AIR NEW ZEALAND

29 April 2022

Katie Bhreatnach
GM Customer and Regulatory Partnerships
Airways NZ

Katie.Bhreatnach@airways.co.nz

Dear Katie,

Proposed Pricing for the 2022-2025 Period

Please find attached Air New Zealand's response to Airways' pricing consultation relating to pricing for the FY23-FY25 period.

This consultation is occurring at a critical time for Air New Zealand as we look to recover from the ravages of COVID-19 and the devastating impact this has had on air transport operators. As such it is critical that costs are maintained at levels that are justified and necessary to ensure the safe and efficient operation of the air transport network.

Airways must remain mindful of its role, alongside other organisations, in facilitating domestic and international connectivity which are critical to ensuring the ongoing success of the New Zealand economy. Charging regimes across several agencies are at various stages of review and the cumulative impact of these need to be considered carefully so as not to unfairly burden the sector with excessive costs which will have an impact on the trajectory of the economic recovery.

Air New Zealand looks forward to continuing to work closely with Airways to ensure New Zealand maintains a world class and sustainable air transport system which contributes positively to the country and ensures we can continue to provide the connections which are essential to our society.

Yours sincerely

David Morgan
Chief Operational Integrity and Safety Officer

Airways' Proposed Pricing Consultation

Submission Template

To assist with making submissions, this template lists the feedback questions set out in Airways' Proposed Pricing for the 2022 - 2025 Period Consultation Document, April 2022. You are welcome to comment on other topics relating to the proposed pricing should you wish to.

Once you've read the Consultation Document, you can download this template, open in Microsoft Word and type directly into the spaces provided. Primary submissions are to be emailed to submissions@airways.co.nz by 29 April 2022. The same template can be used for cross-submissions if it's helpful. Any cross-submissions are to be sent to the same email address by 13 May 2022.

Important note for submitters

Please note that we will publish all submissions on our website. This is an important step as it allows us to run a transparent consultation process and enables others to consider whether they wish to make cross-submissions. However, if you wish to provide Airways with confidential information in a submission, you must supply both confidential and public versions of your submissions. The public version will be the one published on our website. The responsibility for ensuring that confidential information is not included in a public version of a submission rests with the submitter.

Your details

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Consultation feedback questions

Section: Operating Costs

Q1: Do you agree that Airways' forecast of base operating costs is appropriate in light of the objective of maintaining safe and efficient services?

Feedback:

Air New Zealand supports Airways' objective of maintaining safe and efficient services. It is noted that Airways' forecast operating costs in each year of the period are lower than the previous forecast for FY22 established in 2019 and this is commended.

Airways' has also referenced a number of other strategic objectives for the FY23-FY25 period. It will be important to ensure that the focus for this period, when the industry will be rebuilding from the impacts of COVID19, is on maintaining safe and efficient services at a sustainable cost, with potentially less effort applied to, e.g. transitioning to "the aviation environment of the future". Such transition may be better left to future periods when the sector is better placed to fund innovations.

Current forecast operating costs see an overall 5% increase in FY23 followed by reductions in each of the subsequent years. Air New Zealand questions whether this front-loading of operating cost increases is appropriate.

Q2: Recognising that the inflation inputs will be updated with current information at the time of setting final prices, do you agree with Airways' inflationary inputs?

Feedback:

Given current global pressures, assumptions around inflation are a key part of pricing over this period. Air New Zealand notes the current uncertainty around salary and wage inflation given that Airways is currently in negotiations with NZALPA and AME on collective employment agreements and agrees that if the results of these are known at the time prices are set, these outcomes should be reflected in the inflation inputs.

Air New Zealand agrees, in principle, that the proposed inputs (NZIER LCI and NZIER PPI forecasts) are appropriate. We do question however whether those full forecasts should be used or whether there should be an onus on Airways to manage its operating costs so that productivity gains are made which result in increases at less than inflation. It is noted that Airways has used the NZIER LCI SEP21 forecast for the purpose of inflating GA pricing yet has not included these forecasts in the commercial airline parameters – is there a reason for this?

Q3: Recognising that the capital charge inputs will be updated with current information at the time of setting final prices, do you agree with the inputs into Airways' capital charge calculation?

