Public Submissions Document

Proposed Volume risk sharing changes to Airways' Pricing Framework & Standard Terms and Conditions.

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Introduction

In February 2017, Airways Corporation of New Zealand released a formal consultation document setting out proposed improvements to the risk sharing mechanism in its Pricing Framework and Standard Terms and Conditions.

Airways sought feedback on the proposals set out in the document, inviting the public to provide feedback in writing by 6 March 2017.

Written submissions were received from Air New Zealand, Board of Airline Representatives New Zealand (BARNZ), International Air Transport Association (IATA), and Qantas Group.

Airways will consider each submission and will publish a document summarising any changes to the Pricing Framework and Standard Terms and Conditions on 10 April 2017.

Public Submission Documents

Airways has published a public submissions document featuring all of the submissions received. The purpose of publishing submissions is to ensure the consultation process is transparent and well understood.

The document lists submitters by name (in alphabetical order) and has been compiled as a single document to make submissions easy to download, read, and cross reference.

Submissions

Air New Zealand

Airways is currently consulting on a proposal to modify the risk sharing mechanism of its Pricing Framework.

The current mechanism provides for an adjustment to charges in a subsequent year if volumes are more than +/-2% of that forecast when Airways set prices at the year pricing period. The adjustment made is 75% of the variation above the 2% neutral zone. This mechanism proved to be an inadequate mechanism to properly share risk in FY16, the third year of the most recent pricing period, which saw a significant uplift in volume above that forecast.

Airways is proposing instead to reforecast, prior to the commencement of years 2 and 3 of a pricing period, the revenue expected based on up to date airline schedules for those years. If the reforecast indicates a variation of revenue from the original forecast at the commencement of the pricing period outside the +/-2% range, a price reset will be triggered taking account of the full forecast variation outside the 2% neutral zone.

Air New Zealand supports Airways' proposal to modify the risk sharing mechanism and considers this is a less complex and more transparent framework. Airways proposal to allow airlines to review the updated forecasts prior to them being finalised is a welcome move which will ensure greater transparency and support.

Airways is also proposing to discontinue the 25%/75% sharing of the variation outside the 2% neutral zone, as it considers the 2% neutral zone provides sufficient incentive to reduce costs and seek economies of scale. Air New Zealand understands that if this sharing were retained Airways would apply it to the adjustment to prices in subsequent years rather than apply it to any over/under-recovery (outside the 2% neutral zone) in a prior year. On this basis Air New Zealand supports Airways proposal to discontinue this 25%/75% sharing.

Board of Airline Representatives New Zealand (BARNZ)

Airways' Pricing Framework currently includes a volume risk sharing mechanism. This adjusts Airways' airline charges to account for significant variations between forecast and actual revenues (resulting from unforecast changes in movement volumes) within Airways' three-year pricing period. Airways is now proposing improvements to this mechanism.

The current mechanism works in the following way:

- No adjustments are made to prices where Airways' actual airline revenues are within ±2% of the original forecast

- Where revenues are more than ±2% away the original forecast, 25% of the difference between these forecasts is absorbed by Airways and 75% of the difference is reflected in an adjustment of the following year's prices. This reset does not occur if actual revenues differ from forecast revenues in the final year of the pricing period.

Proposal

The proposed new mechanism would:

- Retain the ±2% threshold within which revenue variations are borne or gained by Airways and do not lead to price adjustments

- Introduce a trigger mechanism for a price rest where forecast revenues fluctuate by more than ±2% from the original forecast revenues.

- Remove the 25%/75% split that applied when estimated actual revenues vary by more than ±2% from the original forecast revenues.

The price reset trigger mechanism would work as follows:

- In April and May of the first year of a pricing period Airways will update its volume and revenue forecasts for the second year

- If these updated forecasts indicate that revenues in the second year of the pricing period are likely to be more than ±2% different from the original revenue forecasts when prices were set, Airways will reset prices for the second year based on the new forecasts

- In April and May of the second year of a pricing period Airways will update its volume and revenue forecasts for the third year

- If these updated forecasts indicate that revenues in the third year of the pricing period are likely to be more than ±2% different from the original revenue forecasts when prices were set, Airways will reset prices for the third year based on the new forecasts.

