



## Supplementary submission to the Productivity Commission

### Economic Regulation of Airports 23 November 2018



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# Table of Contents

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<b>Table of Contents</b> .....		<b>2</b>
<b>List of abbreviations</b> .....		<b>3</b>
<b>Part A: Executive summary</b> .....		<b>4</b>
1.	Introduction	4
2.	Structure of this submission	5
<b>Part B: A suggested way forward</b> .....		<b>6</b>
1.1	Current regulatory environment facilitates positive commercial outcomes	6
1.2	Sydney Airport supports the development of negotiation and contracting principles	11
1.3	Principles should address key issues	11
<b>Part C: Appendices</b> .....		<b>13</b>
Appendix 1.	Response to other submissions	13
Appendix 2.	Response to specific comments about Sydney Airport	18
Appendix 3.	Response to other issues	20
<b>Part D: Confidential Appendices: Commercial in Confidence</b> .....		<b>22</b>

## List of abbreviations

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<b>2001 ACCC Decision</b>	ACCC, <i>Sydney Airports Corporation Ltd: Aeronautical Pricing Proposal Decision</i> , May 2001
<b>2015 BARA ASA</b>	The Aeronautical Services Agreement for International Air Operators negotiated between the Board of Airline Representatives and Sydney Airport in 2015
<b>A4ANZ</b>	Airlines for Australia and New Zealand
<b>A4E</b>	Airlines for Europe
<b>AAA</b>	Australian Airports Association
<b>AAA Supplementary Submission</b>	AAA supplementary submission dated 5 November 2018
<b>ACCC</b>	Australian Competition and Consumer Commission
<b>ASA</b>	Air Services Agreement
<b>BARA</b>	Board of Airline Representatives of Australia Inc
<b>Commission</b>	Productivity Commission
<b>EBITA</b>	earnings before interest, tax and amortisation
<b>EBITDA</b>	earnings before interest, tax, depreciation and amortisation
<b>First Submission</b>	Sydney Airport's submission to the Commission dated 10 September 2018
<b>IATA</b>	International Air Transport Association
<b>ICAO</b>	International Civil Aviation Organisation
<b>ICF</b>	Industry Consultative Forum
<b>KPI</b>	key performance indicator
<b>ROCE</b>	Return on Capital Employed
<b>T1</b>	Terminal 1 (International terminal)
<b>T2</b>	Terminal 2 (Common user domestic terminal)
<b>T3</b>	Terminal 3 (Qantas domestic terminal)
<b>WACC</b>	weighted average cost of capital
<b>YTD</b>	year to date

# Part A:

## Executive summary

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### 1. Introduction

Sydney Airport provided a submission to the Productivity Commission's inquiry into the economic regulation of airports on 10 September 2018 (**First Submission**). This supplementary submission is made to the Productivity Commission (**Commission**) after Sydney Airport has had the opportunity to review the submissions made by other participants.

The current regulatory environment is effective and facilitates the negotiation of commercial agreements between airports and stakeholders. While negotiations can be protracted, this is not a sign that the current regulatory environment is ineffective. Rather, it reflects the comparable strength in the bargaining position of each party to the negotiations.

Under the current regulatory regime, the Australian Competition and Consumer Commission's (**ACCC**) monitoring of pricing and quality of service has not identified a market failure. On the contrary, Sydney Airport has negotiated and agreed with airlines a number of increasingly mature and sophisticated mutually beneficial commercial agreements that also benefit passengers.

This maturity is evidenced by the agreement negotiated between the Board of Airline Representatives (**BARA**) and Sydney Airport in 2015 (**2015 BARA ASA**), which fosters collaboration between Sydney Airport and airlines. The ACCC and BARA noted these "commercial arrangements... provide a step forward regarding service assurance at [Sydney] airport"<sup>1</sup> and they "should serve as a model for Australia's other major international airports"<sup>2</sup> respectively.

Heavy regulatory intervention resulting in arbitrated outcomes disincentivises negotiation on commercial terms, reverses the gains and maturation of existing negotiated agreements, invites gaming of the regulatory arrangements and unnecessarily increases the regulatory (red tape) burden.

The Australian aviation industry, particularly Sydney Airport, is working well for all stakeholders as indicated by the following:

- **Airports** have improved efficiency of operations and service levels, and Sydney Airport has invested extensively and efficiently to meet the increasing demand for air travel.
- **Airlines** have benefited from reasonable pricing for aeronautical services and efficient investment at, and operation of, Sydney Airport. Airlines have negotiated, on a commercial basis, sophisticated, fair and balanced agreements with Sydney Airport to meet their bespoke requirements. Domestic and regional airlines have recently reported healthy profits<sup>3</sup>.
- **Passengers** have benefited from increased choice and airline competition with 47 airlines now operating at Sydney Airport, declining airfares and improvements in service quality standards at Sydney Airport over time.
- The **Wider Community** has benefited from the contribution airports make. Australian aviation is vitally important to the Australian economy, with the Sydney Airport precinct making a significant contribution by generating \$38 billion in economic activity each year. Sydney Airport competes

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<sup>1</sup> *Airport Monitoring Report 2015-16*, Australian Competition and Consumer Commission (ACCC), 2017 p. 12

<sup>2</sup> *Airline Views*, Board of Airline Representatives, June 2017

<sup>3</sup> AAA Supplementary Submission, p 2.

globally to attract airlines and in doing so brings an ever-greater number of passengers and trade from all over the world.

