

14 March 2008

Geoff Connor
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Competition, Trade & Investment
Ministry of Economic Development
PO Box 1473
WELLINGTON

Dear Mr Connor

REVIEW OF AIRPORT REGULATION

Thank you for your letter of 26 February 2008 inviting us to submit on three proposed options for carrying out a further review on the scope and form of airport regulation in New Zealand.

For the reasons outlined below, we would recommend option three – not proceeding with further work at this time, at least in relation to smaller airports such as Queenstown.

Public policy objectives

We agree with the Government's proposed objectives for Part 4 of the Commerce Act – namely that any regulation of prices and quality of goods and services (in markets where there is little or no competition or prospect of competition) should promote outcomes, for the long term benefit of consumers, such that suppliers:

- have incentives to innovate and invest, including in replacement, upgraded and new assets and in related businesses;
- face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands;
- share the benefits of efficiency gains with consumers, including through lower prices;
- are limited in their ability to extract excessive profits.

Regulatory options

We note that the Government intends to amend Part 4 of the Commerce Act to provide the following menu of regulatory tools:

- Information disclosure
- A negotiate/arbitrate regime
- A 'default/customised price-quality path' regime for sectors like electricity lines to replace Part 4A, and
- Customised (conventional) price-quality control for individual businesses.

Test and process for imposing regulation

In their paper to the Cabinet Policy Committee on 14 November 2007, Ministers recommended two tests for whether regulation should be imposed, and (if so) the form of regulation::

- Whether there is little or no competition and prospect of competition, and there is substantial scope for the exercise of market power, taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements); and
- Whether the benefits of regulation in meeting the objectives of the objectives outlined above clearly exceed the costs and risks of regulation.

Ministers also recommended that:

- The Commerce Commission should undertake qualitative analysis concerning this test, with quantification where possible and practical; and
- The Minister of Commerce should make decisions on whether to impose or amend regulation in consultation with sector Ministers and after considering recommendations by the Commerce Commission.

We concur with these tests and this process. We are therefore very concerned that, in one of the first potential applications of this new framework, the Government is considering a major departure from its own recommended tests and process.

Application to smaller airports

Options one and two in the Ministry's discussion paper do not provide a robust process to establish whether or not there is a real regulatory problem in relation to smaller airports such as Queenstown. Neither option would involve any empirical analysis or airport-specific problem-definition.

As noted in the Ministry's discussion paper, these options "would **not** be aimed at identifying any evidence of abuse of market power by monopoly airport companies, but would take a conceptual approach in identifying the appropriate form of regulation" (*emphasis added*)

Options one and two both omit the step recommended above. Both exclude the Commission undertaking quantitative and qualitative analysis to assess whether the proposed objectives for Part 4 would be achieved.

This is simply not a sound basis for deciding whether to regulate. The putative savings in time would be greatly outweighed by the risk of inadequate analysis and poor regulatory recommendations.

Options one and two are not consistent with the framework outlined above. Nor are they consistent with accepted standards of best practice for regulating, in Australia¹ or New Zealand, which require that:

- Governments should not act to address 'problems' until a case for action has been clearly established. This should include establishing the nature of the problem and why actions additional to existing measures are needed, recognising that not all 'problems' will justify (additional) government action;
- A range of feasible policy options (including self-regulatory and co-regulatory approaches) need to be identified and their benefits and costs (including compliance costs) assessed within an appropriate framework; and
- Only the option that generates the greatest net benefit for the community, taking into account all the impacts, should be adopted.

To proceed with options one and two in relation to smaller airports such as Queenstown would also tend to indicate a bias to regulate, which is clearly contrary to the Ministry's own advice in relation to good regulatory practice².

Application to larger airports

The process followed to date by the Government in relation to Auckland, Wellington and Christchurch airports has been quite different. The Government's recent regulatory decisions relating to the three larger airports have been made in the light of:

- A review of the information disclosure regime under the Airport Authorities Act by Arthur Anderson in 2001;
- An extensive inquiry under Part 4 of the Commerce Act by the Commerce Commission into airfield activities at the three larger airports, the final report for which was issued in August 2002;

¹ Australian Best Practice Regulation Handbook (August 2007)

² APEC Initiatives on Good Regulatory Practice (Bailey and Boxall)

- Consideration of the Commission's inquiry report by the Government, with recommendations from the Minister of Commerce to Cabinet³; and
- Government concerns in relation to the possibility of significant foreign ownership of Auckland International Airport, particularly perceived risks of overseas owners extracting monopoly rents, the potential for which was identified by the Commerce Commission in its 2002 report.

