INQUIRY INTO PRICE REGULATION OF AIRPORT SERVICES

Submission by The Shell Company of Australia Limited

Background

The Shell group of companies in Australia is a refiner and supplier of aviation gasoline (AVGAS) and aviation turbine fuel (AVTUR) and provides storage and refuelling facilities and services at capital city and regional airports.

This submission focuses principally on the monitored airports[1]. By their nature these airports are natural monopolies[2] but it does not follow as a matter of course that economic inefficiency will result. Rather, the issue becomes one of how and the extent to which airport owners extract economic benefits for themselves from that ownership. In Shell's experience the behaviour of airport owners varies considerably. Some owners are more transparent than others. Those owners that are less transparent tend to have less concern about the value and benefit that is being provided to Shell and its customers. In Shell's experience this leads to less than efficient outcomes in terms of the ultimate cost of fuel and allocation of capital at those airports.

At the monitored airports fuel is supplied through joint user hydrant installations (JUHI). The JUHI are fuel storage, transfer and under ground reticulation facilities to the aircraft bays jointly owned with other fuel suppliers. Shell is also a supplier of fuel at regional airports, usually from facilities that are owned solely by it.

A JUHI is operated by a participant who is responsible for managing the receipt of transfers from suppliers into the storage facility, storing the received transfers and 'reticulating' it via the distribution network to the tarmac outlet at each aircraft parking bay and monitoring total JUHI fuel volume movements. Where aircraft are fuelled from a mobile tanker the manager is responsible for providing facilities from which the fuel can be uplifted and managing the fleet of tankers. The manager is also responsible for the maintenance of the JUHI generally.

All JUHI supplier participants are Civil Aviation Authority approved fuel suppliers and each participant is responsible for arranging for the into-plane transfer of fuel. Each participant manages its customer relationship, attending to its own marketing and invoicing and customer pricing. The long standing underlying rationale for the joint ventures is one of capital efficiency in the provision of the capital intensive JUHI infrastructure and safety. Each participant creates a market for itself individually on the airport and competes at a commercial level.

Submission

Based on Shells' experience since privatisation of Australian airports, some of which is set out in the discussion below, it makes the following submissions:

- The charging regimes at some monitored airports have lead to outcomes that are not as efficient in terms of resource allocation as might ordinarily be expected

[1] Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney
[2] That is not to say that as monopolies they do not face business pressures.

from negotiations in a non-monopolistic market place. These outcomes are a combination of the historical documentation that has underpinned arrangements pursuant to which Shell participates at airports and of the behaviour of some airport owners through the exercise of monopolistic market power, both relative to that documentation and generally.

- It is likely that as those airports that currently behave in a more transparent manner less typically associated with monopoly behaviour see those airports that do not similarly behave extracting greater economic rent streams, they will come under unsustainable pressure to pursue similar behaviours, exacerbating the level of resource inefficiency and cost uplift with no corresponding benefit.

- From Shell's perspective the regulatory regime as it currently exists is essentially ineffective as a facilitator of negotiated outcomes that under a non-monopolistic market would be considered commercial. This is because the level of transparency that underpins behaviour ordinarily expected in a non-monopolistic market place but does not exist at some airports cannot be leveraged. Shell confirms its 2005 submission to the Department of Transport and Regional Services that the exclusion of reporting on services which are the subject of an agreement with the Federal Airports Corporation should be removed. In particular fuel throughput levies and other fees should be a reportable disclosure under Direction 27.

- Greater transparency and consistency is required in relation to asset valuation for the benefit of the aviation industry as a whole. Shell believes that on the basis that airport owners are themselves lessees charged with an obligation to operate an airport, it is insupportable for airport land to be revalued and for that revaluation to underpin increased returns to airport owners as lessees.

- The lease payments and licence and throughput fees are only part of the contribution that Shell and other JUHI participants make. There is little or no recognition of capital contributed by and required of JUHI participants in support of the aeronautical asset base, some of which is not on airport land. This puts JUHI participants at a significant disadvantage.

