Volume risk sharing for aircraft over 5 tonnes

Consultation Response Document

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10 April 2017

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Contents

1 Executive Summary

Airways' Pricing Framework and Standard Terms and Conditions include a risk sharing mechanism to account for significant fluctuations in volume within a pricing period. While the mechanism has worked effectively in the past when volume variations are moderate, the exceptional growth experienced in the 2015/16 year highlighted that the mechanism is not effective when volume variations are large.

Airways issued a proposal document on 13 February 2017 detailing refinements to the risk sharing mechanism to provide a more equitable sharing of risk between customers and Airways.

This document represents the final stage in Airways' consultation process and includes a summary of the feedback received, Airways' response to that feedback and the final risk sharing mechanism.

Airways received submissions from Air New Zealand, Board of Airline Representatives of New Zealand (BARNZ), International Air Transport Association (IATA), and Qantas Group which were carefully considered. The key changes to the risk sharing mechanism resulting from this consultation are:

- **Trigger for risk sharing mechanism to be based on forecasted airline schedule information -** In the first two years of a pricing period Airways will reforecast the following year's revenue based on airline schedules. If the forecast for the following year indicates that revenue will lie outside a range of +/- 2% of the target pricing revenue, then a price reset will be triggered for that following year.

- **Removal of the 75%/25% sharing of risk outside the 2% range –** To make the risk sharing mechanism simpler and easier to understand the 75%/25% feature of the risk sharing mechanism has been removed. Airways will bear all of the risk and receive all of the rewards for forecasted revenue variances less than 2%. Prices will be adjusted up, or down, for variances greater than 2%.

- **Changes to apply to the 2017/18 year -** The published prices for the 2017/18 year will be the first subject to the new risk sharing mechanism. Airways will accordingly be making the results of its traffic volume forecast (as at 1 April) available to airlines on 30 April 2017 and looking to receive any schedule updates or details of other expected schedule changes by 15 May 2017.

A detailed response to submission topics is provided in section 3 of this document.

2 Introduction

Airways invited feedback on its proposed changes to the risk sharing mechanism in February and March 2017. The proposal document can be found on our website at:

http://www.airways.co.nz/products-and-services/air-navigation-services/new-zealand-service-framework/proposed-changes-to-airways-pricing-framework/

2.1 Document purpose

The purpose of this document is to:

- Summarise the key issues raised by submitters to *Volume risk sharing for aircraft over 5 tonnes.*
- Outline Airways' responses and the rationale for those responses.
- Describe the changes made to the risk sharing mechanism.

2.2 Consultation process

This document completes the consultation process by providing Airways' responses to the issues raised in submissions, and describing the changes to the risk sharing mechanism. The consultation process is summarised in figure 1.

Figure 1: Consultation process

Task or milestone	Planned date	Status
Consultation documents released	13 Feb 2017	✔ Completed
Closing date to request additional information	27 Feb 2017	✔ Completed
Deadline for submissions	6 Mar 2017	✔ Completed
Submissions published on Airways' website	8 Mar 2017	✔ Completed
Airways' decision	6 Apr 2017	✔ Completed
Publication of Consultation Response Document and any changes to the Pricing Framework and Standard Terms and Conditions	10 Apr 2017	✔ Completed

2.3 Background

Current mechanism

Airways' Pricing Framework and Standard Terms and Conditions include a volume risk sharing mechanism to account for significant fluctuations in volume within a pricing period.

The current mechanism automatically adjusts prices when volumes are more, or less, than 2% of the original forecast made when Airways' sets its three-yearly prices. The mechanism has the following features:

- No adjustment is made to prices when actual volumes are within a range of +/- 2% of the original forecast. This means there is a 2% neutral zone in both directions where small variations in revenue are absorbed by Airways.
- When actual volumes are outside the range of +/- 2% range of the original forecast the difference is shared between Airways and Customers, with 75% of the difference being reflected in the following year's prices. 25% of the difference is absorbed by Airways.
- No reset is required at the end of the final year of the pricing period as the following year's prices are adjusted to reflect actual volumes as the part of the three-yearly price setting process.

2.4 Submissions received

A total of four written submissions were received from Air New Zealand, Board of Airline Representatives of New Zealand (BARNZ), International Air Transport Association (IATA), and Qantas Group

Customer submissions were published on Airways' website on 8 March 2017 to ensure transparency.

