WESTRALIA AIRPORTS CORPORATION

PERTH INTERNATIONAL AIRPORT

SUBMISSION TO PRODUCTIVITY COMMISSION INQUIRY

PRICES REGULATION OF AIRPORTS

MARCH 2001

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EXECUTIVE SUMMARY

The regulatory arrangements that have applied to privatised airports have failed to achieve most of the Government's stated objectives. In particular:

- the objective of minimising costs of regulatory oversight for both the ACCC and the airport operators has not been achieved;
- the prices oversight regime has not created the conditions for commercially-driven decisions on the part of the airport operators; and
- airport operators and their airline customers have generally not been successful in negotiating outcomes on pricing and investment.

Nevertheless, Perth International Airport (PIA) has delivered substantial cost savings to airlines through reduced landing charges under the CPI-X charging regime.

WAC is concerned that the starting point prices for the CPI-X regulatory period under-recovered the direct operating costs of providing aeronautical services at PIA and did not recover to any extent, a return on the aeronautical asset base. Based on the building block approach to price determination, WAC estimates that it will have an accumulated shortfall in aeronautical cost recovery in excess of $27m by June 2002, despite achieving significant operating cost efficiencies and productivity improvements since taking over the airport.

Market power and the abuse of market power in the context of the aeronautical and aeronautical-related services are the major issues for this review. The mere existence of market power is not prima facie cause to invoke prices regulation, without conclusive evidence that this market power has been abused.

On the other hand, the possible existence of countervailing market power of airlines has been acknowledged in the PC's issues paper. This submission demonstrates specific instances where airlines have countervailing market power and where they have used it for commercial advantage.

As an alternative to future prices regulation, WAC proposes a solution whereby airports and airlines enter into commercially negotiated aeronautical services agreements, incorporating the scope and pricing of airport services, the conditions of use by airlines of the airport, the process for consultation and exchange of information and quality of service. Such agreements when accompanied by the access provisions of the Trade Practices Act and the significant countervailing market power of airlines would constitute an effective body of counter-measures to alleviate concerns over abuse of market power by airports.

Airport specific, aeronautical services agreements may require legislative support, through for example, the application of a Government policy directive. This should be developed on the overriding philosophy that all services provided by the airport operator are treated as contestable unless one of the parties can prove that the other has market power and is abusing that market power in relation to that service or proposed service. The policy directive should provide guidance to determine the criteria for demonstrating market power and abuse of market power. The policy directive would also define the key parameters of the airport-airline consultation environment that apply in the absence of agreement between the airport and airlines.

WAC believes that all parties, airport operators, airlines and the Government, through the policy directive, should work collaboratively to secure an environment that provides incentives for airports to invest in aeronautical infrastructure, encourages competition, is administratively efficient, facilitates transparency and encourages parties to arrive at negotiated resolution rather than rely on a costly and intrusive regulatory response.

1. INTRODUCTION

The current regulatory regime administered by the Australian Competition and Consumer Commission (ACCC) in respect to leased airports is subject to a review prior to the conclusion of the first five-years following grant of the airport leases. For Westralia Airports Corporation (WAC), the operator of Perth International Airport (PIA) this will be 30 June 2002.

WAC is pleased that the Assistant Treasurer has referred this review to the Productivity Commission (PC) rather than the ACCC. WAC believes that it is inappropriate for the current regulator, the ACCC to conduct a self-assessment of its own regulatory performance to date or of its possible continuing role in regulation of the airport industry.

This submission considers three main issues, which WAC believes are central to the PC's review. Section 2 presents WAC's experiences with the regulatory regime to date. This commentary is presented to assist the PC in its review of the existing arrangements for price regulation of airport services.

In Section 2, WAC will present evidence that demonstrates the ACCC has not regulated airports in a consistent or light handed manner, the process has lacked transparency and has created an incentive for airlines to engage in regulatory gaming, and that generally, in WAC's opinion, the regulatory arrangements have failed to achieve the Government's objectives.

Section 3 presents WAC's views and experiences in respect of the question of market power and, importantly, the existence of significant countervailing market power by airlines. The prevailing assumption that airports have and abuse market power appears to have been a major determinant of the way the ACCC has applied airport regulation to date.

Finally, in section 4, WAC presents some preliminary views on future airport prices regulation.

2. REGULATION OF PRIVATISED AIRPORTS – PERTH INTERNATIONAL AIRPORT'S EXPERIENCES TO DATE

As one of the three phase one airports sold by the Commonwealth Government on July 1 1997, WAC will have operated for 4 years under the current regulatory framework administered by the ACCC by June 2001.

The terms of reference for this inquiry require the PC to evaluate the operation of the existing prices regulation, and to analyse and quantify the benefits, costs and economic and distributional impacts of the current arrangements.[1]

WAC believes it is well placed to provide informed comment to the PC in respect to both the application and administration of the regulatory regime to date. This is evidenced by WAC having lodged a number of submissions to the ACCC in respect to Necessary New Aeronautical Investment (NNAI) proposals, provided detailed regulatory accounts to the ACCC each year, reported to the ACCC on compliance with the CPI-X price cap and Government mandated security services, completed quality of service monitoring, attended a number of ACCC regulatory forums and conducted extensive consultation with airlines.

Additionally, WAC has attempted to clarify its understanding of the ACCC's procedures and processes through meetings and regular contact with ACCC officers and Commissioners.

Overall, WAC is strongly of the view that the regulatory regime put in place for the Phase 1 airports has failed to achieve most of the Government's stated objectives. In particular, WAC will demonstrate that the objective of minimising costs of regulatory oversight for both the ACCC and the airport operators has not been achieved, that appropriate economic outcomes have not been achieved, that the prices oversight regime has not created the conditions for commercially-driven decisions on the part of the airport operators and that airport operators and their customers (airlines) have generally not been successful in negotiating outcomes on pricing and investment.

Before entering into more detailed discussion regarding the existing regulatory regime, it is worth examining some important aspects of the ownership of the privatised airports, and the basis upon which the owners of PIA lodged their bid for the airport lease.

2.1 AIRPORT AND AIRLINE OWNERSHIP PROFILES

The current owners of PIA are predominantly Australian investors, with a minority overseas shareholder. Hastings Funds Management is an Australian specialist infrastructure fund manager, which manages entities with an 85% interest in PIA, as well as equity interests in several other Australian airports and infrastructure assets. Hastings investments are held through the Australian Infrastructure Fund (AIF) and Utilities Trust of Australia. AIF is the only listed vehicle, providing retail and institutional investors with access to a diversified portfolio of Australian airports, and has in excess of $150m invested across six airports in Australia. Hastings has more than $2b of funds under management.

[1] Price Regulation of Airport Services Issues Paper – January 2001, p14

Shareholding in the two other Phase 1 airports, Brisbane and Melbourne is similarly dominated by Australian investors, with a minority of overseas investors. In fact, taking all three Phase 1 airports together, Australian investors account for $457m, or approximately 84% of total equity invested.

There seems to be, however, a reasonably widespread misconception that privatised Australian airports are predominantly foreign owned. Clearly, the facts presented show that this is not the case.

The high degree of Australian ownership in airports means that adverse investment outcomes, which limit or provide sub-optimal returns to these investors, such as the risk of setting regulated returns too low, have a direct impact on the economic welfare of these Australian investors. Conversely, where these investors are adequately compensated for their investment, there will be more incentive for them to retain or even increase their ownership in Australian infrastructure assets.

This was recognised in a report from the Department of Transport and Regional Development to the Australian National Audit Office, which stated that " the foreign ownership requirements of the Act, in setting a limit of 49% for aggregate foreign stakes in an airport lessee company, are not (as for example, the Broadcasting Act is) directed principally towards control issues. The intention of the legislation is to see that Australians are the principal beneficiaries of the operation of the airports."[2]

By contrast, ownership of the major Australian airlines, Qantas and Ansett is characterised by a far more significant degree of foreign ownership, with up to 49% of Qantas owned by foreigners including British Airways and 100% of Ansett owned by Air New Zealand. Apart from regional airlines, all other airlines are entirely foreign owned.

The Commonwealth Government has recognised the strategic importance of limiting the extent of foreign ownership in organisations generally, through the enactment of such measures as the thin capitalisation provisions of the Income Tax Assessment Act. In the case of airports, the Commonwealth specifically requires a majority Australian ownership.[3] WAC firmly believes that the contrast in foreign ownership profiles between airports and airlines and therefore the extent to which Australian investors are impacted by regulatory outcomes is a relevant and important consideration for the PC in this review.

2.2 AIRPORT INVESTOR EXPECTATIONS

As the first phase of the Government's privatisation of 22 airports owned and operated by the Federal Airports Corporation, the sale of Perth, Melbourne and Brisbane airports in particular attracted considerable investor interest both domestically and internationally. In the case of PIA, the gross proceeds of $639m from the sale represented a multiple in excess of 20 times the EBITDA recorded under FAC for the year ending June 1997.

[2] Australian National Audit Office – Audit Report No38 1997-98 Sale of Brisbane, Melbourne and Perth Airports, p69
[3] Transport and Regional Development – Pricing Policy Paper and Airports Act 1986

Optimisation of the proceeds from the airports' sale was a clear objective of the Government's sales process. The Office of Asset Sales and the Government's business adviser sought to maximise sales proceeds by highlighting the value potential of the airports in the marketing campaign, the information memorandum and data presented in the buyer data rooms.

The bidders for PIA were attracted to statements in the information memorandum that highlighted the investment opportunity of the airport, its growth prospects and the unexploited commercial potential in retail, trading, car-parking, ground transport and property development.

From a regulatory perspective, bidders were encouraged by policy statements made by the Commonwealth Government, which highlighted that:

- the Government would not mandate the use of single till – stating that this would be a matter for airport operators to determine;
- the Government would encourage airport operators and their customers to resolve pricing issues commercially rather than through the regulatory process; and
- that the economic regulatory framework would be flexible.

The Commonwealth Government's Pricing Policy Paper, November 1996 also confirmed that the price cap would only apply to those charges for aeronautical services covered by the definition in the FAC Act and stated that "this coverage best meets the need for new owners of airports and aviation users to have some certainty about price structures and the impact of the CPI-X cap".

