Please direct any comments or questions to:

Dominic Schuster
Manager Aviation Pricing and Economics
Sydney Airports Corporation Limited

Email: dominic.schuster@syd.com.au
Phone: +61 2 9667 6407
Facsimile: +61 2 9667 6428
Locked Bag 5000
Sydney International Airport
MASCOT NSW 2020
AUSTRALIA

Executive Summary

Sydney Airport Corporation Limited (SACL) believes that the Government's policy of light-handed regulation remains the most appropriate and economically efficient method of price regulation for Australian airports.

SACL also believes that the Government's Review Principles, as set out in the joint press release issued by the Minister for Transport and Regional Services and the Treasurer on 13 May 2002, strike an appropriate balance between the commercial interests of airport operators and their airline customers and provide sufficient guidance on the Government's expectations under light-handed regulation.

Based on its experience operating under the light-handed regulatory regime over the past four years, SACL believes that the effectiveness of the current regime could be improved by:

- the Government reinforcing its commitment to light-handed regulation as a long-term approach, rather than merely a "probationary" position, thereby providing airports and airlines with substantially greater business certainty in relation to the regulatory environment and greater incentives to commit to commercially negotiated outcomes; and

- the Productivity Commission providing further clarity as to the manner in which the Government's Review Principles ought to be applied in practice.

This would be expected to provide an enhanced environment in which commercial relationships are operating between airports and airlines. Within this environment, disputes relating to the formation of agreements should be able to be adequately resolved by appropriate commercial dispute resolution.

Any dispute resolution mechanism must be commercially focussed and provide the correct incentives to reach genuine commercial outcomes, otherwise the benefits of the light-handed policy may be undermined. SACL supports the framework promulgated by the Prime Minister's Export Infrastructure Task Force.

At Sydney Airport, the light-handed regime has been characterised by price stability, consistent quality of service and facilities, revenue recovery below 'allowable revenue', and continuing high levels of new investment to meet emerging airline needs and maintain service quality.

This regime has also helped to develop an increased airline customer focus. While airlines face pressures from increased costs, such as fuel and security, airport charges have remained a small and stable component of airline operating costs.

Since the introduction of light-handed regulation in July 2002, SACL believes it has acted in accordance with the approach outlined by the Commission in its Inquiry Report on the Price Regulation of Airport Services (2002) and in a manner that is fully consistent with the Government's stated policy objectives and Review Principles. In particular:

- SACL has continued to set aeronautical charges in a manner that is both reasonable and fully justifiable, based on the Government's expectations as set out in its Review Principles;

- between 2001-02 and 2005-06, SACL substantially under-recovered against the aeronautical revenues considered appropriate by the Australian Competition and Consumer Commission (**ACCC**) in its May 2001 pricing decision;

- SACL has continued to invest in aeronautical facilities, facilitate access for airlines and encourage them to develop their businesses;

- commercial contractual arrangements are in place with the vast majority of airline customers in relation to the use of aeronautical facilities; and

- SACL has continued to engage in good faith negotiations with those customers to enhance those commercial arrangements to the mutual advantage of all parties.

Sydney Airport's capacity is limited by regulatory constraints including a curfew, movement cap, noise sharing, and regional slot and price protection. As Australia's primary international gateway, Sydney Airport has a fundamental role to play in facilitating export and economic growth. Accordingly, priority must increasingly be given to larger aircraft and international passenger services. Structural rigidities should be assessed to encouraging more appropriate use of the constrained facilities. This will also require a flexible pricing regime, appropriate regard to correct pricing signals, and strong commercial relationships with airlines.

The period since the Productivity Commission's Inquiry in 2001, has seen further concentration of the domestic airline market, increased competition among Australian and world airports for new routes and services and an increased airline focus on costs. These have led to increased scrutiny of, and pressure on, airport prices.

Airport land should be appropriately valued on the basis of opportunity cost, with aeronautical charges at the very least adopting an appropriate starting point value. Revaluation of airport assets does not result in 'windfall gains' to airport owners but economically efficient prices.

Continued financial and quality of service disclosure for major airports provides appropriate transparency under the light-handed regime. The two sets of financial reporting definitions should be aligned. However, there is no basis for the expansion of the items included as 'aeronautical' services. SACL strongly supports, and is actively pursuing, service level commitments to its airline customers. Against this commercial focus on quality, quality of service monitoring could be streamlined through direct disclosure by major airports of passenger satisfaction measures.

1. Introduction

Sydney Airport Corporation Limited (SACL) welcomes this review by the Productivity Commission of price regulation at Australia's major international and domestic airports. Following five years' experience under the initial 'probationary' period, it is now timely to examine the regulatory approach and whether there are ways to make it work more smoothly and effectively to deliver outcomes which meet the overall public interest while also encouraging positive commercial relationships between the parties.

Accordingly, this submission:

- examines the extent to which changes in the market since 2001 have enhanced the climate for commercial negotiation;
- reviews the experience of Sydney and other airports during the 5 year period; and
- suggests ways to improve the effectiveness of the regulatory regime so that it better achieves the desired outcomes for airports and airlines.

The Commission is required by its Terms of Reference to conduct the present Inquiry against the background of the Government's Review Principles. Those Principles were announced by the Government in the course of releasing its response to the recommendations made by the Commission in its January 2002 Inquiry Report *Price Regulation of Airport Services*. SACL believes that those Review Principles were then, and remain now, an appropriate basis on which to determine the appropriate regulatory settings for pricing at major Australian Airports.

The Commission's 2002 Report set out a number of findings and recommendations upon which the present regulatory regime was based. SACL believes that the reasoning underlying those findings and recommendations remain equally valid today and that:

- The Government's approach of light-handed regulation of Australia's major airports remains the most appropriate and efficient;
- the conclusion of mutually acceptable commercial arrangements by negotiation between airports and airlines is, as a matter of sound public policy, to be preferred to regulatory setting of price and non-price terms and conditions;
- minor modifications to the access regime would be beneficial, in addition to the procedural improvements to the National Access Regime in the *Trade Practices Amendment (National Access Regime) Bill 2006*, to improve certainty over application of the national access regime*;*
- price and quality of service monitoring by the ACCC provide transparency to Government regarding the operation of the light-handed regime and increase the competitive dynamic between airports; and
- prices for aeronautical services should be set at an economically efficient level, based on appropriate asset valuations, within the context of commercially negotiated pricing outcomes. Within this approach, Aeronautical land should appropriately be valued at its opportunity cost.

Commercial negotiations to enhance existing airline agreements are continuing. The prevailing nature of the regulatory environment in which commercial negotiations have been progressing has itself provided an inducement for airlines, quite rationally, not to conclude final agreements. This is because, in so doing, they may deprive themselves of further advantage that they perceive might otherwise arise through either the Virgin Part IIIA proceedings or this scheduled Productivity Commission review. Light-handed regulation has in large part been successful. It is, however, now appropriate that some limited but important changes be considered to the regime to ensure that it is more effective as an ongoing policy for all major airports.

Structure of this Submission

Section 2: Provides a brief overview of the ways in which the Australian aviation and airports markets have evolved and matured since the Commission's last inquiry

Section 3: Describes the regulatory and operating environment at Sydney Airport

Section 4: Reports on SACL's conduct and achievements under the light-handed regulatory regime, and its compliance with the Government's Review Principles

Section 5: Assesses incentive structures under the light-handed regulatory regime and, in particular, explains why it has not fully achieved its objectives

Section 6: Outlines SACL's recommendations for change

Section 7: Deals with a number of other issues raised by the Commission in its Issues Paper

Section 8: Provides conclusions

Appendix A: Provides a detailed analysis of the recent ACT decision declaring the domestic Airside Service at Sydney Airport under Part IIIA of the Trade Practices Act (**TPA**)

Appendix B: Outlines the circumstances surrounding the conversion of domestic runway charges to a passenger-based charge

Appendix C: Is a detailed report prepared by Access Economics in relation to the appropriate methodology for valuing airport land

Appendix D: Provides correspondence between SACL and the Department of Transport and Regional Services regarding financial reporting definitions

2. Market Change Since 2001

Key Points:

The period since the Productivity Commission's Inquiry in 2001 has seen:

- further concentration of the domestic airline market with a return to two powerful operators with considerable negotiating strength
- the development of new airlines and services in niche operations
- further attention on airport charges as a cost component amongst airlines worldwide
- an increased focus on cost issues in airlines' selection of airports from which to operate.

Taken together these have led to increased scrutiny of, and pressure on, airport prices.

However, airport charges have remained a stable and small component of airline costs.

In May 2002, the Government announced the introduction of a five-year probationary period of light-handed regulation. This policy took effect from 1 July 2002, concurrent with the privatisation of Sydney Airport at the end of June 2002. Towards the end of the five-year period, there was to be a review of the regime and compliance with the Government's Review Principles.

The decision to introduce this light-handed regime was made based on the recommendations of the Productivity Commission's inquiry into *Price Regulation of Airport Services*, provided to the Government at the end of 2001. The review was undertaken in accordance with the Government's intention, expressed when the Phase I airports were privatised, that the form of price regulation would be reviewed after a five-year period.

The aviation industry has continued to evolve since the Productivity Commission's previous review was undertaken in 2001. In particular, increased domestic market concentration, international market competition and cost-consciousness of airlines has, if anything, increased the countervailing power of airlines and the pressures on airport charges.

In SACL's view, these industry dynamics have reinforced the importance of strong commercial relationships between airports and airlines and have re-emphasised the necessity of price and regulatory flexibility to provide for timely and responsive reactions to changes in the market, the needs of airlines, and requirements for new investment.

Among the changes in the market that have been observed since 2002 are:

- further concentration in the domestic airline industry and relative increases in the market power of those carriers;
- increased cost-consciousness of airlines world-wide and strong pressure for reductions in input costs;

- increased competition among Australian airports for new traffic and for the location of airline headquarters and maintenance operations;
- increased competition internationally for airline routes;
- growth of point-to-point domestic routes, resulting in reduced hub activity;
- impending introduction of new aircraft that require improved airport facilities;
- the prospect of a trans-Tasman cooperation agreement between dominant carriers on those routes;
- expectations of airlines that they will be provided with incentives by airports for new routes and services;
- competition between States for new services, resulting in State Government incentives being offered;
- the emergence of new low-cost carriers and low-cost subsidiaries of existing carriers;
- start-ups by different domestic business models, such as Regional Express and OzJet;
- the emergence of competing "second" airports in some large population centres; and
- a heightened awareness of the risks of traffic shock events.

This rapid pace of change is nothing new, but underlines the need for airports to be regulated in a way that allows airport operators to respond to the continually evolving needs of new entrants, new technology and other new developments. The light-handed regime has allowed airports and airlines to work together to adapt and respond to change in a timely manner, in contrast with the previous regime.

The following sections expand on the impact of these market changes.

Concentration in the domestic airline industry and relative increases in the market power of those carriers

The Commission's previous review of airport price regulation was undertaken in the context of a domestic aviation market featuring four major airlines, including two dominant full service carriers (Qantas and Ansett), and two growing new market participants (Virgin Blue and Impulse). Impulse was acquired by Qantas in mid 2001. Subsequently Ansett operated under administration from September 2001 prior to its collapse in March 2002. This left the full service carrier, Qantas, and lower cost airline, Virgin Blue as the dominant market participants.

With these developments, the previous strong competition between airlines for growth in market share and new passengers became less intense and the two major carriers have more recently settled into a more stable duopoly environment. Aside from the effects of this on competition in the market, this has increased the relative market power of the two airlines and the degree of countervailing power that they are able to bring to bear in dealings with airport operators.

Qantas has also significantly altered its operations to include its low-cost subsidiary, Jetstar, established in 2004, so that it now competes in both the full-service and low-cost market segments. The formation of Jetstar has assisted Qantas to retain a domestic market share of around two-thirds.

