

Our Ref: 2-99

Your Ref:

Direct Telephone
(03) 6216 1630

16 March 2001

Ms Lisa Gropp
Assistant Commissioner
Productivity Commission
Airports Inquiry
LB2, Collins Street East
MELBOURNE VIC 8003

Attention Ms Michelle Cross

Dear Ms Gropp,

SUBMISSION ON PRICE REGULATION OF AIRPORTS

Thank you for the opportunity to make a submission on the Commission's Inquiry into the above matter.

Please find enclosed a copy of our Company's submission for consideration. We look forward to meeting with the members of the Inquiry to discuss and elaborate upon the contents of the enclosed document.

Yours sincerely,

Robert Noga
Manager Business Development & Operations
General Counsel

HOBART INTERNATIONAL AIRPORT PTY LTD

SUBMISSION TO PRODUCTIVITY COMMISSION

ON

THE PRICE REGULATION OF AIRPORTS

Introduction

Hobart International Airport Pty Ltd purchased the lease of Hobart International Airport, with effect from 11 June 1998. The tender system and representations adopted by the Commonwealth at the time Phase 2 Airports were privatised ensured that the Commonwealth identified the true market value of its privatised airports.

The experience of most Airport Operator Companies (AOC) is that the privatisation of airports has created an exciting operating environment. There is now a real focus on the need for passenger and freight growth through the facilitation of new domestic tourism markets, passenger and freight growth, and airport property development, to support and encourage the renewal and further development of airport infrastructure.

The privatisation of the airports has, to a significant degree, promoted the commercial reality that there is an inter-relationship and reliance that needs to be fostered between government infrastructure, transport and tourism agencies, tourism operators, the airlines and AOC's. At this time in the evolution of a deregulated operating environment, however, much work still remains to be undertaken to move the parties towards a more cooperative and strategic working relationship that recognises each other's operating needs, strengths and weaknesses. In our Company's experience the inter-relationship between AOC's and the airlines has been recognised and worked best at the local, rather than the policy or corporate level.

For its part our Company has invested considerable time and expense to shift the culture of the organisation from an FAC regulatory approach towards tenants and airport users, to one that emphasises supporting and fostering the business viability of its tenants and the provision of quality customer service.

Regulatory oversight and pricing regimes have to some extent operated to restrict a maturing of relationships between the parties. The regimes have tended to foster an adversarial approach to commercial relationships and pricing, by providing a third party avenue of redress whose decision may not be in accord with the commercial or market realities faced by one or all of the parties.

Equally, in our Company's experience the staff of regulatory and oversight agencies have maintained a positive and professional relationship with our Company's staff and employees, providing invaluable support and assistance.

The operation of, and pricing within, the privatised airports is regulated and impacted by a variety of means and agencies. The relevant agencies and their effect on pricing are set out in **Table 1**, which is annexed hereto. The intent of the Table is to give one a picture of the extent of regulation and oversight, not to criticise its existence.

The Inquiry and the Commission's Terms of Reference are timely. Our Company has read the Terms of Reference and supports them. It also adopts the recent submission by the Australian Airports Association. It does not intend, in this submission, to canvass the matters contained therein. Our Company does wish to comment briefly on the particular Tasmanian and local environment in which it operates, and the effect of this environment on market pricing, as opposed to regulatory price control.

In our Company's opinion Tasmanian airports have no capacity to exercise monopolistic market power, whether of an access or pricing nature.

The Tasmanian Operating Environment

Tasmanian airports do not possess market power, either as a whole, or in relation to specific services, and have no ability to abuse prices. The viability of each of the airports rests on price sensitivity, and increasingly, the level and quality of service and support provided to tenants and airport users.

Tasmania is a small, isolated and depressed regional area on the canvas of the Australian economic landscape. Deregulation, the loss of manufacturing capacity, and the centralisation of corporate decision making and capital in Brisbane, Sydney and Melbourne, has led to a significant loss of economic capacity. Tourism growth is currently seen as providing the main opportunity to redress this loss of capacity, and provide for future economic growth. In the current economic climate it is difficult for Tasmanian AOC's to make inappropriate pricing decisions due to competitive and market realities. Put simply, the market determines the price for airport access and services in Tasmania.

Tasmania has four regional airports, servicing a declining population of 473,000 people. The Hobart International Airports and Launceston Airports are the most significant. Ownership is varied crossing local and State governments, and the private sector. Government ownership creates its own additional sensitivities.

