



INTERNATIONAL AIR TRANSPORT  
ASSOCIATION  
(IATA)

Submission to the New Zealand Ministry of  
Economic Development's review of the  
regulatory provisions under the Commerce  
Act 1986

## **International Air Transport Association's submission to the New Zealand Ministry of Economic Development's review of the regulatory provisions under the Commerce Act 1986**

This submission presents the response of International Air Transport Association (IATA). IATA's mission is to represent, lead and serve the airline industry and brings together 250 member airlines whose flights account for 94% of all international scheduled air traffic. IATA welcomes this opportunity to submit its comments to the New Zealand Ministry of Economic Development as part of its review of the regulatory provisions under the Commerce Act of 1986. IATA's comments are from an international perspective and are based on the requirements of, and practices in, international civil aviation.

The IATA New Zealand office was opened in 1974 to facilitate the implementation of the Billing and Settlement Plan – New Zealand (BSP). The Cargo Agent Settlement System -CASS was implemented in 1992. The IATA New Zealand office is responsible for oversight of the BSP and CASS operations as well as participation in general aviation related matters that have an impact on Airlines operating in the region. The BSP operation settles approx NZD40M in funds between 55 airlines and 530 Travel Agents each week. The CASS operation settles funds between 27 airlines and 83 Cargo Agents each week. The IATA New Zealand office is also responsible for the same activities in Fiji, Samoa, Kingdom of Tonga, Cook Islands and Vanuatu. 6 staff are currently employed in the IATA Auckland office.

Main activities of the IATA New Zealand office include:

- Local involvement in all aviation-related Government and Industry lobby activities
- Building and maintaining relationships with all industry stakeholders in NZ and SWPI
- Full oversight of the IATA Finance Settlement Systems (BSP & CASS)
- Sales, marketing and promotions of IATA products and services

Of the 20 Airlines that operate services to New Zealand, 17 are full IATA members. IATA actively participates in regulatory and charges issues associated with aviation in New Zealand.

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## Executive Summary

- The desirable characteristics of effective Economic Regulation are Independence, Transparency, Consultation, Flexibility, Neutral dispute settlement mechanism and Regulatory benchmarking.
- The main issues with the current regulatory regime are:
  - Lack of pricing and consultation guidelines for uncontrolled businesses
  - Resource intensive processes
  - Uncertainty of conditions under which businesses will be subject to controls
  - Lack of a purpose statement on pricing efficiency
- The primary objective of regulation is to prevent abuse of market power by monopolistic businesses.
- Rather than doing an efficiency test (to judge if regulatory control should be imposed), the focus needs to be on developing the right type of regulation that ensures efficiency improvements while curbing the market power of monopolistic businesses.
- A well-designed and effective framework can provide benefits for both users and for regulated companies.
- A regulatory-specific purpose statement is desirable and the same statement should apply to Parts 4, 4A and the relevant sections of Part 5.
- IATA agrees with the Ministry's proposed statement with an additional clause for the regulation to ensure that related businesses share the benefits with consumers.
- IATA supports economic regulation where there is a risk of abuse of market power by monopoly suppliers.
- IATA does not agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers exceed direct and indirect costs.
- The regulatory framework needs to be transparent, unambiguous and independent from political interests.
- Amendments are needed to the Airport Authorities Act to ensure consistency with the regulatory framework and objectives of the Commerce Act.
- The critical aspects for an effective regulatory regime are price cap regulation, single-till approach and a strong negotiation & dispute resolution processes
- Key input decisions should be set as a stand-alone process in advance of an inquiry and recommendation to regulate and should be set generically.
- The key inputs that IATA considers to be highly important are: 1) WACC and the appropriate rate of return 2) Asset valuation.
- IATA is of the opinion that benchmarking should be on a regional or global level and should not be limited to New Zealand airports.
- There is scope for the sharing of best practices between different regulated industries.
- IATA is in favour of regulation on an individual basis rather than on a system-wide basis.
- IATA is indifferent as to whether firms are allowed to propose their own control terms for the Commission's consideration.
- IATA does not support the use of a price threshold regime and comparative benchmarking limited to New Zealand.
- In general, IATA is against interim reviews but understands that under true exceptional circumstances, the re-opening of control terms for reconsideration has merit.

- For the purposes of ensuring accountability, a neutral dispute settlement mechanism is required.
  - A neutral dispute settlement mechanism reduces the risk of regulatory failure and chances of reaching sub-optimal decisions, provides another information channel for stakeholders to communicate their views and supports the practice of the transfer of best practices from other industries.
  - **Air transport is an extremely important industry for the New Zealand economy, in terms of its own direct contribution, its key role in the travel and tourism industry and the wider benefits it creates through providing greater access for New Zealand to the global economy.**
  - **Restrictions on air transport – including constraints arising from high airport charges and poor airport service quality – can have a significant negative impact not just on airlines but on the whole economy.**
  - **Conversely, an effective system of regulation that seeks ongoing efficiency and service quality improvements can have long-lasting and sizeable economic benefits.**
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## Overview of IATA submission

This submission, attempts to detail the following:

- What needs to be improved: deficiencies of the current framework
- How this can be done: improvements needed in the regulatory framework
- Why this needs to happen: the current economic inefficiencies and imbalances and the benefits of implementing the improvements

### **This submission covers the following issues in detail:**

- Key Issues with the current regime
- Key improvements needed for regulatory models
- Improvements needed to the decision process on whether to impose regulation
- IATA preferred model for airport regulation
- Global Best Practices including key positive outcomes of the Australian PC review
- Passenger cost and welfare impact – fare, terminal charges, parking cost options
- Impact of air transport on the overall New Zealand economy/tourism/employment
- Profitability and financial performance of Auckland and other airports as compared to airline and other industry partners
- Cost benefit analysis of effective regulation
- Changes needed to the Airport Authorities Act to ensure full application of updated Commerce Act in the Airport sector

For clarity purposes, the above issues are covered under the relevant questions as listed in the Discussion Document's "Questions for Submitters". It should also be noted that the IATA submission is limited to the aspects of the Commerce Act that are relevant to the aviation industry and its broader impact on Tourism and the New Zealand economy. This submission also details the changes that will be required in the Airport Authorities Act to ensure that there is uniform application of the Commerce Act principles and objectives in the New Zealand airport sector.

On 4 April 2007, Hon. Lianne Dalziel, Minister of Commerce, stated the following regarding the objective of the Commerce Act review:

*"We want to better ensure that consumers are protected from excessive prices or the possibility of poor quality service from monopoly suppliers, such as gas pipeline or electricity lines companies. At the same time we want to make sure firms retain incentives to invest in infrastructure."*

IATA believes that the issues identified in this submission and the recommended improvements need to be acted upon to ensure that the core objective of the review – *the protection of consumers from excessive pricing by monopoly suppliers* – is met. IATA hopes that the New Zealand government will take these views into account and is willing and able to assist in any follow-up that is required in this regard.

## Questions for submitters

### Chapter 1: Introduction

1. Do you have any comments on the desirable characteristics of a regulatory regime as outlined in this Chapter?

IATA is in general agreement with the desirable characteristics of a regulatory regime as outlined in this Chapter and would like to make additional commentary and discussion points related to each characteristic:

- **Minimising regulatory uncertainty:** While regulatory certainty is important it should not be used as an argument to avoid taking action when instances of abuse of market power occur.
- **Regulatory consistency:** This principle works towards objectivity and fairness in processes but it should not be viewed as an impediment to refining/amending current regulatory processes that have proven to be ineffective.
- **Transparent, cost effective and timely processes:** We concur with this as processes of such nature are the building blocks for a successful and effective regulatory regime.
- **Sufficient flexibility:** It should be noted that the regulatory regime in question will have to strike the appropriate balance between regulatory consistency and flexibility.
- **Accountability and independence:** This has a direct bearing on the regulatory regime's effectiveness and credibility, which we elaborate on further below.

In addition to the above mentioned, we would also like to stress the following additional characteristics for consideration:

- **Independence:** Economic regulation should be independent from direct control by governments or vested business interests. An economic regulator should be established with clear objectives and statutory duties and then provided with the resources and operational independence to meet these objectives.
- **A neutral dispute settlement mechanism:** The regulated companies and the airline and other users should have a mechanism for appealing against the regulator's decisions. Typically the neutral body will be the national competition authority. This provides an additional safeguard within the framework against regulatory failure, minimising the risk that the regulatory body itself can reach sub-optimal decisions. However, in order to minimise regulatory delays and complexity, the neutral authority should have the ability to assess and, if necessary reject, an appeal against certain criteria (i.e. the grounds for the appeal) before undertaking a more detailed assessment.
- **Enforceable penalties for poor performance:** Effective regulation also requires a credible threat of penalty measures in the event of regulatory targets not being met. In other words, the regulated company must believe that penalties will be enforced if it is shown to have abused its market power.
- **Focus on incentives:** An effective regulatory structure should look to provide clear incentives for the regulated parties for operating efficiency improvements, capital investments and adherence to service quality standards.
- **Regulatory Benchmarking:** There will be many common aspects between the regulatory process for different industries and entities. As such, a forum should be

available for best-practice regulation benchmarking, both in terms of revealing additional information for the regulator and for regulated companies and users to assess the performance of their regulators.