Despite the strengthening of the market position of the Qantas group and Virgin Blue, there has been scope for expansion of other operators in more specialised markets. Regional Express (Rex) emerged as a significant regional carrier, taking on a number of regional routes formerly operated by Ansett. For a time Rex also offered a credible service on the Sydney to Canberra route. In addition, a new premium full service carrier, OzJet, operated scheduled services for a period over 2005-06, prior to ceasing scheduled services and focussing on charter operations.

Prior to commencement of the five year probationary period of light-handed regulation, SACL was able to facilitate the start-up of Virgin Blue and Impulse through the development of a low-cost terminal in 2000. The subsequent availability of the former Ansett terminal as a common-user facility under SACL ownership has allowed for the expansion of Virgin Blue, the start up of OzJet and the ongoing operations of Rex, Jetstar and a number of regional carriers.

The operations of such a range of carriers would not have been achieved under the previous terminal ownership structure where domestic terminal capacity at Sydney was tied up under long-term leases by the incumbent airlines. Qantas operates its own domestic terminal at Sydney under a long term lease. The acquisition by SACL of the former Ansett terminal, now operated as Terminal 2, has significantly improved terminal access for new domestic entrants at Sydney, compared with 5 years ago.

Increasing cost-consciousness of airlines world-wide and strong pressure for reductions in input costs

The market shock of the September 2001 terrorist attacks, coupled with subsequent world events such as the Iraq War and the SARs outbreak, led to a shake up of the world aviation industry. This saw the collapse of a number of international airlines such as Ansett, Sabena, Swissair, as well as mergers such as Swissair and Crossair and Air France and KLM. A number of other substantial carriers entered Chapter 11 arrangements in the United States, including United Airlines, Delta and, Northwest. This in turn led to an increase in focus among all airlines on their operating costs, including those associated with airports.

The emergence throughout the world of the low cost carrier model has also had a significant impact on the cost-consciousness of the full service or “legacy” carriers. These more established airlines have higher costs and less flexible staffing arrangements, contracts and business structures which have necessitated taking a broad view of the areas in which their operating costs should be restructured to enable them to compete more effectively with the new class of low-cost carrier.

Airport costs have also come under increased airline scrutiny. Airport charges continue to represent a small proportion of a passenger’s ticket price and of airline operating costs. The Airports Council International has found that airport charges have remained at around 4% of airline operating costs for several decades. Where the industry is facing increasing cost pressures, these are coming predominantly from areas such as fuel and security, not from airport charges.

Notwithstanding, airlines’ increased focus on airport costs has been clearly enunciated by the International Air Transport Association, such as through statements of Mr Giovanni Bisignani, its Director General and CEO in Paris in June this year that:

> *"The wake-up call is for all airports not yet on board: efficiency is coming. You can run, but you cannot hide. This is one wake-up call you cannot turn off".*

Again, in December 2005, *Aviation Daily* reported statements by the Chairman of IATA, Mr Robert Milton, that airlines would lobby aggressively to keep fees and charges in check, including collectively boycotting airports that refuse to cooperate with carriers to reduce their costs. The pressure from IATA appears to have been successful in Japan, where Narita and Centrair significantly reduced landing charges, while Kansai provides a large discount programme against its scheduled charges.

Clearly, airports should not be immune from cost scrutiny and should continue to look to improve the efficiency of their operations. In this regard, SACL has made significant reductions in its cost base under privatisation. However, as infrastructure providers, airports are entitled to generate a reasonable return on their investment. Indeed, efficient market outcomes overall are best achieved where airline users are not shielded from the true cost of using airport facilities. The introduction by the majority of Australian airports of passenger based charges provides for airports to share volume risk more fully with airlines, reducing the impact of airport charges during periods of market downturn and fluctuating traffic.

Increased competition among airports for new traffic

Developments in the aviation market over the past few years have also supported the adage that "airports are not monopolies at the margin", as airports are increasingly subject to competition for new domestic and international air services and routes.

Domestically, the growth of low-cost carriers and leisure traffic has seen the emergence of a range of city pairs and point-to-point operations that bypass Sydney rather than being operated as hub and spoke services. Airlines have become increasingly flexible as to the routes they operate and the frequency of their services, frequently moving aircraft onto alternative routes and services to maximise yields.

While SACL does not consider that air passengers are highly sensitive to airport charges, as they represent only a small proportion of airfares, airport costs are certainly relevant to airlines' decisions on routes and frequencies. This has impacts at the individual route and service frequency level, but the industry has also increasingly witnessed domestic carriers "shopping around" to achieve the lowest cost airport outcome across all operational aspects. This was notably done by Virgin Blue, Jetstar and Jetstar International in their negotiations on where to base their operations and commence new services. In addition, competition for services does not occur at the airport level alone, with a number of State governments such as Victoria and Queensland offering incentives to airlines to base services and operations within their States.

In international terms, Australia is but one of a myriad of destinations that airlines can choose to service, and a difficult and lengthy route at that. SACL must continually market its airport, Sydney and Australia to world airlines in an effort to attract new routes and services and, in many instances, to retain existing routes and frequencies. Securing new carriers, routes or services can require offering significant incentive discounts against scheduled aeronautical charges. The competition for new services does not come only from other international destinations, but also from Australian international airports.

These marketing activities are also generally undertaken within the overlay of international air rights agreements which restrict the ability of new carriers and routes

to operate to Sydney. This is reflected in continued Government protection of Australian carriers on key routes and policies that distinguish between ports, thus restricting the access of international airlines to Sydney.

The increasing exposure of airports to airline operational decisions has been highlighted over recent years by proposals for closer coordination of operations between Qantas and Air New Zealand, with the current proposal for a joint services agreement for trans-Tasman services. Longer standing arrangements such as the Qantas-British Airways Joint Service Agreement on the Australia-London route are another example of this. Arrangements such as these have the potential to significantly alter the pattern of services at airports and, through increased airfares, the level of air traffic. This in turn directly impacts the revenues of airports.

As well as competition between airports domestically and internationally, Australian airports are also increasingly seeing the development of competition from alternative airport service providers in the same catchment areas. This is particularly apparent at airports such as Melbourne, with the availability of Avalon Airport, but also at Brisbane with the nearby Gold Coast Airport (which is in turn in competition with emerging regional airports such as Ballina).

The presence of competition for Sydney Airport's services is not immediately as apparent. However, Newcastle is increasingly positioning itself as an alternative port for the northern population centre of the Sydney Basin, which has experienced substantial growth over the last couple of years. Bankstown stands poised to offer an alternative to Sydney for smaller regular public transport services. Canberra Airport is actively marketing itself as the 'Second Sydney Airport' for international services and has specifically extended its runway to cater for large international aircraft.

To summarise, SACL believes that Australia's airports are now subject to a greater degree of cost scrutiny and pressure from airlines than was the case when the Productivity Commission conducted its previous review. This has been reinforced by increasing levels of competition internationally and domestically for new airline routes and services and continues to erode the notion that an airport is an unchallenged monopoly service provider.

3. Sydney Airport's Regulatory and Operating Environment

Key Points:

Sydney is Australia's primary international gateway.

Sydney Airport's capacity is limited by regulatory constraints including a curfew, movement cap, noise sharing, and regional slot and price protection.

Priority must increasingly be given to larger aircraft and international passenger services to allow the airport to facilitate export and economic growth.

Regulatory and Operational Constraints

Sydney Airport operates under a range of regulatory constraints that impact on its operations, including:

The curfew between 2300 and 0600

This restricts use of the airport for the majority of jet aircraft movements overnight. It also concentrates international passenger services to morning and afternoon peaks. This limits the growth of long-haul services, which are constrained by overseas curfews, the length of the flight sector to Sydney and traveller preferences for flight times.

A cap of 80 movements in an hour

This limits the effective capacity of the airport. It also leads to significant capacity constraints in morning and evening peaks, when the majority of international and domestic services wish to arrive and depart at Sydney. The protection of regional slots exacerbates this effect.

Noise sharing

This is implemented by Airservices Australia under the Long-Term Operating Plan to vary the pattern of arrivals and departures based on noise sharing objectives. It reduces the operational efficiency of the airport.

Regional Service Protections

A pool that equates to approximately 25% of peak slots is reserved for regional (intra-NSW) aircraft movements under the *Sydney Airport Demand Management Act 1997*. While some modifications have been made to this arrangement to require minimum aircraft sizes for new services, these slots are "ring-fenced" and cannot generally be reallocated to larger, non-regional aircraft or international services. Peak slots are therefore less efficiently used and the benefit of export growth through international passenger and cargo services is restricted.

Sydney Airport remains formally price regulated under Part VIIA of the TPA for aeronautical services provided to regional users. The ACCC is restricted in its ability to approve increases in charges for regional services above annual inflation.

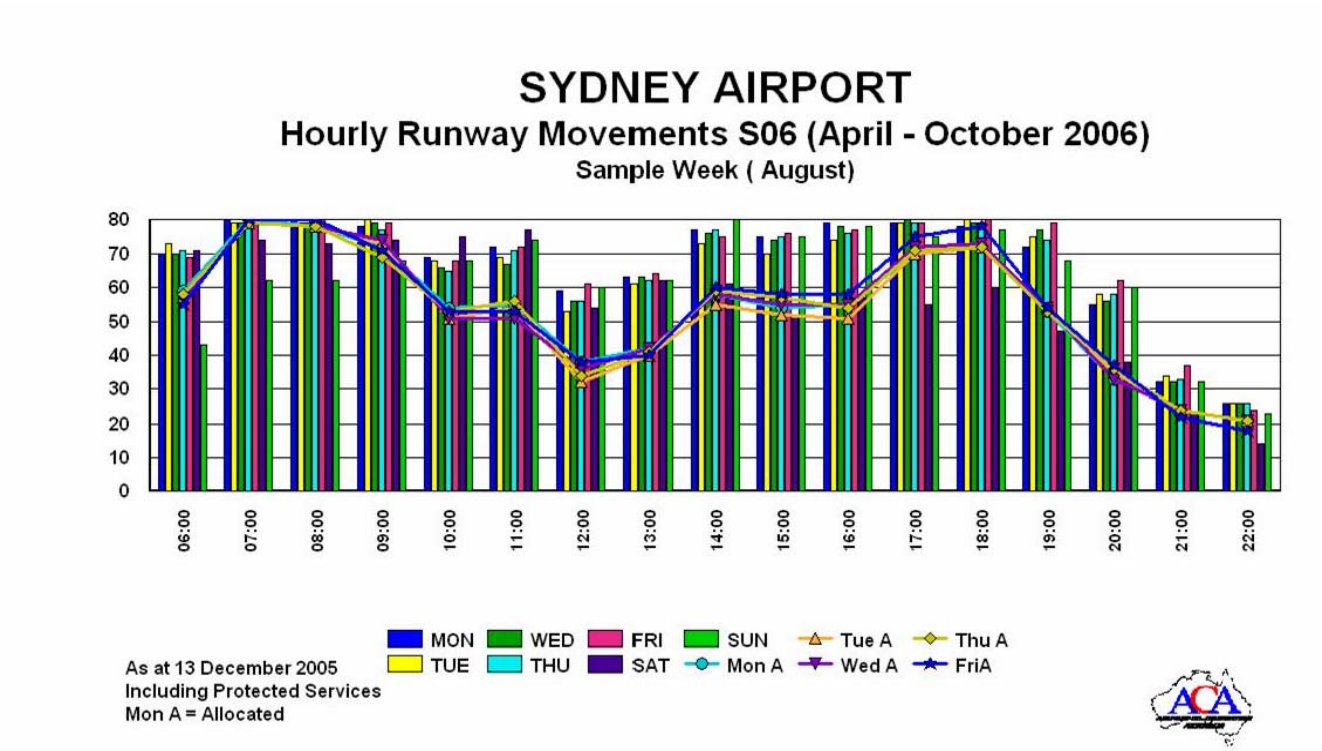
These price constraints mean that regional users are subsidised by other airport users, including for the cost of new investment and security. The price controls also entrench preferential minimum runway charges, which do not provide any incentive for regional users to operate larger aircraft. Demand management pricing, if

implemented, generally could not be used to encourage smaller regional aircraft into off-peak periods.