The Hobart and Launceston Airports are located within two hours driving distance of each other, a short distance compared to that often required to be travelled by passengers accessing the other major interstate airports. The Devonport and Wynyard Airports are a similar distance from the Launceston Airport. Passengers from the south and the north of the State frequently use out of area airports. In addition, Hobart International Airport has a significant General Aviation airport (with an industrial estate) adjacent to its boundary.

In addition to the above RPT services, Tasmania is serviced internally by the National Highway network and rail, and externally by sea. The Sea Cat (George Town) and Spirit of Tasmania (Devonport) passenger and vehicle services are augmented by

substantial sea freight terminals at Hobart, Bell Bay (Launceston), and at Burnie on the north west coast. The operation of these passenger and freight services is supported and subsidised by the Commonwealth's freight equalisation scheme. The Burnie Port authority was recently given a substantial grant by the State Government to assist with the retention of its port operations.

The continued existence of Tasmanian airports relies heavily on passenger and freight growth. However, the four airports, but Hobart and Launceston in particular, are engaged in relentless competition with each other. The competition is directed towards retaining what freight and RPT market share they currently enjoy, whilst attempting to secure a share of any growth, at the expense of the other three airports. A number of illustrations highlight the trading situations Tasmanian airports face.

Due to the location of the Tasmanian airports and the geography of the State, an RPT passenger may land at any of the airports and leave from another. This ability creates a situation where the operator of the departing airport gains no return on its capital expenditure. For example, a passenger may arrive at Launceston and hire a vehicle, paying the access fee thereon to Launceston Airport. The same passenger may (and commonly does) depart from Hobart, leaving the hire car at the airport free of charge.

Competition for the RPT passenger is significant and real. Holiday packages are a feature of the Tasmanian tourism market. Because it costs less to fly to Wynyard, Devonport and Launceston, the packages are cheaper to those destinations. Package passengers tend to arrive and leave from the same destination airport, thus precluding the other airports sharing the revenue generated by the tourist.

Due to the close proximity of Launceston to Hobart, intrastate and interstate domestic producers and manufacturers, and exporters, road freight their goods to Launceston Airport for transshipment by air, due to the cost impact of a 20-minute flight between Hobart and Launceston, compared to road freight costs.

All Tasmanian airports suffer from the competition of subsidised sea passenger and freight transport. These services are real and substantial. Subsidised sea passenger and freight transport adversely affects the revenue of airports and their tenants, particularly the hire car firms and freight companies. For example, Tasmanian salmon producers use both sea and air transport. Our advice is that it costs \$2 per case less to transport salmon by road-sea freight from Hobart to Melbourne, than by air. The other advantage of road-sea freight is that it is a seamless service from say the salmon factory at Dover in the south of Tasmania, across Bass Strait, to the markets of South Australia, Victoria and New South Wales. The breakdown of the Spirit of Tasmania last year had a significant and positive impact on the revenues of Tasmanian airports and their tenants.

The same airline companies operate the air freight facilities at both airports, and therefore the attention of both the Hobart and Launceston AOC's is directed towards ensuring that either the status quo remains (in the case of Hobart), or taking the other's freight operations (in the case of Launceston). Both AOC's direct their energies towards trying to improve facilities and encouraging growth in the business of their freight tenants.

This latter point leads to another factor impacting on pricing that is not generally appreciated. The operating costs of AOC's are generally fixed. They are faced with mandated capital and maintenance works expenditure programs. However, they have little or no ability to guarantee existing revenue. The major domestic passenger and freight companies unilaterally determine the degree to which they avail themselves of airport facilities. Schedules are frequently cancelled or aircraft type changed, with significant impact on airport revenues. Freight can be unilaterally moved from one airport to another. Rarely, if ever, would the airlines forewarn or consult with the AOC, before implementing such changes.

Hobart and Launceston Airports suffer, by far, the highest Air Services Australia landing charges of the Phase 1 and Phase 2 airports, at \$15.17 and \$15.98 per tonne respectively. To these amounts must be added the AOC's landing charge of approximately \$6.00 per tonne. Both AOC's receive regular and strident criticism over

landing charges, and are very sensitive to any growth in landing charges (falling within their sphere of control) because they directly impact on the number of profitable airline passenger seats per flight, and the price per kilo for freight. Without the airlines having profitable passenger and freight routes AOC revenue is endangered.

The foregoing competitive pressures are reflected not only in the pricing approach of Tasmanian airports, but also in their relationships with tenants, airport users, and prospective developers.

Revenue, Expenditure and Pricing

Revenue at Hobart International Airport is derived from three main sources. They are:

- Aeronautical (landing and parking fees) 31%;
- Trading (access licences, car parking and courtesy bays) 30%;
- Property 32%; and
- Other (outgoings recovery and contract work) 7%.

