



INTERNATIONAL AIR TRANSPORT
ASSOCIATION
(IATA)

Submission to the Productivity
Commission's inquiry into price regulation
of airport services

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Executive Summary

This submission presents the response of International Air Transport Association (IATA). IATA's mission is to represent, lead and serve the airline industry and brings together 261 member airlines whose flights account for 94% of all international scheduled air traffic. IATA welcomes this opportunity to submit its comments in response to the Productivity Commission's Draft Report on Pricing Regulation of Airport Services. IATA's comments are from an international perspective and are based on the requirements of, and practices in, international civil aviation.

IATA would like the Productivity Commission to take the following key facts into account:

1. Airports are natural monopolies with considerable market power
2. The Australian government has recognized the need to prevent airports from using their market power for windfall gains
3. Price Monitoring does not work and is not effective in preventing airports from realizing windfall gains
4. As the reasoning behind the current price monitoring regime seems to be the implicit threat of future price controls, a return to a price controlled regime would enable the Governments' objectives to be met directly and efficiently
5. If the Government continues with the current price-monitoring framework, effective pricing guidelines and efficient access to third party arbitration needs to be developed.

The Commission has solicited submissions in 2 broad categories related to price regulation of airport services. IATA's response to these issues can be summarized as follows:

Outcomes of the current arrangements

- The current arrangements do not provide adequate incentives for the airport operators to reach fruitful agreements with airport users
- There is no evidence to suggest that compared to the previous arrangements, the current arrangements have better provided for required investments
- Data gathered in the ACCC's price and quality monitoring reports, though useful, cannot be solely used to judge the effectiveness of the price monitoring regime or consistency with the regime's objectives as laid out in the Terms of Reference
- In the period of 2002~2005, price levels at all the Australian price monitored airports increased by up to 76% (average 46%) even though airlines decreased their overall controllable costs by 11%.
- Price and service monitoring in its current form is ineffective in meeting the Government's objectives due to lack of:
 - Pricing guidelines

- Effective access to third party arbitration in case commercial agreements are not reached between the airport and its users
- There are a number of deficiencies in the current charging structure including
 - proliferation of fuel throughput levies
 - price discrimination and peak/off-peak pricing
 - endorsement of revenue collection in excess of production costs

Future arrangements

- IATA firmly believes that the Government objectives of effective price regulation as specified in the Terms of Reference can only be met by re-introducing a price cap based regulatory mechanism of airports.
- In case the Australian government continues with light-handed regulation, immediate steps need to be taken to rectify the deficiencies identified in the current regulatory regime.
- In particular, the use of Asset revaluation tactics to inflate the cost base (and thus higher prices) should not be permitted as it results in windfall gains at the expense of the users – airlines and passengers.
- Improvements are also required in the guidelines related to dual-till, price discrimination, fuel charges and non-revenue neutral pricing policies as the current arrangements do not lead to equitable outcomes

IATA urges the Productivity Commission to give due consideration to the views included in this submission. It is IATA's intention to participate in the subsequent stages of this inquiry based on our members' positions. The Commission is also requested to contact IATA at any stage of this inquiry if additional information or clarification is required.

IATA's views and key positions are further detailed in the following sections:

1. Performance of the current regulatory model
2. The Preferred Regulatory model
3. Asset Valuation
4. WACC and the appropriate rate of return
5. Fuel Throughput Levy

1. Performance of the current regulatory model

There is a broad range of regulations governing the Australian airports as a whole, but the key relevant aspects are:

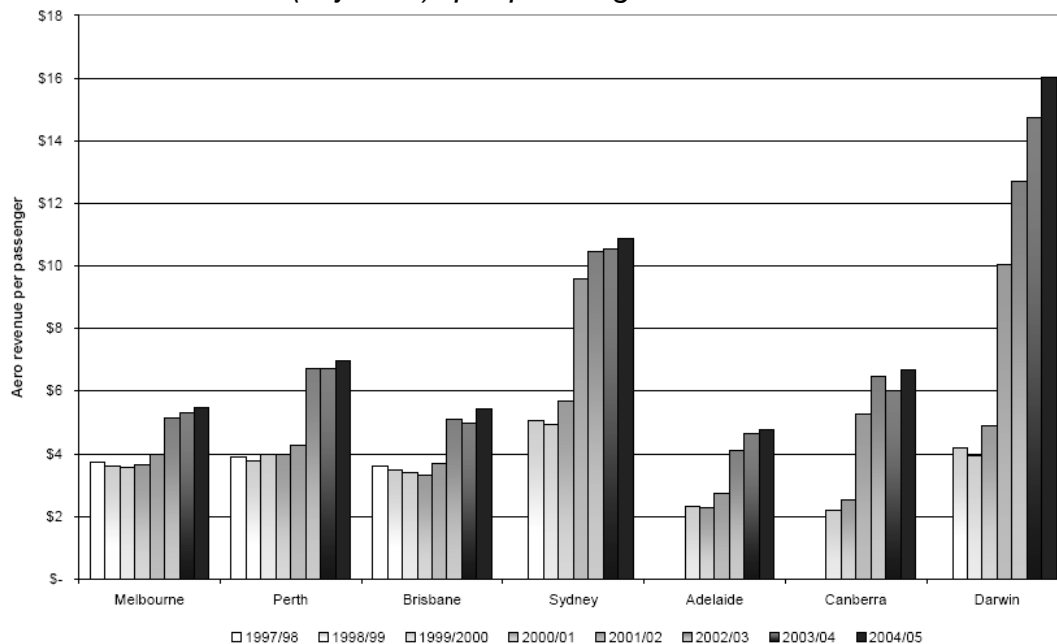
- Price levels and value chain imbalances
- Charges structure
- Procedural efficiency and Transparency

1.1 Price levels and value chain imbalances

As a result of the 2002 decision, the ACCC's role has been limited to one of price and quality of service level monitoring. ACCC has published detailed reports on these issues comparing the results of the price-capped airports versus the price-monitored ones. ACCC's findings summarized the following for Airport Prices:

"In 2004–05 passenger numbers continued to grow, after a fall in traffic in 2001–02. Aeronautical revenue per passenger (as a proxy for prices) also continued to increase at all airports. Increased passenger numbers, combined with increased revenue per passenger, resulted in increases in total aeronautical revenue of between 10 and 28 per cent. Changes in aeronautical operating expenses per passenger varied among airports, with most reporting reductions in costs or small increases, leading to strong increases in operating margin per passenger at the majority of airports. Changes in returns on reported assets were more varied and reported results are affected by significant upward revaluations of asset values by some airports."