There are also some key principles that should be adhered to for an effective economic framework:

- **Appropriateness:** Regulation should focus on entities and industries that have clear natural monopoly characteristics that allow them to exploit their market power in setting charges. The need for regulation should be considered on a case-by case basis, and not imposed where the cost of regulation exceeds any potential benefits.
- **No cross-subsidisation:** Heavier forms of regulation, i.e. price control, should be undertaken at an individual entity level, with the decisions made on a basis appropriate to the key objectives in each case. For example a system regulation, that sets a price cap for more than one airport, can lead to sub-optimal decisions.
- **Non-discrimination:** The regulatory structure should not distinguish between different types of users. The consultation process should be open to a range of stakeholders and the regulatory decisions should be applied on a non-discriminatory basis. Regulators should take into account the interests of existing users while safeguarding the rights of future potential users.

A well-designed and effective framework can provide benefits for both users and for regulated companies. An incentive-led process helps to improve efficiency, often through consultation with users who experience several aspects of service quality and can provide constructive help. It can also improve the business investment planning process, delivering capital investment in accordance with the needs of existing users while also safeguarding the rights of potential new users. Independent and transparent economic regulation can reduce uncertainty on both sides, helping to reduce investor risks and financing costs. The stability provided by an effective regulatory framework can also attract longer-term investment finance into the industry, avoiding the potential volatility in infrastructure asset prices driven by short-term speculative behaviour.

#### **IATA position summary**

- The desirable characteristics of effective Economic Regulation are Independence, Transparency, Consultation, Flexibility, Neutral dispute settlement mechanism and Regulatory benchmarking.

### **Chapter 3: Potential issues with the current regime**

1. Does the above list capture the main issues with the current regulatory regime?
2. Are these issues adequately identified and described?
3. Are there any other issues with the current regime that are not listed above and should be considered as part of this review?

The current regulatory regime has a number of shortcomings that have resulted in some of the objectives of the Commerce Act not being met. While the regulatory control provisions of Parts 4 and 5 provide for the theoretical regulation of monopoly providers, the reality is that the overall “light-handed” regulatory framework has been largely ineffective in curbing the monopolistic behaviour of some companies. Given that regulation is the second best alternative to actual competition, the true measure of the success of a regulatory regime is the level to which it can mimic the results of free market competition. In this respect, certain aspects of the Commerce Act fail the test. One of the key issues for this failure is that the current regime is not designed to deal with natural monopoly sectors. Consequently, it does not offer a credible threat to deter abuses of market power in these sectors. A regulatory model will only be effective if it is credible.

The rejection of regulation for Auckland based on the reason of high regulatory costs effectively gives the airport a carte blanche, this is evident by its extremely high levels of profitability and use of its revalued asset base, as at July 2006, in order to justify higher airport charges. In addition, the lack of credibility is somewhat related to lack of clear definitions of what constitutes market power against which performance can be measured and penalties introduced if necessary.

Chapter 3 has listed some of the issues with the current regulatory regime but the net result is the imbalance in the commercial relationship between the supplier of goods/services and its users – in the favour of the supplier. This has been largely due to the following underlying problems:

- **Lack of pricing and consultation guidelines for uncontrolled businesses:** Part 4A of the Commerce Act provides some level of pricing guidance and threshold tests for electricity lines businesses. However, the other industry sectors do not have any pricing or consultation guidelines. For example, the obligations of the Airports (under the Airports Authority Act) are limited to “Every airport company must consult with every substantial customer...”. All this results in is a long drawn consultation process that enables the Airport to meet its “statutory” obligations, while not limiting the airport’s freedom to ignore the users’ positions and views while setting charges. In other words, consultation processes in name rather than substance, do not address the fundamental problem of asymmetric information between airports and airlines. If airports do not provide sufficient information or engage in meaningful negotiations the process is not worthwhile.
- **Resource intensive processes:** In the current framework, businesses and their users are left with no option but to consult “in a vacuum” (due to the lack of guidelines). This inevitably leads to protracted consultations with detailed analysis and positioning from all parties in an attempt to justify their respective view points. This is a very resource intensive process and the costs of consultation are largely being borne by the end-users.

- **Uncertainty of conditions under which businesses WILL be subject to controls:** While there are provisions under the Commerce Act that allow for businesses to be controlled but there is no clarity in the process for invoking these provisions. There is uncertainty and a lack of clear guidelines regarding the process for initiating an inquiry and the conditions that need to exist before such an inquiry will be initiated. Also, the Act allows for uncertainty in the decision on whether to impose regulation (discussed in detail in Chapter 6). This is a key deficiency in the current regime and seriously damages the transparency and independence of the regulatory framework.
- **Lack of a purpose statement on economic efficiency.** Currently, the Commerce Act does not specify incentives and guidelines for businesses to improve on productivity and cost efficiency – and more importantly - to share these gains with the users.

### Operating Profit Margins of Air New Zealand and New Zealand Airports

Airport	FY0203	FY0304	FY0405	FY0506
Air New Zealand	6.45%	6.71%	5.86%	3.89%
Auckland Airport	64.12%	65.62%	67.10%	65.93%
Christchurch Airport	37.70%	36.19%	41.68%	38.81%
Wellington Airport	54.59%	58.27%	53.65%	28.60%*

\* Reduced profitability due to ad hoc subvention payment for the year.

### TRL 2006 Airport Performance Indicators for Auckland Airport

Performance Indicator	Value	Global Ranking
Aero.Revenues/Total Costs (%)	156.3%	2
Operating Profit (%)	66%	2
Operating Profit/Passenger	6.22	3
Return on Capital Employed (%)	19.3%	3
Return on Shareholders Funds (%)	19.4	4
EBITDA as % of turnover (%)	79.1%	3

### Evidence of failure of implementation of the objectives of the Commerce Act

The first table shows the high levels of profitability of New Zealand airports compared to the national carrier, Air New Zealand. Over the past four years, while Air New Zealand has had a declining single figured operating profit margin (3.89 to 6.71%), yet the operating profit margins of the airports are all double digit figures. In the second table: at its current levels of profitability, Auckland Airport ranks very highly on a world-wide basis in a wide variety of airport profit and return performance indicators. Such a situation prevails because Air New Zealand competes in a very competitive international market for air travel while in the case of the airports, the lack of competition and regulatory controls has resulted in a monopoly situation. This allows airports to achieve high levels of profitability at the expense of customers.

### IATA position summary

The main issues with the current regulatory regime are:

- Lack of pricing and consultation guidelines for uncontrolled businesses
- Resource Intensive processes:
- Uncertainty of conditions under which businesses will be subject to controls
- Lack of a purpose statement on cost efficiency.

#### **Chapter 4: Objectives of economic regulation**

1. Do you agree that a regulatory regime needs to be available to address issues in markets with monopoly characteristics?
2. Do you consider that the sole or primary objective of a regulatory regime should be economic efficiency or consumer protection (distribution), or do you consider that both should be taken into account?

IATA is of the firm view that independent economic regulation is needed where suppliers (e.g. airports) have the potential to exploit a natural monopoly position.

IATA considers that the primary objective of regulation is to prevent the abuse of market power by monopolistic businesses. While both economic efficiency and consumer protection should be addressed in the regulatory regime, the primary focus should be mainly on protection of consumers from the abuse of market power by monopolists.

Economic regulation is the second best alternative to free-market competition, but is both necessary and desirable where such competition does not exist (i.e. in a monopolistic market). In this respect, IATA agrees with the general Background as detailed in Section 4.1 of the Discussion Document. However, IATA does not completely agree with the Efficiency and Distributional outcomes analysis in this Chapter for the following reasons:

**Efficiency outcomes:** An effective Regulatory framework HAS to target ongoing efficiency improvements. Therefore, regulation should provide clear incentives and targets for efficiency, with monitoring to assess performance and potential improvements. Effective economic regulation can provide both a carrot and stick approach to improving productive efficiency. The main mechanism through which this operates is by the regulator setting a reasonable profile for performance improvement over the next regulatory period. This is based on the regulator's judgement of feasible improvements in efficiency, accounting for past performance and planned investments. It then provides an incentive for the company by allowing it to keep additional profits from performing more efficiently than anticipated by the regulator during the period, along with the penalty effect of costs higher than anticipated not being reimbursed by users.

