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Major Airports Review  
Ministry of Business, Innovation and Employment  
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## **EFFECTIVENESS OF INFORMATION DISCLOSURE REGULATION FOR MAJOR INTERNATIONAL AIRPORTS**

The International Air Transport Association (IATA) represents some 240 airlines comprising 84% of total air traffic. The major scheduled airlines operating to the three major international airports in New Zealand are members of IATA. IATA is in a position to provide an international perspective on the effectiveness of information disclosure regulation for major international airports in New Zealand.

IATA is aware of a submission made by the Board of Airline Representatives New Zealand (BARNZ) on this consultation and supports the views expressed by BARNZ in its written submission. Additionally, IATA is supplementing BARNZ's comments with views drawn from its international experience and recognized research on economic regulation.

IATA's submission will provide general comments on economic regulation followed by a response to three of the questions posed in the document entitled 'Effectiveness of information disclosure regulation for major international airports'. IATA has chosen to respond to these questions where it considers its international experience can best support deliberation in New Zealand with regards to effectiveness of information disclosure regulation for major international airports. The three questions are:

1. In areas where the Commission has been unable to draw a conclusion on the effectiveness of information disclosure, do you consider it likely that conclusions would be able to be drawn in the future?
2. Is information disclosure for major international airports working effectively to achieve the objectives in Part 4 of the Commerce Act?
3. Do you have any comments on how the requirement to consult on capital expenditure in section 4C of the AAA fits into the overall regulatory regime for major international airports?

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## General comments on economic regulation

- Generally, major airports should be assumed to have significant market power unless it can be demonstrated otherwise through an assessment such as a market power assessment.
- Major airports have significant market power as the confluence of characteristics such as capital intensiveness, economies of scale and permit requirements combined with strong passenger preference for airports in close proximity and high switching costs of airlines allow the airport to be in a dominant position and impact the efficient functioning of air transport markets.
- IATA has not undertaken market power assessments for each of the three major international airports in New Zealand but considers that the characteristics and prevailing conditions at these airports point to them as having significant market power.
- It has sometimes been argued that airports are incentivized to keep charges low to increase passenger throughput so that non-aeronautical revenues can be maximized. This is based on the view that airports are a two-sided platform where the incentive to increase revenues on one side of the platform is sufficiently strong to keep prices low on the other side - therefore, economic regulation is not necessary. But this view is secondary to the issue of market power. Even if one were to accept airports as two-sided markets, there is nothing to suggest that increasing revenue on one side of the platform would necessarily lead to lower prices on the other. Market power can exist on either or both sides of the platform. Therefore, the need for regulation of aeronautical charges at a dual or hybrid till airport is just as relevant, if not more so, as under a single-till regulatory framework.
- In the presence of market power, regulatory intervention is needed to ensure consumer interests are safeguarded while allowing for the efficient functioning of the market. Robust independent economic regulation can provide the needed incentives for efficiency in operations, investment and pricing combined with fair returns for investors.
- Robust independent economic regulation needs to comprise of the following criteria:
  - Independence – regulators need to have clear objectives and autonomy to take decision to implement objectives.
  - Transparency – over the process for regulatory decision and the expenditure and investment plans of a regulated company.
  - Full and timely consultation with airport users that is open and constructive.



- Adequate length of agreement – regulatory reviews should cover sufficient period of time (4-5 years) to give certainty and opportunity to extract cost efficiency.
  - Flexibility – ability to adapt to external shocks.
  - A neutral dispute settlement mechanism – an appeal process against the regulator's decisions
- Transparency is provided in the regulatory approach in New Zealand through information disclosure.
  - On independence, the Commerce Commission serves as an independent body in the regulatory process albeit playing a relatively passive role.
  - Other key elements of full and timely consultation, length of agreement and flexibility are left to the functioning of the market. Information disclosure attempts to provide sufficient transparency to allow for proper functioning of the market given the ex-post threat of further regulation. While IATA accepts that the market can define these three elements, we disagree that this approach will deliver efficient outcomes or is in the interest of airport users.
  - A dispute settlement mechanism or appeal process is not something that can be delivered by the market and is an element missing from the regulatory framework employed in New Zealand.
- IATA does not consider the specific ex-post mechanism employed in New Zealand to be able to deliver efficient outcomes. However, putting aside consideration of other ex-post mechanisms, we are of the view that introducing ex-ante elements to the existing regulatory framework such as putting in place cost-effective arbitration can help deliver better outcomes.



**In areas where the Commission has been unable to draw a conclusion on the effectiveness of information disclosure, do you consider it likely that conclusions would be able to be drawn in the future?**

