AIRWAYS CORPORATION OF NEW ZEALAND LIMITED

REVIEW OF PRICING FRAMEWORK AND STANDARD TERMS AND CONDITIONS - CONSULTATION PROCESS

DECISION PAPER

January 2022

Contents

1. Executive summary

1.1 This paper outlines Airways' decision to issue a revised version of its Pricing Framework incorporating a change to the treatment of works-in-progress (**WIP**) and a revised version of its Standard Terms and Conditions (**Standard Terms**), following industry consultation.

1.2 The Pricing Framework defines the methodologies Airways uses to price its services as set out in the Service Framework. The charges are set accordingly every three years, with the next cycle running from 1 July 2022 to 30 June 2025. Airways sought industry views on a proposed change to the treatment of the WIP and asked for feedback on any other aspects of the Pricing Framework that industry consider worthy to highlight to Airways.

1.3 The Standard Terms and Conditions set out the contractual terms on which Airways' services are provided and related pricing information. Airways sought feedback on a number of minor proposed updates to the Standard Terms (to comply with changes to legislation or reflect current practice) and on any other aspects of the document submitters wished to address.

1.4 Airways published a draft revised Pricing Framework, draft revised Standard Terms, and an accompanying consultation paper. Consultation with the industry took place between 3 November and 15 December 2021, allowing time for submissions and cross-submissions. Airways received seven submissions; no cross-submissions were received.

1.5 Airways has considered all submissions carefully and appreciates the effort that stakeholders have put into sharing their views.

1.6 Submitters generally indicated support for the proposed change to the treatment of WIP under the Pricing Framework. Some submitters also provided comment on the Standard Terms.

1.7 Airways has decided to make the proposed change to its Pricing Framework in regard to the treatment of WIP, and publish revised versions of both the Framework and Standard Terms taking into account the feedback received.

2. Background

2.1 As part of its Customer Strategy, Airways has been taking the opportunity to review the frameworks under which it supplies air traffic control services the New Zealand aviation community.

2.2 The first phase of the review began in May 2021 with a review of the Service Framework, which sets out the basis on which Airways supplies air traffic control services. The major change proposed was to draw a distinction between contestable services over which Airways does not have a statutory monopoly and base services. Under this proposal, contestable services would be removed from the Pricing Framework. Submitters were generally opposed to this change. Airways decided not to proceed with the proposal at such time.

2.3 This paper concerns the second phase of the review. Prior to setting prices for the next three-year pricing period, Airways consulted on one major proposed change to the Pricing Framework (treatment of WIP), and sought any additional feedback from the industry on the framework and contractual terms on which it supplies its services. Airways believes the proposed change to the treatment of WIP has the potential to make its approach to pricing more equitable and better aligned with common practice.

2.4 The final stage of Airways' review is to reset prices planned to take effect from 1 July 2022, which will take into account any changes to the Pricing Framework and other contractual arrangements.

3. Consultation process

3.1 Consultation opened on 3 November 2021 with the publication on our public website of:

a) the Pricing Framework and Standard Terms Review Consultation Paper (**consultation paper**) setting out Airways' proposal and questions to submitters;[1]

b) the Proposed Revised Airways Pricing Framework;[2] and

c) The Proposed Revised Standard Terms.[3]

3.2 A key component of Airways' proposal was the amendment to the treatment of WIP, incorporated into the revised Pricing Framework.

3.3 The consultation paper invited submitters to respond to the following:

a) 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?

b) Airways invites your feedback on any aspects of this consultation paper, the Pricing Framework and the Standard Terms and Conditions.

3.4 The consultation comprised a four-week submission period followed by a two-week cross-submission period. All submissions were published on Airways' website.[4]

3.5 Airways has carefully considered the submissions received. It has made a decision that, in its view, best accommodates the feedback and is in accordance with the consultation principles set out in the consultation paper.