Aeronautical revenue (adjusted) per passenger*

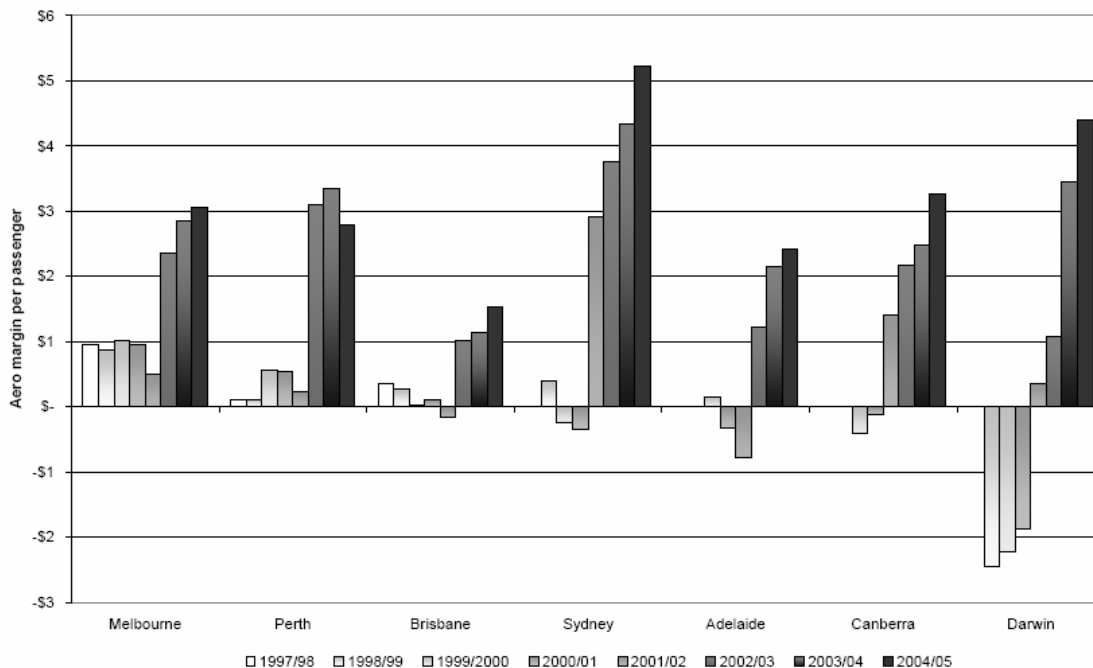


(source : Airports price monitoring and financial reporting 2004-5/ACCC-February 2006)

Between 2002 and 2006, the increase in aeronautical revenue per passenger has varied from 13% to 76 % depending on the airport with an average of 46% for the 7 price-monitored airports (source: ACCC 2006a).

Also, a review of the aeronautical operating margins for all the 7 airports show dramatic increases – especially during the last 3 years.

Aeronautical operating margin per passenger



(source : Airports price monitoring and financial reporting 2004-5/ACCC-February 2006)

It is worthwhile to note that during the same period, the airline industry successfully reduced its non-fuel unit costs by 11% but accumulated a loss of about US\$30billion (globally). This is particularly important in the context of airport profitability – Melbourne, Sydney and Brisbane were among the 10 most profitable airports globally in 2005 (operating profit as a % of revenue – source TRL: Airport Performance Indicators 2005).

It can be concluded that the airports have used their market power to maximize their profits under the light-handed regulation. This has led to imbalances in the aviation value chain as the airlines are at the mercy of the airports. Such an imbalance is not in the best interests of the viability and growth of the Australian aviation industry and the ultimate users – the passengers.

One of the key Government objectives of the Regulatory framework is:

“.....facilitating commercially negotiated outcomes in airport operations.....”

While the price monitoring provides an overview of the airport pricing structure and revenues, there are no benchmarks to make a qualitative analysis or judgement on the airport’s performance versus the Government’s objectives. The biggest deficiency lies in the absence of guidelines for acceptable pricing.

The Commission has also recognized this weakness in its Issues Paper and it is IATA's position that such guidelines should have been put in place when the current regime was implemented in 2002. This would have set "boundaries" for both airports and airlines engaging in commercial negotiations and would surely have led to more equitable outcomes.

1.2 Charging Structure

The 3 key factors while determining aeronautical charges are the definition of services, the asset base and the acceptable (or target) rate of return. The current light-handed regulatory framework fails to provide clear guidelines on all 3 fronts.

- The current regulatory framework fails to provide clear guidance on the definition of aeronautical assets and charges. This is particularly evident in the area of fuel facilities and the Fuel Throughput Levy being charges by Brisbane and Perth. Fuel Throughput Levy needs to be included in the regulated Aeronautical Charges.
- ACCC price monitoring reports have shown that there have been some substantial upward revaluations of assets by airports leading to inflated asset values - Brisbane: 95%; Perth:105% (source : Airports price monitoring and financial reporting 2004-5/ACCC-February 2006). Airports continue to use these inflated asset values to artificially portray a low rate of return in an attempt to justify increase in charges. IATA does not support one off revaluation of assets and supports the Commission's view that such revaluations run counter to the new IFRS.
- It is IATA's view that regulation needs to be in place to determine the acceptable (or target) revenue that can be earned by the Airports. The current regime does not provide any guidelines or limits on the revenue, profitability or any other measure of financial accountability on the airports. IATA views this as a serious shortcoming of the current framework as it gives a free reign to the airports.

Related information on these issues is detailed in Sections 3 to 5.