Thus, rather than doing an efficiency test (to judge if regulatory control should be imposed), the focus needs to be on developing the right type of regulation that ensures efficiency improvements while curbing the market power of monopolistic businesses.

**Distribution outcomes:** The discussion document focuses on the redistribution of wealth and the cost of regulation but it ignores the wider impact of the commercial imbalance due to an unregulated monopoly. In the aviation industry, increased charges by monopolistic airports can impact the cost of travel and viability of routes. Studies have shown that a 10% increase in ticket prices can lead to up to 15% decrease in demand. This in turn can have a dramatic impact on the greater tourism industry and even the overall economy of a country – especially one that is reliant on and at the end of the transport chain. Also, it is difficult (if not impossible) to estimate the pricing levels for an unregulated monopoly.

Next, aviation itself brings about a wide range of economic benefits to consumers, industries (e.g. tourism) and economies. Basically, aviation connectivity:

- helps firms to access global markets
- helps to attract a wider range of suppliers, thus improving efficiency
- facilitates investment flows
- allows firms to take advantage of economies of scale

Given the key role that aviation plays in facilitating economic development, any system that allows monopolistic providers to constrain the industry through their exploitation of market power is going to adversely affect not just consumers but also the broader economy. In the case of New Zealand, given its geographic location, it is especially important to minimise such possible negative effects.

The discussion document also refers to the benefits and the costs of control. IATA agrees that regulation is not a zero-cost proposition. It does involve costs, in terms of both resources needed and the risk of regulatory failure in responding to insufficient or asymmetric information. However, as noted earlier, a well-designed and effective framework can provide benefits for both users and for regulated companies. An incentive-led process helps to improve efficiency, often through consultation with users who experience several aspects of service quality and can provide constructive help. It can also improve the business investment planning process, delivering capital investment in accordance with the needs of existing users while also safeguarding the rights of potential new users. Independent and transparent economic regulation can reduce uncertainty on both sides, helping to reduce investor risks and financing costs.

On the issue of costs, previous estimates of the “direct costs of control” (including the regulator’s and market participants costs) have overestimated the true **additional** costs of regulation. The last review estimated an annual average direct cost of NZ\$0.62-1.32 million. However, this is not contrasted against the alternative of no regulation. In the event, what has actually occurred over the last few years is a large amount of expenditure, by both airports and airlines, on consultants, lawyers, etc where disputes have arisen that would otherwise have been resolved through clear pricing principles having regulatory force. In other words, much – if not even more – of the estimated direct costs of regulation are incurred in the situation of no regulation too, so the direct additional costs of regulation are significantly lower.

Secondly, arguments stating that distributional outcomes are simply a transfer of rents from producers (airports) to acquirers (airlines) and therefore do not produce welfare losses are incorrect. The competitive nature of the airline industry means that any gain through lower charges is eventually passed on to airline users in the form of lower fares, which in turn increase consumer surpluses and additional benefits, especially where demand is price elastic, such as in leisure markets. We illustrate this by way of example below:

- IATA estimates that there were around 7.44 million international arrivals and departures in New Zealand in 2006, paying an average one-way fare of US\$410
- Assuming that airport and ANSP charges are at least 10% of operating costs, a 10% increase in efficiency can reduce overall costs by 1%, translating into fares being reduced by 1%
- With a price elasticity of 1, a 1% fall in fares (\$4.1) increases passenger numbers by 1% (74,400)
- This alone provides an additional benefit (on top of the transfer from producer to consumer surplus) of US\$152,500 (i.e.  $0.5 \times 4.1 \times 74,400$ )

- If the price elasticity were as high as 1.5, the additional benefit would be US\$228,780

Thirdly, the wider economic benefits of increasing traffic and optimising the connections to the global air transport network are neglected. IATA has undertaken some recent research with the consultants Intervistas that estimate that a 10% increase in a country's connectivity relative to GDP can boost annual long-term GDP by 0.07%<sup>1</sup>. For New Zealand, where GDP is around US\$100 billion, a 10% rise in connectivity relative to GDP can generate an annual benefit of US\$70 million. On IATA's measures, New Zealand currently has a connectivity measure relative to GDP of 0.477, significantly higher than 0.373 for Australia. Therefore, holding everything else constant, the difference in connectivity alone adds around 0.2% to New Zealand GDP growth compared with Australia. Constraints on air transport growth and connectivity, such as inefficient high-cost airports, put these benefits at risk.

#### **IATA position summary**

- The primary objective of regulation is to prevent abuse of market power by monopolistic businesses.
- Rather than doing an efficiency test (to judge if regulatory control should be imposed), the focus needs to be on developing the right type of regulation that ensures efficiency improvements while curbing the market power of monopolistic businesses.
- A well-designed and effective framework can provide benefits for both users and for regulated companies.

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<sup>1</sup> See IATA Economics Briefing, "Aviation Economic Benefits", available from [www.iata.org/economics](http://www.iata.org/economics).

## **Chapter 5: Purpose statement**

1. In your opinion, is a regulatory-specific purpose statement desirable?
2. If so, do you agree with the proposed regulatory-specific purpose statement, or do you prefer an alternative formulation? If so, please suggest specific wording.

IATA is of the firm view that a regulatory purpose statement is desirable. IATA fully agrees with the Discussion document's analysis that the absence of such a statement has contributed to the uncertainty and ambiguity about policy intent.

IATA supports the Ministry's consideration that the same statement should apply to Parts 4, 4A and the relevant sections of Part 5. But, IATA is of the view that the proposed purpose statement should be amended as follows:

*"The purpose of this Part is, in markets where there is little or no competition or prospect of competition, to provide for economic regulation for the long term benefit of consumers of New Zealand. Any regulation under this Part should seek to ensure that suppliers:*

- (a) are limited in their ability to earn excessive profits;*
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands;*
- (c) share the benefits of efficiency gains with consumers, including through lower prices; and*
- (d) have incentives to innovate and to invest including in replacement, upgraded and new assets*
- (e) have incentives to engage in related businesses and share the benefits of such any resulting efficiency gains with consumers*
- (f) are aware of and will face clear and credible penalties in the event of an abuse of market power has been proven"*

In the case of (e), IATA does not seek to restrict the commercial activities of airports in non-related areas, but instead seeks to ensure that the development of related businesses involves shared incentives and shared risks and rewards. Related businesses refer to those activities at an airport that rely upon the passengers that airlines bring in (e.g. terminal retail activities). In the aviation industry, this concept is commonly referred to as single-till. The arguments for single-till regulation are described in detail later under the "Preferred Regulatory Model" section.

## **IATA position summary**

- A regulatory-specific purpose statement is desirable and the same statement should apply to Parts 4, 4A and the relevant sections of Part 5.
- IATA agrees with the Ministry's proposed statement with an additional clause for the regulation to ensure that related businesses share the benefits with consumers.

## Chapter 6: The decision on whether to impose regulation

1. Do you agree with the proposed criteria for deciding on whether regulation *may* be imposed?
2. If you agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers *exceed* direct and indirect costs, do you consider that such benefits should (a) '*substantially*' or (b) '*clearly*' exceed costs, or should there be some other guidance on weighting?
3. If you agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers exceed direct and indirect costs, should those benefits be considered regardless of whether acquirers acquire the goods and services *directly or indirectly*, or should it be necessary to establish that benefits *will* be passed on to end users (or consumers or end-acquirers)?
4. Should the current provisions in the Act allowing control to be imposed in the interests of *suppliers* (to a monopsonist) be retained?
5. Do you agree that there should not be a legislative test for when regulation *should* be imposed?
6. Do you agree that the Minister should remain the decision-maker on whether control should be imposed under Part 4, but that that the Minister must receive a report and recommendation from the Commerce Commission before making a decision?
7. Do you agree that the decisions on *whether* and, if so, *how* to regulate should be undertaken simultaneously rather than sequentially?

IATA is of the view that the criteria for deciding whether regulation may be imposed is - if there is a "risk of abuse of market power". This can be specified by a combination of conditions such as below:

- There is little or no competition or prospect of competition in the relevant market
- The goods or services are supplied by a person or persons with market power.

IATA agrees that consideration should be given to whether long term benefits to acquirers exceed direct and indirect costs, but remains unconvinced that reviews have fully and properly taken into account all of the costs and benefits and therefore think that the test as it currently stands may be misleading. The reasons for this are as follows:

- In markets with relatively inelastic demand, the potential costs to acquirers (in the absence of control) can be unpredictably high and thus there is a risk of underestimation of the long term benefits to acquirers of control
- The test does not take into account the potential indirect benefits to suppliers and indirect acquirers (as opposed to end-users). For example, reduction in airport charges may result in traffic growth - thus benefiting both duty-free sales at the airport and hotels in the city.