4. Submissions and cross-submissions

4.1 Airways received seven submissions from:

a) Air New Zealand

b) Board of Airline Representative of New Zealand (**BARNZ**)

c) Emirates

d) International Air Transport Association (**IATA**)

e) Jon Brooks

f) New Zealand Airports Association (**NZAA**)

g) Qantas Group

4.2 No cross-submissions were received.

---

[1] https://www.airways.co.nz/assets/Documents/Pricing-Framework-consultation/Consultation-Paper-Review-of-Pricing-Framework-and-Standard-Terms-and-Conditions.pdf

[2] https://www.airways.co.nz/assets/Documents/Pricing-Framework-consultation/Airways-Pricing-Framework.pdf

[3] https://www.airways.co.nz/assets/Documents/Pricing-Framework-consultation/Airways-Standard-Terms-and-Conditions.pdf

[4] https://www.airways.co.nz/about/performance-and-pricing/ans-services-and-pricing-explained/

4.3 Key themes drawn from the submissions are as follows:

a) Submitters highlighted the significant downturn in the aviation sector due to the COVID-19 pandemic and the importance of reviewing service and pricing frameworks to ensure they are structured in a way that supports recovery.

b) Submitters identified the importance of continuing to collaborate in responding to the challenges facing the aviation sector, and identifying areas that could be more efficient and other opportunities, which will assist with the recovery of the industry. Airways will continue to engage with industry outside of this consultation process on this issue.

c) Submitters largely supported Airways' proposed change to the treatment of WIP in the Pricing Framework and the proposed amendments to both the framework and the Standard Terms.

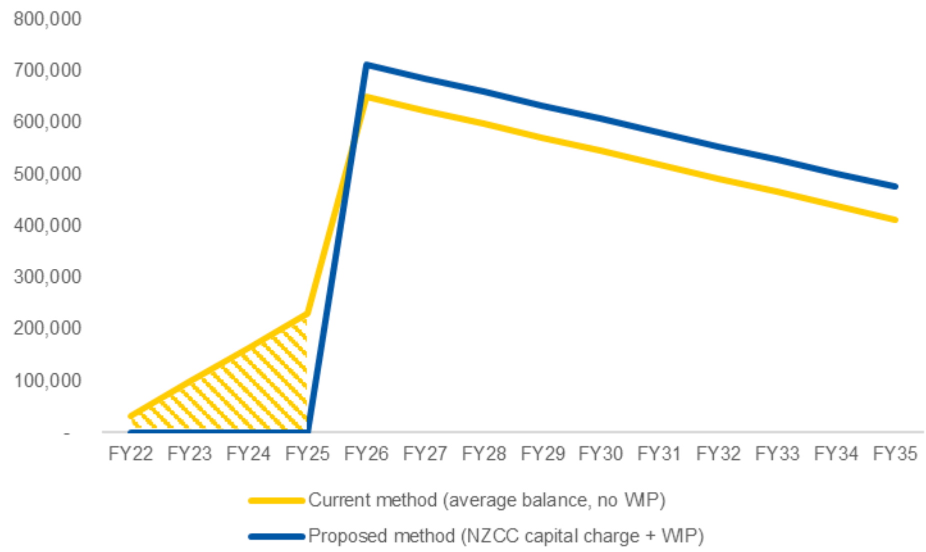
5. Airways' assessment of key submission points

Treatment of works-in-progress

5.1 The introduction of a WIP account is a customer centric proposal responding to concerns customers have previously raised that they should only pay for services once they start to receive a benefit from those services. In response to these concerns, Airways has sought to align its practice for recovering WIP with that adopted by the New Zealand Commerce Commission (**NZCC**). This involves capex for WIP being held in a separate WIP account and only entering the asset base once the asset is commissioned (**WIP approach**).

5.2 The WIP approach is Net Present Value (**NPV**) neutral compared to the current approach (where capex enters the asset base as soon as cost is incurred), so long as the WIP account is rolled forward using the weighted average cost of capital (**WACC**). The difference between the two approaches is therefore the time profile of recovery. This is shown in Figure 1 below, which presents a simple example of a project that requires $1m of capex per year over four years (i.e., $4m total cost spread evenly over four years).

Figure 1: Time profile of recovery under current and WIP approaches



5.3 This example illustrates that under the current approach, customers would pay the shaded area prior to commissioning and therefore before they derive any benefit from the expenditure. Under the WIP approach, customers do not pay until the asset is commissioned. In this example, because the expenditure is over four years and thus spans two three-year pricing periods, customers would pay nothing during the first pricing period despite the majority of the expenditure occurring during that period. The corollary to this is that once the asset is commissioned in the future, charges will be slightly higher to offset the earlier under recovery and ensure NPV neutrality.

