AIRWAYS CORPORATION OF NEW ZEALAND

REVIEW OF PRICING FRAMEWORK AND STANDARD TERMS AND CONDITIONS

CONSULTATION PAPER

November 2021

Contents

1. Executive Summary

1.1. As part of its new Customer Strategy, Airways has been taking the opportunity to review the frameworks under which it supplies services to the industry.

1.2. This is the second phase of Airways' review of the arrangements under which it supplies air traffic control (**ATC**) to the New Zealand aviation community.

1.3. The first phase began in May 2021 with a review of the Service Framework, which sets out the basis on which Airways supplies ATC services. The major change proposed was to draw a distinction between contestable services over which Airways does not have a statutory monopoly — in particular the Aerodrome Air Traffic Management Service (**ATMS**) — and base services. Under the proposal, contestable services would be provided to aerodromes on negotiated terms, which would pay for those services directly instead of the costs of those services being recovered from airlines and other aircraft operators. Under this proposal, contestable services would therefore be removed from the Pricing Framework.

1.4. Submitters were generally opposed to that proposal. A strong theme emerged that airports in particular did not think it appropriate for Airways to charge them directly for ATMS.

1.5. After taking into account submissions, Airways decided not to make any major changes to its Service Framework at this stage and will move onto to the planned consultation on the Pricing Framework, Standard Terms and Conditions and the commercial terms of its relationships.[1]

1.6. Airways is now proceeding with phase two of its review. This consultation document describes a proposed change on one aspect of the Pricing Framework which Airways seeks stakeholder views on, and provides an opportunity for the industry to submit any additional feedback on the framework and contractual terms on which it supplies its services.

1.7. The Pricing Framework was established in July 2012 and is periodically reviewed. Airways' prices are set on a three-yearly cycle, with the next cycle running from 1 July 2022 to 30 June 2025.

1.8. Before Airways sets prices for that period, it is consulting on the following proposed aspect of the Pricing Framework which it believes has the potential to make its approach to pricing more equitable and efficient:

a) *Treatment of works-in-progress*. Airways currently includes capital expenditure (**capex**) in pricing when it occurs, rather than when the asset in question is commissioned. Airways is considering whether it should hold works-in-progress (**WIP**) in a separate account until the assets are commissioned. Airways' view is that this change should be implemented as it is beneficial to its customers and aligns with common practice, however it would value stakeholders' feedback on this proposal.

1.9. It is noted that while reviewing the Pricing Framework and Standard Terms and Conditions, Airways has identified a number of minor areas that require updating either to correct inaccuracies, comply with changes to legislation or reflect current practice. Revised versions of these documents incorporating these changes will be published at the conclusion of the consultation process. Airways welcomes any suggestions about other detailed matters of implementation that stakeholders think could be improved.

[1] See Airways' Service Framework Decision Paper on its website at https://www.airways.co.nz/assets/Service-Framework-Decision-Paper.pdf.

1.10. At the conclusion of stage two, Airways will look to reset its prices to take effect from 1 July 2022 as stage three.

2. Review of Pricing Framework

Introduction

2.1. Airways' current Pricing Framework was first published in July 2012. It explains that in competitive markets, prices are determined by market forces. As there is no competition for many of Airways' services, including the services over which Airways has a statutory monopoly, a different mechanism is needed to set prices.

2.2. That mechanism is set out in the Pricing Framework. Airways' aim is to carry out its business efficiently and build stakeholder confidence by maintaining a well-understood Pricing Framework for setting prices.

2.3. The purpose of this review of the Pricing Framework is to explore whether there are changes that Airways could make to the Pricing Framework to promote those objectives, at this time.

2.4. The Pricing Framework adopts a set of seven principles as the basis for developing the Framework and to guide its implementation. These principles are that prices should:

a) Be predictable, consistent and durable;

b) Be transparent and practicable to implement;

c) Reflect costs;

d) Take account of differences in the value customers derive from Airways' services;

e) Be commercially sustainable;

f) Encourage Airways to innovate and operate efficiently; and

g) Comply with relevant regulations.

2.5. The Framework uses a building block methodology (**BBM**) to set prices. BBM is commonly used in New Zealand and overseas to set prices for services in regulated industries.

2.6. This methodology is based on the amount of revenue required to cover the efficient costs of Airways' base services. It involves calculating Airways' asset base and calculating base revenue as the sum of forecast operating costs, depreciation, tax and a capital charge (calculated by multiplying the value of Airways' asset based by its weighted average cost of capital (**WACC**)). Additional mechanisms have been introduced to enhance the ability of the model to respond to uncertainty in economic conditions and encourage innovation and operational efficiency.

2.7. Once base revenue for the pricing period is calculated, Airways calculates the amount of revenue to be recovered from each service and location. This calculation uses a set of costing policies to the overall revenue figure, and then a mixture of location-specific and service cluster pricing to best suit the characteristics of each service. Through this process Airways determines the revenue to be recovered from each service and location.

2.8. Once the revenue requirements have been set for each service, a unit price is calculated that will return the required revenue on the basis of volume forecasts over the pricing period.

2.9. At this point, Airways is seeking input on one area where it considers an improvement could be made to the Pricing Framework to make it more efficient and fair. This concerns the treatment of WIP.

Treatment of works-in-progress

2.10. As noted above, part of the process of calculating Airways' base revenue involves the construction of an asset base. Values for existing assets are carried forward from the previous period adjusted for depreciation, with new capital expenditure (capex) for the period being added to the asset base. Airways then recovers revenue taking into account the value of the revised asset base.