Having set the scene for what investors in WAC reasonably understood to be light-handed regulation which encouraged airports and airlines to negotiate commercially, the promise of no single-till and explicit identification of additional income sources, including fuel throughput fees, ground transport charges and opportunities to improve car-parking charges, WAC will demonstrate in the sections to follow that what has actually taken place to date is:

- intrusive and single minded ACCC regulation;
- airlines exploiting the incentive provided by the regulatory regime not to negotiate;
- unexpected surprises in ACCC decisions and opposition to new income sources;
- increasing and unwarranted focus on single til; resulting in
- wealth transfer from Australian airport investors to foreign airline investors

2.3 AIRPORT STAKEHOLDER EXPECTATIONS

While airlines are important stakeholders in airports, other bodies, such as local and state governments, as well as organisations involved in the tourism and hospitality industries, have a vital interest in airport services.

For example, governments are concerned to maximise the employment benefits arising from airports and their outputs, and to foster sustainable competition. All parties want to ensure that the airport has capacity to accommodate future growth and to provide a level of efficiency, convenience and ambience, which ensures that visitors arrive and depart with positive experiences.

Airlines, on the other hand, have demonstrated that their priorities are for airports to minimise costs and provide the minimal acceptable level of efficiency, convenience and ambience. There is no better example of the airlines' attitude in this regard, than the fiasco which surrounds the Adelaide Multi-User International Terminal, which has languished due to airline recalcitrance, despite the urgent need for improved terminal facilities expressed by stakeholders other than airlines.

WAC has experienced similar frustration to date in its efforts to secure airline agreement for a major redevelopment and expansion of the Perth international terminal. This is despite strong support for the project on the part of the State Government and the tourism and hospitality industries in Western Australia.

2.4 AERONAUTICAL CHARGES UNDER CPI-X

With the X factor for PIA set at 5.5%, WAC has the highest reduction in unit aeronautical charges of any privatised airport in Australia.

The Commonwealth Government's Pricing Policy Paper, November 1996 stated "the X value in the CPI-X formula reflects expected general productivity improvements… in the delivery of aeronautical services at each airport."

WAC has sought to obtain information from both the Department of Transport and Regional Services (DOTRS) and the ACCC to establish how X was determined and, in particular, how the expected level of productivity improvements had been determined. Unfortunately, neither party has been prepared to divulge the basis for the determination of "X", and in fact, DOTRS has publicly stated that it would not be prepared to "unpick" X in respect of privatised airports.

With aeronautical services subject to the "X" factor constituting approximately 30% of WAC revenues, it is, in WAC's view, not unreasonable to expect that the basis and assumptions used in the setting of X should have been made available to each of the privatised airports. WAC regards this as a demonstrative example of where the regulatory framework has not lived up to a legitimate expectation by stakeholders of transparency.

Apart from the level of "X", the other major determinant of unit aeronautical charges at PIA is of course the level of CPI. The price cap formula uses the underlying measure of CPI recorded in the year to the previous March quarter to set aeronautical charges. In the 5 years leading up to the period in which the CPI-X formula for privatised airports was established, the underlying CPI measure averaged 2.5%.

In the period since July 1997, Australia has experienced a period of low inflation, with the underlying measure of CPI averaging just 1.9%. The lower than reasonably expected CPI that has applied throughout the period of regulation to date has resulted in a higher reduction in unit aeronautical charges by privatised airports.

It should be noted that the Government's Pricing Policy Paper specified that the underlying measure of CPI, as published by the Australian Bureau of Statistics (ABS), would be used for the price cap, on the basis that the underlying CPI is adjusted to remove some of the more volatile price components. The ABS discontinued publishing the underlying CPI figure in late 1999. In June 2000, Treasury wrote to airports advising that the ACCC will calculate the Treasury underlying rate of CPI.

The reduction in unit aeronautical charges brought about through the CPI-X price cap has been substantial, as evidenced by the following Figures. The graphs show a comparison between a continuation of the prices applying immediately prior to the sale of PIA to the unit charges applying at PIA under the price cap, extrapolated to 2002.

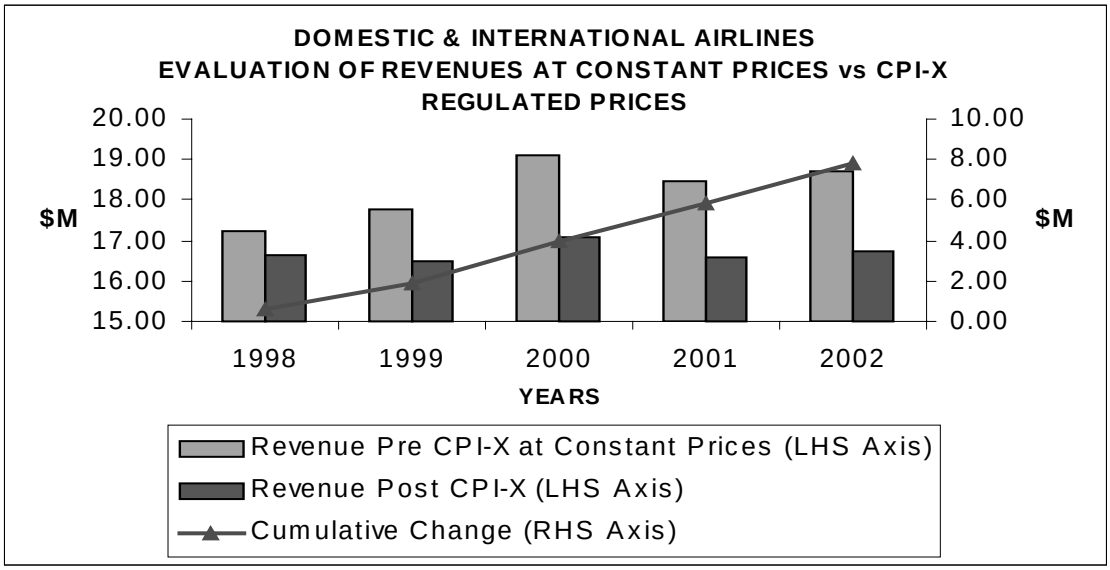

Figure 1 Source: WAC

Significantly, WAC will have passed through cost savings to all airlines using PIA totalling almost $8m, (8.5% real) by June 2002. Similarly large cost savings will have been also passed through to airlines by the owners of other privatised airports in Australia over this period through the CPI-X reductions in aeronautical charges, resulting in total cost savings running into tens of millions of dollars.

To date, however, there has been no conclusive evidence that these cost savings enjoyed by airlines have been translated into lower airline charges. In fact, a recent report in the Brisbane Sunday Mail newspaper[4] reported "the average price of Australia's cheapest domestic airfares fell less than 2% last year, despite the so-called air fare wars". The article went on to report that, "at the same time, the price of full economy fares jumped 14% and business-class fares 17%" and that "the new Bureau of Transport Economics index also reveals an 18% rise in discount fares between September and December last year… the biggest quarterly rise .. since the bureau started calculating average fares in 1992". What this points to is that there has been a wealth transfer from airport (and principally Australian) investors to airline (principally foreign) investors.

A final aspect of PIA aeronautical charges that must be commented on is the relativity of charges to other international airports. Evidence presented by Sydney Airports Corporation in its initial draft aeronautical pricing proposal to the ACCC included a report from the respected Transport Research Laboratory (TRL).

This report presented a regional airport charges index, covering Pacific Rim airports. The results of this, confirming the low level of airport charges at PIA is reproduced in Figure 2.

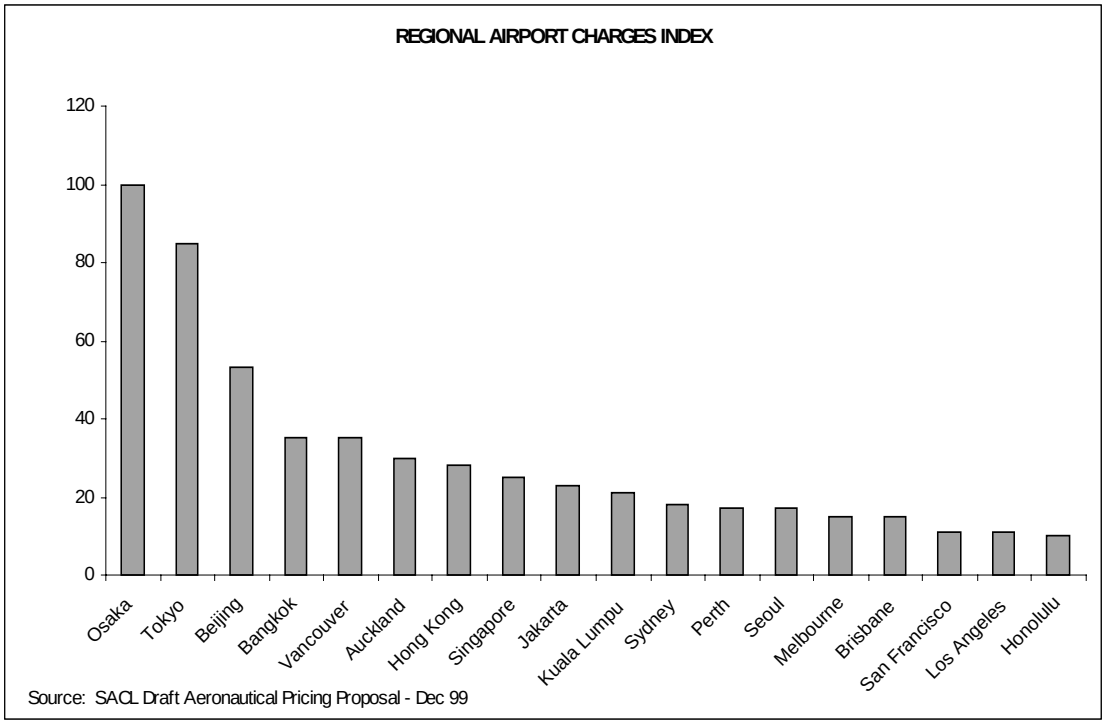

Figure 2

It is particularly relevant to note that, since the survey was conducted in 1999, charges at privatised Australian airports have reduced further as a result of the CPI-X price cap, while international charges may have increased, thereby widening the already considerable pricing differential.