The success of the Australian aviation industry has been supported by the current regulatory regime. Sydney Airport is subject to very real constraints and does not exercise market power. There is no need for the introduction of a new untested regulatory regime. Additional regulation would be a backward step likely to threaten the trend of the significant improvements that have been made under the current regulatory regime.

Sydney Airport appreciates, however, that the negotiation processes and behaviours of both airports and airlines could be improved without the impost of commercially distorting regulation. Sydney Airport also believes that commercial agreements should be fair, balanced and reasonable. Therefore, Sydney Airport supports the AAA's proposal for the establishment of principles for negotiating and contracting that provide guidance for:

- a structured, transparent and constructive approach to negotiations for both airlines and airports, with a focus on positive outcomes for passengers; and
- the elements of an acceptable agreement.

Any decision on the form and substance of this guidance should be made in consultation with all stakeholders. Sydney Airport would welcome the opportunity to participate in the development of such guidance.

## **2. Structure of this submission**

This submission is structured as follows:

**Part B** presents a suggested way forward.

It provides a list of matters that Sydney Airport considers that a commercial negotiation between airlines and airports should resolve. It also compares the terms in Sydney Airport's 2015 BARA ASA with BARA's position on reasonable commercial outcomes. In this Part, Sydney Airport supports the establishment of negotiating and contracting principles, in consultation with all stakeholders.

**Part C** contains the Appendices to this submission.

**Appendix 1** discusses the submissions made by airlines and rebuts assertions that Sydney Airport has exercised market power. In particular, evidence is provided to show that Sydney Airport is not earning excessive returns, that service quality has increased at Sydney Airport and that investments are being made efficiently. This evidence is provided to assist the Commission to assess the claims made by airlines and airline groups.

**Appendix 2** responds to specific comments made about Sydney Airport in various submissions. This includes explanations on how the free drop-off and pick-up area at Sydney Airport is classified and operates, Sydney Airport's investments in the international terminal baggage system and the proportion of passengers that are transfer passengers at Sydney Airport.

**Appendix 3** provides information on how Sydney Airport treats the recovery of security assets, and what the security charge to airlines is. This appendix also corrects a statement in the First Submission in relation to how BARA members respond to the ACCC monitoring report.

**Part D** contains the Confidential Appendices to this submission.

## Part B:

### A suggested way forward

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#### 1.1 Current regulatory environment facilitates positive commercial outcomes

- 1 The current regulatory environment is effective and facilitates the negotiation of commercial agreements between airports and stakeholders. While negotiations can be protracted, this is not a sign that the current regulatory environment is ineffective. Rather, it reflects the comparable strength in the bargaining position of each party to the negotiations.
- 2 There have been references in some airline submissions such as the A4ANZ and Qantas submissions, to airports adopting a ‘take it or leave it’ approach to negotiations<sup>4</sup>. This is not reflective of Sydney Airport’s approach or experience.
- 3 Sydney Airport agrees with BARA’s view that a commercial negotiation should resolve the following matters:
  - *“What are the services to be delivered*
  - *To what standard are the services to be delivered*
  - *What is necessary to deliver the services*
  - *How should success be measured*
  - *What are the accountabilities for airports and airlines*
  - *What are the legal rights and limitations of each party*
  - *And finally, pricing.”*

*BARA, Submission to the Productivity Commission – Economic regulation of airports, 3 Sept 2018, p 8*
- 4 Sydney Airport also agrees with BARA that by directly negotiating these issues, the commercial agreement and subsequent outcomes would be better than if determined by an economic regulator<sup>5</sup>. Similarly, Sydney Airport believes that negotiated outcomes will be better for all parties than arbitrated outcomes.
- 5 Sydney Airport further agrees with BARA that commercial agreements should be balanced and reasonable<sup>6</sup>. Indeed, the current 2015 BARA ASA goes a long way towards addressing the commercially-balanced outcomes BARA suggests in its submission, as set out in Figure 1 below.

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<sup>4</sup> See, for example, Qantas Group, *Qantas Group Submission: Productivity Commission Inquiry into Economic Regulation of Airports*, September 2018, p 8.

<sup>5</sup> BARA, *Submission to the Productivity Commission – economic regulation of airports*, 3 September 2018, p 8.

<sup>6</sup> BARA, *Submission to the Productivity Commission – economic regulation of airports*, 3 September 2018, p 45.