It should be noted that, while all feedback has been considered in making the decisions set out in section 3, and this document provides a summary of the key points made in the submissions, this document is not intended to provide an exhaustive list of all points raised.

For a full list of submissions please refer to our website, at:

http://www.airways.co.nz/products-and-services/air-navigation-services/new-zealand-service-framework/proposed-changes-to-airways-pricing-framework/

3 Consideration of submissions

This section provides Airways' response to the topics raised in the four submissions received.

Airways have carefully considered all four submissions received before finalising changes to the risk sharing mechanism. An example calculation of how a price reset would be calculated following the changes is provided in appendix 1.

3.1 Trigger mechanism and basis for a within period price reset

Current mechanism

Currently a price reset is triggered when unexpected variations in volume cause actual revenue for a year to be more than 2% different (in either direction) from the required revenue set as part of the three-yearly price setting process. The price reset applies to the year following the year when the unexpected volume variation occurred. The difference between the actual revenue and the 2% neutral zone is the basis for calculating the amount of the price reset.

Airways' proposed

By 30 April of years 1&2 of a pricing period Airways will prepare a revenue forecast for the following year based on airlines' published schedules. If the forecast indicates that revenue is likely to be outside a range of +/- 2% of the required revenue set as part of the three-yearly price setting process, then a price reset will be required for the following year. If the forecast indicates that the forecast revenue is likely to be within +/- 2% of the required revenue, then no price reset will occur. The forecast will be the basis for calculating the amount of the price reset. Note this mechanism is not required in the third year of a pricing period because the following year's prices will be recalculated as part of the usual price setting process.

Summary of submissions

There were no objections to the proposal to use a forecast as the trigger and basis of a price reset.

Customer feedback mostly sought clarification about how the forecasts would be shared with customers and the level of consultation required before prices were reset. BARNZ submitted that Airways should consult with airlines on revised forecasts and should only update prices when there is clear airline support. IATA submitted that forecasts should be made available to airlines even if the estimates do not exceed the 2% range.