[4] Sunday Mail (Brisbane) General News Section P12 Sunday 11 March 2001

2.5 OPERATING COST EFFICIENCIES

One of the Government's objectives of the prices oversight regime was to "promote the operation of the airports in as an efficient and commercial manner as possible".

The CPI-X price cap regulation has been promoted as being superior to traditional rate of return based regulation because it provides greater incentives for cost efficiency and productivity. This argument rests largely on the assumption that the regulated firm gets to capture any savings in its operating costs that it can achieve through efficiency measures or through productivity improvements.

Figure 3 shows the breakdown of total operating costs for PIA for the 1999/2000 financial year.

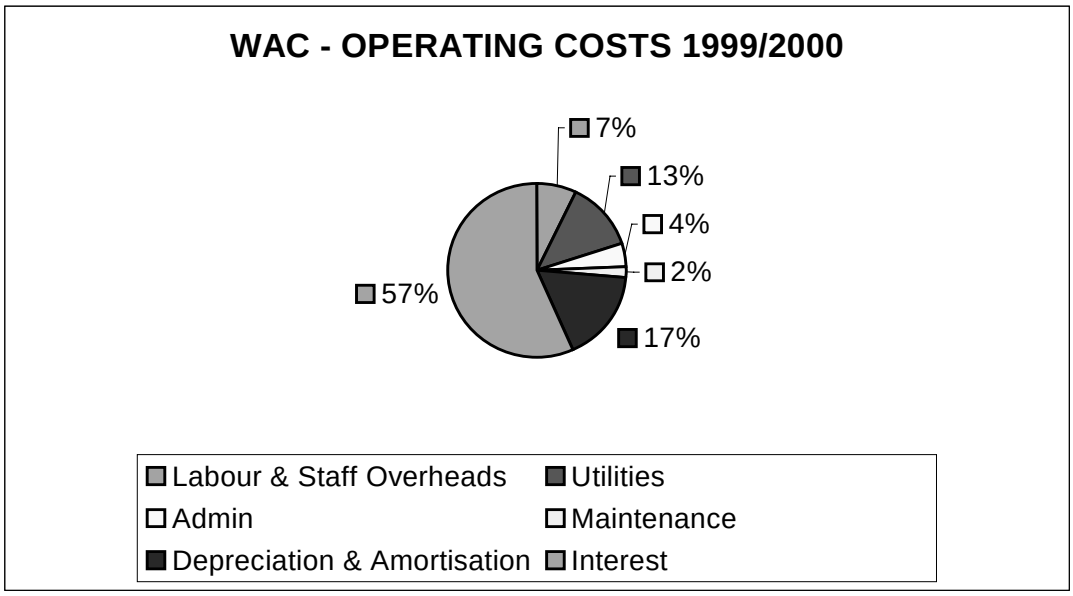

Figure 3 Source: WAC Annual Report 2000

One of the distinguishing features of the graph (which is a defining characteristic generally of airports), is the very high fixed cost nature of the business. In the case of WAC, interest, depreciation and amortisation represent approximately 74% of the total operating costs. The corollary is that costs that WAC regards as variable, and in particular, labour, maintenance and administration, account for only 13%, or $12.5m of total operating costs, with the balance (utilities expenditure) principally fixed.

The implications of this are clear. The ability for WAC to capture efficiency savings is largely confined to the variable cost component of the business, which for WAC is just 13% of total costs. Even assuming WAC was able to achieve a further efficiency saving of say, 10% pa, the resultant saving of approximately $1.2m pa is much smaller than the reduction in aeronautical charges through CPI-X, which for 2001, is expected to be in excess of $1.8m.

WAC has managed to achieve some operating cost efficiencies in real terms, since being privatised, as evidenced by Figure 4.

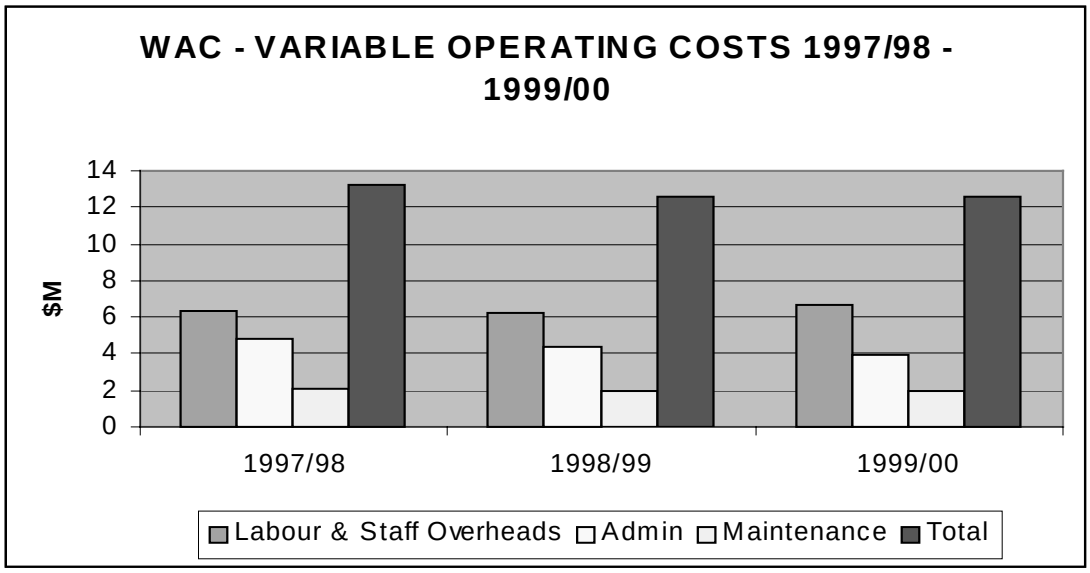

Figure 4 Source: WAC Annual Reports 1998,1999,2000

Total variable operating costs have been reduced in the three years since privatisation by 4.9% in real terms. These reductions have been achieved through a combination of effective cost management, re-negotiation of contractual arrangements with third party suppliers, and an effective staff redundancy program.

However it is important to note that the potential for continued efficiency gains, such as those achieved in the first 3 years is limited. WAC has achieved the cost efficiencies shown to date without compromising either quality of service or operational security and safety standards. WAC believes that it has achieved an optimal blend in its labour mix between activities and services which it contracts out and those which, for airport operational and customer service reasons, it retains. It is therefore important that it is recognised that much of the hard work has already been done by WAC in extracting efficiency gains from the variable cost base.

Of course, WAC recognises that its high fixed cost base may give rise to the potential for productivity gains as aeronautical volume increases. This is demonstrated in Figure 5.

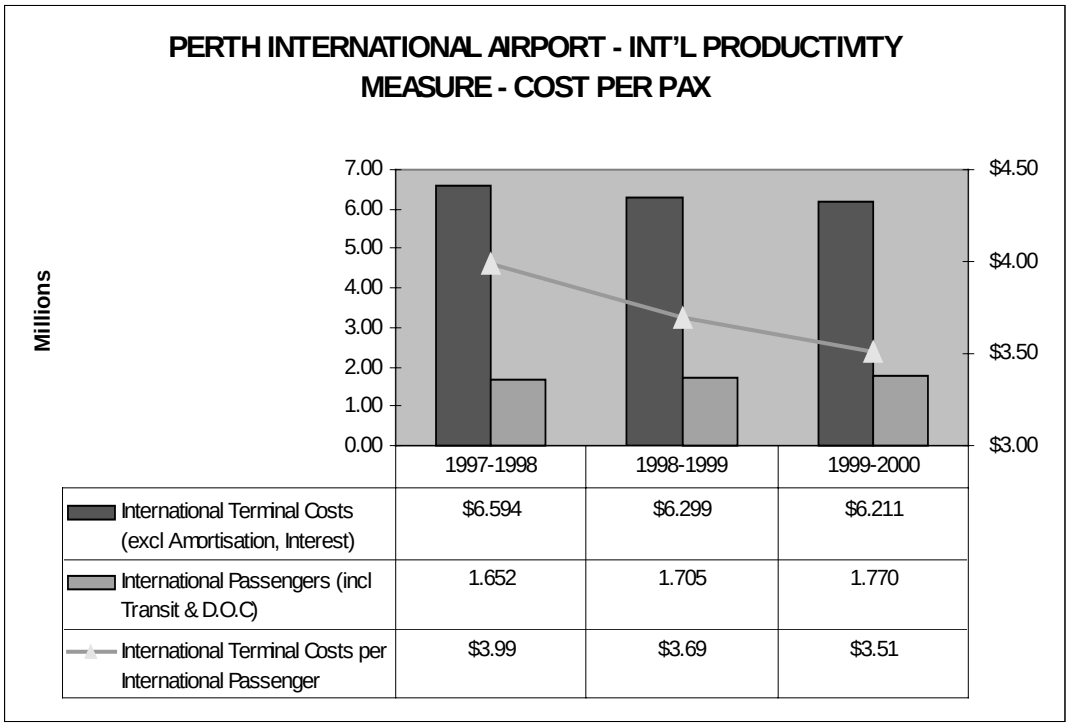

Figure 5 Source: WAC

This graph illustrates the performance of WAC' s international terminal over the period from 1997/98 to 1999/2000. It demonstrates that prima facie, there has been a significant reduction in the costs per international passenger.

This is the product of the combined effect of a reduction in the terminal operating costs and a 7% increase in international passengers over the period. It is worth noting, however that the reduction in terminal operating costs is the result of both the cost efficiency initiatives discussed earlier in this section, and a reduction in depreciation charges.

The preceding commentary concluded that it would be unlikely for WAC to continue to extract ongoing efficiency savings in variable operating costs to the same degree as has been achieved previously. Moreover, the reduction in terminal depreciation charges reflects the fact that the terminal is now 15 years old and that a reasonably high proportion of the fixtures and fittings have been fully depreciated.

WAC is faced with the need to undertake significant capital investment in the next 2 to 3 years, to improve the amenity, functionality and capacity of the international terminal to accommodate future aeronautical growth. This will, if approved, lead to a substantial change in the cost profile of the international terminal, and overall, to a likely step up in total terminal operating costs, due to higher depreciation charges.

