

PERTH AIRPORT

Gary Potts
Price Regulation of Airport Services Inquiry
Productivity Commission
PO Box 80
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14 July 2006

Dear Mr Potts

Price Regulation of Airport Services: Productivity Commission's Public Inquiry

Westralia Airports Corporation (WAC) fully supports and welcomes the Productivity Commission's review of the price monitoring regime. I am pleased to submit WAC's formal response to the Commission's Issues Paper, and I look forward to working with the Commission towards a successful review.

I would like to take this opportunity to draw your attention to some particular points in WAC's submission.

Overall, WAC's experience of operating under the price monitoring regime, which was established following the Commission's 2002 Inquiry, has been very positive indeed. This is best illustrated by the outcomes for Perth Airport and its customers. In particular, service growth and quality have improved as a result of substantial increases in investment and the continuing development of the airport's positive working relationships with the airlines. WAC's submission demonstrates that objective measures of performance illustrate that the price monitoring regime is working well.

It is important, however, to assess the price monitoring regime against alternative regulatory models. WAC's submission therefore recaps on its experience under CPI-X regulation and the negative outcomes delivered by that regime, particularly in terms of investment. WAC is concerned that this experience should not be overlooked by the Commission's current review. I note, in particular, that it was the experience of CPI-X regulation that led the Commission, quite rightly, to recommend the adoption of price monitoring in its 2002 Inquiry.

It is equally important for all parties to recognise that there is not a perfect form of regulation. Therefore, whilst valid criticisms of the current price monitoring regime might be made, it does not follow that the regime can be easily improved upon. In WAC's view, the Commission should consider whether it is possible to make incremental improvements to the current regime without resorting to intrusive regulation. WAC believes that the Commission may be able to develop an improved reporting regime, perhaps by better linking service and price outcomes. It would also be useful for the Commission to resolve the issue of which services ought to be subject to price monitoring. WAC's submission provides some preliminary thoughts on this issue.

WAC has used its best endeavours to act in accordance with the Government's Review Principles at all times. In particular, WAC has given careful consideration to the ACCC's regulatory approaches to revenue-setting, whilst engaging the airlines in constructive dialogue in relation to investment, service and price. WAC's submission includes a case study of the International Terminal Baggage Handling project, which shows how the airlines and the airport have worked together successfully to deliver an innovative and cost-effective enhancement of services and facilities at Perth Airport. The case study plainly shows that this outcome could not be achieved under CPI-X regulation.

Despite these good results, WAC realises that the Commission's public inquiry opens the door for some parties to criticise the airport for its conduct and performance. In part, these criticisms arise because WAC's customers operate in a highly competitive environment where any reduction in airport charges would be warmly welcomed. In WAC's view, however, it is important that short-term price reductions are not achieved at the expense of a workable and sustainable regulatory regime.

WAC has been careful not to exploit any market power that it may possess in relation to the provision of aeronautical services. Recently, WAC notified aircraft operators of the revised aeronautical charges to apply at Perth Airport from 1 July 2006. The notification confirmed that as a result of forecast total passenger growth for the 2006 financial year being in excess of 10% to the forecast passenger numbers for the year in the Prices and Services Accord (PSA), WAC would not increase the airfield charge for the 2006/07 financial year. This pricing decision results in a real reduction in airfield charges when CPI is taken into account, and is the second consecutive year where there has been a real reduction in the airfield charge.

WAC notes that its decision to freeze all aeronautical charges in nominal terms goes beyond the strict requirements of the PSA. In particular, the PSA only requires WAC to consult with the airlines in relation to pricing for those passenger numbers in excess of the +10% annual forecast error threshold. It is also important for stakeholders to remember that the present PSA will be re-negotiated for a further five year term from 1 July next year. During the forthcoming negotiations with the airlines, WAC expects to take into account the unexpected passenger number growth that has occurred during the current five-year pricing term. WAC also intends to consult fully with airlines on the structure of aeronautical charges.

To conclude, I firmly believe that Perth Airport's recent performance in terms of investment, passenger growth, service outcomes and price has vindicated the Commission's recommendation in 2002 that a price monitoring regime should be adopted. There is scope for improving the current regime incrementally, but a return to heavy-handed regulation would put at risk the economy-wide benefits that have been obtained, and will continue to be delivered under the price monitoring regime.

Yours sincerely,

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David Crawford,
Chairman, Westralia Airports Corporation



PERTH AIRPORT

Submission to
Productivity Commission Issues Paper

Price regulation of Airport Services

14 July 2006

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OVERVIEW AND SUMMARY

Background

The Productivity Commission (the Commission) has been asked by the Australian Government to examine the effectiveness of the current regulatory regime for airport pricing. Westralia Airports Corporation (WAC), as the operator of Perth Airport, welcomes this opportunity to respond to the Commission's Issues Paper.

Perth Airport is the fourth largest airport in Australia, as measured by passenger traffic. Perth Airport won the Australian Airport Association's Australian Major Airport of the Year Award in 2003 and 2004.

Perth Airport's commercial environment

Like many other airports in Australia and internationally, Perth Airport operates in a dynamic market place. Passenger numbers and aircraft traffic volumes are affected by the commercial decisions of airlines as well as global phenomena such as SARS, bird flu, and terrorism. Perth Airport is particularly affected by international events because a relatively high proportion of its total passenger numbers are international travellers. This heightens the risk profile of the airport from a commercial perspective.

The collapse of Ansett Australia (Ansett) in 2001 marked a significant change in the Australian aviation market, and highlighted the increasingly competitive nature of the industry. The Commission's 2002 Inquiry Report into airport pricing noted that it was "not possible to assess confidently whether recent events would constitute a short-term aberration or the start of a fundamentally different longer-term trend in the demand for aviation and airport services"¹. WAC believes that the uncertainty noted by the Commission is still highly relevant today.

The long-term commercial success of Perth Airport is dependent on the airport's ability to grow passenger traffic volumes by providing quality aeronautical services at a competitive price. WAC is committed to continuing to grow Perth Airport so that the value of this asset to all stakeholders is maximised.

The dynamic market environment in which Perth Airport operates requires it to act commercially, and to be responsive to the needs and preferences of airport users in order to attract new carriers and grow services.

Experience under the CPI minus X regime and the Government's preference for a better approach

It is widely understood that the airport sector differs from traditional network utilities that are typically regulated under a heavy-handed price control framework, such as CPI-X regulation. CPI-X regulation is much less effective in sectors such as airports, where expenditure may need to change rapidly in response to customer requirements or Government regulations, particularly in relation to security. Furthermore, unlike domestic electricity and gas consumers, airlines are commercially powerful organisations with the capability to negotiate favourable outcomes in their dealings with airports, or to seek remedies under the legal framework provided by the national access regime.

¹ Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, 23 January 2002, page 9.

In fact, the inappropriateness of CPI-X regulation to the airport sector was borne out by WAC's experience of the regime immediately following privatisation. For Perth Airport, the regime delivered unsustainably low aeronautical prices and investment. In its 2002 Inquiry Report, the Commission properly recognised the shortcomings of the CPI-X regime, and argued that the airport sector would be better suited to price monitoring. The Commission commented that²:

"Some of these problems [with the CPI-X regime] could have been avoided by a more transparent process and clearer guidelines from the outset; others reflect the design of the price caps. Though price caps could be redesigned to incorporate planned investment, and benchmarks could be used to provide independent estimates of achievable productivity growth, inevitably there will have to be an eventual assessment by the regulator of an airport's operating and capital costs, land values, risk, and demand growth. Given the substantial conceptual and information problems in asset valuation and cost assessment (assessing the opportunity cost of airport land being especially problematic), the risks of regulatory error and the potentially damaging consequences of this for investment correspondingly increase.

Accordingly, the Commission considers that price caps, while preferable to explicit rate-of-return regulation, should be reserved for situations where there is a strong likelihood of excessive pricing and where such pricing is likely to impose major costs on the community."

More recently, the Minister for Transport and Regional Services reiterated the Government's commitment to light handed regulation of the airports³:

"The Government's policy is to encourage continued growth of the sector by allowing commercial businesses to negotiate business outcomes with no or minimal Government intervention... Consistent with its overall policy aims, the Government has consciously and deliberately moved to a light-handed pricing regulatory approach following the Productivity Commission's airport pricing report in 2002."

WAC appreciates that the Commission must conduct the current review on its merits and should not simply repeat the findings of its 2002 Inquiry. Equally, however, it is important that the Commission does not lose sight of the unsatisfactory experience of the CPI-X framework in the airport sector. It would be highly regrettable if the Commission's review were to result in a return to a heavy-handed regime such as CPI-X, given the substantially improved outcomes - described below - which have been delivered to all stakeholders since the introduction of price monitoring in 2002.

Positive outcomes delivered under the price monitoring framework

The price monitoring regime is predicated on the view that airports and airlines are capable of negotiating commercial terms that will deliver acceptable outcomes to all stakeholders in terms of investment, growth, service and price. WAC's experience of, and commercial conduct within the price monitoring regime strongly suggests that this view is well-founded. In particular, the regime has facilitated the delivery of:

- the adoption of greater innovation by WAC in meeting the needs of airport users, together with substantial increases in capital expenditure, and substantial improvements to facilities compared to that achieved under the CPI-X regime;

² Ibid, page XXXII.

³ Hon Warren Truss, Speech to the Australian Airports 24th National Convention and Industry Exhibition, 14 November 2005.

- greater than expected growth in passenger numbers, in spite of global and domestic events that have had pronounced effects on the aviation industry;
- adoption at Perth Airport of an effective consultative approach to negotiating price and service outcomes, as well as addressing operational issues; and
- sustained or improved levels of service quality compared to historic levels, as noted in the ACCC's annual Quality of Service reports covering the price-monitored airports.

Perth Airport's approach to negotiation and dispute resolution

Under the price monitoring regime, two major undertakings have been established between WAC and the airlines:

- the terminal facility agreement with Virgin Blue; and
- the Price and Services Accord with the airline operators servicing Perth Airport.

In each case, the airlines have been actively engaged in negotiating the detail of these undertakings. An important goal of WAC and its customers in negotiating these undertakings has been to establish robust and effective dispute resolution processes. This goal has been achieved. Moreover, it is pleasing to note that no disputes have arisen that have required the dispute resolution processes under these instruments to be invoked.

More generally, WAC has put a framework in place to ensure that effective formal communication and consultation takes places with airport users. This framework consists of a number of different forums which meet regularly to address specific operational and/or commercial matters.

The structure of aeronautical charges is a matter of commercial negotiation between WAC and the airlines. During the negotiations that took place following the cessation of the price control regime in 2002, all airlines accepted an amended charging structure based on passenger numbers. Nearly 3½ years after Perth Airport obtained the agreement of its customers to move to a passenger-based charging structure, the Australian Competition Tribunal (ACT) published its decision to declare airside services at Sydney Airport. An important finding of the ACT Sydney Airport Decision (which is subject to appeal) was that Sydney Airport had abused its market power in adopting passenger-based charging.

In considering the implications of the ACT Sydney Airport Decision for Perth Airport, it is useful to note the comments of Virgin Blue in its evidence to the ACT review⁴:

"Virgin Blue had a ready explanation, which we accept, for the reason why it was prepared to accept passenger-based charges at other airports but not at Sydney Airport. Mr Pen said that Virgin Blue had accepted these charges at other airports as part of wider commercial arrangements with those airports. In particular, in relation to Perth and Melbourne airports, Virgin Blue was able, in exchange for a passenger-based charge, to obtain certainty of price over a long term, commitment to maintain the quality of the airports' services at an acceptable level, and a reduced rate for domestic terminals."

⁴ Australian Competition Tribunal Virgin Blue Airlines Pty Limited [2005] ACompT 5, paragraphs 287.

Similarly positive comments regarding WAC's conduct in negotiations on investment, service and price have also been noted by the Board of Airline Representatives of Australia (BARA)⁵:

"Pricing arrangements at other major privatised airports are different [from those at Sydney]. Following the cessation of their CPI-X price cap on 30 June 2002, the operators of Brisbane, Melbourne, Adelaide and Perth airports entered into five-year commercial agreements with airlines. Those agreements address prices for aeronautical services, capital expenditure programs and service levels. BARA and its member airlines had the confidence to engage in negotiations with those airport operators for a commercial agreement because they had implemented cost efficiency measures under the CPI-X price cap and airlines accepted that their cost bases were reasonably efficient. While ever the operators of Brisbane, Melbourne, Adelaide and Perth airports act in accordance with the commercial agreements in place, BARA would have no incentive to seek declaration of aeronautical services at those airports."

WAC believes that the above comments illustrate that it has engaged in effective consultation and negotiation with its customers. In fact, these comments are particularly encouraging given that the Commission had said in its 2002 Inquiry Report⁶ that it expected some teething problems as airport regulation transitioned to the new price monitoring regime.

Pricing outcomes delivered under the price monitoring framework

The Commission's 2002 Inquiry Report recognised that aeronautical charges would need to increase, whether or not a price monitoring regime was adopted⁷:

"The Commission recognises that its preferred option would involve a considerable shift from current arrangements at the four major airports — though one largely envisaged by the architects of the regulatory arrangements put in place at the time of airport privatisations. The Commission also recognises that some parties may find such a transition difficult, particularly given the long history of government provision of airport services at those airports, and pricing structures that have effectively subsidised aeronautical charges. Nonetheless, even if price caps were to be maintained (in any form), aeronautical charges would still need to rise to encourage efficient long-run service provision.

The Commission considers that the full benefits of privatisation of airports are unlikely to be realised if commercial relationships between airports and airlines continue to be heavily conditioned by intrusive price regulation. The ongoing need for substantial investments at major airports requires a more commercial and cooperative approach. The potential for heavy-handed regulation to unduly constrain prices and commercial relationships poses a real risk and one that could impose large costs on consumers in the future."

Accordingly, after the expiration of the initial CPI-X price caps and following the conclusion of the Commission's 2002 Inquiry, WAC revised its aeronautical charges to ensure that total expected revenues from the sale of aeronautical services would recover the total cost of providing the services, including a commercial return on the relevant assets. In this context, it is noteworthy that in his speech to the Australian Airports 24th National Convention and Industry Exhibition on 14 November 2005, the Minister for Transport and Regional Services commented that:

⁵ BARA, *Airline Views* (newsletter), August 2003, page 1.

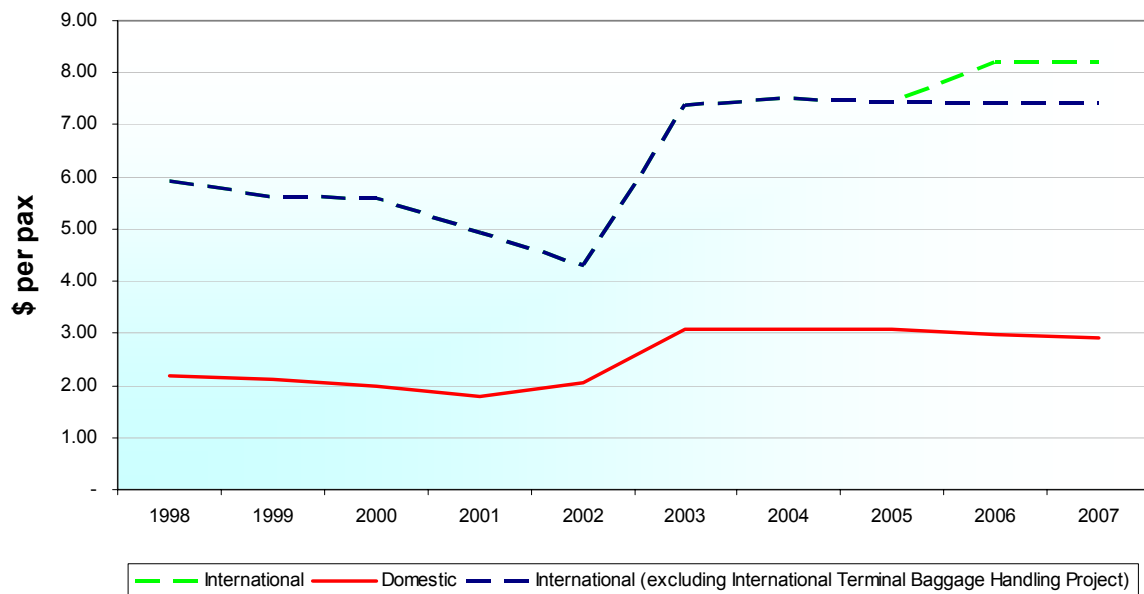
⁶ Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, 23 January 2002, page XLV.

⁷ *Ibid*, page XLV.

“The Government has previously stated that negotiated pricing outcomes should be based on efficient costs and an adequate return on capital. To date the indications are that commercial negotiations have so far produced good results.”

Figure A below shows the average price path (expressed in June 1998 dollars per passenger) for aeronautical services over the period from 1998 to 2007.

**Figure A: Average prices for aeronautical services⁸ at Perth Airport
(June 1998 dollars per passenger)⁹**



Following the adjustment of aeronautical charges in July 2002, Perth Airport’s charges per passenger for both domestic and international arrivals and departures remain competitive alongside those of other major Australian airports¹⁰.

It is noted, however, that caution must be applied in comparing and interpreting the per passenger charges levied by different airports. The costs incurred - and therefore to an extent the prices charged - by different airports reflect their particular inherent and inherited characteristics and operating environments. In WAC’s case:

- The existence of separate international and domestic terminals at Perth unavoidably leads to higher infrastructure costs as well as higher operating costs compared to those that would be incurred if a single, integrated terminal existed.

⁸ The two price paths for international per passenger charges show the impact of the additional charges that were agreed with the airlines following completion in 2005 of the International Terminal Baggage Handling Project.

⁹ Landing charges from 1997 to 2002 were MTOW based and have been converted to passenger-based average charges for comparability purposes. International charges include terminal charges. NNAI charges related to international and domestic flights are included where relevant. All security charges are excluded. GST is excluded. The CPI applied is the All Groups weighted average of eight capital cities.

¹⁰ Please refer to the report titled *Airports price monitoring and financial reporting 2004–05*, published by the ACCC in February 2006 for further details.

- Perth has an infrastructure base that is comparable to larger airports, and must spread the costs of that infrastructure over lower passenger numbers.
- Perth Airport's operation on a curfew-free basis also has an impact on its operating cost structure.

Notwithstanding these factors and their impacts on costs, Perth Airport is able to offer competitive prices.

It is also noteworthy that total airport charges are typically less than the fuel surcharges applied by airlines, and generally comprise a small proportion of the total cost of the passenger ticket. Fuel surcharges have increased substantially since their introduction by the airlines in May 2004 because of the continued escalation in the price of crude oil and jet fuel. To the extent that increases in fuel prices and fuel surcharges impact on the final ticket price paid by passengers (and hence, potentially, on the demand for air travel) Perth Airport is exposed to the risk of reduced passenger throughput. This consideration, coupled with the sensitivity of ticket prices and airline margins (particularly for low cost carriers) to changes in aviation fuel prices places strong downward pressure on Perth Airport's pricing of aeronautical services, especially when aviation fuel prices are escalating.

Finally, it is also worth noting that airlines can and do make domestic and international route rationalisation decisions that affect the demand for aeronautical services. In particular, the demonstrated ability of the airlines to suspend or withdraw from unprofitable routes provides a competitive discipline on the airports, and a strong incentive for airports to act and price in a way that is not likely to precipitate such a response from the airlines. Examples demonstrating the countervailing market power of the airlines are provided in section 1.3 of this submission.

WAC fully accepts that airport pricing will remain a contentious issue, especially in light of the competitive pressures faced by airlines. However, Perth Airport's current charging arrangements are subject to the Prices and Services Accord, which was developed in consultation with the airlines. Indeed, as already noted, the airlines (through the Board of Airline Representatives of Australia) have acknowledged the reasonableness of Perth Airport's conduct in negotiating new terms and conditions for aeronautical services since the introduction of price monitoring.

Asset revaluation

Other matters that the Commission is required to consider in its review include an examination of aeronautical asset revaluation practices. The implicit concern is that revaluations of assets may lead to windfall gains for airports.

In considering the issue of asset valuations it is important to note that whilst the asset value is an important input to Perth Airport's pricing model, the negotiated prices and revenue outcomes are a function of commercial discussions with airlines and the prevailing domestic and international market conditions. In contrast to CPI-X regulation, where regulated revenues can be set precisely to recover the estimated building block costs, the price monitoring regime is not intended to directly link asset values and aeronautical revenues.

Notwithstanding the relatively weak link between asset valuation and pricing in the current regulatory regime, Perth Airport believes that its approach to asset valuation has been reasonable. In particular, Perth Airport's approach to asset valuation (and revaluations) has been strongly influenced by the methodology adopted by the Australian Competition and

Consumer Commission (ACCC) in its regulation of more traditional utility companies. This has been necessary in light of WAC's firmly held view that the book value established for Perth Airport at the time of privatisation in 1997 was not fit for the purpose of determining future aeronautical charges because:

- the Federal Airports Corporation (FAC) asset register on which the 1997 valuation was based was incomplete and inaccurate; and
- the valuations were high-level, desktop valuations only.

Therefore, in accordance with the ACCC's approach to asset valuation, WAC revalued its assets using an Optimised Depreciated Replacement Cost (ODRC) approach. It is important to note that this approach breaks the nexus between the expected revenue earning capacity of an asset (which may include monopoly rents) and asset values, by setting an objective asset value that reflects the efficient capital cost of a notional new entrant. The approach therefore sets an efficient "shadow value" for the asset base for regulatory purposes, which is independent of the price paid for the asset at privatisation.

WAC does not expect to reapply the ODRC methodology in the foreseeable future for pricing purposes, as pricing is a matter for commercial negotiation. To inform those negotiations, WAC expects to continue to assess prices and forecast revenues with reference to a revenue building block model using an asset value that 'rolls-forward' its 2001 ODRC valuation using an appropriate index and taking into account depreciation and new capital additions. It is noted that this approach would be consistent with the ACCC's regulatory approach for energy transmission networks. WAC's approach to asset valuation is also consistent with the Government's Review Principles.

Effectiveness of the ACCC's price and quality monitoring reports

WAC strongly supports the service quality monitoring regime administered by the ACCC. WAC's experience of the ACCC's price reporting regime is that the key messages can be lost by voluminous detail and analysis. WAC believes that the Commission could improve the reporting regime by providing some clear guidelines to the ACCC with regard to the purpose of the reporting framework and the information that should be collected. WAC therefore warmly welcomes the Commission's review of the current information reporting framework.

Scope of price monitored services and the Government's commitment to a dual till approach

The Commission's Issues Paper raises the question of which services should be subject to price monitoring. On this issue, WAC believes that the current definition of aeronautical and aeronautical-related services is confusing, as has been noted on occasion by the ACCC and also the ACT. In WAC's view, a better approach would be to require price monitoring of "aeronautical services" only, and to revisit the current definition.

In thinking about the question of which services should be price monitored, it is useful to remember that price monitoring is a lighter-handed form of regulation. In the event that a more heavy-handed form of regulation is determined to be required, services may be declared under Part IIIA of the Trade Practices Act (TPA). Ultimately, these services could be subject to price control (as applied to monopoly utilities such as gas and electricity networks). Therefore, it is possible to consider a spectrum of regulation, from light-handed regulation (price monitoring) to heavy-handed (price control).

In light of these considerations, WAC's view is that the definition of price monitored services ought to be aligned with those services that could be subject to more heavy-handed regulation. On this basis, WAC considers that the development of an appropriate definition of price monitored services should have regard to the concept of *declared services* in the TPA. In particular, it seems reasonable that price monitoring should apply to the same services that may be subject to declaration under Part IIIA of the TPA.

In fact, this type of analytical framework and approach had been applied by the ACCC in its administration of s.192 of the Airports Act¹¹. Under that approach, the ACCC developed two simple criteria, which reflect the essence of the criteria for declaration of a service as set out in section 44H(4) of the TPA. These criteria are:

- Criterion (i): The services are necessary for the purposes of operating and/or maintaining civil aviation services at the airport; and
- Criterion (ii): The services are provided by means of significant facilities at the airport, being facilities that cannot be economically duplicated.

Although the regulatory regime has changed since then, the criteria developed by the ACCC still provide a very useful and simple framework for identifying services that are likely to be subject to declaration under Part IIIA of the TPA.

Applying that framework, WAC considers that:

- An appropriate definition of price monitored services would include all of the services presently defined under Direction 27 as "aeronautical services" plus "landside vehicle access to terminals".
- The case for continuing to price monitor the remaining services that are presently contained in the Direction 27 category of "aeronautical related services" is highly questionable.

It is important to note that the final definition of price monitored services would not prevent an airline attempting to seek declaration of a service under Part IIIA of the TPA, even if that service is not subject to price monitoring.

On the other hand, drawing a very wide definition of price monitored services would effectively erode the concept of the dual till, and would be counter to the commitments made at privatisation and the benefits of dual till regulation as previously noted by the Commission and the ACCC.

The Issues Paper also notes that the Commission will be assessing how well the dual till system has worked. Regulation on a dual till basis allows the airport to enjoy the benefit of revenue from non-aeronautical services. Passenger throughput is a key driver of non-aeronautical revenue, and airports have a clear incentive to grow passenger throughput by offering competitive prices for aeronautical services and by delivering improvements in service quality. In turn, dual till regulation provides the airlines with enhanced negotiating strength because the volume of aeronautical services will affect Perth Airport's aeronautical and non-aeronautical revenue.

¹¹ ACCC, *Draft Guide, Section 192 of the Airports Act — Declaration of airport services*, October 1998. It is noted that this section of the Airports Act has subsequently been repealed.

WAC believes that the benefits of the dual till approach are evidenced by the positive outcomes delivered under the price monitoring framework.

In assessing the operation of the dual till system, and in considering the definition of services that are to be subject to price monitoring, a key consideration for the Commission will be the commitment to the concept of dual till regulation which was made by Government at privatisation, and reinforced in paragraph 2(a) of the Government's Review Principles for this review.

Closing remarks

In its review, the Commission is required to consider whether Perth Airport has complied with the Review Principles, which were established by the Government at the start of the price monitoring regime. The Review Principles focus on the achievement of efficient pricing, acceptable service quality and commercially negotiated outcomes and agreements. WAC is confident that it has indeed acted in accordance with the Government's Review Principles and that the outcomes delivered under the price monitoring regime accord with those Principles.

The Commission's terms of reference also require it to have regard to the ACT Sydney Airport decision. In considering its preferred future charging arrangements following the expiry of the Prices and Services Accord, WAC will consult very carefully with its airline customers in the light of the ACT Sydney Airport Decision and any subsequent finding by the Federal Court. Beyond this, however, it is doubtful whether firm conclusions can be drawn from the ACT Sydney Airport Decision in relation to Perth Airport's conduct. More broadly, WAC believes that it would be inappropriate to conclude that the ACT Sydney Airport Decision illustrates a failure of the price monitoring regime adopted by Government because:

- whilst the protracted nature of the regulatory process surrounding that particular dispute has no doubt created unwelcome uncertainty for all airports and airlines, it nonetheless provides a path to securing fair and reasonable access to essential facilities after all efforts to reach a commercial solution have been exhausted; and
- at the same time, the nature of that path provides a strong incentive for all parties to a dispute to reach a commercial settlement to avoid the costs of litigation.

In light of these considerations, it might therefore be argued that the ACT Sydney Airport Decision provides evidence that the price monitoring and national access regimes are working as intended.

WAC fully supports and welcomes the Commission's review of the price monitoring regime. WAC's firmly held view is that Perth Airport's performance since 2002 vindicates the Commission's 2002 Inquiry recommendation and the Government's decision to adopt a price monitoring regime. In particular, whilst prices have increased in order to correct many years of under-pricing of aeronautical services:

- investment and passenger numbers have increased substantially;
- facilities have been improved;
- quality has been maintained at a high level and Perth Airport is now operating on a sound financial footing; and

- negotiation and consultation is continuing to develop along commercial lines rather than being heavily conditioned and constrained by intrusive price regulation.

WAC strongly believes that a return to more heavy-handed regulation would put at risk the economy-wide benefits that have been obtained, and will continue to be delivered under a light handed price monitoring regime.

1 INTRODUCTION AND BACKGROUND

1.1 Purpose of this submission

The Productivity Commission (“the Commission”) has been asked by the Australian Government to examine the effectiveness of the current regulatory regime for airport pricing and to advise on any changes to the regime. This review was foreshadowed in 2002 when the Government accepted the Commission’s earlier recommendation that a light-handed price monitoring regime for airport services should be introduced.

The terms of reference for the review require the Commission to deliver a final report to the Government by 6 January 2007. In May 2006, the Commission commenced the review with the publication of an Issues Paper. Westralia Airports Corporation (WAC), as the operator of Perth Airport, welcomes this opportunity to respond to the Issues Paper.

The Issues Paper appropriately canvasses a broad set of questions for stakeholders to consider in accordance with the Commission’s terms of reference. As operator of Perth Airport, WAC is acutely aware of the Commission’s requirement to:

“report on whether airport operators have acted in a manner consistent with the Government’s Review Principles, and on the effectiveness of the current form of price regulation of airport services having regard to the objectives of:

- promoting the economically efficient operation of airports;
- minimising compliance costs for airport operators and the Government; and
- facilitating commercially negotiated outcomes in airport operations, benchmarking comparisons between airports and competition in the provision of services within airports (especially protecting small users and new entrants against discrimination).”