Demand for Airport Facilities

The pressure arising from these operational regulatory constraints is becoming apparent at Sydney Airport.

Slot demand is administratively allocated by Airport Coordination Australia (ACA). The following chart prepared by ACA shows slot allocations and protected slots for an indicative week during the current scheduling season from April to October 2006.

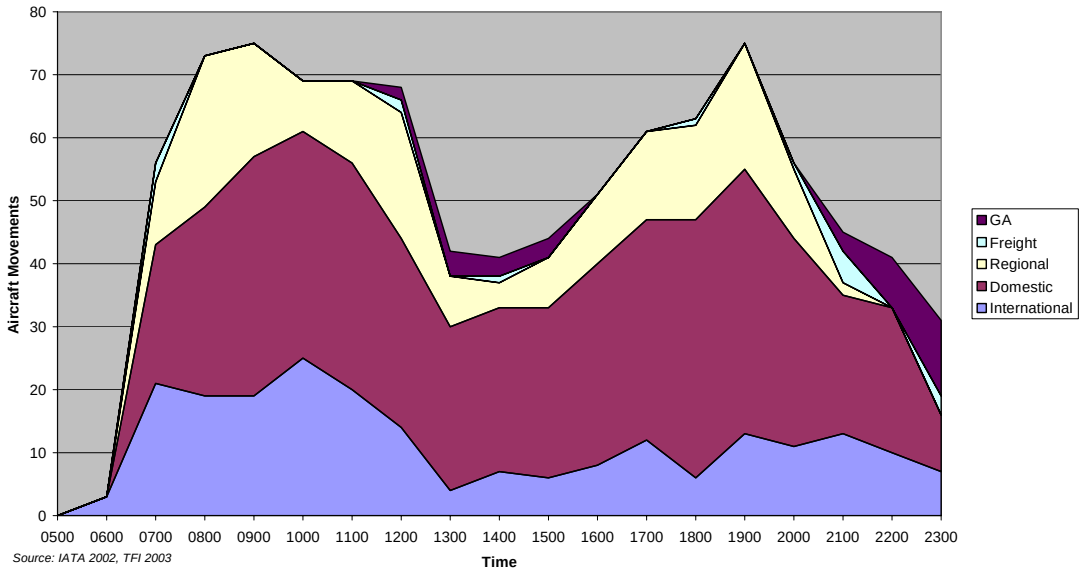


The bars in the above chart show all allocated slots. The lines are allocated slots excluding those that have been 'protected' following the collapse of airlines such as Ansett, and which can only be used on an ad hoc basis pending their allocation to start up services.

SACL's current Master Plan, dated March 2004, concludes that Sydney Airport is expected to be able to manage forecast traffic over the next 20 years. The following chart from the Master Plan shows forecast 'busy day' demand by 2023/24.

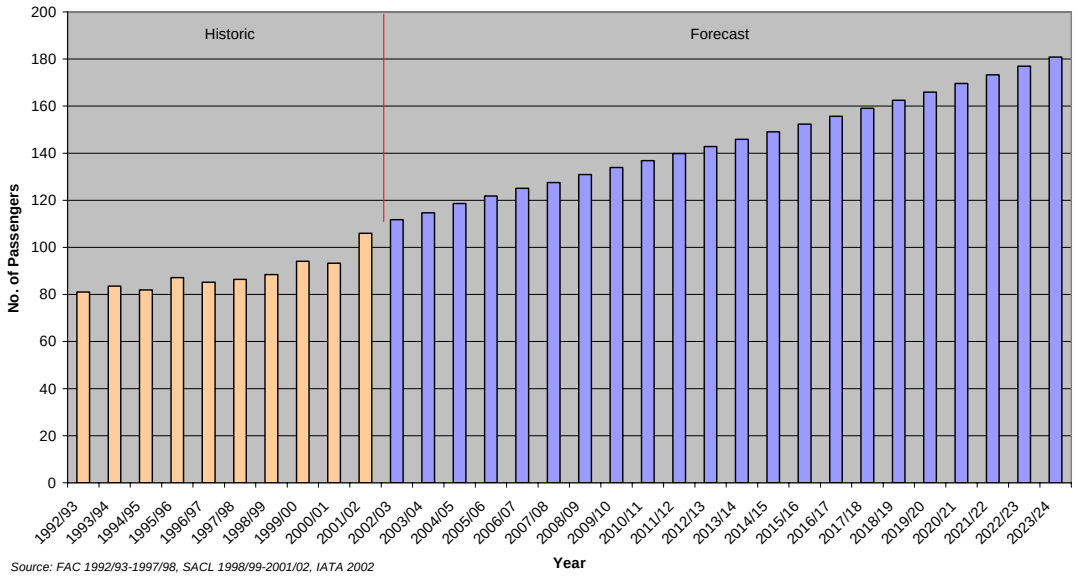
Morning peaks are expected to continue to be pronounced for international and domestic services, with a significant portion of morning and afternoon peak slots forecast to be occupied by regional (intra-NSW) services.

Figure 6.8 - 2013/14 (Phase 2) "Busy Day" Hourly Aircraft Movements



In particular, the ability to cater for demand as forecast in the Master Plan relies in part on the use by airlines of larger capacity aircraft, representing an increase of approximately 70% increase in the average number of passengers per plane by 2023/24 (see following chart).

Figure 6.6 - Historic and Forecast Average Passengers per Flight



Conclusions

Sydney Airport is Australia's premier international gateway. It facilitates almost half of Australia's international passenger traffic and approximately 50% of Australia's international airfreight traffic (constituting over $33 billion of airfreight annually). As such it is fundamental to the nation's ability to generate export income and economic growth. The airport must increasingly be viewed as one that prioritises larger aircraft and international passenger services, particularly in peak periods.

It is in the interests of Australia that the most efficient use is made of the nation's most important international gateway. SACL recommends that the structural rigidities in place at Sydney Airport be reviewed to ensure that the Government's overall objectives are being met, including balancing the interests of regional users and other stakeholders.

Encouraging more appropriate use of the constrained facilities will require a flexible pricing regime, a responsible charging policy that has appropriate regard to correct pricing signals, and strong commercial relationships with airlines.

4. Sydney Airport Under the Light Handed Regime

Key Points:

Consistent with the Government's Review Principles, SACL's behaviour under light-handed regulation clearly demonstrates:

- Price stability
- Revenue recovery below levels previously approved by the ACCC
- Continued and high levels of new investment to meet emerging airline needs
- Full and ready provision of access to aeronautical services and facilities
- The conclusion of comprehensive, binding commercial agreements with all regular passenger airline customers
- A concerted effort to negotiate further enhanced commercial arrangements for the mutual benefit of SACL and its airline customers.

Introduction

Against the broader market background set out in the preceding section, it is appropriate to record how SACL has acted under the light-handed regulatory regime and its performance against the Government's Review Principles. Accordingly, in the following sections, SACL sets out relevant data concerning its prices, revenue recovery, charging structures, access provision, new investment and negotiation of existing and proposed new commercial agreements with airlines.

Achievements of the Light-Handed Regime

The light-handed regime at Sydney Airport has delivered:

- price stability;
- consistent quality of service of airport facilities;
- revenue recovery below levels previously envisaged by ACCC under heavy-handed regulation;
- continuing high levels of new investment to meet emerging airline needs and maintain service quality;
- an increased airline customer focus;
- full access to aeronautical services and facilities for airline customers, enhanced by SACL's opening of Terminal 2 as a common user facility;
- comprehensive, binding commercial user agreements with all regular passenger airline customers; and
- a concerted effort to negotiate further enhanced commercial arrangements.

Significantly, increases in the profitability of SACL over the past four years have not been driven by increases in aeronautical charges to airlines. They have resulted from increased passenger numbers, broader commercial product offerings, and efficiency gains. These are the types of outcomes expected from the introduction of private sector innovation and discipline through the airport privatisation program.

Aeronautical Charges

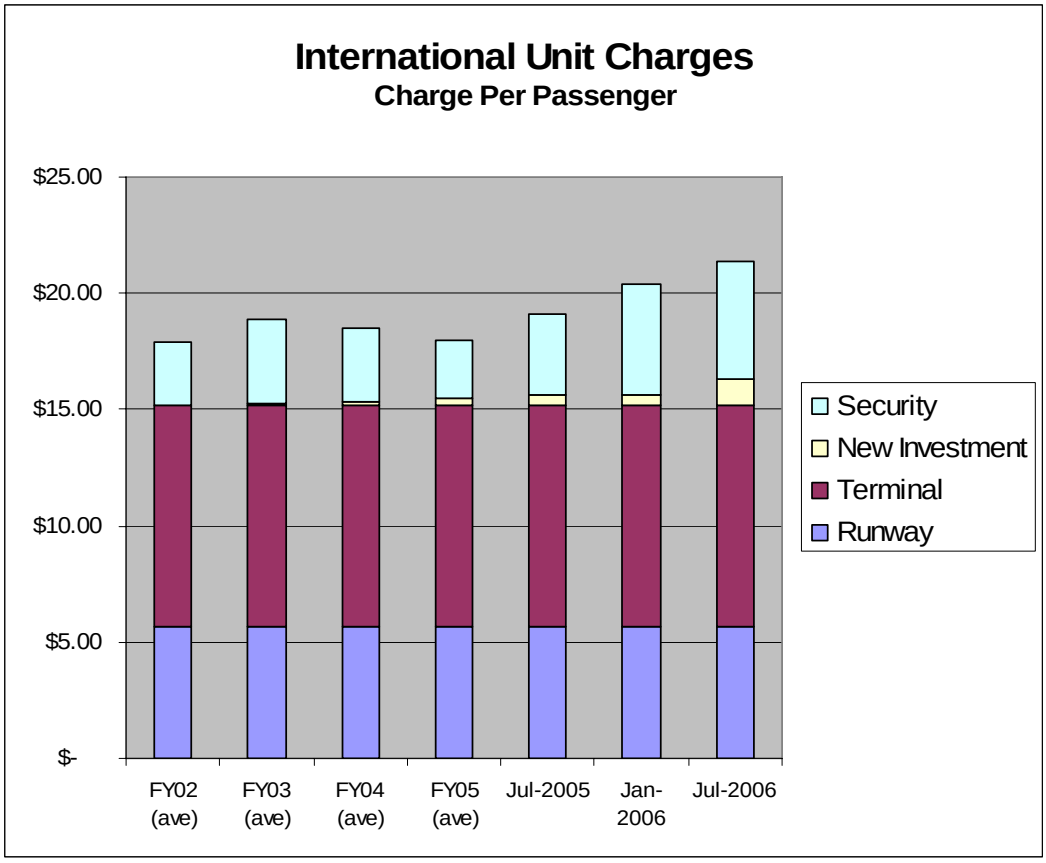
International Passenger Services

SACL's current charges levied for international services are as established by the ACCC in its May 2001 pricing decision and the subsequent August 2001 decision to convert international charges to a single passenger based charge, varied only to:

- recover the cost of new investment in aeronautical facilities as agreed with airlines in consultative processes ($1.11 per passenger since 1 July 2002); and

- recover the cost of providing security services to meet Government-mandated security obligations, with charges fluctuating over time to reconcile actual costs incurred with revenue collected.

Movements in the International Passenger Services Charge between 2002 and now are shown in the following chart.