2.6 AERONAUTICAL COST RECOVERY

The starting point prices for aeronautical services for the CPI-X regulatory period for privatised airports, including PIA, were those in existence immediately prior to the airport privatisations ie, those that had been determined under the FAC ownership.

The FAC had been working with the aviation industry for almost 2 years in the lead up to privatisation, with the objective of introducing more economic efficiency into its pricing for aeronautical services. This involved the development of location specific and service specific pricing and a move away from the single-till pricing methodology for airport aeronautical services – in line with the Government's adoption of these recommendations from the PSA inquiry into the FAC's charges.

The FAC explained to an industry consultative meeting on 19 June 1996 that it had been set an overall target rate of return of 9.5% on its assets by the Government. Based on FAC's 1996/97 forecasts, FAC estimated that, in order to achieve this rate of return, it would need to increase aeronautical charges by approximately 13.8% to achieve 50% of the EBIT shortfall (the other 50% EBIT shortfall coming from non-aeronautical charges).

During an industry consultative meeting on August 14 1996, the FAC presented a range of scenarios to achieve its required aeronautical charge increase. The scenario recommended was for the recovery of the full 13.8% increase from Sydney, Melbourne, Brisbane, Adelaide and Perth airports only, with the charge increases recovering 100% of all allocated aeronautical operating costs, but excluding any return on the aeronautical asset base. For PIA, this proposal represented an average charge increase of 21% across all aeronautical services.

In October 1996, the Government approved an average increase in aeronautical charges across all FAC owned and operated airports of just 10.8%, the first increase in 3 years.

This decision meant that, at the time of privatisation, average aeronautical charges at PIA did not fully recover the direct operating costs of providing the aeronautical services and did not recover to any extent a return on the assets utilised to provide the aeronautical services.

WAC has prepared the following analysis (Table 1), which compares and forecasts aeronautical revenues resulting from applying the ACCC's building block approach to its aeronautical asset base to the revenues earned under the CPI-X framework for the 5 year regulatory period post privatisation.

COMPARISON OF AERONAUTICAL REVENUES – PERTH INTERNATIONAL AIRPORT BUILDING BLOCKS APPROACH VS CPI-X REVENUES

	97/98 ($)	98/99 ($)	99/00 ($)	Est 00/01 ($)	Est 01/02 ($)
Aero Asset Base at 30 June	79.708	96.540	92.218	88.000	84.000
WACC	7.86%	7.86%	7.86%	7.86%	7.86%
Return on Capital	6.265	7.588	7.248	6.917	6.602
Depreciation	5.229	6.553	5.418	5.000	5.000
O&M Expenses	11.055	10.350	9.674	9.500	9.500
Allowable Revenue	22.549	24.491	22.340	21.417	21.102
CPI-X Revenues	16.912	16.570	17.110	16.678	17.044
Shortfall in Regulated Revenues	5.637	7.921	5.230	4.739	4.058
Cumulative Shortfall	5.637	13.558	18.788	23.527	27.586

Table 1 Source: WAC

The analysis shows that since privatisation, WAC has under-recovered aeronautical revenues at PIA by approximately $19m and that, by the end of the 5-year regulatory period, this will have grown to approximately $27.5m. This implies a rate of return on aeronautical assets under the present regulatory scheme, of just 2.2% for 1999/2000.

WAC believes that there is a misconception among airlines that WAC "inherited" a level of aeronautical charges from FAC that provide satisfactory returns on the underlying aeronautical assets, and an adequate funding pool for replacement capital expenditure.

The preceding commentary and analysis clearly demonstrates that WAC started with aeronautical prices much lower than what, on the basis of the ACCC's building block approach, should have been the case.

For the Government's stated policy of promoting the efficient and economic development and operation of airports to be achieved, the initial prices used in the price cap formula should have reflected efficient prices. Clearly this has not been the case. In the determination of new pricing arrangements for aeronautical services, WAC must be given the opportunity of re-determining its aeronautical prices on economically efficient grounds – that is, on the basis of achieving the revenues derived using the building block approach.

2.7 QUALITY OF SERVICE

The PC states in the Issues Paper that, "given the incentives for cost reduction under the price cap, airport operators could choose to lower their costs through reducing the quality of service, as well as (or instead of) improving the efficiency of providing a given level of service".

The prices regulation regime includes provision for quality monitoring by the ACCC under Part 8 of the Airports Act.

WAC has participated in three quality of service reviews and overall, the ACCC has confirmed in each review that PIA provides an appropriate level of service to airlines and passengers.

However, given that a number of Government agencies and the airlines themselves have a more direct impact on provision of services at an airport, the results of these surveys need to be taken in context.

For example, passengers may experience delays at check-in because airlines provide too few check-in staff. Similarly, passenger delays on arrivals or departures may be due to insufficient border agency staff on duty.

WAC's achievements in continuing to provide appropriate levels of service in the face of continued traffic growth, pursuit of operating cost efficiencies and the continued real reduction in aeronautical charges can only be seen as a positive endorsement of WAC's commitment to service quality.

2.8 AIRPORT CONSULTATION

The Commonwealth Government's Pricing Policy Paper stated "airport operators and their customers are encouraged to negotiate directly, and resolve prices rather than involve the Government of the day" and that "the Government's aim is that airlines and new airport operators form close and co-operative working arrangements".

The price oversight arrangements, as administered by the ACCC, go further than this philosophical approach in respect to necessary new aeronautical investment, by explicitly requiring support from airport users with a significant interest in the investment for the operator's proposals and the new charges.

WAC has gone to considerable lengths in developing and seeking to improve the consultative process with airlines in particular. In the 3½ years since privatisation, WAC has conducted 5 formal consultative meetings with airlines, in addition to regular telephone discussion and face to face meetings with airline officials.

WAC has been fully transparent in providing information regarding its business plan objectives, future capital works plans, traffic forecasts and operating results. In November 2000, WAC tabled a proposed consultation policy, designed to provide both airlines and WAC with an effective framework for the mutual sharing of information and open and frank exchange of views, to facilitate ongoing improvement of airport facilities and services at PIA.

Unfortunately, and contrary to the spirit of the Government's Pricing Policy Paper, it seems that airlines are not equally committed to this process. This is evidenced by recent decisions by a major carrier to code-share on routes from Perth, resulting in substantial revenue losses to WAC, and significant loss of competitive choice by WA based travellers to a major overseas market, being made without any form of consultation with WAC. This particular decision resulted in the loss of 13 x B747 aircraft landings per week to WAC, which in revenue terms, is a loss of over $1m pa. This constitutes 6% of WAC's aeronautical revenues, and 1.4% of WAC's total revenues. In percentage terms, this is the equivalent of a decision that adversely impacted Qantas revenues by $126m pa. Qantas would lobby vigorously against a decision that affected its revenues to this magnitude.

Airlines in some locations are refusing to provide essential data on passenger movements and WAC is also aware that in some locations, airlines have unilaterally refused to pay aeronautical charges. There have been numerous instances where airlines have not responded to WAC correspondence.

Regrettably, the current regulatory arrangements provide a clear incentive for airlines to collectively object to an airport proposal, on the understanding that if they do, the ACCC is not likely to approve the proposal. The airlines are well aware of this, and in fact a senior airlines' representative stated in a meeting in Perth with WAC executives that "there was no incentive for airlines to concede on anything, as they had so far got everything they have wanted out of the regulatory process". It is relevant to point out that in respect to a number of industry submissions on issues to date, the submissions from a number of the airlines have been almost identical. This demonstrates that airlines act collaboratively in responding to such issues and underscores the market power held by airlines.

The ACCC was critical of WAC in its final decision on WAC's application for cost recovery of certain necessary new aeronautical projects, stating that "the consultation process between PIA and users appeared to have been less than totally effective because PIA appeared to have come to the Commission without negotiated outcomes on key projects".

In this regard, the ACCC has taken a lack of consensus as a lack of consultation. WAC undertook extensive consultation with airlines, but failed to reach consensus. The current proposal by Adelaide Airport to develop the MUIT project is a further example, which demonstrates the ability of airlines under the current regulatory arrangements to effectively block a major project by undertaking regulatory gaming.

2.9 NECESSARY NEW AERONAUTICAL INVESTMENT

The issue of what constitutes Necessary New Aeronautical Investment (NNAI) has probably been one of the most controversial and debated matters in the regulatory framework to date.

It was not until March 2000, over half way through the 5-year regulatory period, that the ACCC released its final interpretation of the term Necessary New Aeronautical Investment.

The ACCC's interpretation came down to a consideration of whether the investment increases capacity or enhances standards of service. If the expenditure does not meet these criteria, the Commission has stated that it considers the expenditure falling into the category of replacement investment, or operating and maintenance costs and not recoverable through the price cap.

When responding to the ACCC's draft interpretation of NNAI in February 2000, WAC identified several threshold issues that it regarded as being of fundamental significance to the formulation of a final position on NNAI. WAC strongly maintains that these issues continue to be relevant, so we have reproduced them below.[5]

- The Commonwealth's Airport Sales Process

  "*The draft position paper presents one approach to the definitional problem associated with the lack of clarity of Direction 13.*

  Had this framework been in place and expressly conveyed to bidders at the time of the development of bids for the Phase 1 Airports, bidders would have had the benefit of far greater certainty in relation to the investment climate pertaining to the aeronautical segment of the business and would have factored this into (a lower) price paid for the airport lease.

  It is widely accepted that airport buyers paid what is recognised to be full value for the airport leases. This value has in a large part, accrued by virtue of explicit assumptions in the bid business plans and financial models in respect to the recoverability of NNAI and the rate of return on this investment. We understand that these assumptions were well known by both the Government Sales Team and the Commission.

  The Commission's draft position paper on NNAI, together with other recent decisions in respect to cost of capital, imposes a new set of circumstances that are vastly different to those that bidders based their bids on.

  It also follows a number of other interpretations by the Commission in respect of airport revenue initiatives, which differ significantly to those upon which airport bids were based.

  Regarding expenditure on replacement, enhancement and acquisition of aeronautical infrastructure, bids for the airport lease were based on the reasonable assumption that the Airport Lessee Company (ALC) would earn appropriate economic returns on NNAI outside of the price cap.