1.3 Procedural efficiency and Transparency

In its Issues Paper, the Productivity Commission has listed a number of relevant questions related to Procedural Efficiency. IATA's concerns are as follows:

- Lack of guidelines and incentives for airports to consult effectively with airlines
- Equitable commercial agreements can only be made if the airports enter the consultations in the true spirit of cooperation and transparency. This has not always been the case
- There is no efficient mechanism in place for the airlines to appeal to a third party if the airport continues to unilaterally impose unreasonable charges
- Lack of a mechanism for airlines to recover any charges that have been proven to be excessive as a result of a public inquiry or legal instruments.

In summary, the current light-handed regulation has a number of deficiencies and has not been able to meet the Government's objectives on Airport pricing.

2. The Preferred Regulatory Model

It is IATA's basic position that effective regulation of Australian airports can only be achieved through an unambiguous regulatory model that ensures that the monopoly Airports cannot abuse their pricing power for windfall gains. This calls for a price cap arrangement and clear guidelines on the critical drivers of airport charges. In the event that the Australian Government continues with the current light-handed regulatory regime, IATA urges the Government to urgently rectify the deficiencies identified in the previous section and to implement the other improvement opportunities listed below.

In privatising Australia's major airports, the Government recognised the monopoly market power of Airport that could potentially be used to inefficiently raise prices for their services above those that would prevail in a more contestable market. Accordingly, privatisation was accompanied by the introduction of economic regulation at the major airports. Thus, the goal of Economic regulation has to be the reproduction of the desirable elements of a competitive market in a situation where competition is not possible.

The Productivity Commission should give due consideration to the following critical aspects for an effective regulatory regime:

- Price Cap Regulation
- Dual or Single Till
- Price discrimination and Peak/Off-peak pricing
- Revenue in excess of production costs

2.1 Price Cap Regulation

Airports are natural monopolies and thus require some form of economic regulation. While there are many different methods of economic regulation in use across a range of industries around the world, it is IATA's position that **Incentive Regulation (CPI-X)** is the most appropriate as in essence, CPI-X aims to mimic the competitive market outcome by:

- Allowing for innovators to enjoy temporary benefits
- Providing an incentive to reveal attainable cost efficiencies
- Being forward looking with forecasts of potential productivity improvements whereas rate of return is backward looking and is based on historical costs
- Giving regulators more degree of freedom because of the range of factors that can go into X
- Allowing scope for bargaining under CPI-X (which may lead to better outcomes)

Guidelines are also required on the Asset Base and Allowable Rate of Return. Detailed IATA positions on these 2 critical issues are detailed in Sections 3 and 4.

2.2 Dual or Single Till

By definition, the primary purpose of an airport is airline operations. Airports in Australia have used the dual till framework to maximize their commercial revenues in addition to imposing substantial increases in aeronautical charges. Australian Airports now get around 40~50% of their total revenues from Non-aeronautical activities. While IATA recognizes and supports the Airport Operators' right to optimize returns from its investments, we believe that the Government's original intention of allowing for unrestrained commercial revenues to minimize the need for increases in airport charges has not been realized.

Given the increase in the profitability of the Australian airports that result from the dual till, at the expense of higher charges to airlines and higher fares to their passengers, the reasonable interests of users to the airports are better served by the single till than by the dual till. IATA supports the implementation of the single till for a number of reasons:

Interdependency It has long been accepted that there is a very strong symbiotic relationship between airlines and airports, as each needs the services provided by the other. Economic activities at airports are generated by the presence of airlines – the situation at airports in Australia is no exception. It is reasonable to assume that in the absence of aeronautical services there would be no market for non-aeronautical services such as retail concessions and car parking.

Absence of a competitive environment for airports Airports are natural monopolies, thus their pricing behaviour is tempered by the lack of formal competition. It is IATA's strong belief that if it were possible to place airport management companies into a competitive environment, for example, if they had to regularly tender to provide airport services to airlines, they would not treat aeronautical and non aeronautical as two distinct and separate income streams. Instead, a rational airport provider is most likely to promote aeronautical pricing solutions that would increase passenger throughput at their airport in order to maximise their non-aeronautical revenue. Thus they would use income generated from non-aeronautical services to support aeronautical charges to encourage additional passenger throughput.