Airways intends that the new mechanism will be in place by 30 April 2017, in time for it to be used when re-setting prices for the 2017/18 year, should that be necessary.

BARNZ View

2% target revenue band

BARNZ supports the current ±2% band around the forecast revenue, within which Airways bears all of the risk of volume fluctuations. This provides a useful incentive for Airways to reduce costs and avoids the need to adjust prices when the changes in volume from the original forecast are relatively small.

Price reset trigger mechanism

BARNZ supports the proposal for Airways to review its traffic forecasts before the start of the second and third years of a pricing period and adjust prices if the new forecasts indicate that revenues are expected to be more than ±2% from the originally forecast revenues for each year. This should improve the accuracy of the forecasts used to re-set prices, particularly in the third year of the pricing period.

BARNZ assumes that the new prices will be calculated by dividing the original forecast revenue by the new forecast volume less 2% of the original forecast volume if the volumes are up by more than 2%, or by the new forecast volume plus 2% of the original forecast volume if volumes are down.

BARNZ presumes that Airways will consult with airlines on their revised traffic forecasts and BARNZ believes that Airways should only update their prices where the revised forecasts have clear airline support.

Current price rest mechanism (25%/75%)

BARNZ agrees tha current price reet mechanism (the 25%/75% price reset) is not optimal as it does not allow for wash-ups in the final year of the pricing period. BARNZ is comfortable with this being remove from Airways' pricing framework, provided the annual revenue reforecasts are robust and subject to meaningful consultation.

International Air Transport Association (IATA)

As the global trade association representing the world's leading airlines, the International Air Transport Association (IATA) appreciates the opportunity to contribute feedback to Airways New Zealand's (Airways) proposal to review its risk sharing mechanism and also acknowledges the consultation activities that Airways undertakes with airspace users. In particular the several phone hook-ups undertaken with IATA to provide more detail on the paper and on specific queries have been helpful and appreciated.

With respect to the paper, IATA has no significant objections to the amendments proposed. The proposal to re-forecast traffic projections at the start of years two and three is supported and we iterate that forecasts should be made available to stakeholders even if the Airways' estimates do not exceed the +/-2% trigger. This permits an external comparison to other forecasts and any additional consultation required.

IATA does not object to retention of the 2% trigger value, however there is no strong support for the removal of the 25/75% split as it maintains the incentive for Airways to reduce costs when forecasts predict declining numbers, and to seek economies of scale when growth is projected to be higher than expected. In the absence of an improved alternative that may also address any actual over- or under- recovery in prior years, IATA supports retention of the split to avoid the risk shifting more to airspace users.

Qantas Group

The Qantas Group is concerned with the application of the mechanism in the case of a downside of activity. We appreciate that the risk sharing mechanism was designed to be symmetrical on either side of the neutral zone. However, Airways currently earns a WACC return which incorporates an element of risk. By introducing a risk sharing mechanism, Airways and airlines share the activity risk, but Airways still earns the sae return and their risk profile has shifted to airlines. We propose that in case of a downside, the risk sharing mechanism is triggered, providing a lower WACC (debt rate) is used to recalculate the charges.

Our long term view is that the consultation process at the start of a 3 year period should take into account this new volume risk sharing mechanism, The current WACC (6.9%) was set and agreed for the 3 year pricing period (FY17-19), with Airways bearing the activity risk. In view of the next pricing period (FY20-22), if a similar risk sharing mechanism was to be implemented, the Qantas Group would request the adoption of a lower WACC based on Airways' debt rate only.

The Qantas Group is also concerned that the mechanism only provides an opportunity to reset future prices without any consideration given to any under/over recovery in the current year. This could potentially lead to a situation where Airways over recovers in the current year without any rebate adjustment back to the airlines, and at the same time revise their forecast down for the subsequent year, resulting in an increase of costs for airlines in that subsequent year. The Qantas Group would like to propose that in the case of a downside price rest, any over recovery by Airways in the previous and current years of the pricing period are taken into account in the recalculation of the future prices. Given that consultation process to date, it may be beneficial for Airways to consider reopening the risk sharing mechanism discussion in the next pricing period discussions.

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