As a precursor to its recent regulatory decisions in relation to the three larger airports, the Government has, in effect, considered on an empirical basis:

- The relevant market for airfield activities at each of the three larger airports;
- Whether any of the three larger airport companies are able to exercise market power in the airfield services market, such that competition is limited in terms of section 52 of the Commerce Act;
- General pricing principles that may be appropriate for determining efficient prices and evaluating performance for those airports;
- Asset valuations relating to airfield service at the three larger airports, which is relevant for the purposes of both determining the price for, and assessing the performance of, airfield activities at those airports;
- The weighted average cost of capital (WACC)⁴ for the airfield activities of each airport, which involves quantifying the risk-free rate, debt premium, market risk premium, asset beta and leverage;
- To what extent the structure of prices for airfield activities at the three larger airports were allocatively efficient, and whether there was any cross-subsidisation.
- Whether price control would lead to an improvement in service users' economic welfare⁵;
- Whether shareholders of the three larger airports were extracting (or could extract) returns in excess of the appropriate target WACC over time (also considering whether those returns reflect superior productive efficiency improvements); and
- The overall costs and benefits of regulation.

Information about smaller airports

³ Set out in the Minister's Memorandum to Cabinet – 'Regulatory Control Inquiry into Airfield Activities' – dated 10 May 2003

⁴ The element of the pricing model that allows for a required rate of return to be earned by debt and equity security providers

⁵ As measured in relation to productive, allocative, and dynamic efficiencies

None of these factors have been assessed or considered in relation to smaller airports such as Queenstown. As noted in Minister's paper to the Cabinet Policy Committee in November 2007, "we do not have any reliable information on the nature and size of any problems, options or solutions [in relation to smaller airports]"⁶.

⁶ At para 70

Consistent with best regulatory practice, the first step should be to determine, on an empirical and airport-specific basis, whether there is a real problem to be solved. By contrast, options one and two in the Ministry's discussion paper "would **not** be aimed at identifying **any** evidence of abuse of market power by monopoly airport companies, but would take a conceptual approach" (emphasis added).

Whether an airport has any monopoly power, whether it is abusing any such power, whether regulation will deliver net economic benefits in relation to that particular airport, and (if so) what regulatory tool should be used – these questions cannot be answered on a generic or abstract basis, certainly not with sufficient robustness to decide to regulate a particular airport.

To follow such a generic abstract process would be extremely blunt and crude, providing very limited insight into the real nature of the relevant markets, and low prospects of properly assessing relevant costs and benefits.

Other issues

The Ministry' discussion paper asserts that option one would offer "a holistic approach to airport regulation".

Consistency of regulatory response to like problems is certainly a relevant objective; but seeking uniformity for its own sake speaks more of a 'tidy mind' than intelligent well-targeted restraints on possible monopoly abuse.

The Ministry also asserts that option two would allow for the design of regulation for second-tier airports to be informed by the process of implementing the new regime for the three larger airports. The implication is that the second-tier review would come after the new large airport regime has been put in place. However, the Ministry's report on tier-two airports would be due in June 2009, and this is unlikely to provide much opportunity to 'learn' from the first-tier experience.

This would also create a long period of uncertainty, stretching out until possible implementation in July 2012. It is also not clear that the experience of the larger airports is particularly relevant to the smaller airports.

We agree with the disadvantages identified in relation to options one and two, and conclude that options one and two do not appear to offer any net benefits.

Queenstown Airport's size

Queenstown Airport is community-owned with 100 percent of shares held by the Queenstown Lakes District Council. Key comparisons relative to Auckland, Wellington and Christchurch for 2007 are set out below:

	Queenstown	Auckland	Wellington	Christchurch
Airfield revenue	\$4.8m	\$66.2m ⁷	\$32.4m	\$23m
Net profit (after tax)	\$2.8m (incl one off propert sale \$1.8m)	\$92m	\$5.5m	\$24m
Property, Plant + Equipment	\$45.2m	\$2,540m	\$513m	\$645m
Total passengers	0.65m	12.35m	4.64m	5.63m
Total aircraft movements	4,000	224,515	111,100	134,000

Queenstown Airport's pricing

Queenstown Airport operates a 'Two Component' model for charging scheduled airlines who operate to and from ZQN. The model has evolved in very close consultation with scheduled airlines and has underpinned the recent \$31M upgrade of Queenstown Airport. Many industry members have referred to the consultation process used as an exemplary instance of constructive consultation between airlines and a New Zealand airport to reach a determination. The two component nature of the model ensures that potential cross subsidisation is minimised and that charges to airlines fairly reflect the facilities and services used. Queenstown Airport has, and values highly, its open, amicable and mature relationship with the airlines operating scheduled services from its facilities.

The model distinguishes between 'Airside' and 'Landside' costs and the ultimate charges borne by airlines reflect the extent to which they utilise Airside and Landside facilities respectively. Airside charges recover the cost of providing the runway, taxiways, apron and hard-stands. Landside charges recover the cost of providing the terminal building.

Airside Charges

The cost of providing the runway, taxiways, apron and hard-stands is recovered through a landing charge component proportional to the Maximum Certified Take Off Weight (MCTOW) of the aircraft per Table 1. The rationale for linking the airside component of the landing charge to MCTOW is that the degradation of the airside facilities is proportional (exponentially) to the weight of the aircraft using them.