WAC strongly believes that it has acted in a manner consistent with the Government’s Review Principles, and that operational experience under the current regime confirms the Commission’s findings in 2002 that price monitoring is the appropriate form of regulation for airport pricing. To explain WAC’s views in detail, this submission is structured as follows:

- The remainder of this section provides further background information in relation to Perth Airport; the commercial environment; WAC’s early experience under CPI-X regulation; the Commission’s findings in 2002; and the broader regulatory and commercial context in which this review is taking place.
- Section 2 examines in detail the experience under the price monitoring regime in terms of the consultation and negotiation of price and service outcomes; the significant achievements at Perth Airport since 2002; the substantial increases in new investment; and the practical operation of the monitoring regime.
- Section 3 focuses on how WAC has satisfied the Government’s Review Principles.
- Section 4 briefly discusses a number of other issues that are specifically mentioned in the Commission’s terms of reference or discussed in its Issues Paper. These issues include: aeronautical asset revaluation; the effectiveness of the ACCC’s price and quality monitoring reports; the coverage of the price monitoring regime; dispute resolution mechanisms; and the implications for this review of the ACT Sydney Airport Decision and the COAG review of National Competition Policy.

- Section 5 presents brief closing remarks.
- Appendix 1 sets out answers to the questions contained in the Issues Paper.
- Appendix 2 provides a “case study” which examines in some detail the conduct and experience of Perth Airport in the negotiation and delivery, under the price monitoring framework, of a major project (the Baggage Handling System) at Terminal 1.
- Appendix 3 contains a copy of the Price and Services Accord, the key price and services undertaking established in 2002 by Perth Airport through negotiations with the airlines.

1.2 Background to Perth Airport

On 1 July 1997, leases over Melbourne, Brisbane and Perth airports were granted to Australian Pacific Airports Corporation, Brisbane Airport Corporation Ltd and Airstralia Development Group (ADG) respectively. The airports had previously been owned and operated by the Federal Airports Corporation (FAC). The leases are for an initial term of 50 years with the option of a further 49 years.

WAC is a wholly owned subsidiary of ADG. In accordance with the Government’s objectives for the sale, the holders of the ordinary equity and shareholder loans in ADG are predominantly Australian investors¹².

Perth Airport is curfew-free and is the only airport serving Perth for scheduled interstate, intrastate and international air services. There are no significant airspace or infrastructure capacity constraints at Perth Airport¹³, so there are opportunities and incentives for WAC to increase traffic volumes, and to encourage new entrants and new services at the airport.

Perth is strategically located within close proximity to South East Asia, Africa and Europe. Perth Airport is the fourth largest airport in Australia, as measured by passenger traffic, and it has won the Australian Airport Association’s award for Australian Major Airport of the Year in 2003 and 2004.

A report completed in 2004 by Economic Research Associates Pty Ltd studied the economic significance of Perth Airport to Western Australia’s economy. The report estimated that all airport-associated activities generated approximately \$2.2 billion a year, or 3% of the Gross State Product (GSP) for Western Australia. Direct employment was estimated to be 5,960 jobs, with \$342 million in direct salaries and wages. In total, Perth Airport was estimated to provide around 16,800 jobs for Western Australians, generating approximately \$850 million in wages.

¹² ADG’s shareholders as at 31 December 2005 were: Utilities Trust of Australia; Australia Infrastructure Fund; BAA Australia Pty Ltd; Perth Airport Property Fund; The Infrastructure Fund; Westscheme; Officers Superannuation Fund; and Colonial First State Private Capital Limited.

¹³ Section 7.3 of Perth Airport’s Master Plan 2004 (<http://www.perthairport.com/default.aspx?MenuID=42>) explains that simulation modelling of airspace and airport operations has been undertaken to test the capacity of the existing movement area layout as well as future expansion proposals. Modelling indicates that it should not be necessary to construct new runways or extend existing runways over the next 20 years. However, the simulation modelling shows the need for new taxiways and apron expansion within the next 20 years.

Perth Airport is part of a 2,105 hectare site. The site has the capacity to expand to meet projected commercial aviation demand well into the 21st century. The site is well located, being adjacent to primary roadways.

Perth Airport's primary aviation facilities include:

- a two runway system which is able to handle both existing and planned intercontinental commercial aircraft including the next generation Airbus A380;
- a Multi-User Air freight facility, aviation fuel and in-flight catering facilities;
- air traffic control facilities; and
- 24-hour rescue and fire fighting facilities.

Perth Airport comprises three terminal buildings:

1. Terminal 1 (the International terminal) which is operated and maintained by WAC for all international arrivals and departures. The terminal has seven operational aircraft bays, five of which have aerobridges, and two stand-off aircraft bays;
2. Terminal 2, which is leased to Qantas, and which accommodates Qantas domestic as well as Jetstar; and
3. Terminal 3, which is operated and maintained by WAC as a multi-user domestic terminal. Virgin Blue and Skywest currently occupy this terminal.

The Domestic Terminal complex has three freighter positions and a total of 22 operational aircraft bays, five of which have aerobridges.

Perth Airport services all scheduled domestic and international air travel into and out of Perth. As already noted, Perth Airport is integral to the Western Australian economy. In Western Australia the importance of Perth Airport is enhanced due to Perth's relative isolation compared to other capital cities.

Perth Airport's international and domestic route maps are shown in Figures 1 and 2 below.

Figure 1: Perth Airport's international route map



Source: Perth Airport website (<http://www.perthairport.com/>)

Figure 2: Perth Airport's domestic route map



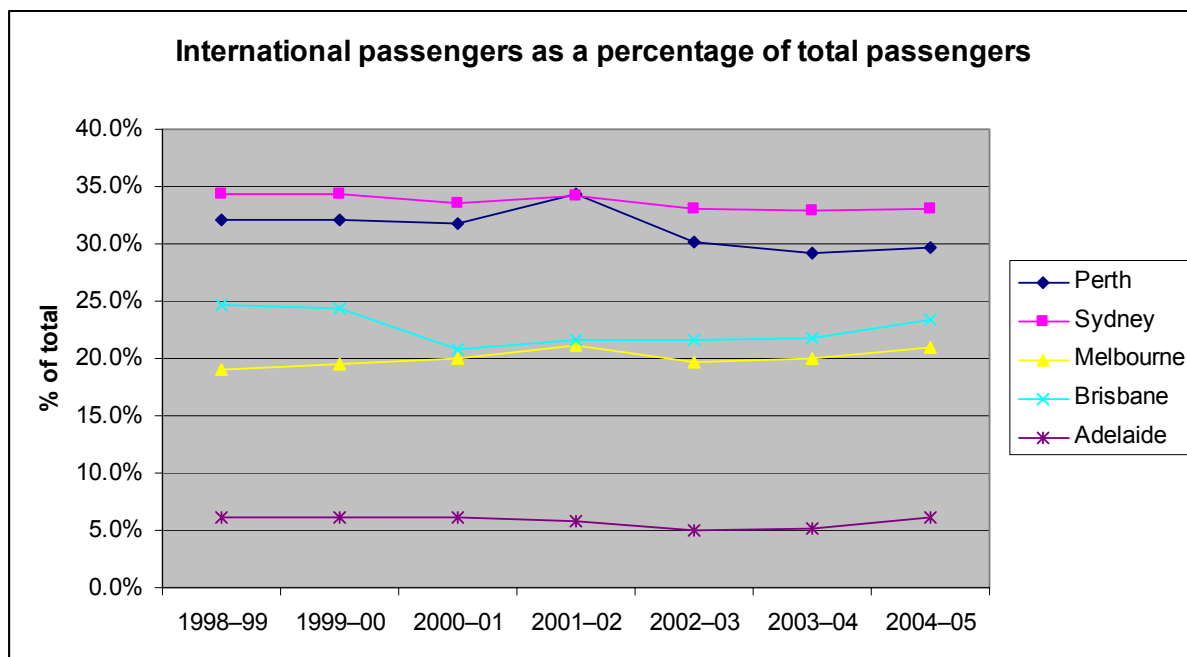
Source: Perth Airport website (<http://www.perthairport.com/>)

1.3 The commercial environment and the countervailing market power of airlines

1.3.1 Commercial environment

Perth Airport has a relatively high proportion of international passengers. In 2004/05 international travel accounted for approximately 30% of all passengers at Perth Airport. This equates to almost 2 million passengers, which is generally high compared to other Australian airports, as shown in Figure 3 below.

Figure 3



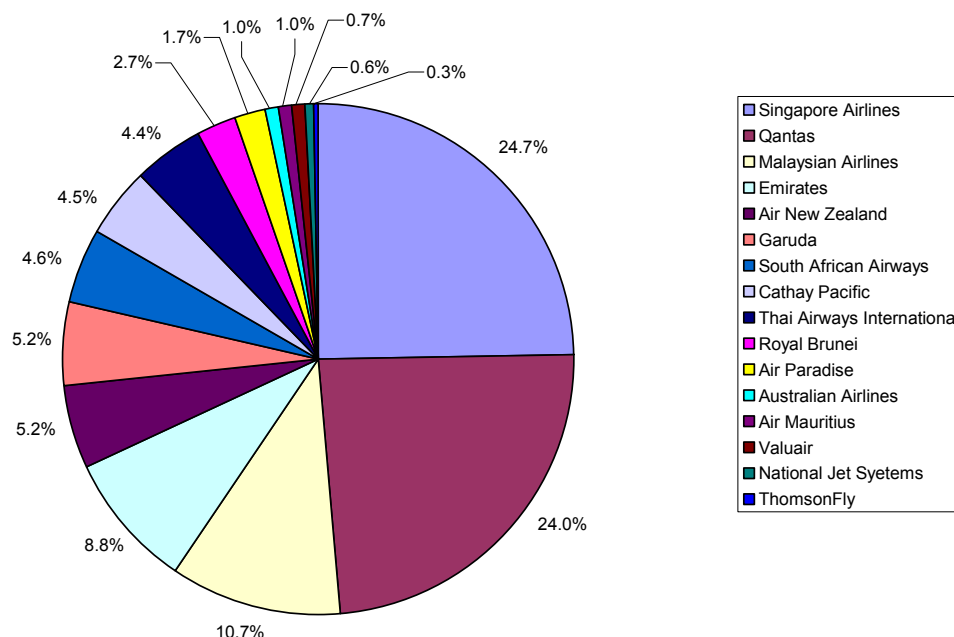
Source: WAC

As explained in further detail below, the relatively high proportion of international traffic through Perth Airport generally heightens the risk profile of the airport from a commercial perspective.

Whilst Qantas is the largest carrier of international passengers, Perth Airport is serviced by a number of foreign-based international airlines which account for 75% of international passenger arrivals. Accordingly, as shown in Figure 4 below international arrivals to Perth are from diverse carriers and locations.

Figure: 4

International Passenger Arrivals by Airline to Perth Airport FY 2005/2006



Source: WAC

Note that Air Paradise, Australian Airlines, Valuair and ThomsonFly are no longer flying out of Perth Airport as of 1 July 2006.

It is important to note, however, that:

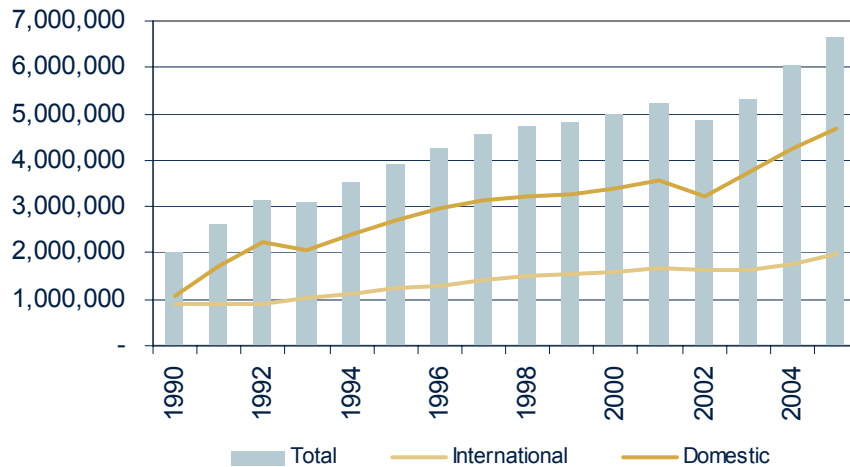
- two airlines (Qantas and Singapore Airlines) together account for nearly 50% of international passenger arrivals into Perth;
- because of its geographic location, Perth has a particular exposure to the economies of South East Asian countries; and
- Perth Airport's catchment area is smaller than those of the larger airports such as Sydney, Brisbane and Melbourne¹⁴. In addition, Perth Airport has a relatively high proportion of tourist passenger traffic. These factors increase the sensitivity of Perth Airport's traffic volumes (and revenues) to international and domestic events and economic conditions.

Figure 5 below shows the total domestic and international passenger movements at Perth Airport for the period from 1990 to 2005. Over this period Perth Airport has achieved a cumulative annual growth rate of 6.87% in total passenger movements.

¹⁴

A small catchment area was cited as a potential weakness in a Standard and Poor's credit rating report on Perth Airport, completed in December 2005. This factor is considered by the rating agency to limit longer term origin-based passenger potential.

Figure 5: Perth Airport Passenger History (financial years shown)

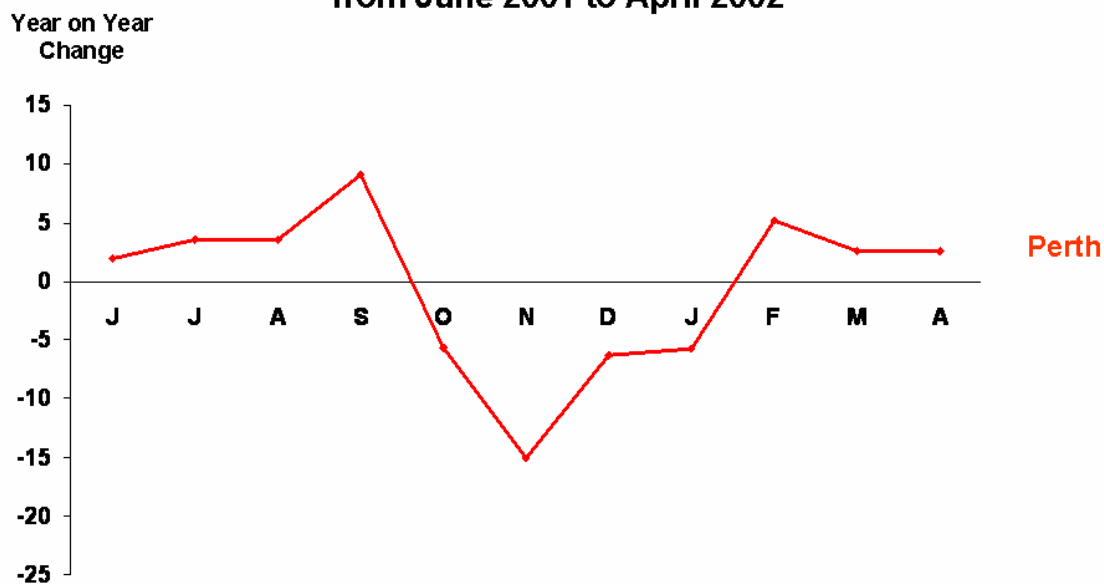


Source: WAC

Figure 5 shows a decrease of 7% in passenger totals in 2001-2002 which was caused by the September 11 terrorist attacks in New York and the collapse of Ansett Airlines. The Bali bombings in 2002 and 2005 also had an impact on international operations. In 2002 domestic travel rebounded due to the emergence of Virgin Blue airlines as a competitor to Qantas. Strong economic growth and an improved affordability of domestic travel due to airline competition have led to a significant increase in passenger movements for the recent period (from 2001 to 2005).

Figure 6 below illustrates the impact of the 11 September terrorist attacks on international traffic volumes at Perth Airport.

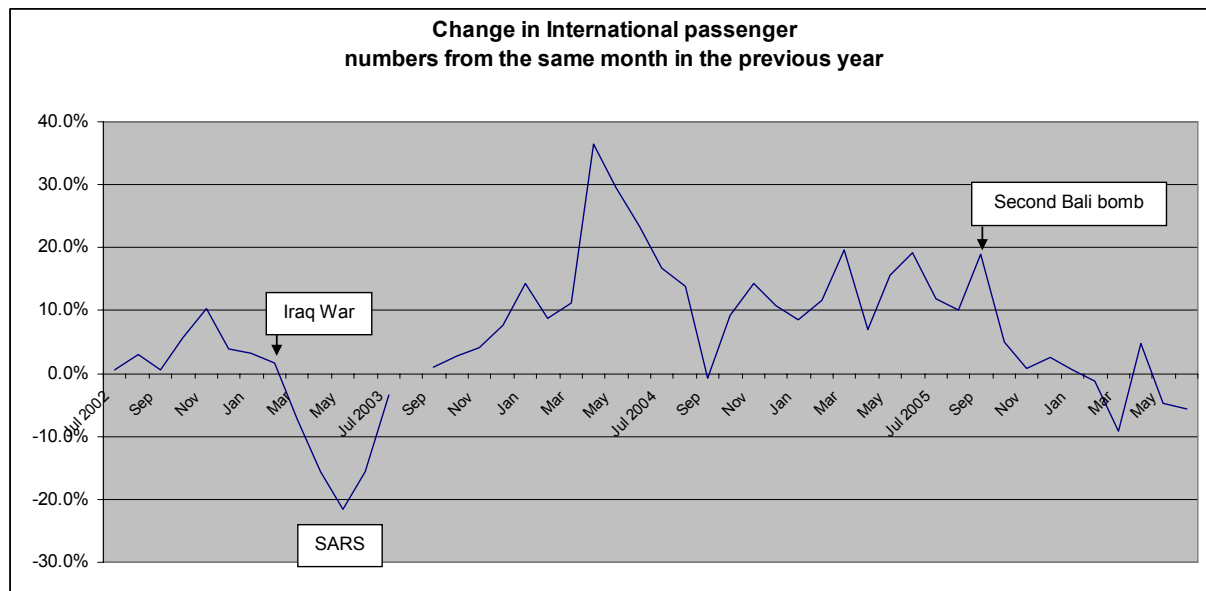
Figure 6
Impact of September 11th on
International Passengers Volumes
from June 2001 to April 2002



Source: WAC

Figure 7 below illustrates the impact of recent external global events on international passenger traffic at Perth Airport.

Figure 7

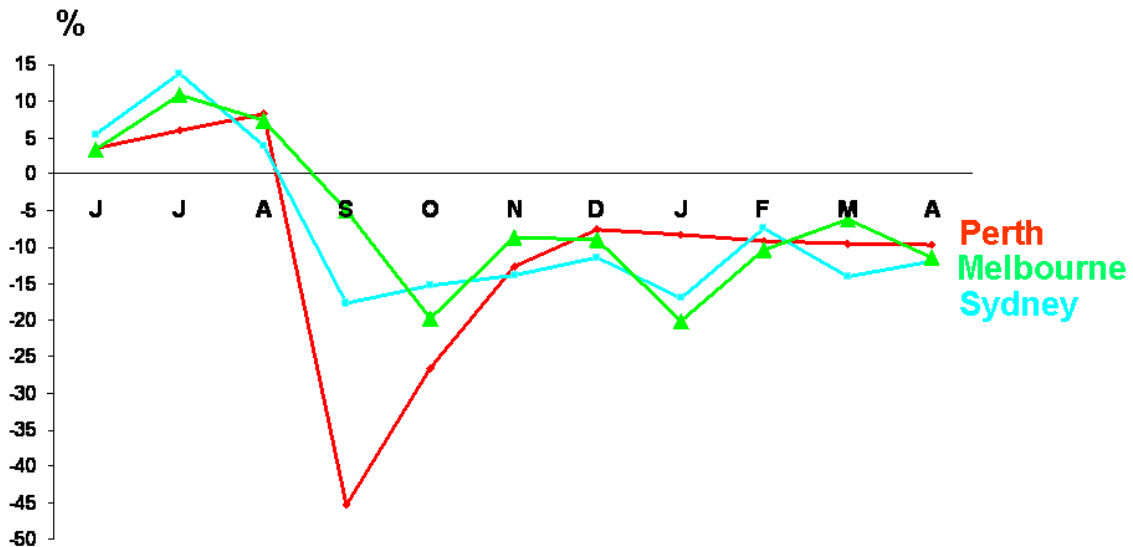


Source: WAC

It is important to note that international events continue to create uncertainty for the airline sector in general, and Perth Airport more specifically. In 2002, the Commission could not have predicted the impact of SARS in 2002/03, or whether the disease could be effectively contained. Over the next 5 year period, world fuel prices and the threat of a bird 'flu pandemic are two known factors that will continue to cast a shadow over the aviation industry. It would be a matter of speculation to comment on other (as yet unknown) global factors that may also affect the future of the sector.

In addition to being exposed to major world events, Perth Airport is also exposed to significant events that affect the domestic economy. The most recent major domestic economic event affecting the aviation sector was the collapse of Ansett Airlines in 2001. Figure 8 below illustrates the impact of the Ansett collapse on domestic passenger traffic over the period from June 2001 to April 2002.

Figure 8
Impact of Ansett Collapse on Domestic Traffic Volumes
(June 2001 to April 2002)



Source: WAC

The events of 2001 had a significant impact on the structure of the domestic aviation sector. In terms of the outlook for the airline industry structure immediately following Ansett's collapse, the Commission's 2002 Inquiry Report commented as follows¹⁵:

"These changes in the structure of the airline industry are expected to result in Qantas having a significantly larger share of the domestic aviation market in the short to medium term. In the medium term industry analysts have predicted that Qantas' share of the domestic commercial aviation market could remain at 65 per cent at least and potentially much higher (Bartholomeusz, 2001; Ferguson and Meyrick, 2001)."

This observation raises the issue of "countervailing market power" which was discussed at length in the 2002 Inquiry, and which continues to be highly relevant to Perth Airport in its negotiations and consultation with airlines. This issue is examined in further detail in the following section.

1.3.2 Characteristics of the market for aeronautical services and countervailing market power of airlines

In WAC's submission to the Commission's 2002 Inquiry, the ability of the airlines to affect airport revenue was noted as follows¹⁶:

"The concentration of revenues to major carriers and alliances 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,

¹⁵ Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, 23 January 2002, page 24.

¹⁶ Ibid, page 34.

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."

The countervailing market power of the airlines has certainly not diminished since WAC's submission to the Commission in 2001¹⁷. Qantas continues to hold strong market shares in the domestic and international markets. Qantas' resources and commercial strength¹⁸ allow it to take a strong negotiating position with Perth Airport, and enable the airline to exert substantial influence on policy makers.

The response of the airlines to issues surrounding the provision of aeronautical services at Sydney Airport provides a good example of the ability of airport users to exert pressure on the airports. For instance, in its April 2004 newsletter, *Airline Views*, the Board of Airline Representatives of Australia (BARA) commented that:

"Airlines are planning to bring the A380 to Sydney progressively from the second quarter of 2006. In order to accommodate the new aircraft, SACL will need to complete extensive runway, taxiway, apron and terminal redevelopment.

The problem for SACL is that it does not have in place with airlines an agreed aeronautical charging structure that accounts for the new capital program. That is not the case at Melbourne Airport where a commercial agreement and an aeronautical services price path, which includes a capital program for A380 infrastructure, has been in place since July 2002. Unless SACL moves quickly the A380 may have to be introduced to Melbourne Airport ahead of Sydney...

SACL has to make up a considerable amount of time wasted since October 2003 in order to get airlines' acceptance of a price path for aeronautical services under a commercial agreement. If it fails to do so SACL may face the ignominy of A380s overflying Sydney to Melbourne."

A further important characteristic of the market for aeronautical services is that in spite of Perth Airport's geographic location, it does compete vigorously with other Australian international airports¹⁹.

In addition to the above factors, it is also worth noting that airport charges generally comprise a small proportion of the total cost of the passenger ticket, and are typically less than the fuel surcharges applied by airlines. Fuel surcharges have increased substantially since their introduction by the airlines in May 2004 because of the continued escalation in the price of crude oil and jet fuel. To the extent that increases in fuel prices and fuel surcharges impact on the final ticket price paid by passengers (and hence, potentially, on the

¹⁷ A separate document containing data relating to the market share of Qantas at Perth Airport has been provided to the Commission on a commercial-in-confidence basis.

¹⁸ Aeronautical service revenues from Qantas comprise a significant portion of Perth Airport's total aeronautical services revenue. In addition, Qantas is a substantially larger business than Perth Airport. For instance, in 2004/05, Qantas earned revenues of \$12.6 billion, employed 35,500 staff and had total assets in excess of \$12 billion. By comparison, over the same period, Perth Airport generated revenues of \$140 million, employed 134 staff and had total assets of \$890 million.

¹⁹ A separate document setting out details of the incentives offered by Perth Airport to encourage new and increased international services into Perth has been provided to the Commission on a commercial-in-confidence basis.

demand for air travel) Perth Airport is exposed to the risk of reduced passenger throughput. This consideration, coupled with the sensitivity of ticket prices and airline margins (particularly for low cost carriers) to changes in aviation fuel prices places strong downward pressure on Perth Airport's pricing of aeronautical services, especially when aviation fuel prices are escalating.

Finally, it is noteworthy that airlines can - and do - rationalise domestic and international routes in response to changing aviation market conditions. For instance:

- Recent plans announced by Qantas and Air New Zealand of their intentions to code-share trans-Tasman routes could potentially lead to a reduction in trans-Tasman services, in turn having a negative affect on some airports' revenues²⁰.
- Valuair commenced services between Singapore and Perth in December 2004. Valuair was the first low cost carrier attracted to Australia from Asia. However when Jetstar Asia (45% owned by Qantas) commenced and consolidated with Valuair, the Valuair services to Perth were withdrawn, leaving only the full service carriers, being Qantas and Singapore Airlines serving Singapore.
- On 1 July 2005, Virgin Blue confirmed schedule changes following a detailed review of services to the Northern Territory. Virgin Blue announced that from 4 September, 2005, the airline will withdraw from flying Adelaide to Alice Springs direct and Sydney to Darwin direct. Virgin Blue's media release²¹ stated: "We are disappointed to have to make these changes however the commercial reality is that despite our best efforts and those of other stakeholders, we have been monitoring unsatisfactory loads for some time, and demand for these flights has been below our initial expectations."
- One of the strategies employed by Qantas to improve overall shareholder value is to withdraw from routes that do not generate an acceptable return²².
- The withdrawal of British Airways from the Perth market in 2001 reduced weekly seat capacity to Singapore from 10,290 to 9,088²³.
- As already noted, a decision in 2001 by Qantas and South African Airlines to code-share services to South Africa from Perth, and over-fly Perth to Sydney and Melbourne, resulted in the loss of 5% per annum of WAC's aeronautical revenues at the time.

The airlines' route rationalisation decisions affect the demand for aeronautical services, and provide a competitive discipline on the airports. In particular, the demonstrated ability of the airlines to suspend or withdraw from unprofitable routes provides a strong incentive for airports to act and price in a way that is not likely to precipitate such a response from airlines. This is particularly so for Perth Airport, which is not a major hub and, therefore, airlines can choose to bypass Perth or reduce the capacity of the services provided into and out of Perth. This factor further strengthens the airlines' countervailing market power.

WAC appreciates that the Commission will need to weigh up the relative 'market powers' of the airports and the airlines in considering the appropriate form of regulation. However, in

²⁰ "Qantas faces backlash over Air NZ deal", *Australian Financial Review*, 6 June 2006

²¹ http://www.virginblue.com.au/about_us/news/index.php?co=vb&artdate=072005#news010705

²² Presentation by Qantas Chief Financial Officer to UBS Australian Transport Conference, 31 March 2004

²³ Westralia Airports Corporation, *Annual Report*, 2001.

weighing up the evidence, WAC encourages the Commission to take a broader perspective by comparing the airport sector with other utility sectors that are subject to economic regulation. For instance, in contrast to gas or electricity distribution networks which serve very large numbers of domestic and small industrial and commercial customers with practically no bargaining power, Perth Airport faces the commercial reality of servicing a small number of customers (the airlines) who have substantial countervailing market power. As already noted, domestic and international airlines can and do make decisions to increase or decrease services, and the high fixed costs of airport operations means that such decisions can have a material impact on profitability.

The countervailing market power enjoyed by the airlines is further strengthened by the airports' incentive to grow non-aeronautical services and revenues, through "dual till regulation". Before explaining the relationship between dual till regulation and the airlines' negotiating strength, it is worth recalling that the Government at privatisation²⁴, the ACCC in its submission²⁵ to the Commission's 2002 Inquiry and the Commission's recommendations all confirmed that a dual till approach to regulation was superior to a single till approach. The Commission commented as follows²⁶:

"Leases for privatised core-regulated airports were sold with an explicit undertaking that a single till would not be mandated. It appears that Sydney Airport will be sold on the same basis. Nonetheless, various airline participants have argued that price regulation should ensure that some or all non-aeronautical profits are applied to reduce aeronautical charges.