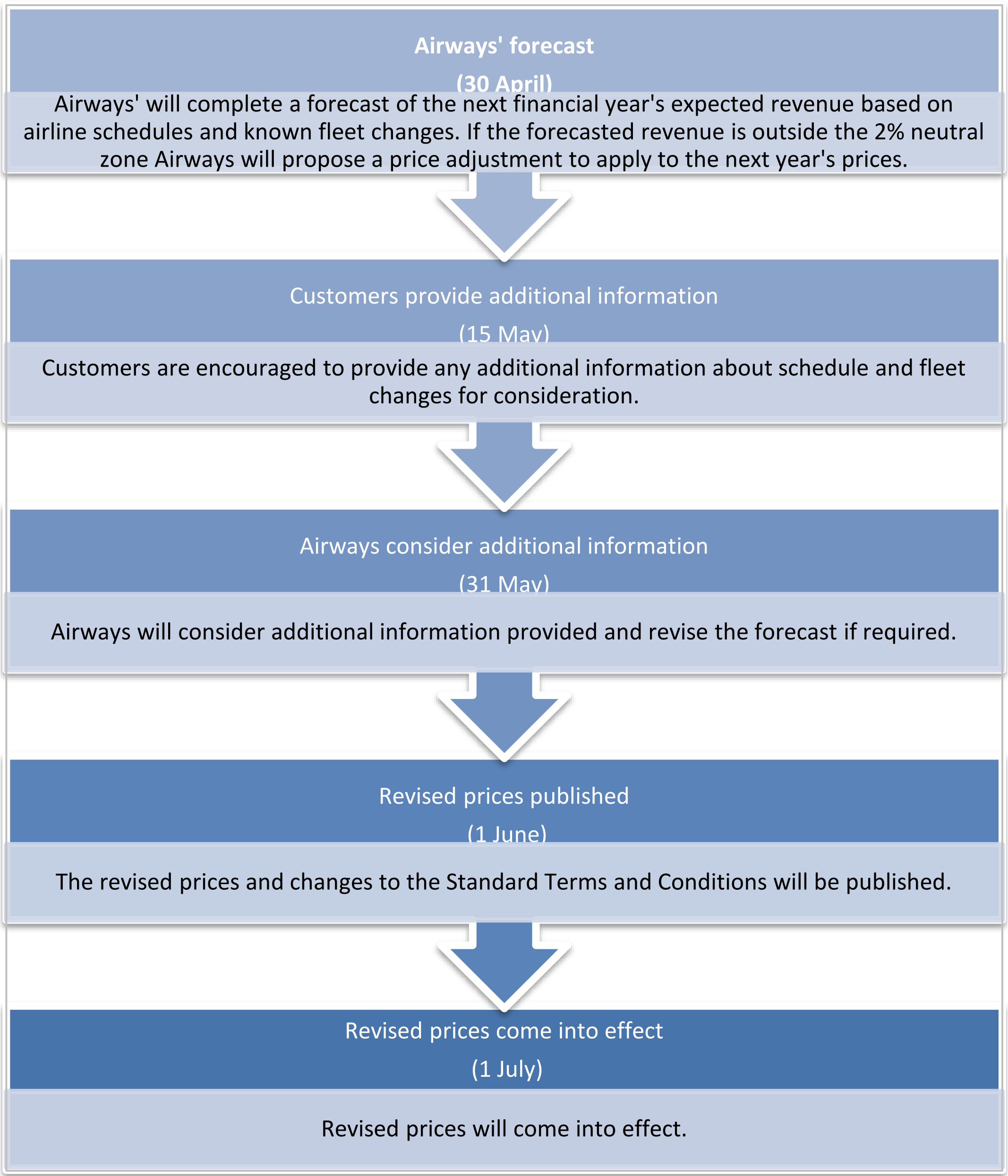
Airways' response

Airways will use a forecast of the following year's revenue based on airline schedules as the trigger and basis of a price reset. The price reset process is outlined in figure 2. Each year Airways will complete a forecast of the next financial year's expected revenue based on airline schedules. Airways will publish the outcomes of the forecast, along with any significant assumptions by 30 April.

In response to BARNZ's submission, customers will have a 15-day period to provide additional information around airline schedules and fleet changes for consideration before Airways set the final prices on 31 May. This process is similar to the consultation process already used during the three-yearly pricing consultation process. The consultation process is focussed on ensuring an equitable and timely pricing outcome for both customers and Airways. While airlines will be given a period to provide additional information and comment, the obtaining of 'clear airline support' may not be practical given the relatively short timeframe between when forecast information becomes available and when the following year's prices need to be published.

In response to IATA's comments, Airways agree that the forecast information will be provided regardless of whether a price reset is required.

Figure 2: Price reset process.



3.2 Size of the neutral zone

Current mechanism

Currently if there is less than a 2% deviation between actual revenues and the original forecasted revenue there is no change made to prices. Within this 2% neutral zone Airways bears all of the risk and receives all of the rewards. The neutral zone means that small variations in traffic do not result in changes in price.

Airways' proposed

No change to the current 2% neutral zone.

Summary of submissions

Two submitters commented on the size of the neutral zone. BARNZ supported the retention of the 2% neutral zone, while Qantas did not support the symmetrical nature of the neutral zone. Qantas argued that the zone should only apply to forecasted over recoveries because Airways' downside risk is reflected in Airways' Weighted Average Cost of Capital (WACC) calculation.

Airways' response

Airways disagree with the Qantas argument that Airways' downside risk is already reflected in its WACC. Airways' risk relative to the overall market risk is reflected in the asset beta component of the WACC calculation. Airways use an asset beta of 0.6 which is in line with NATS (the air traffic provider in the United Kingdom) and Airservices (Australia's provider). Both NATS and Airservices have volume risk-sharing mechanisms and Airways considers these businesses comparable for the purposes of estimating asset beta. The removal of the downside neutral zone would lead to a higher asset beta and therefore a higher WACC and prices for customers.

The symmetrical 2% neutral zone will be retained.

3.3 Balance of risk sharing between customers and Airways

Current mechanism

Under the current volume risk sharing model any variance greater than 2% is shared between customers and Airways with customers bearing 75% of the volume risk, and Airways bearing 25%. This means that if the aggregate volume of traffic falls by 10%, Airways' revenue will fall by 4%. The reverse is also true: if traffic increases by 10%, Airways' revenue will increase by 4%.