5.4 In its submission on the consultation document, Qantas Group suggested using the cost of debt to roll forward capex in the WIP account instead of WACC. Airways' view is that this would undercompensate Airways for its opportunity cost of capital and thus result in Airways under-recovering and earning a negative NPV on new investments. The suggested approach would also be inconsistent with the approach taken by the NZCC to the same issue. In this regard, we note that airports are separately arguing for consistency with the NZCC methodologies. Adopting the Qantas Group's suggestion would be a departure from this.

5.5 Some submitters have requested more detail on the WACC to be used. Airways' approach to WACC is not defined in the Pricing Framework and will instead be addressed when Airways conducts its pricing reset. We do however note that Airways generally aligns its WACC calculation with the NZCC's methodology. Regarding the proposed change to the Pricing Framework to introduce a WIP account, we note that so long as the forecast WACC for the pricing period is also used for the WIP account during that pricing period (which is Airways' intent), the revenue Airways receives will be identical in NPV terms between the current and proposed approaches. As already shown in the figure above, implementing a WIP account results in an NPV neutral reprofiling of cashflow.

5.6 In its submission, IATA requested more detail on the WIP calculation, given the statement in the consultation document that alignment of the capital charge with the NZCC approach would increase the present value of revenues. As noted in the passage that IATA is referring to,[5] this increase occurs because Airways' current approach to calculating the return on capital component of charges (which is based on the average of opening and closing asset values) actually undercompensates Airways (i.e. results in NPV<0). As noted in the consultation paper, aligning the capital charge calculation with the NZCC will result in an increase in the forward looking present value of revenues. Furthermore, aligning the capital charge with the NZCC approach, which is required for consistency with how the WIP account would operate, simply restores Airways to an NPV = 0 position.

5.7 In Appendix A to this decision paper, we provide a simple worked example demonstrating that Airways under recovers under the current "average balance" approach and how calculating the capital charge using the NZCC/WIP approach gives NPV = 0.

Objectives and methodologies

5.8 In its submission on the consultation paper, the NZAA suggest that Airways' pricing principles do not reflect the same customer focussed approach that the Commerce Act establishes for regulated businesses. Specifically, NZAA's view is that "Airways' principles are directed to ensuring that Airways can recover costs, earn a commercial return and be encouraged to operate efficiently."

5.9 Airways' view is that our overall corporate objectives, and the pricing principles that operationalise these objectives (for the purpose of pricing), result in a materially similar customer focus as the Part 4 objectives. For example, Airways' Service Objectives are:

a) a modern, fit for purpose aviation system that delivers safety and efficiency;

b) alignment with the aviation industry's commercial imperatives;

c) productive relationships with our customers and stakeholders;

d) closer alignment between customer relationships and the provision of Airways services;

e) frameworks that incentivise innovation and quality outcomes.

5.10 Turning to the pricing principles specifically, the principle "Encourage Airways to innovate and operate efficiently" aligns with the customer focussed objectives of Part 4 regulation. This principle is further detailed in the Pricing Framework (section 3, p.8) as follows:

> "Provide Airways with incentives to innovate in the supply of existing and new services, to operate and invest efficiently and improve productivity and for **customers to benefit over time from such innovation, productivity improvements and efficient operation**"

5.11 NZAA also suggests that Airways should have close regard to the Commerce Act regulatory framework. Airways considers the proposed approach takes appropriate guidance from the Commerce Act approach, taking into account Airways' statutory purposes and other regulatory obligations. The change to introduce the WIP account is an example of this. Regulatory intervention has costs,[6] and Airways considers its approach adopts an

[5] Consultation paper, November 2021, footnote 4 on page 6: https://www.airways.co.nz/assets/Documents/Pricing-Framework-consultation/Consultation-Paper-Review-of-Pricing-Framework-and-Standard-Terms-and-Conditions.pdf.