Under-investment in aeronautical resources Under a dual till approach, airports will have to make continued capital investment decisions, given there is an implicit scarcity of financing resources within all companies, capital will be allocated to fund resources that provide the highest economic return. Non-aeronautical investment as an unregulated source of income will generate higher returns when compared to aeronautical investment. Thus future investment decisions under a dual till environment will be weighted to non-aeronautical infrastructure. This could lead to an imbalance in service levels between the two areas and ultimately could compromise the integrity of the aeronautical infrastructure.

It has been argued that the single till approach may provide weaker incentives for the airport operator to invest in improvements in its non-aeronautical assets. However, under single till the aviation charges are usually set by considering budgeted cost and ancillary income streams, which will be discussed with the users, higher results thanks to performing better than agreed (lower cost, higher ancillary income) remains with the operator, with the compliments of the users until the following regulatory review when

the single till is re-set. This provides an incentive to the airport to develop non-aeronautical revenue whilst at the same time ensuring that in the longer term airlines share in the benefits of the fact that it is they who bring the retail spending power of passengers to the airport.

2.3 Price discrimination and Peak/Off-peak pricing

One of the Government's Review Principles in the Terms of Reference of this Inquiry, relates to:

"b) 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."

IATA does not see any positive relationship between price discrimination and efficiency in the utilization of resources. Therefore, IATA does not agree to price discrimination in the forms of peak/off-peak pricing, marginal pricing and discriminatory & non-cost related discounts and rebates, which we further elaborate below.

Any charging policy should be consistent with the basic ICAO principles on user charges – non-discrimination, transparency, cost-relationship and meaningful consultation – and subject to economic regulation

With regards to peak/off-peak charging, such demand-altering pricing schemes could only have an effect if users have control over their demand patterns. This is not the case. Peak charges will therefore only increase the costs for those users operating during the peak periods and may discriminate against certain users. Further, the transparency of airport charges deteriorates with peak/off-peak charges.

Further, during times of low demand, the airlines usually do not have the possibility to generate the required levels of revenue to adequately cover their full costs. Hence, the surplus revenue during high demand is essential for airlines to generate the normal profits or in some cases, just to cover full costs of operating a specific route. If indeed the airlines were to be deprived of generating surplus revenue during times and seasons of high demand, then they would be compelled to eliminate the losses they accumulate during low demand by reducing capacity offered during such periods, while maximising capacity during the peak. Therefore, monopoly pricing during congestion could lead to escalating the problems of congestion and not resolving them.

In view of all of the above, we strongly urge the Productivity Commission to recommend that peak/off-peak pricing not be allowed in future, and not leave such decision in the hands of the monopoly service providers.

2.4 Revenue in excess of production costs

One of the Government's Review Principles in the Terms of Reference of this Inquiry, relates to:

“c) 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.”

IATA does not support the collection of revenue in excess of production costs to create additional capacity. This is basically pre-financing of new capital investments and IATA's opposition to the proposal is based on four main arguments:

- Expensive. Raising funds for new capital investments from airlines effectively means paying for the projects where the source of financing is most expensive. Airlines have an estimated cost of capital of 7-8%, significantly higher than the cost of capital faced by governments or public-sector bodies. There is no spare cash fund in the airline industry to meet these pre-financing related charges, so it effectively acts as an additional financing tax on airlines.
- Inefficient. Providing an upfront funding pool can distort incentives and reduce the cost-effectiveness of the capital investment. By placing the cart in front of the horse, it weakens the potential returns from the research and investment. For example, the use of funding from external sources means that the capital investment in question seeks to maximise its cost-effectiveness to generate sufficient returns to repay the funding. By contrast, the use of pre-financing creates a fund to use, but fewer incentives on spending the money in the most effective way.
- Impractical. Global airlines have experienced the worst financial crisis in their history over the last five years. Even though some of our members have returned to profitability, the rate of return on capital employed is only around 2%, well below the 7-8% cost of capital level required for long-term sustainability. Airlines also continue to face significant risks to profitability from volatile fuel prices and burdensome regulations. In summary, a pre-financing related charge places an unjustified additional financial burden on an industry that is already facing significant financial pressures.
- Unfair. The success of a capital investment creates benefits far beyond the airline industry. Airlines have an interest in the cost-effectiveness development of such investments and would pay for usage of the system once implemented. But the wider economic and social benefit of the project means that governments and airports should have the key stake in financing its development.

