit needs to be removed so airports have to attempt to work with their customers and reach agreement. As outlined above, this is what occurred between the Airways Corporation and the airlines and is also the situation with other monopoly industries such as electricity, telecommunications, ports and gas.

It is also essential for principles to be developed to guide the pricing process. These principles need to address questions such as asset valuation and allocation of costs and assets. The Act currently provides no guidance as to how an airport should price other than directing it to act commercially. The Commerce Commission's decision demonstrated that there is a substantial difference between charges which are commercial and acceptable under the Airport Authorities Act and charges which are economically efficient. The Commerce Commission developed a set of pricing principles which could be used to set economically efficient prices, however, the airport companies have not been prepared to accept these.

The disclosure regulations also need to be revised and changes made to ensure sufficient information regarding asset values is provided so that users have a thorough understanding of how asset values are changing.

In addition, a deadlock breaking mechanism, similar to the role which has been developed for the Commerce Commission in the electricity and telecommunications sectors should be developed. This would be beneficial to all parties as it would enable the question of over-charging to be expeditiously addressed.

The Minister of Transport has recently decided to undertake a review of the information disclosure and consultation requirements of the Airport Authorities Act. It is to be hoped that this review will result in some long needed amendments to the Act designed to redress the imbalance of power between New Zealand airports and airlines.

In its current form, the Airport Authorities Act is not preventing the earning of monopoly profits by airport companies and is not protecting consumer's interests. The balance is not right and unless changes are made, airport companies will continue earning monopoly profits at the cost of the airlines and the travelling public. The Government's recent decision not to impose control at Auckland and Wellington airports has given the airports carte blanche to continue pricing as they have been, and is likely to result in airports seeking to earn higher returns on their assets and moving to higher valuations.

Unfortunately, airlines have no option but to land at these airports – even though it is by no means an appropriately priced landing.