**Figure 1**

**Comparison of Sydney Airport's 2015 BARA ASA with BARA's position on reasonable commercial outcomes**

Commercial item	BARA's position on reasonable commercial outcomes <sup>7</sup>	Sydney Airport's 2015 BARA ASA position
<p><b>Accountability for service delivery</b></p>	<p>BARA seeks agreements that address the degree of skill, care, prudence, foresight and practice which may reasonably be expected from time to time of a skilled and experienced operator of a large international airport. It includes the following practices by the airport operator:</p> <ul style="list-style-type: none"> <li>▪ co-ordination of operations at and around the airport to optimise local capacity;</li> <li>▪ active liaison with all relevant parties to minimise disruption and to facilitate on time performance;</li> <li>▪ co-operation with relevant authorities and all other parties having a guardian role for service delivery at the airport; and</li> <li>▪ development of comprehensive business continuity plans that are coordinated with airport users and other stakeholders.</li> </ul>	<p>Sydney Airport is accountable for service delivery. In clause 2.2 of the 2015 BARA ASA, Sydney Airport commits to supply facilities and services that are fit for purpose, with due care and skill and in accordance with good airport management practice. This is supported by a Service Level Recovery Mechanism which provides a rebate to airlines when a key facility at Sydney Airport is out of service and has caused delay, as outlined in clause 2.6. In practice, Sydney Airport's standard operating procedures are to actively engage and coordinate operations with airlines and key stakeholders in the event of service disruptions.</p> <p>Clause 2.3 facilitates the development of a service level agreement in relation to cleaning and maintenance standards. Further, as outlined in the First Submission, the KPI regime has been implemented much more broadly and includes outcomes around on time performance, queue time, bussing, baggage and customer satisfaction</p> <p>Part 5 of the 2015 BARA ASA sets up the Industry Consultative Forum (ICF) which provides quarterly investment strategy reporting and facilitates discussions on a range of issues including initiation of projects to improve airline and airport operating efficiencies, developing and reporting on service levels and improvements to the international terminal.</p>

<sup>7</sup> BARA, *Submission to the Productivity Commission – economic regulation of airports*, 3 September 2018, p 37 - 39.

Commercial item	BARA's position on reasonable commercial outcomes <sup>7</sup>	Sydney Airport's 2015 BARA ASA position
<b>Allocation of commercial risk</b>	<p>BARA objects to terms that require an airline to waive usual commercial remedies available to an airline; that is, it can seek a legal (financial) remedy for substantial or ongoing breaches of the agreement by the airport operator.</p> <p>BARA seeks that an airport operator is accountable for its actions and those of its contractors.</p> <p>BARA seeks agreements that require small, administratively simple rebates be provided to the airline to formally recognise the airport operator's poor service performance that has significantly disrupted an international flight.</p>	<p>There is a balanced allocation of commercial risk between Sydney Airport and the airlines, and Sydney Airport is accountable for its actions, and the actions of its agents.</p> <p>The 2015 BARA ASA does not contain any term by which airlines agree to waive legal commercial rights. Commercial remedies for breach of agreement are available to each airline. Sydney Airport is accountable for its actions when they cause delays through the Service Level Recovery Mechanism outlined in clause 2.6. This includes timeframes for response by Sydney Airport and a dispute resolution regime.</p>
<b>Individual major project (+600m) terms</b>	<p>BARA seeks clearly defined deliverables and improvement in outcomes to airlines.</p> <p>BARA would like the airport operator to share accountability for delivering the project on time and on budget.</p> <p>BARA seeks that plans and processes for minimising the impact of the construction works on airline operations form part of the project's commercial agreement.</p>	<p>Major projects and delivery dates were provided to airlines in Schedule 1 to the 2015 BARA ASA. Clause 3.3 provides that Sydney Airport will use reasonable endeavours to spend the Total Aeronautical Investment in Schedule 1.</p> <p>The ICF, which was set up under Part 5 of the 2015 BARA ASA, facilitates discussions between airlines and Sydney Airport in relation to the ongoing development of the airport, the implementation of the investment strategy and any changes to charges. Any unplanned capital expenditure is subject to consultation in the Industry Consultative Forum pursuant to clause 3.3(c).</p>
<b>Performance and engagement</b>	<p>BARA states that agreements should require the airport operator to establish a key performance indicator (KPI) regime covering performance measures in the areas of on time performance, baggage, safety and the passenger experience</p>	<p>Sydney Airport has clear performance targets, and regularly engages with airlines. The ICF, which was set up under Part 5 of the 2015 BARA ASA, facilitates discussions between airlines and Sydney Airport, including in relation to developing and reporting on service levels. As part of the new agreement, Sydney Airport established the ICF as</p>



<b>Commercial item</b>	<b>BARA's position on reasonable commercial outcomes<sup>7</sup></b>	<b>Sydney Airport's 2015 BARA ASA position</b>
	<p>BARA seeks that agreements require a new consultative forum established that focuses on applying the commercial agreement and providing continuous improvement in service delivery</p> <p>BARA seeks positive obligations on the airport operator to act in response to identified performance issues.</p>	<p>outlined above, as well as several sub forums such as those with ground handlers.</p> <p>Clause 5.2(c)(2) requires that Sydney Airport and airlines must, within six months, agree on an initial set of KPIs which address planning and resource allocation, baggage, safety and the passenger experience.</p> <p>KPIs were established in consultation with airlines and are now in place and are reviewed quarterly. As outlined in the First Submission, remedies against identified performance issues have been developed through the ICF and have been applied during the course of the agreement.</p>
<b>Compliance with unseen and unprovided issues</b>	<p>BARA seeks that agreements clearly identify specific requirements and airline obligations in agreements.</p>	<p>Sydney Airport is transparent with compliance requirements. Sydney Airport provides requirements in Clause 6.1, and a list of Operating Manuals and documents that airlines must comply with per Clause 6.2 of the 2015 BARA ASA.</p> <p>Sydney Airport has committed that, where appropriate, it will use reasonable endeavours to consult with airlines and provide notice before making changes to these documents.</p> <p>Clause 6.1(b) requires airlines to reasonably co-operate with Sydney Airport. This is required as there are inherent uncertainties to the operating environment, so it is not possible to foresee every event that may eventuate.</p>
<b>Unilateral right to amend</b>	<p>BARA seeks agreements where both parties must agree to any changes to the commercial agreement.</p> <p>BARA requires that airline operating requirements be specified in operating manuals rather than the commercial agreement.</p>	<p>Sydney Airport does not have a unilateral right to change the terms of the 2015 BARA ASA.</p> <p>Airline operating requirements are in operating manuals (referred to in clause 6.2 of the 2015 BARA ASA).</p>