Airways' proposed

Airways proposed to remove the risk weighting from the pricing reset calculation and simply adjust prices back to the limit of the neutral zone. This means that if the aggregate volume of traffic falls by 10%, prices will increase by 8% and Airways' revenue will fall by 2%. The reverse is also true: if traffic increases by 10%, prices will reduce by 8% and Airways' revenue will increase by 2%.

Summary of submissions

BARNZ and Air New Zealand both supported the removal of the 75%/25% sharing of risk outside the 2% neutral zone. IATA disagreed with the removal of the 75%/25% sharing, especially as there is no mechanism that addresses actual variances from previous years.

Airways' response

The 75%/25% balance of risk sharing between customers and Airways was introduced as part of the Pricing Framework changes in 2012 following extensive consultation. The purpose of the 75%/25% risk sharing approach was to:

i) Encourage Airways to achieve economies of scale when volumes are higher than forecast, and

ii) Encourage Airways to find cost savings when volumes are lower than forecast.

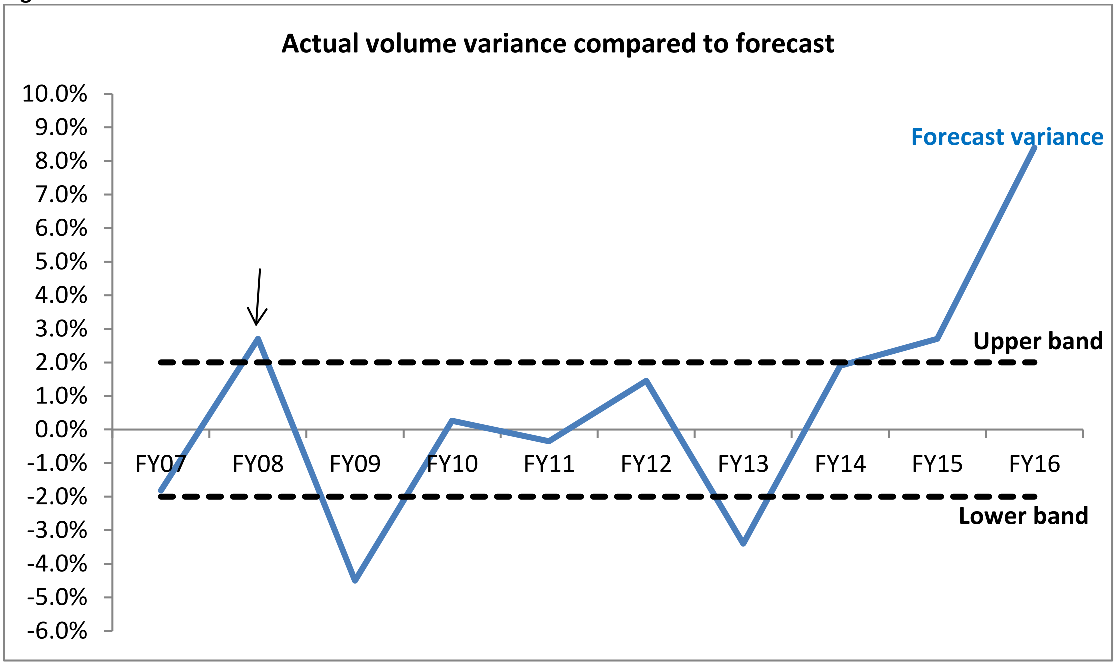
Figure 2 compares the pricing and revenue impact with, and without, the 75%/25% risk sharing approach. Figure 2 shows that when actual growth is within 2 – 3% of forecast the 75%/25% risk sharing component is relatively immaterial.

Figure 2 – Impact of the 75%/25% risk sharing approach

Actual volume variance	With 75%/25% risk sharing		Without 75%/25% risk sharing	
	Revenue adjustment	Price adjustment	Revenue adjustment	Price adjustment
2.0%	$0.0m	0.0%	$0.0m	0.0%
2.5%	$0.7m	0.4%	$0.9m	0.5%
3.0%	$1.3m	0.8%	$1.8m	1.0%
3.5%	$2.0m	1.1%	$2.7m	1.5%
4.0%	$2.7m	1.5%	$3.6m	2.0%
4.5%	$3.4m	1.9%	$4.5m	2.5%
5.0%	$4.1m	2.3%	$5.5m	3.0%

Aside from the 2015/16 year which is a clear outlier actual volume variances are typically within the 0 – 3% range as shown in figure 3.