Though airports are likely to offer incentives to encourage aeronautical traffic in order to increase profits from related commercial activities, mandating the transfer of non-aeronautical rents is likely to discourage development by the airport of both aeronautical and non-aeronautical services, generating large efficiency losses in the long run. Indeed, reversion to a regulated single till, even on a partial basis, could stifle the risk-taking, innovation and development of the airport site that are regarded as major benefits of privatisation (as well as raising issues of sovereign risk)."

In effect, regulation on a dual till basis allows the airport to enjoy the benefit of revenue from non-aeronautical services. Passenger throughput is a key driver of non-aeronautical revenue, and airports have a clear incentive to grow passenger throughput by offering competitive prices for aeronautical services and by delivering improvements in service quality.

In summary, the Government's commitment to dual till regulation provides further impetus on Perth Airport to keep airport charges at an efficient, sustainable level. In turn, dual till regulation provides the airlines with enhanced negotiating strength because the volume of aeronautical services will affect Perth Airport's aeronautical and non-aeronautical revenue.²⁷

A final point worth noting is that in light of the significance of Perth Airport to the Western Australian economy,²⁸ WAC and the WA State Government have a common interest in

²⁴ For example, see DoTRD Pricing Policy Paper (1996).

²⁵ ACCC, Submission to the Productivity Commission's Inquiry into Price Regulation of Airport Services, May 2001, page 9.

²⁶ Ibid, page XXXII

²⁷ In this context, it is noted that recent suggestions have been made regarding the possible expansion of the definition of aeronautical (price monitored) services to include car parking. Further detailed discussion of this issue is set out in section 4.4 of this submission.

²⁸ Refer to section 1.2 for further details.

working together to ensure that the value of Perth Airport to the State as a whole is maximised. The State Government and WAC have developed a strong relationship to achieve this goal²⁹. Whilst the Government has no direct involvement in Perth Airport's commercial dealings with its customers, WAC is very conscious of the State's interest in seeing the airport facilitate economic activity and the growth of the State economy.

The foregoing discussion illustrates that Perth Airport operates in a dynamic market place, where passenger numbers will be affected by the decisions of airlines as well as global phenomena such as SARS, bird flu, and terrorism in addition to the impacts of economic activity domestically and overseas. It is a market environment that requires the airport operator to act commercially, and to be responsive to the needs and preferences of airport users in order to attract new carriers and grow services.

1.4 Early experience - from privatisation to 2002

Whilst the Commission's current review is focused on the performance of the present regulatory regime, it is essential that the Commission does not lose sight of the experience of CPI-X regulation in the five-year period immediately following privatisation. In its submission to the Commission's 2002 Inquiry³⁰, WAC argued that the regulatory regime put in place for the Phase 1 airports failed to achieve most of the Government's stated objectives. In particular, WAC explained that:

- the objective of minimising costs of regulatory oversight for both the ACCC and the airport operators had not been achieved;
- appropriate economic outcomes had not been achieved;
- the prices oversight regime did not create the conditions for commercially-driven decisions on the part of the airport operators; and
- airport operators and their airline customers were not successful in negotiating outcomes on pricing and investment.

It is also essential to recall that the CPI-X regime established in 1997 was described as a *transitional measure*, which would allow airport operators and other stakeholders to adjust to the new operating environment. The Commission noted this point in its 2002 Inquiry Report as follows³¹:

"In 1996, the then Department of Transport and Regional Development (DoTRD 1996) described the prices oversight arrangements as transitional measures, designed to allow airport operators, users and the Government regulator time to adjust to the new operating environment for airports. It was envisaged that pricing arrangements would change after experience was gained in the new operating environment. As such, a review of the pricing arrangements was a key feature of the privatisation program developed by the Commonwealth Government.

²⁹ For instance, WAC and the State Government jointly fund business development and economic development initiatives that are aimed at increasing passenger numbers at Perth, and economic activity within the State.

³⁰ Westralia Airports Corporation, *Submission to Productivity Commission Inquiry: Prices Regulation of Airports*, March 2001.

³¹ Productivity Commission, *Price Regulation Of Airport Services: Inquiry Report*, 23 January 2002, page 4.

The review will be based on the premise that the price cap applied to aeronautical charges during the first five years will no longer operate. In its place, the review will aim to develop arrangements targeted at those charges where the airport operator has most potential to abuse market power. The existing set of aeronautical charges will be examined, on an airport-by-airport basis, with the review assessing whether services should be added or removed from surveillance. (DoTRD 1996, p. 7)

The review was to be completed before the end of the first five-year period of the leases.”

Price regulation, administered by the Australian Competition and Consumer Commission (ACCC) under the *Prices Surveillance Act 1983*, comprised a five-year, CPI-X annual cap on prices for aeronautical services at 11 of the largest privatised airports - Melbourne, Brisbane, Perth, Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville. Essentially, these arrangements extended, for the first five years of privatisation, the FAC aeronautical prices that were in place prior to privatisation. The cap was complemented by cost pass-through provisions for ‘necessary new investment’ and government-mandated security services as well as by quality monitoring and by special access arrangements designed to facilitate new airline entrants.

With an X factor for Perth Airport of 5.5%, WAC faced the highest reduction in unit aeronautical charges of any privatised airport in Australia. In theory, the X value in the CPI-X formula was intended to reflect expected productivity improvements in the delivery of aeronautical services at each airport. In practice, however, WAC was unable to obtain information from the Department of Transport and Regional Services (DOTRS) or the ACCC on how the extraordinarily high X factor for Perth Airport was determined.

One of the distinguishing operational features of an airport is the very high fixed cost nature of the business. In the case of Perth Airport, the cost of interest, depreciation and amortisation accounted for more than 60% of total operating costs in 2004/05. In this environment, delivering real price reductions of 5.5% per annum is simply not sustainable.

WAC’s submission to the Commission’s 2002 Inquiry explained that there was a misconception among airlines that WAC “inherited” a level of aeronautical charges from the FAC that provide satisfactory returns on the underlying aeronautical assets, and an adequate funding pool for replacement capital expenditure. As explained in detail in WAC’s submission to the 2002 Inquiry, this was in fact not the case. At the time of privatisation, average aeronautical charges at Perth Airport 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 also explained to the Commission that concern regarding the unsustainably low level of aeronautical charges pre-dated privatisation. For instance, during an industry consultative meeting on 14 August 1996, the FAC presented a range of scenarios regarding the increases in aeronautical charges required to achieve the overall target rate of return (9.5% on assets) which was set by the Government. For Perth Airport, the FAC proposal represented an average charge increase of 21% across all aeronautical services. In October 1996, however, the Government approved an average increase in aeronautical charges across all FAC owned and operated airports of just 10.8%. This was the first increase in 3 years.

Given the level of aeronautical charges at privatisation; the application of an X factor in the case of Perth Airport of 5.5%; and the fixed cost structure of airports, it is not surprising that WAC’s submission to the Commission’s 2002 Inquiry highlighted the need for an increase in aeronautical charges. In fact, WAC provided detailed analysis to quantify the revenue

shortfall (or under-recovery) on its aeronautical services, where the shortfall is the difference between:

- aeronautical revenues resulting from applying the ACCC's building block approach (as set out in its *Statement of Principles for the Regulation of Transmission Revenues* in the electricity sector) to Perth Airport's aeronautical asset base; and
- the revenues earned by Perth Airport under the CPI-X framework for the 5 year regulatory period post privatisation

That analysis showed that in the first three years of the post-privatisation CPI-X regime, WAC had under-recovered aeronautical revenues at Perth Airport by approximately \$19 million and that, by the end of the 5-year regulatory period, this under-recovery was expected to grow to approximately \$27.5 million. This implied a rate of return on aeronautical assets under the CPI-X regulatory scheme, of just 2.2% for 1999/2000.

For Perth Airport, therefore, a key criticism of the CPI-X regime is that the resulting prices were unsustainably low. Low prices and low rates of return have the effect of discouraging investment – which impacts negatively on airlines and passengers. The adverse impact on new investment was compounded by the ACCC's approach to determining the expenditure that constitutes Necessary New Aeronautical Investment (NNAI). For instance:

- 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 failed to meet these criteria, the expenditure had to be met through price-capped charges.
- In the first 3½ years of private ownership of Perth Airport, WAC undertook a total of \$6.1 million of capital investment in aeronautical infrastructure³². Of this amount, \$3.4 million was approved by the ACCC as NNAI. The expenditure not approved by the ACCC related 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 its inability to recover the costs, due to safety, security, environmental or regulatory requirements.
- WAC's submission to the Commission's 2002 Inquiry noted that the ACCC placed great weight on airline support when considering projects for approval. However, the ACCC's approach to this issue encouraged airlines to support NNAI initiatives only if it suited them to do so. WAC's experience was that airlines were principally focused on minimising airport charges and therefore were reluctant to support most initiatives put forward by Perth Airport – even where these initiatives were necessary in order to accommodate expected traffic demand.

The pass-through arrangements for Government mandated airport security requirements provide a further example of how CPI-X regulation created unnecessary costs and uncertainty for the industry. Direction 13(3) of the *Prices Surveillance Act 1983* stated that:

³² A total of \$8.2 million was invested in aeronautical infrastructure for the period from privatisation in 1997 to June 2002.

“The ACCC is to allow a 100 per cent pass-through of those direct costs related to Government mandated airport security requirements.”

Whilst the intention of the above Direction appears to be clear, the guidance from a Department of Transport Pricing Policy Paper (November 1996) created confusion by suggesting that the airports should not earn a reasonable rate of return on security investments. As a result, the ACCC’s initial interpretation of the Direction only allowed the airports to earn a rate of return equal to the cost of debt. Following submissions from WAC and other stakeholders, the ACCC’s final position (March 2000) accepted that airports should be able to earn their weighted average cost of capital on security investments. However, the lengthy regulatory deliberations on such an important matter created considerable uncertainty and unnecessary costs for the sector.

On the basis of this experience, WAC remains convinced that CPI-X regulation failed to deliver the prices and investment outcomes that were necessary to encourage growth and efficient development at Perth Airport. Subsequent sections of this submission will explain how investment at Perth Airport has increased very significantly under the price monitoring regime, and that in recent years Perth Airport has enjoyed substantial growth in passenger numbers. It is important that the Commission’s present review does not result in a return to a regulatory regime which has already been demonstrated to have delivered suboptimal outcomes. In this context, it is useful to revisit the findings of the Productivity Commission’s 2002 Inquiry.

1.5 Overview of the Productivity Commission’s 2002 Review

Section 1.4 above recapped on the principal concerns previously expressed by WAC in relation to the operation of the CPI-X regulatory regime, which came into operation immediately after privatisation. WAC encourages the Commission to review the effectiveness of the current regulatory regime in the context of the CPI-X regulation that it replaced. In reality, all forms of regulation are likely to be inferior to competitive market outcomes – and therefore the choice between regulatory regimes must be based on minimising compliance costs and adverse outcomes.

It is equally important that the Commission’s earlier analysis of the airport sector in its 2002 Inquiry is not overlooked. WAC notes that in its 2002 deliberations, the Commission held informal discussions with organisations, companies, and individuals to seek information and to canvass a wide range of views. Fifty submissions were received in response to the Commission’s issues paper. Interested parties were given the opportunity to respond to matters raised in the draft report by way of written submissions and at public hearings held in October 2001. Twenty-nine supplementary submissions were received in response to the draft report.

Given the extent of the Commission’s work at that time, it is worth recapping on the Commission’s key findings.

At the outset, it is important to note that the Commission concurred with the view expressed by WAC, that the pre-existing prices in place at the start of the regulatory regime were not adequate to provide for efficient replacement aeronautical investment on a dual-till basis. The Commission also found that the regulatory arrangements implemented immediately

after privatisation discouraged efficient investment. The Commission explained its views as follows³³:

“A range of issues has arisen in relation to price-cap arrangements applying to Australian airports. The inherited FAC starting prices (set to provide a modest return on capital, based on income from all sources) were not adequate to provide for efficient replacement aeronautical investment on a dual-till basis. These prices then combined with X values that incorporated expected productivity and passenger growth and some undefined investments, and (initially ill-defined) investment cost pass-through provisions.

At best, a lack of clarity has promoted strategic behaviour by all parties, increased compliance costs and discouraged commercial negotiation. At worst, the arrangements, which combine elements of incentive and cost-based regulation, have discouraged efficient investment by sending poor price signals both to airport operators and users about the costs of providing aeronautical services and by requiring very detailed regulatory assessment of every investment proposal.”

The Commission further noted that whilst some of the problems could have been avoided by more clearly defining the regulatory regime in the first place, there are nonetheless important inherent difficulties in price cap regulation. In particular, the Commission noted that the question of asset valuation is problematic and the consequences of regulatory error are substantial. The Commission therefore explained that price cap regulation ought to be reserved for those instances where excessive pricing is likely to impose major costs on the community³⁴:

“Some of these problems could have been avoided by a more transparent process and clearer guidelines from the outset; others reflect the design of the price caps. Though price caps could be redesigned to incorporate planned investment, and benchmarks could be used to provide independent estimates of achievable productivity growth, inevitably there will have to be an eventual assessment by the regulator of an airport’s operating and capital costs, land values, risk, and demand growth. Given the substantial conceptual and information problems in asset valuation and cost assessment (assessing the opportunity cost of airport land being especially problematic), the risks of regulatory error and the potentially damaging consequences of this for investment correspondingly increase.

Accordingly, the Commission considers that price caps, while preferable to explicit rate-of-return regulation, should be reserved for situations where there is a strong likelihood of excessive pricing and where such pricing is likely to impose major costs on the community.”

The Commission also noted that the move to a price monitoring regime had been foreshadowed at the time of airport privatisation. Nevertheless, the Commission believed that some parties would find the transition difficult – especially as aeronautical charges were not currently cost reflective and would need to increase whatever form of regulation were adopted. The Commission concluded its comments by noting some of the risks and potential costs associated with heavy-handed regulation³⁵:

“The Commission recognises that its preferred option would involve a considerable shift from current arrangements at the four major airports — though one largely envisaged by the architects of the regulatory arrangements put in place at the time of airport privatisations. The Commission also recognises that some parties may find such a transition difficult, particularly

³³ Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, 23 January 2002, page XXXII.

³⁴ Ibid, page XXXII.

³⁵ Ibid, page XLV.

given the long history of government provision of airport services at those airports, and pricing structures that have effectively subsidised aeronautical charges. Nonetheless, even if price caps were to be maintained (in any form), aeronautical charges would still need to rise to encourage efficient long-run service provision.

The Commission considers that the full benefits of privatisation of airports are unlikely to be realised if commercial relationships between airports and airlines continue to be heavily conditioned by intrusive price regulation. The ongoing need for substantial investments at major airports requires a more commercial and cooperative approach. The potential for heavy-handed regulation to unduly constrain prices and commercial relationships poses a real risk and one that could impose large costs on consumers in the future.”

A further important point to note from the Commission’s 2002 Inquiry relates to the question of market power. The Commission found that the four largest airports have considerable market power. However, the Commission strongly questioned whether the existence of considerable market power would have an adverse effect on consumers³⁶. In particular, the Commission argued that there were strong incentives for the airports to grow passenger volumes, and that these commercial drivers would provide an effective natural restraint on any potential abuse of market power³⁷:

“Though the four largest airports have considerable market power, the prospect of them using that power in a way that would generate significant costs to the economy or community is supported neither by the evidence nor the analysis. There are strong commercial incentives pulling in the other direction, including scope for increased profits in non-aeronautical activities from increasing passenger volumes and incentives to discriminate and differentiate in pricing.”

Finally, it is worth re-capping on the Government’s response to the recommendations made by the Commission at the conclusion of the 2002 Inquiry. The joint press release of the Minister for Transport & Regional Services and the Treasurer stated³⁸:

“The Government has accepted the Commission’s recommendation that Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin airports be subject to price monitoring for five years.

‘The Government’s response has taken into account the interests of airports, airport users and the travelling public,’ Mr Costello and Mr Anderson said. ‘The price monitoring arrangements will provide airports with greater scope to undertake efficient aeronautical investments and more flexibility to respond to a changing aviation environment.

‘The major airports have a strong commercial incentive to encourage passenger growth and maximise non-aeronautical revenue. Nevertheless, the Government will initiate a review if there is evidence of unjustifiable price increases. This would be in addition to the statutory protection given to stakeholders under the Trade Practices Act 1974.’ ”

³⁶ It is also worth noting that in its 1994 Discussion Paper titled *Pricing Guidelines for Efficiency and Fairness* the Prices Surveillance Authority (PSA) examined the statutory criteria specified in section 17(3) of the Prices Surveillance Act 1983. Specifically, when discussing criterion B of 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.”

³⁷ Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, 23 January 2002, page XLII.

³⁸ <http://www.treasurer.gov.au/tsr/content/pressreleases/2002/024.asp>

WAC fully appreciates that the Commission must start its review ‘afresh’, rather than take as a starting point its findings from the 2002 Inquiry. However, whilst WAC fully supports the Commission’s careful re-examination of the issues, we remain firmly of the view that the performance of Perth Airport since 2002 vindicates the Commission’s reasoning in its 2002 Inquiry and the Government’s response to the Commission’s recommendations. In particular, whilst prices have increased in order to correct many years of under-pricing of aeronautical services, investment and passenger numbers have increased substantially. Negotiation and consultation is continuing to develop along commercial lines rather than being heavily conditioned by intrusive price regulation. WAC strongly believes that a return to more heavy-handed regulation would put at risk the economy-wide benefits that have been delivered under the price monitoring regime.

1.6 Regulatory developments since the Commission’s 2002 Inquiry

1.6.1 Introduction

In the previous section, WAC has argued that its previous submissions to the Commission’s 2002 Inquiry and the Commission’s own deliberations in that inquiry are still relevant to the Commission’s current review. In the context of the present review, WAC also believes that the Commission should also have regard to broader regulatory developments that have occurred since the publication of the 2002 Inquiry Report. In this regard, the following decisions and reports are particularly relevant to the Commission’s current review:

- the Western Australian Supreme Court decision of *Re Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd* [2002] WASCA 231 (the “Epic Decision”);
- the Productivity Commission’s Review of the Gas Access Regime;
- the Report to the Prime Minister by the Exports and Infrastructure Taskforce;
- the Australian Competition Tribunal’s decision of 9 December 2005 to declare the airside services at Sydney Airport and the subsequent consideration of this matter by the Federal Court; and
- the outcomes of the Council of Australian Government’s (COAG) 2005 review of National Competition Policy.

It is noted that the Commission’s terms of reference for this review specifically require the Commission to have regard to the last two matters listed above. These matters are addressed separately in section 4 of this submission, while the remaining three issues are addressed in turn below.

1.6.2 The Epic Decision

In the Epic Decision the Western Australian Supreme Court made a number of statements which have been the subject of careful consideration and much discussion among regulators, regulated entities and other stakeholders in recent years. It is interesting to note the commentary of Dr Darryl Biggar on the court’s decision, particularly in light of the fact that Dr Biggar’s commentary formed part of the submission of the ACCC to the Productivity Commission’s Review of the Gas Access Regime³⁹.

³⁹ ACCC, *Submission to the Productivity Commission Review of the Gas Access Regime*, 15 September 2003, attachment 1

Dr Biggar stated that the Court took the opportunity to emphasise certain outcomes of a workably competitive market that it would like to see replicated, and noted the “strong implication that these are the outcomes which the Commission should seek to replicate”.

WAC believes that the Court’s findings, as described by Dr Biggar, provide useful insights into how the Commission might examine the issues of market power and workable competition in its current review. It is particularly interesting to note that Dr Biggar argues that the regulator ought to place due weight on the incentives to take risks, to exploit opportunities and to innovate. He further cautions against the application of narrow notions of efficiency.

Quoting the Epic Decision at paragraph 128, Dr Biggar commented as follows⁴⁰:

- “(a) First, workable competition is a dynamic process: ‘A workably competitive market is not a fixed and immutable condition with any absolute or precise qualities, but a process which involves rivalrous market behaviour. ... As such, a workably competitive market will react over time and according to the nature and degree of various forces that are happening within the market.’
- (b) Second, there may be temporary departures from static equilibrium conditions: ‘There may well be a degree of tolerance of changing pressures or unusual circumstances before there is a market reaction. The expert evidence and writings tendered in evidence suggest that a workably competitive market may well tolerate a degree of market power, even over a prolonged period.’
- (c) Third, efficiency does not necessarily attain ‘theoretically ideal [static] efficiency’: ‘The underlying theory and expectation of economists, however, is that with workable competition market forces will increase efficiency beyond that which could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal [static] efficiency.’

Dr Biggar then discussed the third of these outcomes concluding that⁴¹:

“[The] primary force of the Court’s argument is that the regulator should not place undue weight on static concepts of efficiency. Instead, according to the Court, the regulator should place due weight on the dynamic efficiency outcomes of competitive markets – the incentives to take risks, to exploit opportunities and to innovate. This could lead to temporary (or even prolonged) deviations from some narrow notions of efficiency, but to the greater good of efficiency overall.”

Dr Biggar then proceeded to state:

“Finally, the Court seems to acknowledge that a workably competitive market must be sustainable in the long run: ‘The expert evidence ... suggested a growing awareness of the long term disadvantages of striking the balance [between the interests of consumers in obtaining low prices and the service provider in receiving high prices] with too great an emphasis on the interest of consumers in securing lower prices, and without due regard to the interest of the service provider in recovering both higher prices and its investment’.”⁴²

⁴⁰ Ibid, page 111.

⁴¹ Ibid, page 112.

⁴² Ibid, page 113.

1.6.3 The Productivity Commission's Review of the Gas Access Regime

In its Review of the Gas Access Regime, the Commission commented on the potential for CPI-X regulation to distort investment and inhibit innovation. The Commission also noted that the 'building block' approach to incentive-based regulation tended to encourage regulators to set prices with a false sense of precision:

"...Based on the Commission's assessment (of both costs and benefits), including taking into account input from interested parties, it is reasonable to conclude that there are problems with the current regime. These mainly arise from the considerable costs the regime imposes and its real potential to distort investment and inhibit innovation."⁴³

"Regulators seek a large amount of detailed information from service providers and users. They also commission or undertake a substantial amount of research. In this way, service providers and regulators can incur large costs. Principally, regulators require the information to satisfy themselves that they have discharged their responsibilities in relation to approving and determining reference tariffs, in accordance with the flexible and highly discretionary framework set out in the regime. The outcome is the intrusive and meticulous use of the 'building block' cost method and incentive regulation framework to set reference tariffs with a false sense of precision."⁴⁴

WAC expects that the Commission will continue to be cognisant of the risks and costs of CPI-X regulation and other heavy-handed forms of regulation when it considers potential changes to the existing light-handed regulation that applies to airport pricing.

1.6.4 The Report to the Prime Minister by the Exports and Infrastructure Taskforce

It is worth commenting briefly on the Exports and Infrastructure Taskforce that was established by the Prime Minister in March 2005 to identify any bottlenecks, of a physical or regulatory kind, in the operation of Australia's infrastructure that may impede the full realisation of Australia's export opportunities. In relation to regulatory regimes, the Taskforce commented as follows⁴⁵:

"There is a need to rationalise our regulatory regimes, with consideration being given to the practicality and desirability of a single national regulator. However, perhaps even more important than the structure of regulation is improving the efficiency of our regulatory processes.

In our view, there should be a presumption that issues associated with export oriented infrastructure will be resolved by commercial negotiation between the infrastructure provider and users. We accept that this will often be imperfect, at times significantly so, but it is still likely to be preferable to the intrusive regulation that has become widespread. We therefore believe that some further tightening is desirable of the hurdles that need to be met before regulatory solutions are imposed on export oriented infrastructure.

Where those hurdles are met, and regulation is imposed, the initial presumption should be for light handed regulation (that is, price monitoring). Only where light handed regulation has demonstrably failed should more intrusive regulatory approaches be applied."

⁴³ Productivity Commission, Review of the Gas Access Regime, 11 June 2004, page XXVII.

⁴⁴ *ibid.*, page XXVIII.

⁴⁵ The Report to the Prime Minister by the Exports and Infrastructure Taskforce, May 2005, page 3.

1.6.5 Concluding comments on recent developments

Since the finalisation of the Commission's 2002 Inquiry there is now a significant and growing body of authoritative and independent opinion that demonstrates the importance of avoiding regulatory error under price cap regimes, and the risks to regulated infrastructure investment - and thus the long term interests of customers - that might arise from those errors. Whilst WAC believes that the Commission must consider the regulatory issues facing airports on their merits, it is also equally important that the present review does not start with a 'blank page' when considering the pros and cons of alternative regulatory regimes.

1.7 Summary of key points

This section of WAC's submission to the Commission has provided background information in relation to:

- the physical location and operational characteristics of Perth Airport, including the airlines and markets that it services;
- the dynamic market place in which Perth Airport operates, where passenger numbers will be affected by the commercial decisions of airlines as well as global phenomena such as SARS, bird flu, and terrorism in addition to the impacts of economic activity domestically and overseas. It is an environment in which:
 - airlines possess countervailing market power; and in which
 - the airport operator must respond positively to the needs and preferences of the airlines, and act commercially in order to attract new carriers and grow services.

This section of WAC's submission has also provided background information regarding:

- WAC's experience under CPI-X regulation immediately after privatisation, especially in relation to the under-pricing of aeronautical services and the fact that overly intrusive regulation acted as a brake on innovation and efficient new investment;
- the key findings of the Commission's 2002 Inquiry, noting in particular the Commission's comments regarding the potential costs associated with heavy-handed regulation; and
- the lessons from regulatory developments since the Commission's 2002 Inquiry, including:
 - a decision in Western Australia's Supreme Court, which indicates that regulators ought to have due regard to concepts of dynamic efficiency;
 - the findings of the Commission's review of the Gas Access Regime which noted, among other things, that regulators should avoid price-setting techniques that encourage a false sense of precision; and
 - the report of the Exports and Infrastructure Taskforce, which noted that issues associated with export-oriented infrastructure should be resolved by commercial negotiation - recognising and accepting that this will often be imperfect - and where regulation is warranted the initial presumption should be for light handed regulation (that is, price monitoring).

In summary, this background information provides strong anecdotal evidence that supports the conclusions reached by the Commission in its 2002 Inquiry. This submission now turns to the evidence regarding Perth Airport's operation since price monitoring was introduced. WAC submits that this evidence demonstrates that price monitoring continues to be the appropriate regulatory regime for Perth Airport.

2 WAC'S EXPERIENCE UNDER THE PRICE MONITORING REGIME

2.1 Introduction

This section of the submission examines WAC's experience under the price monitoring regime, as follows:

- Section 2.2 provides an overview of Perth Airport's approach to communicating and consulting with its customers and other stakeholders. This section also provides an outline of WAC's approach to determining its terms and conditions for the provision of aeronautical services, and its approach to commercial negotiation under the price monitoring framework.
- Sections 2.3 to 2.5 describe the outcomes, in terms of prices, service quality and new investment delivered at Perth Airport under the price monitoring regime.
- Section 2.6 describes the dispute resolution arrangements that presently exist, and examines the effectiveness of these arrangements.
- Section 2.7 provides a summary of key points.

2.2 Price-service negotiations under the price monitoring framework

2.2.1 Overview

The price monitoring regime is premised on the notion that Perth Airport and the airlines can negotiate commercial terms without the need for on-going regulatory intervention. Given the commercial drivers faced by Perth Airport (described in section 1 above), and Perth Airport's conduct in negotiating terms and conditions for aeronautical services since the introduction of price monitoring (described in detail in sections 2.2.2 and 2.2.3 below) WAC believes that this premise is sound.

In this section WAC describes the development of two major undertakings which have taken place under the price monitoring regime. These are:

- the terminal facility agreement with Virgin Blue; and
- the Price and Services Accord with the airline operators servicing Perth Airport.

Before examining the development of these two undertakings in detail, it is worth noting that Perth Airport has put a framework in place to ensure that effective formal communication and consultation takes places with airport users on operational matters as well as on commercial issues. This framework consists of a number of different forums which meet regularly to address specific operational and/or commercial matters.

It is acknowledged that most, if not all of these forums would exist regardless of the form of regulation applied to Perth Airport. Nonetheless, WAC's experience is that these forums have tended to operate in a more constructive manner since the cessation of heavy-handed price control and the associated regulatory arrangements governing new aeronautical investment. It should also be noted that consultation is continuing to develop at Perth Airport. An overview of the purpose and composition of the various forums is provided in Table 1 below.