Commercial item	BARA's position on reasonable commercial outcomes <sup>7</sup>	Sydney Airport's 2015 BARA ASA position
<b>Indemnities</b>	<p>BARA acknowledges that it is appropriate to allocate some liability (for example liability for death and personal injury claims) on a no-fault basis but as a general rule, BARA considers that liability should be fault based.</p> <p>BARA states that the risk allocation should reflect which party is best able to manage the risk and should not go beyond what is necessary to protect the airport operator's legitimate business interests.</p> <p>BARA seeks that liability for some risks should be mutual between the airline and airport operator.</p>	<p>The indemnities in the 2015 BARA ASA are fair and balanced. Under clause 8.1, an airline is only required to indemnify Sydney Airport in circumstances where the issue resulted from the airline's (or its associate's) act, omission, default, breach of agreement or breach of any statutory requirement. This liability is reduced proportionally to the extent that the fault is partially caused by Sydney Airport. Sydney Airport similarly indemnifies the airline in clause 8.2.</p> <p>These indemnity clauses do not go beyond what is necessary to protect Sydney Airport's legitimate interests.</p>
<b>Releases</b>	<p>BARA is concerned that releases can undermine insurance cover.</p> <p>BARA's preference is for mutual approach and coverage.</p>	<p>There is a mutual approach to releases in Part 8 of the 2015 BARA ASA.</p>
<b>Fair and reasonable terms</b>	<p>BARA objects to agreements that include clauses requiring airlines to acknowledge the agreement is 'fair and reasonable'.</p> <p>BARA's view is that such 'deeming' clauses should not be included in the commercial agreements.</p>	<p>The 2015 BARA ASA does not contain a clause which requires airlines to acknowledge that the agreement is 'fair and reasonable'.</p>
<b>Future agreements</b>	<p>BARA objects to airlines being required to accept published aeronautical terms and conditions when agreements end. BARA states that members should not be required to accept the price and (draconian) non-price terms published on the airport operator's website.</p>	<p>Practically, in very rare circumstances would this type of fall-back option eventuate. Clause 9.9 of the 2015 BARA ASA provides that the discussion for a new agreement commence by no later than 1 January 2020, which allows for a six-month negotiation period before the current agreement terminates on 30 June 2020.</p> <p>Sydney Airport has already reached out to BARA to commence discussions on a future agreement, more than 18 months ahead of the termination date.</p>

Commercial item	BARA's position on reasonable commercial outcomes <sup>7</sup>	Sydney Airport's 2015 BARA ASA position
<b>Ordered and streamlined</b>	BARA has provided its sought-after ordering of clauses and wants to remove extensive and unnecessary repetition within agreements.	Sydney Airport put significant effort into ensuring the 2015 BARA ASA is ordered, concise, not repetitive and easy to read.

## 1.2 Sydney Airport supports the development of negotiation and contracting principles

- 6 Sydney Airport acknowledges a consistent theme in submissions from both airports and airlines that there are challenges associated with negotiating new agreements and working together constructively through the lifecycle of agreements. While the approach to the negotiation processes and behaviours varies between industry participants, in general, there is an opportunity to improve negotiations and relationships between airlines and airports.
- 7 These challenges could be improved by a more structured, transparent and constructive approach to negotiations as proposed by the AAA.
- 8 The establishment of negotiating and contracting principles that describe the elements of a 'good' agreement and an appropriate and constructive approach to negotiations could assist in ensuring that agreements with airlines continue to focus on improving outcomes for passengers. To be effective, this type of guidance must apply to both airlines and airports.
- 9 Sydney Airport supports the AAA's position that all parties would benefit from an industry-wide discussion on this matter<sup>8</sup>. Sydney Airport would welcome the opportunity to participate in the development of such guidance and backs the AAA's request to the Commission to organise a comprehensive workshop involving airports and airlines to develop these principles.

## 1.3 Principles should address key issues

- 10 There are aspects of BARA's 'progressive commercial principles' that Sydney Airport does not agree with (for example, the proposed approach to cost of capital and the need for a formal dispute resolution mechanism)<sup>9</sup>. Nevertheless, BARA's 'progressive commercial principles' are a helpful starting point for the development of a framework to guide airport and airline approaches to working together to establish and deliver on agreements.
- 11 While Sydney Airport is determined to work towards fair and reasonable outcomes for airlines by negotiating in good faith, the airlines should also be required to act in good faith. Sydney Airport considers that the principles should be broader to also address:
- (a) appropriate standards of airline behaviour in negotiations (for example addressing delay tactics);
  - (b) non-cooperative and disruptive behaviour in using common-use environments;
  - (c) refusing to comply with commercially agreed terms (for example refusing to vacate premises after lease expiry);

<sup>8</sup> AAA Supplementary Submission, p 8.