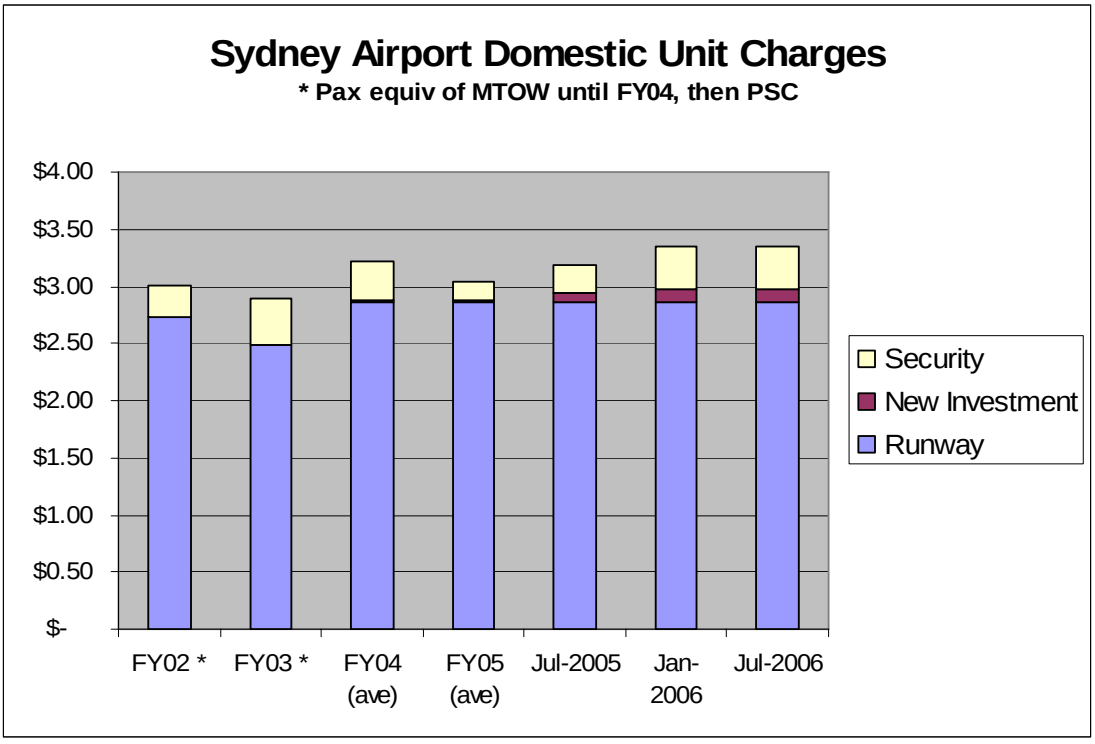


Domestic Airside Charges

Similarly, SACL's current charges levied for domestic services are as established by the ACCC in its May 2001 pricing decision, varied only to:

- convert MTOW charges to a passenger basis;
- recover the cost of new investment in aeronautical facilities as agreed with airlines in consultative processes ($0.14 per passenger since the adoption of passenger-based charges on 1 July 2003); and
- recover the cost of providing security services to meet Government-mandated security obligations, with charges fluctuating over time to reconcile actual costs incurred with revenue collected.

The following chart shows the movements in SACL's charges levied for use of airside facilities by domestic passenger services since the introduction of light-handed regulation:

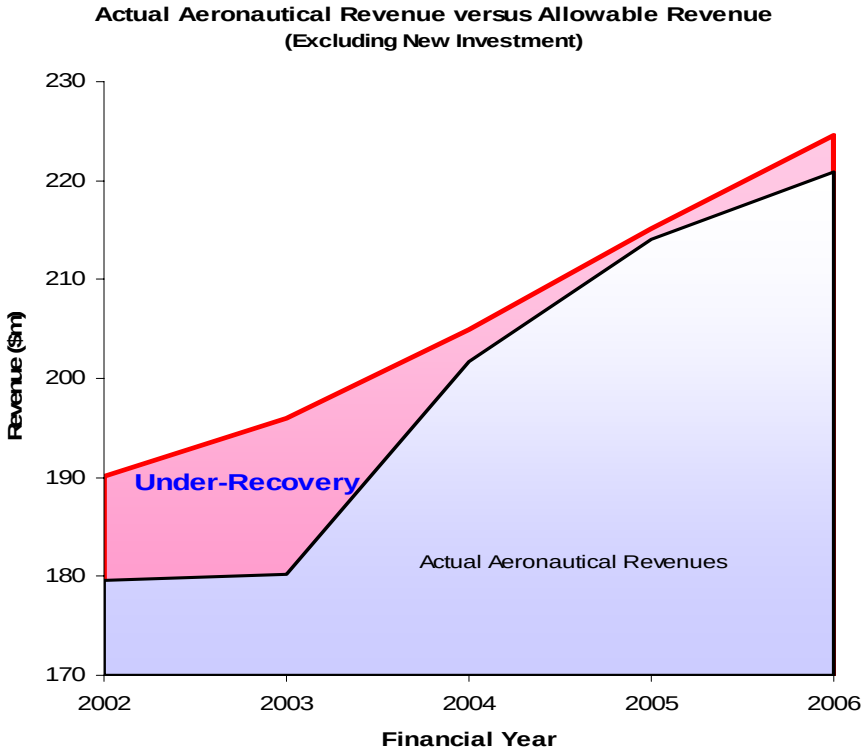


International and domestic runway and airfield charges were established by the ACCC on a tonnage (maximum take-off weight) basis in 2001. A move to a per passenger basis for international carriers was approved by ACCC in August of that year. Following the ending of formal price controls, domestic charges were similarly moved to a per passenger basis in July 2003. Although a similar approach has been applied at many Australian airports, the approach proved controversial at Sydney, being supported by Qantas and opposed by Virgin Blue. Further details on this are included in Appendix B.

Actual Revenue Outcomes

In its May 2001 decision, the ACCC calculated SACL's allowable revenue at between $183m in 2001 and $215m in 2005. These allowable revenues were calculated to apply for five years from 1 July 2000, but were not approved for implementation until May 2001.

The following chart shows SACL's aeronautical and aeronautical -related revenue (and shortfall by reference to the ACCC's allowable revenue assessment) over the period since financial year 2002. To enable a proper comparison, both the allowable revenue and recovered revenue lines exclude the costs of new investment and security services, and include an imputed allowable revenue figure for 2006 derived from the ACCC 2001 model.



The above chart shows that revenue has been some $35m less than that which would have provided a satisfactory return on assets using the ACCC's methodology. SACL has not varied its charges, as set in 2001, to the extent that would be required to recover that level of revenue, despite the ACCC support for revenue of this order and its capacity to increase its charges under existing contractual arrangements with airlines.

As detailed later in this submission, SACL has been engaged in negotiations with airlines regarding new commercial arrangements. As part of those negotiations, SACL has offered airlines a five year path under which charges as at 30 June 2006 would be maintained, subject only to recovery of new capital investment. SACL has offered a fixed price that it considers to be reasonable in the context of the commercial proposal, and which is lower than could be justified by adopting an opportunity cost of land, updated asset beta and new traffic forecasts.

New Investment at Sydney Airport

The light-handed regime has been characterised by a continued commitment to new investment in aeronautical assets to meet the needs of the aviation industry, airlines and the travelling public. This has included the acquisition in 2002 of the former Ansett terminal for $205 million to provide a common user domestic and regional facility, investment of some $150 million to accommodate the A380 aircraft, runway and taxiway overlays, airfield lighting upgrades, terminal refurbishment, and additional aircraft parking aprons. In all, SACL has invested in excess of $400 million since 2002.

The charges and allowable revenue set by the ACCC in 2001 were exclusive of any allowance for subsequent investment in aeronautical assets. The recovery of subsequent new aeronautical investment from airlines is shown as "New Investment" in the preceding charts showing changes in international and domestic charges.

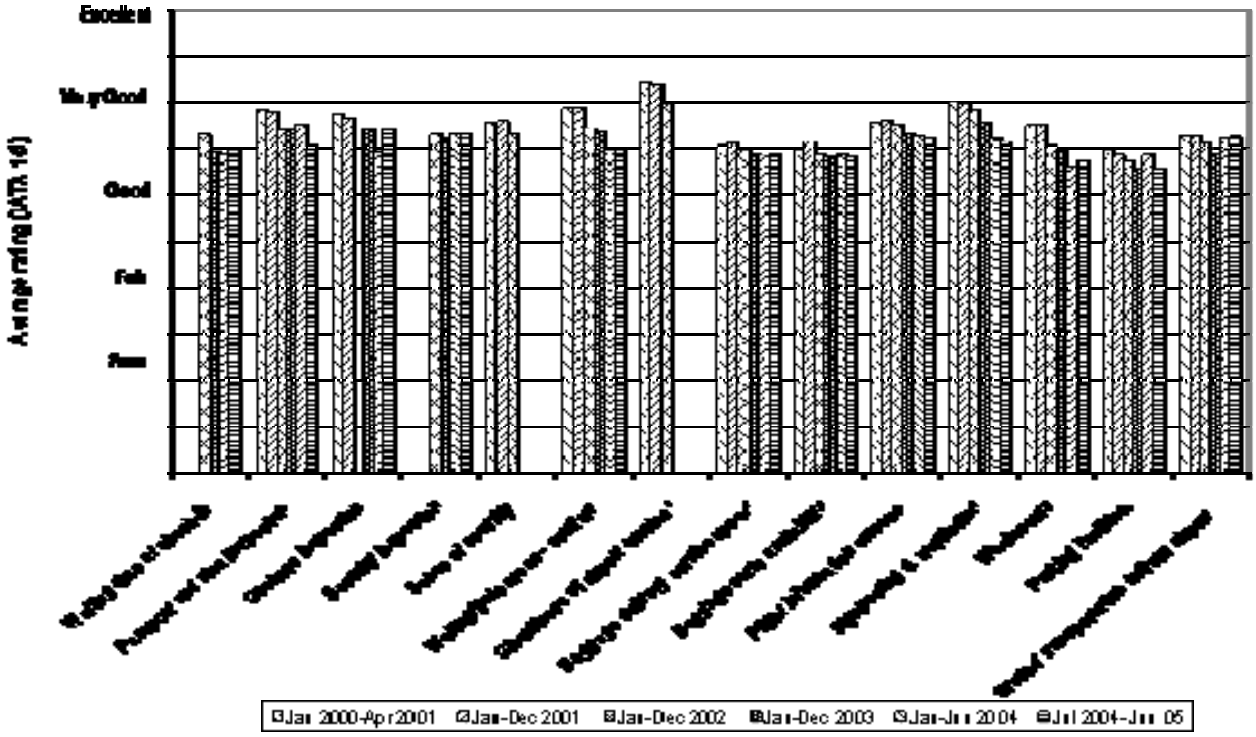
The Government's Review Principles also stipulate that consultation mechanisms should be established with stakeholders to facilitate the two way provision of information on airport operations and requirements. SACL has engaged in extensive consultation with its airline customers (and, as appropriate, with its stakeholders more generally) in relation to each of the new investment projects it has contemplated under the light-handed regime. In its draft long-term aeronautical services agreements currently being negotiated with airlines, SACL has offered to contractually entrench and enhance its current consultation processes, including an unprecedented level of involvement in relation to development and implementation of new investment.

In addition, the Review Principles contemplate that, at a significantly capacity constrained airport, efficient peak/off-peak prices may generate revenues in excess of production costs. The Principles express support for such measures provided that any additional funding thereby generated is applied to the creation of additional capacity or undertaking necessary infrastructure improvements. This principle was established in response to the potential situation where peak charges might need to be increased in order to influence demand patterns by more than could be offset by off-peak reductions. However, given the entrenched opposition by most airlines to such an approach, SACL has not introduced demand management pricing to date.

Improvements to the existing light handed regime, to ensure that airlines have appropriate incentive to negotiate in good faith and conclude enhanced commercial arrangements, should provide the necessary framework for ensuring that appropriate investment continues at the airport.

Quality of Service

The ACCC monitors quality of service outcomes as an adjunct to prices to ensure that airports do not attempt to achieve implicit price increases through a diminution of service standards. Price stability at Sydney Airport has been matched by consistently high-quality services. The ACCC's annual quality of service monitoring reports consistently indicate passenger's perception of service quality (as measured by the IATA/ACI international airport survey) as between 'good' and 'very good' (between 3 and 4 out of 5) for international and domestic facilities. The following chart from the ACCC 2005 Quality of Service Monitoring Report shows a time series of results from international passenger perception surveys for Sydney Airport.



SACL has actively engaged with its airline customers to develop service level standards for inclusion in its commercial agreements with them, breach of which would entitle airlines to a rebate of the charges otherwise payable by them. In each of these respects, SACL's actions have been consistent with the Government's Review Principles.