Effective control can be implemented without imposing a substantial cost burden on the suppliers and acquirers.

The regulatory framework needs to be transparent, unambiguous and independent. Thus, IATA is of the view that there needs to be a legislative test or criterion when regulation *should* be imposed. This will remove the ambiguity due to the '*may*' test and will ensure that the purpose and objectives of the Commerce Act are fulfilled. Regulation should be imposed if the conditions of '*whether*' control is needed are met.

Else, there is a risk that the provisions of the Act will exist only on paper and implementation will not occur due to other unrelated factors.

Also, IATA does not believe that the Commerce Act will be well served by having the Minister as the decision-maker on whether control should be imposed. Economic regulation should be independent from direct control by governments or vested business interests. Independence relates to the operational freedom of the regulatory body. In most cases, governments will set broad regulatory objectives, along with personnel and administrative budgets. Once specific objectives (or statutory duties) and the level of resources are set, the regulator should then be allowed to make decisions on an independent basis.

The decisions on whether and how to regulate should be undertaken simultaneously, as they are closely interrelated and separate decision making processes will involve considerable overlap and unnecessary costs.

**IATA position summary**

- IATA supports economic regulation where there is a risk of abuse of market power by monopoly suppliers.
- IATA does not agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers exceed direct and indirect costs.
- The regulatory framework needs to be transparent, unambiguous and independent from political interests.

## **Chapter 7: Types of economic regulation**

1. Do you agree that it is desirable to widen the scope of the Commerce Act by providing for regulatory options other than control, specifically:

- negotiation/arbitration and
- price monitoring/information disclosure?

2. Do you consider that specific, easier tests should be provided to determine whether lighter-handed types of regulation, such as information disclosure, may be imposed, such as:

- meeting the competition criteria only
- requiring qualitative (rather than quantitative) cost-benefit analysis?

There is no definitive model for economic regulation. The optimal model to put in place will change with the circumstances involved. IATA is open to the consideration of a wide range of potential regulatory frameworks. However, our experiences with airports, economic regulators, governments and other involved stakeholders in other countries on this subject matter have led us to prefer a single-till, price cap regulation model that has strong negotiation and dispute resolution processes.

### **Key Elements To Include In Strong, Robust and Politically Independent Economic Regulation of Airports and ANSPs**

1. Effective stakeholder engagement should ensure the early and timely involvement of airlines in negotiations on business plans, future investments and operational expenditures. This involvement should continue until a successful conclusion is reached.
2. Transparency should be provided on the future business strategy and plans, future investments, essential historical and forecast financial and operational performance data.
3. Capital expenditure should only be undertaken with the agreement of airline users on both the need for and the financing of infrastructure.
4. Strong support to encourage airports and ANSPs to strive for cost reduction, and better cost efficiency on a continuous basis by setting clear and measurable cost efficiency targets.
5. Agreed quality and operational performance standards through service level agreements. These should be regularly measured to ensure performance meets the required standards.
6. Charges should be non-discriminatory.
7. No cross subsidisation between user groups.
8. Single till should be applied at airports.
9. ICAO Policies on charges for airports and air navigation services should be applied
10. A binding neutral dispute settlement mechanism that is easily available to all involved stakeholders
11. An independent appeal body should be available in the event of a dispute.

### **The Preferred Regulatory Model**

*It is IATA's basic position that effective regulation of New Zealand's major airports can only be achieved through an unambiguous regulatory model that ensures that the monopoly Airports cannot abuse their pricing power for windfall gains. This calls for a*

*price cap arrangement and clear guidelines on the critical drivers of airport charges. In the event that the New Zealand Government continues with the current light-handed regulatory regime, IATA urges the Government to urgently rectify the deficiencies identified in the previous section and consider opportunities for further improvement listed below.*

In privatising New Zealand's major airports, the Government recognised the monopoly market power of Airport that could potentially be used to inefficiently raise prices for their services above those that would prevail in a more contestable market, and sought to deal with this through the light-handed regulatory regime included in the Airport Authorities Act. The goal of economic regulation has to be the reproduction of the desirable elements of a competitive market in a situation where competition is not possible. Unfortunately the current regime is not achieving this goal.

The Government should therefore give due consideration to the following critical aspects for an effective regulatory regime:

- Price Cap Regulation
- Single Till
- Strong Negotiation & Dispute Resolution Processes

### **Price Cap Regulation**

Airports are natural monopolies and thus require some form of economic regulation. While there are many different methods of economic regulation in use across a range of industries around the world, it is IATA's view that **Incentive Regulation (CPI-X)** is the most appropriate as in essence, CPI-X aims to mimic the competitive market outcome by:

- Allowing for innovators to enjoy benefits within each regulatory period
- Providing an incentive to pursue attainable cost efficiencies
- Being forward looking with forecasts of potential productivity improvements whereas a rate of return regulatory system is backward looking and is based on historical costs
- Giving regulators more degree of freedom because of the range of factors that can go into X
- Allowing scope for bargaining under CPI-X (which may lead to better outcomes)

Guidelines are also required on the Asset Base and Allowable Rate of Return. Detailed IATA positions on these two critical issues are detailed in the response to questions from Chapter 8.

### **Single Till**

By definition, the primary purpose of an airport is airline operations. Airports in New Zealand have used the dual till framework to maximize their commercial revenues in addition to imposing substantial increases in aeronautical charges. New Zealand Airports now get around 40~50% of their total revenues from non-aeronautical activities. While IATA recognizes and supports the Airport Operators' right to optimize returns

from its investments, we believe that the Government's original intention of allowing for unrestrained commercial revenues to minimize the need for increases in airport charges has not been realized.

Given the increase in the profitability of the New Zealand airports that result from the dual till, at the expense of higher charges to airlines and higher fares to their passengers, the reasonable interests of users to the airports are better served by the single till than by the dual till. IATA supports the implementation of the single till for a number of reasons:

- Interdependency It has long been accepted that there is a very strong symbiotic relationship between airlines and airports, as each needs the services provided by the other. Economic activities at airports are generated by the presence of airlines – the situation at airports in New Zealand is no exception. It is reasonable to assume that in the absence of aeronautical services there would be no market for non-aeronautical services such as retail concessions and car parking.
- Absence of a competitive environment for airports Airports are natural monopolies, thus their pricing behaviour is tempered by the lack of formal competition. It is IATA's strong belief that if it were possible to place airport management companies into a competitive environment, for example, if they had to regularly tender to provide airport services to airlines, they would not treat aeronautical and non-aeronautical as two distinct and separate income streams. Instead, a rational airport provider is most likely to promote aeronautical pricing solutions that would increase passenger throughput at their airport in order to maximise their non-aeronautical revenue. Thus they would use income generated from non-aeronautical services to support aeronautical charges to encourage additional passenger throughput.
- Under-investment in aeronautical resources Under a dual till approach, airports will have to make continued capital investment decisions, given there is an implicit scarcity of financing resources within all companies, capital will be allocated to fund resources that provide the highest economic return. Non-aeronautical investment as an unregulated source of income will generate higher returns when compared to aeronautical investment. Thus future investment decisions under a dual till environment risk being weighted to non-aeronautical infrastructure. This could lead to an imbalance in service levels between the two areas and ultimately could compromise the integrity of the aeronautical infrastructure.
- It has been argued that the single till approach may provide weaker incentives for the airport operator to invest in improvements in its non-aeronautical assets. However, under single till the aviation charges are usually set by considering budgeted cost and ancillary income streams, which will be discussed with the users. Higher results, thanks to performing better than agreed (e.g. lower cost, higher ancillary income), remains with the operator, until the following regulatory review when the single till is re-set. This provides an incentive for the airport to develop non-aeronautical revenue whilst at the same time ensuring that in the longer term airlines share in the benefits of the fact that its they who bring the retail spending power of passengers to the airport.