<sup>9</sup> BARA, *Submission to the Productivity Commission – economic regulation of airports*, 3 September 2018, p 60.

- (d) practices such as short payments in relation to both aeronautical and non-aeronautical charges, and infrastructure blocking by airlines; and
- (e) threatening airports with the behaviours above.

12 Central to the success of any framework must be a willingness from both airports and airlines to do the following:

- **Share information that facilitates good decision-making:** Sydney Airport shares a significant volume of information with airlines during negotiations and then on an ongoing basis. However, airlines are under no obligation (and are often unwilling) to share information that could significantly enhance planning and decision-making (e.g. baggage data, customer feedback on performance of Sydney Airport, traffic forecasts, forward fleet and network planning and on-time-performance classification information). All parties to a negotiation should share information that will facilitate the establishment of a commercial agreement.
- **Accept individual or shared accountability for outcomes:** Airlines expect airports to focus on service and improvements through KPI reporting and target setting. However, some KPIs require both airports and airlines to collectively work towards delivering the outcome for the benefit of passengers. Airlines do not always acknowledge this shared responsibility for outcomes or that airlines bear a level of responsibility for the broader system outcomes<sup>10</sup>. Further, some airlines may not support the creation of incentives to prioritise operators who embrace a community responsibility to the overall operational system. This can impact the ability of the airport to effect overall positive change and deliver holistic improved outcomes for passengers.
- **Collaborate more effectively on projects:** A changing external environment, technology improvements and new business plans and strategies mean that airports need to be agile and continually assess projects for their ability to deliver desired outcomes. A more structured approach to collaboration through small working groups representative of the airline and ground handling community throughout the project development and delivery lifecycle could assist in ensuring projects deliver the right outcomes.

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<sup>10</sup> An example of this is the lack of clear communication regarding aircraft target off-block times to the airport ground controllers.

## Part C: Appendices

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### Appendix 1. Response to other submissions

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#### 1.1. Overview

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- 13 Several airline submissions including those made by A4ANZ, Qantas and Virgin contend that airports have used market power to:
- earn excessive returns;
  - transfer risks from airports to airlines unreasonably;
  - increase prices unreasonably;
  - provide poor service quality; and
  - undertake inefficient investment.
- 14 None of these assertions can withstand detailed scrutiny. This chapter provides Sydney Airport's response to those assertions and key references from Sydney Airport's First Submission and the AAA submissions to assist the Commission in its assessment of the claims. A summary of Sydney Airport's response is set out in Figure 2 below.

#### 1.2. Sydney Airport's response to airline contentions

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- 15 Please see the table on the next page.

Airline contentions	Response
<p><b>Airport returns are excessive</b></p> <p>Some airlines' submissions suggest that airports earn excessive returns<sup>11</sup>. These airlines have based this assertion primarily on their analysis of increases in airports' aeronautical revenue above inflation, EBITDA margins at Australian airports relative to other airports worldwide, and airports' Return on Capital Employed (ROCE).</p>	<p><b>Reasonable returns</b></p> <ul style="list-style-type: none"> <li>▪ HoustonKemp's expert report prepared for the AAA demonstrates that the aeronautical returns of each of the four major airports are reasonable<sup>12</sup>. In earlier discussions including as part of the First Submission, Sydney Airport has outlined that the ACCC Monitoring Reports overstate the airport's aeronautical returns. The conclusions drawn by airlines using these ACCC metrics are therefore also inaccurate. Refer to the Confidential Appendix 1 for further details.</li> <li>▪ Sydney Airport supports the points raised in the AAA Supplementary Submission regarding the flaws and limitations of the airlines' analysis<sup>13</sup>. While the AAA's points are sufficient to rebut airlines' analysis, Sydney Airport is ready to assist the Commission further as required.</li> </ul> <p><b>EBITDA margins</b></p> <ul style="list-style-type: none"> <li>▪ EBITDA margins are not an appropriate measure of airport returns and profitability.</li> <li>▪ Sydney Airport's EBITDA margin has remained relatively stable over the past 12 years and remains consistent with the EBITDA margins under prices set by the ACCC<sup>14</sup>.</li> </ul>
<p><b>Airports face few risks</b></p> <p>Airlines and airline industry groups have also argued that airports take few risks, and that airlines mitigate the economic risk faced by airports by reducing airfares when economic growth is slow<sup>15</sup>.</p>	<p><b>Airports face various risks</b></p> <ul style="list-style-type: none"> <li>▪ Sydney Airport has assumed greater risk in its contracts with airlines (for traffic, capex, opex and financing) compared to that calculated in the <i>2001 ACCC Decision</i>.</li> <li>▪ From 2001 to 2015, the evidence shows that international passenger traffic has largely underperformed relative to forecasts in international and domestic aeronautical agreements (as shown in the Confidential Appendix 2). This displays the traffic risk taken on by airports, which is</li> </ul>

<sup>11</sup> See, for example, A4ANZ Submissions, p 6.