Provision of Access at Sydney Airport

Consistent with the Government's Review Principles and with SACL's incentive to promote traffic growth, SACL continues to encourage new traffic to Sydney Airport. SACL actively markets to prospective new carriers and for new routes and services, and responds to request for access to its facilities. It does this through such means as the construction of facilities to accommodate new services, such as the Domestic Express Terminal and acquisition of Terminal 2 as a common-user facility. SACL also has an incentives programme and offers start-up incentive, marketing and discount arrangements to encourage new services to Sydney.

Airline Commercial Agreement Negotiations at Sydney Airport

In its report in 2002, the Productivity Commission recommended that:

> "*Commercial agreements should be encouraged and assisted (for example, by providing guidelines regarding coverage) under price-monitoring arrangements, or price caps, if they were retained at some airports*" (Recommendation 5).

The Government supported this recommendation in principle and stated that:

> "*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.*
>
> *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*"[1].

SACL continues to support the Government's stated policy position, including its acknowledgement that agreements may take a range of different forms and cover a range of different matters. It also supports the view that Part IIIA of the TPA should apply only if commercial agreement cannot be reached in relation to matters which affect *access to* the relevant airport facility.

In response to the questions raised in the Productivity Commission's Issues Paper, this section provides information in relation to the way in which commercial agreements currently operate at Sydney Airport, and of the ways in which SACL has sought to achieve more optimal and mutually acceptable commercial arrangements with its airline customers.

Background to commercial agreements at Sydney Airport

Prior to commercialisation, the *Federal Airports Corporation Act 1986* empowered the FAC to determine aeronautical charges, initially unilaterally but later subject to formal prices surveillance. The Act also allowed the FAC to determine, subject to Ministerial approval, other terms and conditions "*governing the provision to, or use by, any person, or class or persons, of services provided by, or facilities owned or operated by, the Corporation*": section 72(1)(c).

Under that regime there was effectively no room for formal negotiation on, or disputation about, terms and conditions governing access at Sydney Airport.

Development of Current Commercial Agreements

Following commercialisation but prior to privatisation, when those statutory powers were no longer available to it, SACL developed price and non-price Conditions of Use which it published and on the basis of which it offered to supply aeronautical services to airlines. Those Conditions of Use were not markedly different from the former FAC by-laws, and aeronautical charges were only able to be increased following approval by the ACCC under the then *Prices Surveillance Act 1983*.

In publishing these Conditions of Use, SACL, like other airports internationally, maintained that use of the airport by an airline constituted contractually binding acceptance of the terms and conditions set out in its Conditions of Use, in much the

[1] Joint Press Release by the Minister for Transport and Regional Affairs and the Treasurer dated 13 May 2002

same way as those who avail themselves of entry to a car-parking station do so on the basis of the terms and conditions displayed at the point of entry.

Some airlines disputed the legal effect of their use of Sydney Airport. However, the vast majority of airline customers subsequently accepted written documents setting out the terms and conditions upon which they use Sydney Airport's aeronautical facilities and services.

In doing so, a large number of airlines have, without any apparent difficulty, agreed to the "standard form" Conditions of Use. However, SACL has also compromised on, and varied, a number of its "standard" provisions in order to address concerns raised by individual customers during the course of negotiations. More particularly SACL has:

- negotiated and formalised tailored Conditions of Use agreements with Qantas (later extended to Jetstar), Air New Zealand and later Virgin Blue;

- negotiated a standard Conditions of Use agreement with BARA, subsequently formalised with the majority of international airline customers;

- implemented commercial arrangements to 2019 with Virgin Blue, Qantas and Jetstar for Terminal 2, and licence arrangements for varying periods with other domestic and regional carriers for the use of that terminal; and

- negotiated with BARA, and implemented with international carriers operating out of Sydney Airport, commercial agreements for the use of check-in-counters at Terminal 1.

Each of these agreements remains current and in force.

As a result, it is only casual users of Sydney Airport and some freight operations that continue to use the airport under the provisions of SACL's unilaterally determined Conditions of Use.

In short, SACL has concluded comprehensive, binding bilateral contracts with the majority of its customers, and in most cases without undue difficulty or contention between the parties involved.

In SACL's view, the fact that so many airlines have accepted the Conditions of Use (with or without amendment) and agreed the terms on which they use terminal facilities demonstrates that those agreements or arrangements are far from unreasonable. It also demonstrates that airports and airlines are quite capable of achieving commercially negotiated outcomes without regulatory intervention.

Subject to any confidentiality restrictions, SACL would be pleased to provide further information to the Commission in relation to its contractual arrangements with airline customers, if requested, on a confidential basis.

The proposed new Long Term Aeronautical Services Agreement

While the Sydney Airport Conditions of Use have been accepted by airline customers (with or without variation), both SACL and airlines recognise that they are not optimal from the perspective of either party.

SACL understands that, for their part, airlines seek:

- a more consultative and cooperative environment in which they can have greater input into SACL's operational and investment decisions;
- greater assurance as to the quality of the services that SACL provides; and
- protection against the potential that SACL may unilaterally raise charges to levels that are not justifiable (although this potential has not eventuated to date and appears to SACL to be remote).

For its part, SACL seeks:

- a more consultative and cooperative environment in which its operational and investment decisions can be made with a clear understanding of the airlines' perspective;
- a capacity to proceed with and charge for new investment that is agreed by the majority of (but not necessarily all) airlines; and
- a mechanism that recognises the shared responsibilities of airports and airlines for overall airport operations where the acts of one airline can impede SACL's ability to deliver quality services to others.

Once its Master Plan had been accepted by Government in March 2004, SACL sought to actively engage in detailed negotiations with all major airlines, either directly or through BARA, with a view to agreeing new long-term aeronautical services agreements that are mutually acceptable. SACL has endeavoured to develop a package of contractual terms that, viewed as a whole, might be a mutually acceptable proposition for all concerned. In summary, SACL has offered significantly enhanced terms of use to airlines, including:

- at least five years of price certainty;
- capital works for five years included in charges, with the risk of unforeseen projects and costs generally resting with SACL;
- a more reciprocal approach to risk associated with the provision and use of aeronautical facilities;
- service level undertakings with financial rebates where they are not met;
- increased consultation on capital works and operations at the airport;
- cost, traffic and revenue risk residing with SACL; and
- a simplified, plain English contract for use of facilities.

If accepted in this or a similar form, such an agreement would constitute a significant advance both because of its comprehensiveness and its level of commitment in relation to such key issues as price certainty, consultation, service level standards and rebates for their non-attainment.

The aeronautical charge elements of the proposal are based on continuation of existing charges. SACL considers this to be a moderate approach as these are lower than would be justified were SACL to adjust its charges for the elements that it considers were flawed in the ACCC's 2001 decision, namely:

- adopting a corrected land value based on opportunity cost; and
- correcting the value that should be assigned to the asset beta (the measure of that asset's risk in relation to the market) component of the formula for the weighted average cost of capital to reflect that implied by an assessment of market comparables.

The capital investment programme referred to as 'Project STAR' is aimed at ensuring that SACL can continue to provide world-class airport facilities, and includes a planned redevelopment of the international terminal and recovery of the works required to accommodate the new A380 aircraft. The cost of this programme was proposed to be recovered by an agreed Airport Development Charge. The Airport Development Charge was calculated as a single charge per international passenger to apply for the initial five year period, with full recovery of the projects achieved over the remaining useful lives of the works.

The ongoing uncertainty posed by the application for declaration of the Domestic Airside Service, and the relative importance to international services of the works proposed under Project STAR, led SACL to focus its efforts on concluding a new commercial agreement to cover international passenger services, prior to recommencing negotiations to cover domestic airside facilities.

Proposed enhanced airline agreements have not been achieved within the timeframe envisaged and SACL has needed to continue to undertake new investment for works already agreed outside the proposed Airport Development Charge framework. Accordingly, the cost of this new investment continues to be recovered once projects are completed, consistently with the process previously adopted under the former regulated framework.

Airlines have argued that these new investment projects ought to be absorbed by SACL within the existing base aeronautical charges as aeronautical traffic grows. However, in SACL's view, the Government's Review Principles imply that it is not appropriate to consider aeronautical charges solely on a short-term view of costs and revenues without regard to the longer-term costs of providing aeronautical services and the need to ensure that correct price signals and incentives to invest are maintained.

SACL does not consider that its proposed commercial offer could be considered to be an unreasonable one. While recognising that the offer has not been found acceptable by BARA's members to date, comments in the BARA newsletter of October 2005 imply that the proposal is not on its face unreasonable. BARA's *Airline Views* newsletter of October 2005 noted that:

> *"To SACL's credit, the airport operator seems focussed on ensuring that Sydney Airport is able to cater for expected demand growth and technological developments in the international aviation environment" and that "early indications show that the new pricing offer seems to represent a reasonable concession by SACL. The proposed pricing structure seems more in line with that sought by airlines."*

It also observed that:

> *"SACL has provided a new plain English commercial agreement for consideration by airlines…[that] represents a considerable improvement over the previous contract put forward by SACL."*

Following receipt of proposals by BARA, SACL also extensively reworked its previous draft of the proposed long-term agreement to incorporate extensive service level provisions and these have been the subject of subsequent discussion with BARA. Indeed, BARA wrote to SACL in December 2005 noting that "discussions between SACL and airline representatives on the description of service level requirements as currently specified in the proposed aeronautical services agreement are nearly finalised".

The service level undertakings that have been offered to BARA, based on the framework proposed by BARA, include:

- a commitment to service levels for international check-in counters; outward security screening; outward baggage; aircraft aprons; runways; aerobridges; inward baggage; bussing operations; and international terminal electrical supply;
- specification of the minimum service standard for each such service or facility;
- commitment to a time in which to respond to service shortfalls;
- commitment to a time in which service shortfalls will be rectified;
- a specific percentage rebate against charges for flights affected by a failure by SACL to meet the service commitments; and
- corresponding obligations on airlines where their conduct can impact on service outcomes.

While progress has not always been as either party might desire, there has been ongoing negotiation and compromise in which the list of outstanding issues has been consistently whittled down. While there remain some important issues yet to be resolved, there is no reason why this cannot be achieved by negotiating in good faith within the current regulatory environment.

5. Incentive Structures under Light-handed Regulation

Key Points:

The light-handed regime remains the most appropriate, flexible, and economically efficient method of regulation for major Australian Airports.

The "probationary" nature of the present light-handed regulatory regime and uncertainty regarding the final outcome of Virgin Blue's Part IIIA application have acted as an obstacle to achieving the full benefits of the light-handed approach.

These have combined to provide airlines with reduced incentives to conclude new agreements with airports on terms that airlines perceive may be less favourable than those that may apply if there was a return to greater regulatory intervention.

Introduction

Key objectives of light-handed regulation were to avoid unwarranted price increases for aeronautical services at major Australian airports and to encourage the formation of mutually acceptable commercial agreements between those airports and their airline customers.

However, airports were not all in a homogeneous situation at the time light handed regulation was introduced and thus the pricing and agreement outcomes since 2002 vary between airports. Price increases at Sydney Airport since 2002 have been extremely minor when compared with other airports, but this is readily explained by the differential application of the former regulatory regime which saw ACCC approval in 2001 for increased average charges at Sydney Airport of almost 100%. This placed Sydney's charges on a location-specific, dual-till basis, while other airports were constrained to CPI - X changes built upon the single-till and network-based FAC starting price.

In SACL's view, this difference in position was a material factor in airlines' apparent willingness to reach forms of agreement at other airports compared with the more protracted process at Sydney Airport towards new commercial agreements. In addition, with formal arrangements already in place at Sydney Airport, the probationary nature of the light-handed regulatory regime has itself adversely impacted on the incentive for airlines to conclude new long-term contractual agreements.

Accordingly, this section examines the varying impacts which the introduction of light-handed regulation has had on pricing and the attainment of long-term commercial arrangements at Sydney Airport and at other major Airports.