## **Strong Negotiation & Dispute Resolution Processes**

Given that airports are natural monopolies, there is an asymmetry of information and economic power between airport and airline customers. Any form of commercial negotiations between the two will be strongly in favour of the provider due to the reason stated above. As such, airline customers would tend to come out from negotiations with less than favourable outcomes. Secondly, while the current Airport Authorities Act states that airports must consult with the customer before and after altering prices, there are no guidelines whatsoever on the processes and outcomes that should be entailed in the consultation. Therefore, an effective regulatory regime needs a set of rigorous and binding guidelines to facilitate negotiation and dispute resolution. These include:

- Legally binding guidelines on the negotiation/arbitration system that is made known and understood by all parties
- Airports providing their major customers with their accounts and any modelling work underpinning proposed charges in order to minimise informational asymmetries between the two negotiating parties
- In the event of failing to reach a final agreement, provisions exist for both parties will enter into arbitration with an appointed independent qualified arbitrator
- Outcomes from arbitration are final and binding to both parties

The Airport Authorities Act should acknowledge the monopolistic nature of Airports. Amendments are needed to the Airport Authorities Act to ensure consistency with the regulatory framework and objectives of the Commerce Act.

### **Price Monitoring Regime**

Price monitoring adopts a backward-looking view on actual price and service quality changes to assess whether market power has been exploited. One of the key advantages of a price monitoring regime over heavy handed regulation is that it requires significantly less resources and avoids the need to project future efficient cost levels. However, a number of disadvantages or uncertainties are also associated with a price monitoring system:

- no clear incentive for efficiency
- exploitation of market power not defined
- sanctions may not be effective or credible
- unclear impact on new investment

The above mentioned has been somewhat evident in Australia, as the inability of the price monitoring regime in Australia to be effective in preventing abuses of market power stems from the vague principles that it was built on. Specifically, the consistent failure to provide definitive criteria for market power and its misuse has weakened the system.

#### **IATA position summary**

- Amendments are needed to the Airport Authorities Act to ensure consistency with the regulatory framework and objectives of the Commerce Act.
- The critical aspects for an effective regulatory regime are price cap regulation, single-till approach and a strong negotiation & dispute resolution processes

## **Chapter 8: Key input decisions**

1. Do you see value in having key input decisions set as a stand-alone process in advance of an inquiry and recommendation to regulate? If so, should they be set for a specific sector once an inquiry has been initiated, or set generically irrespective of whether or not an inquiry has been initiated?
2. Is it practical, or possible, to set generic methodologies that could apply to all potentially regulated sectors?
3. Do you consider that input methodologies should be set:
  - as guidelines by the Commerce Commission;
  - as Rules by the Minister following a recommendation from the Commission; or
  - another option (please specify)?

IATA is of the opinion that key input decisions should be set as a stand-alone process in advance of an inquiry and recommendation to regulate and should be set generically irrespective of whether or not an inquiry has been initiated. The presence of generic guidelines formulated in advance is crucial as it forms the first line of defence in preventing the abuses of market power from occurring in the first place.

With regards to this subject matter, the key inputs that IATA considers to be of high importance are:

- WACC and the appropriate rate of return
- Asset valuation

### **WACC and the appropriate rate of return**

One of the key improvement areas that the Government needs to consider is the issue of appropriate rate of return. In any regulatory model (included light handed), there need to be clear regulations (or guidelines in a light handed model) that specify the appropriate rate of return. Only then will airports and users be able to judge the validity of the revenue (and pricing) levels under discussion. The calculation of the WACC is often complicated, producing a range of possible values from which the Regulator makes a determination of the actual value. However, it is an extremely important part of the regulatory model. Small changes in the WACC can have a major impact on the level of the price cap that is set.

Best practices from regulatory models around the world suggest that the process involved in calculating the WACC raises several issues, amongst which are:

- Actual not project gearing level used. The gearing level of a firm can change significantly, especially if new investment is funded primarily through debt. As such, firm's are allocated a relatively high WACC based on its capital structure at the start of the period, but as gearing increases the actual WACC they face reduces. Alternatives that a regulator can use include a projected gearing level (e.g. for NATS in the UK) or an assumption of the optimal gearing level for the firm during the regulatory period.
- Low interest rates have given regulated firms a windfall. With historically low interest rates over the last few years, the actual WACC has been lower than the level allowed for by the regulator. Analysis suggests that as there is often a delay in new

investment being added to the regulatory asset base (e.g. only one adjustment each year) the marginal return may actual be below the allowed WACC for many firms during each regulatory period. However, regulated firms have continued to invest significantly, suggesting that their marginal returns are still well above the actual cost of debt (rather than the WACC) that they face.

- Little probability for equity investment. Though the WACC is set on the basis of the cost of equity and debt, firm's have typically relied on debt as the main source of external finance for new investment. The regulator can pursue options such as a split cost of capital (i.e. a lower WACC for a return on the existing regulatory asset base, a higher WACC to attract equity finance for new investment).

## Asset Valuation

Some airports claim that they are entitled to raise their land values in keeping with increases in land prices in surrounding areas, and to reflect those higher values in aeronautical charges. IATA believes that an increase in land values based on the use of an opportunity cost valuation is:

- Inefficient. It overvalues the true value of the asset, certainly in relation to the price that was initially paid for it. Airports argue that it provides a signal of the value captured by the airport being in a particular location. However, allowing airports to artificially increase the value of their assets and the return they receive on it does not create any clear incentives for greater efficiency in the use of these assets. By contrast, airports can look to rely on higher land values to maintain their profitability, rather than actively work with airline customers to improve operational efficiency.
- Unfair. It merely creates unearned returns (i.e. windfall gains) for an airport. The asset base on which an airport earns its return should properly reflect the risk that has been taken, i.e. the capital that has been invested. Airlines should only be expected to compensate the airport for this invested capital, not for higher values that airports have not paid for or placed capital at risk.
- Impractical. When there is no feasible alternative use, the opportunity cost valuation has no clear basis. In this case, much of the land is either designated for aviation use or impractical for other uses. Indeed, in many cases outside New Zealand the land is leased rather than owned by the airport company, so could not be sold without Government consent in any case. If the land is owned, and can be sold, it can appear in the airport's financial accounts, with the higher value realised when sold, but should not form part of the "regulated" asset base.
- Not standard practice. As outlined in more detail below, appreciating land values are not taken into account in the majority of other regulatory structures.

It is also important to note that the revaluation of land to reflect higher surrounding property values (and therefore a higher opportunity cost of land use) is **not** standard regulatory practise elsewhere.

In Australia, the privatisation of Phase I and II airports did not explicitly include a valuation of aeronautical assets. However, it did require an investment of capital commensurate to the bidders revealed valuation of the asset base. As such, initial expected returns were based on the basis of this revealed valuation and expected future investment. The 2006 Productivity Commission Review of Price Regulation of Airport Services recommended that airports not be allowed to revalue their aeronautical asset bases to justify price increases. This recommendation was subsequently accepted by the Australian government

In the UK and Ireland, land forms part of the typical Regulated Asset Base (RAB) but is not given an explicit value. Instead, the initial value of the RAB is usually calculated on the basis of the debt and equity value at the time of privatisation and adjusted in accordance with investment, depreciation and inflation but not by external and unearned increases in asset values. In particular, the UK and Ireland approach values the RAB on the basis of:

- The value that investors initially placed in the company at the time of privatisation, based on its enterprise (debt plus equity) value. If the assets were undervalued at the time of privatisation it can represent a windfall gain to the company (e.g. in terms of a subsequent uplift in equity market capitalisation) but not one that customers should be forced to pay for through higher charges on a revalued asset base.
- The asset base is not valued on the basis of opportunity cost. Often, the land or assets in question are legally required to be used for their current purpose, so have no legal alternative use.
- The RAB changes throughout the regulatory control period on the basis of incurred capital expenditure, depreciation and expected inflation. Adjustments are also made at each regulatory review, where changes are made on the basis of difference between actual expenditure and planned expenditure.
- A real Weighted Cost of Capital (WACC) return is allowed on the RAB. Therefore, actual return differs as the WACC is applied to a RAB that changes in value in each year of the regulatory period.
- Land valuation has typically only been applicable when surplus land assets are disposed. In this case, the Airport can realise capital gains on its land holdings. However, in some cases, the regulator seeks to share some of this windfall gain, for example, in the UK water industry, an amount equivalent to half the sale price of the land is deducted from the RAB.

#### **IATA position summary**

- Key input decisions should be set as a stand-alone process in advance of an inquiry and recommendation to regulate and should be set generically.
- The key inputs that IATA considers to be highly important are: 1) WACC and the appropriate rate of return 2) Asset valuation.

### **Chapter 9: Regulatory control design issues**

1. Should specific provision be made (e.g. in Part 5) to allow the Commerce Commission to use comparative benchmarking as a methodology for setting control terms?
2. Should specific provision be made to allow the Minister to request at the Commission to consider whether economic regulation may be imposed on a *sector as a whole* (rather than each individual firm within a sector) and if so, should provision be made for cost benefit analysis on this matter to be undertaken in *qualitative* (rather than quantitative) terms?
3. Is there value in allowing firms to propose their own control terms for the Commission's consideration ('propose/respond' model)?
4. If firms are able to propose their own control terms, should the Commission be required to accept proposals that meet pre-set criteria? Do you have any comment on the proposed 'reasonableness criteria'?
5. If firms have the ability to propose their own control terms, should this proposal take place before or after declaration of control by the Minister (note that in section 9.3 the paper proposes different sequences for control of individual firms compared to sector control)?