Since privatisation, the Airport has seen a number of new non-aeronautical commercial developments, representing the first building activity on the Airport for some 20 years. Other developments are being progressed.

The 30% revenue derived from trading activities breaks down into –

- Public car parking 48%;
- Access licenses 45%; and
- Courtesy bays 7%.

There is little capacity to increase landing charges for the above reasons. Similarly, car parking fees have little room for movement, due to a combination of adverse public reaction and competition from potential off-airport operators. Recently, our

Company has moved towards value adding in an attempt to generate additional car park revenue. A valet undercover service will shortly commence operations as an adjunct to the car park. Growth in access licence revenue is dependent on an increase in passenger numbers and utilisation of the services offered by tenants.

When the 30% property income is separated into aeronautically related and general property, the following emerges –

- Terminals (90%) and hangars (10%) 63%; and
- General property (Non aviation activities) 37%.

The Domestic Terminal Building is wholly leased to Qantas and Ansett until 2012 and 2017 respectively, under terms mandated by the Commonwealth government on FAC. The leases contain provisions for annual CPI rent adjustments, but the application of the adjustment formulae produces a result that significantly discounts the CPI for the previous 12 months. In reality, each year the value of the leases decline in real terms, and have been doing so since 1987. Accordingly, in addition the effect of the price cap, the real income derived from the major component of aeronautical property income is projected to reduce in real terms every year, for 30 years.

The airlines and our Company informally recognise that the Domestic Terminal Building requires either replacement or significant capital improvement.

The International Terminal Building is operated by our Company and, with the commencement of Impulse flights in April, offers the opportunity to generate real growth in aeronautical property income.

The rent on the freight hangar leases is determined by a combination of independent market valuation and negotiation with the airlines. The exercise of monopolistic powers is prevented by the need to ensure that the tenant will remain viable on the airport.

The cost of maintaining and operating aeronautical activities is substantially subsidised by non-aeronautical income. With the significant committed capital and maintenance works programs over the next 10 years (*Table 1 - Sale Agreement*), increasing the proportion of non-aeronautical property income is regarded as a critical element of our Company's business strategy. Yet, in this regard the prospects are not clear. Between Hobart Airport and the City is some 11 kilometres of vacant industrial land. At the entrance to the Airport (on Cambridge Airport – a competitor) is a large, privately owned industrial estate, with numerous unsold vacant blocks. The public wrongly has the perception that the Airport is too far from the centre of Hobart, and is most reluctant to support any business at the Airport that relies on passing customer trade.

Telstra, the electricity and water and sewerage authorities, will provide services to each lot in an off airport subdivision. However, these same authorities regard the Airport as a single lot, with the result that our Company often has to fund infrastructure works costing up to a \$100,000 to attract a tenant paying rent at a rate of \$3.50 to \$15^{m2}. Telstra's unconcerned response is to say 'pass it on to the tenant', however, when the tenant can obtain the same services free 100 metres from the Airport this becomes an unrealistic option.

Capital and operational expenditure is incurred in the following areas:

- Labour expenses 33%;
- Contract services 19%;
- Statutory charges 7%;
- Administration 8%; and
- Depreciation 23%;
- Property maintenance 10%

Since privatisation the recurrent expenditure budget has been reduced some 20%, whilst staffing levels have been reduced by 30%. Only 18 employees now maintain a 24 hour airport operation. There is little if any further scope to achieve effectiveness and efficiency gains without impacting on infrastructure, and shortening the time in

which it has to be replaced. Representations to DoTRS resulted in the removal of the Counter Terrorist First Response facility, removing a significant cost to the airlines. The ACCC has publicly lauded the total savings achieved under the price cap, (all of which have been passed to the airline shareholders, rather than our Company or airline passengers).

In the Tasmanian context, airports share similar (and in the case of Air Services Australia charges, greater) cost structures to other interstate airports, but without the capacity and revenue to support significant efficiencies.

A general review of capital and maintenance expenditure projections indicates that over the next 10 to 15 years the Airport's road and hydraulic systems will need to be replaced, irrespective of whether there is any revenue growth from non aeronautical activities. The cost of these works, which is in addition to the 1-year's revenue expenditure required under the terms of the sale agreement, is anticipated to be another year's revenue. Accordingly, over the next 10 to 15 years, approximately two year's revenue will need to be devoted to existing infrastructure. The most significant expenditure is the runway overlay within the next two years, at an approximate cost of \$3,000,000. This cost, as with the other capital and maintenance expenditure, has been excluded by the ACCC as necessary new development.