[6] Specifically, direct costs such as staff time and indirect costs such as distorted investment.

appropriate balance. Airways does not consider the Pricing Framework is materially out of alignment with the NZCC regime or pricing methodologies.

5.12 NZAA suggests in particular that Airways should not use the avoidable cost allocation methodology (**ACAM**) because it is, in its view, inconsistent with the NZCC approach, and will result in a materially different allocation of costs to an accounting-based allocation approach.

5.13 Cost allocation is addressed in section 6 of the Pricing Framework. This step in the overall determination of prices follows the determination of the total revenue that needs to be recovered for core services covered in section 5 of the framework. The use of ACAM in this context has no impact on the total revenues recovered from core services taken as a whole. Allocating costs between services within the Pricing Framework would mechanically increase the price of the service that is allocated more cost and decrease the price for the service that is allocated less costs, with no impact on overall revenue.

5.14 The primary effect of applying ACAM within the pricing model is that regional aerodromes only face their incremental costs and thus other services (international aerodromes, approach and enroute) bear a greater share of corporate overheads. In Airways' view, ACAM is administratively simple to implement and can support services in regional aerodromes where an alternative cost allocation might render the service uneconomic. Further, the use of ACAM accords with Airways' objectives, and is in the interests of its stakeholders. While the ACAM approach may result in different allocations than other accounting methods, it is nonetheless an appropriate approach in the particular circumstances of New Zealand's aviation industry.

5.15 NZAA also submits that Airways' proposal to update the Pricing Framework to reflect the risk sharing mechanism in the current Standard Terms ought to comply with Part 4 of the Commerce Act, in particular consultation and disclosure requirements. Airways is not statutorily obliged to comply with the specific requirements of Part 4. Moreover, Airways consulted on changes to the risk sharing mechanism during the pricing consultation in 2017, and the mechanism was included in the Standard Terms (but not the Pricing Framework) following that consultation. Airways' proposal is simply to ensure the Pricing Framework is in accordance with the Standard Terms. As was our view in 2017, the proposal is appropriate and ought to be adopted. It is in accordance with Airways' statutory obligations, and with the objectives and principles of the Pricing Framework.

5.16 NZAA further submits that Airways ought to closely emulate NZCC regulatory and disclosure regimes. Regarding the costs of regulation more generally, and the NZCC Information Disclosure regime that applies to airports specifically, regulation would likely entail material direct and indirect costs. Direct costs are the staff and time costs associated with designing, implementing and operating a regulatory regime for the NZCC, the regulated business and stakeholders. Indirect costs refer to the fact that regulation cannot be perfectly implemented and may itself result in inefficiencies. The NZCC's previous estimates of these costs for other industries are material:

a) In the 2016 preliminary inquiry into regulating gas metering services, the NZCC estimated "direct costs" of regulating the service to be approximately $15m over a 10-year period;[7]

[7] Table 1.1 of 2016 Gas Metering Services inquiry: https://comcom.govt.nz/__data/assets/pdf_file/0022/62572/Preliminary-assessment-of-whether-to-conduct-a-Part-4-inquiry-into-gas-metering-services-1-April-2016.PDF.

b) In the 2012 preliminary inquiry into regulating Eastland Port, the NZCC set out estimates of the direct costs it would incur (i.e. excluding directs costs for the regulated firm and stakeholders).[8] The NZCC estimated the upfront set up costs for the new regime would be between $3.5m and $5.5m depending on whether information disclosure or price quality regulation was imposed, with ongoing costs of $150k per year for ID regulation and $40 – $80k of compliance costs for PQ regulation. Under PQ regulation, the NZCC estimated it would incur further costs of $1.5m every time there was a price reset (which assumed would happen every five years).

c) In the 2004 Gas inquiry, the NZCC estimated that a combination of direct and indirect costs was equivalent to a margin over WACC of 0.6% to 2.8%;[9]

d) In the 2002 Airports inquiry, the NZCC estimated the average annual total costs of imposing regulation as $2.084-$2.340m per year.[10]

5.17 In Airways' view, the costs of regulation are likely to be disproportionate given:

a) Airways Pricing Framework seeks to replicate materially similar customer outcomes and constraints on excess profit that regulation can seek to promote, but without the associated costs.

b) Airways is a small part of the aeronautical value chain, and thus in relative terms the costs of a regulatory regime are likely to be large.

c) Airways is not a traditional natural monopoly, infrastructure focused business (our costs are primarily people and software), and thus a regime set up for physical infrastructure businesses may be inappropriate and lead to perverse outcomes. This also means set up costs could not be avoided as other regimes could not simply be copied and applied to the aviation industry.