  Application of the framework proposed by the Commission results in significant inequity to investors in the airport asset through sub-normal returns on such investments because it potentially restricts the projects that qualify as NNAI while at the same time not recognising the basis upon which the investment in the asset was made when the bid for the airport was documented and accepted by the Commonwealth.

[5] WAC Submission to ACCC- Necessary New Aeronautical Investment February 2000

WAC is strongly of the view that this outcome is in direct contradiction to matters specified in section 17(3) of the Prices Surveillance Act (1983) which the Commission is required to have regard to when determining pricing policy for regulated enterprises.

Specifically, the Commission must consider " the need to maintain investment and employment, including the influence of profitability on investment and employment".

Where the ALC is faced with the prospect of securing sub-normal returns on an investment, the entity is likely to not undertake or at least delay that investment until economies are introduced into the investment equation.

- *Defining Necessary New Aeronautical Investment*

Defining which projects qualify as NNAI essentially involves considering two elements of this term – what is regarded as "new" and what is "investment".

Unfortunately, Direction 13 does not define any part of this term, and therefore we maintain that the context of the airport sales process is also relevant to this issue.

WAC assumed during its bid and continues to maintain that "new" means any investment incurred by the ALC.

It is irrelevant whether or not this was in replacement of existing assets which had reached the end of their useful life – if the investment is funded by the ALC, and it is in respect to declared aeronautical services, then WAC strongly maintains that it is new investment.

The second element of NNAI that is relevant to consider is the term "investment". The Commission takes an extremely narrow interpretation of the term investment in its draft paper, that seeks to draw a distinction between investment in capacity and quality to that in asset replacement.

In effect, the Commission seeks to classify Replacement Investment as a sub-set of Maintenance rather than as a separate investment classification. This has the potential to create several outcomes that WAC argues conflict with desired regulatory outcomes.

Firstly, there will be reluctance on the part of ALC's to replace existing assets, if the ALC cannot satisfy its shareholders that the full costs, inclusive of a reasonable rate of return on capital are recovered in respect of the investment. This will result in a tendency towards slippage in service, safety and security standards to those that just satisfy regulatory requirements.

Secondly, the narrow definition suggested provides an incentive to ALC's to select more costly solutions that unquestionably qualify as capital rather than what may well be more economic short-term investment solutions that are denied because of the definition.

Thirdly, there will be an increasing tendency toward new airline entrants paying higher charges for new assets than existing operators if replacement expenditure is excluded from the definition. This is in contravention of competition policy guidelines.

WAC strongly argues that a much broader definition of "investment" be adopted to include the following types of expenditure, to the extent it relates to declared aeronautical services:

- *expansionary - eg: new runway/terminal expansion,*
- *safety or security related – eg: movement area signage, terminal security,*
- *environmental – eg: drainage basins, remediation of contaminated land*
- *service standard – eg: baggage system upgrades, FIDS enhancements,*
- *asset useful life extension – eg: runway, taxiway apron overlays, and*
- *efficiency – eg: plant replacement, renewal of technology*

This view of investment as it relates to aeronautical infrastructure is supported by international precedent. In the United States, airport authorities typically fund aeronautical infrastructure through Airport Improvement Program grants and Passenger Facility Charges.

Eligibility for these grants is governed by the Federal Aviation Administration (FAA). Section 3, Chapter 5 of the FAA Grant Eligibility Handbook sets out the type of projects eligible for these grants. Significantly, eligible projects include construction, reconstruction and repair[•] of runways, taxiways and aprons.

Further support is provided by the PFC Statute and Implementing Regulations, which require that PFC revenues be used to finance eligible airport –related projects that "preserve or enhance safety, capacity or security of the national air transportation system, reduce noise or mitigate noise impacts….or furnish opportunities for enhanced competition between or among air carriers".

A further aspect to the draft paper that WAC strongly disagrees with is in respect to the question of capacity. The Commission seems to ignore the factor of time when considering whether a runway overlay qualifies under the definitions it proposes as NNAI.

In reality, a runway overlay creates a new asset, that not only means existing capacity can be maintained, but provides the ability to accommodate future increases in capacity, (and therefore landing fees) typically for a period of up to 15 years. This view is also supported by the guidelines of the FAA, in paragraph 521 of Chapter 5 that confirms such costs as being eligible if the existing capability of the runway is preserved or enhanced.

[•] Note – Pavement repair work is eligible where periodic pavement surveys reveal trends in deterioration and it is determined that repair will retain the serviceability of the pavement. The sponsor must have made a conscientious good faith effort to maintain the pavement since the previous construction/restoration/repair project.

Significantly, capitalisation of runway overlay costs by WAC has received unqualified support from the auditors, as it meets the criteria of Statement of Accounting Concepts (SAC 4) for recognition of assets. SAC 4 provides that an asset should only be recognised in the statement of financial position when it is probable that future economic benefits embodied in the asset will eventuate.

Future economic benefits are synonymous with the notion of service potential. SAC 4 regards Future Economic Benefits as future net cash flows generated through the use of the asset, including any reductions in future cash outflows attributable to productivity or technology savings."

A further aspect of the ACCC's decision on NNAI, which WAC made a submission on, was in respect to regulatory precedent. The following is an extract from WAC's submission to the ACCC dated 8 March 2000.

"The second area that the Commission's Draft Decision appears to conflict with is in respect to the Commission's Statement of Principles for the Regulation of Transmission Revenues (the Statement).

While this Statement has particular application to the energy sector, it has previously been made clear by the Commission that it sees the principles set out in this document as having relevance to other regulated industries, such as airports.

The approach set out in this document is to set revenue tariffs based on an "accrual building block" approach, where the allowed revenues are the sum of a return on capital, depreciation and operating and maintenance costs. Thus, a life cycle approach is taken to a particular investment that determines the total project costs, inclusive of opex over the estimated life of the investment.

The dichotomy that the Commission's interpretation of New Investment presents can be best described through an example of an investment by WAC in a new taxiway.

There seems to be little doubt, inter-alia, that such an investment would qualify as NNAI under the guidelines. Determination of unit aeronautical prices, using the principles of the AAL decision and the Statement would be based on a return at the allowed WACC of the capital cost of the project, together with a return of capital (depreciation) and associated opex, over the estimated life of the project.

The Commission's proposed definition of NNAI however, would seem to preclude recovery of opex for such a project. Surely, the Commission does not expect investors to fund the capital cost of such investment with no further recovery for opex or asset maintenance. WAC would appreciate the Commission's clarification of this, as it would probably lead to decisions not to invest in such projects.

Should, as we expect, the Commission confirm that opex is recoverable as part of the new investment, then we would like to understand how the Commission can differentiate this situation to that where expenditure that the Commission arguably sees as opex in respect to previous investments is not recoverable. WAC strongly maintains that this situation creates a regulatory environment that is inconsistent and unpredictable. This will, in turn, force investors to demand a higher risk premium for such investments, yielding a higher cost of capital requirement."

In making this submission to the PC, WAC wishes to emphasise that it retains the views it has expressed in the submissions quoted above to the ACCC. In particular, WAC believes that the current definition of NNAI must be broadened, to incorporate the types of expenditure outlined in the February 2000 response to the ACCC, that the current definition of NNAI can result in distorted outcomes that conflict with the outcomes of an efficient incentive based regulatory system and are inconsistent with other regulatory decisions.

2.10 FUEL THROUGHPUT LEVY

Many airports around the world receive concession type revenues from oil companies, which sell fuel to the airlines. Typically, these are based on the volume of fuel sold.

The bidders for PIA factored new revenue from the fuel levy into their bid, on the basis that pre-existing contracts allowing for the fuel levy had been entered into by the FAC and agreed with fuel companies prior to the airport sale. Moreover, the opportunity to implement the fuel levy was specifically referenced by the Commonwealth Government in the Information Memorandum.[6]

Accordingly, airports which acquired the benefits of these contracts, have merely exercised their rights to charge the fee. It should also be noted that the reasonableness of this fee has been confirmed by an independent expert, appointed in accordance with the lease. The independent expert examined similar fees that are in place at many airports throughout the world in coming to this conclusion.

In rejecting airline opposition to the levy, the independent expert stated that the oil companies would be getting a "free ride" in the expansion of their business if they did not contribute to airport revenues via the levy.

WAC finds it extraordinary that the ACCC could have concluded, despite the evidence presented, that airport operators have taken advantage of market power in the provision of aircraft refuelling services. WAC believes the ACCC has failed to take into account two primary issues in forming this conclusion.

Firstly, the ACCC failed to focus on the question of what is a reasonable approach for establishing the fee in question. In this regard, the fact that WAC derived the fee by taking into account market comparables, and that the independent expert confirmed the reasonableness of the fee was conveniently overlooked by the ACCC.

[6] Perth Airport Information Memorandum, Section 2.6 Business Potential, p20

Secondly, WAC believes a significant factor that, if apparent, would demonstrate an abuse of market power. This relates to evidence from the airlines that in fact the fee proposed by WAC would cause them to seek alternative refuelling means in order to serve the Perth market.

In fact, in their submission to the ACCC, Qantas clearly stated that a fee of less than one or two cents per litre would have no effect on their decision to use existing fuelling services at PIA. WAC's fee is less than 20% of this maximum stated level. In light of Qantas' own submission, it is hard to imagine how WAC's fee would have any impact on the airlines refuelling activities at PIA.

WAC sees the debate about the fuel levy as a distributional issue – involving the relative profitability of airlines, oil companies and airports, rather than as a social welfare issue impacting on airfares. Indeed, the decision late last year by airlines to unilaterally impose a $10 surcharge on domestic airfares to cover rising fuel costs was taken without consultation and, it seems without objection by the regulator, yet has a far greater and more direct impact on airfares than the fuel levy charged by WAC - which, if passed on to passengers by airlines, equates to approximately $0.50 per international passenger.

The ACCC referred this matter to the Commonwealth Government for decision in December 1998. To date, no decision has been taken by the Commonwealth in respect to the ACCC's recommendation that this charge be brought under some form of price cap.

WAC objects in the strongest possible terms the notion that this charge is in any way an abuse of market power, and therefore also objects to the inclusion of this charge in any form of price cap.

