

Airways' Pricing Consultation



Customer Feedback Template

This feedback template features the questions set out in Airways' proposed pricing for the 2019 – 2022 period consultation document, as well as one final question relating to any further comments you may want to make.

The feedback questions are there to help you develop your submission and to help Airways analyse your feedback. You are welcome to comment on other topics should you wish to.

The template is in a Microsoft Word format for you to download from Airways' website. Please save it and type directly into the spaces provided.

Please start by reading Airways' proposed pricing for the 2019 – 2022 period consultation document before filling out this template. Email your completed template to submissions@airways.co.nz by 15 March 2019. Alternatively, you can post your completed template to: Airways pricing consultation, Airways New Zealand, PO Box 294, Wellington 6140.

All customer submissions will be carefully considered before prices are finalised and released publicly on 29 May 2019.

Important note for submitters

All submissions will be made available to the public from Airways' website. However, you can request the removal of content (clearly identified in your submission) as commercially-sensitive or confidential and Airways will remove the information prior to publication. Submitters should highlight any comments or contents that are commercially-sensitive or confidential.

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Consultation feedback questions



Question 1: Do you support Airways' roadmap to implement digital tower services at Invercargill and Auckland during the 2019-2022 pricing period?

Feedback: Yes. BARNZ supports Airways' investments and innovations in digital towers, which we expect to deliver a lower cost and more flexible service in the future.

Question 2: Do you support Airways' involvement in the AIAL project to implement an FCR at Auckland?

Feedback: BARNZ has supported the FCR investment to date as a sensible investment to provide for maintenance of the Auckland runway. However, airlines have become concerned about the cost of the project. We understand that Auckland Airport MACPAC is to reach a view on the investment in April 2019. We recommend that Airways review what Auckland Airport's decision on the project is and remove it from the expenditure programme if AIAL ultimately does not proceed with the investment. If AIAL proceeds with the investment, then of course it should be retained in Airways' expenditure programme. We welcome exploring alternative options with AIAL and Airways, including an option of periodic, well notified, night-time runway closures without investing in an FCR.

If AIAL's position is still unclear at the time prices are set, we believe the cost should be included in the 2019-2022 pricing but with a clear mechanism to reduce prices on 1 July 2020 and/or 1 July 2021 if the project does not proceed to return the full cost of the investment to customers.

We are happy to work with Airways to develop such a mechanism. Figure 4 of the consultation paper indicates that Airways will set prices to recover \$5m of revenues for the FCR over the 2019-2022 pricing period, so, for example, there could be a reduction in prices of \$2.5m for Auckland aerodrome services on both 1 July 2020 and 1 July 2021 (with a time value of money adjustment as required). A useful guide for this adjustment might be the Commerce Commission's "capex wash-up adjustment" that is applied to electricity network businesses.¹

¹ See the formula in clause 3.1.3(1)(p) and the definition of 'capex wash-up adjustment' in clause 1.1.4(2) of this determination:

https://comcom.govt.nz/_data/assets/pdf_file/0017/60542/Electricity-distribution-services-input-methodologies-determination-2012-consolidated-January-2019-31-January-2019.pdf.

Question 3: Do you support Airways' UAV detection and management initiatives to enhance safety in and around controlled airspace?

Feedback: UAVs present a variety of interesting opportunities to businesses and individuals, but it is clear that some drones pose an increasing risk to aviation in New Zealand and globally. We support efforts to manage and control UAVs to make sure they do not pose undue threats to aviation safety or efficiency and are pleased to see Airways taking a leadership position in this space.

However, airlines should not be required to pay for drone management – airlines are not the causer of the issues experienced with drones and it is unreasonable for airlines and travellers to foot the bill. Airlines believe they are being asked to pay for this for no other reason than they are a convenient and easy party to charge, which we do not accept to be a sufficient justification. The cost of UAV management should ultimately be borne by UAV operators – if a registration charge is deemed unworkable, some form of sales charge could be applied to UAV sales in New Zealand and UAV imports or the government could fund the investment by way of a reduced dividend payment from Airways (as discussed in our main submission).

Question 4: Do you support the projects in figure 11? Are there other service enhancements that Airways should be considering?

Feedback: n/a

Question 5: Do you support Airways' business transformation to improve the resilience and flexibility of future services?

Feedback: BARNZ supports the business transformation programme and the efforts Airways is making to improve efficiency, although airlines would have liked to see benefits realised more quickly. We look forward to seeing benefits from the business transformation programme in the next pricing round.

Question 6: Do you support Airways' capital programme to maintain safe and reliable services? Note full details of the capital programme are provided in Appendix 2.2.

Feedback: BARNZ considers there may be value in deferring the ILS replacements at Wellington and Dunedin Airports while alternative options using PBN are considered.

Question 7: To continue to maintain safe and efficient services do you accept Airways' increase to base operating costs?