Overview of Commercial Outcomes

Late in 2001, prior to the decision to introduce light handed price regulation, the Government permitted airports to introduce a one-off increase in their aeronautical charges above the price cap in reaction to the upheaval caused by the terrorist events of 11 September 2001 and the collapse of Ansett. This effectively recognised the limitations of the CPI-X regime, and arguably formal price regulation, to deal with

market changes in a timely manner. Recognising the inflexibility of the price cap regime, the Government removed price caps at eight of the secondary price regulated airports and permitted one-off increases through the cap at Melbourne, Brisbane and Perth Airports of between 6.2% and 7.2%.

With the lifting of formal price controls upon the introduction of light-handed regulation, other Australian airports justifiably wished to pursue the precedent established by the ACCC's Sydney Airport 2001 pricing decision and further adjust their charges to move them closer to location-specific, efficient charges that better reflected the cost of providing aeronautical services.

These price increases were an outcome of the pre-privatisation regime that was defined by rigidity in the approach to charges and necessitated significant discrete increases to reflect more appropriate pricing levels reflecting a location-specific dual till approach. Indeed, this was an outcome anticipated by the Government as evidenced by public statements by the then Minister for Transport and Regional Services in his speech to the Transport and Tourism Industry Summit in September 2003, where he noted that:

> *"So far, the major airports have responded to the new price monitoring system as expected".*

Commercial relationships between airports and airlines are complex and involve many non-price considerations. However, one could surmise that the removal of the artificial CPI-X regime, coupled with the ACCC's decision on appropriate pricing at Sydney Airport, signalled to airlines that the airport pricing environment had changed in Australia and that they could no longer plan their operations on the basis of significantly underpriced airport services.

Such a conclusion would provide airlines with an incentive to achieve price certainty under a form of commercial arrangement with those other airports. Airports also had an incentive to move quickly to revised aeronautical charges. This, coupled with the significant difference between their regulated charges and those justified under a dual till building blocks framework, presumably provided those airports with a degree of latitude in the level of aeronautical charges that they were prepared to offer under an initial commercial arrangement in the light-handed environment. This was an anticipated and desirable outcome of the light-handed regime.

So far as SACL is aware, the types of commercial arrangements reached between airports and airlines under the initial period following light-handed regulation has varied, with formally accepted binding terms far from commonplace. SACL understands that the forms of arrangement range from executed contracts including service level undertakings, to negotiated terms to which some airline customers are signatories, to unsigned 'accords'. The circumstances of each airport are different and all may well represent a legitimate approach to the differing needs and expectations of airlines and airports under the light handed regime.

Notably, while it has been a matter of contention at Sydney Airport (see Appendices A and B), the majority of Australian airports levy domestic charges on a per passenger basis, with the exception of Brisbane and Adelaide, the latter of which offers a choice of a passenger or MTOW charge.

Commercial Outcomes at Sydney Airport

SACL notes that in terms of its own commercial relationships:

- it has currently operative commercial arrangements that are comprehensive, binding and definitive; and
- its significantly different price circumstances at the time of the move to light handed regulation have made the formalisation with airlines of enhanced commercial arrangements at Sydney Airport more difficult than such a task might have been at other airports.

SACL and airlines have not yet brought to fruition their negotiation of new long term aeronautical services agreements. However, this is hardly surprising for a number of quite fundamental reasons:

- SACL already provides access to its aeronautical facilities on terms that have been accepted by airlines, although these could be improved;
- access is assured under the terms of SACL's Head Lease from the Commonwealth, which allows only very limited circumstances in which it can cease providing its services to airlines;
- SACL's aeronautical charges had already moved from a single-till, network-basis under the ACCC's 2001 decision, and accordingly airlines had little need to reach agreement on non-price terms and conditions in order to temper or trade-off an otherwise large price increase of the magnitude they faced at other regulated airports;
- commercial agreements are already in place and, while they can be improved, they operate effectively and there has been no abuse of, or significant disputation about exercise of their terms;
- the formulation of the proposed new style agreements is a novel process that requires careful deliberation given the significance of the issues under consideration; and
- because of the lack of precedent for such agreements, both parties need to move from their initial intuitive and rather traditional perspectives towards a more shared perspective where new compromises are struck.

In addition, the prevailing nature of the regulatory environment in which these negotiations have been progressing has itself provided an inducement for airlines, quite rationally, not to conclude final agreements. This is because, in so doing, they may deprive themselves of further advantage that they perceive might otherwise arise through either the Virgin Part IIIA proceedings or this scheduled Productivity Commission review.

Thus, the fact that these new-style agreements have not been finally concluded does not in any way indicate that mutually acceptable commercial agreements cannot be reached between airports and airlines (or, even more particularly, between SACL and airlines), or that greater regulatory intervention is warranted.

Rather, if anything, it demonstrates the desirability of clarifying the ambiguity of the current regulatory arrangements and leaving airports and airlines to get on with the task of achieving enhanced commercial arrangements against a background in which, as in other industries, Parts IIIA, IV and VIIA of the TPA provide sufficient protection against unjustifiable conduct.

SACL does not believe that the Government anticipated that the light-handed regime should be characterised by a strict, mechanistic adherence to replicating the expected outcomes of cost-based regulation in establishing prices under commercial agreements with airlines. To do so would inappropriately remove the primary bargaining position of airports, who would otherwise be constrained to negotiations on what enhanced terms could be offered to airlines to accompany the lowest price outcome that airlines could conceive under a regulatory environment.

In this regard, SACL considers that the recommendations to the Prime Minister in May 2005 of the Exports and Infrastructure Task Force, which were subsequently accepted by Government, are relevant to an assessment of the expected pricing outcomes under a light-handed regime. Airports are at least as important a piece of international infrastructure as the ports and export infrastructure considered by that taskforce, and arguably more so given the role that airports play in facilitating national and international travel, tourism and freight.

The taskforce concluded that, among other things, Australia's economic regulatory framework was "subject to gaming by participants". It also concluded that a "quest for 'first best' solutions, combined with a focus on removing monopoly rents, has distracted from what should be the regulatory task: which is not to determine whether what has been proposed by way of access conditions is optimal, but whether it is reasonable."

In other words, the timely and inefficient operation of infrastructure and delivery of infrastructure investment cannot occur under a framework of strict adherence to an allegedly 'correct' price, where deviations from one often subjective view of the correct price could lead to regulatory intervention. Rather, in keeping with the Export and Infrastructure Taskforce recommendations, the light handed regime needs to recognise the commercial realities of business and that, in practice, charges would be expected to vary within a range of what might be reasonably viewed as the minimum and the maximum charges that could be struck for the service. Provided that charges fall within this range, there should be no need for government or regulatory intervention.

SACL considers that this is also consistent with the approach adopted by the Australian Competition Tribunal in its decisions on the *Application by GasNet Australia (Operations) Pty Ltd* [2003] and *Application by Epic Energy South Australia Pty Ltd* [2003]. While both of these decisions involved interpretation of the Gas Code, SACL is of the view that these decisions demonstrate a recognition at the Tribunal level that government and regulators should not always seek to impose the most conservative outcomes implied by a regulatory approach.

6. Future Price Regulation of Airports

Key Points:

Light handed regulation, with its focus on commercially negotiated outcomes, remains the most appropriate and economically efficient method of regulating airports.

Commercially negotiated outcomes would be further facilitated by:

- removing the notion of "probationary" light handed regulation, such that it is endorsed as the Government's preferred policy, without scheduled periodic review; and
- the Productivity Commission providing further clarity on how certain key issues raised in the current Review Principles should be applied in practice.

Within this environment, airports and airlines would be well placed to resolve any disputes through commercial negotiations or appropriate commercial dispute resolution procedures.

Should there be a view that a form of external dispute resolution may be required to address intractable disputes, this must be commercially focused and promote reasonable outcomes in the context of the commercial environment and policy framework. SACL supports the Exports and Infrastructure Task Force framework for commercially based dispute resolution.

The Part IIIA access regime should continue to apply in situations where to address genuine access concerns, not primarily as a means of price intervention.

SACL believes that light handed regulation, with its focus on commercially negotiated outcomes, remains the most appropriate and economically efficient method of regulating airports.

However, SACL believes that the light handed regulatory regime could be improved, and commercially negotiated outcomes further facilitated, by:

- removing the notion of "probationary" light handed regulation, such that it is endorsed as the Government's preferred policy, without scheduled periodic review; and

- the Productivity Commission providing further clarity on how certain key issues raised in the Government's Review Principles should be applied in practice.

In this regard, a stable ongoing regime will reduce the potential for regulatory gaming in place of genuinely working to finalise commercial agreements.

SACL already has workable and binding commercial agreements in place with the vast majority of its airline customers and is currently negotiating enhancements to those commercial arrangements. As in any commercial negotiation process, the negotiations between SACL and its airlines customers have involved points of contention. However, a very large number of matters that were in contention at the

start of the process have now been resolved through commercial negotiation and concessions by both SACL and the airlines.

SACL believes that the current light-handed regulatory regime, refined as suggested above, would provide increased incentives for both airlines and airports to find commercial solutions to any currently outstanding matters and in future negotiations.

Should there be a view that a form of external dispute resolution may be required to address intractable disputes, this must be commercially focused and promote reasonable outcomes in the context of the commercial environment and policy framework.

The Government has accepted the views of the Exports and Infrastructure Task Force in May 2005, that more intrusive regulatory approaches should only be applied where light handed regulation has demonstrably failed. In the Task Force's view:

> "*there should be a presumption that issues associated with export oriented infrastructure [such as major international airports] will be resolved by commercial negotiation between the infrastructure providers and users. We accept that this will be imperfect, at times significantly so, but it is still likely to be preferable to the intrusive regulation that has become widespread*"[2].

Significantly, the Task Force considered that any regulatory intervention, if warranted at all, should be simplified and restricted in scope. It should not seek to determine alternative outcomes, but merely to express a view on whether a commercial proposal is reasonable. Specifically, the Task Force stated that:

> "*The relevant test applied by regulators should be simplified and based on whether what has been proposed by the infrastructure owner is reasonable in the commercial circumstances and in the light of the statutory objectives. This test – under which a regulator could not reject a proposed access arrangement that fell within a reasonable range, merely because it preferred another point in that range – should be applied universally and uniformly, as envisaged under the National Competition Policy reforms. Simplifying the regulatory test to one that merely considers whether the infrastructure owner's provider is reasonable in the commercial circumstances and falls within a reasonable range should reduce the complexity of the regulator's task and result in a more timely process*"[3].

SACL supports the recommendations of the Task Force.

SACL believes that the light handed regime is able to provide a comprehensive commercial framework. Under this regime, Parts IIIA, IV and VIIA of the TPA would continue to be available as potential remedies, and would continue to operate as a powerful and effective constraint, although should not be required to be invoked within the light-handed framework.

Part IIIA of the TPA should continue to be available in situations where there is a genuine concern in relation to access to monopoly infrastructure, rather than primarily as a method of price intervention. The extent to which it provides for this will depend on the outcome of the current Federal Court proceedings. Having regard

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[2] Australia's Export Infrastructure, Report to the Prime Minister by the Exports and Infrastructure Task Force, May 2005, page 3

[3] Ibid, page 4.

to that outcome, it may however be necessary to clarify the operation of Part IIIA of the TPA as suggested in Appendix A, particularly in circumstances where the relevant facility owner is not vertically integrated and already provides access to all potential users.

Use of Pricing Principles

In its Issues Paper, the Commission also sought comments on the possibility of explicit pricing principles being encapsulated in any future price monitoring regime to provide guidance to airports and airlines.

SACL considers that the Government's Review Principles already provide substantial guidance to airports and airlines in relation to how they should conduct their commercial relationships under the current light-handed regulatory regime.

In these circumstances, SACL does not believe that there is a need for any further pricing "guidelines" or "pricing principles". However, as set out above, SACL believes that there would be substantial benefits in the Productivity Commission providing further clarity on how certain key issues raised in the current Review Principles should be applied. That additional clarity would provide significant assistance to airports and airlines in reaching future agreements on both the price and non-price terms which govern their commercial relationships, without entrenching regulatory second-guessing.