It is anticipated that the above expenditure will be funded from growth in tourism and non-aeronautical property development. Nevertheless, a small company such as ours regards with serious concern: -

- the prospect of a 'single till' approach to pricing;
- the hiatus with respect to the Fuel Throughput Levy and taxi fees; and
- the prospect of these items and car park revenue being regarded as aeronautical income for the purposes of the price cap.

The reason for this concern is the inability of our Company to influence tourism and property development growth. Landing charges alone will never provide for the cost of maintaining and replacing all aeronautical infrastructure. Whilst our Company can

facilitate individual development proposals, whether the proposals exist or not depends on the decision of government and commercial enterprises, and the state of the economy. The concept that all income should simply support aeronautical activities, and particularly those subject to the price cap, ignores the fact that, for example, airport roads and hydraulics infrastructure supports the business needs of not only passengers and the airlines, but the wider local and State economies.

Further, in providing for the future aeronautical capital and maintenance needs of the Airport, our Company is deliberately pursuing a policy of enhancing existing, and developing new, non-aeronautical income streams to subsidise the costs associated therewith.

When revenue and expenditure is classified according to whether it is related to aeronautical activities or not, the following picture emerges, as set out in **Table 2**, which is annexed hereto **AS A COMMERCIAL IN CONFIDENCE ITEM**. All revenue and expenditure relating to the Domestic Terminal Building has been excluded from this exercise, as the building is wholly leased to Ansett and Qantas. As with Launceston Airport, Hobart has no input into “Passenger processing facilities and activities” in so far as this category relates to Ansett and Qantas. Outgoings payments by the two airlines are determined and calculated in accordance with lease formulae.

Our Company does have an international terminal building. Such is the exercise of our ‘monopolistic power’ that DIMA, Customs and AQIS have never been charged for the provision of any service, or been asked to pay outgoings on the building or its infrastructure. The domestic airlines, and other Airport tenants frequently use the building and its surrounding apron and holding areas free of charge for their own operational purposes.

Table 2 confirms that aeronautical expenditure is not wholly recovered from landing charges, and that other income is used to support this activity. If anything, a conservative approach was adopted on calculating the document.

Accordingly, our Company finds it difficult to understand how Tasmanian airports are capable of exercising monopolistic pricing powers.

Terms of Reference

Many of the Terms of Reference are addressed in the submission from the Australian Airports Association and need not be re-canvassed. Some local comment may nevertheless, be appropriately made in relation to some Terms.

Tasmanian airports do not operate in a monopolistic environment. Like any small business operator, the airports are in reality governed by the business decisions of their largest customers, the two main airlines, and their freight arms. They are free to operate RPT and freight services to any one of the four airports, who would welcome the business.

Effects of Current Prices Regulation

Our Company, like the other Tasmanian AOC's is risk adverse. Prospective income is difficult to forecast. New capital investment will never occur on a speculative basis, and demand management is a problem that is not even on the horizon. Airline freight companies are pressing for new freight facilities involving an extension to aprons and taxiways, to facilitate freight growth into export markets. The cost of the extensions is significant and it is unlikely our Company could, or would fund those works, without the direct financial support of the airlines.

Whilst efficiency and effectiveness gains have occurred, further savings forced under the price cap may be at the cost of necessary maintenance.

To date the approach of our Company is simply to look to an overall rate of return on investment, without seeking to ensure aeronautical services are profitable as a stand-alone activity. In fact, without cross subsidisation, landing charges would have a

substantial and further negative and unsustainable impact on the Tasmanian economy, and our Company.

Compliance costs, whilst not prohibitive, consume a significant percentage of the resources of our financial department.

In Tasmania the current pricing regime has not operated to promote or retard competition, or acted as a barrier to new airline entrants and small business operators. The reality is that the market is small, with little prospect for solid growth in what is, after all, an “end” destination. The real approach of Tasmanian airports is often to simply ask the prospective tenant or user what they are willing to pay! The real regulatory issue is the right of AOC’s (in the face of conciliated and arbitrated action) to maintain an appropriate mix and number of commercial uses, to ensure that non-aeronautical revenue is balanced and therefore sustainable – the common goal of any shopping centre manager.

Future Prices Regulation

Our Company’s preferred option is to exclude Tasmanian airports from aeronautical and declared services pricing regulation. An extension of the negative price cap after five years, for Hobart International Airport, will inevitably lead to a degradation of existing infrastructure, and further cross subsidisation of aeronautical activities beyond a sustainable level. Required to maintain a physical asset, there is a limit to what maintenance can be rationalised, made more efficient or improved from a diminishing revenue base.

