



MORRISON&CO

22 March 2019

Economic Regulation of Airports Inquiry
Productivity Commission
Locked Bag 2
Collins Street East VIC 8003

Dear Commissioners,

RE: Productivity Commission Inquiry into Economic Regulation of Airports – observations following the Commission’s draft report

Who is H.R.L Morrison & Co?

H.R.L Morrison & Co (Morrison & Co) is a specialist infrastructure investment manager. Morrison & Co currently has ~A\$16bn in consolidated assets under management and has been the manager of NZX listed Infratil, one of the world’s first listed infrastructure funds, since its launch in 1994.

Our clients include leading sovereign wealth funds and superannuation funds, as well as a range of domestic and global institutional investors. The firm is headquartered in Wellington and has offices in Australia, New Zealand, the United States of America, China and United Kingdom.

Morrison & Co is a signatory to the Australian Airport Investor Group (AAIG) submission (submission 20).

Our Airport experience & MCO’s clients with airport exposure

Morrison & Co is a highly experienced infrastructure investor and manager with a long history and depth of experience in airports and regulatory systems throughout Australia, New Zealand and beyond. Our experts have been involved in airport policy discussion and regulatory reviews in New Zealand and Australia since privatisation. Morrison & Co has managed a majority stake in Wellington International Airport (“WIAL”) since 1998 and manages private investments on behalf of its clients in three of Australia’s largest airports being Perth, Melbourne and Gold Coast, as well as the regional airports of Townsville, Launceston, Mount Isa and Longreach. Morrison & Co has been active in the Australian market since 1994, initially acting as an advisor to various state governments regarding a number of infrastructure privatisations. In 1994, Morrison & Co also established Infratil Australia Limited, an ASX listed infrastructure fund which it managed until 2000, when the fund was acquired by Australian Infrastructure Fund. The assets of Infratil Australia included

Perth Airport and Northern Territory Airports. Morrison & Co's Australian airport interests are managed on behalf of leading Australian sovereign and superannuation funds. Morrison & Co also previously managed airports in Scotland, England and Germany.

In addition to these private market investments, Morrison and Co invests in listed airport companies in Europe, Asia and New Zealand, including previously having a substantial stake and being Board represented at Auckland Airport.

Perspectives on the Commission's draft report

Morrison & Co welcomes the release of the Commissions' draft report on the economic regulation of Australian airports. We thank the Commission for its robust analysis of the evidence placed before it, in addition to its own research. We consider that the outcome of this strong process has been well informed draft conclusions.

As a manager of investments in airports, our comments and perspectives on the Commissions' draft report are primarily in relation to the drivers of an environment conducive to investment in airports and how the current light handed regulatory environment in Australia supports this investment. In summary, these drivers are:

- A stable and predictable regulatory framework, which provides investors with confidence in the ability to recover investment over the long-term investment horizon required for the airport sector
- A commercial framework that enables airports to price efficiently and flexibly to encourage airline competition and incentivise growth in passenger traffic
- An oversight approach which facilitates investment in customer-centric services and facilities

With reference to the initial AAIG submission¹, capital is mobile and Australian airports compete for financing with different opportunities across geographies, sub-sectors, asset classes and listed and unlisted products. The capital allocation decision to invest in infrastructure comes at a material opportunity cost due to its size, illiquidity and long-dated payback period. Airports exhibit more volatile returns than many other infrastructure sub-sectors including regulated utilities, ports and toll roads due to greater volume volatility and the high proportion of airport revenues linked to discretionary spend.

It is fundamental that the regulatory framework for airport investment is stable and predictable and provides investors with confidence in their ability to recover operating and capital expenses over the long investment horizon and earn a return on capital that is reflective of the risk-reward trade off. This is in the best interest of the final customers – the passengers – as it ensures that the appropriate level of airport services will be provided at the right time and at a reasonable cost.

¹ Submission 20, page 6

Why the current system works

Negotiations are complex and robust, with airports sharing substantial amounts of information with their airline customers. The open and transparent approach to consultation from Perth Airport was previously adopted at Wellington Airport and is seen as a best practice methodology to ensure airlines have a level playing field of factual information and an opportunity to discuss and influence a common starting point for individual negotiations.

Since the introduction of the light handed regulatory regime in 2002, airports and airlines have been successful in reaching agreements after robust testing of investment decisions and price during negotiations. Airport operators and airport investors understand their responsibilities to develop airports in the interests of all customers and local communities. Airlines also generally understand that airport infrastructure is planned and delivered to meet the needs of all airlines and that costs need to be equitably shared.

The negotiating position adopted by Qantas in relation to a number of airports is a recent exception to the strong history of airport operators and airlines achieving commercially negotiated pricing outcomes and contrasts with the approach they have adopted historically. While Qantas has used its market power in short-paying invoices at a number of airports, the legal proceedings that have recently been commenced by Perth Airport to recover unpaid fees is a nationwide first. This is evidence of the effectiveness of the current system. Morrison & Co also notes that the ACCC has not recommended to the Minister that an inquiry be undertaken and, aside from regional air services at Sydney Airport, there have been no price notification directions issued under Part VIIA of the Competition and Consumer Act 2010. Despite successful declaration of certain services at Sydney Airport no disputes were brought during the declaration period.