<sup>12</sup> HoustonKemp Economists, *Assessing market power in aeronautical services*, A report for the Australian Airports Association (Report, 5 September 2018) (*HoustonKemp Report*).

<sup>13</sup> AAA Supplementary Submission, p 6.

<sup>14</sup> Sydney Airport's EBITDA margin under prices set in the 2001 ACCC Decision has only increased by 1.2% over 12 years, from 79.7% in 2005 to 80.9% in 2017

<sup>15</sup> See, for example, Qantas Group, *Qantas Group Submission: Productivity Commission Inquiry into Economic Regulation of Airports*, September 2018, p 18.

Airline contentions	Response
	<p>a major concern given airports do not control demand by altering charges and do not increase charges to compensate for any decline in passenger numbers.</p>
<p><b>Airports using market power to increase aeronautical prices</b></p> <p>Submissions made by A4ANZ, Qantas and Virgin argue that airports have exercised market power to enable prices to increase at a rate higher than inflation<sup>16</sup>.</p>	<p><b>Prices reflecting the growing asset base</b></p> <ul style="list-style-type: none"> <li>▪ It is not unexpected that aeronautical prices have increased in real terms as airports have invested in major assets, bought terminals from airlines, and invested in facilities to enable significant operating efficiencies for airlines. The increase in prices are reflective of a range of factors including how the asset base has grown over time: <ul style="list-style-type: none"> <li>– <b>Brownfield investments:</b> The marginal cost of investment for a large established airport is significantly higher than the depreciated cost of historic investment, given the new investment is in a constrained operational area, and because it is undepreciated.</li> <li>– <b>New activities:</b> Airports have substantially increased the services they provide. Sydney Airport acquired T3 from Qantas in 2015 for \$535 million and now provides domestic terminal facilitation from it. The agreement was positive for Qantas’ shareholders, with the implied cost of funding being below the group’s weighted average cost of capital<sup>17</sup>.</li> <li>– <b>Investments to reduce airline costs:</b> Airports have made many investments that have improved airline operating efficiency and reduced their operating costs. While airport charges may have increased due to these investments, airlines have gained substantial operational efficiencies and achieved the resulting cost savings<sup>18</sup>.</li> </ul> </li> <li>▪ Experience at other international airports is also that charges increase at a rate higher than inflation. Despite heavier-handed regulation, airport charges in Europe have increased more quickly than they have in Australian airports. In particular, A4E (the European equivalent of A4ANZ) and International Air Transport Association (<b>IATA</b>) claim that airport charges at</li> </ul>

<sup>16</sup> See, for example, Qantas Group, *Qantas Group Submission: Productivity Commission Inquiry into Economic Regulation of Airports*, September 2018, p 7.

<sup>17</sup> Qantas, *Qantas And Sydney Airport Reach Commercial Agreement On Domestic Terminal*, 18 August 2018, <<https://www.qantasnewsroom.com.au/media-releases/qantas-and-sydney-airport-reach-commercial-agreement-on-domestic-terminal/>>.

<sup>18</sup> See chapter 7 of Sydney Airport’s First Submission.

Airline contentions	Response
	<p>European airports more than doubled over the last decade (<i>SYD note: in nominal terms</i>)<sup>19</sup>. By comparison, A4ANZ asserts that charges at the monitored Australian airports have increased by the relatively smaller amount of 25% in real terms (equivalent to ~50-60% in nominal terms) over the same period<sup>20</sup>.</p> <ul style="list-style-type: none"> <li>As far back as 2002, the Commission recognised that at capacity-constrained airports, airport charges should be expected to increase at no less than inflation<sup>21</sup>.</li> </ul>
<p><b>Service quality has not improved</b></p> <p>A number of airline submissions, including A4ANZ, claimed that airport service quality has not improved over the past decade, and that this is indicative of airports misusing their market power<sup>22</sup>.</p>	<p><b>Statistically significant service quality improvement</b></p> <ul style="list-style-type: none"> <li>Sydney Airport's overall service quality score has improved from 3.83/5 (almost 'good') in 2015 to 4.14/5 (above 'good') in YTD 2018 at the T1 international terminal and from 3.85/5 in 2015 to 4.14/5 in YTD 2018 at the T2 and T3 domestic terminals.</li> <li>With a 95% confidence interval of +/- 0.05, this is a statistically significant increase in service quality and Sydney Airport continues to work towards further improvement.</li> </ul>
<p><b>Airport investment is inefficient and piecemeal</b></p> <p>Some airline submissions claim that airport investment is made incrementally and is inefficient<sup>23</sup>.</p>	<p><b>Investment consultation program as part of the aeronautical agreements</b></p> <ul style="list-style-type: none"> <li>The international aeronautical agreement with BARA (<b>2015 BARA ASA</b>) includes a consultation program that takes a holistic approach to airport investment. Sydney Airport consults with airlines on investment projects on an ongoing basis and a forward-looking investment program is considered each year that addresses capital expenditures. Individual investments are then evaluated within this context. Sydney Airport takes capex risk during the term of the agreement.</li> </ul>

<sup>19</sup> IATA Economics, *IATA Economics Briefing: Economic benefits from effective regulation of European airports*, 22 September 2017, <<https://www.iata.org/whatwedo/Documents/economics/Economic-Benefits-of-Lower-Airport-Charges-2017.pdf>>; A4E, *Revised airport regulation will benefit European consumers*, 6 March 2018, <<https://a4e.eu/revised-airport-regulation-will-benefit-european-consumers/>>.

