16 March 2001

Professor Richard Snape
Commissioner
Productivity Commission
Airports Inquiry
LB2 Collins Street East
MELBOURNE VIC 8003

Dear Professor Snape,

AMP Henderson Global Investors (AMP Henderson) is pleased to make the following submission to the Productivity Commission in relation to the Price Regulation of Airport Services. AMP Henderson is a significant investor in Australian infrastructure and funds managed by AMP Henderson hold 49.9% of the equity in Australia Pacific Airports Corporation Limited (APAC). While AMP Henderson believes the views made by Melbourne Airport in its submission to this inquiry are consistent with the issues specifically raised in our submission, we would draw your attention specifically to the following issues:

- Certainty and transparency in the regulatory regime for airports is a pre-requisite to promote investor confidence in this sector;

- Our expectation at the time of investing $172m of equity and $161m of debt in to Melbourne Airport was for the regulatory environment post 30 June 2002 to be either lifted completely or at most, light handed in nature. AMP Henderson still holds this expectation;

- The APAC Board supported by AMP Henderson has encouraged investment in both the regulated (aeronautical) and non regulated (non aeronautical) parts of the business since privatisation; and

- AMP Henderson is opposed to any form of single till to apply at any Australian Airport.

We would see ourselves as long term investors in Australian infrastructure and we look forward to a regulatory regime that allows us to recommend this sector to our clients.

Yours truly,

Danny Latham
Head of Infrastructure

AMP Henderson Global Investors

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Price Regulation of Airport Services

Background

Private Capital is a division of AMP Henderson, a subsidiary of AMP Limited. It employs 60 staff across UK, Australia, New Zealand and Chile, that specialise in sourcing and managing private capital investments worldwide.

Over a 36 year history, Private Capital has gained a wealth of investment management experience in the unlisted resources, industrials and infrastructure sectors of the private capital market. Specialist skills have arisen from active participation in Australia's economic development.

In 1994, as a result of the upsurge in opportunities for private sector infrastructure investment, AMP Henderson established a dedicated Infrastructure Team within Private Capital. The Infrastructure team now manages approximately $1.5b of funds under management. Appendix 1 contains a summary of the AMP Henderson Infrastructure portfolio (and is provided under a separate cover).

AMP Henderson has been at the forefront of unlisted infrastructure investment in the Australian market with a first mover advantage in the sector as Government privatisation began and markets deregulated. Examples include winning our clients stakes in:

- Optus (1991) - as a founding shareholder;
- United Energy (1995) - the first electricity distribution company to be privatised by the Victorian Government;
- Melbourne Airport (1997);
- Pulse Energy (1999) - Australia's first pure energy retailer; and
- COMindico (2000) - Australia's first national internet protocol telecommunications network.

The Australian investors in APAC are a major source of institutional investment in Australian infrastructure, namely AMP Henderson, Deutsche Asset Management and Hastings Funds Management. As a collective group these fund managers manage over $5 billion of equity in infrastructure investments and over the last 6 years have invested in infrastructure assets with an enterprise value in excess of $12 billion.

Rationale For Investing In Infrastructure and Specifically Airports

The Private Capital Infrastructure portfolio includes a range of investments across various sectors including telecommunications, toll roads, gas

pipelines and distribution, electricity distribution, water treatment plants, and airports. Within these sectors, the portfolio is invested in both regulated and unregulated businesses in the domestic and international economies. In circumstances where there was clarity and certainty on regulation, there were clients of AMP Henderson that preferred to invest in regulated infrastructure businesses. **Uncertainty over future regulatory outcomes remains a primary concern of AMP Henderson and its clients**.

Airports, as an asset class within Infrastructure was identified by AMP Henderson as early as 1994 when it commenced discussions with BAA plc to pursue Australian airport privatisations. AMP Henderson recommended its clients invest in APAC with an understanding of the current regulatory environment and an expectation of what lies beyond year 5. This expectation is based on broad principles outlined in a letter written to Mr A Jurenko, the then CEO of APAC dated 17 June 1997 by the Treasurer the Hon. Peter Costello. Some of the principles include the following:

- "As with the initial five year period, the Government will not mandate the use of a single till approach to airport pricing."[1]
- "It is the Government's intention to step back from setting prices at individual, privately-leased airports; and to provide a framework in which – over time – airport operators and their customers are encouraged to negotiate directly, and resolve prices rather than involve the Government of the day."[2]
- "Prices oversight under the Prices Surveillance Act 1983 is based on voluntary restraint….If an airport operator were to attempt to establish charges above those allowed for by the price cap, then measures contained in the Prices Surveillance Act 1983 could be applied."[3]
- "The first five years of the scheme is viewed essentially as a period of transition, to allow all stakeholders to adjust to the new operating environment for airports."[4]
- The ACCC's first review of prices oversight arrangements will be based on… "(d) prices oversight arrangements should minimise compliance costs on operators and the Government;"[5]

In light of these principles, AMP Henderson invested $172m of equity and $161m[6] of subordinated debt in to the sector in 1997. This was one of the largest single investments into the airport sector of any Australian financial institution at the time. Furthermore AMP Henderson invested at the time in to a dual till regulatory regime with a view on volume growth in the underlying asset.

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[1] Letter by the Treasurer the Hon. Peter Costello dated 17 June 1997 addressed to Mr A Jurenko, CEO of APAC Page 8, Attachment A
[2] ibid, page 3
[3] ibid, page 6
[4] ibid, page 8
[5] ibid, page 11
[6] As at 16 March 2001, AMP Henderson held $141m of subordinated debt as a result of a sale of $20m last year.