Removal of price regulation would not result in an abuse of market power for the reasons explained earlier. Further, in the case of Hobart International Airport non-aeronautical prices tend to be **negotiated** for fixed periods of five years, whilst aeronautical and declared services pricing is either constrained by the market (in the case of landing charges) or by the pricing terms of the Domestic Terminal Leases.

The above approach would minimise compliance and reporting costs, particularly when coupled with the level of awareness of the provisions of Part IV the Trade Practices Act 1974 within the Company.

It is difficult to determine how price regulation would facilitate meaningful benchmarking between airports. The release of comparative Air Services Australia landing charges last year provoked strong media and industry reaction against our Company last year. The reality is that our Company has no influence over the ASA charge and indeed, it is a product of required safety measures, ASA mandated corporate overheads, and the number of flights ameliorating that cost.

In our experience the intervention of the ACCC in negotiating a dispute over access pricing highlights the difficulty AOC's sometimes face when a regulatory body, with little or no commercial expertise, becomes involved in such an exercise. The ACCC recommended an outcome whereby the applicant was granted direct access to perhaps \$100,000 of our Company's annual income (lost earnings) in return for an annual access fee equivalent to 1.2% of that income.

Another related issue is that, as a property developer and owner, the AOC attempts to achieve a blend and number of commercial uses that maximises the return on investment within market constraints. One suspects that in some instances the aim of the regulator is often simply to force an access decision onto the AOC, as a means of avoiding a potentially difficulty decision, against what he or she perceives to be a member of the public dealing with a rapacious monopoly. For example, airports continually face pressure to admit access to an increasing number of car rental firms. There are sound consumer, commercial and quality reasons for resisting this pressure, however, they appear not always to be appreciated.

Conclusion

As indicated in the introduction to this paper Hobart International Airport Pty Ltd, its Directors, management and employees, regard the privatisation of the Airport with

excitement. It provides us with an opportunity to assist in developing the local and Tasmanian economy, through the provision of infrastructure that encourages and promotes future passenger and freight growth.

The provision and maintenance of this infrastructure and the operation of the Airport is cost and labour intensive. Our hope is that the regulatory authorities come to appreciate that funding these costs, and maintaining a supportive and profitable revenue base, is a matter of some balance and sensitivity in the context of regional Tasmania.

Wayne Tucker
Chief Executive Officer

16 March 2001

TABLE 1

REGULATORY AGENCY	REGULATORY TYPE	REFLECTED PRICING IMPACT
Department of Transport and Regional Services	<ul style="list-style-type: none"> • Lease • Sale agreement • Performance reporting 	<ul style="list-style-type: none"> • Prohibits denial of access to air transport operators, except in accordance with demand management plan. • Requires maintenance of airport environment restricting development options due to areas of aboriginal and flora significance. • Requires maintenance of built infrastructure to an extent that is not required on adjacent commercial land. • Applies local rates and charges, including land tax. • Requires AOC to pay for building, planning and environmental regulation. • Requires positive capital development of airport site. • Requires agreed maintenance works over 10 years at a cost equivalent to 1 year's revenue. • Requires a range of customer support criteria to be met annually.
Department of Primary Industry Water & Environment	<ul style="list-style-type: none"> • Water quality and treatment • Aboriginal heritage 	<ul style="list-style-type: none"> • Requires variety of capital works to reduce impact of pollutants on environment • Requires land to be protected against access, and costly & time consuming cultural surveys as part of building approvals process
Air Services Australia	Air traffic control & fire and rescue	Landing charges second most expensive of capital cities. Virtually precludes any AOC increase in landing charges due to inability of market to pay, cost competitiveness of subsidised road and sea freight, and competition from Launceston Airport.

REGULATORY AGENCY	REGULATORY TYPE	PRICING IMPACT
Department of Immigration and Multicultural Affairs / Australian Customs Service / AQIS	Leasing and infrastructure requirements	Requires significant floor space and offices in ITB to be set aside for international RPT for nominal rent, with overhead costs also absorbed by AOC.
CASA	Airport safety & operations	Costs associated with maintenance and upgrading of physical and other operational assets, including audit, plans and exercises.
ACCC	<ul style="list-style-type: none"> • Price Cap • Aeronautical charges • Declared services and facilities • Access arrangements 	<p>Real reduction in charges to airlines that are not reflected in cheaper airfares and therefore passenger growth, but are reflected in AOC cost reductions resulting in pressure to meet on-going maintenance requirements.</p> <ul style="list-style-type: none"> • Denial of Fuel Throughput levies in breach of Commonwealth representations and contractual agreements. • A charge on taxis is considered to fall within the price cap. <p>Conciliation and arbitration of commercial arrangements with little nexus to market reality.</p>