- The trend appears to be accelerating that some airport owners are looking to shorter term lease arrangements with refuelling participants notwithstanding their long term capital commitments as a method of extracting disproportionate economic benefits for themselves.

- Many commercial agreements with airport owners that Shell is a direct or indirect party to have dispute resolution provisions that have proven or are likely to be inadequate or irrelevant, either as a result of anomalies arising under agreements predating the airport privatisation program or the exercise of monopolistic negotiation power post airport privatisation. Shell believes that:
  - guidelines in relation to valuations and their use
  - a requirement for greater transparency on the part of airports in relation to revenue and costs
  - nomination of a mediation or advisory panel comprising individual members with airport and air travel industry expertise with the power to make their determinations public

  would in combination result generally in more commercially efficient outcomes, reduce disputes and where they did arise, assist in their effective resolution in the interests of Australian air transport.

Discussion

Leases and Licences

Land on which the JUHI facilities are constructed is leased or licensed from the airport owner, itself a lessee for the purposes of operating an airport under the Airports Act 1996, in consideration of a lease or licence fee (often both) based on 'commercial' terms. The current leasing regime, with its requirement to support investment in airport master plans, was entered into by the refuelling companies in the late 1980's in very difficult circumstances. Be that as it may, the leases contained provisions regarding contributions to facility relocation and ongoing general investment requirements.

In addition to the leases of surface land occupied by the fuel suppliers, at most airports the JUHI participants pay licence fees for the ground through which the subterranean pipelines run. Shell has recent experience of one airport owner seeking to increase the cost of licences based on exclusive possession of the surface land, despite that land being occupied by others – principally the airport owner for runways, aircraft taxiways and aircraft parking bays.

When developing the new leases the FAC introduced the 'blue sky'[3] of throughput fees. Since privatisation some airport owners have introduced this variable fee. The fee is now payable at Darwin (general aviation only), Brisbane, Perth, Archerfield, Alice Springs & Tennant Creek. Whilst having provisions in its lease that contemplate the introduction of a fuel throughput fee Melbourne has determined not to proceed down this path.

The Sydney airport owner has the right to introduce a throughput fee when it can reasonably assert that the payment of throughput fees is common around Australia, which to date has not been able to be made out. However, the Sydney airport JUHI lease is coming up for renewal. On current indications any imposed throughput fee is likely to result in a very significant cost increase that is many times greater than the current commercially based lease charge. No additional benefit is being offered.

Lease and licence fee amounts are at a market rate, adjusted by CPI and market reviews. The result is that where charged, fuel throughput fees are over and above the commercial 'rent' that would otherwise be payable. The fuel throughput fees are exempt from price monitoring and some airports have required that confidentiality agreements be entered into in relation to discussions about the level of charges that are to be paid.

The following is an illustration of the behaviour of one airport owner that in Shell's opinion would be unable to be sustained in a more competitive environment.

At Airport A Shell sought to resist the introduction of throughput fees on the basis that no benefit could be seen to accrue to the refuelling companies for this charge. Shell ultimately agreed to sign a new lease in the face of the commercial leverage applied by the airport owner that Shell vacate the premises and remove the facilities that it had supplied. The airport owner indicated that it would build a new facility and charge the refuelling companies accordingly, ie based on the capital it expended.

[3] The FAC did not charge throughput fees but the leases provided that they could be introduced without an effective cap on their level, thereby enabling a broad range of pricing assumptions.

In Shell's view the economic outcome from the inferred threat was that Shell's operating costs would have increased dramatically and its capital investment made redundant. More generally, the outcome would be difficult to justify on capital efficiency grounds, the existing facilities being fit for purpose. The new lease provided for increased fees, including a throughput fee. Shell has neither seen any increase to it in service levels nor been provided with any benefit that it can pass onto its customers. Sales volumes at the airport have reduced, thereby increasing the unit cost.