It is unacceptable, in WAC's view, to be heading into a future pricing regime with the uncertainty of the Government's response to this issue. It is also unacceptable in WAC's view if the Government accepts the opinion of the ACCC and imposes some form of price cap on this service. The Government cannot sell assets, which have commercially agreed and binding contracts and then seek to deny the purchasers of those assets the benefits of these commercially agreed terms. Accordingly, WAC believes the PC should reject the ACCC's recommendation and exclude the fuel levy from any form of prices oversight.

2.11 GROUND FACILITIES FEE

The business plan submitted to the Commonwealth Government by the bidders for PIA explicitly included new revenues from ground transport charges, on the basis of representations made by the Commonwealth in the Information Memorandum.[7]

[7] Perth Airport Information Memorandum, Section 4.4 Business Potential, p47

In September 1998, the ACCC advised that revenues from ground transport charges introduced by WAC are covered by Declaration No 83, as they relate to landside roads, and would therefore be included in the price cap.

WAC has maintained the view that the ground facilities fee is not a levy on taxis or any other commercial vehicles for access to the airport. The fee puts in place an equitable system of charges at the airport for all businesses that derive revenue from the airport market, and is consistent with charges levied on car rental operators that are in place and not regulated. Ground facilities fees are commonplace at airports elsewhere in the world, reflecting the principle that those who benefit from the airport's growth, should contribute to its revenue base. It is also relevant to point out that WAC provided substantial facility enhancements to cater for the expressed needs of the taxi industry.

Conclusive statements from senior officers of the Department of Transport and Regional Services have reiterated the Government's position that ground transport revenue was never intended to be included in the price cap.[8]

The effect of the ACCC's interpretation is again a re-distribution of wealth from airport shareholders to airline shareholders, which stand to benefit by the further reduction in aeronautical charges.

As with the fuel levy, this matter has been with the Commonwealth Government for a considerable time, during which the ACCC alleges that, as a result of its interpretation, WAC has failed to comply with the CPI-X price cap. WAC maintains its strong opposition to this proposition.

WAC believes the PC should recognise the arguments supporting the concessionary nature of this charge and reject the recommendation from the ACCC that the charge should be included in the price cap.

2.12 ACCC PROCESSES

In commenting on the regulatory process to date, it is worth re-capping on the Commonwealth Government's objectives, set out in the Pricing Policy Paper 1996.

The Government envisioned that the regulatory system (administered by the ACCC) would :

- minimise costs of regulatory oversight for both the ACCC and airport operators;
- achieve appropriate regulatory outcomes;
- create conditions for commercially driven decisions on the part of airport operators;
- encourage airport operators and their customers to negotiate outcomes on pricing and investment;
- facilitate the comparison of airport performance in a transparent manner; and
- not mandate the use of single till to airport pricing.

[8] DOTRS – Ground Access Fees and the CPI-X Price Cap , 14 December 1998

WAC makes the following comments in respect to these objectives.

WAC has incurred considerable costs in terms of both complying with the price oversight arrangements and, in particular, in respect of the development and submission of pricing proposals.

The magnitude of these costs has, in part, been impacted by the fact that a number of aspects of the regulatory framework – for example, the definition of NNAI, the weighted average cost of capital, and the definition of direct cost for the purposes of security charges had to be developed during the period.

WAC notes that, contrary to the spirit of the Government's Pricing Policy Paper, that the regulatory process for lodgement of submissions has generally encouraged the preparation of complex and lengthy submissions, accompanied by detailed external consultants' reports on the part of both airport operators and airlines. The ACCC has also engaged a number of external experts to undertake analysis of proposals. There appears to WAC to have been a culture established by participants to "out gun" one another by making submissions more complex, and engaging the "best" intellectual resources, encouraged by the prospect that success brings.

This process seems to be escalating. In the recent SACL proposal, for example, a lengthy submission by SACL was addressed by a 184 page response by the ACCC. Airline submissions, particularly BARA's were also extremely lengthy.

It is understood that the ACCC has greatly increased the number of personnel in its Airports Group since the airports were privatised. An increasing amount of time has been devoted to regulatory affairs by airport staff and no doubt by airline personnel also.

The guidelines, which the ACCC must take into account in considering NNAI proposals by airports, do not assist this process. No consideration has been given to differentiating project submissions according to their materiality. All projects are considered equally under the regulatory guidelines – whether they are the provision of lighting towers for General Aviation operators, worth several thousand dollars or a terminal expansion worth tens of millions of dollars.

WAC has a strong sense that senior officers within the ACCC have a pre-conceived view on regulatory outcomes, that is more about an over-riding objective of keeping airport prices low rather than achieving efficient prices that provide incentives for investment.

An example of this is WAC's submission to the ACCC in respect of its cost of capital. WAC's economic advisers, NECG, developed strong arguments that supported the use of a higher asset beta (0.95) for PIA. In spite of the compelling evidence presented by NECG, and following the preparation of a response by the ACCC's consultant, an effective rebuttal to the consultant's response, the ACCC final decision on PIA's asset beta remained unchanged from its draft decision.

Moreover, the ACCC appears to have a disposition towards "splitting the difference" in a number of regulatory decisions that WAC has observed. The most apparent evidence of this is in the ACCC's draft decision on SACL's proposal, where, following extensive regulatory comment, the decision delivered an outcome that is roughly between the airline low-end increase and SACL's proposed increase.

Regulatory consistency and the potential for distorted outcomes has also been a concern to WAC, particularly in respect to regulatory decisions on the treatment of maintenance related capital expenditure referred to in the previous section.

One example, which typifies how a position taken by the ACCC did not create conditions for commercially driven decisions on the part of airport operators is the ACCC's decision in relation to the allowable rates of return for mandated security projects.

The ACCC initially refused to allow airports to earn a return on capital invested to purchase security equipment of greater than the cost of debt. This created a dis-incentive for airport operators to invest in the required capital equipment, thus allowing the security contractors to supply and charge for the equipment at rates which, presumably did allow for an equity return.

Following strong airport submissions, the ACCC reconsidered its decision, but reduced the allowable return on what it had previously allowed on NNAI projects, citing the fact that, given the relative certainty of cash-flows associated with cost recovery arrangements, a lower asset beta should be applied. Unfortunately, however, given the tight timeframe given to airports by DOTRS to implement the new security arrangements, and the extended period of time taken by the ACCC in its consideration of the matter, a number of airports had already committed to the security contractors to provide the equipment. This has led to the possibility that airline users may be paying higher charges than what may otherwise have been the case, if the security contractor's cost of capital is higher than the ACCC's allowed cost of capital.

As outlined previously, the regulatory objective of encouraging airports and their users to negotiate outcomes on pricing and investment has failed. Airlines have a clear incentive not to negotiate under the present arrangements. DOTRS has acknowledged the failure of the regulatory arrangements in this respect. In 1999, DOTRS convened a meeting between airports and airlines and issued an administrative guidance document. This document essentially encouraged airports and airlines to develop ongoing relationships on a commercial basis, but also acknowledged that any oversight arrangement by the ACCC should be minimal. More recently, at the Australian Airports Association Aviation Conference in Perth, a senior executive from DOTRS quoted the failure of the airport-airline consultative process as "my personal pain".

In terms of the objective of comparing the performance of airports in a transparent manner, WAC is of the view that the regulatory process has been ineffectual. Regulated airports lodge annual accounts with the ACCC, and while the form of the final published accounts is consistent between airports, there is no way of determining whether each airport has applied the same methodology in reporting aeronautical and non-aeronautical costs. WAC understands that each airport employs different cost accounting tools to achieve the split.

Further, a large component of each airport's costs, interest and amortisation is not allocated between aeronautical and non-aeronautical services by all airports. The ACCC has acknowledged this in the published reports.

Finally, in respect to this matter, there were reported inaccuracies in the ACCC's final reports for the 1998/99 year for Perth and Brisbane airports. WAC presented audited results to the ACCC and does not accept responsibility for inaccuracies in the final printed report. It is worth concluding with an observation that WAC only received the first draft of its 1999/2000 regulatory accounts (lodged with the ACCC on Sept 30 2000) in the first week of March 2001 – 5 months after lodgement.

In regard to the issue of single till, the Commonwealth Government has made its position clear – it would not mandate the use of single till and would leave this as a matter for operators.

The ACCC has, in WAC's opinion, operated outside of Government policy in its draft decision on SACL, where it has applied a single till to SACL's services. This is a clear example of regulatory over-reach by the ACCC and confirms a widely held view that the ACCC has been over zealous in its dealings with airports. The position taken by the ACCC in respect to WAC's fuel levy and ground facilities fee effectively amounts to an application of the single till to these services.

2.13 CAPITAL INVESTMENT IN AERONAUTICAL FACILITIES

In the 3½ years of private ownership of PIA, WAC has undertaken a total of $6.1m of capital investment in aeronautical infrastructure. Of this amount, $3.4m has been approved by the ACCC as NNAI. The expenditure not approved by the ACCC relates to projects which WAC was unable to secure airline agreement to or which did not satisfy the ACCC's NNAI definition. WAC elected to undertake these projects notwithstanding the inability to recover the costs, due to safety, security, environmental or regulatory requirements.

It is important to highlight that under the current regulatory framework, the level of NNAI will be primarily determined by the preparedness of the majority of airlines to agree to not only the project itself, but also to the level of charges. The ACCC places great weight on airline support when considering projects for approval.

It has previously been stated that the airlines understand the criteria used by the ACCC in assessing NNAI very well. Airlines have a single-minded agenda to minimise airport charges. Typically, this means that airlines will only support a NNAI initiative if it suits them to do so – that is, if the perceived benefits of undertaking the project exceed the costs of supporting the proposal. WAC's experience to date has been that generally, airlines have been reluctant to support most initiatives put forward – even where these initiatives are to accommodate expected traffic demand.

The current efforts of WAC to secure airline support for a redevelopment of the international terminal at PIA is a prime example. In this instance, local airline operational staff support WAC's proposal to improve the amenity, capacity and passenger facilitation of the existing 15 year old building. In contrast, the airlines rates and charges personnel, located at their corporate offices, are of a different view and the negotiations to date have proceeded very slowly. This suits the airlines.