The availability of these options, along with annual monitoring and periodic Productivity Commission reviews has been effective in creating an environment for commercial agreements to be reached. As the PC has demonstrated, the outcome of the agreements has been one which balances the interests of stakeholders, and in particular the overall level of prices is not too high as it reports that airport financial returns are not excessive.

Why additional regulation is likely to harm investment

Morrison & Co notes that any form of more intrusive regulation that would interpose a third party as decision maker would create a risk for investment that is not justified by the potential benefits. This includes the "simple and quick" forms of regulation being proposed by some of the inquiry participants and more comprehensive regulatory regimes.

“Simple and Quick” Forms of Regulation

“Simple and quick” forms of regulation (like negotiate/arbitrate – with either the ACCC or a commercial arbitrator - or final offer arbitration) in many ways create the greatest risk to economic benefits and future investment in the sector. That is because:

- a process that is necessarily limited in scope and only has a limited number of industry participants has a high risk of arriving at an outcome that damages the economy through delayed, cancelled or modified investment outcomes that do not support airline competition; and
- an unexpected outcome, or chance of an unexpected outcome, from a specific regulatory process will send a signal to investors generally about the stability of the investment environment and it is unlikely that this wider economic impact would be given sufficient weight in a limited scope regulatory process.

Risk to economic benefits

In meeting the needs of final customers (passengers), airports have a contractual duty to the Commonwealth to supply capacity to meet expected demand and facilitate the access of new airlines to airport services. Whilst this is in the best interest of the airport, it is also in the best interests of the economy and community which it serves.

If a single airline (or subset of airlines) is able to access a restricted scope third party determination process, it is likely this will become either a default process and undermine the genuine engagement between airports and airlines or create an environment in which airports seek to satisfy vocal incumbents over the interests of the economy and community. The economy and community will be best served through having airport capacity available and a level playing field for airline competition. A narrow third party process will only be able to fully consider the needs of the participants.

Risk to investment appetite and future investment

The scope of issues that could create unintended consequences include the desirability of particular investments, optimisation of investments, quality of services and facilities and appropriate risk-weighted returns. Also, regulatory intervention that unexpectedly changes the return profile of existing investments will dampen investor demand and/or increase the cost of future investment due to the increased perceived risk.

Extensive Regulatory Regimes

In order to avoid the pitfalls of a “simple and quick” regulatory intervention, it could be argued that an extensive, broad ranging and highly resourced regulatory regime would be needed. The obvious problem with this is that the cost of the process in terms of both resources and delay time will certainly not be justified by the benefits. In addition, however,

the Australian energy sector provides a current example of where an extensive regulatory regime can arrive at an inconsistent conclusion that also threatens future investment.

Australian Energy regulation (transmission)

The current Integrated System Plan (ISP), the Regulatory Investment Test for Transmission (RIT-T) and the Rate of Return Guideline (ROR) for the sector are inherently incompatible.

The ISP identifies a number of critical large investments that are needed to deliver energy from generators to consumers as the energy system evolves, including to facilitate the growth of renewable energy. The RIT-T is an intensive re-examination conducted on a project by project basis. The RIT-T process is lengthy and expensive, with no certainty of the form of investment until it has been concluded and approved. The ROR has set an expected return for the sector that is at a rate that has no allowance for the types of risks inherent in new investment, which include the planning and approval process and construction risks. In addition to these processes being in conflict with each other, the processes themselves are unwieldy and costly.

Major Airports leased from the Commonwealth and Queensland Governments have Government endorsed Master Plans (a requirement of the Airports Act) which are analogous to the ISP. Major investments also require a Major Development Plan that is required to be approved by the Minister after extensive consultation. To introduce an economic regulator that can determine through their decisions whether such projects are investable is analogous to the current ROR process in the energy sector and risks bringing inconsistency into the process and raising costs.

Conclusion

Our experience across multiple sectors and jurisdictions leads us to conclude that light handed regulation of airports in Australia is working well.

We agree the Commission's view that a more interventionist approach to regulation, such as negotiate/arbitrate or final offer arbitration, would be time-consuming and costly and ultimately not in the best interests of the industry or passengers. Airport operators make long-term investments in generally common-use infrastructure. Introducing the ability for a single airline to routinely utilise a third party framework to hold up investment in airport capacity would reduce the efficiency of the airport as a whole and negatively affect passengers who benefit from increased services and greater competition between airlines.

The countervailing market power of large and sophisticated airline customers, the opportunities available to reach mutually beneficial agreements and the threat of retrograde regulation is a genuine deterrent to any mis-use of market power. As an infrastructure investor across other sub-sectors, Morrison & Co is familiar with the prescriptive and inflexible heavy regulation in other sub-sectors such as water and power utilities. As

highlighted above, maintaining strong appetite for investment in airports relates to the stable light handed regulatory regime which encourages commercial outcomes, and allows investors to earn an appropriate risk-adjusted return that reflects the volatility of the sector. As such, we agree with the Commission's view in their draft report that the existing regulatory regime remains fit for purpose.

Yours sincerely
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