IATA is of the opinion that there is little scope for benchmarking between airports in New Zealand due to the limited number of comparable airports. But benchmarking should be considered on a global or regional basis to measure the performance of the NZ airports vis-à-vis best practices. There may be scope for benchmarking and sharing of best practices between different regulated industries.

IATA is in favour of regulation on an individual basis rather than on a system-wide basis, with the decisions made on a basis appropriate to the key objectives in each case, reflecting the difference in circumstances or objectives for each regulated entity. System-wide regulation that sets a price cap for more than one airport, can lead to sub-optimal decisions, in the form of cross-subsidisation where there is common ownership. It occurs when users at one airport potentially face higher charges in order to cross-subsidise users at another airport in the system. Such cross-subsidisation is neither economically or operationally efficient.

IATA is indifferent as to whether firms are allowed to propose their own control terms for the Commission's consideration, as long as the proposals are judged by a credible and appropriate by an independent regulator. Lastly, IATA considers that firm should have the ability to propose their own control terms only after declaration of control.

#### **IATA position summary**

- IATA is of the opinion that benchmarking should be on a regional or global level and should not be limited to New Zealand airports.
- There is scope for the sharing of best practices between different regulated industries.
- IATA is in favour of regulation on an individual basis rather than on a system-wide basis.
- IATA is indifferent as to whether firms are allowed to propose their own control terms for the Commission's consideration.

## **Chapter 10: Possible packages of 'how to regulate'**

1. With regard to the Part 4A thresholds regime do you favour:

- retaining the threshold regime and making it more generic (that is, applicable to sectors other than electricity lines businesses), or
- repealing Part 4A and amending Part 5 to allow the Commerce Commission to use comparative benchmarking to set terms and conditions for control while allowing firms to seek customised control terms.

2. In your opinion, are there other options for addressing the issues with the Part 4A thresholds regime?

3. Are small businesses within a sector likely to be disproportionately affected by the requirements of the regulatory regimes proposed in this document? What are the likely *incremental* costs of complying with the current Part 4A and proposed alternative regimes? How could these costs be minimised?

4. Should local community owned trusts be subject to a different regulatory regime than larger non-trust electricity lines businesses?

IATA is of the position that all businesses should be subject to common regulatory mechanisms. Thus, IATA is in favour of having Part 4A repealed and having electricity lines businesses being under the jurisdiction of Part 4 like all the other types of businesses. However, as discussed in the previous Chapter, comparative benchmarking limited to New Zealand should not set the basis for setting terms and conditions of control. In addition, IATA does not agree to apply a threshold regime based on prices in Part 4A to other businesses. A threshold regime that operates on the basis of price levels only encourages regulated businesses to increase prices to the highest possible yet safe level before being inquired by regulators. As such, permissible forms of threshold regime are those that operate on the basis of the maximum allowable revenue that may be earned by businesses. Therefore, the combination of a price threshold regime and comparative benchmarking results in ineffective regulation and encourages price increases. Lastly, with regards to this Chapter, given that airports are natural monopolies, the regulatory requirements for airports should be stringent and differ from other businesses but nonetheless, best practices in other regulated industries should also be applied to airports.

### **IATA position summary**

- IATA is in favour of having Part 4A repealed and having electricity lines businesses being under the jurisdiction of Part 4 like all the other types of businesses.
- IATA does not support the use of threshold regime based on prices and comparative benchmarking limited to New Zealand.

### **Chapter 11: Processes for amending and enforcing control terms**

1. Do you agree that control terms should not be re-opened within a specified control period, other than under exceptional circumstances? If so, do you agree with the exceptional circumstances suggested in this Chapter?
2. Are the current provisions relating to penalties in the Act for breaches of control terms (s70C) satisfactory or should additional guidance be provided?

In principle, IATA is against interim reviews but will permit control terms to be re-opened within a specified control period under exceptional circumstances. However, there is potential room for abuse if regulated entities expect to automatically use this as a mechanism for re-opening control terms whenever it faces adversity in its operating environment. This would only result in automatic cost pass-throughs from airports to airlines and airline users. In addition, the credibility of the regime will be negatively affected. As such, regulators should strongly enforce the ruling that re-opening of control terms will only be allowed if and only if exceptional circumstances exist.

### **IATA position summary**

- In general, IATA is against interim reviews but understands that under true exceptional circumstances, the re-opening of control terms for reconsideration has merit.

## **Chapter 12: Accountability mechanisms**

1. Do you consider that it is desirable to provide for merits review of regulatory decisions or does judicial review provide sufficient constraints on regulatory decisions?
2. Do you agree with the document's conclusions that, if merits review is provided for, it should only apply to control decisions made by the Commission and be limited to the form of 'appeals by way of re-hearing' where new evidence can be introduced only if it is fresh and material and it could not have been submitted at the original decision-making stage?
3. What is your preferred composition of any merits review body, taking into account New Zealand's small size and limited resources?

IATA is of the opinion that judicial review on an infrequent basis is not sufficient. We would like to reiterate that for the purposes of ensuring accountability, a neutral dispute settlement mechanism is required, in which regulated companies and the airline and other users are able to appeal against the regulator's decisions through this setup. The neutral review body in question should be New Zealand's relevant national competition authority. While such a setup serves to primarily reduce the risk of regulatory failure and the probability of reaching sub-optimal decisions, it also provides another channel for stakeholders' views and allows the issues (e.g. cost of capital) to be communicated on a wider basis than that by an aviation specific regulator, this also allows for the transfer of best practices from other industries. This is evident in the UK, in which CAA's price-cap proposals automatically go to the Competition Commission for review before they are finalised.

In the event of failing to reach a final agreement, both parties will enter into arbitration with an appointed independent qualified arbitrator (e.g. competition authority). Outcomes from arbitration are final and binding to both parties

### **IATA position summary**

- For the purposes of ensuring accountability, a neutral dispute settlement mechanism is required.
- A neutral dispute settlement mechanism reduces the risk of regulatory failure and chances of reaching sub-optimal decisions, provides another information channel for stakeholders to communicate their views and supports the practice of the transfer of best practices from other industries.

### Chapter 13: Next steps

1. Submitters are requested to provide specific, quantitative information on costs and benefits wherever possible to assist the Ministry in undertaking any cost benefit analysis.

Air transport is an extremely important industry for the New Zealand economy, in terms of its own direct contribution, its key role in the travel and tourism industry and the wider benefits it creates through providing greater access for New Zealand to the global economy.

Air transport is an essential component for New Zealand's travel and tourism sector, one of the most important industries in the New Zealand economy. According to the WTTC, the travel and tourism sector supports 328,000 direct and indirect jobs in New Zealand, equivalent to around 15% of total employment. The WTTC also estimates that the travel and tourism sector generated NZ\$ 33.9 billion in expenditure in 2006, equivalent to 18% of total expenditure in the New Zealand economy.

Therefore, restrictions on air transport – including constraints arising from high airport charges and poor airport service quality – can have a significant negative impact not just on airlines but on the whole economy. Conversely, an effective system of regulation that seeks ongoing efficiency and service quality improvements can have long-lasting and sizeable economic benefits.

### New Zealand International Air Traffic is Growing at a Faster Rate than GDP

Air transport is not only important for the New Zealand economy; it is also one of its fastest growing sectors. International air traffic has grown at more than twice the rate of real GDP over the last ten years (see Chart 1). The dip in air traffic growth following the collapse of Ansett and the events of 9/11 was only a temporary effect, with the resumption of a strong rate of growth in the last three years.

New Zealand's geographical location means that it struggles to compete as a hub for international transfer and connecting air traffic. As such, the vast majority of international air passenger growth has New Zealand as its origin or final destination point. Therefore, the significant benefits generated by increasing the level of business and leisure traffic will be received directly by the New Zealand economy.