Table 1: Industry consultative forums at Perth Airport

Forum	Meeting Frequency	Meeting Purpose	Membership
Airline Industry Consultation	Bi annual (currently two meetings in Perth, one in Sydney)	Update on contemporary airport issues including pricing, security, capital expenditure and planning.	Airlines' local, regional, and national managers, BARA & WAC senior management
Airline Operators Committee (AOC)	Monthly	General operational issues relating to the terminal	Station Managers or their deputies, handling agents (associated members)
Airport Facilitation Committee	Quarterly	Airport facilitation issues from check-in to the point of departure	Station Managers or their deputies, handling agents and control authorities
Evacuation Committee	Bi annual	Fire safety and evacuation matters. One committee per terminal	Airline representative, control authorities, tenants
Terminal 3 Tenants Committee	Bi monthly	General points relating to the operation of the terminal	T3 tenants including airlines
Check-in user group	When required	Check-in counter allocation, management of check-in hall	Nominated representatives from the AOC and handling agents
Baggage hall user group	When required	Occupational safety and health (OH&S) and operational issues in the BMU	Baggage handling staff and managers
Project Managers Group	When required	Industry consultation on major construction projects	Nominated carriers and/or nominated AOC member
Ad hoc meetings	When required	Specific issues e.g. transfer bus operation	Various airline staff
Security Committee	Bi monthly	Airport security-related matters	Station Managers or their deputies, handling agents and external security agencies
Airside Safety Committee	Monthly	Airside safety issues	Airside ramp and safety managers
Emergency Procedures Committee	Quarterly	Airport Emergency Plan procedures	Airlines, state government and response agencies
Noise Management Committee	Quarterly	Address community concerns regarding aircraft noise	Airlines, state and local government, WAC and occasionally Federal MPs

2.2.2 Terminal Facility Agreement - Virgin Blue

Virgin Blue commenced operating services to Perth in December 2001. Ansett ceased operations in March 2002.

Initially, Virgin Blue operated out of the international terminal and WAC made some building modifications to accommodate Virgin Blue's immediate needs. (For instance, there is no requirement for domestic passengers to clear customs and immigration, so a route for domestic passengers through the international terminal was established). WAC took over the former Ansett terminal (which is now referred to as Terminal 3) with effect from 1 September 2002. After completing some refurbishment and modification works at the terminal, Virgin Blue commenced operations from Terminal 3 in early December 2002.

During the negotiations between Virgin Blue and WAC in the period before December 2002, a range of different pricing approaches were considered and discussed. Whilst Virgin Blue had expressed a preference for weight-based aeronautical charges, it accepted a passenger-based pricing structure as part of a wider package of negotiated outcomes, including "obtaining certainty of price over a long term, commitment to maintain the quality of the airport's services at an acceptable level, and a reduced rate for domestic terminals."⁴⁶

Following these negotiations, both parties agreed to an arrangement under which prices step down as passenger-volume increases, and elements of the fees would be unbundled to enable Virgin Blue to reduce the charges it would pay if it elected to not use certain specified elements of aeronautical services. The agreement grants rights for signage, apron and check-in counter usage, and provides for a dispute resolution mechanism (see section 2.6 below). The agreement specifies that the charges will increase by CPI annually.

WAC has increased the charges by CPI as specified in the agreement. The agreement provides for additional charges to be levied by WAC for capital improvements made at the request of Virgin Blue or as agreed between WAC and Virgin Blue. WAC has spent a little under \$3 million on capital improvements in the aeronautical areas of the terminal and has not sought additional charges in relation to that expenditure.

2.2.3 The Prices and Services Accord

The Prices and Services Accord outlines the terms and conditions under which Perth Airport provides aeronautical services to the airline operators for the 5-year period commencing on 1 July 2002. Specifically, the Prices and Services Accord:

- details the services and facilities WAC will provide;
- outlines WAC's commitment to providing an appropriate quality of services and facilities;
- outlines WAC's commitment to maintaining the capacity of services and facilities;
- outlines WAC's proposed capital expenditure (investment) program for the 5 years from July 2002;
- presents the schedule of charges at the Airport;

⁴⁶ Australian Competition Tribunal Virgin Blue Airlines Pty Limited [2005] ACompT 5, paragraph 287.

- outlines what WAC expects from airline operators in relation to the use of WAC services and facilities, payment of charges, consultation and compliance with legal requirements;
- outlines WAC's proposed consultation process and information sharing principles; and
- outlines a proposed procedure for dispute resolution.

The Prices and Services Accord also outlines the incentive program offered by Perth Airport to encourage international airline operators to expand services into Perth. Specifically, WAC has committed to providing funds for marketing of new services, as set out below:

Market Development Fund	WAC will provide funds for the development of tactical advertising campaigns to encourage inbound travel to Perth on new air services. WAC will seek to leverage other contributions to the campaign by the airline operator concerned and other parties, such as WATC and inbound tour operators.
Increased Frequencies	In cases where airline operators introduce additional international services on established routes, WAC will provide a contribution to the marketing campaign of up to 25% of estimated charges for the airfield and terminal for one year.
New Non-Stop Services	Where the sector is serviced by existing carriers, a contribution of up to 25% for one year. Where the sector is not operated by existing carriers, a contribution of up to 35% for one year and 20% for a second year.

WAC estimates that a total of approximately \$4 million worth of incentives has been paid by Perth Airport under these arrangements since they were put in place⁴⁷.

A copy of the Prices and Services Accord is provided in Appendix 3.

WAC initiated the development of the Prices and Services Accord in advance of the Commission finalising its Inquiry Report in January 2002. As already noted, it was widely acknowledged (even prior to privatisation) that prices for aeronautical services were not fully recovering the costs of providing the service. At the time of the Commission's 2002 Inquiry, WAC was therefore keen to evaluate alternative pricing arrangements, and to adopt a sound methodology for determining aeronautical prices.

One of the methods examined by WAC was the revenue "building block" approach. This approach is applied widely throughout Australia by capital-intensive utility businesses to determine their total revenue requirements. Importantly, the approach is also applied by the ACCC to determine the aggregate revenue requirements of electricity transmission network businesses⁴⁸. The building block approach is therefore well-documented and widely applied, and on this basis WAC's view is that it is a suitable tool for assessing the total sustainable revenue requirement of capital-intensive businesses such as airports.

⁴⁷ Information provided to the Commission under separate cover (and on a commercial-in-confidence basis) provides details of the incentives offered by Perth Airport.

⁴⁸ ACCC, *Statement of principles for the regulation of electricity transmission revenues*, December 2004.

Under the building block approach, the aggregate charges are based on the total cost of providing services, where the cost includes operating expenditure, depreciation and a reasonable return on assets after tax.

In applying the building block method to its own particular circumstances:

- WAC sought specialist independent advice on a range of matters including asset valuation, the cost of capital, revenue modelling methodologies, and traffic forecasts; and
- WAC adopted robust methodologies and soundly-based estimates of key inputs, to ensure that its prices are justifiable using regulatory yardsticks.

In the course of its revenue building block analysis, WAC concluded that the asset value established for Perth Airport in 1997 was not fit for the purpose of determining future aeronautical charges because:

- the FAC asset register on which the 1997 valuation was based was incomplete and inaccurate; and
- the valuations were high-level, desktop valuations only.

It is noteworthy that other stakeholders have also recognised that the book values of the airports at the time of privatisation were not fit for the purpose of determining aeronautical revenue requirements. For instance, in its June 2006 *Airline Views* newsletter, the BARA commented that

“The privatisation of Phase I and II airports did not explicitly involve a valuation of aeronautical assets at the time of the sale.”

Given these considerations, WAC adopted an ODRC valuation of assets for revenue determination purposes, and applied a revenue building block model (consistent with that applied by the ACCC in the electricity transmission sector) to assess its total revenue requirement for aeronautical services. The model was then used to assess the prices for aeronautical services to apply under the Prices and Services Accord from 1 July 2002.

The Prices and Services Accord covers Terminal 1 (international) and airfield charges only. Terminal 2 (Qantas) remains the subject of a long term leasing agreement entered into by the FAC and is therefore outside of aeronautical pricing. Terminal 3 (previously the Ansett terminal) was the subject of negotiations with the administrators of Ansett, so WAC did not control the terminal at that time.

Using the model, a number of different pricing scenarios were developed. These included pricing based on maximum take off weight (the status quo), passenger numbers and movements. The pricing scenarios also included offering a smoothed price path (reflecting annual inflation increases) and a price path that essentially varied over time due to traffic growth and adjustments to the asset base.

WAC presented these options to the airlines at a consultative meeting in March 2002. WAC’s consultative process essentially dealt with BARA representing the international carriers into Perth, Qantas and Virgin Blue⁴⁹.

⁴⁹ As already noted, Virgin Blue had only commenced operations into Perth in December 2001 and represented a very small proportion of Perth traffic at that time.

From March to June 2002, WAC held a number of meetings with BARA, Qantas and Virgin Blue. As part of this process, WAC sought and received feedback from the airlines on its draft Prices and Services Accord document. WAC also provided its building block revenue analysis (including details of input assumptions relating to future operations and maintenance costs, capital expenditure, asset values, required returns and traffic forecasts) to the airlines for their review. Passenger-based charging (except for freight & general aviation which continues to pay a tonnage-based charge) was adopted with the support of the majority of the airlines⁵⁰. In this regard, it is noted that the airlines saw two advantages in passenger-based charges:

- First, a charge based on passenger numbers⁵¹ can be separately identified on the airline ticket and this meant that it would be excluded from travel agency commissions. A charge based on maximum take off weight cannot be so segregated.
- Secondly, a charge based on passenger numbers automatically provides some short term relief to airlines in periods of downturns. For example, during the SARS epidemic when load factors were severely affected, WAC's charge for landing an aircraft was automatically lower. The passenger-based charging structure thereby provides a mechanism for the airlines to share passenger number risk with the airport.

Further details of the reasons for WAC's preference for passenger-based charges are set out in section 3.4.

2.2.4 Concluding comments on Perth Airport's conduct under the price monitoring regime

In initiating the development of the Prices and Services Accord, and in negotiating the Virgin Blue terminal agreement, WAC was particularly interested in clearly setting out Perth Airport's commitment to providing an appropriate quality of services and facilities, as well as a commitment to maintaining the capacity of services and facilities. In addition, in light of the widespread and long-standing recognition that prices for aeronautical services were unsustainably low, WAC was interested in establishing new prices for aeronautical services that would be reasonable from the perspective of customers, whilst also providing a commercially sustainable revenue stream to the Airport.

WAC consulted with the airlines in the development of the Prices and Services Accord, and adopted a transparent approach in the development and substantiation of the prices. Indeed, the airlines (through BARA) have acknowledged the reasonableness of Perth Airport's conduct in negotiating new terms and conditions for aeronautical services since the introduction of price monitoring, as follows⁵²:

"Following the cessation of their CPI-X price cap on 30 June 2002, the operators of Brisbane, Melbourne, Adelaide and Perth airports entered into five-year commercial agreements with airlines. Those agreements address prices for aeronautical services, capital expenditure programs and service levels. BARA and its member airlines had the confidence to engage in negotiations with those airport operators for a commercial agreement because they had

⁵⁰ The only airline which initially preferred an alternative to passenger-based charges was Virgin Blue. However, as already noted in section 2.2.2 above, Virgin Blue subsequently agreed to accept passenger-based charging as part of a wider package of arrangements it negotiated with WAC.

⁵¹ As part of the Prices and Services Accord negotiations, there was some debate over the definition of "passenger" for the purposes of the charge. WAC agreed to airline requests to exclude infants, positioning crew and operating crew from the definition.

⁵² BARA, *Airline Views* (newsletter), August 2003, page 1.

implemented cost efficiency measures under the CPI-X price cap and airlines accepted that their cost bases were reasonably efficient.”

WAC considers that its conduct throughout the process of the development and implementation of the Prices and Services Accord and the Virgin Blue terminal agreement reflects a commitment to achieving effective commercially-negotiated outcomes, in accordance with the objectives of the light-handed regulatory regime that was put in place following the Commission’s 2002 Inquiry.

In addition, WAC has established a framework to ensure that effective formal communication and consultation takes place with airport users on operational matters as well as on commercial issues. Perth Airport’s initiatives in this regard, along with the cooperation and participation of the airport users, have been important in ensuring the achievement of one of Government’s key objectives for the price monitoring regime - namely, promoting the economically efficient operation of airports.

2.3 Investment outcomes under the price monitoring framework

As part of the agreement governing the sale of Perth Airport, WAC was required to commit to capital expenditure totalling approximately \$87 million over 10 years on “Airport Development”. Of this amount, a total of \$54 million was to be invested over the period up to 2002, and a further \$33 million was to be invested over the period from 2003 to 2007.

These provisions were set out in Schedule 11 of the agreement and are generally referred to as WAC’s “Schedule 11 commitments.” It is important to note that the definition of “Airport Development” is not limited to items of aeronautical capital expenditure, and includes roads, car parking, freight facilities and other developments.

Towards the end of 2002, it became apparent that the level of capital investment undertaken by WAC for the 2002 period would be below that required by its Schedule 11 commitments. Accordingly, WAC applied to DOTARS for an extension of the term, and this was application was accepted. WAC subsequently cleared the investment backlog, and in fact discharged its commitment early, with DOTARS confirming in January 2006 that WAC had met all of its Schedule 11 commitments at the end of the 2005 financial year⁵³.

In addition to meeting its Schedule 11 commitments, the Prices and Services Accord requires WAC to consult with airline operators on all capital expenditure projects⁵⁴. Table 2 below summarises the proposed capital expenditure plan relating to the provision of aeronautical services at the airport for the 5-year period commencing on 1 July 2002 as set out in the Prices and Services Accord⁵⁵.

⁵³ Schedule 11 requires WAC to lodge an audited submission to DOTARS to substantiate the record of annual expenditure.

⁵⁴ As noted in section 2.2 above, the Prices and Services Accord outlines the terms and conditions under which Perth Airport provides aeronautical services to the airline operators for the 5-year period commencing on 1 July 2002.

⁵⁵ The amounts shown are those components of capital expenditure that are attributable to aeronautical services, in accordance with WAC’s Activity Based Costing model.

Table 2 - Proposed Aeronautical Capital Expenditure 2002/03 – 2006/07 (\$000s of the day)

Asset Class	2002/03	2003/04	2004/05	2005/06	2006/07
Runways, Taxiways and Aprons	5,693	11,420	6,673	3,493	1,963
Roads and Car Parks	1,435	1,090	0	10	384
Fences and Gates	20	20	20	20	20
Passenger Terminal Buildings	373	3,172	2,601	84	64
Main Services	320	155	350	0	300
Fixed Plant and Equipment	15	8	0	0	0
Movable Plant and Equipment	53	98	0	0	0
Motor Vehicles – Heavy	52	65	0	0	0
Motor Vehicles – Light	169	149	268	123	63
Computer Hardware	594	247	154	225	87
Furniture and Fittings	0	0	0	0	10
Total	8,724	16,424	10,066	3,954	2,890
Cumulative Total	8,724	25,148	35,214	39,168	42,058

Table 2 shows that under the Prices and Services Accord, WAC committed to a program of \$42 million of aeronautical capital expenditure to be covered under the current price paths (that is, for the period from July 2002 to June 2007). By the end of 2006/07, WAC is expecting to have invested a total of \$49 million in aeronautical infrastructure over the period of the Prices and Services Accord, which exceeds WAC's commitment under the Accord by approximately \$7 million.

Over the initial 5 year period of CPI-X price capping, (from 1998 to 2002) total aeronautical capital expenditure was \$8.2 million. By contrast:

- Under the first five years of the price monitoring regime (from 2003 to 2007, as noted above) aeronautical capital expenditure relating to the Prices and Services Accord is forecast to be \$49 million, with approximately \$36 million already spent.
- The \$36 million invested to date by WAC under the Prices and Services Accord excludes a further \$12 million worth of aeronautical investment, the cost of which is to be recovered by agreement with the airlines, and capital expenditure on Terminal 3 which is also outside the scope of the Prices and Services Accord.
- WAC is presently forecasting to invest a total of \$94.8 million on aeronautical assets over the period from 2007/08 to 2011/12, as shown in Table 3 below.

Table 3: Forecast Aeronautical Capital Expenditure – Major Items over the period from 2007/08 - 2011/12

	(\$000's)
Airfield	\$37,800
Terminal buildings	\$57,000
Total	\$94,800

The planned capital expenditure will provide the increases in capacity required at Perth Airport in coming years, to ensure that congestion is alleviated or avoided, and that a high standard of service can continue to be provided.

The very positive investment outcomes delivered under the price monitoring regime contrast sharply with the relatively poor investment outcomes achieved under the initial CPI-X price cap regime. The substantial increases in investment by WAC are attributable to:

- the ability, under the light handed regulatory regime established in 2002, of Perth Airport now being able to negotiate charges for new facilities that have a reasonable prospect of recovering a fair return on the capital invested to provide those facilities; and
- the removal of the barriers to efficient investment - such as the “Necessary New Aeronautical Investment” framework - that existed under the initial CPI-X price cap regime.

WAC considers that the substantial improvements in investment outcomes delivered under the price monitoring regime demonstrate that the regime has been effective in promoting the economically efficient operation of Perth Airport through commercial negotiation - rather than through heavy-handed regulatory involvement - in accordance with the objectives set by Government. In addition, the investment outcomes demonstrate that under a light-handed regulatory regime, the prospect of achieving a fair rate of return coupled with the positive impacts of passenger growth on the other segments of the business have encouraged Perth Airport to voluntarily commit to undertaking more aeronautical development than required under the Prices and Services Accord.

2.4 Service outcomes under the price monitoring framework

2.4.1 Introduction

WAC recognises the importance of meeting the needs of its customers and other stakeholders to the long term commercial success of Perth Airport. This recognition is reflected in Perth Airport’s 2006/07 business plan, which was recently approved by the Board. The plan sets out the values, strategies, actions and internal performance measures that Perth Airport will employ in meeting its objective of operating and developing Perth Airport to grow value for its shareholders and to satisfy its stakeholders. The business plan emphasises customer satisfaction through the adoption of values which include “being customer focused in all we do”, and through the adoption of strategies including:

- working with airlines, the travel industry and governments to grow air services; and

- delivering superior services and facilities for Perth Airport's customers.

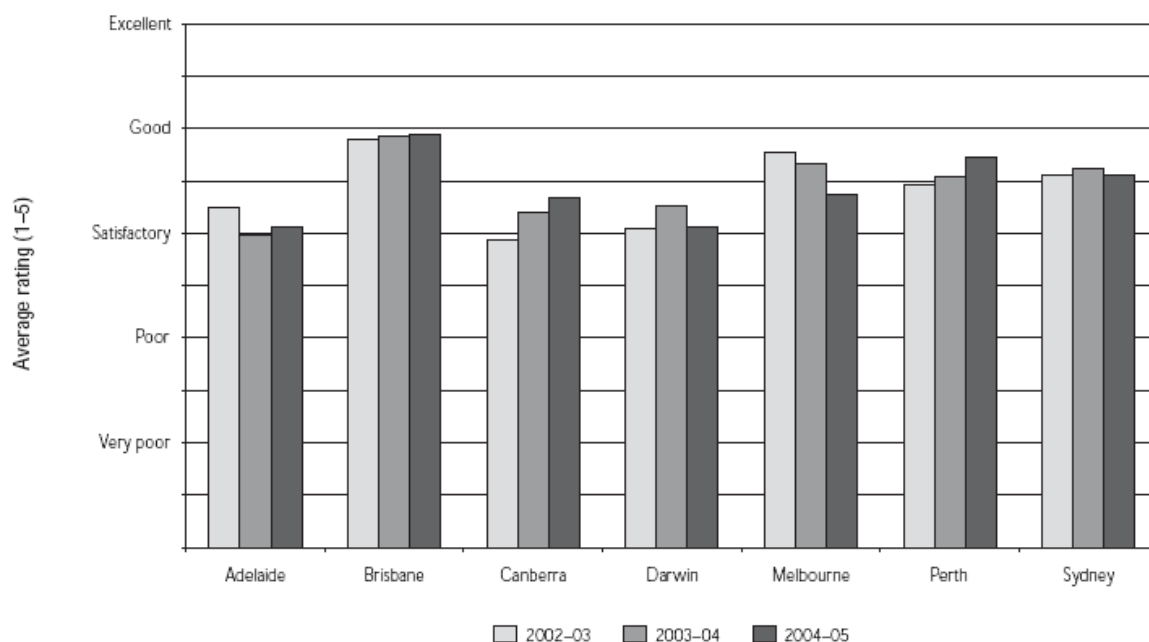
WAC provides reports to the ACCC regarding service quality at Perth Airport in accordance with the requirements of the Airports Act and the price monitoring regime administered by the ACCC. Notwithstanding the statutory requirements relating to reporting of service quality, WAC is committed to undertaking detailed monitoring of the quality of services it provides at Perth Airport:

- to determine the needs, preferences and expectations of customers regarding airport services;
- to monitor Perth Airport's performance in meeting customers' expectations;
- to benchmark the performance of Perth Airport against its peers;
- to identify specific areas in which performance is poor;
- to seek feedback directly from customers about service quality, and to canvass customers' views about how services can be improved; and
- to gather information relevant to planning the delivery and expansion of services, with the aim of ensuring that the services provided at Perth Airport meet or exceed travellers' expectations.

2.4.2 Comparative service quality at the price-monitored airports

As already noted, WAC submits annual Quality Service Monitoring (QSM) reports to the ACCC. Figure 9 below is taken from the ACCC's 2004/05 Quality of Service report for price-monitored airports. It shows the overall average rating of quality of service at all airports from 2002–03 to 2004–05. This rating is based on a weighted average over the range of quality of service indicators examined at each airport.

Figure 9: Overall airport quality ratings

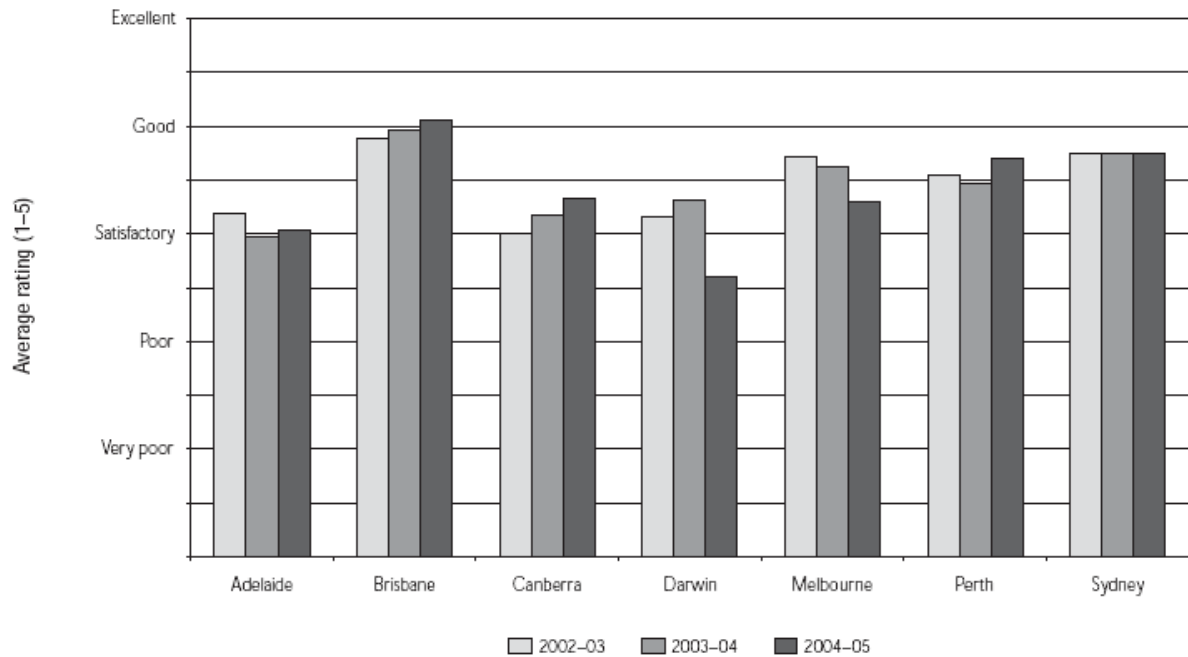


Source: ACCC

The ACCC report shows that Perth Airport has achieved a steady improvement in its overall quality rating over the three years to 2004/05. It also shows that in 2004/05, Perth achieved the second-highest rating of the seven price-monitored airports.

Figure 10 below is also sourced from the ACCC's 2004/05 Quality of Service report. It shows the average ratings of the availability of facilities provided at all airports from 2002–03 to 2004–05. This rating is based on a weighted average over the range of quality of service indicators relating to the availability of facilities provided by each airport operator.

Figure 10: Overall airport ratings—availability of facilities

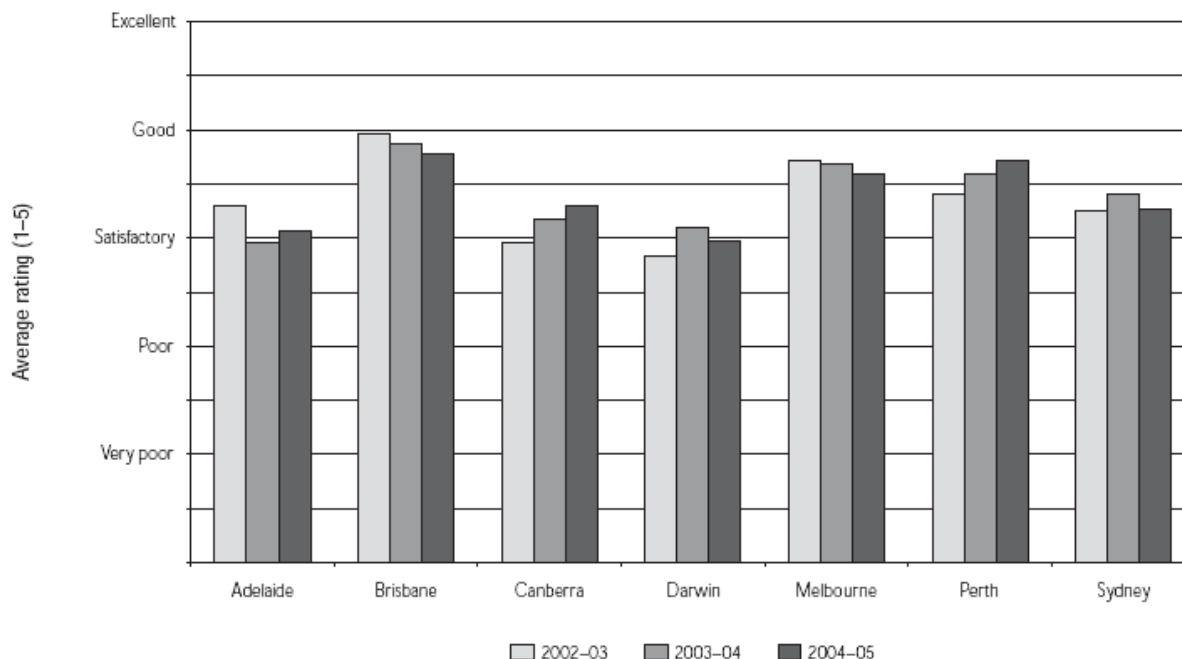


Source: ACCC

Figure 10 shows that Perth's overall rating improved slightly over the period, and in 2004/05 was in the upper quartile.

The overall ratings of the price-monitored airports in terms of the standard of their facilities is shown in Figure 11 below.

Figure 11: Overall airport ratings—standard of facilities



Source: ACCC

Figure 11 shows a strong improvement in Perth's rating over the period. By 2004/05, Perth achieved the second-highest overall rating for the standard of its facilities.

Further details of the service quality standards achieved by Perth Airport are set out in the report titled *Quality of service - Price-monitored airports: 2004/05*, published by the ACCC in November 2005.

It is interesting to note that page 54 of the ACCC's 2004/05 *Quality of service* report observed that:

- Ratings by airlines of the airside and international terminal facilities at Perth Airport increased during 2004–05, with facilities rated as satisfactory to good on average.
- Minor trends are apparent in the ratings of the international terminal and management responsiveness: ratings generally fell over the period during which the CPI-X price caps were in place, however ratings have risen since 2001/02 following the introduction of the price monitoring regime.