Feedback:

Airways states that its capital charge calculation is aligned with the New Zealand Commerce Commission. While broadly correct, there are a couple of parameters where Airways has deviated from the Commerce Commission framework, resulting in an elevated cost of capital.

Airways has proposed use of a market risk premium of 7.5%, based on the "most recent input methodologies estimate in 2020". Air New Zealand notes that the IM for airports has yet to be revisited (this is due to occur over the next 18 months). Until such time as any change is made to the airports IM, Air New Zealand considers the existing parameter (7%) should be used.

Airways has proposed using leverage of 57% rather than the 19% used by the Commerce Commission in its consideration of New Zealand airports. A feature of the New Zealand cost of capital calculation is that an increase in leverage will result in an increase in the cost of capital. Air New Zealand considers Airways should adopt the target leverage for airports as used by the Commerce Commission.

Airways has proposed using a "conservative" WACC percentile range of 67%, claiming the "risk and cost of underinvestment is likely higher" than that of airports and other regulated businesses. Airways has provided no evidence to support this claim. This input alone (assuming all other inputs are appropriate which as per above Air New Zealand disputes) increases the WACC from 6.33% to 7%. An uplift of this nature cannot be justified on the basis of a subjective and unsubstantiated statement. In the absence of adequate substantiation, we request Airways' reconsideration of its decision to deviate from the 50th percentile.

Section: Proposed capital plan

Q4: Do you agree that Airways' investment programme is appropriate to enhance safety and system resilience, while transitioning to digital services over time?

Feedback:

Airways has proposed an investment programme of $188.3 million over the period, with $83.1 million of this being "major investments."

Airways has changed to use of a WIP approach where assets do not enter the pricing asset base until such time as they are commissioned. It is unclear from the information provided when the capital projects are brought into the pricing asset base. Further detail in the form of a detailed financial model would assist in making this more transparent.

$27 million is forecast for the Auckland tower replacement, which is not expected to be replaced until 2027. It is not clear whether this expenditure is included for the basis of pricing or is simply shown here as the year in which it is expended.

$34 million is forecast for Primary and Secondary Radar replacement. Air New Zealand requests further details regarding the split between PSR and SSR. CAA as part of its Future Surveillance Service Model requires 3 SSR radars as contingency to support "system safety". This has only a minor indirect benefit to commercial operators now that ADS-B is functional and should be funded by Government. PSR provides for detection of uncooperative aircraft targets and drones near airports. We acknowledge this can provide a benefit to commercial operations by avoiding risk and enhancing the ability to continue operations, however there needs to be a review of the actual risk versus the cost/benefit of undertaking the spend to understand if it is warranted.

$6.3 million is forecast for drone management. Air New Zealand considers this should not be a cost imposed on airlines but should instead be funded by UAS users or, if that is not considered possible, the Government.

Air New Zealand supports the rationalisation of en route assets, and the transition to GNSS as the primary means of navigation. It is noted that Airways intends to decommission "several" end-of-life property and navigational assets. It would be useful to have a roadmap setting out Airways' plan for this and the locations involved.

$51 million is forecast to be spent over the period on National Operations. Air New Zealand requests further detail on this expenditure and the benefits (and timing of those) airlines can expect to accrue from this expenditure.

Section: Assumed industry recovery

Q5: Do you consider the position taken for domestic recovery is reasonable? Are there other material factors that should be taken into account that may influence the domestic volume forecast?

Feedback:

Air New Zealand notes there remains significant uncertainty regarding traffic forecasts as we recover from the impacts of COVID-19. While the short-term domestic forecasts appear reasonable at this time, we believe it is overly pessimistic to assume no growth in domestic traffic beyond November 2023.

Given the significant uncertainty that remains around the recovery trajectory, Air New Zealand considers it worthwhile undertaking a one-off re-forecast during the first 6 months of FY23 which could enable an adjustment of pricing in the second half of FY23 as greater certainty returns to schedules. This would be in addition to the annual risk-sharing review.

Q6: Do you consider the position taken for Trans-Tasman recovery is reasonable? Are there other material factors that should be taken into account that may influence the Trans-Tasman volume forecast?

Feedback:

Air New Zealand notes there remains significant uncertainty regarding traffic forecasts as we recover from the impacts of COVID-19.