2.11. Airways has considered how capex for new projects is added to the asset base, and particularly the timing of its inclusion. Currently, capex is included in the asset base when the expenditure is incurred, even though the construction of the asset may not be complete. The consequence of this arrangement is that Airways calculates revenue taking into account those assets before they are commissioned and thus available for use in providing services to customers. In this sense, customers are therefore paying for assets they are not currently using.

2.12. Airways understands that businesses regulated under Part 4 of the Commerce Act 1986 are required by the New Zealand Commerce Commission (NZCC) to hold the cost of works-in-progress (WIP) in a separate account, with the costs of the assets only entering the asset base once they are commissioned.[2]

2.13. Additionally, in considering how we would implement a WIP account, it has become clear that Airways approach to calculating the capital charge is not aligned with the approach taken by the NZCC. Specifically, when calculating the capital charge component of the base revenue calculation, Airways has historically applied the WACC to the average of the opening and closing asset base in a given year (the "average balance" approach). Because the closing value has depreciation removed, Airways has historically been under-recovering the capital charge component.

2.14. Airways is therefore considering whether to amend its base revenue calculation methodology and the Pricing Framework to provide that:

a) Capex would only enter the pricing base once an asset is commissioned;

b) Until the asset is commissioned, capex costs would be held in a works-in-progress account, which would be rolled forward at the WACC. This would ensure that the value of the capex was not eroded and the principle of Financial Capital Maintenance (FCM) is maintained;[3]

c) The capital charge and roll forward of the WIP would be calculated by applying WACC to the opening asset base and assuming capex occurs half-way through the year; and

d) Prices would be set based on forecast commissioning dates.

2.15. Airways considers that this change might produce a number of benefits for customers:

a) It would remove any unfairness to customers of being charged for assets that are not yet available to deliver services (and thus deliver lower prices in the near term, compared to the current approach);

b) It would incentivise the timely completion of capex programmes;

[2] Specifically, this is the NZCC's treatment of "works under construction". Similar issues also arise in relation to "assets held for future use".

[3] FCM is an economic principle that says that firms should have an expectation of earning a reasonable rate of return on their efficient investments, by ensuring that the present value of a firm's allowed revenue stream is equal to the present value of its expenditure stream. This is also often referred to as the NPV=0 principal in regulatory settings.

c) It would be consistent with the approach taken by the NZCC under the Commerce Act 1986;

d) It would be NPV-neutral, as long as the WIP account is rolled forward at the WACC.[4]

2.16. The downside for Airways would be delayed cash recovery and some additional administrative complexity in the requirement to forecast commissioning dates.

2.17. Balancing the efficiency and customer-focused benefits of this proposal against the costs, Airways' proposed decision is to implement this change and incorporate it into the Pricing Framework.

Question 1: What are your views on the proposed change to treatment of works-in-progress? Are there any concerns if Airways was to implement this change?

3. Other Changes

3.1. While reviewing the Pricing Framework and Standard Terms and Conditions, Airways has identified a number of minor areas that require updating to correct inaccuracies, comply with changes to legislation or reflect current practice. A change that falls under the latter category relates to the risk sharing mechanism that accounts for significant fluctuations in volume within a pricing period.

3.2. In 2017 it was identified that the risk sharing mechanism used was not effective when volume variations were large. Airways consulted on refinements to the mechanism with a view to provide a more equitable allocation of risk between customers and Airways. Following that consultation process, Airways decided to implement the proposed changes to the mechanism for the 2017/18 financial year onwards.

3.3. This new (and current) mechanism is that if Airways' traffic volume forecast, in respect of aircraft of 5 tonnes and over, for the second and/or third year of a pricing period indicates that revenue derived from such aircraft movements will be outside a range of -2% to +2% from the target pricing revenue used at the start of the relevant pricing period, Airways will reset prices in respect of such aircraft for the relevant reset year.

3.4. The mechanism refinements were reflected in the Standard Terms and Conditions[5] document at the time, but not the Pricing Framework. To reflect current practice and for consistency, Airways will incorporate the 2017 change into the revised Pricing Framework to be published at the end of this consultation process, along with a revised version of the Standard Terms and Conditions.

3.5. Lastly, Airways continues to explore ways in which it can better meet the objectives and principles of the Pricing Framework, summarised in paragraphs 2.2 and 2.4 above. Airways welcomes feedback on ways in which it could improve or develop the Pricing Framework to further promote those aims and in turn, guide future reviews.

[4] We note that aligning the capital charge calculation with the NZCC would result in an increase in the forward looking present value of revenues, but this is only because Airways current "average balance" approach results in an under-recovery. In this sense, this aspect of the change restores Airways to an NPV=0 position.

[5] See 6.3 of the Standard Terms and Conditions.

Question 2: Airways invites your feedback on any aspects of this consultation paper, the Pricing Framework or the Standard Terms and Conditions.

4. Consultation Process – How to Make a Submission

4.1. We invite submissions in response to this consultation paper per the following indicative timetable:

a) Primary submissions are to be submitted by **1 December 2021**. Submissions will be posted on Airways' website for customers, stakeholders and the industry to review and submit cross-submissions on.

b) Cross-submissions are to be submitted by **15 December 2021**. Similarly, these will be posted on Airways' website.

c) All submissions will then be carefully considered by Airways, and will inform its decision on whether to make any changes to the Pricing Framework and Standard Terms and Conditions.

d) A paper outlining Airways' decision will then be published. We will keep you updated with our progress.

4.2. Please send submissions by email to submissions@airways.co.nz. As submissions will be made available to the public, they should not contain any commercially sensitive or confidential information.