As already noted, in addition to providing data to the ACCC under the service quality monitoring regime, WAC also commissions independent studies of its service quality performance. Independent benchmarking studies completed for WAC in June 2005 showed that of the 15 BAA airports world-wide:

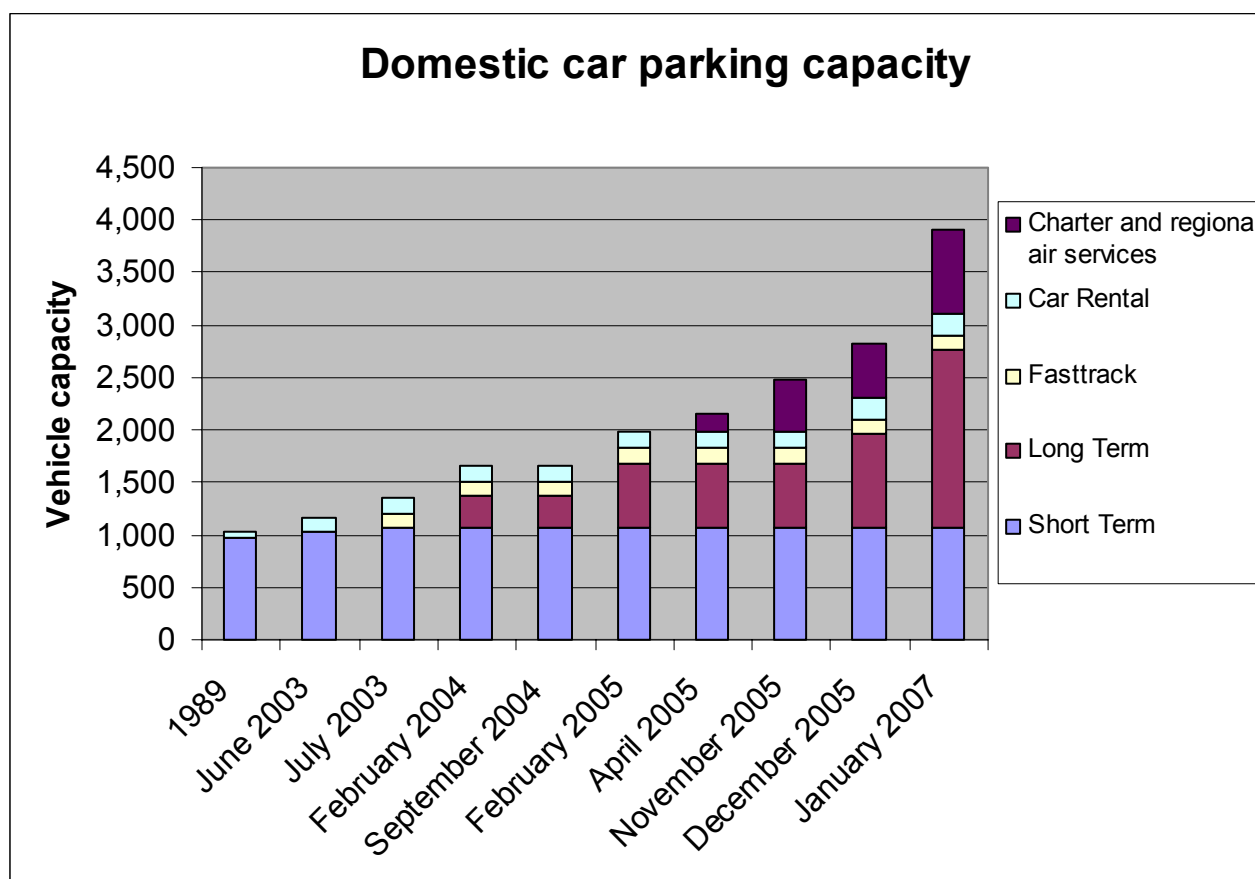
- Perth Airport's Terminal 1 ranked third in terms of "overall airport experience" from the perspective of departing passengers.
- In terms of arrivals, Terminal 1 was ranked second of the 15 BAA airports, while Terminal 3 was ranked fourth.
- Terminal 3 achieved a ranking of ninth from departing passengers' perspective.

Since this study was completed, WAC has undertaken refurbishment work at Terminal 1 to improve the amenity of that facility for departing passengers. Security screening points have been relocated, the retail area has been expanded and the passenger departure lounge has been improved and expanded. WAC would expect these capital improvements to lead to a substantial increase in the level of passenger satisfaction.

2.4.3 Car parking at Perth Airport

Passenger surveys conducted for the 2003/04 and 2004/05 Quality of Service reports indicated that the level of passenger satisfaction with the availability and standard of car parking - particularly at the domestic terminals - was relatively low. WAC has recognised the need to improve car parking facilities, and, as shown in Figures 12a and 12b below, car parking capacity is continuing to be expanded. In particular, car park capacity at the domestic terminals is programmed to be increased by a further one-third in January 2007, and car park capacity at the international terminal is programmed to be increased by a further 20% in March 2007.

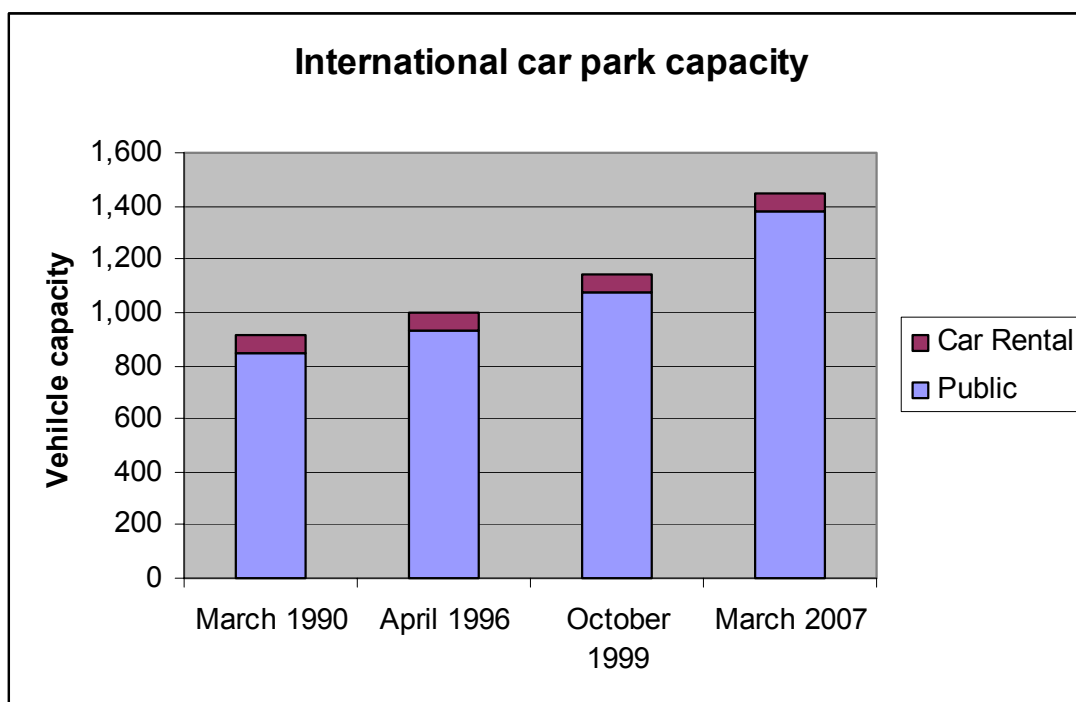
Figure 12a: Increases in actual and forecast domestic car park capacity



Source: WAC

There is very limited ground area available within a reasonable walking distance of the terminals to increase the capacity of the domestic short term car park. Consequently, WAC plans to increase short term parking capacity at the domestic terminals by constructing a multi-storey car park.

Figure 12b: Increases in actual and forecast international domestic car park capacity



Source: WAC

A description and discussion of Perth Airport's approach to marketing and pricing car parking is set out in section 2.5.3.

2.4.4 Concluding comments on service quality outcomes

The information set out above demonstrates WAC's commitment to monitoring and improving the quality of services provided at Perth Airport. The overall key performance indicators achieved over the period since 2001/02 demonstrate that Perth Airport continues to provide a high standard of service and facilities. Results of passenger and airline surveys continue to indicate that the overall level of satisfaction with the services and facilities at Perth Airport remains high.

This evidence demonstrates that since the introduction of price monitoring in 2002, WAC has continued to remain focused on responding to customers' needs and expectations, and quality of service has been maintained at a high level.

2.5 Price outcomes under the price monitoring framework

2.5.1 Price adjustment in 2002

As already noted in this submission, it had been widely recognised that aeronautical prices established at the time of privatisation - and the subsequent price path locked in for five years under the price cap regime - were well below the cost of providing the services. Indeed, as noted in section 1.4:

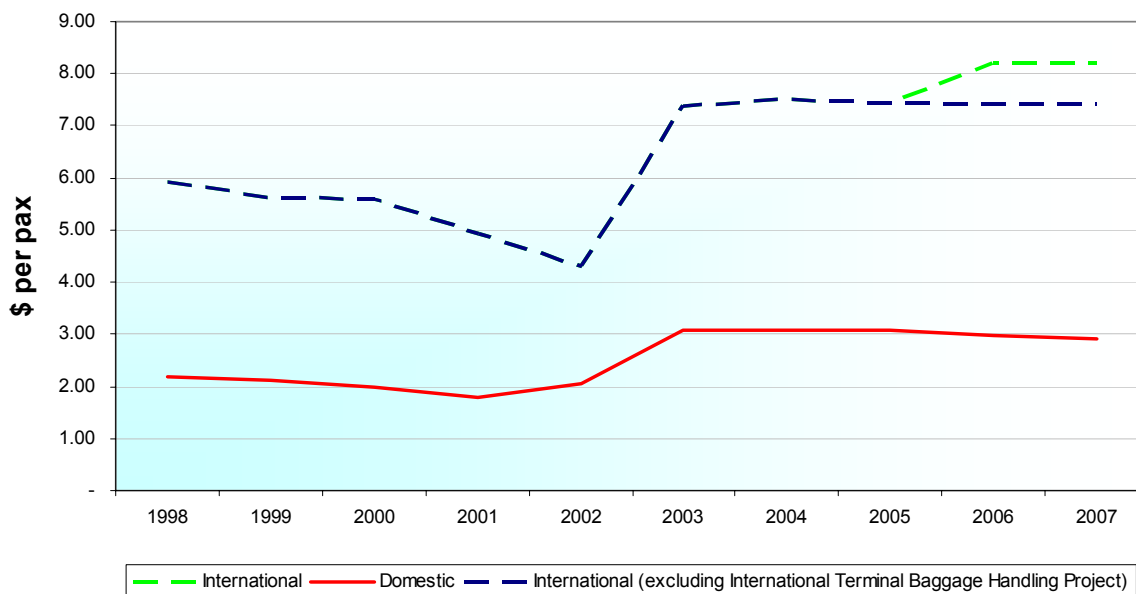
- average aeronautical charges at Perth Airport did not fully recover the direct operating costs of providing the aeronautical services;

- those charges did not recover a reasonable return on the assets utilised to provide the aeronautical services; and
- in 2002, the Commission stated that it was aware that the inherited FAC starting prices were not adequate to provide for efficient replacement aeronautical investment on a dual-till basis.

Accordingly, after the expiration of the initial CPI-X price caps and following the conclusion of the Commission's 2002 Inquiry, WAC revised its aeronautical charges to ensure that total expected revenues from the sale of aeronautical services would recover the total cost of providing the services, including a commercial return on the relevant assets⁵⁶.

Figure 13 below shows the average price path (expressed in June 1998 dollars per passenger) for aeronautical services over the period from 1998 to 2007.

**Figure 13: Average prices for aeronautical services⁵⁷ at Perth Airport
(June 1998 dollars per passenger)⁵⁸**



Source: WAC

Following the adjustment of aeronautical charges in July 2002, Perth Airport's charges per passenger for both domestic and international arrivals and departures remain competitive alongside those of other major Australian airports.⁵⁹

⁵⁶ Section 2.2.3 provides an overview of the approach applied by WAC to develop charges for aeronautical services, based on the revenue "building block" approach applied by the ACCC in other capital-intensive utility industries such as electricity transmission.

⁵⁷ The two price paths for international per passenger charges show the impact of the additional charges that were agreed with the airlines following the completion in 2005 of the International Terminal Baggage Handling Project.

⁵⁸ Note: Landing charges from 1997 to 2002 were MTOW based and have been converted to passenger-based average charges for comparability purposes. International charges include terminal charges. NNAI charges related to international and domestic flights are included where relevant. All security charges are excluded. GST is excluded. The CPI applied is the All Groups weighted average of eight capital cities.

It is noted however, that caution must be applied in comparing and interpreting the per passenger charges levied by different airports. The costs incurred - and therefore to an extent the prices charged - by different airports reflect their particular inherent and inherited characteristics and operating environments. In WAC's case:

- The existence of separate international and domestic terminals at Perth unavoidably leads to higher infrastructure costs as well as higher operating costs compared to those that would be incurred if a single, integrated terminal existed. For instance, the split terminal operation necessitates the splitting (and in some cases, duplication) of building control systems, gate allocation for incoming aircraft, security, and terminal management.
- Perth has an infrastructure base that is comparable to larger airports, and must spread the cost of that infrastructure over lower passenger numbers.
- Perth Airport's operation on a curfew-free basis also has an impact on its operating cost structure.

Notwithstanding these factors and their impacts on costs, Perth Airport is able to offer competitive prices.

2.5.2 Price outcomes for aeronautical services since 2002

As noted in section 2.2, the Prices and Services Accord outlines the terms and conditions under which Perth Airport provides aeronautical services to the airline operators for the 5-year period commencing on 1 July 2002. In particular, section 10 of the Prices and Services Accord sets out the schedule of charges applying to aeronautical services from 1 July 2002. The arrangements for the annual escalation of these charges are set out in section 4.8. A copy of the Prices and Services Accord is provided in Appendix 3.

As noted earlier, the charges applying from 1 July 2002 allowed for a substantial increase in aeronautical charges which had previously been unsustainably low. The Price and Services Accord requires that the above schedule of charges to be revised as follows:

- From 1 July 2003, by the change in the CPI for the Airfield charge and by CPI + 2.8% for the International Terminal charge and thereafter by the change in CPI. (The 2.8% increase provides for terrorism insurance previously recovered as a security charge).
- If actual passenger numbers for a financial year differ by plus or minus 10% from the updated forecasts shown in Attachment 2 of the Prices and Services Accord, then WAC will consult with the airlines on variations to pricing for those passenger numbers outside the 10% range.

The Prices and Services Accord also provides for Industry Consultation Meetings to be held biannually in March and November, in Perth⁶⁰. The purpose of the March meeting is to

⁵⁹ Please refer to the report titled *Airports price monitoring and financial reporting 2004–05*, published by the ACCC in February 2006 for further details.

⁶⁰ At the request of the airlines, WAC subsequently agreed to hold the November meeting in Sydney, so that key airline representatives could attend more easily. The November meeting is particularly important, as WAC uses the outcomes of negotiations and decisions at these meetings to inform the development of the annual business plan and capital budget for Perth Airport. (In practice, the timing of the meetings may be varied by agreement among the parties, depending on the availability of relevant data and/or the availability of staff to attend the meetings.)

consider the schedule of charges for the following financial year and the basis upon which these charges have been determined, as well as capital and major maintenance projects which are planned to be undertaken.

WAC is required to use best endeavours to provide airline operators with at least 90 days notice of any proposed changes to charges.

The Prices and Services Accord also allows WAC to recover from the airlines the costs of providing any Government mandated security arrangements. Under or over recoveries of charges for Government mandated security arrangements are to be adjusted for annually, in the financial year after the Government mandated security charges are incurred. Any such differences are to be recovered throughout the year.

Under the Prices and Services Accord, WAC is required to provide a statement to confirm revenues and costs associated with the Government mandated security arrangements within 90 days of the end of each financial year (for charges incurred in that financial year).

Increases in charges over the period from 2003 to 2005 have been made in accordance with the Prices and Services Accord. In relation to security charges, WAC has made a concession to airlines by agreeing to recoup the under-recovery in 2005 (as a result of increased security requirements) over the 12 months from January 2006. This concession will reduce the impact on airport security charges.

Total passenger numbers exceeded the Prices and Services Accord forecast by more than 10% in 2005 and are expected to do so again in 2006. In this context, it is noteworthy that section 4.8 of the Prices and Services Accord provides that under such circumstances:

“WAC will consult with the airlines on variations to pricing for those passenger numbers outside the 10% range.”

In light of the differences between actual passenger numbers and the forecasts for 2005 and 2006 set out in the Prices and Services Accord, WAC has voluntarily refrained from increasing the airfield charge applied to *all* passenger numbers in 2006, and WAC proposes to maintain prices at this level for 2007 as well. This real-term reduction in airfield service prices provides the airlines with outcomes that are more favourable than those which the airlines had accepted under the Prices and Services Accord. WAC offered this pricing concession voluntarily, with the express intention of providing its customers with a greater share of the benefits generated by unexpected increases in passenger numbers over the term of the Prices and Services Accord. WAC considers that its pricing decision provides an example of responsible and even-handed commercial conduct under the price-monitoring regulatory framework.

The International Terminal Baggage Handling project provides a good example of the successful commercial negotiation by airlines of improvements to aeronautical services. This new project was not anticipated in the Prices and Services Accord⁶¹. However, following consultation with the airlines, WAC agreed to provide an automated baggage system and checked bag screening system. After a number of revisions to the project scope, the final total project cost was in excess of \$25 million. In negotiating a revised price, WAC and the airlines agreed additional charges for check in counters, checked bag screening and the baggage handling system. At the airlines' request, the agreed charges are not subject to annual increases. The airlines and WAC worked together constructively to

⁶¹ The Prices and Services Accord anticipated a fairly simple project costing approximately \$3.5 million

develop innovative and cost-effective solutions to a wide range of complex problems during the course of this major project.

Not unexpectedly, commercial negotiations surrounding the project were robust. However the negotiations were also undertaken by all parties in a timely, professional, and effective manner. In particular, there was a high level of transparency regarding WAC's costing and pricing of the project and the arrangements put in place by WAC to ensure cost-effective delivery of the project. It is WAC's view that the positive outcomes from the International Terminal Baggage Handling project could not have been achieved under a CPI-X regime.

Appendix 2 sets out a more detailed account - in the form of a case study - of the International Terminal Baggage Handling project

2.5.3 Marketing and pricing of car parking

WAC has marketed car parking services at the airport to ensure that competitive pricing is maintained. Within the constraint of maintaining competitive pricing, car parking services have been defined and priced so as to provide a commercial return to Perth Airport's owners.

For example:

- For long term parking, Perth Airport offers a rate of \$2 per day after three days in the domestic car park and after two days in the international car park.
- Perth Airport also offers a premium product called FastTrack which is an under-cover service located directly in front of the domestic terminals. This service is targeted at business customers, who place a high value on the convenience and high standard of service available. The FastTrack service is priced at a level that reflects its value relative to typical parking services.

Perth Airport's car parking charges are published on the airport's website.

Tables 4a and 4b below show the changes in car parking charges since 1997/98.

Table 4a: Short term car parking charges (shown in money of the day) at Perth Airport

	1997/98	1998/99	1999/00	2000/01 ⁶²	2001/02	2002/03	2003/04	2004/05
First 5 minutes	Free	Free	Free	Free	Free	Free	Free	Free
5 - 30 mins	\$2.00	\$3.00	\$3.00	\$3.30	\$3.30	\$3.30	\$3.30	\$3.50
30 mins - 1 hour	\$4.00	\$4.00	\$4.00	\$4.40	\$4.60	\$4.60	\$4.60	\$5.00
1 - 2 hours	\$5.00	\$5.00	\$5.00	\$5.50	\$5.80	\$5.80	\$5.80	\$6.50
2 - 3 hours	\$7.00	\$6.00	\$6.00	\$6.60	\$6.80	\$6.80	\$6.80	\$7.50
3 - 4 hours	\$7.00	\$7.00	\$7.00	\$7.70	\$8.00	\$8.00	\$8.00	\$8.50
4 - 5 hours	\$7.00	\$8.00	\$8.00	\$8.80	\$9.20	\$9.20	\$9.20	\$9.50
5 - 6 hours	\$9.00	\$9.00	\$9.00	\$9.90	\$10.20	\$10.20	\$10.20	\$10.50
6 - 7 hours	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00
7 - 8 hours	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00
8 - 9 hours	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00
9 - 10 hours	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00
10 - 11 hours	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00
11 - 12 hours	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00
12 - 24 hours	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00

Table 4b: Long term car parking charges (shown in money of the day) at Perth Airport

	1997/98	1998/99	1999/00	2000/01 ⁶³	Int'l 2001/02 & 2002/03	Domestic 2001/02 & 2002/03	Int'l 2003/04 & 2004/05	Domestic 2003/04 & 2004/05
1 day	\$12.00	\$12.00	\$15.00	\$16.50	\$16.00	\$16.00	\$17.00	\$17.00
2 days	\$24.00	\$24.00	\$30.00	\$33.00	\$32.00	\$32.00	\$34.00	\$34.00
3 days	\$36.00	\$36.00	\$45.00	\$49.50	\$34.00	\$48.00	\$36.00	\$51.00
4 days	\$42.00	\$42.00	\$55.00	\$60.50	\$36.00	\$50.00	\$38.00	\$53.00
5 days	\$48.00	\$48.00	\$60.00	\$66.00	\$38.00	\$52.00	\$40.00	\$55.00
6 days	\$48.00	\$48.00	\$60.00	\$66.00	\$40.00	\$54.00	\$42.00	\$57.00
7 days	\$48.00	\$48.00	\$60.00	\$66.00	\$42.00	\$56.00	\$44.00	\$59.00
8 days	\$54.00	\$54.00	\$70.00	\$77.00	\$44.00	\$58.00	\$46.00	\$61.00
9 days	\$60.00	\$60.00	\$80.00	\$88.00	\$46.00	\$60.00	\$48.00	\$63.00
10 days	\$66.00	\$66.00	\$90.00	\$99.00	\$48.00	\$62.00	\$50.00	\$65.00
11 days	\$72.00	\$72.00	\$100.00	\$110.00	\$50.00	\$64.00	\$52.00	\$67.00
12 days	\$78.00	\$78.00	\$110.00	\$121.00	\$52.00	\$66.00	\$54.00	\$69.00
13 days	\$84.00	\$84.00	\$120.00	\$132.00	\$54.00	\$68.00	\$56.00	\$71.00
14 days	\$90.00	\$90.00	\$130.00	\$143.00	\$56.00	\$70.00	\$58.00	\$73.00
15 days	\$96.00	\$96.00	\$140.00	\$154.00	\$58.00	\$72.00	\$60.00	\$75.00

⁶² Price increase includes the impact of the introduction of GST.

⁶³ Price increase includes the impact of the introduction of GST.

As already noted, Perth Airport's car parking charges are consistent with competitive price benchmarks. For instance, on 6 March 2006, the *West Australian* reported that the average casual parking rate for 8 hours in the Perth CBD had increased from \$9 in 2001 to \$18 in 2006. By contrast, WAC's daily rate on 1 July 2002 was \$16.50 for over six hours and is now \$17.00. The long term rate was actually dropped from \$11 per day after the first 7 days to \$2 per day after the first three days in the same time period. This pricing strategy was adopted with the objectives of:

- alleviating congestion in the short term car park, which was being used by a large number of customers for long-term parking (that is, for periods of 3 to 4 days); and
- increasing Perth Airport's market penetration in long term car parking, where passengers have a range of alternative services from which to choose.

The information set out above (and in section 2.4.3) demonstrates that Perth Airport has responded appropriately to airport users' needs for car parking, by substantially increasing the capacity of car parks, whilst maintaining prices at a competitive level. As noted in section 2.4.3, WAC is investigating options for providing further increases in car parking capacity at the airport. To this end, WAC has engaged independent consultants to review its car park strategy. That review will include consideration of options for increasing car parking capacity, including the construction of a multi-storey short term car park.

2.5.4 Concluding comments on price outcomes

The pricing outcomes delivered under the price monitoring regulatory framework were foreshadowed by WAC in its submissions to the Commission's 2002 Inquiry. At the commencement of the price monitoring regime, charges were subject to a once-off adjustment to bring them to competitive, commercially sustainable levels. Since that time, the Prices and Services Accord has:

- provided a transparent framework within which Perth Airport has committed to containing further increases in charges; and
- provided a robust framework for the effective negotiation of charges for new or additional services.

WAC considers that these pricing outcomes demonstrate the effectiveness of the price monitoring framework in meeting the objectives and principles established by Government.

2.6 Dispute resolution under the price monitoring framework

Both the Prices and Services Accord and the Virgin Blue terminal licence agreement have dispute resolution provisions.

The Prices and Services Accord provisions are:

"WAC proposes the following dispute resolution process for dealing with any disputes that may arise under or in relation to this Accord between WAC and the Airline Operator:

- Within 14 days of the dispute arising the Airline Operator and WAC must meet to negotiate in good faith with a view to resolving the dispute;
- If the dispute is not resolved the Airline Operator and WAC will refer the dispute to mediation.

Within 7 days, the President of the Law Society of Western Australia will be requested to appoint a mediator to mediate the dispute.

The mediation:

- Is to be conducted in accordance with the mediation rules of the Law Society of Western Australia; and
- Is to take place in Perth, Western Australia.

The Airline Operator and WAC are to equally share the cost of the mediation. The Airline Operator and WAC may not seek any other means of resolving the dispute (other than seeking an urgent, interlocutory or interim injunction) until the mediation has taken place.”

No disputes have arisen that have required mediation to date.

The Virgin Blue Terminal Licence Agreement provides for referral of disputes to an Expert (the type of expert depends on the nature of the dispute). The Expert’s decision is binding on both parties.

Again, no disputes have been referred to an Expert to date.

2.7 Summary of key points

This section of the submission has examined WAC’s experience and performance under the price monitoring regime. It has been demonstrated that:

- WAC is strongly committed to monitoring and improving the quality of services provided at Perth Airport. The overall key performance indicators achieved over the period since 2001/02 demonstrate that Perth Airport continues to provide a high standard of service and facilities. Results of passenger and airline surveys continue to indicate that the overall level of satisfaction with the services and facilities at Perth Airport remains high. This evidence demonstrates that since the introduction of price monitoring in 2002, WAC has continued to remain focused on responding to customers’ needs and expectations, and quality of service has been maintained at a high level.
- WAC’s conduct since the cessation of the CPI-X price cap in developing new service undertakings with its customers reflects a strong commitment to achieving effective commercially-negotiated outcomes, in accordance with the objectives of the light-handed regulatory regime that was put in place following the Commission’s 2002 Inquiry.
- In initiating the development of these undertakings and agreements with its customers, WAC has been particularly interested in:
 - clearly setting out Perth Airport’s commitment to providing an appropriate quality of services and facilities, as well as a commitment to maintaining the capacity of services and facilities; and
 - establishing robust and effective dispute resolution mechanisms.
- WAC has also established a framework to ensure that effective formal communication and consultation takes places with airport users on operational matters as well as on commercial issues. Perth Airport’s initiatives in this regard, along with the cooperation and participation of the airport users, have been important in ensuring the achievement

of one of Government's key objectives for the price monitoring regime - namely, promoting the economically efficient operation of airports.

- In light of the widespread and long-standing recognition that prices for aeronautical services were unsustainably low, WAC has made substantial efforts to ensure that prices for aeronautical services following the introduction of price monitoring would be competitive and reasonable from the perspective of customers, whilst also providing a commercially sustainable revenue stream to the Airport.
- The pricing outcomes delivered under the price monitoring regulatory framework were foreshadowed by WAC in its submissions to the Commission's 2002 Inquiry. Moreover, it was recognised by the Commission that aeronautical charges would need to be raised substantially to reflect the full costs of providing aeronautical services. At the commencement of the price monitoring regime, charges were subject to a once-off adjustment to bring them to competitive, commercially sustainable levels. Since that time, the Prices and Services Accord has:
 - provided a transparent framework within which Perth Airport has committed to containing further increases in charges; and
 - provided a robust framework for the effective negotiation of charges for new or additional services.
- These pricing outcomes demonstrate the effectiveness of the price monitoring framework in meeting the objectives and principles established by Government.
- Substantial improvements in investment outcomes have been delivered under the price monitoring regime. This demonstrates that the regime has been effective in promoting the economically efficient operation of Perth Airport through commercial negotiation - rather than through heavy-handed regulatory involvement - in accordance with the objectives set by Government. In addition, under a light-handed regulatory regime, the prospect of achieving a fair rate of return coupled with the positive impacts of passenger growth on the other segments of the business have encouraged Perth Airport to voluntarily commit to undertaking more aeronautical development than required under the Prices and Services Accord.

Looking forward, WAC sees a number of opportunities to invest in further substantial improvements in facilities at Perth Airport. Some of the projects being examined presently include: rebalancing of international and domestic passenger traffic between terminals; options involving more creative use of Terminal 2; construction of a multi-storey short term car park; and the possible development of office accommodation. The commercial attractiveness of such opportunities is dependent, to an extent, on the regulatory regime governing airport charges. As already noted in this submission, experience in the airport sector shows that heavy-handed regulatory approaches tend to dampen incentives for investment, and hamper innovation. Maintenance of a light handed regulatory framework would provide an environment that is most conducive to further investment, innovation and service improvement at Perth Airport.

3 SATISFYING THE GOVERNMENT'S REVIEW PRINCIPLES

3.1 Introduction

The previous sections of this submission have provided detailed background information regarding Perth Airport's experience of CPI-X regulation prior to the Commission's 2002 Inquiry, and its more recent experience of the price monitoring regime that followed. WAC firmly believes that the improved performance of the airport – particularly in relation to investment, service outcomes and growth – in the context of commercial negotiation with its customers indicates that the price monitoring regime is working as intended.

In its response to the Commission's 2002 Inquiry Report, the Government stated that it would only consider re-introducing price controls on an airport if it formed the view that the airport had operated in a manner inconsistent with the four Review Principles set out in the Government's response⁶⁴.

In accordance with that statement, the Government has specifically asked the Commission to have regard to the Review Principles in undertaking its present assessment of the price monitoring regime. In light of this formal requirement, the remainder of this section is structured as follows:

- Section 3.2 presents a table that demonstrates at a high-level that WAC has complied with the Review Principles;
- Section 3.3 presents a more detailed discussion of WAC's performance with reference to Review Principle 1; and
- Section 3.4 provides more detailed information on two particular aspects of WAC's current charging structure in order to address specific points raised by the Commission in its Issues Paper.

3.2 Demonstration of WAC's compliance with the Government's Review Principles

Table 5 below lists the Review Principles and provides a high-level description of how WAC has complied with each principle. Cross-references to earlier sections of this submission are provided to demonstrate WAC's performance against the Review Principles, where appropriate.

⁶⁴ The Government's Review Principles are set out in the table in section 3.2 below.