In addition to the rent, licence fees and fuel throughput fees (where payable) the JUHI participants pay for services to their leased areas. The JUHI Participants pay for their own security, parking and services.

Shell is now finding that some airport owners that do not have clauses in their leases allowing the introduction of throughput fees and 'miscellaneous' charges are leveraging other mechanisms. An example is airport owners exploring supplementary payments for the right to negotiate lease extensions and the inclusion of throughput fees, without which the leases will not be extended. These initiatives lack transparency, are difficult to resist and result in increased cost for no apparent benefit.

Shell's experience is that under new leases entered into since privatisation, costs have increased generating neither greater business opportunities from which the company can benefit nor any additional benefit that can be passed on to customers.

<u>Capital investment</u>

Historically the JUHI infrastructure has largely[4] been provided by the fuel suppliers, not the airport owners. This has reflected the capital costs associated with the refuelling infrastructure on and off the airport offsite (eg industry pipelines on land not associated with the airport itself) and the pool of industry experience available in the operation of this type of facility.

At many of the capital city JUHI's and large regional airports, the leases between the JUHI Manager and the airport owner specifically contain clauses requiring the JUHI participants (via the manager) to invest as required by the airport owner to support potential airport growth and infrastructure changes. Notwithstanding the call upon its capital Shell normally has no role in the determination of this requirement.

This required support investment does not always produce a return for the JUHI participants. In 2004 the JUHI participants at Melbourne were required to invest in hydrant extensions to accommodate the Airbus A330 aircraft type for domestic travel. This involved conversion of 2 aircraft parking bays and installation of hydrant systems and associated infrastructure at a capital cost of $700,000. Shortly after this expenditure, this aircraft was changed to international operations with the consequence that this infrastructure will remain unused despite the substantial investment.

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[4] There are generally terms in the lease documentation that provide for certain types of relocation of facilities to be paid for, or at least a contribution made for the relocation cost, by the airport owner. See also below in relation to Canberra and Adelaide airports. Shell has found these provisions to be of limited value in negotiations, it often being asserted that facilities are not be relocated, rather that they are required for expansion.

There has been and continues to be substantial capital infrastructure required of JUHI participants to support the Airbus A380 aircraft expected to operate through Melbourne, Sydney and Brisbane airports which the JUHI participants are required to support with hydrant extensions. To date, there are 2 A380 aircraft parking bays in Sydney, 2 in Brisbane and 2 in Melbourne that have either been completed or are currently being constructed. In 2006 Sydney has a requirement for another 2 A380 bays, in 2007 another 4 and in 2008 another bay. The conversion costs of these bays are typically $500,000 -$700,000 per bay. At best, this investment will sit idle for in excess of 12 months before being used and, depending on the number of A380's visiting Australia, some of these bays may not be required at all.[5]

The usual presumption (and assertion by airport owners) underpinning the requirement by the airport owners on the JUHI participants to undertake capital improvements is that fuel volumes will increase and that thereby the cost of capital will be recovered[6]. However, there are a number of examples, setting aside the above, where the capital cost has been incurred by the JUHI participants as required but the forecasted increased fuel sales by the airport owner has not materialised.

Shell understands and accepts that capital investment always carries risk. However, in the case of the structure of the relationships with the airports there is no effective mechanism by which Shell can hold the airport owner accountable for requirements to expend capital or dispute the airports owner's unilateral requirement to invest.

In so far as the airport owner is concerned the implicit expectation is merely that Shell will cover the additional capital either generally or by passing on the costs to its customers. From the JUHI participants' perspective the option that is often faced is to spend the capital or breach the lease.