It is difficult to justify why airlines should be a special case in bearing the upfront cost and risk through pre-financing a capital investment. This is not the case in other transport industries. For example, in the UK rail system investment in infrastructure safety systems is financed by the infrastructure manager (through either direct debt issuance or debt through a special purpose investment vehicle) and only reflected in user charges once operational.

In conclusion, IATA does not support the collection of revenues in excess of production costs for future infrastructure investments.

3. Asset Valuation

Several of the price monitored Australian 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. IATA believes that an increase in land values based on the use of an opportunity cost valuation is:

- Inefficient. It overvalues the true value of the asset, certainly in relation to the price that was initially paid for it. Airports argue that it provides a signal of the value captured by the airport being in a particular location. However, allowing airports to artificially increase the value of their assets and the return they receive on it does not create any clear incentives for greater efficiency in the use of these assets. By contrast, airports can look to rely on higher land values to maintain their profitability, rather than actively work with airline customers to improve operational efficiency.
- Unfair. It merely creates unearned returns (i.e. windfall gains) for an airport. The asset base on which an airport earns its return should properly reflect the risk that has been taken, i.e. the capital that has been invested. Airlines should only be expected to compensate the airport for this invested capital, not for higher values that airports have not paid for or placed capital at risk.
- Impractical. When there is no feasible alternative use, the opportunity cost valuation has no clear basis. In this case, much of the land is either designated for aviation use or impractical for other uses. Indeed, the land is leased rather than owned by the airport company, so could not be sold without Government consent in any case. If the land is owned, and can be sold, it can appear in the airport's financial accounts, with the higher value realised when sold, but should not form part of the "regulated" asset base.
- Not standard practice. As outlined in more detail below, appreciating land values are not taken into account in the majority of other regulatory structures.

The privatisation of Phase I and II airports did not explicitly include a valuation of aeronautical assets. However, it did require an investment of capital commensurate to the bidders revealed valuation of the asset base. As such, initial expected returns were be on the basis of this revealed valuation and expected future investment.

It is also important to note that the revaluation of land to reflect higher surrounding property values (and therefore a higher opportunity cost of land use) is **not** standard regulatory practise elsewhere.

The New Zealand Commerce Commission has used it in 2002 to value the land asset base at New Zealand's three main airports. However, in the case of Auckland airport, a move from depreciated replacement cost to opportunity cost actually reduced the value of its airfield land. In addition, the Commission was strict in treating the opportunity costs of specialised assets as zero, as there was no alternative use. Instead, these assets were included in the asset base at historical cost.

In the UK and Ireland, land forms part of the typical Regulated Asset Base (RAB) but is not given an explicit value. Instead, the initial value of the RAB is usually calculated on

the basis of the debt and equity value at the time of privatisation and adjusted in accordance with investment, depreciation and inflation but not by external and unearned increases in asset values. In particular, the UK and Ireland approach values the RAB on the basis of:

- The value that investors initially placed in the company at the time of privatisation, based on its enterprise (debt plus equity) value. If the assets were undervalued at the time of privatisation it can represent a windfall gain to the company (e.g. in terms of a subsequent uplift in equity market capitalisation) but not one that customers should be forced to pay for through higher charges on a revalued asset base.
- The asset base is not valued on the basis of opportunity cost. Often, the land or assets in question are legally required to be used for their current purpose, so have no legal alternative use.
- The RAB changes throughout the regulatory control period on the basis on incurred capital expenditure, depreciation and expected inflation. Adjustments are also made at each regulatory review, where changes are made on the basis of difference between actual expenditure and planned expenditure.
- A real Weighted Cost of Capital (WACC) return is allowed on the RAB. Therefore, actual return differs as the WACC is applied to a RAB that changes in value in each year of the regulatory period.
- Land valuation has typically only been applicable when surplus land assets are disposed. In this case, the Airport can realise capital gains on its land holdings. However, in some cases, the regulator seeks to share some of this windfall gain, for example, in the UK water industry, an amount equivalent to half the sale price of the land is deducted from the RAB.