Feedback: BARNZ's airline members are disappointed that Airways has not managed to keep operating costs in line with inflation. As noted above, we look forward to improvements in

operating cost efficiency from the business transformation programme to keep cost increases at or below the rate of inflation in future pricing periods.

BARNZ understands that a notable portion of cost growth is related to the increasing cost of staff leave balances. We understand Airways is considering ways to address this problem and support efforts to reduce leave balances in the coming years.

Question 8: Recognising that the inflation inputs will be updated with current information at the time of setting final prices, do you agree with the sources of Airways' inflationary inputs?

Feedback: The forecasts being applied seem reasonable.

Question 9: Do you agree with the inputs into Airways' capital charge calculation?

Feedback: Not all of them. Airways has mis-applied the Commerce Commission's cost of capital framework and has arrived at a result using mis-matched inputs that cannot be justified.

For clarity, we support all inputs used by Airways for its proposed WACC other than the asset beta and/or leverage inputs, which we discuss below.

Overview

Airways proposes to:

- Use the Commerce Commission's asset beta estimate for regulated airports of 0.6; and
- Use its own target leverage value of 58%, rather than the Commission's leverage estimate for regulated airports of 19%.

There are a number of problems with this approach, which make it untenable. To set prices on this basis would not be credible. A credible method would be to either (a) apply both the 0.6 asset beta and 19% leverage value; or (b) use the average asset beta and leverage values from the three international air traffic control service providers for whom data is available.

Airways' proposed WACC components undermine trust in Airways pricing method

Airways is proposing a WACC of 6.9% for the 2019-2022 pricing period, unchanged from the WACC it applied in 2016-2019. Applying the same WACC is a surprising outcome since the two WACC parameters that typically change over time (the risk-free rate and the debt premium) have both fallen since 2016. Also, since 2016 the Commerce Commission has redetermined the debt issuance cost parameter at a lower level. All of these changes would lead a reasonable observer to expect the WACC value to decline relative to 2016.

However, Airways is proposing to hold the WACC unchanged despite these decreasing parameters. It has achieved this by increasing the “target leverage” parameter.

As a first point, using a “target” leverage as the basis for pricing is deeply troubling. There is no transparent, independent basis for this number other than Airways’ stated intention to achieve a leverage of this value during the forthcoming pricing period. From an airline perspective, there is no obligation on Airways to achieve this leverage value. If Airways was to find that its actual leverage over the next pricing period was different from 58%, there would be no mechanism to adjust prices to reflect the actual leverage. The fact that the 58% leverage parameter happens to deliver an unchanged WACC in the face of other parameters that have decreased also raises concerns that the value is not robust.

The Commerce Commission has previously decided that a regulated monopoly should not use its actual leverage to set its WACC because this would create perverse incentives for the company to increase its leverage and thus get a higher WACC (discussed more below). Airways has taken this perverse incentive even further. Airways has not changed its actual leverage (which we understand is currently around 40%, as in the previous pricing decision); instead Airways has stated that it will have a higher leverage in future and on the basis of this claim it is proposing that its WACC should be higher. This is not a position that we can accept as it implies an ability for a monopoly service provider to effectively choose its own WACC by way of announcing a particular target leverage value.

It is safe to say that if a regulated airport attempted this approach, the response from airlines and the Commission would be swift and strongly opposed.

Leverage and beta values need to be consistent

The established Commerce Commission methodology for setting WACC, which Airways seeks to follow, includes the use of the simplified Brennan-Lally Capital Asset Pricing Methodology (CAPM). The simplified Brennan-Lally CAPM has a known issue, which is that WACC increases with leverage. The Commission was concerned that this would create an incentive, as noted above, for regulated companies to increase their leverage just to increase their WACC.

The solution the Commission reached to address this problem was to use a leverage value from a notional efficient airport and apply this in its WACC determination.² The Commission estimated a beta of 0.6 for regulated airports using the average beta of a set of 26 listed airport companies from around the world. The 19% leverage assumption is the average leverage of those 26

² For a detailed background discussion of this point, see the Commerce Commission’s 2010 Input Methodology Reasons Paper, Appendix E3, pages 204-222.

companies. Therefore, where the asset beta of 0.6 is used, the 19% leverage value should also be used in a WACC calculation. To use one and not the other undermines the Commission's methodology.

Airways has stated that 19% leverage does not reflect its actual debt structure. This is true, but it is also true that New Zealand's regulated airports do not have 19% leverage but still operate successfully under the Commission's WACC determinations.

What would a credible and consistent approach be?

We consider that there are two reasonable approaches that Airways could take to setting its cost of capital:

- It can follow the Commission's airport methodology in full, using both the 0.6 asset beta value and the 19% leverage value. Our calculations suggest this would deliver a WACC of approximately 6.5%.
- It can use the average asset beta and leverage values from the three overseas air traffic control companies discussed in the consultation document. This would be an asset beta of 0.57 and a leverage value of perhaps 57.5%³. Our calculations suggest these values would deliver a WACC of approximately 6.6%.