5.18 Lastly, BARNZ proposed adding an additional pricing objective – "to assist the recovery of the aviation sector". In Airways' view, this objective is encapsulated in the second objective, namely "alignment with the aviation industry's commercial imperatives". Airways is and remains committed to continuing its work with the industry in relation to recovering from the effects of the COVID-19 pandemic.

Pricing considerations for General Aviation (**GA**)

5.19 In its submission, BARNZ has proposed that subsidisation of GA customers be removed from the pricing model to benefit airlines recovering from COVID-19.

5.20 The aviation industry, and Airways in particular, is conscious of the issues around the relative recovery of costs from different customer groups. However, it is not a straightforward matter of choosing to remove a subsidy from one stakeholder to benefit another. A range of factors are relevant, including the extent to which GA ought to be subsidised by the wider aviation industry, the relevance of Airways' statutory responsibilities, whether and how GA would be able to operate without subsidies, whether and how airlines are capable of

[8] Table 1 of 2012 Eastland Port inquiry: https://comcom.govt.nz/__data/assets/pdf_file/0023/61664/Draft-report-Preliminary-assessment-of-whether-to-initiate-a-Part-4-inquiry-into-port-services-provided-by-Eastland-Port-25-October-2012.pdf.
[9] Table 6.5 of 2004 Gas inquiry: https://regulationbodyofknowledge.org/wp-content/uploads/2013/03/CommerceCommissionofNewZealand_Gas_Control_Inquiry.pdf.
[10] Table 29 of 2002 Airports inquiry: https://comcom.govt.nz/__data/assets/pdf_file/0024/90285/Part-4-inquiry-into-airfield-activities-at-Auckland,-Wellington,-and-Christchurch-international-airports-1-August-2002.pdf.

subsidising GA, and the administrative costs in designing, implementing and monitoring a new regime.

5.21 Airways appreciates the industry is under strain in light of COVID-19. As noted, Airways is and remains committed to continuing its work with the industry in relation to recovering from the effects of the pandemic which has affected all sectors of the aviation industry. However, it does not consider it an appropriate time to implement a fundamental change to the complex balance of pricing between GA and airlines. Airways nonetheless remains open to engagement with all its stakeholders on this issue.

Other changes to the Pricing Framework and Standard Terms

5.22 NZAA and BARNZ made submissions regarding improvements to performance and service availability reporting. Airways currently discloses information through its annual reports, and intends to explore improvements to the information it discloses on performance, including using scorecards, as part of the Price Reset consultation process.

5.23 A private submitter proposed a change to the Vicinity Landing Charge. Taking into account wider pricing model principles, constraints and implications, Airways considers it is appropriate to remain with the current arrangement for the Vicinity Landing Charge.

5.24 Submitters noted it was not clear in the draft revised version of the Pricing Framework that consultation would take place should prices be reviewed within a pricing period if a trigger event occurred. We have reviewed this section and in response, reinstated wording confirming that if a price review is initiated, Airways will consult with stakeholders to reset prices to take account of the trigger event.

5.25 Airways also considered additional submissions made on other minor aspects of the Pricing Framework. As above, to the extent it considers appropriate, these have been incorporated into the revised framework.

5.26 Airways has considered submissions made on minor aspects of the Standard Terms. To the extent it considers appropriate, Airways has incorporated these submissions in the revised Standard Terms. Otherwise, Airways' position is that the Standard Terms are reasonable and appropriate, and notes the Service Framework allows for alternative commercial arrangements to be agreed if a need arises.

6. Decision

6.1 Airways thanks submitters for their thoughtful and informed submissions. Airways has carefully reviewed and considered the feedback received in coming to its decision.