Undertakings

In its Issues paper, the Productivity Commission also sought comments on the mechanism for providing access undertakings under Part IIIA of the TPA.

SACL supports the principle of availability of undertakings and the Government's proposal, contained in the *Trade Practice Amendment (National Access Regime) Bill 2006*, to extend their availability to services which have been declared.

SACL has not, to date, sought to provide an access undertaking to the ACCC, largely on the basis that it considers that commercially negotiated bilateral or multilateral agreements that are tailored to the relevant parties' interests are likely to offer better prospects for mutually acceptable and beneficial outcomes for both SACL and its airline customers.

7. Other Issues Raised by the Commission

Key Points:

- Airport land should appropriately be valued on the basis of opportunity cost, with aeronautical charges at the very least adopting an appropriate starting point value
- Non-land airport assets should also be appropriately valued at their depreciated optimised replacement cost
- Revaluation of airport assets does not result in 'windfall gains' to airport owners but economically efficient prices
- Continued financial and quality of service disclosure for major airports provides appropriate transparency under the light-handed regime
- Alignment of the definitions of aeronautical services used for financial reporting and prices monitoring is desirable in principle, but should not capture currently excluded services or those where airports have no substantial market power
- Quality of service monitoring could more appropriately focus on passenger satisfaction data, which could be publicly reported annually directly by airports.

Introduction

The Productivity Commission has requested information on a range of matters in its Issues Paper beyond those already discussed in this submission. In this section, SACL addresses those that it considers to be most pertinent to its circumstances, being:

- asset valuation for aeronautical pricing purposes;
- weighted average cost of capital;
- demand management pricing;
- fuel throughput levies; and
- financial and quality reporting.

Land and Asset Valuation

Approach to Valuation

Consistent with the views of the Government and the recommendations made on the appropriate basis for valuing land by the Productivity Commission, SACL continues to believe that a revaluation of its land assets is warranted in order to reflect the economically efficient price of providing its aeronautical services. The light-handed regime provides an environment where adjustments to charges to reflect opportunity cost may be negotiated as part of enhanced commercial terms.

Access Economics prepared a paper in October 2005 for the Australian Airports Association, entitled *The Value of Airport Land*, which details the economic case for the valuation of airport land at its opportunity cost for the purposes of setting

aeronautical charges.

While recommending the opportunity cost approach to land valuation, the ACCC's decision in 2001 to adopt an indexed historical was primarily based on its view that opportunity cost was difficult to establish. To address this, Access Economics has also prepared a paper for SACL, provided at Appendix C, which provides a framework for assessing the opportunity cost of land for pricing purposes.

In summary, the two Access Economics papers support a case for the use of the opportunity cost of aeronautical land for setting aeronautical charges, because it ensures that:

- economic welfare is maximised through efficient resource allocation by matching users' willingness to pay with the cost of provision of the facility;
- prices reflect a competitive market outcome, where if the opportunity cost of land and assets is not reflected in prices, then they will be put to an alternative use;
- prices for use of the airport reflect the cost of provision of facilities in that location; and
- charges also provide the correct price signals for use of airport land between aeronautical and non-aeronautical purposes.

Access Economics also observes that, while distributional issues are relevant considerations, they should not be reflected at the expense of overall economic efficiency.

These considerations are equally relevant to the value of non-land assets incurred in the provision of aeronautical services.

The primary reason for adopting efficient charges that reflect the cost of providing airport services is to reduce resource distortions, promote better investment decisions and maximise economic welfare.

If airport users are not prepared to pay the cost of the locational attributes of the Sydney Airport site, then it should be located elsewhere. While the market value of land in the Sydney region, particularly within 10 kilometres of the central business district, is notably higher than that of other capital cities, this simply reflects the cost of providing an airport in Sydney. Merely because it is higher than other cities does not support a case for airport charges to be held artificially low, just as one would not expect the price of a residential or development block in Sydney to be discounted to bring it more in line with the cost of land in other cities.

It is not relevant to the value of the land whether the airport could now be relocated unilaterally by SACL. The Commonwealth has made a decision to provide long-term leasehold tenure over an airport located at Mascot, land for which a significant price could otherwise be received for an alternative use. The privatisation of the airport should not dictate inefficient pricing outcomes for almost a century.

It is useful to give some perspective to the land valuation debate. The ACCC determined a value of aeronautical land of $69 per square metre in its 2001 decision, equivalent to $81 per square metre in current dollars. In generating this value, inadequacies in land acquisition data seriously skewed the imputed value of land

acquired prior to 1947. One-third of the aeronautical land at Sydney Airport (218 hectares) was valued based on the purchase price of a 36 hectare parcel of land in 1921. This gave an indexed value in 2000 of only $4 per square metre for the total 254 hectares acquired prior to 1947. This compares with the average indexed value of land acquired post-1947 of $304 per square metre.

SACL's draft advice regarding the current opportunity cost value of its aeronautical land is approximately $126 per square metre, as estimated by Jones Lang LeSalle based on the methodology developed in conjunction with Access Economics (and discussed in Appendix C). All other things remaining equal, indicative modelling suggests that the difference between these two valuation approaches equates to a variation in charges of approximately 10% for international and domestic users.

Views of Government

The Minister for Transport and Regional Services stated in a speech at the Australian Airports Association convention in November last year that:

> *"One particular issue that the Productivity Commission [will be] asked to review is the issue of aeronautical asset valuations (particularly leased land) and whether seeking to increase aeronautical prices on the basis of re valued aeronautical assets could lead to windfall gains for the airport operators at the expense of the travelling public.*
>
> *The Government is not prepared to support such windfall gains from frequent asset revaluations at our leased airports."*

Presumably this view arises because of a concern that the opportunity cost of land should not be included in aeronautical charges where that cost was arguably not reflected in the bid price for Sydney Airport.

The Productivity Commission recommended that *"bidders for Sydney Airport should have a clear picture of the regulatory framework for that facility so that expected future airport charges can be factored adequately into the sale price."*[4] Elsewhere, the Commission observed that it would "seem preferable" for appropriate land values to be fully incorporated into aeronautical charges prior to the sale of Sydney Airport to ensure that the value was captured by the Government and community"[5].

SACL does not consider that adjustment of charges prior to privatisation was essential for value to be fully captured, with the competitive sales process and disclosure of the light-handed regulatory principles providing an adequate mechanism for the Government to capture in proceeds from the sale of SACL the value of potential future charges.

Prospective purchasers of a major business such as Sydney Airport, formulating bids in a competitive tender environment, must make a myriad of judgements, assumptions and decisions in determining the expected cash flows from the business and deriving the price that they are prepared to pay. In doing so, they must fully incorporate information known to all bidders, as well as making their own judgements regarding aspects for which they have imperfect information.

[4] Productivity Commission, 23 January 2002, op cit., page XLVII.
[5] Productivity Commission, 23 January 2002, op cit., page 257.

The appropriate approach to valuation of aeronautical land for the purposes of setting future charges was fully disclosed to all bidders in the bid process for Sydney Airport:

- *Clarity of regulatory regime*: The Government had announced and clearly articulated the regime of light-handed regulation that was to apply for a probationary period of at least the first five years following the privatisation of Sydney Airport, subject to appropriate pricing behaviour by airports. In particular, the Government indicated that airport *"prices should allow a return on (appropriately defined and valued) assets (including land)"*.[6] The announced regime provided scope for the owner of Sydney Airport to attempt to negotiate charges under a commercial framework that reflected a more appropriate valuation of land.

- *Clarification of appropriate basis for valuation of land*: The prevailing view at the time of the Sydney Airport privatisation was that opportunity cost was the appropriate approach to land valuation from an economic efficiency perspective. SACL considers that this notion was supported by the Productivity Commission's 2002 report, which stated that *"while historical costs may make for a simpler assessment, they are less likely to encourage efficient production and investment in this industry, especially where the current opportunity cost of significant assets is substantially above their historic cost (eg aeronautical land at Sydney Airport)"*[7], also adding that *"if regulation of Sydney Airport aeronautical charges continues to involve prices set by the regulator on a production-cost basis, aeronautical land should be valued at its opportunity cost rather than its indexed historic cost"*[8].

In this regard, bidders for Sydney Airport had a much greater degree of clarity as to the basis for forecasting appropriate charges as part of their bid price than did bidders for the Phase I & II airport privatisations. Consequently, the Government and the public were more assured of receiving the benefits through privatisation of efficient charges at Sydney Airport than was the case for those airports that were privatised on the basis of a CPI-X regime to apply for five years, with an uncertain regulatory approach thereafter.

Opportunity Cost of Assets in the Light-Handed Framework

In SACL's view, aeronautical charges *should* reflect the opportunity cost of the land and the market value of assets used to provide aeronautical services. As noted in the Access Economics paper, efficient airport charges should also reflect periodic revaluations of land and assets.

SACL has however not sought to increase aeronautical prices from 'frequent assets revaluations'. It has adopted an approach that a balanced, periodic revaluation of land and assets for the purposes of charges would be a legitimate potential pricing outcome under the light-handed regime and would be economically efficient.

[6] Joint Media Statement, the Hon John Anderson MP and Hon Peter Costello MP, *Productivity Commission Report on Airport Price Regulation*, 13 May 2002, page 5.
[7] Productivity Commission, 23 January 2002, op cit., page XXXVI.
[8] Productivity Commission, 23 January 2002, op cit., page 257.

SACL does not support frequent 'automatic' adjustments to market values but considers that revaluations should occur at reasonable and commercially justifiable intervals.

Importantly, the extent to which this occurs ought to be left to be negotiated in the context of commercial agreements with airlines.

The notion and application of opportunity cost of land and market value of assets has been extensively canvassed since the Commission's 2002 report. Guidance as to the Commission's current thinking may therefore be useful in clarifying the basis of commercial negotiations.

Weighted Average Cost of Capital

The other area where SACL considered that the ACCC had erred in setting charges in 2001 was the adoption of an appropriate asset beta, which reflects relative risk in the weighted average cost of capital used to estimate the required rate of return on assets.

The ACCC adopted what it termed an 'income elasticity' approach to estimating an asset beta, rather than the more commonly accepted method of using market comparatives. SACL contends that the ACCC's methodology was not clearly enunciated, and in focussing on domestic GDP did not adequately take into account the exposure of SACL's revenues to international GDP. Further, SACL contends that there is little logic behind the difference between the asset beta allowed for SACL of 0.6 and that granted to other major Australian airports (0.7).

SACL commissioned a review by Ernst & Young, in conjunction with airlines, of SACL's market comparatives approach. This generally supported the methodology applied by SACL.

An estimate of asset beta based on market comparatives implies a beta in the range of 0.7 to 0.75.

SACL maintains that an asset beta of 0.7 more appropriately reflects the underlying risk of the airport investment. This value has been incorporated in the pricing of new investment projects. While this revised value has not been incorporated into existing charges, it is one of the range of matters that SACL has sought to negotiate with airlines as part of a new commercial arrangement.

Fuel Throughput Levies

SACL notes that, in common with the purchasers of other privatised airports, in acquiring Sydney Airport it thereby gained the contractual right to impose a fuel throughput levy under the former FAC's agreement with the Joint Users Hydrant Installation (JUHI) joint venture that provides aircraft refueling at Sydney Airport.

However, SACL also notes that:

- it has not yet sought to exercise that contractual right and does not levy fuel throughput charges; and
- in its negotiations with airlines for a long-term aeronautical services agreement it has indicated a preparedness to consider concessions in this regard as part of an overall commercial arrangement.

Over the course of price regulation and monitoring of airport charges, revenues from fuel services on airport have been incorporated into the definition of "aeronautical services" but have nevertheless remained outside the regulatory framework by virtue of the long-standing exemption for revenues derived from contracts, leases, licences or arrangements that are under the FAC Common Seal.