Shell acknowledges that there is a need to invest in infrastructure to secure additional fuel sales at an airport. This situation is, however, often distorted in assertions by airport owners when seeking to justify the introduction of new, or increasing existing fees and charges, that they are providing a platform and building growth for the benefit of the JUHI participants. This might be a justified 'explanation' if it was the airport owner that was the contributor of capital (and hence taking the risk associated with that capital expenditure). The reality, however, is that Shell and other suppliers are self-funding, have contributed capital to the airport infrastructure in their own right and are under obligations to continue to do so. Shell believes that there are no adequate mechanisms that recognise these contributions and obligations[7], in the absence of which there are inherent and emerging inefficiencies.

At two of the monitored airports, fixed refuelling facilities have recently been installed by the airport owners. The levels of transparency that have been adopted are very different.

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[5] By way of historical example of sunk cost, there is a British Airways/Air France Concorde hydrant system under the tarmac at Sydney Airport that has remained largely unused except for a short period in the late 1960's.

[6] In such circumstances it is also Shell's experience that often the forecasts made by the airport owner are contrary to its own projections and those of other participants in the aviation industry.

[7] It is Shell's experience that the underlying issues outlined are not reflected in lease fee adjusting mechanisms or in the setting of throughput fees charged to the JUHI participants.

When designing facilities at Adelaide the airport owner required a change to the refuelling infrastructure, including a fuel hydrant system which it constructed itself. The airport owner has increased the passenger charges to include the capital recovery and return on investment so this is passed directly to the travelling public. Shell believes that this is an efficient and transparent means of funding the infrastructure.

At Canberra airport the airport owner recently constructed a new fuel storage facility and a "facility fee" is now charged to the facility manager appointed to manage both the storage and into plane transfers. The facility manager has advised that it is bound by a confidentiality agreement and cannot disclose the structure of the facility fee to others who are hosted through the facility. The current facility fee is subject to change although the criteria for this change is unknown. Based on Shell's understandings it is believed that the fee is set at a level to recover the airport owner's capital investment, required rate of return and land rent, plus a range of non-fuel related charges.

Again, subject to the comment below, Shell does not have concern about an airport owner recovering the capital cost and a reasonable rate of return from necessary infrastructure. However, the process by which this is achieved, it believes, should be transparent and inclusive, particularly where airport owners are not subject to effective competitive market forces[8], and where capital expenditure on infrastructure is required of or has been provided by Shell.

There appears to be a growing willingness and desire on the part of some airport owners to take over the assets of the refueller participants at little or no cost to themselves. Shell has seen a range of mechanisms suggested by airports to achieve this possibility. These assets will have a life well beyond the current JUHI participants' lease term. Given that for the foreseeable future the airports will remain airports, the behaviour exhibited seems indicative of a mindset by some airports consistent with the exercise of monopoly market power.

This issue of asset takeover raises the issue of transparency in relation to valuations by airport owners and the use to which these are put. The exhibited behaviour by some airport owners leaves little doubt in Shell's perception that if assets are taken over at nominal cost to the airport owner they will be revalued upwards immediately after the sale to reflect their value as a source of future income.

Furthermore, to the extent that the valuation applied then underpins the lease, licence throughput or other fees charged by reference to the airport owner's overall return on capital and there is no transparency around whether the capital contribution (past and future) by Shell and others has been taken into account, a distortion is introduced into the pricing arrangements. These distortions are ultimately not in anyone's interests.

Looking to the future, Shell also notes that some airport owners appear keen to unlock land at airports for economic activities that would not ordinarily be characterised as aeronautical, notwithstanding the basic use to which the land is to be put. Shell has no issue with the concept of maximising the beneficial use to which airport land can be put but is of the view that guidelines and mechanisms need to be

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[8] Virgin Blue Airlines Pty Limited [2005] ACompT 5 paras 124ff. See also Productivity Commission Inquiry Report No. 19, 23 January 2002 *Price Regulation of Airport Services* p179. Shell would submit, based on its experience, that the degree of market power rating for 'Aircraft refuelling' could be justified as being 'High' rather than 'Moderate/High'.

developed that appropriately recognises contributions to aeronautical assets so that a general ratcheting up to the aviation industry generally does not occur.