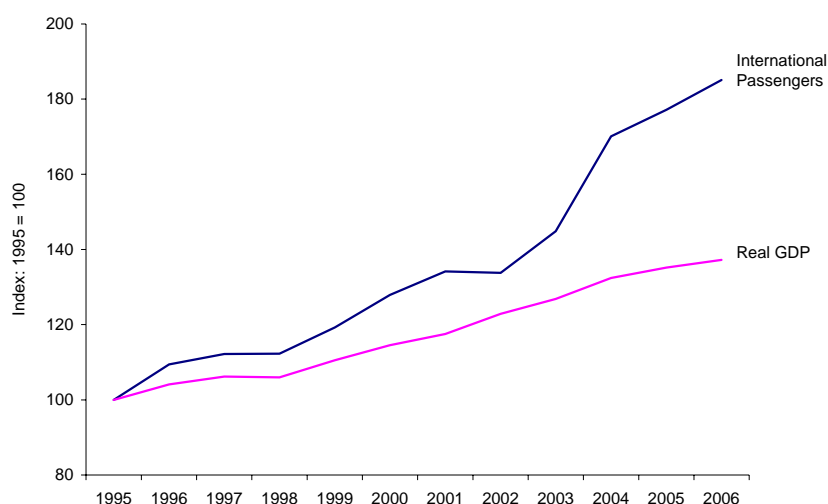
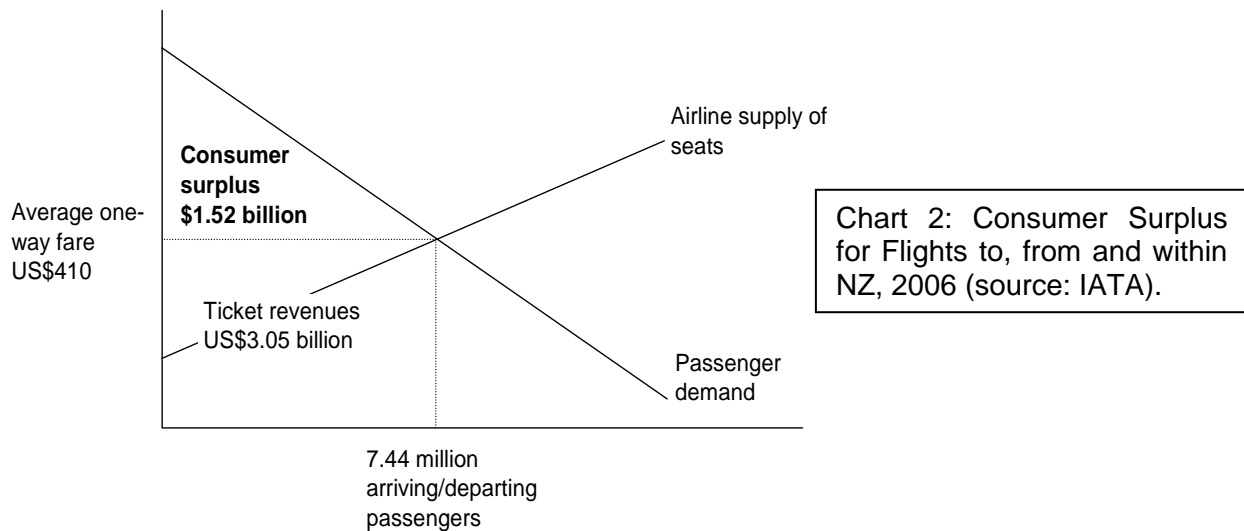


Chart1: New Zealand Real GDP growth vs International Air Passenger Growth

### Substantial Consumer Surplus Benefits for Air Passengers in New Zealand

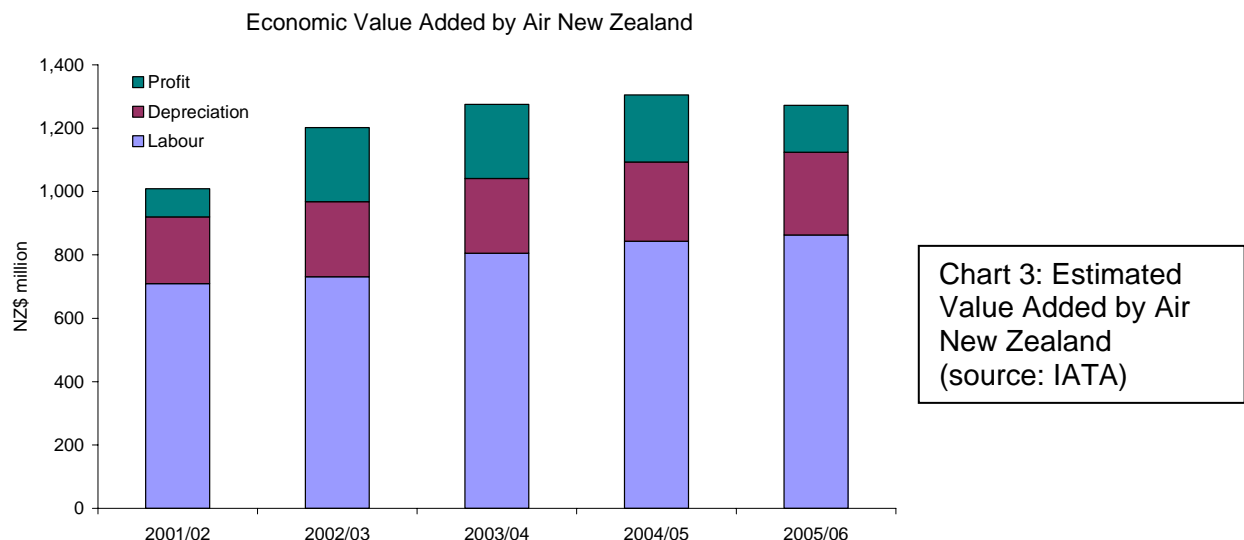
One of the key economic benefits from air transport is the value received by airline passengers themselves. Passengers are obviously willing to pay the air fare at which they travel. But a large number of passengers will also value the trip far more than the cost of the fare, for the pleasure of the tourist visit or for the value of the business contacts made through the trip. This additional value is called consumer surplus.

The market for passenger air travel to, from and within New Zealand is estimated to total US\$3.05 billion in 2006, with an average one-way fare of US\$410 for 7.44 million passenger enplanements. Using an average price elasticity for passenger demand of -1, the consumer surplus for passengers is estimated to be worth US\$1.52 billion in 2006 (see Chart 2).



### Value Added generated by New Zealand airlines

New Zealand's airlines also make a significant direct contribution to the economy; through their use of labour, their investment in capital and the returns they generate. Using a quick calculation of annual economic value added based upon the sum of labour costs, depreciation and profitability, Air New Zealand alone is estimated to create a value added of over NZ\$1.2 billion each year (see Chart 3).



### Supply-Side Benefits from Air Connectivity

For a geographically isolated country such as New Zealand, air transport connections to key markets are vital for long-term economic development and growth. As such it is important to introduce or expand routes to major destinations around the globe; i.e. increasing the connectivity of New Zealand to the global air transport network.

In 2000, New Zealand's main international connections were to Australia, the Pacific Islands and developed Asia, with a couple of routes to Europe and North America (see Chart 4). In 2007, the picture has changed somewhat (see Chart 5). A major destination in each of Europe and the US has been removed (Frankfurt and Chicago), but several new routes have been opened up in to fast-growing markets; in particular, China, the Middle East and Chile.