- IATA does not consider that conclusions would be able to be drawn in the future if the current framework for assessing information disclosure continues to be used. In order to assess the effectiveness of information disclosure, the assessment framework needs to develop more robust counterfactuals or alternatively assess the airports based purely on objective measures, for example through benchmarking the performance of New Zealand's major airports against comparable international airports. The current framework does contain an objective measure for assessing an element of the Part 4 criteria, as evidenced by the approach employed to assess the effectiveness of information disclosure in limiting the ability of the airport to extract excessive profits. There is scope to develop more objective measures in the current framework.
- The approach taken by the Commission in assessing the effectiveness of information disclosure provides conclusions that are in sharp contradiction to the structure of incentives under the current regulatory framework, as elaborated below.
  - Innovation and investment: Airports have an incentive to innovate and invest only if it translates to increasing their profitability. However, under the current framework, if airports in New Zealand are too profitable they risk being targeted for further regulation. Therefore, incentives to innovate and invest will be limited to the point where such measures do not exceed the “acceptable” level of return. Furthermore, if airports find it easier to increase profitability by abusing their market power rather than innovating and investing, they will opt for the easier option.
  - Efficiency and quality of service: Similarly, airports will only have an incentive to improve efficiency if the improvements translate to increased profitability. Since excessive profitability, even if it is driven by productivity improvement, can expose the airport to further regulation, airports are incentivized to moderate efficiency improvements so as to avoid exceeding the “acceptable” level of return. On service quality, information disclosure alone may not be sufficient to enable constructive consultation between airports and airlines that can ensure the airport is responding to consumer needs.
  - Sharing of efficiency gains with consumers: Airports have an incentive to capture all efficiency gains rather than pass them on to consumers. The presence of market power will serve as an enabling factor for capturing those gains by the airports.



- Excessive profits: The main reason the findings of the Commerce Commission were conclusive was because of the presence of an objective benchmark chosen against which to assess the performance of an information disclosure regime. Information disclosure can reveal whether airports are generating or expected to generate excessive profits, which if combined with a credible threat of further regulation, can serve to curtail excessive profit taking.

The existence of these incentives further underlines the importance of having objective measures to assess whether the scheme is delivering the efficient outcomes envisioned under Part 4.



**Is information disclosure for major international airports working effectively to achieve the objectives in Part 4 of the Commerce Act?**

- The Commerce Commission in the course of the s56g review process concluded that Wellington and Christchurch airports were targeting excessive profits. Auckland airport was targeting above normal returns which falls just within the upper boundary of the Commission's acceptable WACC range. These conclusions leave no doubt that information disclosure for major international airports has not been effective in achieving the objectives in Part 4 of the Commerce Act.
- In the presence of market power, using light touch regulation can lead to inefficient charges as well as misdirected, excessive or insufficient provision of capacity and/or service. Economic theory and international experience suggest that in addition to excessive pricing, it is likely that the regulatory approach in New Zealand will have adverse effects on efficiency of investment and may have led to unrealized potential in driving efficiency improvements in operations.
- Below is a summary of international experience that has direct relevance for assessing the effectiveness of relying on information disclosure:
  - Inefficient charges level
    - If there is no cap on aggregate revenues, the airport will be incentivized to leverage its market power to maximize profits (as the cases in New Zealand have demonstrated). Oversight is essential over entities with market power and should in general take the form of direct economic regulation. If direct economic regulation is not deemed appropriate, a credible threat of further regulation complemented by a cost-effective dispute resolution mechanism (arbiter) between the airport and airlines is essential.
    - However, even in cases where allowable total revenues are capped, if the airport retains flexibility to set individual charges it will likely lead to strategic behaviour by the airport and inefficient individual charge levels. This strategic airport bias can result in inefficient development of the air transport network for example through propping up inefficient carriers. A case in point is London Gatwick Airport in the United Kingdom where airlines were compelled to enter into bilateral agreements with the airport with little ability to influence service levels. For some airlines, airport charges may actually rise to compensate the discounts offered to other airlines.



- Too much or the 'wrong' investment
  - If airports do not need to agree their investment plans with regulators and airport users, there is increased risk that these investments don't adequately address or are not aligned to the needs of airport users. In the absence of regulation, the prevalence of market power by airports over airport users means that the consultation process over investment choices is unlikely to be balanced or effective. An example is in Rome where a long term contract was agreed between the State and the airport which envisaged a series of investments not required by the users.
- Service provided by airports may not reflect market demand
  - Another risk is that airports do not adequately respond to demands of service levels by airport users. For example, airports may allow service quality to fall (by cutting corners) in order for it to potentially generate windfall profits. In Australia, the Australian Competition and Consumer Commission (ACCC) suggested that Sydney airport had increased its profits by running down the quality of its services. It found that the airport had low responsiveness to concerns on delivery and quality of aeronautical services.
- Impact when capacity is constrained
  - In the long term, under light handed regulation, investment in increasing capacity is likely to be neglected. As investments in increasing capacity are deferred, rents are likely to increase because of scarcity. In such cases the airport, would be in a position to gain higher profits.



**Do you have any comments on how the requirement to consult on capital expenditure in section 4C of the AAA fits into the overall regulatory regime for major international airports?**

- Having consultations prior to decisions on any major capital expenditure is an important process as it can ensure that investments are being identified that are required to meet user needs. Furthermore, international experience has shown time and again that through constructive dialogue, airports and airlines can bring together their operational insights and business needs to drive cost effective ways of achieving desired performance levels and improvements.
- Central to effective consultation is an equal level dialogue between airlines and airports which is currently not the case in New Zealand. Strengthening the effectiveness of the consultation process in New Zealand is much needed.

Yours sincerely

A handwritten signature in purple ink, appearing to read "Malvyn Tan", positioned above a horizontal line.

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A handwritten signature in blue ink, appearing to read "G. Anjaparidze", positioned above a horizontal line.

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