Table 5: WAC's performance against the Government's Review Principles

Government's Review Principles	WAC's performance against each principle
<p>1. At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a 'dual-till' basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.</p>	<p>As noted in section 2.2.3, WAC has employed a building block approach consistent with the approach adopted by the ACCC in order to inform price, investment and service negotiations with its customers.</p> <p>Asset valuation is an important input to the pricing model, but ultimately prices are negotiated with airlines alongside a number of other service issues.</p> <p>Further detailed discussion of WAC's performance against this Review Principle is set out in section 3.3 below.</p>
<p>2. Price discrimination and multi-part pricing that promotes efficient use of the airport is permitted. This may mean that some users pay a price above the long-run average costs of providing aeronautical services, whereas more price-sensitive users pay a price closer to marginal cost.</p>	<p>WAC has not adopted a Ramsey Pricing framework to establishing aeronautical charges. Rather, it explicitly stated in its Prices and Services Accord that one of its pricing principles was 'non discrimination between users of the same facilities'.</p> <p>WAC will, however, offer incentives to airlines in order to secure traffic growth. Section 2.2.3 outlines the incentive program offered by Perth Airport to encourage international Airline Operators to expand services into Perth.</p> <p>The broader question of efficient charging structures is addressed in further detail in section 3.4 below.</p>
<p>3. At airports with significant capacity constraints, efficient peak/off-peak prices may generate revenues that exceed the production costs incurred by the airport. Such demand management pricing practices should be directed toward efficient use of airport infrastructure and, when not broadly revenue neutral, any additional funding that is generated should be applied to the creation of additional capacity or undertaking necessary infrastructure improvements.</p>	<p>As noted in section 1.2 of this submission, there are no significant airspace or infrastructure capacity constraints at Perth Airport. For Perth Airport, therefore, there is no need for peak/off-peak prices at present or in the foreseeable future.</p> <p>As noted in sections 2.4.3 and 2.5.3, WAC has adopted marketing and pricing strategies to encourage the efficient utilisation of available short-term and long term car parking facilities. WAC has substantially increased car parking capacity since acquiring Perth Airport, and further expansion of car parking capacity is being investigated.</p>
<p>4. Quality of service outcomes should be consistent with user's reasonable expectations, and consultation mechanisms should be established with stakeholders to facilitate the two way provision of information on airport operations and requirements. It is expected that airlines and airports will primarily operate under commercial agreements and in a commercial manner, and that airport operators and users will negotiate arrangements for access to airport services."</p>	<p>As noted in detail in section 2.2, WAC has put a framework in place to ensure that effective formal communication and consultation takes places with airport users on commercial and operational issues.</p> <p>In relation to service outcomes, WAC has recognised the importance of meeting the needs of its customers and other stakeholders to the long term commercial success of Perth Airport.</p> <p>As shown in section 2.4, the outcomes reported by the ACCC in its service quality monitoring reports provide independent confirmation that WAC's performance has met or exceeded expectations.</p>

3.3 WAC's performance against Review Principle 1

Review Principle 1 states that:

- efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a 'dual-till' basis); and
- prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.

As noted already in sections 2.2 and 2.5 of this submission, the prices charged by WAC are subject to commercial negotiation and agreement with the airlines.

Notwithstanding this, WAC is conscious of the need to be able to demonstrate compliance with Review Principle 1. To this end, WAC applied the “building block” revenue model to inform its price negotiations with customers following the cessation of the CPI-X price control regime in 2002. In applying the model, WAC has sought to adopt robust methodologies and soundly-based estimates of key inputs, to ensure that its prices are justifiable using the regulatory yardsticks implicit in Review Principle 1.

In particular, in developing its pricing model for the 2002-07 pricing period, WAC obtained specialist independent advice on a range of matters including:

- asset valuation, to ensure that assets are defined and valued appropriately in accordance with the requirements of Review Principle 1, and having regard to established regulatory practice in other infrastructure industries such as electricity transmission;
- the cost of capital, to ensure that forecast revenues provide a rate of return commensurate with the regulatory and commercial risks involved - in accordance with the requirements of Review Principle 1 - and having regard to previous decisions of the ACCC regarding the cost of capital to the airports;
- activity based costing methods, to ensure that costs are allocated to aeronautical services on a robust basis;
- revenue modelling methodologies, and
- passenger and aircraft traffic forecasts, to ensure that average charges per passenger over the five-year pricing period reflected an unbiased estimate of passenger numbers, based on the best available information at the time of the negotiations (in 2002) .

It is important to emphasise that WAC's application of the building block model was undertaken *before-the-event*, in order to provide information to facilitate the negotiation of a five-year price and service undertaking with customers. Importantly, when WAC was negotiating its charges for aeronautical services for the 2002-07 pricing period, it provided a copy of the pricing model - including input data and assumptions - to the airlines. The airlines therefore had access to detailed price modelling and parameter information, which could be used by all parties to inform the price negotiations.

In this context, it is equally important to recognise that Review Principle 1 refers to *expected revenue*; that is to say, an estimate of revenue *before-the-event*, which must necessarily be based on forecasts of key variables such as passenger numbers and aircraft traffic. Review

Principle 1 therefore contemplates the notion of a “fair and reasonable” revenue stream in a forward-looking sense. Importantly, the principle does **not** place a limit on the actual rate of return earned by the airport. Placing limits on the actual rate of return is known as *rate of return regulation*, which is perhaps the least efficient of all heavy-handed forms of regulation. The Commission’s 2002 Inquiry, and the Government’s response to it, clearly specified a light-handed regime that is quite different from rate of return regulation.

Having said this, WAC recognises the possibility that some stakeholders may seek to infer from the information published in the ACCC’s price monitoring reports that the returns achieved by WAC *after-the-event* suggest that Review Principle 1 has not been met. WAC cautions against any such inferences being drawn from that information, for the following reasons:

- WAC and the airlines agreed a passenger-based charging structure in 2002, in a commercial environment that was (and continues to be) highly uncertain. As it turned out, events over the period since 2002 resulted in an unexpected increase in passenger numbers as well as an unexpected improvement in load factors. In accordance with the agreed charging structure, WAC has benefited financially because passenger numbers have been higher than expected. Given these charging arrangements, it would be unreasonable to argue that WAC has earned excessive returns.
- In 2005/06 and 2006/07 WAC sought to share some of the benefits of unanticipated passenger number growth in recent years by voluntarily restricting its airfield charges to levels below those provided for by the Prices and Services Accord. WAC estimates that its decisions to reduce airfield charges in real terms have led to aggregate savings to customers of \$0.89 million for the 2005/06 financial year and a further \$2.14 million for the 2006/07 financial year, compared to the savings that would have been delivered through a strict interpretation and application of clause 4.8 of the Prices and Services Accord.
- The Prices and Services Accord will be re-negotiated for a further five year term from 1 July next year. During the forthcoming negotiations, WAC expects to take into account the impacts of passenger number growth during the current five-year pricing term.

WAC considers that its conduct in negotiating the present five-year price and service undertaking, and its subsequent conduct (in seeking to share some of the benefits that have accrued through higher than expected passenger growth over the present five-year pricing period) provide clear evidence that Review Principle 1 has been met.

3.4 Detailed charging structure issues

This section considers two specific charging issues that were raised in the Commission’s Issues Paper. These are:

- the structure of charges for aeronautical and related services at the price monitored airports; and
- the application of fuel throughput fee.

In response to the issues raised by the Commission, the following sections set out WAC’s rationale for developing passenger-based charges, and the rationale for the fuel throughput levy at Perth Airport.

3.4.1 WAC's development of passenger-based charges

Efficient prices are those that are reflective of costs and are set at levels that allow businesses to recover the long-run costs of efficiently providing aeronautical services. In addition to the overall level at which prices should be set, there is also the question of how prices should be structured so as to promote economic efficiency. This is an issue upon which widely disparate views exist, particularly in relation to the weighting that should be given to various objectives.

In the period from privatisation up to 2002 WAC, and other Australian airports, charged for aeronautical services according to aircraft maximum take-off weight ("MTOW"). Since 2002 airport operators have shifted towards passenger-based charges, predominately in negotiation with the airlines. This change has exposed airports to the same volume risks as airlines, whilst also providing the same incentive to increase passenger numbers.

It has been argued by some sectors of the market that MTOW is a more appropriate charging structure for aeronautical services given that the service is used principally by aircraft rather than passengers. The most prominent example of this was the dispute between Virgin Blue and Sydney Airport Corporation, with the Australian Competition Tribunal (ACT) finding that⁶⁵:

"efficient pricing of the Airside Service required consideration of the underlying cost drivers of that Service by reference to the nature of the aircraft using the Service, rather than by reference to the number of passengers travelling in such aircraft."

The broader implications of the ACT Sydney Airport Decision to the Commission's current review are discussed in more detail in section 4 of this submission. However, for the purposes of considering whether Perth Airport acted reasonably in adopting passenger-based charges it is useful to consider the specific factors that WAC applied in developing its preferred charging structure. In particular, the following objectives were adopted by WAC in its consideration of the merits of establishing passenger-based charges:

- achievement of a level of airport charges that provides a fair return on the aeronautical asset base and places the company onto a more acceptable financial footing;
- establishment of prices that can be defended on economic efficiency grounds;
- establishment of a pricing structure and commercial agreement with airlines that does not encourage recourse to the regulator;
- achievement of a non-discriminatory pricing structure;
- simplification of aeronautical charges;
- achievement of an appropriate sharing of risks, and
- recognition of the potential sensitivity of international carriers in particular to ongoing price increases.

A particular issue of concern with the previous charging structure was that airfield charges differed markedly between international and domestic carriers. The adoption of passenger-

⁶⁵ Australian Competition Tribunal, Virgin Blue Airlines Pty Limited [2005] ACompT 5, paragraph 15

based charges provided an effective means of moving to a more cost-reflective charging basis, taking account of the differences in charges that existed at that time, and which were difficult to justify in terms of cost.

In concluding in 2002 that a passenger-based charging structure was preferred, WAC also noted that:

- MTOW-based charges would not properly reflect costs - such as terminal and security costs - that are driven by passenger numbers or aircraft movements; and
- the adoption of a passenger-based charging structure had a number of administrative advantages over more complex charging arrangements. (For instance, Government-mandated security and checked bag screening can only reasonably be charged on a per passenger basis, so it is simpler from an administrative perspective to charge other aeronautical services on a per passenger basis.)

Furthermore, as noted in section 2.2 of this submission, all airlines were consulted in relation to the new charging structure.

In light of the discussion presented above, WAC believes that its current charging structure is consistent with the Government's Review Principles. Notwithstanding this view, as noted elsewhere in this submission, WAC will continue to consult with airlines in relation to the charging structure.

3.4.2 Fuel throughput fee

As noted on page 168 of the Commission's 2002 Inquiry Report, at larger airports, oil companies pay licence fees and rent to the airport operator for use of airport land. A fuel throughput fee has been applied, in addition to the land rental, at Brisbane and Perth airports. The Commission noted that the imposition of the fuel throughput fees has generated a significant amount of debate, particularly about the extent to which they reflect an abuse of market power and hence should be considered part of aeronautical services.

At the time of privatisation WAC inherited contracts for aircraft refuelling. The fuel throughput fee was noted in the Information Memorandum made available to airport bidders, and as such was factored into the prices paid for the airports. WAC further notes that Section 3 of Direction 27 states:

"The facilities and activities referred to in sub-paragraphs 2(a) and 2(b) do not include, in relation to an airport, the provision of a service which, on the date the airport lease was granted, was the subject of a contract, lease, licence, or authority given under the common seal of the Federal Airports Corporation.

Note: This exclusion extends to a contract, lease, licence or authority exercised under an option in a contract, lease, licence or authority given under the common seal of the Federal Airports Corporation."

Therefore, WAC's view is that the fuel throughput fee was part of a commercial arrangement in existence at the time of privatisation, and in accordance with Direction 27, should be excluded from any price monitoring arrangements. WAC's fuel throughput fee is similar in nature to a concession fee, and from an international perspective, the fee is not unusual in nature or magnitude. It should also be noted that WAC has a contractual right to increase the fuel throughput fee in line with CPI, but has not done so for 2006/07 in consideration of the current fuel cost pressures faced by airlines.

Although WAC maintains its view that the fuel throughput fee is reasonable, WAC notes that the Commission's 2002 Inquiry Report (page 168) commented on this issue as follows:

"The airports involved contended that the fact that they were simply exercising a contractual right to impose the levy meant that they had not abused market power. BAC, for example, argued:

BACL strongly refutes any suggestion that it has abused its market power because it 'activated' a fee covered by an existing contractual arrangement and determined as reasonable by an independent expert.

However, even if they were exercising a contractual right, this does not mean necessarily that the imposition of the charges did not reflect an abuse of market power. In addition, even if the imposition of a charge of that type would not have been an abuse of market power, the level of the charge imposed might have been."

For the reasons outlined above, WAC does not believe that it has exercised market power in relation to the fuel throughput fee. However, in accordance with the Review Principles, WAC will continue to consult with its customers on the charging arrangements at Perth Airport including the future application of the fuel throughput fee. For the purposes of this review, however, WAC remains firmly of the view that the application of the fuel throughput fee is not inconsistent with the Review Principles.

3.5 Summary of key points

This section has provided a high-level summary which demonstrates that WAC has complied with the Government's Review Principles. In particular:

- This section has set out the reasons as to why WAC considers that its conduct in negotiating the present five-year price and service undertaking, and its subsequent conduct (in seeking to share some of the benefits that have accrued through higher than expected passenger growth over the present five-year pricing period) provide clear evidence that Review Principle 1 has been met.
- This section has also shown that a detailed consideration of WAC's rationale for adopting a passenger-based charging structure illustrates that it is consistent with the Government's Review Principles.

WAC will continue to consult with airlines in relation to future charging arrangements, including the application of the fuel throughput fee, which WAC recognises to be a controversial issue.

4 OTHER ISSUES IN THE COMMISSION'S TERMS OF REFERENCE

4.1 Introduction

The previous sections of this submission have focused on the commercial and operational characteristics of Perth Airport, and WAC's experience of the regulatory arrangements that have been in place since privatisation. The key points from this analysis are:

- Perth Airport operates in a dynamic market place, in which it has strong incentives to negotiate reasonable terms and conditions with its customers in order to capture growth opportunities;
- WAC strongly supports the Commission's 2002 Inquiry findings that CPI-X regulation should be replaced by a price monitoring regime;
- WAC has achieved very positive performance results under the price monitoring regime in terms of investment, service outputs and price levels;
- WAC has entered into effective commercial negotiations with the airlines, and has received positive feedback on its conduct, especially from BARA; and
- WAC has also delivered outcomes that are consistent with the Government's Review Principles.

WAC recognises that no form of regulation is perfect, and that criticisms can be levelled at some aspects of the current arrangement. Nevertheless, WAC firmly believes that its performance to date should give the Commission confidence to confirm that its 2002 Inquiry recommendations were correct.

In this final section of its submission, WAC briefly discusses a number of other issues that are specifically mentioned in the Commission's terms of reference for this review or discussed in its Issues Paper. These issues are:

- aeronautical asset revaluation practices (Commission's terms of reference, item 3);
- the effectiveness of the ACCC's price and quality monitoring reports (Issues Paper, page 16)
- the coverage of the price monitoring regime (Issues Paper, page 24);
- dispute resolution mechanisms (Commission's terms of reference, item 3); and
- the implications for this review of the ACT Sydney Airport Decision and the COAG review of National Competition Policy (Commission's terms of reference, item 5).

Each of these matters is addressed in turn below.

4.2 Aeronautical asset revaluation practices

On page 25 of its Issues Paper, the Commission makes the following comments in relation to asset valuation:

“Asset valuations and revaluations can have a significant impact on measured airport profitability and hence on assessments of both:

- the extent to which airports have exercised market power in setting charges; and
- the effectiveness of the price monitoring regime in constraining such behaviour.

A particularly contentious issue in this regard is the way in which airport land should be valued. Recently, several of the price monitored airports have claimed that they are entitled to raise their land values in keeping with increases in land prices in surrounding areas, and to reflect those higher values in aeronautical charges.

The Commission understands that such revaluations would run counter to International Financial Reporting Standards which Australia is currently adopting, that specify that assets under an operating lease are not to be re-valued during the term of the lease. (For price monitoring purposes, the ACCC simply accepts the land values provided by airport operators.) More generally, there is a wide diversity of views on what valuation approach would best encourage both the efficient use of existing airport services and an appropriate geographic location of those services over the longer term.”

The Commission poses the following sets of questions in relation to asset valuation:

- *How do current approaches for valuing and revaluing airport assets impact on charges for airport services? Is there an appropriate degree of transparency in regard to revaluations of the asset base? Aside from land valuation, are there other significant conceptual issues that need to be addressed?*
- *How is airport land most appropriately valued for charging, monitoring and longer term capacity augmentation purposes? Is the argument that airport land should be priced in line with its value in alternative uses (less conversion and related costs) conceptually valid? Aside from accounting requirements, are there measurement or other constraints that militate against the use of this approach in practice?*
- *How would revaluations of airport land based on its value in alternative uses impact on airport charges and ticket prices at the price monitored airports? To what extent should airports be able to appropriate the benefits of increases in the value of airport land subsequent to the commencement of their operating leases? At centrally located airports such as Sydney — where the pressure on ticket prices from land revaluations might be expected to be greatest — how would likely price increases compare with the lower costs of travelling to and from the airport, relative to those for airports further from the city centre?*

As described in section 2.2.3 of this submission, the asset valuation inherited by Perth Airport at privatisation was not fit for the purpose of determining future aeronautical charges because:

- the FAC asset register on which the 1997 valuation was based was incomplete; and
- the valuations were high-level, desktop valuations only.

In any event, at privatisation there was substantial evidence to suggest that the 1997 asset valuation would **not** be relevant in determining future aeronautical charges and revenue. In particular:

- WAC was unable to obtain information from the Department of Transport and Regional Services or the ACCC on how the X factor for Perth Airport was determined;
- in contrast to other privatisations, notably the Victorian gas and electricity sectors, detailed rules for the revenue-setting methodology, including the initial asset values adopted for revenue determination purposes, were not available to the prospective purchasers of Perth Airport;
- the longer-term regulatory framework at the time of privatisation was far from settled (hence the Commission's 2002 Inquiry and its current review); and
- an extraordinarily high X factor of 5.5% was applied to Perth Airport's aeronautical charges, which produced unsustainably low aeronautical charges as noted by the Commission in its 2002 Inquiry.

The limited relevance of the 1997 book values for revenue-setting purposes was further confirmed by the findings of the Commission's 2002 Inquiry, which explained that the intention of the new price monitoring regime was to be based around commercial negotiation of price, rather than regulation⁶⁶:

"The Commission considers that the full benefits of privatisation of airports are unlikely to be realised if commercial relationships between airports and airlines continue to be heavily conditioned by intrusive price regulation. The ongoing need for substantial investments at major airports requires a more commercial and cooperative approach. The potential for heavy-handed regulation to unduly constrain prices and commercial relationships poses a real risk and one that could impose large costs on consumers in the future."

In section 2.2.3 of this submission, WAC noted that in response to the Commission's 2002 Inquiry and the deficiencies in the asset valuation at privatisation (and the unsustainably low aeronautical prices) it embarked upon establishing a pricing model as a starting point for its commercial negotiations with the airlines. An important component of the pricing model is the valuation of assets employed in the provision of aeronautical services.

In considering an appropriate valuation of assets employed, WAC had regard to the ACCC's Statement of Regulatory Principles (which it applies in the electricity transmission sector) and the ACCC's use of the Optimised Depreciated Replacement Cost (ODRC) valuation methodology. Effectively, the adoption of an ODRC valuation approach by WAC amounts to a one-off revaluation of WAC's asset base. However, it is important to note that whilst the asset value is an important input to the pricing model, the negotiated prices and revenue outcomes are a function of commercial discussion with airlines and the prevailing domestic and international market conditions. In contrast to CPI-X regulation, where regulated revenues can be set precisely to recover building block costs, the price monitoring regime is not intended to directly link asset values and aeronautical revenues.

WAC notes, however, that the Commission's Issues Paper appears to suggest that asset revaluations could imply a windfall gain to airports. The Commission's suggestion implies that there is a strong linkage between asset valuation and airport revenue, whereas in fact

⁶⁶ Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, 23 January 2002, p. XLV.

the price monitoring regime implies that there should be a much weaker linkage. Nevertheless, WAC's view is that even under a formal CPI-X regime, the suggestion of a windfall gain as a result of asset revaluation is open to challenge. In particular, WAC notes that in its review of electricity transmission revenues, the ACCC revisited the pre-existing book value of assets where these were considered to be inadequate. The ACCC explains this approach in its Statement of Regulatory Principles⁶⁷ as follows:

"The main economic principle for assessing the economic value of any asset is that its value to investors is equal to the present value of the expected future cash flows generated by those assets. The practical difficulty in making this assessment for regulated monopoly businesses is that the future revenue derived from the assets is determined by the regulator.

This circularity can be eliminated by the use of the DORC approach. The DORC methodology divorces the asset valuation from the assumed profile of revenues that an asset may generate. Given this characteristic, the DORC approach is a useful tool in the transition from government ownership to formal regulation by an independent regulator.

At the time the ACCC assumed responsibility for setting the revenues of TNSPs in the NEM, one approach would have been to adopt the pre-existing book values of these companies and use them as the basis for setting future revenues. However, there were a number of problems with this approach including:

- inconsistent accounting approaches across states and
- poor historical records.

All jurisdictional regulators in the NEM determined the value of TNSPs' assets using the DORC valuation methodology, with the exception of easements which, in some cases, were valued using a historic cost approach.

Given the code requirement for all first round revenue caps, the ACCC adopted the existing DORC jurisdictional valuations to determine the revenue stream for first round revenue cap decisions."

In relation to aeronautical prices and revenues, even if Government had adopted a formal CPI-X regime following the 2002 Commission Inquiry a strong case could be made for revisiting Perth Airport's 1997 book values because, similar to the experience in the electricity transmission sector, these values were not an appropriate basis for setting aeronautical revenue. Moreover, as noted above, under a price monitoring regime asset values do not directly drive aeronautical revenue.

Some stakeholders have suggested that the appropriate asset value to adopt under the price monitoring framework is the value paid by investors at the time of privatisation. For instance, in its June 2006 *Airline Views* newsletter, BARA commented that the appropriate value to adopt is "the amount actually invested by airport operators in obtaining the lease over the aeronautical assets at the time of sale."

In response, WAC notes that it is widely recognised by regulators that establishing a connection between the price offered for an asset at privatisation and the expected future revenue-earning capability of that asset, would constitute poor public policy for the following reasons:

- Had bidders assumed, or been encouraged to assume that the prices offered for assets at privatisation would be recovered through future revenues generated by the assets, then these circumstances would almost certainly have led to asset valuations at

⁶⁷ ACCC, Decision: Statement of Principles for the Regulation of Electricity Transmission Revenues - Background Paper, 8 December 2004, pages 37 and 38.

privatisation that would have been well in excess of the efficient replacement costs of those assets.

- Allowing owners to earn a normal return on inflated asset values - through increased revenues - would result in revenue being significantly above the long-run costs of efficiently providing aeronautical services.
- This, in turn, would likely result in allocative and dynamic inefficiency. It would also be inconsistent with the Government's principles and objectives for regulation of airports (and all other infrastructure, for that matter).

In light of these considerations, there is a fundamental need to break the nexus between the expected revenue earning capacity of an asset (which may include monopoly rents) and asset values at the time of privatisation.

As the ACCC has noted in the excerpt above, this is achieved by setting an objective asset value that reflects the efficient capital cost of a notional new entrant. The ODRC approach is an attempt to do this by setting an efficient "shadow value" for the asset base for regulatory purposes, which is independent of the price paid for the asset at privatisation.

WAC notes that although aeronautical revenues are not directly correlated with asset values, asset values may have an important role in the price monitoring regime. In particular, as noted by the Commission, benchmarking comparisons between airports may include comparisons of return on assets employed.

However, it is not clear how a simple comparison of return on assets employed would provide sufficient information to determine whether an airport is *abusing its market power* (to the extent that it enjoys market power). For example, annual returns achieved will vary over time as domestic and international market conditions change. It is also possible that these market conditions as well as the level of productive efficiency may vary across airports, which could further distort judgments on whether a particular airport is abusing its market power. Therefore, return on assets is likely to be only one of a number of indicators that may be employed in a price monitoring regime.

Notwithstanding the above concerns, if return on assets is to be used as a benchmark comparator, it could be reasonably argued that an accurate comparison of rates of return across airports requires the valuation of assets to be conducted on a consistent basis between airports.

In this context, WAC notes that the present price monitoring regime effectively requires the asset values used in an airport's statutory financial accounts to be adopted for regulatory reporting purposes as well. In WAC's view, the accounting rules (IFRS) governing asset valuation for statutory financial reporting purposes do not provide an asset valuation framework that is entirely fit for the purpose of monitoring returns under a price monitoring regime. Indeed, in other regulated infrastructure sectors, regulators have recognised that there may be good reasons why the asset values adopted for statutory financial accounting purposes differ from those adopted for regulatory reporting purposes.

These considerations may lead the Commission to consider whether a formal valuation handbook ought to be developed to ensure that assets are valued consistently across the Australian airports. Such a handbook could also ensure that any revaluations would be reasonable and consistent across the airports. In WAC's view, the asset valuation for price

monitoring purposes should be the regulated value of the assets, which may differ from the accounting value.

The benefit of developing and implementing a handbook for asset valuation must be considered in the light of the Government's stated objectives for the regulatory regime, which are:

- to promote the economically efficient operation of airports;
- to minimise compliance costs on airport operators and the Government; and
- to facilitate commercially negotiated outcomes in airport operations, benchmarking comparisons between airports and competition in the provision of services within airports (especially protecting against discrimination in relation to small users and new entrants).

At this stage, WAC doubts whether the application of a formal handbook would assist with the efficient operation of airports or in minimizing compliance costs. In relation to benchmarking, WAC notes that even if assets were valued across the airports on a consistent basis, inter-airport comparisons of the return on assets employed may still be misleading. For example, the remaining life of airport assets may differ significantly across airports, as might capitalisation policies and accounting treatments of asset renewal expenditure. Whilst it is possible to set reporting rules to address some of these issues, it is likely that the costs in doing so would outweigh the benefits.

WAC agrees with the Commission that the valuation of land is controversial and, to some degree, subjective. Whilst WAC believes that it was appropriate to adopt the land valuation established by experts Knight Frank in 2001, the case for periodically revaluing land is relatively weak from a practical perspective (even if economic theory supports periodic revaluations). As a result, WAC intends to 'roll-forward' its 2001 ODRC valuation using an appropriate index, and taking into account depreciation and new capital additions. Whilst this roll-forward methodology is reasonably useful from a price modelling perspective, as noted earlier it does not necessarily have a direct impact on aeronautical prices and (more importantly) revenues.

To summarise, WAC's views on asset valuation are:

- the book value of assets inherited by the airport at privatisation was not fit for the purpose of determining future aeronautical charges;
- CPI-X regulation in Australia typically employs an ODRC approach to asset valuation, and the ACCC has accepted asset revaluations on the basis that pre-existing book values may be poor and inconsistent across jurisdictions;
- it would not be appropriate to set the asset value on the basis of the price paid by investors because this creates a circularity problem as noted by the ACCC;
- the current price monitoring regime was designed to encourage the negotiation of prices and service outcomes, and therefore the valuation of assets is much less relevant than in a formal CPI-X regime; and
- on balance, the development and application of a formal asset valuation handbook is unlikely to improve the current regulatory regime in terms of achieving the Government's stated objectives.

4.3 Effectiveness of the ACCC's price and quality monitoring reports

The Commission's Issues Paper notes that whilst the price monitoring regime is less intrusive than the previous CPI-X regime, the current arrangements still require airport operators to provide a considerable amount of information. The Commission notes that one indicator of the extent of these requirements is the size of the price and service quality monitoring reports produced by the ACCC which, in 2004-05, together amounted to more than 320 pages. The Commission suggests (on page 22 of the Issues Paper) that one possible improvement could be the integration of the price monitoring and service quality to help to inform judgements about whether price increases are reasonable having regard to accompanying improvements in service quality.

As a general comment, WAC acknowledges that under a price monitoring regime it is necessary for the regulator to ensure that the airports are acting in a manner consistent with the intent of the regime, and delivering outputs in terms of investment, service and prices that are broadly acceptable to all stakeholders. However, a fine balance must be struck between monitoring the performance of airports and containing the costs of regulation.

WAC's experience of the ACCC's reporting regime is that the key messages can be lost because of voluminous detail and analysis. A particular area of concern relates to the reporting of rates of return on assets, which, for the reasons outlined in section 4.2 above, can provide misleading impressions of financial performance, or lead to invalid inter-airport comparisons⁶⁸. In WAC's view, collecting and reporting information is only useful if it provides clear and accurate measures of performance against some agreed benchmark or standard. At present, WAC believes that the ACCC's reporting falls somewhat short of this requirement.