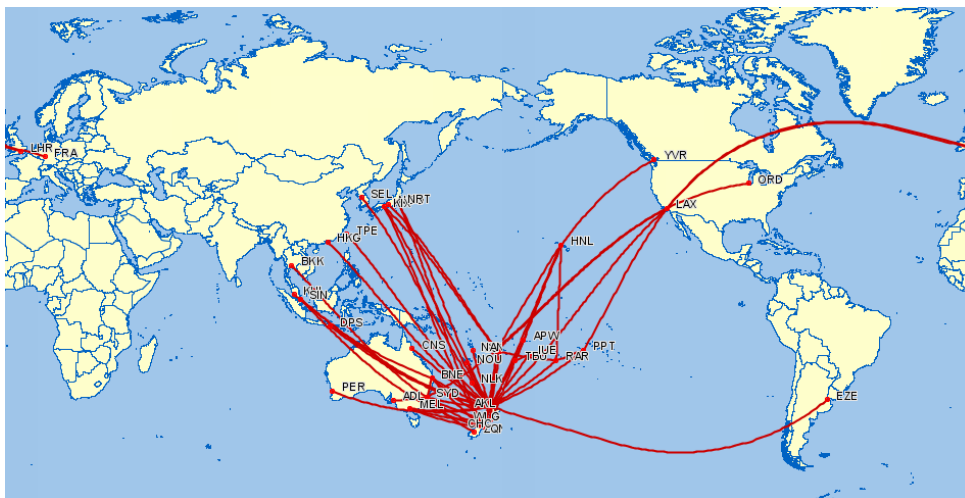


Chart 4:  
International Routes  
from New Zealand,  
2000

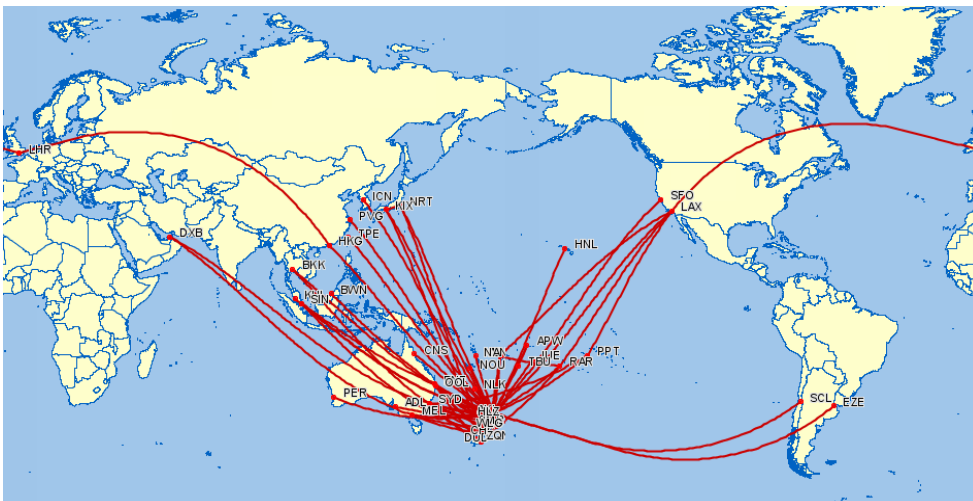
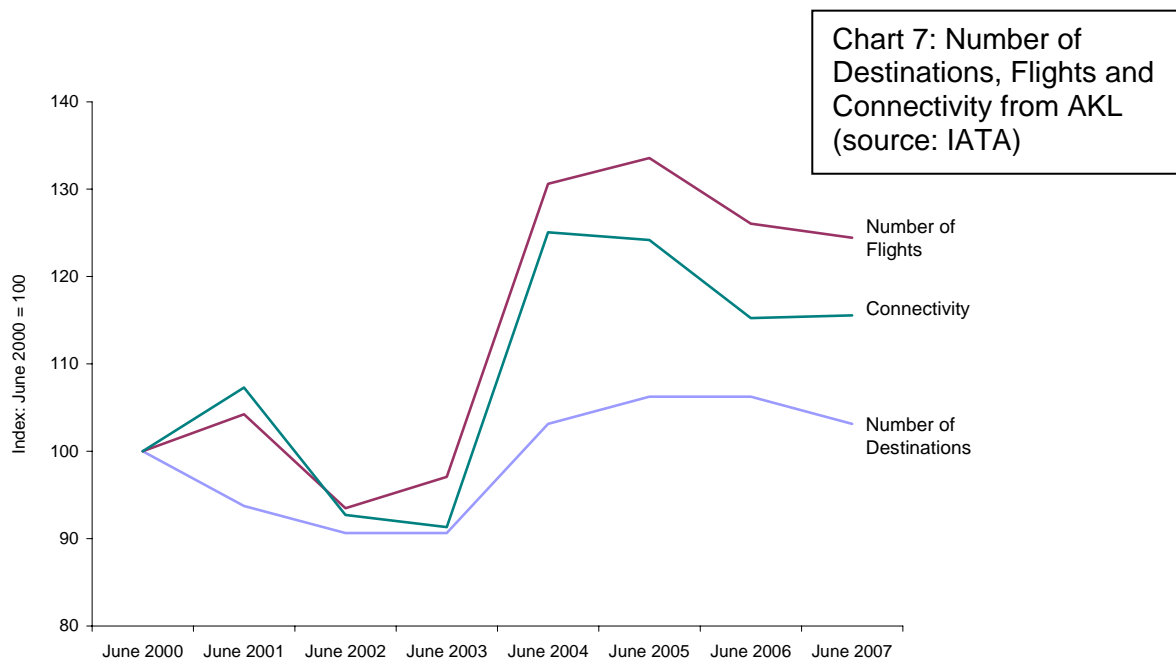
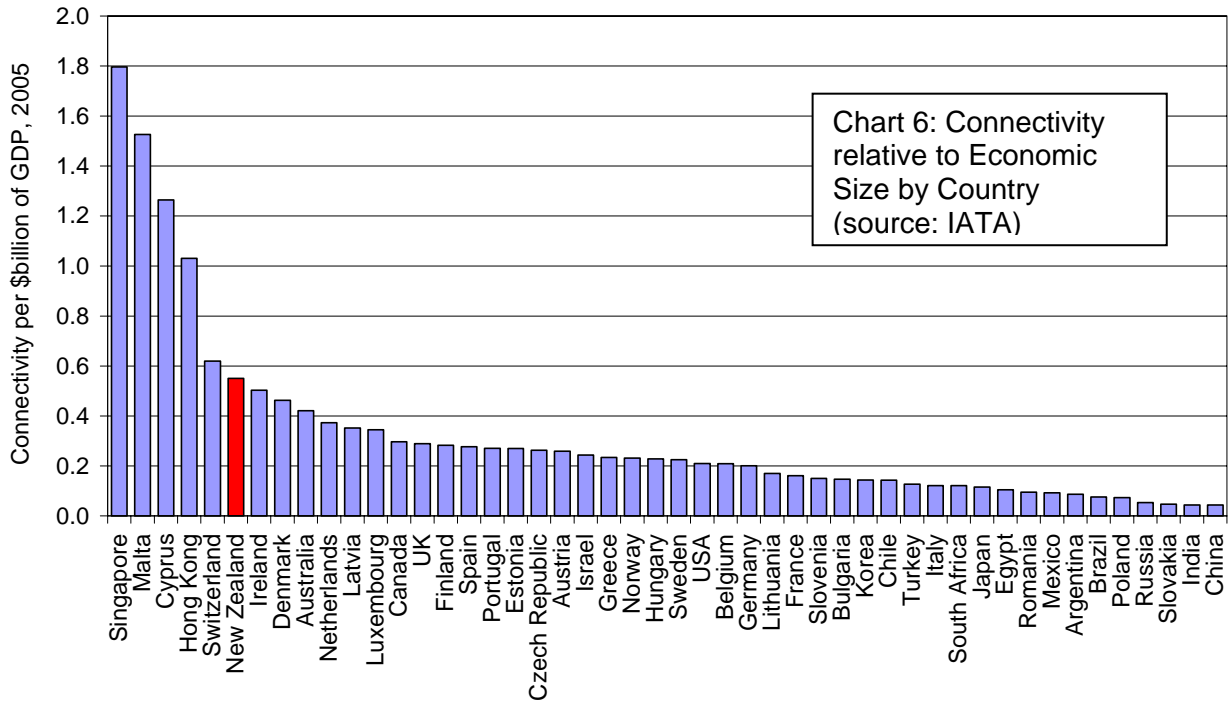


Chart 5:  
international Routes  
from New Zealand,  
2007

Recent research by IATA has shown a significant link between air connectivity, business productivity and long-term economic growth. The more connected a country is to the global air transport network the higher the benefits. In terms of connectivity relative to the size of a country's GDP, New Zealand is currently relatively well-connected (see Chart 6), with a higher level than Australia and many European countries. This high level of connectivity, holding all other factors constant, can provide a significant boost to New Zealand economic growth each year.



However, there are signs that New Zealand may be facing some constraints on any further growth in connectivity that could harm its long-term economic growth. In particular, focusing on Auckland airport shows that though connectivity recovered strongly in 2004 following the post-2001 decline, it has since levelled-off and even declined (see Chart 7). Taking the June period in each year, the number of destinations and the number of flights served from Auckland airport has declined from their peak levels in 2005, resulting in a fall in overall connectivity from Auckland. Yet this same period has been one of high airport charges and very high profitability for Auckland airport. As such, high charges may be a key negative impact on the constraints to further growth in connectivity that will limit, or even reduce, the economic benefits this can generate over the long-term.

To reiterate, an effective system of regulation that seeks ongoing efficiency and service quality improvements can have long-lasting and sizeable economic benefits. On the other hand, an ineffective regulatory framework may have negative consequences far beyond the direct impact on suppliers and consumers.

#### **IATA position summary**

- Air transport is an extremely important industry for the New Zealand economy, in terms of its own direct contribution, its key role in the travel and tourism industry and the wider benefits it creates through providing greater access for New Zealand to the global economy.
- Restrictions on air transport – including constraints arising from high airport charges and poor airport service quality – can have a significant negative impact not just on airlines but on the whole economy.
- Conversely, an effective system of regulation that seeks ongoing efficiency and service quality improvements can have long-lasting and sizeable economic benefits.