We consider that airports are a reasonable proxy for air traffic service providers, in the absence of better data. However, we would expect that New Zealand's air traffic services would have lower systematic risk (and so a lower beta and therefore lower WACC) than New Zealand's airports because Airways' services cover an entire country and includes revenues from overflights and from military customers – therefore Airways' revenue base is more diverse and less risky than that of any single airport. This gives us some confidence that a mid-point WACC estimate for Airways that is somewhat lower than the mid-point WACC estimate for regulated airports is appropriate.

67th percentile

As broader context, Airways is proposing to apply a 67th percentile uplift to its cost of capital to mitigate the risk that its WACC estimate is too low. There is some regulatory theory that supports this approach, and it is consistent with the Commission's methodology for monopolies that do not have a dual till revenue stream. However, we believe it is generous given Airways' low-risk position as a State-Owned Enterprise. We also agree with the remarks of the High Court, in its merits review judgment on the Commission's WACC methodology in 2013, that permanently

³ The Airways consultation paper only provides leverage values for two overseas air traffic control service providers – NATS and AirServicesAustralia – the average of these two from the consultation paper (page 58) is 57.5%. However, BARNZ's own analysis of the leverage of these two firms plus IAA, based on the publicly available information we could find, is an average of around 40% - we are happy to discuss this further with Airways.

applying a WACC percentile uplift is likely to result in undue charges to consumers over time.⁴ We consider that a 60th percentile WACC would be justified.

That said, if Airways continues to apply the 67th percentile, this should give comfort to Airways that the probability of its WACC being too low are relatively small, and this should make the adoption of either approach that we suggest above in relation to leverage and asset beta more comfortable.

Airways' upper bound WACC estimates

In the consultation material, Airways has presented a lower-bound and upper-bound WACC estimate. It proposes to use the lower-bound estimate, which we believe is too high due to the issues discussed above about leverage and asset beta.

However, for the record, we do not believe the upper bound WACC estimate in the consultation paper would be a credible estimate to use for pricing purposes and should not be referenced by Airways as a benchmark when choosing its WACC input. The upper bound inputs would deliver a WACC of above 8%, far above what any New Zealand regulated monopoly is currently able to use for price setting. The inputs delivering this estimate relate to a 7.5% TAMRP, the use of 10-year bond estimates when the pricing period is shorter than 10 years and the use of a 75th percentile WACC estimate for pricing purposes. These inputs have all been debated in detail in the New Zealand context in the past decade and have not been supported by regulators or the courts. We see no basis for Airways to apply these approaches when other monopoly providers of essential services are required to use lower inputs.

Question 10: Is there any other information Airways should consider to forecast future volume growth?

Feedback: BARNZ has not identified other useful data inputs for Airways to consider.

Question 11: Do you support proposed changes to charges for Queenstown night operations, and extended or unscheduled out-of-hours services?

Feedback: BARNZ agrees it seems reasonable to share the charges for Queenstown night operations across all aircraft that use the service.

⁴ Wellington International Airport & ors v the Commerce Commission, 11 December 2013, NZHC 2389 [1472]-[1486]

Question 12: Do you support the Scorecard metrics in figure 27?

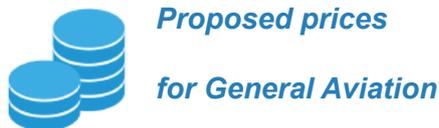
Feedback: We agree with most of the metrics.

However, we do not believe 'average delay per flight' is very useful. As an average, this will necessarily smooth a great deal of data, so it does not help to identify the underlying service quality. A better target would be focused on a minimum quality of service to all aircraft, so aircraft operators will have a standard they can expect (eg 'no more than x% of flights with a delay of more than y seconds').

In the scorecard, proposed targets for 'IFR movement per core FTE' and 'cost per IFR flight hour' are both higher than actual performance in the most recent financial year. If these metrics are useful measures of cost efficiency, then there is a concern that efficiencies are not being met. If the metrics are not useful, then there would be value in finding and reporting alternative measures of cost efficiency.

Question 13: Are there any other measures Airways should consider including in the Scorecard?

Feedback: See response to question 12.



Question 14: Do you agree with the inflationary inputs used to uplift GA prices?

Feedback: n/a

Question 15: Do you agree with the proposed changes to Milford prices?

Feedback: n/a



Other feedback

Are there any other comments you would like to make?

Feedback: As discussed in our main submission, we believe Airways' shareholder should contribute to the costs of the substantial investment programme being undertaken, particularly due to the strong growth Airways has benefited from in recent years, Airways' high returns that have been made and the delay in realising the benefits of the business transformation programme.