WAC believes that the Commission could improve the reporting regime by providing some clear guidelines to the ACCC with regard to the purpose of the reporting framework and the information that should be collected. In WAC's view, the Commission should establish a reporting framework that describes:

- how, in practical terms, the ACCC should give effect to the Government's principles for price monitoring;
- how the ACCC should use the financial information provided by the Airports to undertake price monitoring;
- what performance monitoring reports the ACCC will publish on a regular basis; and
- how these reports will relate to its framework for price monitoring.

WAC believes that the above approach will provide a long term benefit to the industry in terms of ensuring consistency of regulatory reporting and avoiding any potential confusion and misinterpretation arising from any future price monitoring report prepared by the ACCC.

In addition to the views set out above, WAC has some specific comments which are relevant to the Commission's consideration of the effectiveness of the present arrangements, and which have implications for the design of the reporting framework:

⁶⁸ It is noted that WAC firmly believes that the method of asset valuation prescribed by International Financial Reporting Standards (IFRS) reflects particular accounting rules that do not provide an appropriate valuation framework for regulatory reporting.

- As already noted, WAC believes that collecting and reporting information is only useful if it provides clear and accurate measures of performance against defined benchmarks. In this regard, WAC considers that price monitoring should be confined to aeronautical services. Therefore, the framework should not encompass the monitoring of prices and profits relating to non-aeronautical services.
- The timeliness of publication of the ACCC's reports could be improved. Typically, the airports submit data in September of each year. However, the ACCC report is sometimes not published until February or March of the following year.
- The ACCC has exhibited a tendency (particularly in the reports it produced immediately after the introduction of price monitoring) to interpret and comment on data in a way that at times has been less than fully objective from WAC's perspective. Whilst there has been an improvement in the most recent price monitoring reports, WAC is concerned that contemporaneous price levels continue to be compared to those that existed immediately prior to the introduction of price monitoring in 2002. WAC expects that following the price increases that occurred in 2002, subsequent price monitoring reports should have focused on the changes in prices in one year compared to the previous year.
- There is insufficient recognition in the price monitoring reports of the relationship between prices on the one hand, and the new investment and improvements in services and facilities that have been delivered on the other. In some circumstances, this may result in the price monitoring reports presenting an incomplete (and therefore potentially unfair) picture of the changes in prices - and the drivers of those changes. For instance, in Perth Airport's case, while international terminal charges increased in 2005, the price increases were agreed as part of a major capital project which involved Perth Airport and the airlines working together to achieve the successful delivery of major improvements to facilities at the terminal⁶⁹.
- WAC estimates that the avoidable cost to Perth Airport of complying with the present price monitoring regime is in the range of \$50,000 to \$100,000 per year.

WAC warmly welcomes the Commission's review of the current information reporting framework.

4.4 Coverage of the price monitoring regime

The Commission's Issues Paper (on page 23) discusses the future scope of the price monitoring regime as follows:

"If price monitoring is to continue, consideration will need to be given to whether it should apply to the existing or a different group of airports. This will require the Commission to assess if there have been any recent changes in the level of market power enjoyed by particular airports that would warrant deletions or additions to the monitored list.

It will also need to assess how well the current 'dual till' system has worked, whether it has given rise to unforeseen difficulties or implementation issues, and how it might be improved. In particular, the Commission is seeking input on whether:

⁶⁹ Appendix 2 provides a description of the cooperative approach adopted by the airlines and WAC in order to ensure the successful completion of the international terminal baggage handling project.

- there are any contestable services currently included in the price monitored till for which airports have little or no opportunity to inefficiently sustain prices above competitive levels; and/or
- there are non-monitored services for which airports can exercise significant market power and where there is evidence that they have used that power to inefficiently raise prices.

In this latter regard, one matter that has already been drawn to the Commission's attention, is the question of whether airport car parking and other transport concessionaire services should be added to the price monitored till.

The treatment of 'fuel throughput levies' — an arrangement whereby oil companies are charged for the refuelling facilities that they operate at airports partly on the basis of the volume of fuel delivered — has also been a contentious issue. While fuel throughput levies are encompassed by the Direction 27 definitions of monitored services, they are exempted from monitoring where such arrangements had been approved prior to the airports privatisation process. Also, these levies are not separately identified in the definition of aeronautical services in the Airports Act."

WAC firmly agrees with the Commission that the future scope of the price monitoring regime should be addressed in the Commission's review. However, it is also important for the Commission to have due regard to the commitments made by Government to bidders at privatisation, that regulation should be on a dual till basis, rather than a single till. As noted in section 1.3.2 of this submission, the advantages of a dual till approach were widely acknowledged at the time of privatisation and confirmed by the Commission's 2002 Inquiry. The dual-till approach is also embedded in paragraph 2(a) of the Government's Review Principles, which are quoted in the Commission's terms of reference for the current inquiry. Given this background, a movement away from a dual till approach would represent an unexpected and unwarranted shift in the regulatory regime.

For the reasons set out elsewhere in this submission, WAC believes that a continuation of the price monitoring and dual till approach to airport regulation is warranted. However, it would be beneficial to all parties if the scope of the price monitoring regime were clarified by the Commission's review. The need for clarification is borne out by a brief consideration of the definitions of those activities that are currently subject to price monitoring.

The services that are subject to price monitoring are aeronautical and aeronautical-related services. Under Direction 27 "aeronautical services" is limited to:

(a) aircraft movement facilities and activities, meaning any of the following:

- i. airside grounds, runways, taxiways and aprons;
- ii. airfield lighting, airside roads and airside lighting;
- iii. airside safety;
- iv. nose-in guidance;
- v. aircraft parking;
- vi. visual navigation aids; and
- vii. aircraft refuelling services;

(b) passenger processing facilities and activities, meaning any of the following:

- i. forward airline support area services;
- ii. aerobridges and airside buses;
- iii. departure lounges and holding lounges (but excluding commercially important persons lounges);
- iv. immigration and customs service areas;
- v. security systems and services (including closed circuit surveillance systems);
- vi. baggage make-up, handling and reclaim;
- vii. public areas in terminals, public amenities, public lifts, escalators and moving walkways; and
- viii. flight information display and public address systems.

Under Direction 27, aeronautical-related services are defined to include:

- (a) landside vehicle access to terminals;
- (b) landside vehicle services, including:
 - i. public and staff car parking (but not valet parking); and
 - ii. taxi holding and feeder rank services on airport;
- (c) check-in counters and related facilities; and
- (d) aircraft light and emergency maintenance sites and buildings.

It is worth making two general comments in relation to the above definition of aeronautical and aeronautical-related services:

- The list of services making up the definition of "aeronautical" services" for Regulation 7.03 (pursuant to Part 7 of the Airports Act 1996) does not coincide with the list of "aeronautical services" in Direction 27, nor with the expanded list including "aeronautical-related services". This point has been noted by the ACCC⁷⁰ and is likely to lead to amendments in Direction 27 and Regulation 7.03 to more closely align the definition of "aeronautical services" in these two instruments⁷¹.
- The Commission's Issues Paper (quoted at the start of this section) gives the erroneous impression that aircraft refuelling services and car parking are not subject to the price monitoring regime. In fact, both of these services fall within the scope of the price monitoring regime under Direction 27.

In WAC's view the price monitoring regime should provide greater clarity on those services that are subject to price monitoring. The current terminology of aeronautical and aeronautical-related services is confusing, as borne out by the above observations.

In thinking about the question of which services should be price monitored, it is useful to remember that price monitoring is a lighter-handed form of regulation. In the event that a

⁷⁰ ACCC, Submission to Department of Transport and Regional Services, Review of *Airports Act 1996*, February 2003, page 8.

⁷¹ Hon Warren Truss MP, Media Release, dated 14th November 2005.
http://www.ministers.dotars.gov.au/wtr/releases/2005/November/053WT_2005.htm

more heavy-handed form of regulation is determined to be required, services may be declared under Part IIIA of the Trade Practices Act (TPA). Ultimately, these services could be subject to price control (as applied to monopoly utilities such as gas and electricity networks). Therefore, it is possible to consider a spectrum of regulation, from light-handed regulation (price monitoring) to heavy-handed (price control).

In light of these considerations, WAC's view is that the definition of price monitored services ought to be aligned with those services that could be subject to more heavy-handed regulation. On this basis, WAC considers that the development of an appropriate definition of price monitored services should have regard to the concept of *declared services* in the TPA. In particular, it seems reasonable that price monitoring should apply to the same services that may be subject to declaration under Part IIIA of the TPA.

Section 44H(4) of the TPA provides that the designated Minister cannot declare a service unless the Minister is satisfied of all of the following criteria:

- (a) that access or increased access to the service would promote competition in at least one market other than the market for the service;
- (b) that it would be uneconomical for anyone to develop another facility to provide the service;
- (c) that the facility is of national significance having regard to its size, its importance to constitutional trade or commerce, or the importance of the facility to the national economy;
- (d) that access to the service can be provided without undue risk to human health or safety;
- (e) that access to the service is not already the subject of an effective access regime; and
- (f) that access or increased access to the service would not be contrary to the public interest.

The essence of all of these criteria is captured in two criteria that were developed and applied by the ACCC in its administration of s.192 of the Airports Act in 1998⁷². Although section 192 is no longer operative, the criteria developed by the ACCC in its Draft Guide still provide a very useful and simple framework for identifying services that are likely to be subject to declaration under Part IIIA of the TPA. These criteria were:

- Criterion (i): The services are necessary for the purposes of operating and/or maintaining civil aviation services at the airport; and
- Criterion (ii): The services are provided by means of significant facilities at the airport, being facilities that cannot be economically duplicated.

In applying these criteria to the definition of landside vehicle facilities that might reasonably be subject to declaration, the ACCC's Draft Guide stated:

⁷² ACCC, *Draft Guide, Section 192 of the Airports Act — Declaration of airport services*, October 1998. It is noted that this section of the Airports Act has subsequently been repealed.

“Facilities for landside vehicle access include roads for vehicles to access the airport site, terminal buildings and airside facilities. This discussion does not cover car parks. The Commission considers that those facilities will not be subject to declaration under the Airports Act.

Vehicles require access to landside facilities for the purposes of transporting people or goods to the airport. The types of vehicles that use these facilities include private cars, rental cars, buses, taxis and trains.”

As already noted, whilst the regulatory regime has changed since the ACCC’s findings in 1998, WAC believes that the principles underpinning the ACCC’s conclusions are still relevant in developing an appropriate definition of aeronautical services. Importantly, given that Government policy has confirmed that airport regulation is to be on “dual till” basis, there must be a clear distinction between those services that are truly aeronautical services, and those services that are not aeronautical services (even if the service is conducted on airport property).

Applying the ACCC’s criteria in the context of dual till regulation, WAC considers that:

- An appropriate definition of price monitored services would include all of the services presently defined under Direction 27 as “aeronautical services” plus “landside vehicle access to terminals” (which is presently defined as an “aeronautical-related service”).
- The case for continuing to price monitor the remaining services that are presently contained in the Direction 27 category of “aeronautical related services” is highly questionable. Indeed, WAC is of the view that the definition of two separate categories of price monitored services (namely, “aeronautical services” and “aeronautical-related services”) has itself contributed to the persistent confusion surrounding the definition of “aeronautical services”. This consideration lends weight to WAC’s view that there should be a clear definition of a single category of services that is subject to price monitoring.

For the avoidance of doubt, the agreed definition of price monitored services would not prevent an airline attempting to seek declaration of a service under Part IIIA of the TPA, even if that service is not subject to price monitoring. On the other hand, drawing a very wide definition of price monitored services would effectively erode the concept of the dual till, and would be counter to the commitments made at privatisation and the benefits of dual till regulation as previously noted by the Commission and the ACCC.

4.5 Dispute resolution mechanisms

The terms of reference for this inquiry requires the Commission to review the dispute resolution mechanisms at each of the price monitored airports and advise on improvements that would be consistent with the Government’s Review Principles. On page 28 of its Issues Paper, the Commission makes the following comments in relation to commercial negotiation and dispute resolution:

“Facilitating speedier and more fruitful resolution of disputes that arise in commercial negotiations regarding access to airport services would evidently help to enhance the functioning of any future price monitoring regime.

The negotiation of commercial agreements — in the airport area or elsewhere — will normally be an iterative process involving give and take by the various parties. Sometimes parties in commercial negotiations may voluntarily agree to provision for independent arbitration on either a case-specific basis, or as part of their ongoing negotiation framework.

From this perspective, much of the responsibility for ensuring constructive negotiations and speedy resolution of disputes in this area will lie with the parties directly involved. Moreover, negotiations and dispute resolution between the major airports and their customers are already additionally facilitated by:

- the available guidance on efficient pricing of airport services (see above);
- the legislative remedies available under the national access regime to those unable to secure access on satisfactory terms and conditions to nationally significant infrastructure services; and
- the constraint on the price of access from the threat of stronger regulation that underlies the price monitoring regime.”

WAC strongly concurs with the Commission’s comments in relation to dispute resolution and commercial negotiation. The price monitoring regime is predicated on the view that airports and airlines are capable of negotiating commercial terms and, moreover, the process of commercial negotiation is likely be more effective than heavy-handed regulation in delivering outcomes that the airports and airlines find acceptable. As noted in section 1 of this submission, commercial negotiation is particularly important in relation to the provision of aeronautical services because airlines operate in a dynamic and competitive market environment (in contrast to traditional regulated utilities).

WAC also agrees with the Commission’s observation that parties may voluntarily agree to dispute resolution mechanisms in the event that negotiations fail to reach a satisfactory solution. As noted in section 2.6 of this submission, under the price monitoring regime WAC has negotiated the Prices and Services Accord and the Virgin Blue Terminal Facility Agreement; both agreements contain dispute resolution provisions. It is noted that the dispute resolution provisions in the more recently negotiated Virgin Blue terminal licence agreement provide for an independent expert to make a binding determination.

In relation to the ACT Sydney Airport Decision, the ACT concluded that Sydney Airport could exert monopoly power because its agreements with the airlines did not contain dispute resolution mechanisms. In particular the ACT commented⁷³:

“We are satisfied that any commercial negotiations in the future between SACL and airlines using Sydney Airport as to the non-price terms and conditions on which the airlines utilise the facilities and related services at Sydney Airport are likely, as in the past, to continue to be protracted, inefficient, and ultimately resolved by SACL using its monopoly power to produce outcomes that would be unlikely to arise in a more competitive environment. This situation is exacerbated by the lack of an appropriate dispute resolution procedure providing independent arbitration in any of the commercial agreements entered into or proposed between SACL and the airlines.”

In contrast to the situation described by the ACT, WAC has negotiated dispute resolution processes with the airlines. As noted in section 2.6 of this submission, WAC’s experience to date is that no disputes have arisen in relation to these agreements. In future, WAC and its customers may negotiate enhanced dispute resolution provisions, possibly using the Virgin Blue Terminal Facility Agreement as a template. In this regard, WAC agrees with the following comments from the Commission, which indicate that further experience with negotiation and arbitration processes will also assist in resolving disputes⁷⁴:

⁷³ Australian Competition Tribunal Virgin Blue Airlines Pty Limited [2005] ACompT 5, paragraph 17.

⁷⁴ *ibid*, page 28.

“It is also likely that experience and precedents arising from ongoing negotiations between airports and their customers, and possibly from arbitrations under the national access regime, will in future serve to narrow the initial divide between the parties and thus facilitate speedier resolution of disputes.”

In addition to the negotiated dispute resolution processes, WAC notes that airlines also have recourse to the legislative remedies available under the national access regime if negotiations ultimately fail to deliver satisfactory outcomes.

Overall, experience at Perth Airport strongly suggests that the existing combination of agreed and statutory dispute resolution mechanisms have proved to be effective to date. On this basis, WAC does not believe that there is a case to develop and impose industry guidelines or other instruments to govern commercial negotiations or to provide additional dispute resolution paths. In fact, WAC believes that introducing such measures could undermine the benefits of allowing airports and airlines to enter into unfettered commercial negotiations.

4.6 Implications arising from the ACT Sydney Airport Decision and the COAG review of National Competition Policy

The Commission’s terms of reference for this review specifically require the Commission to have regard to:

- the ACT Sydney Airport Decision and the subsequent consideration of this matter by the Federal Court; and
- the outcomes of the Council of Australian Government’s (COAG) 2005 review of National Competition Policy.

In the following two sections, WAC sets out the key implications of these recent reports for the Commission’s current review.

4.6.1 ACT Sydney Airport Decision

In October 2002, Virgin Blue applied to the National Competition Council (NCC) for a recommendation that certain services (Airside Services) provided at Sydney Airport be declared pursuant to s 44G of the Trade Practices Act (TPA). The NCC recommended, and the Minister accepted, that the Airside Service should not be declared.

Following an application for review of that decision, the ACT determined in December 2005 (under s44K(8)(b) of the TPA) that the Minister’s decision be set aside and that:

“The service for the use of runways, taxiways, parking aprons and other associated facilities (Airside Facilities) necessary to allow aircraft carrying domestic passengers to:

- i. take off and land using the runways at Sydney Airport; and
 - ii. move between the runways and the passenger terminals at Sydney Airport,
- (defined as the “Airside Service”), be declared.”

The service was declared for a period of five years, expiring on 8 December 2010.

From WAC's perspective the following comments from the ACT Sydney Airport Decision raise important issues for Perth Airport⁷⁵:

"One of the principal issues canvassed in the proceeding was whether SACL had misused its monopoly power in such a manner as warranted the conclusion that there had been, and would continue to be in the absence of declaration of the Airside Service, an effect on competition in the dependent market. When we refer to a misuse of monopoly power, we are referring to an exercise of power in a manner which would not occur in a competitive environment.

We are satisfied that SACL has misused its monopoly power in the past, and that, unless the Airside Service is declared, competition in the dependent market will continue to be affected. In particular, we are satisfied that SACL has misused its monopoly power by the manner in which, and the reasons for which, it changed the basis for its charge for providing the Airside Service in July 2003 from an aircraft's maximum take-off weight ("MTOW") basis to a charge on a per-passenger basis ("known as the Domestic PSC"). This change adversely affected low cost carriers such as Virgin Blue as against full service airlines such as Qantas. Further, the evidence disclosed that SACL chose a passenger-based charge "because Qantas preferred it". At the time the basis for this charge was altered, SACL knew that it would impact more adversely on Virgin Blue than on Qantas."

SACL submitted that the Domestic PSC encouraged a more efficient use of the services and facilities provided at Sydney Airport than did the former MTOW-based charge, and that efficient pricing principles warranted the use of a Domestic PSC. We have rejected this submission. We are satisfied that efficient pricing of the Airside Service required consideration of the underlying cost drivers of that Service by reference to the nature of the aircraft using the Service, rather than by reference to the number of passengers travelling in such aircraft."

WAC is particularly conscious of the ACT's comments in relation to the relative efficiency of passenger-based and MTOW-based charging structures. As discussed in section 3 of this submission, Perth Airport carefully considered the views of all of its airline customers when it decided to adopt a passenger-based charging structure. In contrast to the situation at Sydney Airport, whilst Virgin Blue raised concerns in relation to passenger-based charges, Perth airport was able to address these concerns through negotiation. As noted earlier in this submission, the contrast between Virgin Blue's experience at Perth and Sydney airports was noted in the evidence presented to the ACT by Virgin Blue⁷⁶:

"Virgin Blue had a ready explanation, which we accept, for the reason why it was prepared to accept passenger-based charges at other airports but not at Sydney Airport. Mr Pen said that Virgin Blue had accepted these charges at other airports as part of wider commercial arrangements with those airports. In particular, in relation to Perth and Melbourne airports, Virgin Blue was able, in exchange for a passenger-based charge, to obtain certainty of price over a long term, commitment to maintain the quality of the airports' services at an acceptable level, and a reduced rate for domestic terminals."

In addition to noting the comments from Virgin Blue, it is also important to recognise that

- the ACT Sydney Airport Decision was published nearly 3½ years **after** Perth Airport obtained the agreement of its customers to move to a passenger-based charging structure;

⁷⁵ Australian Competition Tribunal Virgin Blue Airlines Pty Limited [2005] ACompT 5, paragraph 12

⁷⁶ *ibid*, paragraph 287.

- the ACT Sydney Airport Decision is strictly limited to examining the experience at Sydney and it is difficult to draw broad implications for other airports, including Perth; and
- the decision is the subject of an appeal to the Federal Court, which could overturn all or part of the Tribunal's determination.

Therefore, whilst the Tribunal's views in relation to the actions of Sydney Airport are of considerable interest to WAC and its airline customers, it is doubtful whether firm conclusions can be drawn from the ACT Sydney Airport Decision in relation to:

- whether WAC acted reasonably in adopting passenger-based charges; or
- whether WAC should in future adopt MTOW charges.

In this regard it is particularly noteworthy that BARA has acknowledged the limited applicability of the ACT Sydney Airport Decision to other airports as follows⁷⁷:

"Pricing arrangements at other major privatised airports are different [from those at Sydney]. Following the cessation of their CPI-X price cap on 30 June 2002, the operators of Brisbane, Melbourne, Adelaide and Perth airports entered into five-year commercial agreements with airlines. Those agreements address prices for aeronautical services, capital expenditure programs and service levels. BARA and its member airlines had the confidence to engage in negotiations with those airport operators for a commercial agreement because they had implemented cost efficiency measures under the CPI-X price cap and airlines accepted that their cost bases were reasonably efficient. While ever the operators of Brisbane, Melbourne, Adelaide and Perth airports act in accordance with the commercial agreements in place, BARA would have no incentive to seek declaration of aeronautical services at those airports."

Given the airlines' views, and based on the evidence set out elsewhere in this submission, WAC believes that it has indeed acted reasonably in adopting passenger-based charges, noting in particular the consultative approach that it employed and the negotiated outcome with Virgin Blue. In considering its preferred future charging arrangements following the expiry of the Prices and Services Accord, WAC will consult very carefully with its airline customers in the light of the ACT Sydney Airport Decision and any subsequent finding by the Federal Court.

At a broader level, WAC believes that an important lesson to be drawn from the ACT Sydney Airport Decision is that the price monitoring regime adopted by Government is, in fact, working effectively. The Government's response to the Commission's 2002 Inquiry recommendation 5 commented that:

"The Government supports this recommendation in principle and it was always the Government's intention that airports and stakeholders should commercially negotiate pricing outcomes on aeronautical and aeronautical-related services. The Government agrees that there is merit in supporting the development of commercial agreements. However, it is not clear that the Government needs to, or should, play a role in preparing guidelines for the conduct of those negotiations or the content of particular agreements that may take various forms and cover any variety of matters. The Government is conscious of the costs that would arise from a highly prescriptive regulatory process and considers that it is the parties affected that are best placed to determine these matters in a manner that suits their particular operational needs."

⁷⁷ BARA, *Airline Views* (newsletter), August 2003, page 1.

In the event that commercial agreement cannot be concluded in relation to access terms and conditions, the access provisions in Part IIIA of the TP Act provide recourse to arbitration for determining those conditions for 'declared' services.

The Government is, however, prepared to assist airports and airport users develop industry guidelines for commercial agreements should that be required.”

The experience in relation to Sydney Airport is that Virgin Blue was not able to negotiate terms and conditions that it believed to be acceptable. The airline therefore sought the declaration of services in accordance with Part IIIA of the TPA. Whilst the protracted nature of the regulatory process has no doubt created unwelcome uncertainty for all airports and airlines, it nonetheless provides a path to securing fair and reasonable access to essential facilities after all efforts to reach a commercial solution have been exhausted. At the same time, the nature of that path provides a strong incentive on all parties to a dispute to reach a commercial settlement, and to thereby avoid the costs of litigation. On this basis, WAC believes that it would be inappropriate to conclude that the ACT Sydney Airport Decision illustrates a failing in the price monitoring regime adopted by Government.

4.6.2 Council of Australian Government's (COAG) 2005 review of National Competition Policy

The COAG review of National Competition Policy (NCP) made a number of observations regarding infrastructure regulation and best practice regulation which are relevant to the Commission's current review. In its 10 February 2006 Communiqué, COAG responded to the National Competition Policy review in the following terms:

“In response to the National Competition Policy (NCP) Review, COAG has agreed a new NCP reform agenda aimed at providing a supportive market and regulatory framework for productive investment in energy, transport and other export-oriented infrastructure, and its efficient use, by improving pricing and investment signals and establishing competitive markets. These will be progressed as part of the Competition stream of the National Reform Agenda. COAG also agreed with the NCP Review's recommendations on reducing the regulatory burden on business. These will be progressed as the 'deregulation' stream of the National Reform Agenda. The details of COAG's specific decisions are outlined below.”

Whilst it is not appropriate to reproduce in this submission the detail of COAG's specific decisions, it is worthwhile to draw the Commission's attention to the overall thrust of the COAG response to the NCP. In particular, COAG has stated that it recognises the importance of investment in infrastructure and the need to reduce the regulatory burden on business. In relation to the concept of price monitoring, COAG commented that⁷⁸:

“The introduction of price monitoring for services provided by means of significant infrastructure facilities should be considered, where this would improve the level of price transparency, as a first step where price regulation may be required, or when scaling back from more intrusive regulation.”

The above comment in relation to price monitoring reinforces the view expressed by the Commission in its 2002 Inquiry that price monitoring can provide an effective alternative to more intrusive forms of regulation.

⁷⁸ COAG Communiqué – 10th February 2006, Attachment B, Appendix E, section 2.3.

5 CLOSING COMMENTS

In its review, the Commission is required to consider whether Perth Airport has complied with the Review Principles, which were established by the Government at the start of the price monitoring regime. The Review Principles focus on the achievement of efficient pricing of aeronautical services, acceptable service quality and commercially negotiated outcomes and agreements. On the basis of the evidence presented in the foregoing submission, WAC is confident that it has indeed acted in accordance with the Government's Review Principles, and that the outcomes delivered under the price monitoring regime accord with those Principles.

The Commission's terms of reference also require it to have regard to the ACT Sydney Airport decision. In considering its preferred future charging arrangements following the expiry of the Prices and Services Accord, WAC will consult very carefully with its airline customers in the light of the ACT Sydney Airport Decision and any subsequent finding by the Federal Court. Beyond this, however, it is doubtful whether firm conclusions can be drawn from the ACT Sydney Airport Decision in relation to Perth Airport's conduct. More broadly, WAC believes that it would be inappropriate to conclude that the ACT Sydney Airport Decision illustrates a failing in the price monitoring regime adopted by Government because:

- whilst the protracted nature of the regulatory process surrounding that particular dispute has no doubt created unwelcome uncertainty for all airports and airlines, it nonetheless provides a path to securing fair and reasonable access to essential facilities after all efforts to reach a commercial solution have been exhausted; and
- at the same time, the nature of that path provides a strong incentive on all parties to a dispute to reach a commercial settlement, and to thereby avoid the costs of litigation.

In light of these considerations, it might therefore be argued that the ACT Sydney Airport Decision provides evidence that the price monitoring and national access regimes are working as intended.

WAC fully supports and welcomes the Commission's review of the price monitoring regime. WAC's firmly held view is that Perth Airport's performance since 2002 vindicates the Commission's 2002 Inquiry recommendation and the Government's decision to adopt a price monitoring regime. In particular, whilst prices have increased in order to correct many years of under-pricing of aeronautical services:

- investment and passenger numbers have increased substantially;
- facilities have been improved;
- quality has been maintained at a high level and Perth Airport is now operating on a sound financial footing;
- negotiation and consultation is continuing to develop along commercial lines rather than being heavily conditioned and constrained by intrusive price regulation.

WAC strongly believes that a return to more heavy-handed regulation would put at risk the economy-wide benefits that have been obtained, and will continue to be delivered under a light handed price monitoring regime.

