Volume risk sharing for aircraft over 5 tonnes

Proposed changes to Airways' Pricing Framework & Standard Terms and Conditions

13 February 2017

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1 Purpose

This document outlines Airways' proposed changes to the risk sharing section of its Pricing Framework (Section 5.2 of the *Pricing Framework -July 2012)* and the associated provisions of its Standard Terms and Conditions for the Provision of Airways' Services (i.e. clause 6). The current provisions are included in full in appendix 1.

The proposal seeks feedback regarding the following proposed changes to the automatic price adjustment mechanism:

a. In the first two years of a pricing period Airways will reforecast the following year's revenue.

b. 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.

c. If a price reset is required this reset will be based on the forecasted volumes for the affected year rather than the prior year's revenue.

Section 5 of this document provides a detailed explanation of the proposed Pricing Framework & Standard Terms and Conditions changes.

2 Consultation Process

The key steps in the consultation process are set out in figure 1.

Figure 1: Consultation timetable

Task or Milestone	Date
Consultation documents released	13 February 2017
Closing date to request additional information	27 February 2017
Deadline for submissions	6 March 2017
Submissions published on Airways' website	8 March 2017
Airways' decision	6 April 2017
Publication of any changes to the Pricing Framework & Standard Terms and Conditions	10 April 2017
Any resulting Pricing Framework changes come into effect	30 April 2017

3 Guide to making a submission

Airways welcomes feedback on this proposal. To make a submission, please read through the document and respond in writing by 6 March 2017. All submissions will be carefully considered before any changes to the Pricing Framework are finalised and published on 10 April 2017.

Please send submissions, or lodge enquiries on this proposal to: Submissions@airways.co.nz

Alternatively you can mail to:

Strategy and Pricing
Airways Corporation of New Zealand
100 Willis St
PO Box 294
Wellington 6140

Important note for submissions

All submissions will be made available to the public on Airways' website. However, you can request the removal of content as commercially-sensitive or confidential and Airways will remove the information prior to publication. Submitters should highlight in their submissions any comments or contents that are commercially-sensitive or confidential.

4 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 mechanism works effectively when volume variations are moderate, but the price adjustment made for the 2015/16 year highlighted that the mechanism was ineffective at adjusting prices when volume variations are large.

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.

This risk sharing mechanism was introduced as part of Airways' Pricing Framework which was implemented in 2012 following a robust public consultation. As part of the Pricing Framework consultation a number of risk sharing mechanisms were put forward for discussion and customer feedback. The current risk sharing mechanism was preferred because:

- The automatic price reset mechanism is transparent and simple to administer.
- The 2% neutral zone in both directions provides predictable pricing – price adjustments are only required for significant volume fluctuations.
- The 75%/25% sharing of risk encourages Airways to find cost savings in times when volume growth is lower than expected, and recognise economies of scale when volume growth is more than expected. This improves the alignment between Airways' business drivers and those of our customers.
- The mechanism provides a symmetrical sharing of volume risk and reward.

5 Proposed changes to the risk sharing mechanism

This section outlines the components of the proposed risk sharing mechanism:

5.1 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' proposal

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% (in either direction) 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.

Rationale

The current mechanism effectively creates a one year lag in the price reset process because it uses a historic measure as the trigger to set prices in the future. In other words, the mechanism to initiate a price reset is based on the previous year's results that may be unrelated to the year in which the price reset occurs. The adjustment is also based on historical information that may not reflect the direction and magnitude of growth in the upcoming year, resulting in an inaccurate forecast (this situation occurred when prices for the 2015/16 year were reset based on the historic results from 2014/15).

Resetting prices based on a future forecast is likely to produce more accurate prices than a mechanical price reset based on historic results. Airways have historically been able to forecast one year in advance with a reasonable degree of accuracy by using airline schedules. Traditionally Airways' forecast for the first year of a pricing period has been within 1% of the actual result.

5.2 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' proposal

No change to the current 2% neutral zone.

Rationale

The size of the neutral zone was carefully considered during the 2012 Pricing Framework consultation. The level of 2% was determined to be an appropriate level to ensure that the risk sharing mechanism was only triggered by major economic variations, not normal forecast variations. In practice this has been the case with the one trigger event occurring in 2015 following an unprecedented fall in the price of fuel which drove a significant increase in volume growth.

5.3 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' proposal

Airways propose to remove the risk weighting from the pricing reset 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%.

Rationale

The Pricing Framework consultation in 2012 highlighted the need for Airways to share some of the risk to provide an incentive to reduce costs in times of declining volumes, and seek economies of scale during periods of higher than expected volumes (i.e. fund any additional costs the increasing traffic volumes may cause). Customers strongly supported the notion that Airways should have 'some skin in the game'.

The neutral zone already achieves this sharing of risk without the need for the further complexity of a 75%/25% risk sharing calculation. By resetting prices back to the limit of the neutral zone Airways risk and reward is effectively capped at 2%. This still provides Airways with an incentive to reduce costs in times of declining volumes and seek economies of scale during periods of higher than expected volumes.

5.4 Price resets to apply to airline prices only (users over 5 tonnes)

Current mechanism

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

Airways' proposal

For clarification purposes any price reset resulting from the risk sharing mechanism will be applied to airline prices only.

Rationale

Airline prices are calculated based on the underlying cost to provide the service, a fair return to the shareholder and changes in volume. In comparison, GA prices are not directly calculated from the underlying cost of the service or the change in volumes.

5.5 Proposed amendments to the Standard Terms and Conditions

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.