WAC will not undertake investments in aeronautical infrastructure generally without airline support. To do so means that WAC shareholders, who have already made a substantial investment in PIA and are receiving a sub-standard rate of return on the aeronautical assets, will subsidise airline shareholders, who will receive the utility from these investments without cost.

Concerns which airlines may have regarding "gold plating" of aeronautical infrastructure are unfounded. The rate of return allowance given to the airports by the ACCC ensures that the shareholders in WAC will be focussed on providing an adequate level of amenity and capacity for the investment and in maintaining their scarce capital for projects in the non-aeronautical sector of the business, which provide far greater returns.

3. WHY REGULATE AIRPORTS

The terms of reference for the PC's inquiry into price regulation of airport services clearly specify that future prices regulation should only apply to those aeronautical services and those airports where airport operators have the most potential to abuse market power.

It is therefore necessary to consider the extent to which WAC possesses market power in relation to the provision of aeronautical services at PIA, and also the extent to which WAC has the potential to abuse market power.

Accordingly, WAC considers the characteristics of market power and how market power can be abused and then applies these findings to each of the aeronautical and aeronautical services that are provided at PIA and currently subject to prices oversight. Finally, the existence of countervailing market power by airlines is considered.

3.1 MARKET POWER

The assumption of the existence and potential for abuse of market power in the provision of certain airport services has essentially shaped the development of the pricing regime currently in place for declared organisations, such as WAC. To WAC's knowledge, no empirical study has conclusively identified that market power either exists or is subject to abuse in respect to services currently defined under aeronautical or aeronautical related categories.

The PC, in its issues paper has defined the characteristics of market power – barriers to entry and no close substitutes, and has acknowledged that there is a range of views about the significance of both of these characteristics in the case of airports.

In the case of the availability of substitutes for a particular service or facility, it is generally accepted that, where there is only one supplier of the service for which there are poor substitutes, then the supplier is likely to be able to exert market power.

It is worth noting at the outset, that the presence of market power itself need not be undesirable. This was acknowledged by the Prices Surveillance Authority in 1994, when it was discussing the statutory criteria specified in section 17 (3) of the Prices Surveillance Act 1983. Specifically, when discussing criterion B (Section 17 (3) (b)), the PSA stated "In the Authority's view, this statutory criterion implies that it is not necessarily undesirable for enterprises to hold market power (for example, substantial economies of scale may exist). The concern, rather, is to discourage the abuse of such power in setting prices."[9]

3.2 EXTENT OF MARKET POWER FOR PARTICULAR SERVICES

On the question of abuse of market power, the PC has stated that this would be characterised by a reduction in the quantity provided and an increase in price and/or lowering of quality.

[9] Prices Surveillance Authority – Discussion Paper on Pricing Guidelines for Efficiency and Fairness, March 1994, p6

On the basis of the PC's views on the defining characteristics of market power and its abuse, the following discussion considers the range of aeronautical and aeronautical related services provided by WAC at PIA in this context. For the purposes of this discussion, aeronautical services are those currently defined under Declaration 87 for PIA. These services are grouped into two main categories:

- Aircraft Movement Facilities, comprising airside grounds, runways, taxiways, aprons, airfield lighting, airside roads and airside lighting, airside safety, nose-in guidance, aircraft parking areas and visual navigation aids; and

- Passenger Processing Facilities and Activities, comprising forward airline support area services, aerobridges and airside buses, departure lounges, immigration and customs services areas, public address systems, closed circuit surveillance systems, security systems, baggage make-up, handling and reclaim, public areas in terminals, flight information display systems, landside roads and lighting and covered walkways.

Aeronautical related services comprise aircraft refuelling, maintenance and buildings, freight equipment and storage sites, freight facility sites and buildings, ground support equipment sites, check-in counters and related facilities and public and staff car parks.

- Aeronautical Services

PIA is the only airport servicing international and interstate markets for Perth and for the greater part of Western Australia. WAC accepts that there are high barriers to entry arising from the large economic cost of providing an alternative facility with equivalent amenity and capacity and considerable social and political issues associated with constructing an alternative facility.

WAC also accepts that there are no close substitutes available for passengers wishing to travel to Perth as a destination. Limited visitor arrivals into Perth come from other avenues (car, bus, train, ship), however these alternatives do not constitute a necessarily feasible and practical alternative to the vast majority of travellers.

While WAC accepts the existence of market power in respect of aeronautical services at PIA, the abuse of that market power is another issue. Remembering the characteristics of an abuse of market power, if WAC reduced capacity, increased price (to a level higher than the costs, including a rate of return, of providing the services) and lowered quality, then it could be reasonably argued that it had abused its market power.

PIA has no incentive to reduce capacity, and is currently operating well within airport capacity levels in respect to aircraft movement facilities in particular. In fact, WAC has been working closely with the State Government to attract new airlines in order to build capacity to Perth. It is also worth noting that PIA does compete with other international and domestic airports in Australia for new airline and freight services and for general aviation services.

In respect to passenger processing facilities, WAC has been pro actively seeking to secure airline support to a proposal to redevelop the international terminal, to accommodate future capacity requirements.

In terms of price, WAC's aeronautical charges are among the lowest in the world, as demonstrated earlier, and the charges do not fully recover all of the costs, including a rate of return on the aeronautical asset base.

In terms of quality, WAC refers to the ACCC's Quality of Service monitoring report, and other surveys independently commissioned by WAC. The latest ACCC report into quality of service at PIA[10] confirms that "Overall, it appears that airport users and passengers were satisfied with most aspects of the facilities and services provided at Perth Airport".

On the basis of the preceding comments, WAC accepts that it possesses market power in the provision of aeronautical services, but is strongly of the view that it does not abuse this market power.

- Aeronautical related services

Aeronautical related services have been subject to prices monitoring at privatised airports for the full regulatory period to date. WAC, along with other declared airports has submitted detailed revenue and cost data in respect to each of the designated aeronautical related services to the ACCC each year, as part of the annual regulatory information requirements.

It is noteworthy that, apart from the fuel levy, the ACCC has not felt that the information provided in respect to these aeronautical related services has given it sufficient basis to formally raise concerns with the relevant minister.

Each of the designated aeronautical related services subject to price monitoring is now considered in the context of the PC's comments on market power and its abuse.

- Aircraft refuelling

As noted in the previous section, the ACCC has raised concern that WAC has abused its market power in respect to the provision of these services. WAC accepts that, on the basis of the criteria set out by the PC to define the existence of market power, that there are significant barriers to entry, although WAC notes that airlines do have some capacity to by-pass PIA to refuel. WAC has, however, outlined its strong disagreement to the position taken by the ACCC and totally rejects, on the basis of the evidence provided by the independent expert that it has abused its market power in the provision of these services.

[10] ACCC Regulatory Report for Perth Airport 1999/2000 – p4

- Aircraft maintenance sites and buildings

As noted by SACL in their response to the ACCC's draft decision on aeronautical pricing at Sydney Airport, there are significant competitive pressures for maintenance sites and freight facilities at an airport. This was most recently exemplified by the decision by Qantas to locate new maintenance facilities for wide-bodied aircraft at Brisbane airport. In the case of PIA, maintenance facilities for National Jet Services established on the airport several years ago were competitively secured in the presence of competition from other Australian airports. WAC is therefore of the view that there is a reasonable level of substitutability in the provision of these services to question whether market power exists.

The most significant reason that acts against WAC's potential to abuse market power – if in fact it exists, is that it is not in WAC's interests to ration supply or charge rents that are not market driven. Facilities of this nature are highly sought by airport operators and State Governments due to the significant downstream impacts (employment etc) that they create.

- Freight equipment storage sites

These sites are generally used by ground handling agents to store equipment utilised in their activities and constitute an area of pavement, with some floodlighting. Economic barriers to entry would not be significant, however for operational reasons, the ground handlers need to have these areas in close proximity to their activities. At PIA, revenue from these sites constitutes less than 5% of all revenues from aeronautical related activities.

WAC has, for the same reasons outlined for maintenance sites, no reason to take advantage of any market power it may possess in the provision of these facilities. The adequate supply of airside land at PIA provides incentives for WAC to encourage take-up of these facilities.

- Freight facility sites and buildings

WAC competes with other airports and with off-airport providers, where apron access is not essential. Again, this is an area where WAC has no incentive to ration supply or price land uncompetitively. In fact, in the current year, WAC has undertaken an unprecedented commitment to develop freight facilities for major tenants as part of a strategy to diversify its revenue streams. Existing tenants are protected through long-term agreements.

- Check-in Counters

In many countries, check-in is provided off-airport, for example in railway terminals and hotels. Automated/self check-in is also available at many airports, and this will be further enhanced with advances in technology. A recent example of off-airport check-in in Australia was seen at the Olympic Village In Sydney.

The increasing evidence of alternatives to airport check-in facilities, seems to WAC to support the view that airports do not possess market power in the provision of these facilities.

- Public Car Parks

The Prices Surveillance Authority considered the issue of market power in relation to car parks in its report on its inquiry into the aeronautical and non-aeronautical charges of the FAC in August 1983.

The PSA stated that "the FAC's market power is of two types. The first arises from the locational advantage of the FAC's car-parks. The PSA considers it to be normal commercial practice to recover the locational rents attached to these car-parks. This does not constitute an abuse of market power".

The PSA also stated "that the FAC's market power also stems from its land ownership and ability to control the number of car-park spaces."

Strong demand-side substitutes exist at PIA for access to the airport. Apart from the public car-parks, taxis, hire cars, charter vehicles, valet car parking (operated by Qantas and Ansett), urban public transport, tour coaches, hotel hospitality buses and kerb-side drop off provide alternative means of access to the airport. A survey conducted at PIA in 1997 by Sinclair Knight Mertz concluded that approximately 50% of total domestic passengers using PIA used the public car-park, with the remainder utilising other means of access to and from the airport.

WAC is also aware of off-airport car-park operators, in direct competition to the airport.

Accordingly, WAC argues strongly that it does not possess market power in the provision of car-parking services at PIA.