APPENDICES

Appendix 1: Answers to the questions contained in the Issues Paper

Page	No	Questions	WAC Response
16	1	Outcomes of the current arrangements How adequate are the data in the ACCC's price and quality monitoring reports for judging whether airport operators have acted in a manner consistent with the Government's Review Principles and the effectiveness of the price monitoring regime? What are the major gaps in that information base and can they be practically remedied?	Please refer to section 4.3 of this submission. WAC's view is that the ACCC's price and quality monitoring reports could be improved in a number of respects. WAC welcomes a review of these reports by the Productivity Commission.
	2	What conclusions can be drawn from international comparisons of airport performance?	International comparisons of airports' service quality can be informative, provided that data is collected and analysed on a consistent basis across all airports. However, WAC believes that only limited conclusions can be drawn from benchmarking international airport performance in relation to landing fees. Price and cost benchmarking is notoriously difficult given the different cost structures of airports around the world. Benchmarking can provide the basis for a high level comparison of performance (especially in relation to service quality), however there may be reasonable explanations (which are not revealed through a benchmarking study) as to why one airport's charges are higher or lower than physically similar airports elsewhere.
17	3	Price levels Have increases in charges for airport services under the price monitoring regime been consistent with the efficient operation of airports and the Government's Review Principles? To what extent is the experience to date indicative of what might happen in the future? How do recent increases in charges for aeronautical services at the price monitored airports compare with those at other Australian airports and at comparable airports overseas?	<p>Please refer to section 3.2 of this submission. WAC is confident that it has acted in a manner that is consistent with the Government's Review Principles.</p> <p>In relation to price increases, please refer to sections 2.5 and 3.3 of this submission. The large price increases experienced at many airports from 1 July 2002 reflected the fact that aeronautical charges applying for the five-year period following privatisation were unsustainably low, and did not reflect the true cost of service delivery.</p>

Page	No	Questions	WAC Response
	4	Is there evidence that the price monitored airports have used market power to increase charges by more than could be justified on the basis of costs, new investment requirements, and/or other enhancements to service quality?	<p>Please refer to sections 2.2 to 2.6 of this submission. There is no evidence of abuse of market power by WAC. WAC has negotiated price-service outcomes with its customers, increased investment and improved service levels.</p> <p>The dispute resolution mechanisms contained in WAC's agreements with its customers have not been activated. This indicates that the parties have been able to negotiate mutually acceptable terms and prices for aeronautical services.</p>
	5	Are higher returns earned on non-aeronautical assets suggestive that the price monitoring regime has tempered the exercise of market power for the monitored services? Or does the greater measured profitability of non-aeronautical services reflect other factors such as locational rents? Has generally strong growth in non-aeronautical revenues and higher returns on those services of itself encouraged restraint in charges for aeronautical services?	<p>Please refer to sections 1.3 and 3.3 of this submission. The airport was privatised under a dual till framework, and the Productivity Commission confirmed this approach in its 2002 Inquiry. Under the dual till, WAC has a clear incentive to grow non-aeronautical revenues. This incentive ultimately delivers benefits to airport customers and the Western Australian economy more generally. The incentive to grow non-aeronautical revenues also acts as a constraint on aeronautical charges, because passenger numbers are an important driver of non-aeronautical revenues. In any event, WAC has an incentive to increase airport traffic as explained in section 1.3 of this submission.</p>
18	6	<p>Charging structures</p> <p>How has the structure of charges for airport services changed under the price monitoring regime? Have such changes been facilitated by the more light-handed approach to prices oversight?</p>	<p>Please refer to section 3.4 of this submission. The new price monitoring arrangements provide flexibility to both airports and users to adopt a pricing structure that suited both parties. In 2002, WAC negotiated a move to passenger-based charges, which was agreed to by all airlines in the context of negotiations addressing a broad set of commercial issues including the structure and level of charges, the certainty of those charges over the five year pricing period from 2002, and the commitment of Perth Airport to maintain and expand the quality of services and facilities at the airport.</p>

Page	No	Questions	WAC Response
	7	Is the current structure of charges broadly consistent with the efficient provision of airport services and the Government's Review Principles? If not, what changes would be required to deliver more efficient outcomes?	Please refer to section 3.4 of this submission. Yes, WAC believes that its current structure of charges is broadly consistent with the Government's Review Principles. However, WAC will consult with airlines on the future structure of charges in the light of the recent ACT Sydney Airport Decision.
	8	What effect has the price notification requirement for services provided to regional airlines at Sydney Airport had on the overall structure of charges at the airport? How does the slot management system at the airport, including the provision of a separate pool of landing slots for regional airlines, influence the charging regime?	WAC does not have any views on this matter.
18	9	Quality of service How responsive have the price monitored airports been to users' service needs and preferences? Have changes in service quality been noticeable on a year to year basis? Are there any significant quality problems for services under the control of the airports that are not being addressed? Have necessary new investments generally been made in a timely fashion? How does the quality of service at the price monitored airports compare with comparable airports overseas?	Please refer to sections 2.3 and 2.4 of this submission. WAC believes that service quality and investment outcomes have been very positive under the price monitoring regime. Indeed, the introduction of the price monitoring regime has facilitated the successful completion of the large and complex international baggage handling project, as noted in section 2.5.2 and Appendix 2.
	10	What role has the monitoring undertaken by the ACCC played in sustaining/enhancing service quality? Has some of the information used by the ACCC to gauge quality — for example, passenger surveys — encompassed services not directly under the control of the airports? If so, has the 'overlap' been appropriately handled in the interpretation of the information concerned?	As noted in section 2.4.1, WAC is responsive to airlines' needs and is highly focused on service quality as an issue, notwithstanding the existence of the service quality monitoring regime. In its case, WAC does not believe that the ACCC's monitoring regime has, of itself, had a direct effect on service quality at Perth Airport. Nonetheless, WAC is very supportive of the continuation of the service quality monitoring regime.

Page	No	Questions	WAC Response
19	11	Procedural efficiency and related considerations In broad terms, how procedurally efficient have the price monitoring arrangements been? Have the processes that have emerged under the arrangements been better at some airports than at others and if so why?	Please refer to section 4.3 of this submission. WAC is concerned that the ACCC's reports are not always published in a timely manner.
	12	How costly is it to assemble the information required by the ACCC to undertake its monitoring activities? Has there been any appreciable reduction in compliance costs for airport operators and others under the current regime? Have any extra costs been justified by more efficient outcomes?	Please refer to section 4.3 of this submission. WAC estimates that the avoidable cost is between \$50,000 and \$100,000 per annum. WAC believes that there is a strong case for ensuring that these costs do not increase in future, and some cost efficiencies from the current levels could be achieved.
	13	More broadly, is the information that the ACCC currently collects the most useful and relevant? Could the ACCC have usefully devoted more time to evaluating the information provided to it? Has there been appropriate recognition in the monitoring process of the linkages between quality enhancement and the higher charges often necessary to provide for such enhancement? Have variations in the way that airports report their performance to the ACCC hampered interpretation of the outcomes of price and quality monitoring?	Please refer to section 4.3 of this submission. WAC believes that improvements could be made to the existing reporting framework. WAC welcomes the Productivity Commission's consideration of these issues.
	14	Where disputes over charges or terms of access have arisen, how have they been resolved? Are offers sometimes made on a 'take it or leave it' basis? In keeping with the Government's Review Principles, have appropriate consultation mechanisms been established to facilitate the two-way provision of information on airports' operations and requirements? To date, has the possibility of seeking arbitrated access to airport services under the generic national access regime materially affected commercial negotiations and hence the outcomes observed under price monitoring?	Please refer to section 2.6 of this submission. The dispute-resolution mechanisms contained in WAC's agreements with its customers have not been activated.

Page	No	Questions	WAC Response
20	15	Future arrangements To assist the Commission to document and, as far as possible, quantify the impacts of different arrangements, participants are encouraged to provide as much information as possible on the benefits, costs, economic and distributional impacts of the particular arrangements they consider would be most appropriate in the future.	Please refer to section 5 of this submission. WAC believes that the current price monitoring regime has worked well and should be retained. A return to price control regulation would be detrimental to the industry and the wider economy.
20 - 22	16	Is a further period of price monitoring warranted? Is price monitoring providing a worthwhile constraint on aeronautical charges at the major airports and should it be continued? What should be the duration of any further period of price monitoring and what intra- or end-of-period review arrangements should apply?	Please refer to the previous answer. WAC recommends that price monitoring should be maintained indefinitely, providing that an airport does not abuse its market power. An airline should be able to trigger a Productivity Commission investigation of airport behaviour, providing that there is prima facie evidence that an airport has abused its market power. The Productivity Commission should establish guidelines for how a review could be triggered.
	17	Since the Commission's 2002 inquiry, have there been reductions in the overall market power enjoyed by any of the seven price monitored airports (see table 2) and if so why? For example, has recent development of Avalon and Gold Coast Airports reduced the market power of Melbourne and Brisbane Airports? What are the implications for future assessments of market power at the price monitored or other airports of the analysis by the Australian Competition Tribunal (2005) underpinning its declaration under Part IIIA of airside services at Sydney Airport?	Please refer to section 1.3.2 of this submission. WAC considers that there has been no increase in its market power since the Productivity Commission's last review was completed in 2002. The implications for Perth Airport of the Australian Competition Tribunal's decision are examined in section 4.6.1.

Page	No	Questions	WAC Response
	18	In the light of recent experience, how much weight should now be given to the argument that even if airports have market power, their use of this power to raise aeronautical charges will be constrained by a competing incentive to maximise usage of their facilities, and thereby boost non-aeronautical revenues? Similarly, in practice, how robust is the argument that the scope for airports and airlines to price discriminate between their customers means that the efficiency costs of any monopoly pricing of aeronautical services are unlikely to be large?	<p>WAC believes that these arguments have some weight, noting that they were considered in detail in the Productivity Commission's 2002 Inquiry. In WAC's view the key questions for the Productivity Commission are:</p> <ul style="list-style-type: none"> • Has the airport acted in accordance with the Government's Review Principles; and • Is the price monitoring regime has worked as intended. <p>In WAC's case, the answer to both questions is clearly "yes".</p>
	19	Does the information emerging from the price monitoring process assist commercial negotiations between airports and their customers? Are there occasions where the process may detract from efficient negotiations — through, for example, encouraging the revisiting of agreed arrangements?	<p>WAC does not believe that the price monitoring information has a material bearing on commercial negotiations. Please refer to appendix 2 for WAC's case study on the International Terminal Baggage Handling project.</p>
	20	In the event that the declaration of airside services at Sydney Airport stands, would this raise the spectre of declaration at other major airports and thereby strengthen the negotiating position of users of airport services? Is it likely that, in the future, airports will consider providing Part IIIA undertakings? If not, why not?	<p>Please refer to section 4.6 of this submission. WAC believes that the Sydney Airport case indicates that the price monitoring regime is working as intended. As noted in sections 2.2 and 4.6.1, Perth Airport has been able to agree terms and conditions for the provision of aeronautical services with all of its customers. Dispute resolution mechanisms have not been invoked, and services have not been declared at Perth Airport. WAC therefore considers that the price monitoring regime is working effectively.</p>
	21	To what extent do the costs, lengthy time frames and other procedural aspects of the national access regime detract from its usefulness in (further) constraining the exercise of market power by the major airports? Are the changes to the regime that have been announced by the Government likely to increase its potential role? Are there other generic changes that could be made to Part IIIA to improve its usefulness in an airports context?	<p>Please refer to section 4.6 of this submission. Notwithstanding the unwelcome uncertainty and lengthy time frames associated with the procedural aspects of the national access regime, WAC nonetheless believes that the long time frames will encourage parties to negotiate constructively to reach agreement.</p>

Page	No	Questions	WAC Response
	22	Even if there is some evidence of misuse of market power by the price monitored (or other) airports, do concerns about the potentially adverse effects on investment militate against the reintroduction of more heavy handed price regulation? To what extent has the current light-handed approach addressed the concerns about investment inhibition (and other problems such as an unwillingness to negotiate genuinely) that arose under the previous regulatory regime?	Please refer to sections 1.4, 2.3 and Appendix 2 of this submission. In Perth Airport's case, there is clear evidence that the price control regime worked extremely poorly, and that price monitoring has delivered much better outcomes, especially in relation to investment.
	23	Are there non-regulatory approaches that could be used in place of, or to complement, prices regulation or oversight of some description? What can Australia learn from the experiences of other countries about good regulatory practice in the airports area?	WAC does not support a return to price regulation. The Productivity Commission should avoid the temptation to change any aspect of the current regime, unless it is shown to be deficient.
22 - 23	24	How could procedural efficiency be improved? Are there opportunities to streamline current monitoring arrangements so as to improve procedural efficiency, without compromising effectiveness? For example, could the number of indicators against which the ACCC reports be sensibly reduced, or could it report less frequently? Conversely, in some areas, would more information be desirable?	Please refer to section 4.3 of this submission and WAC's answer to question 13 above.
	25	Do commercial imperatives and requirements in airport leases make it unlikely that airport operators would use any market power to inappropriately reduce quality of service? Would the inclusion of 'service level indicators' in future negotiated price agreements reduce the need for external quality monitoring?	Please refer to section 2.4 of this submission. The price and service undertakings negotiated by WAC include clear commitments regarding service quality at Perth Airport. WAC's service levels have met or exceeded its customers' requirements. Experience at Perth Airport since the introduction of price monitoring demonstrates that WAC has certainly not used any market power to reduce service quality. Indeed, as noted in section 2.4, WAC recognises that the commercial success of its own business is reliant on the maintenance of high quality standards, and the delivery of services that accord with the needs and preferences of its customers.

Page	No	Questions	WAC Response
	26	Nonetheless, is some monitoring of quality levels still desirable to inform judgements of whether quality-adjusted price increases for aeronautical services at the major airports are efficient and reasonable? Should services which are not directly under the control of airport operators be explicitly excluded from any future quality monitoring requirements?	As noted in section 4.3, WAC supports a continuation of service monitoring. Please refer to WAC's answer to question 13 above.
	27	<p>Are there other changes that could be made to the current monitoring process to improve its procedural efficiency or usefulness? For example:</p> <ul style="list-style-type: none"> • Should there be more differentiation in approach between monitored airports according to their particular characteristics? • Should monitoring have regard to prices and/or service quality in comparable overseas airports? Are there any international benchmarking systems that could usefully be employed in this context? • Should there be more ongoing evaluation (beyond the price/quality linkage) of the data and information assembled through the monitoring process? For example, does the relationship between airport profitability and the phase of the airport 'investment cycle' warrant greater attention? • Would there be value in pursuing greater consistency across airports in the methodologies underlying the various performance indicators? 	Please refer to section 4.3 of this submission, and WAC's answer to question 13 above.

Page	No	Questions	WAC Response
24	28	<p>What should any future price monitoring arrangements cover?</p> <p>Under any future price monitoring arrangements, should the current airport coverage be changed? What are the efficiency arguments for any additions or deletions of airports and how do they relate to the considerations that were influential in determining the coverage of the current monitoring regime?</p>	<p>WAC does not have any views on this issue. WAC accepts that Perth Airport should be subject to some form of price monitoring.</p>
	29	<p>Has the market power enjoyed by the major airports in the delivery of particular services changed since the current arrangements were put in place? Does this suggest a need to alter the range of price monitored services?</p> <ul style="list-style-type: none"> In the case of car parking, is there evidence that airports have used market power to raise prices to an excessive extent? Could relatively high charges for parking simply reflect 'location rents' that accrue from the advantages for airport users of being able to park close to the airport terminals? Are there any in-principle reasons why fuel throughput levies should be excluded from the purview of a future price monitoring regime? If not, how would uniform treatment across airports best be pursued and over what time frame? 	<p>Please refer to WAC's answer to question 17 above.</p> <p>In relation to car parking, please refer to sections 2.4.3 and 2.5.3 of this submission. WAC has not exploited any market power in relation to car parking. In fact, car parking investment and capacity has increased and is planned to increase further, while prices have been contained to levels consistent with those in Perth's CBD.</p> <p>WAC's comments in relation to fuel throughput fees are set out in section 3.4.2 of this submission. WAC believes that the coverage of the price monitoring regime should be reviewed (as explained in section 4.4 of this submission). As a matter of principle, where a service has no prospect of being declared under part IIIA of the TPA, WAC does not believe that there is a case for subjecting the service to price monitoring.</p>
	30	<p>More broadly, has the operation of the dual till arrangement given rise to unforeseen consequences, or to implementation problems, that cannot readily be addressed through 'fine-tuning' the arrangement? How do the costs of any unforeseen consequences and implementation problems compare to the likely costs of a return to a single till approach? Are there any lessons to be learnt from recent overseas experience in this area?</p>	<p>Please refer to sections 1.3 and 1.5 of this submission. WAC does not believe that the Productivity Commission should revisit the dual till approach, which was a commitment made by Government at privatisation and is embodied in the Review Principles. The Productivity Commission should take care to ensure that the dual till is properly recognised and preserved, as it provides an effective framework for facilitating the development of the airport to the benefit of all stakeholders.</p>

Page	No	Questions	WAC Response
	31	Has the current divergence of definitions of aeronautical services in the Airports Act and in the Directions made under the TPA given rise to concerns additional to the fuel throughput levy issue? As part of the foreshadowed future alignment of definitions, how might these concerns best be overcome?	Please refer to section 4.4 of this submission. WAC also notes that it intends to negotiate the structure of its charges with airlines, including the fuel throughput fee.
25	32	How should land and other airport assets be valued? How do current approaches for valuing and revaluing airport assets impact on charges for airport services? Is there an appropriate degree of transparency in regard to revaluations of the asset base? Aside from land valuation, are there other significant conceptual issues that need to be addressed?	Please refer to section 4.2 of this submission. The critical issue for WAC is to establish an asset value that is fit for purpose within the price monitoring framework. The asset valuation approach that WAC has applied (for the purpose of informing its price negotiations) is consistent with that adopted by the ACCC, and as such WAC believes that it is reasonable.
	33	How is airport land most appropriately valued for charging, monitoring and longer term capacity augmentation purposes? Is the argument that airport land should be priced in line with its value in alternative uses (less conversion and related costs) conceptually valid? Aside from accounting requirements, are there measurement or other constraints that militate against the use of this approach in practice?	Please refer to section 4.2 of this submission.
	34	How would revaluations of airport land based on its value in alternative uses impact on airport charges and ticket prices at the price monitored airports? To what extent should airports be able to appropriate the benefits of increases in the value of airport land subsequent to the commencement of their operating leases? At centrally located airports such as Sydney — where the pressure on ticket prices from land revaluations might be expected to be greatest — how would likely price increases compare with the lower costs of travelling to and from the airport, relative to those for airports further from the city centre?	Please refer to section 4.2 of this submission. WAC does not expect to revisit asset valuations for price modelling purposes in the foreseeable future.

Page	No	Questions	WAC Response
27	35	Is more guidance on efficient pricing required? Should a future price monitoring regime encapsulate explicit pricing principles? What might these encompass and what would they add to the existing guidance on pricing provided in the Government's Review Principles, pricing frameworks developed for other regulated infrastructure sectors, and the principles to be included in the national access regime?	No. WAC believes that the Government's Review Principles are appropriate. It is important that airlines and airports are able to negotiate commercial agreements without undue regulatory direction regarding efficient pricing.
	36	Is there a risk that the inclusion of more detailed pricing principles, and the increasingly 'forensic' monitoring that might ensue, would compromise a light handed approach to prices oversight? Would it be appropriate for the structure of airport charges, as well as their overall level, to be a potential trigger for more heavy handed price regulation?	WAC believes that the experience under the CPI-X regime demonstrates the costs associated with 'forensic' regulatory approaches. A move towards a more forensic regulatory approach will constrain the abilities of the airport and airlines to negotiate effectively. The Productivity Commission should take care to ensure that any move towards a more forensic and intrusive regime is justified in terms of the prospective costs and benefits. Please refer to WAC's answer to question 35 above.
28	37	How could dispute resolution be improved? As the negotiation process 'matures' and precedents are established, to what extent will it become quicker and easier to resolve disputes concerning access to, and the price of, airport services?	Please refer to sections 2.6 and 4.5 of this submission. The dispute resolution mechanisms have not been activated at Perth Airport.
	38	What changes could airports and their customers make to reinforce such developments? For example, are there opportunities to enhance two-way information flows or the dispute resolution procedures specified in service agreements or contracts? Do the latter currently help to facilitate fruitful negotiations?	Please refer to WAC's answer to question 37 above.

Page	No	Questions	WAC Response
	39	Are there strengths in the processes adopted at particular airports which could be employed more generally? Do approaches and frameworks to facilitate dispute resolution in other infrastructure sectors point to possible ways forward in the airports area? Is there anything to be learnt from dispute resolution arrangements applying in the airports area in other countries?	WAC supports the development of dispute resolution processes through commercial negotiation. It is noted that in establishing such processes, the negotiating parties naturally have regard to arrangements that are in place elsewhere, and adopt a negotiating process that best meets their particular needs. The current arrangements have worked well to date, and while WAC intends to work with its customers to make further improvements to these arrangements, it does not believe that there is any need for the regulator to mandate a particular approach.
	40	Would there be value in the Government and key stakeholders developing some general guidelines or a code of practice for commercial agreements governing access to airport services? If so, what might such guidelines or a code entail? Would such an approach make it less likely that the generic national access regime would be invoked? To what extent would guidelines or a code be likely to simply replicate practices that will emerge naturally as the negotiation process matures?	No – for the reasons outlined in WAC's answer to question 39 above, WAC sees no need for such guidelines or codes to be developed.
	41	Is there any case for a formalised airport-specific arbitration process? Or would the availability of such a process fundamentally undermine commercial negotiations and thus effectively constitute a return to heavy-handed regulation?	WAC believes that Part IIIA of the TPA provides for a formal mechanism of arbitration, if the parties fail to reach commercially acceptable agreements. As noted in section 4.6.1, whilst this process is (probably unavoidably) lengthy and uncertain, the nature of the process itself provides an incentive to all parties to reach a commercial solution. WAC supports this process. An airport-specific arbitration process would be likely to have the effect of returning regulation to a more heavy-handed regime in which prices and terms are determined by the regulator, rather than through commercial negotiation.

Page	No	Questions	WAC Response
29	42	Regional airline services Which of the general issues raised earlier in the paper are of most importance to regional airlines? To what extent do the policy imperatives for regional airlines differ from those for the major domestic and international airlines? Are there other policy issues of importance to regional airlines that fall within the terms of reference but which are not encompassed by the preceding discussion?	WAC has no comments in relation to this issue.
	43	What benefits do the special arrangements in place to assist regional airlines at Sydney Airport provide? How do those benefits compare with the costs? What would be the longer term implications of growing divergence in airport charges between airport users that could result from a continuation of the price cap for regional airlines? Will continuation of the ring fencing arrangements for regional landing slots add significantly to capacity constraint problems at the airport in the future?	WAC has no comments in relation to this issue.
	44	If the Government wishes to continue to support the operations of regional airlines at Sydney Airport, could this support be delivered in a more efficient way?	WAC has no comments in relation to this issue.
30	45	Other matters Are there aspects of the wider regulatory regime governing the operation of airports that need to be specifically examined in the context of this inquiry? More broadly, are there other areas of the regulatory regime where reforms would be likely to deliver significant price benefits to users of airport services and the travelling public?	No.

Page	No	Questions	WAC Response
	46	Do the current price monitoring arrangements for aeronautical services at the major airports have any significant spill-over effects for non-airport/airline related activities? For example, have constraints on aeronautical charges encouraged inefficient expansion of non-aeronautical activities at the airports (such as retailing) to the detriment of businesses elsewhere? Have there been other negative impacts — such as increased congestion adjacent to airports?	No. WAC is not aware of any such concerns in relation to Perth Airport.

Appendix 2: Case study - International Terminal Baggage Handling Project

Background and Introduction

As noted in section 2.5.2 of this submission, the International Terminal Baggage Handling project provides a good illustration of how the price monitoring regime has facilitated a successful commercial negotiation and outcome for WAC and the airlines. This case study provides:

- a brief summary of the improved facilities and services delivered by the project;
- the industry consultation process adopted by WAC and the airlines to determine the preferred project scope;
- the key project issues that were the subject of consultation;
- an overview of the commercial negotiations relating to the project; and
- concluding remarks in relation to the price monitoring regime, based on the experience gained by WAC in the course of this project.

Overview of the project

On Tuesday 30th April 2005, the \$25 million upgrade of Terminal 1 (International) at Perth Airport was formally opened by the Premier of Western Australia, the Hon. Dr Geoff Gallop. The project represents a significant investment in airport infrastructure; it added 2500m² of floor space and 14 additional check-in counters. The works also included replacing the existing check-in counters and installing an inline, checked baggage security screening and automated baggage-handling system together with an additional makeup carousel.

The detailed scope and costs of the project were developed by WAC in conjunction with the airlines and confirmed in a letter to Qantas (John Richards) in August 2003 as follows:

- 38 new check-in counters;
- one new baggage makeup belt;
- a checked bag screening facility;
- an automatic baggage handling system; and
- building extension to house the above facilities.

The letter also noted that the additional cost will be recovered through an extra charge not presently included in the Prices and Services Accord. Whilst the overall scope of works was agreed in August 2003, a number of design issues remained outstanding at that time. WAC and the airlines agreed to work co-operatively to resolve these matters. Details of the consultation process adopted are set out in the following section.

Industry consultation process to determine preferred project scope

The project was initiated by the Government's announcement in December 2002 that there should be 100% checked bag screening for all international services departing Australia. On 11 December 2002, a sub-committee of the Airline Operators Committee (AOC) was convened to review four alternative project options. The meeting concluded that detailed design work and detailed costs on two versions (known as C0 and C2) of the preferred option should proceed.

The three alternative options that were rejected by the airlines were each estimated to cost between \$5 million and \$6 million. The airlines' decision to reject these options reflected their clear preference for a project scope that was significantly beyond the minimum requirement of the Government's security directive.

Following further discussion with the sub-committee of the AOC, WAC wrote to the chairman of the AOC in March 2003 detailing the preferred project scope. In particular, the letter noted that the airline operators agreed to proceed with an automatic baggage handling solution on the basis of increased flexibility, redundancy and overall cost effectiveness.

WAC and the airlines agreed a co-operative working arrangement for ensuring the successful delivery of the project. In particular, WAC and the airlines agreed that:

- a project manager and design architects should be appointed;
- a Project Control Group (PCG) should be established, with two representatives nominated from the AOC; and
- the PCG should meet monthly, with its first meeting scheduled for April 2003.

During the course of the project, the PCG met on 23 occasions in order to resolve a wide-range of detailed design and project delivery issues. The following section provides a high-level summary of some of the matters that were resolved by the PCG, which proved to be an effective forum for delivering the project to the satisfaction of all parties involved.

Key project issues subject to consultation

In this section, WAC briefly summarises the key project issues that were resolved through the adoption of a co-operative and consultative approach between WAC and the airlines. These issues included:

- resolving the requirements of Qantas, and considering the possible reconfiguration of existing Qantas facilities;
- finalising changes to Qantas and Skystar tenancies;
- assessing the operational impact of project and the treatment of associated costs;
- relocation of Sales/Ticketing office;
- considering the possible adoption of a Build Own Operate Transfer (BOOT) model for the delivery of the project;

- addressing the airlines' requirement that baggage handling and check-in capacity is not compromised during the execution of the project;
- finalising check-in design including consideration of: occupational health and safety issues; lighting issues; duress alarm buttons; provision of telephones; accommodation of future installation of PA system and self check-in facilities; type and specification of data cabling; and location of computer monitors;
- design of check-in counter prototype in association with WAC, Airport Alliance, Qantas, Skystar and SITA;
- estimating the number of bags to be transferred between the domestic to international terminals so that requirements for an unloading area and conveyor could be assessed;
- considering other important design elements such as: plinth heights to baggage make up loops; roller bed configuration; and size of LCD displays;
- specification of air conditioning and heating systems; and
- provision of extra queuing barriers.

As noted earlier, the range and quantum of issues required a co-operative approach between all parties to ensure that the final project delivery met the needs of the airlines and WAC in an efficient manner.

Negotiation of commercial matters

Throughout the commercial negotiations, WAC sought to provide detailed information to the airlines regarding the costs and pricing of the project.

Details of the pricing principles and methodology applied by WAC were disclosed to the airlines. Proposed prices were assessed with reference to the building block model that was used to assess the prices contained in the 2002 Prices and Services Accord. However, the passenger number forecasts applied were updated to reflect the latest available information at the time. (These forecasts were prepared by BAA in October 2003 for use in the Master Plan.)

In order to ensure that the project could be delivered as cost-effectively as possible (and within funding and other constraints) WAC explored the option of procuring security screening, baggage handling equipment and check in counters via a build-own-operate arrangement. This innovative approach proved to be less cost-effective than the option of WAC internally funding the project. As noted, a key factor affecting the choice of the preferred funding alternative was the objective of minimising overall costs to the airlines.

WAC's initial price offer involved a price path that would escalate with movements in the CPI. However, the airlines expressed a preference for charges that would be fixed in nominal terms. Accordingly, in early 2004, WAC offered and the airlines accepted a charge for the new services that is fixed in nominal terms for the period from the date of effect of the charges for the additional services (generally 1 January 2005) to 30 June 2007.

Commercial negotiations surrounding the project were robust, however they were undertaken by all parties in a timely, professional, and effective manner. In particular, as

noted, there was a high level of transparency regarding WAC's costs and the basis of its prices.

Closing remarks

This case study provides an example of how Perth Airport and the airlines worked together to achieve the successful delivery of a major capital project that had important implications for the commercial operation of the airport and the airlines. The project was required in order to address a Government directive in relation to airport security, but it is clear from this case study that:

- the detailed requirements of the airlines played an important part in the final scope of the project; and
- the airlines and WAC worked together constructively to develop innovative and cost-effective solutions to a wide range of complex problems during the course of the project.

It is also important to reflect on how this project may have proceeded under CPI-X regulation. There are two broad possibilities:

- the regulator would need to make a capital expenditure allowance for this type of project at each 5 yearly price review; or
- the regulator would make an assessment of the capital expenditure requirements for this type of project as and when the investment need arose.

WAC believes that this case study illustrates very clearly that the first approach would be highly unlikely to deliver an optimal outcome. This is because the project scope can only be ascertained through detailed discussions with the relevant commercial entities, and cannot be forecast with any degree of confidence by a regulator in advance of those discussions taking place.

In relation to the second approach, WAC believes that this would have proved to be highly impractical. It would require the regulator to sit alongside the commercial discussions and to second-guess the cost estimates and the project scope. Rather than facilitating the efficient delivery of the project, the involvement of an industry regulator in this situation would more likely have hampered innovation and constrained the development of effective commercial relationships between the airport and the airlines.

As noted earlier, the International Terminal Baggage Handling project provides a good illustration of how the price monitoring regime can facilitate effective commercial negotiations and beneficial outcomes for all stakeholders.

Appendix 3: Prices and Services Accord