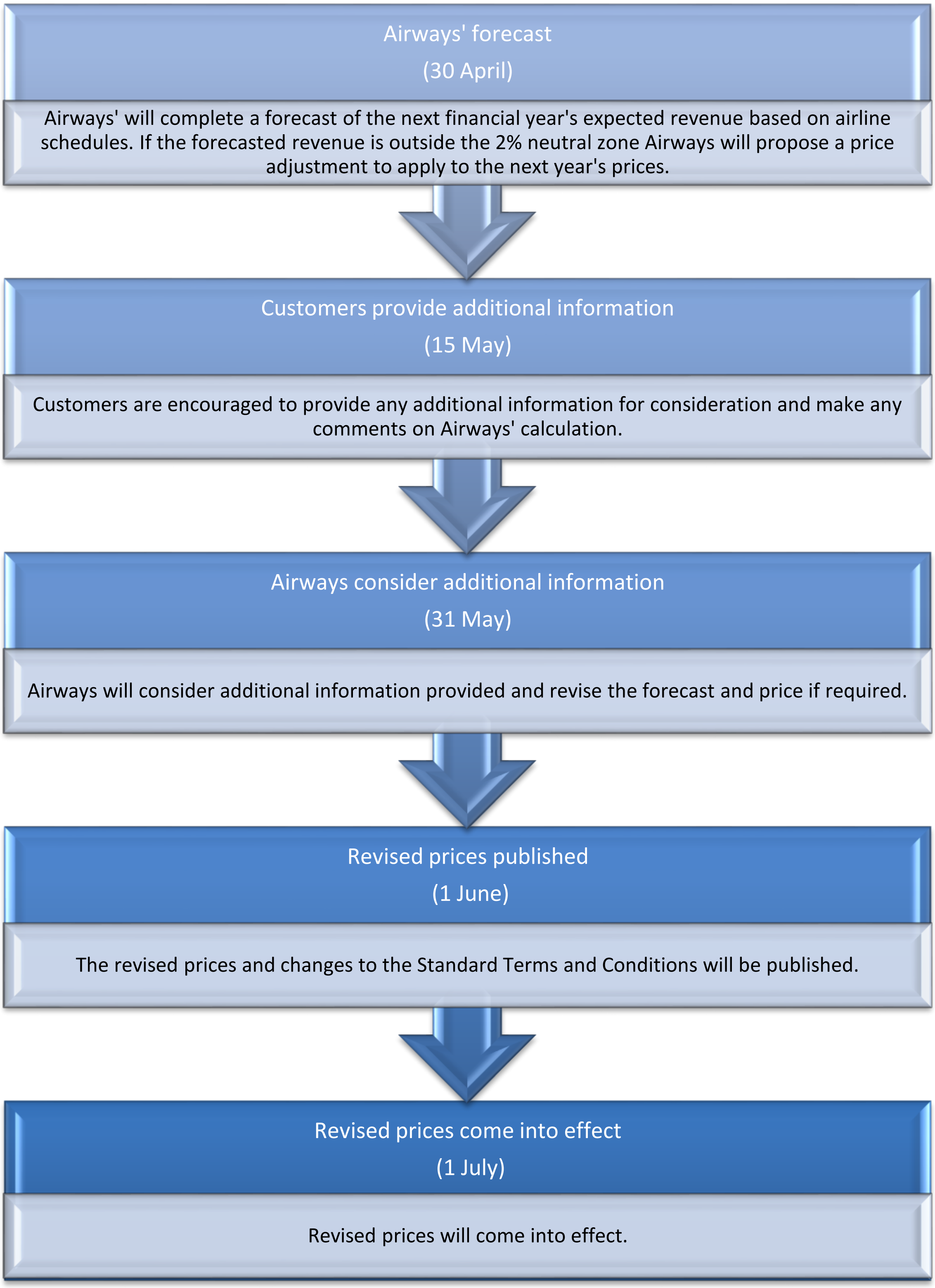
5.6 Effective date for the proposed Pricing Framework changes

Any change to the Pricing Framework and Standard Terms and Conditions resulting from this consultation will be effective from 30 April 2017. The published prices for the 2017/18 year will be the first subject to this price reset mechanism.

6 Summary of the proposed price reset process

Figure 2 outlines how the annual price reset process would occur based on the proposed changes to the risk sharing mechanism.

Figure 2: Proposed price reset process.



Appendix 1 – Current volume risk sharing mechanism

EXTRACT FROM PRICING FRAMEWORK

Volume risk / reward sharing

A key risk faced by Airways is that the volume of traffic that is anticipated at the start of the pricing period does not eventuate. Airways' cost structure is not flexible in the short term to fluctuations in volumes. To mitigate the risk to Airways' financial sustainability, Airways operates a volume risk sharing mechanism based on variations in base revenue from the forecast. Changes in base revenue are used as a proxy to changes in volume. Base revenue is determined through the cost building blocks described in section 5.1 (base revenue excludes any adjustment for risk sharing or efficiency and innovation mechanisms). Prices are determined from base revenue and expected demand volumes (i.e. the forecast volume and weight of traffic). Any difference between base revenue earned in a year and the forecast is, therefore, a result of unexpected variation in volumes.

Prices will automatically be adjusted when base revenue fluctuates significantly from the original forecast.

This mechanism has the following features:

- Revenue difference less than 2%: Airways bears all of the risk and receives all of the rewards. This 2% neutral zone means small variations in traffic or forecasting errors do not result in changes in price.
- Revenue difference greater than 2%: Airways bears 25% of the revenue difference, our customers bearing 75%. 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%.

Any adjustment is made to total revenue in the year following the unexpected variation in volume. The adjustment is made when prices are set for the year. The adjustment is made for one year. Note that if the unexpected variation in volume is in year 3 of a pricing period, the adjustment will occur in year 1 of the next pricing period.