Given the significant uncertainty that remains around the recovery trajectory, Air New Zealand considers it worthwhile undertaking a one-off re-forecast during the first 6 months of FY23 which could enable an adjustment of pricing in the second half of FY23 as greater certainty returns to schedules. This would be in addition to the annual risk-sharing review.

Q7: Do you consider the position taken for other international recovery is reasonable? Are there other material factors that should be taken into account that may influence the other international volume forecast?

Feedback:

Air New Zealand notes there remains significant uncertainty regarding traffic forecasts as we recover from the impacts of COVID-19.

A further material factor to consider is the potential for significant cost increases in operating to New Zealand, e.g. Airways' price increases, could negatively impact demand as international carriers choose to deploy their aircraft to more profitable markets.

Given the significant uncertainty that remains around the recovery trajectory, Air New Zealand considers it worthwhile undertaking a one-off re-forecast during the first 6 months of FY23 which could enable an adjustment of pricing in the second half of FY23 as greater certainty returns to schedules. This would be in addition to the annual risk-sharing review.

Section: Proposed prices for FY23-FY25

Q8: Do you agree that Airways' proposed increase is necessary and appropriate to maintain safe and efficient services at lower volume levels?

Feedback:

Air New Zealand acknowledges that Airways is not targeting an EVA=0 return in FY23. This is appropriate given the current state of the air travel industry, particularly across international markets, many of which remain subject to various entry restrictions and complex public health requirements imposed by Governments in response to COVID-19.

Air New Zealand considers it is counter-intuitive to increase unit prices at a time of lower volumes in an effort to return to pre-COVID-19 revenue levels. A better approach would be to limit increases, and even reduce prices, in order to facilitate a return to sustainable operations for airlines. As core pieces of national infrastructure, Governments should continue to support air navigation service providers – if anything the pandemic has highlighted the vital part entities such as Airways play in facilitating critical connectivity, ongoing national economic activity and maintaining crucial supply chains in the face of vastly fewer international passenger movements.

Air New Zealand supports IATA's proposed "step-change" approach under which increases could be linked to real increases in traffic as we return to pre-COVID levels of activity and associated revenue.

Q9: Recognising that the inflation inputs will be updated with current information at the time of setting final prices, do you agree with the inflationary inputs used to uplift GA prices?

Feedback:

Air New Zealand notes that Airways has proposed using the NZIER LCI SEP21 forecast to inflate GA prices but has not applied this, even as an interim measure for commercial airline pricing. We would like to understand the rationale for this.

Q10: Do you agree with the proposed changes to Milford prices?

Feedback:

NA

Section: Scorecard

Q11: Would you find it useful to receive the Scorecard metrics in Appendix 3?

Feedback:

Air New Zealand considers the proposed Scorecard metrics described in Appendix 3 would be a very useful and transparent tool for tracking Airways' performance over the period. We look forward to continuing to work with Airways to refine these measures.

You are also welcome to provide feedback on other topics relating to the proposed pricing.

Feedback:

As noted in Airways' consultation document, the past two years have been very challenging for all in the sector. The path to recovery remains uncertain and it will continue to be vital that all parts of the sector continue to bear a fair share of the burden.

All participants in the sector are facing the challenge of maintaining safe, efficient, and sustainable operations in a demand environment vastly different from that we faced prior to January 2020. Unfortunately airlines, and our passengers, as the end users of most of these services, bear the heaviest burden of this low demand, with cost challenges apparent across a range of monopoly suppliers. Airways should not consider its pricing intentions in isolation from other parts of the aviation system.

The charging regimes for border control, aviation security, Airways, civil aviation regulation, airports and biosecurity are at various stages of review and as costs to operate rise, entities across the system seek to recover these increases from fewer passengers.

Layering multiple cost increases on the sector will simply prolong the recovery and impact our ability to return to the vibrant economic activity enjoyed a few years ago. The passenger base does not exist to cover the range and scale of cost increases and the sector as a whole will suffer.

New Zealand's economic recovery is closely bound to domestic and international airline connectivity. When any one increase is proposed, it needs to be done in consideration of the cumulative impact of each proposed increase and what this means for that broader recovery objective.

On a separate note, and as noted in relation to the timing of capital expenditure entering the pricing asset base, Air New Zealand considers it would be useful if Airways' provided a detailed financial model of its pricing calculations. This would enhance transparency and increase our comfort with the proposed pricing outcomes.