In terms of the potential for WAC to abuse market power – if, for one moment this is assumed, the presence of competition is an effective measure to ensure that price equilibrium is maintained. Moreover, WAC has no incentive to ration the number of car spaces it provides. On the contrary, WAC has undertaken significant capital expenditure to date to not only increase the capacity of the public car-parks (international car park spaces were increased by 224 (or 26%) over the previous year)[11] but to also improve the amenity and security of these facilities.

On the basis of the commentary above on aeronautical related services, WAC argues strongly that notwithstanding the potential for the existence of market power in respect to some of the services, there is little incentive for WAC to seek to abuse this market power, and no evidence that WAC has abused market power.

3.3 COUNTERVEILLING MARKET POWER

WAC is pleased that the PC has acknowledged that countervailing power of airlines and possibly other users of airport services may exist and counteract market power that airports may possess.

[11] ACCC Regulatory Report Perth Airport 1999/2000 – p8

Before discussing specific instances where airlines do in fact possess market power at airports, including PIA, it is worth reflecting on the differences between the regulatory jurisdiction that applies to airports and that which applies to other regulated industries, such as water, gas, electricity and telecommunications. For the sake of this discussion, these will be referred to as 'utilities'.

WAC sees utilities as being providers of essential services to a diverse range of consumers, who generally lack demand-side market power. Changes in prices, quantity of output and level of service provided by the utility supplier have pervasive effects throughout the economy.

The provision of airport services is very different. Airlines are interposed between the services provided by the airport operator and the final consumers – the travelling public. Airport charges are a very small part of the prices paid by the ultimate consumer for air travel. This has been demonstrated in the SACL pricing proposal, where the charge increases sought in respect to what was a massive capital works program, amount to just $2 per interstate domestic flight and less than $10 per international flight. In percentage terms, an increase of less than 1% for domestic and less than 2% on international airfares.

Furthermore, the direct consumers of airport services are not, as is the case generally with utility services, a diverse group of individuals, but a well organised group of powerful organisations, with considerable economic resources and political lobbying capacity.

The existence of countervailing market power at PIA by airports can be illustrated in a number of ways. Table 2 below shows the composition of operating revenues at PIA for the year ended 30 June 2000.

WESTRALIA AIRPORTS CORPORATION PTY LTD

ANALYSIS OF OPERATING REVENUES 1999/2000

	Qantas/ Ansett	Other	Total	Star Alliance	One World Alliance	Other	Total
Aeronautical Revenues	9.178	10.654	19.832	7.468	9.131	3.233	19.832
%	46%	54%		38%	46%	16%	
Property Revenues	13.088	7.284	20.372	7.143	6.783	6.446	20.372
%	64%	36%		35%	33%	32%	

Table 2 Source: WAC

Approximately 46% of aeronautical revenues and 64% of property revenues come from two customers – Qantas and Ansett. When airline alliances are taken into account, 84% of aeronautical revenues and 68% of property revenues are earned from the two alliances. By contrast, aeronautical charges represent approximately 4% of airline costs.[12]

[12] IATA International Airport Review 1998

The concentration of revenues to major carriers and alliances shown above places WAC in a particularly vulnerable position in respect to decisions made by these carriers and alliances. This was clearly demonstrated in January 2001, when Qantas and South African airlines decided to code-share services to South Africa from Perth, and over-fly Perth to Sydney and Melbourne. As noted previously, this decision, taken without any form of prior consultation with WAC, resulted in the loss of 13 x B747 aircraft landings per week, a revenue loss to WAC of $1m pa, or 5% of WAC's aeronautical revenues.

The break-up of the FAC has been accompanied by the consolidation in airline alliances and airline ownership. This has served to strengthen the already considerable bargaining and negotiating position of the airlines.

Ansett and Qantas possess considerable political power in Australia by virtue of the large number of people they employ, their services to regional centres and, in the case of Qantas, their listing on the Australian stock exchange. These areas are politically sensitive and generally guarantee direct access and a favourable hearing from the most senior politicians in Australia.

The ongoing delay to the proposed Multi User International Terminal project in Adelaide is a prime example of how airlines can utilise their countervailing power to block a project that has widespread community and political support.

By contrast, privatised airports, such as PIA are in a relatively weak position. Privatised airports have obligations under their leases with the Commonwealth, under the Airports Act and under the Trade Practices Act that prevent them from denying access. WAC's financial capacity to sustain protracted legal action is limited compared to the considerable resources of the airlines.

4. FUTURE AIRPORT PRICES REGULATION

This submission has so far focussed on WAC's views on the existing prices regulatory framework, that will terminate on July 1 2002 and considered the question of the existence of and abuse of market power at PIA in respect to the services currently subject to surveillance and monitoring.

WAC notes that the Terms of Reference for this inquiry state that "the purpose of the inquiry is to examine whether new regulatory arrangements, targeted at those charges for airport services or products where the airport operator has been identified as having most potential to abuse market power, are needed to ensure that the existence of any such market power may be appropriately counteracted".

This objective raises two issues:

1. What are the charges for airport services or products that have been identified as having the most potential for the airport operator to abuse market power? and,
2. Are new regulatory arrangements needed, and will they counteract market power for these services?

In the previous section it was noted that there has not, to WAC's knowledge, been any empirical studies undertaken on aeronautical or aeronautical related services, to determine either the existence of market power or the abuse of market power.

The ACCC acknowledged this in their draft decision on the SACL aeronautical pricing proposal, when it stated "the Commission considers that a full investigation of the extent of SACL's market power, or the extent to which aeronautical and non-aeronautical services are interdependent necessitates a detailed market study. It is the view of the Commission that such an evaluation is more appropriately conducted as part of a review of the regulatory environment rather than in its application."

It seems to WAC, that the philosophy that aeronautical and aeronautical related services, as currently defined, are subject to market power is based on no more than a precedent of subjective intuition. In any event, the possible existence of market power itself should not be the basis for implementation of regulation. Furthermore, WAC argues it is difficult to see how regulation would, in itself, remove barriers to entry – a primary determinant of market power. Rather, regulation should be about counteracting abuse of market power.

WAC has examined the question of market power and its abuse, in relation to aeronautical and aeronautical related services provided at PIA, using the PC's criteria for determining characteristics of market power and abuse of market power as set out in the Issues Paper. In this analysis, there is evidence of a clear trend emerging at airports, and at PIA, toward an increasing proportion of airport activities where the primary users of the services provided by those activities have a choice where they conduct those activities. This is an example of where the market for provision of those activities has become contestable. It was highlighted for example, that airport users have an increasing array of options for transport to and from the airport, check-in can be carried out off the airport and freight activities can be, and are carried out on nearby land off the airport.

It is WAC's strong belief that the paradigm that has underscored regulatory practice for airports to date, which is seemingly based on the view that market power is 'bad' and that airports will abuse market power – the 'guilty until proven innocent' presumption, needs to be changed.

Bearing in mind PIA's operating characteristics – operating well within capacity, on an unconstrained basis and, importantly, having adequate supply of land, WAC submits that it has absolutely no incentive to either reduce capacity, increase prices to above costs (for aeronautical services) or market levels (aeronautical related services), or reduce quality and that therefore, it has no incentive to abuse market power – even if it is determined to exist.

WAC is of the view that, apart from lacking the incentive to abuse whatever market power it may possess, the considerable countervailing market power of airlines in particular is an effective counter to airports abusing market power.

WAC strongly believes that there is no case for explicit regulation of either aeronautical services or aeronautical related services at PIA. WAC is however, strongly supportive of negotiated commercial outcomes with airlines. This was one of the stated objectives of the Commonwealth Government's Pricing Policy Paper.

WAC is committed to working with its stakeholders to develop an effective process and forum for the mutual exchange of information, and open and frank exchange of views, to facilitate the ongoing improvement of airport facilities and services at PIA.

WAC envisages this being accomplished through the development of an airport specific, aeronautical services agreement with airlines. The terms and scope of the agreement, could be determined through negotiation with the airport and airlines, but would be likely to include the coverage and pricing of airport services, the conditions of use by airlines of the airport, the process for consultation and sharing of information and quality of service. Such an agreement, when accompanied by the Access provisions of the Trade Practices Act, the incentives for WAC to grow its business, and the significant countervailing market power of airlines, would constitute an effective body of counter-measures, to alleviate concerns over abuse of airport market power.

Development of an airport specific, aeronautical services agreement may require legislative support, through for example, the application of a Government policy directive. This should be constructed on the over-riding philosophy that all services provided by the airport owner are treated as contestable unless one of the parties can prove that the other has market power and is abusing that market power in relation to that service or proposed service. The policy directive should provide guidance to determine the criteria for demonstrating 'market power' and 'abuse of market power'. This could be incorporated into the commercial agreements between the parties.

If disagreement occurred in respect of the aeronautical services agreement, the parties would submit to binding private arbitration. This process is typically a feature of other commercial agreements, such as property leases, between the airport and airlines now.

The policy directive should also define the key parameters of the airport-airline consultation environment that apply in the absence of agreement between the airport and airlines.

These parameters should confirm:

- a wider definition of necessary new aeronautical investment, to include replacement capital expenditure;
- that the starting point prices for currently declared aeronautical services should be determined by applying the building block approach to appropriately allocated aeronautical costs,(subject to audit), including a rate of return on the aeronautical asset base;
- the basis for valuation of assets comprising the aeronautical asset base.
- the requirement for airlines to provide necessary information to airports in respect to passenger and aircraft movements, subject to confidentiality undertakings by the airports; and;
- that a certain level of minor NNAI will be undertaken at airports, and be recovered through increases in aeronautical charges each year.

In the preceding discussion, WAC has put forward a vision that the current system of prices regulation for airport aeronautical and aeronautical related services is replaced by commercial negotiation, supplemented by a legislated policy framework, which applies in the absence of commercial negotiation.

This may be one of a number of practical solutions to address the shortcomings of the current system. WAC has given only limited consideration to this choice of option and expects to develop its position in this regard more fully throughout the review.

As a concluding statement, WAC believes that all parties, airport operators, airlines and the Government, through the policy directive, should work collaboratively to secure an environment that provides incentives for airports to invest in aeronautical infrastructure, encourages competition, is administratively efficient, facilitates transparency and encourages parties to arrive at negotiated resolution rather than rely on an intrusive regulatory response.

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