Price Monitoring

Those activities covered by FAC leases and agreements that were assigned as part of the airport privatisation program are not reportable to the National Competition Commission or Productivity Commission[9] and are therefore not recognised for airport price monitoring purposes. Essentially they are unseen and in Shell's experience some airport owners are keen to maintain that position. This may explain the extremely aggressive, as it appears to Shell, pursuit of them by some airport owners. Given the position of airports as natural monopolies it is Shell's belief that the basket of monitored costs and revenues by the airports, should be expanded, not reduced or removed on the basis that transparency will drive behaviours that are less monopolistic. Whilst Shell understands that this may be a burden on some airports that do not exhibit such behaviours, from a policy perspective it is unlikely to be a burden that outweighs the resulting overall benefit.

Shell last year made the following submission to the Department of Transport and Regional Services in relation to the objective of improving the basis for future monitoring reports:

> Based on this experience Shell is of the view that including aircraft refuelling services in the definition of aeronautical services will have two positive benefits. The first is to provide an opportunity and justification for a change in approach by those charged with negotiating or determining refuelling service fees, particularly under long term leases and licences.
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> The second is that it provides an opportunity for the industry participants to lay down acceptable ground rules and consequent efficiencies in setting the fees to be paid.

In Shell's view, removal of the exemption for reporting fees and charges implied by abrogating the exclusion contained in Direction 27 would need to be supplemented by providing that any fees and charges in relation to refuelling activities made by airport owners, whether under the FAC lease/licence regime or otherwise, is reportable.

Dispute Resolution

Since privatisation of the airports Shell's experience is that there has been a significant increase in instances of disputation, most of which have revolved around introduction or review of throughput fees, subsequent reviews and the containment of licence costs.

The fact that Shell is engaged in a commercial dispute is not of itself an issue. However the mechanisms for setting and adjusting the throughput fees are generally regarded as being inadequate[10] and the cost and time taken in resolving them in the face of significant increases is inefficient, lacks transparency and given the power of the airport owners, almost invariably results in what industry participants view as inequitable outcomes considering generally acceptable economic parameters. Unfortunately Shell anticipates that this trend will continue, worsening as airport owners exercise their power at the time of lease renewals.

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[9] Prices Surveillance Act 1983 Direction No 27, 26 June 2002.

[10] At Brisbane airport the throughput fee has been the subject of two expert determinations, both experts specifically noting that there was virtually no guidance in the lease as to the principles to be applied in setting the level of the fee.

At Airport D Shell represents the JUHI participants as the operator of the JUHI. It is the lessee/licensee from the airport owner.

During the determination of the original throughput fee the then appointed expert acknowledged that the lease gave no useful guidance on the principles to be applied in determining whether the fee advised by the owner was reasonable. Ultimately a fee was set that applied for a six year period, subject to yearly CPI adjustment. That fee was then subject to a further notice of increase by the owner that again went to expert determination, as provided for in the lease. Given the understandings gained about the dual till and single till dichotomies in the intervening period, Shell put forward a discrete economic framework for the determination of the fee.

Although appearing to have some sympathy with Shell's economic framework to give meaning to the determination of the throughput fee and its review, the significant matter that emerged in the determination by the second expert was that notwithstanding the acknowledged lack of guidance about how to determine the throughput fee, he felt constrained to take into consideration or assess changing macro-economic factors, including pricing theories and their application (dual till / single till models), changing industry practice or economic policy under the terms of the agreement. Rather, the expert felt bound to follow the principles applied in the earlier determination.

It is therefore unlikely, in the absence of any government regulatory mechanism, for there to be any commercially realistic resolution of future throughput fee issues that reference factors external to the peculiarities of the lease and the now embedded determinations made under it. Under such circumstances it can be expected that the impost of throughput levies will continue to increase in a manner that is practically unchecked.

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