<sup>20</sup> A4ANZ, *Economic regulation of airports: Submission to the Productivity Commission*, September 2018, p 15.

<sup>21</sup> Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, Report No. 19 (23 January 2002) p 204 <[https://www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0004/19714/airports.pdf](https://www.pc.gov.au/__data/assets/pdf_file/0004/19714/airports.pdf)>.

<sup>22</sup> See, for example, A4ANZ, *Economic Regulation of Airports*, September 2018, p 20.

<sup>23</sup> See, for example, Qantas Group, *Qantas Group Submission: Productivity Commission Inquiry into Economic Regulation of Airports*, September 2018, p 6.



Airline contentions	Response
	<ul style="list-style-type: none"> <li>▪ However, consistent with International Civil Aviation Organisation (ICAO) principles which is clear that airports should retain final decision-authority particularly to avoid incumbent airlines opposing investment to reduce competition<sup>24</sup>, Sydney Airport is responsible for the final investment decision having regard to the wants and needs of 47 airline customers.</li> </ul>
<p><b>Adopting final offer arbitration would produce ~\$18bn economic benefits<sup>50</sup></b></p>	<ul style="list-style-type: none"> <li>▪ AAA supplementary submission notes that the Frontier Economics' analysis prepared for A4ANZ<sup>25</sup> is flawed, and the analysis should be interpreted with caution<sup>26</sup>. Some points raised by the HoustonKemp Report regarding the Frontier Economics' evaluation include the range of inappropriate critical assumptions and the unsubstantiated additional benefits.</li> </ul>
<p><b>No airline countervailing power – only avenue is reducing capacity</b></p>	<ul style="list-style-type: none"> <li>▪ Airlines do have countervailing power and they exercise it through: <ul style="list-style-type: none"> <li>– short-paying or refusing to pay for airport services upon the expiry of a negotiated agreement or lease until they have reached a new agreement;</li> <li>– seeking or threatening increased airport regulation including declaration;</li> <li>– being non-cooperative and disruptive in using common-use environments and blocking key infrastructure;</li> <li>– refusing to vacate premises after leases have expired; and/or</li> <li>– engaging successfully in vigorous commercial negotiations<sup>27</sup>.</li> </ul> </li> </ul>

<sup>24</sup> See, for example, ICAO, *Doc 9562: Airport Economics Manual*, 2013, <[https://www.icao.int/publications/Documents/9562\\_en.pdf](https://www.icao.int/publications/Documents/9562_en.pdf)>, at page 6: 'A project at an airport may have important benefits, but if some users are in a position to block the project, the worthwhile project could be blocked. For instance, a dominant airline might oppose the addition of new capacity that would disproportionately benefit its competitors, or, due to short-term financial problems, may reject any project with future benefits that would increase current costs.' and at page 1: 'There might be potential anti-competitive issues involved regarding airline competition and barriers to entry where ... airlines have a large say in investment plans and in the management of the airport.'

<sup>25</sup> Frontier Economics, *The market power of Australian airports*, A report prepared for A4ANZ, September 2018 (**Frontier Economics Report**).

<sup>26</sup> AAA Supplementary Submission, p 6; HoustonKemp Economists (Attachment 2 of AAA Supplementary Submission), Section 5, p 19.

<sup>27</sup> See chapter 5 of Sydney Airport's First Submission.

## Appendix 2. Response to specific comments about Sydney Airport

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16 This chapter responds to some minor comments made about Sydney Airport in various submissions.

### 2.1. Free drop-off and pick-up area

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- 17 In its submission, Qantas commented that the free pick-up and drop-off area at Sydney Airport was funded by aeronautical charges, but that car parking charges also apply to the area<sup>28</sup>.
- 18 The free Pick-Up and Drop-Off area was specifically designed to be a dedicated pick-up and drop-off area, including a herringbone design for easy vehicle manoeuvrability, a covered waiting area for pedestrians with easy access to the vehicles, and specific signage. It is intended to provide a seamless service to passengers not wanting to use the paid parking facilities. Sydney Airport consulted extensively with airlines as part of the overall Terminal 1 road development plans that ultimately formed part of the aeronautical asset base negotiated under the international ASA, and as a result the dedicated pick-up and drop-off area was included as an aeronautical asset.
- 19 To ensure the area remains quick and efficient for drop-offs and pick-ups, it is necessary to incentivise drivers to respect the 15-minute time limit. Sydney Airport encourages compliance by charging vehicles that stay beyond the 15-minute pick-up period the same rate as they would pay in any of the nearby car parks so that the pick-up zone does not get misused. The revenue generated from this area is less than the operating costs of the area (which are classified as non-aeronautical) and those costs that are not recovered by Sydney Airport through aeronautical charges.

### 2.2. International baggage – quality of service

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- 20 BARA notes that Sydney Airport's international baggage system has had a low service quality rating since 2002/03 and claims that this is evidence of a lack of investment<sup>29</sup>.
- 21 In fact, Sydney Airport has invested significantly in the international terminal baggage system, including investing in:
- a new bag room with 147 make-up positions, resulting in a 53% increase in make-up capacity;
  - automatic early bag storage system with capacity for up to 1,200 bags;
  - expanded reclaims hall to include three additional belts capable of accommodating A380 aircraft or multiple widebody flights, resulting in a 27% increase in reclaims capacity; and
  - numerous refurbishments, replacements and upgrades to improve the reliability and availability of the baggage system.