6.2 Taking into account the general support received from submitters, Airways has decided to proceed with its proposed amendment to the Pricing Framework in relation to the treatment of WIP. This change is reflected in the new Pricing Framework, attached to this paper as Appendix B.

6.3 Airways has also decided to publish a revised version of the Standard Terms including, where appropriate, minor changes and additional amendments in response to points raised by submitters. The new Standard Terms document is attached to this paper as Appendix C.

7. Next steps

7.1 Airways will now proceed with the final phase of its review and consult with its customers and stakeholders regarding pricing for the next three-yearly cycle, which is from 1 July 2022 to 30 June 2025.

7.2 Consultation on the price reset is currently planned to take place in March and April 2022. Following consideration of submissions and cross-submissions, Airways will issue a decision paper setting out its new prices.

Appendix A – Worked examples of change to capital charge and WIP

The tables below presents the cash flows and NPV where the capital charge component is calculated under two methodologies:

1. **Average balance:** the capital charge is calculated by applying WACC to the average of the opening and closing asset balance, where the closing balance differs from the opening and closing balance due to both capex and depreciation.

2. **Opening balance + mid-year capex:** the capital charge is calculated by applying the WACC to the opening balance and also applying six months of WACC compounding to capex during the year.

The examples use the following assumptions:

1 Asset value = $1m;

2 Asset life = 10 years;

3 Depreciation profile = straight line;

4 Capex timing = mid year; and

5 WACC = 6.59% (Being Airways WACC for the last pricing period).

The tables show that the NPV under the "average balance" approach is slightly negative. The reason for the difference is that the closing balance has depreciation subtracted, and thus a full return on capital is not earned.

Current Method (average balance)												
		FY22	**FY23**	**FY24**	**FY25**	**FY26**	**FY27**	**FY28**	**FY29**	**FY30**	**FY31**	**FY32**
Opening BV		-	1,000,000	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000
Capex		1,000,000										
Depn			100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Closing BV	0	1,000,000	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000	-
Average BV		500,000	950,000	850,000	750,000	650,000	550,000	450,000	350,000	250,000	150,000	50,000
WACC	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%
WACC Return		32,950	62,605	56,015	49,425	42,835	36,245	29,655	23,065	16,475	9,885	3,295
Total Cashflow		**32,950**	**162,605**	**156,015**	**149,425**	**142,835**	**136,245**	**129,655**	**123,065**	**116,475**	**109,885**	**103,295**
Discount rate	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%
Discount factor	1.00	0.94	0.88	0.83	0.77	0.73	0.68	0.64	0.60	0.56	0.53	0.50
NPV		**30,913**	**143,120**	**128,830**	**115,760**	**103,813**	**92,901**	**82,942**	**73,859**	**65,582**	**58,046**	**51,192**
NPV of revenue	**946,958**											
NPV of CAPEX	**968,594**											
NPV	**- 21,636**											

Current Method (Opening balance + mid year capex)												
		FY22	**FY23**	**FY24**	**FY25**	**FY26**	**FY27**	**FY28**	**FY29**	**FY30**	**FY31**	**FY32**
Opening BV		-	1,000,000	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000
Capex		1,000,000										
Depn			100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Closing BV	0	1,000,000	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000	-
WACC	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%
WACC Return		32,424	65,900	59,310	52,720	46,130	39,540	32,950	26,360	19,770	13,180	6,590
Total Cashflow		**32,424**	**165,900**	**159,310**	**152,720**	**146,130**	**139,540**	**132,950**	**126,360**	**119,770**	**113,180**	**106,590**
Discount rate	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%	6.59%
Discount factor	1.00	0.94	0.88	0.83	0.77	0.73	0.68	0.64	0.60	0.56	0.53	0.50
NPV		**30,420**	**146,020**	**131,551**	**118,312**	**106,208**	**95,148**	**85,050**	**75,836**	**67,437**	**59,787**	**52,824**
NPV of revenue	**968,594**											
NPV of CAPEX	**968,594**											
NPV	**-**											

Sections 5.1 and 5.2 propose adoption of the NZCC model based on the 'opening balance + mid-year capex' approach, which would result in NPV=0.

Appendix B – Revised Pricing Framework

Appendix C – Revised Standard Terms and Conditions