While it was always expected the consultation process would occur around early 2001, the draft reports of the Australian Competition and Consumer Commission (ACCC) in relation to Sydney Airport[7], raise a level of concern within AMP Henderson. In particular, the position adopted by the ACCC in relation to the inclusion of car parking revenue in the regulated aeronautical till, would represent a departure from the principles outlined by the Treasurer, the Hon. Peter Costello (referred to above) if this approach were to be applied to Melbourne Airport going forward.

AMP Henderson's expectation of regulation of the airports in APAC, is for either no regulation or at least light handed regulation post 30 June 2002. To propose anything more than this would raise sovereign risk issues for AMP Henderson. As an investor in infrastructure projects of significance to the community, issues of transparency and certainty in the regulatory regime are important. The impact of any significant change in government policy relating to the regulation of airports will not only have a detrimental impact on the views of domestic investors but international investors as well.

AMP Life funds represent the retirement funds of in excess of one million Australian retail customers ("mums and dads"). AMP Life is also a major investor in funds managed by Private Capital. Consequently issues that affect the financial performance of APAC will affect the performance of these retirement funds.

Issues

Infrastructure is an essential contributor to the production of other goods and services. It also typically relies on limited use assets and hence represent sunk costs. Therefore any increase in risk, or the perception of risk, will result in a reduction in the capital available for investing in infrastructure or an increase in the returns demanded by that capital.[8] An unfavourable regulatory regime would be perceived by AMP Henderson and its clients as an increase in risk, and would cast serious doubts over our preparedness to invest further capital in to the sector.

AMP Henderson's clients expect sound economic analysis of the investments made on their behalf. This principle applies to Private Capital's investee companies, such as APAC. The ability of airlines to change routes, and the sunk cost nature of aeronautical capital expenditure poses a challenging question about the appropriate rate of return on aeronautical capital expenditure for an airport operator and owner. Airlines have been known to change traffic routes rather quickly. Since privatisation, APAC has had airlines such as Alitalia, Eva Air, Merpati and Polynesia withdraw flights to Melbourne. Fortunately there has not been any significant capital

[7] Sydney Airports Corporation Ltd. Aeronautical Pricing Proposal Draft Decision February 2001, Australian Competition & Consumer Commission.
[8] Submission by The Regulated Businesses Forum to the Department of Treasury and Finance, Victoria, Essential Services Commission, page 8

expenditure made by APAC for these customers, however the rate of return on capital expenditure needs to adequately compensate the investor for the risk involved.

The APAC Board have been strong supporters of management initiatives to grow the non-aeronautical (unregulated) side of the business. Since acquisition APAC has added over 2,000 sqm of retail space, providing passengers with a wider range of retail choice and hence an increase in consumer welfare. This would appear to support the economic premise that the dual till approach to regulating airport prices is likely to provide airports with the incentive to "invest in unregulated non-aeronautical services where it is commercially viable."[9] Similarly this approach is taken by Network Economics Consulting Group in their Final Report-May 2000 to the ACCC where they state the "dual till system is likely to encourage a greater level of dynamic efficiency in the provision of competitive non-aeronautical services compared with the single till alternative."

AMP Henderson understands that the purpose *inter alia* of this inquiry is to identify those charges for airport services or products where the airport operator has been identified as having most potential to abuse market power. The construction of the Multi User Domestic Terminal (MUDT) at Melbourne Airport is an example where APAC has not abused market power in regard to aeronautical services. The decision by APAC to expand terminal capacity for new entrants at Melbourne Airport has increased the level of competition in the domestic aeronautical passenger market.

The intervention of the ACCC in relation to APAC's construction of a MUDT however, was a typical example where regulation has the potential to hamper the efficiency of airport operations. The ACCC's introduction of an additional regulatory layer means that the APAC Board's ability to invest capital in the regulated (aeronautical) side of the business is now necessarily out of step with its ability to approve an investment in the unregulated side of the business. This in turn affects the efficient operations of the airport and also appears to be at odds with the Government's stated intention to step back from setting prices and to allow airport operators to negotiate directly with their customers rather than involve the Government of the day[10].

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[9] 'Dual Till' at Sydney Airport, A Report prepared for the Australian Competition and Consumer Commission by the Network Economics Consulting Group, Final Report – May 2000, page 2

[10] Letter by the Treasurer the Hon. Peter Costello dated 17 June 1997 addressed to Mr A Jurenko, CEO of APAC, Attachment A, page 3

Conclusion

Given the first 5 years was viewed as a period of transition to allow all stakeholders to adjust to the new operating environment for airports, APAC has established relations with the relevant stakeholders in the airline industry. This transition period was probably a sensible approach given this was the first major privatisation of a network of airports any where in the world.

Certainty and transparency in the regulatory regime for airports is a pre-requisite to promote investor confidence in to this sector.

AMP Henderson and its clients would view no airport regulation or at least a sensible light handed regulatory approach as favourable to encourage further investment in to the airports sector.

If the Government decided to take a more aggressive regulatory stance than light handed regulation at Melbourne Airport, then AMP Henderson would clearly prefer some form of dual till. This would at least continue to provide an incentive to continue investment in the unregulated services where it is commercially viable.

In its submission to the Productivity Commission, Melbourne Airport has outlined its case for the need for no form of regulation. This is supported by AMP Henderson.

Danny Latham Stephen Leong