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<sup>28</sup> Qantas Group, *Qantas Group Submission: Productivity Commission Inquiry into Economic Regulation of Airports*, September 2018, p 32.

<sup>29</sup> BARA, *Submission to the Productivity Commission – economic regulation of airports*, 3 September 2018, p 55.

- 22 The baggage example cited by BARA30 actually illustrates the importance of a monitoring system focusing on outcomes rather than input-based measures, as well as differentiating between the responsibilities of Sydney Airport and the shared responsibilities of airlines, ground handlers and other stakeholders. The KPIs in the 2015 BARA ASA have indicated that the difficulties associated with baggage predominantly relate to transfer bags rather than direct bags and are therefore primarily influenced by airline and ground handler processes in the use of the baggage system. Sydney Airport is proactively engaging with international airlines and ground handlers both collectively and on a bilateral basis to seek to facilitate improvements in transfer baggage processes and service level outcomes.

### **2.3. Transfer passengers**

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- 23 The Frontier Economics Report prepared for A4ANZ claims that Sydney Airport's transfer passengers represent less than 1% of total passengers. Accordingly, Frontier Economics dismiss the likelihood that Sydney Airport might face competition for transfer passengers from other airports<sup>31</sup>. This statistic is absurdly low and is clearly based on unrealistic or inaccurate data. Member airlines of A4ANZ would have access to correct data.
- 24 While Sydney Airport does not receive any data on the number of transfer passengers from airline records (since there is no obligation on airlines to provide this data), previous discussions with some airlines as part of the Master Plan process have suggested that transfer passengers represent 15-20% of total passengers.

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<sup>30</sup> BARA, *Submission to the Productivity Commission – economic regulation of airports*, 3 September 2018, p 55.

<sup>31</sup> Frontier Economics Report, p 25.

## Appendix 3. Response to other issues

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### 3.1. Security cost of capital

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- 25 Qantas and Virgin have stated that, because security opex is a cost pass-through, airports should earn a very low rate of return on security capex<sup>32</sup>.
- 26 At Sydney Airport, security opex is a direct cost pass-through, however, security capex is not and has not been since 2006. From July 2006, Sydney Airport, in consultation with airlines, changed the recovery of security assets to be the same as all other aeronautical assets.
- 27 Therefore, security investments are now subject to the same risk and recovery profile as other aeronautical assets:
- the rate of return for new security investments is now the same as it is for other aeronautical assets; and
  - this increased Sydney Airport's risk exposure to a range of factors, including traffic volumes and interest rates. These factors can impact the actual return that Sydney Airport earns on security capex over the remainder of the term of the relevant agreements.
- 28 As background, at the time that Sydney Airport was privatised in 2002, the ACCC used a lower rate of return for security assets than for other aeronautical assets. This was on the basis that security revenues including the return on security capex was reconciled with security expenses each year, and any discrepancy was included in subsequent security charges. As this reconciliation process is no longer in place for security capex, Sydney Airport carries the risk on return on security capex as it does for other aeronautical assets, and it is, therefore, appropriate that it earns the same rate of return for security capex and other aeronautical capex.

### 3.2. Security Operating Expenses

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- 29 The specific security charge at Sydney Airport is almost entirely comprised of operating expenses and is a direct pass through, and the remainder relates to the agreed recovery of security investments made before 2006. Sydney Airport's priority with security is to work with the government agencies and airlines to ensure that the appropriate level of security is provided to passengers at the lowest cost. As a result, aeronautical security recovery per passenger declined by 21.3% (2.0% per annum) between 2008 and 2017 in real terms, despite several new government regulatory requirements which have resulted in stringent and expensive security processes being implemented at the airport.

### 3.3. ACCC monitoring report

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- 30 In its First Submission, Sydney Airport set out its concerns with the ACCC's inclusion of airline feedback as a source of data for its monitoring of airport service quality<sup>33</sup>. One of the concerns raised was that only a small number of airlines respond to the survey, including BARA which

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<sup>32</sup> Qantas Group, *Qantas Group Submission: Productivity Commission Inquiry into Economic Regulation of Airports*, September 2018, p 29; Virgin Group, *Economic regulation of airport services*, September 2018, p 8

<sup>33</sup> See section 9.10 of Sydney Airport's First Submission.

provides an amalgamated view on behalf of its member airlines. BARA has since clarified to Sydney Airport that it does not amalgamate its member airline views but rather receives the electronic survey from the ACCC and emails it to its member airlines who then respond (if they choose to) directly to the ACCC<sup>34</sup>.

- 31 This is a point of clarification that has assisted Sydney Airport to improve its understanding of the ACCC airline survey process. However, concerns regarding the robustness of the ACCC's approach to airline surveys and the integrity and statistical significance of the data reported remain.

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<sup>34</sup> Letter from BARA to Sydney Airport, dated 20 September 2018.

**Part D:**  
**Confidential Appendices: Commercial in Confidence**

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