Table 1

MCTOW (kg)	Landing Charge (\$ per 1,000kgs)
5,701 – 25,000	4.10
25,001 – 40,000	5.95

⁷ Also a separate development charge of \$64.4m

40,000 – 55,000	7.80
55,001 – 70,000	9.60
70,001 – 75,000	11.50

Landside Charges

The cost of providing the terminal building is recovered through a landing charge component proportional to passengers on the aircraft. In calculating the 'passenger' component, passengers are differentiated into International & Domestic, and Arriving & Departing. The rationale for this differentiation is that the international facilities require significant infrastructure, particularly for International Arrivals, that is not utilised by domestic travellers. The Landside component charged to scheduled airlines is calculated per Table 2

Table 2

Passenger Category	Charge (\$ per PAX)
International Arrival	13.50
International Departure	7.00
Domestic Arrival	3.50
Domestic Departure	3.50

For clarity, the following examples show the total charges levied for two fictitious aircraft movements:

Example 1

Aircraft with MCTOW of 60,000kg landing from Sydney with 90 passengers

Total charge of \$1,683

Made up of airside component 60 (,000kg) x \$7.80 and landside component 90 (PAX) x \$13.50

Example 2

Aircraft with MCTOW of 35,000kg departing to Auckland with 40 passengers

Total charge of \$140

Made up of landside component 40 (,000kg) x \$3.50 with no airside component (airside component is only levied on landings)

Queenstown airfield services market

Factors to be considered in assessing the competitive market disciplines on Queenstown Airport's airfield services include:

- The potential competition between airports or from other modes of transport;
- The potential for new entry;
- The potential countervailing power of airlines;
- The existing regulatory environment (which includes a requirement to consult on charges and a threat of further regulation); and
- Competition from off-airport sources of supply.

Detailed and careful empirical analysis would be required to draw firm conclusions. At a high level, however, it is worth noting that:

- Airports at Christchurch, Dunedin, Wanska, and Invercargill all provide competitive alternatives for passengers flying to and from the Central Otago region;
- Only 30% of visitors to Queenstown come by aircraft. The other 70% visit by road;
- Queenstown Airport operates on a fully transparent basis. All financial information is made available to Qantas, Air NZ, and Mount Cook; and
- Air NZ, Mt Cook, and Qantas have agreed Queenstown Airport's WACC and relevant cost-base. Both airlines approved the airport's recent upgrade plans and costs (\$31m). Airfield service charges are also established by agreement with all airlines, which openly share information.

As noted in the Minister's paper to the Cabinet Policy Committee in November 2007:

"...few [of the smaller airports] if any have market power. Most only have one airline customer (Air New Zealand) which has substantial countervailing negotiating power. Therefore, the issues are somewhat different. If anything, the balance of power between Air New Zealand and the smallest airports favours the former".

"There is no issue of Queenstown Airport having or abusing market power. On the contrary, we operate in an exemplary manner, and enjoy the strong support of our two main airline users", quote from a senior Air New Zealand Executive.

Other pricing factors

As a local authority owned company, our owners' profit expectations are different than private owners of airports. To date, our company has never paid a dividend. It is likely that this moderates our pricing relative to airports with private ownership.

The prospect of significant foreign ownership of Auckland International Airport was clearly identified by Ministers as a key factor in their recommendations of November 2007 to regulate AIAL. This is not an issue in relation to Queenstown Airport.

Conclusion

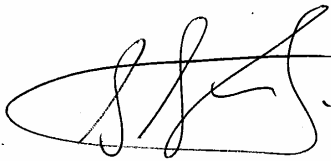
As noted in a Ministry paper⁸, “good regulation is a product of good policy advice and good decision-making. The modern regulatory challenge is to develop a regulatory system which can effectively deal with the increasing demand for regulation, inherent bias to regulate, and complex nature of regulatory interventions”.

To assume that it is logical to extrapolate to smaller airports such as Queenstown the regulatory framework proposed for the three larger airports is superficial and misplaced. A generic conceptual approach in considering whether to regulate a specific airport can only lead to poor decisions that impose unnecessary costs on consumers and the economy as a whole.

The correct approach is first to define properly whether or not there is a regulatory problem in relation to Queenstown airport. It would be a mistake to treat all small airports as if they have the same characteristics and behaviours. They do not.

Proceeding with options one or two would imply there is a problem to solve, and that some of the tools proposed for Part 4 need to be applied. We submit that this approach would be suboptimal, and not relevant to Queenstown airport.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Sanderson', with a large, sweeping flourish at the end.

Steve Sanderson
Chief Executive Officer
Queenstown Airport Corporation Limited

⁸ APEC Initiatives on Good Regulatory Practice (Bailey and Boxall)