Figure 3 – Historic volume variances



In practical terms the objectives of encouraging Airways to achieve economies of scale when volumes are higher than expected, and achieve cost savings when volumes are lower than expected are already achieved by the 2% neutral zone. The 75%/25% sharing of risk outside the neutral zone adds extra complexity and does not significantly alter the equitable sharing of risk between customers and Airways. The 75%/25% sharing of risk will be removed.

3.4 Price resets to apply to airline prices only (users of 5 tonnes and over)

Current mechanism

The current Pricing Framework and Standard Terms and Conditions do not specify which prices a price reset will apply to.

Airways' proposed

For clarification purposes any price reset resulting from the risk sharing mechanism will be applied to prices for users of aircraft from 5 tonnes MCTOW and over (i.e. airlines) only.

Summary of submissions

There were no submissions on this topic.

Airways' response

If a price reset is required under the volume risk sharing mechanism it will be achieved by amending the weight rates that apply to users over 5 tonnes.

3.5 Proposed amendments to the Standard Terms and Conditions

Airways' proposed

To achieve the changes outlined above, it is proposed to amend clause 6.3 of the Standard Terms and Conditions as follows:

6.3 Airways will amend the charges specified in the pricing schedule within a current pricing period in the following circumstances:

6.3.1 ***Forecast Volume fluctuations – Aircraft of 5 tonnes and over***

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 (each a "Reset Year") indicates that revenue derived from such aircraft movements will be outside a range of -2% to +2% from the target pricing revenue used when fixing prices at the start of the relevant pricing period (the "Target Revenue"), Airways will reset prices in respect of such aircraft for the relevant Reset Year. This forecast and reset process shall proceed as follows:

a) Airways will undertake a traffic volume forecast in April of the year preceding each Reset Year (a "Forecast Year") based on airlines' published schedules as at 1 April in the Forecast Year.
b) Airways will post the results of such forecast on its website (or otherwise advise affected operators of the outcomes) on or about 30 April in the Forecast Year.
c) Airways will subsequently update its forecast to take account of:
   a. any updates to airlines' published schedules notified by affected operators before 15 May in the Forecast Year; and
   b. at Airways' absolute discretion, any other expected schedule changes advised by affected operators before 15 May in the Forecast Year.
d) The final forecast completed as outlined above, shall be used to reset prices for the relevant Reset Year as follows:
   a. Airways will bear or receive the benefit of the first 2% of any revenue variance between the Target Revenue for the relevant Reset Year and the forecast revenue.
   b. Prices will be set at the level necessary to adjust (up or down) for any remaining variance between the Target Revenue and the forecast revenue.

Summary of submissions

There were no submissions on this topic.

Airways' response

The proposed changes to section 6.3 of the Standard Terms and Conditions will be made.

3.6 Effective date for the proposed Pricing Framework changes

Airways' proposed

The published prices for the 2017/18 year will be the first subject to this price reset mechanism. Airways will accordingly be making the results of its traffic volume forecast (as at 1 April) available to airlines on 30 April 2017 and looking to receive any schedule updates or details of other expected schedule changes by 15 May 2017.

Summary of submissions

Air New Zealand supported the implementation of changes in time for the 2017/18 financial year.

Airways' response

The published prices for the 2017/18 year will be the first subject to this price reset mechanism.

Appendix 1: Example price reset calculation

The calculation below demonstrates how the risk sharing mechanism will be applied and how a price reset would be calculated across a three-yearly pricing period.

	Year 1	Year 2	Year 3
Target revenue (set as part of three-yearly price setting consultation)	100	100	100
Forecasted revenue based on airline schedules[1]	-	101	103
Variance from target revenue	-	1.0%	3.0%
Price adjustment required	-	Not required	(1.0%)[2]

[1] Note a forecast is not required for the first year as the target revenue set during the pricing consultation has already been based on airline schedules.

[2] Calculated to be the price adjustment required to reduce target revenue to the upper limit of the 2% range.