4. WACC and the appropriate rate of return

One of the key improvement areas that the Productivity Commission needs to consider is the issue of appropriate rate of return. In any regulatory model (included light handed), there need to be clear regulations (or guidelines in a light handed model) that specify what the appropriate rate of return is. Only then will airports and its users be able to judge the validity of the revenue (and pricing) levels under discussion.

In Australia, the return that is allowed to be earned on a regulated asset base is typically based on the calculation of a weighted average cost of capital. The cost of capital is the level of expected return required by financial markets to provide capital to a firm for a given level of risk.

The calculation of the WACC is often complicated, producing a range of possible values from which the Regulator makes a determination of the actual value. However, it is an extremely important part of the regulatory model. Small changes in the WACC can have a major impact on the level of the price cap that is set.

Best practices from regulatory models around the world suggest that the process involved in calculating the WACC raises several issues, amongst which are:

- Actual not project gearing level used. The gearing level of a firm can change significantly, especially if new investment is funded primarily through debt. As such, firm's are allocated a relatively high WACC based on its capital structure at the start of the period, but as gearing increases the actual WACC they face reduces. Alternatives that a regulator can use include a projected gearing level (e.g. for NATS in the UK) or an assumption of the optimal gearing level for the firm during the regulatory period.
- Low interest rates have given regulated firms a windfall. With historically low interest rates over the last few years, the actual WACC has been lower than the level allowed for by the regulator. Analysis suggests that as there is often a delay in new investment being added to the regulatory asset base (e.g. only one adjustment each year) the marginal return may actual be below the allowed WACC for many firms during each regulatory period. However, regulated firms have continued to invest significantly, suggesting that their marginal returns are still well above the actual cost of debt (rather than the WACC) that they face.
- Little probability for equity investment. Though the WACC is set on the basis of the cost of equity and debt, firm's have typically relied on debt as the main source of external finance for new investment. The regulator can pursue options such as a split cost of capital (i.e. a lower WACC for a return on the existing regulatory asset base, a higher WACC to attract equity finance for new investment).

5. Fuel Throughput Levy

IATA is of the position that all fees and charges for services or infrastructure provided on a monopoly basis should be subject to economic regulation.

Brisbane and Perth airports have implemented a Fuel Throughput Levy. Given that the Australian Airports have monopolistic control over the fuel facilities and that the airlines are the ultimate consumers, all fuel services and charges (including Fuel Throughput Levy) should be included in the regulated aeronautical charge base.

IATA recommends that the following guidelines be applied while calculating all fuel related charges:

- The cost of the centralized infrastructure and a reasonable return on equity (pipelines, hydrant system, storage facility, etc.) may be recovered through fees charged to either the airlines or the fuel & oil suppliers.
- However, it has to be ensured that any such fees are cost justified and reasonable and must be established in full and transparent consultation with the users and the airlines.
- Information on the cost of infrastructure (pipelines, hydrant system, storage facility, etc.) should be detailed, transparent and available for scrutiny by all parties including the end users and the airlines.
- As a minimum, this information should provide detailed staff, operating, and maintenance costs, depreciation (historical cost and depreciation period should be shown), and the cost of capital as separate categories.
- The applicable fees must be published to ensure that all users (and airlines if applicable) pay only their fair share of costs.
- It needs to be ensured that there will be no double charging for airport infrastructure through e.g. other airport fees.
- Any charge that is levied by an airport, which is in excess of justified costs and a reasonable return should be considered as not appropriately cost related and hence must not be allowed.
- A formal process should be put in place to ensure that the owners and operators of the infrastructure abide by these requirements.