SACL believes that it is justifiably entitled to generate a market return from providing the right for the JUHI joint venture to occupy prime land on airport in order to provide fuel services to airlines. From a commercial perspective, it would be reasonable to presume that a portion of the benefit of below market rents would be retained by the JUHI joint venture. Indeed, the lease arrangements for the JUHI facility at Sydney Airport make provision for a portion of rental to be paid as lease rent and a portion as a fuel throughput levy. SACL has not invoked its right to receive the fuel throughput element of the payment, and considers that an appropriate market rental could justifiably be retained as a concession rental by the airport operator.

The payment of a fuel throughput levy (or any other form of rental charge) as part of the rental for the JUHI site would not represent a use of monopoly power by Sydney Airport, but imply the collection of location rents for the right to operate the fuel service. The extent to which the rental costs or throughput levy are passed on to airlines would depend on the market power held by the JUHI joint venture, which should provide for the competitive operation of the individual fuel companies. Airlines' arrangements for the provision of fuel at the airport are independent of SACL.

Accordingly, SACL contends that it would be inappropriate for fuel revenues to be incorporated as "aeronautical revenue". From a strict regulatory point of view, to do so would imply that aeronautical revenue should be reduced proportionately by the value derived from fuel service rentals. In practice, any pass-through of rentals to airlines would depend on the behaviour of the fuel service joint venture members.

Financial Reporting and Quality of Service Monitoring

SACL supports continued financial and quality of service disclosure. This provides appropriate transparency under the light-handed regime.

Current financial reporting and quality of service monitoring, while they could be no doubt improved to enhance the adequacy and usefulness of the resultant information published by the ACCC, are not major issues for SACL in terms of regulatory effort and cost. At the same time, SACL understands that they may involve material impositions for smaller airports and it would support any submissions they may make to reduce that burden on them.

Late in 2005, the Department of Transport and Regional Services proposed a new definition of aeronautical services, aimed at aligning the definitions under the Declaration operating under Part VIIA of the TPA and under the Airports Regulations made under the Airports Act in order to simplify the regulatory reporting process. The Government then decided that this should relevantly be considered as part of the Productivity Commission review. The letter from DOTARS and SACL's response at the time are at Appendix D.

SACL supports in-principle the alignment of the financial reporting definitions under the Trade Practices Act and the Airports Act. The differing definitions lead to increased reporting complexity without any advantage as to transparency. Indeed, the existing approach would be expected to increase the level of difficulty

experienced by the ACCC and the public in interpreting financial reporting information.

However, SACL does not support the expansion of the definition of "aeronautical" services, nor the retention of the confusing "aeronautical related" category. It is difficult to see any justification for expanding the definition of "aeronautical" services or increasing the range of services covered by financial monitoring. This would appear to be out of step with what is intended to be a light-handed regime, particularly where such services were not previously subject to price notification. If the Government considers that monitoring of prices for those items currently considered to be "aeronautical related" is warranted, then this should be limited to monitoring prices over time, not to the full financial reporting obligations of revenues and costs.

In contrast to the costs of compliance with monitoring, there are significant direct costs involved in Part IIIA processes and Part VIIA processes. Perhaps more importantly, they carry with them the risk of major indirect cost in the event of regulatory error, affecting not only SACL but those airlines, passengers and other third parties who can be adversely affected if regulatory outcomes do not foster desirable and efficient investment.

SACL accepts the potential for Parts IIIA and VIIA processes to be enlivened but, because of those costs, stresses the need for activation of such processes to be a matter of last resort only when bona fide commercial negotiations have irretrievably failed.

Approach to Quality of Service Monitoring

The current regime of Quality of Service monitoring undertaken by the ACCC is not a matter of significant concern to SACL. It was established at a time when the primary concern was to restrict implicit price increases through diminution of service quality. The light-handed regime has seen a much closer engagement between SACL and airlines as to the quality of services provided and reliability of facilities, based on practical concerns and outcomes. This customer-airport engagement is far more relevant at Sydney Airport than the quality of service monitoring undertaken by the ACCC.

The existing reporting format provides a range of 'static measures' regarding facilities provided at the airport, which are not necessarily insightful as of the resultant service outcomes. For example, the number of Customs desks provides little indication of the manner in which they are used. SACL has little comfort that subjective assessments of service quality by airlines provide an adequate sample, given that it is not apparent that the correct personnel are surveyed, and that voluntary responses to the survey would be expected to bias responses to those with specific 'axes to grind'.

In contrast, passenger satisfaction results provided by SACL to the survey are sourced from the internationally recognised IATA/ACI quality of service monitor. This provides comfort regarding the adequacy of the survey forms used and number of respondents. Arguably, passenger satisfaction is the ultimate measure of an airport's quality of service (although noting that many aspects of service are the responsibility of third parties such as airlines and government agencies). Material aspects of an airport's service standards would be expected to reveal themselves through passengers' experience.

It is not apparent that the ACCC is well placed to add real value to the quality of service reporting, nor is it necessarily its role. A feasible improvement on the current quality of service arrangements would be to dispense with the ACCC reporting

altogether, replacing it with a requirement that major airports publish annually the results of a properly constructed customer satisfaction survey.

8. Conclusions

The light-handed regime is capable of striking an appropriate balance between the commercial interests of airport operators and their airline customers and of providing sufficient guidance on the Government's expectations for airport conduct.

It has generally allowed SACL to price, operate and invest effectively, without unwarranted regulatory intrusion. It has undoubtedly led to a much greater level of commercial engagement with airlines over prices, terms of use, investment plans and service levels than had occurred under the former regime of formal price regulation.

SACL has conducted itself in accordance with the Government's Review Principles over the period since 2002, which has been marked by a high degree of price stability, with charges set within the framework previously established by the ACCC and revenues below those deemed appropriate based on forecast costs. Continued aeronautical investment have provided for emerging airline needs and consistent quality of service. The regime has facilitated an increased airline customer focus, which has included extensive negotiation on enhanced commercial arrangements.

The aviation environment since the 2002 review by the Productivity Commission has been notable for increased concentration of the domestic airline market, an increased cost-consciousness among world airlines and increased competition for routes and services internationally and between Australian airports for services and carriers. This increase in focus on airport costs has come despite airport charges remaining a small and stable component of airline operating expenses.

All of the regular public transport passenger service airlines operating at Sydney Airport have formalised commercial agreements in place with SACL, progressively implemented since 2001. In addition to this, SACL has been engaged in negotiations with the BARA and its major airline customers to significantly enhance the terms on which they use Sydney Airport, including providing price certainty, a pre-agreed capital investment and cost recovery programme, formalised service level commitments with rebates, and enhanced consultation arrangements.

Over this time, Virgin Blue and Qantas have also sought and achieved access declaration of Sydney Airport's domestic Airside Service - in SACL's view, predominantly to increase their negotiating leverage.

As would be expected in a commercial environment, negotiations have been robust. However, in SACL's view, there has not been sufficient imperative for airlines to conclude revised arrangements. Airlines have appeared reluctant to finalise new agreements given the prospect of Part IIIA arbitration and Government intervention following the review of the probationary period of light-handed regulation.

Airport prices under the light-handed regime should adopt a long-run perspective of the cost of providing aeronautical services. They should also have regard to allocative efficiency and provide appropriate pricing signals (including appropriate asset and land valuations), demand management, and incentives to invest.

Importantly, the charges that emerge from negotiated commercial arrangements should not be expected to mirror the minimum outcome that could be conceived of as being granted by a regulator. What should be expected, however, is that those charges fall within the range of what is reasonable.

Long-run pricing for infrastructure assets as important as airports cannot be tied to arbitrary interpretations of privatisation value, without regard to the broader considerations of economic efficiency.

For these reasons, the light-handed regime, with its focus on commercially negotiated outcomes, remains the most appropriate and efficient framework for airport regulation.

The commercial regime could be made more stable and comprehensive by removing the notion of “probationary” light handed regulation, such that it is endorsed as the Government’s preferred policy, without scheduled periodic review. Commercial negotiations may also benefit from the Productivity Commission providing further clarity on how certain key issues raised in the Government’s Review Principles should be applied in practice.

These refinements should provide increased incentives for both airlines and airports to find commercial solutions to any outstanding matters and in future negotiations.

Should there be a view that a form of external dispute resolution may be required to address intractable disputes, this must be commercially focused and promote reasonable outcomes in the context of the commercial environment and policy framework. SACL supports the framework promulgated by the Export Infrastructure Task Force, that more intrusive regulatory approaches should only be applied where light handed regulation has demonstrably failed and should not seek to determine alternative outcomes, but merely to express a view on whether a commercial proposal is reasonable.

Appendix A

Declaration of the Airside Service at Sydney Airport

1. Introduction

Following the release of the Productivity Commission's Inquiry Report on the Price Regulation of Airport Services in 2002, the Federal Government repealed the airport-specific access regime in section 192 of the *Airports Act 1996 (Cth)*, so that airports became subject to the general access regime contained in Part IIIA of the *Trade Practices Act 1974 (Cth)* ("**TPA**").

SACL does not, in principle, have any concerns with Sydney Airport being subject to the same access regime that applies to all other industries in Australia (other than telecommunications, which remains subject to an industry-specific regime). However, based on its recent experience in the application by Virgin Blue Airlines Pty Limited ("**Virgin Blue**") for declaration of the Airside Service at Sydney Airport, SACL has substantial concerns that airlines are seeking to use, and will continue to use, Part IIIA of the TPA not as a method of obtaining access (or increased access) to airport services – such access is already provided - but rather as a method of first resort to seek regulated pricing outcomes and regulated determination of airport operational and commercial issues.

SACL believes that this involves substantial economic costs and is contrary to both the intention of Part IIIA generally and the Government's policy objectives in relation to light-handed regulation of airports in particular.

The potential use of Part IIIA as a method of seeking regulated outcomes in relation to any matter in respect of which airlines and airport providers have diverging views would significantly lessen the incentives for airlines to pursue long term efficient commercial outcomes with airports and would encourage regulatory gaming.

As detailed below, SACL is also concerned that the potential use of Part IIIA to undermine the benefits of light-handed regulation is exacerbated by the broad interpretation adopted by the Australian Competition Tribunal ("**Tribunal**") in relation to the mandatory pre-condition to declaration contained in section 44H(4)(a) of the TPA, which requires "*that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service*".

This interpretation is currently the subject of judicial review proceedings before the Federal Court and it is hoped that the Court will provide definitive guidance on when the requirement in section 44H(4)(a) of the TPA will be satisfied. However, if the Court affirms the interpretation adopted by the Tribunal, or if the Court accepts the even more expansive interpretation advocated by Virgin Blue in those proceedings (also discussed below), there is a substantial risk that Part IIIA will continue to be used by airlines as a method of *first* resort to seek regulated price and operational outcomes rather than engaging in genuine commercial negotiations as anticipated in the Government's policy statement on light handed regulation.

SACL believes that this may undermine the intended benefits of the light-handed regulatory regime. It also involves substantial costs both in terms of encouraging inefficient regulatory gaming and the ever-present risk of regulatory error or unintended consequences in substituting regulated outcomes for commercial conduct.

If the Federal Court upholds the view of Part IIIA adopted by the Tribunal or adopts that espoused before the Court by Virgin Blue, SACL believes that it will be necessary for Part IIIA to be amended in the manner suggested below to ensure that the policy intent of the national access regime is properly given effect.

2. The application by Virgin Blue for declaration of the Airside Service at Sydney Airport

Background to Virgin Blue's application

The application by Virgin Blue

On 1 October 2002, Virgin Blue applied to the National Competition Council ("**NCC**") for a recommendation that the following two services be declared under Part IIIA of the TPA:

> "*(a) a 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,*
>
> *("**Airside Service**"); and*
>
> *(b) a service for the use of domestic passenger terminals and related facilities for the purposes of processing arriving and departing domestic airline passengers and their baggage at Sydney Airport ("**Domestic Terminal Service**")*".

Virgin Blue submitted its application to the NCC despite the fact that:

- only three months had elapsed since the introduction of the light-handed regulatory regime;
- SACL had at all times readily provided Virgin Blue with access to and use of the Airside Service;
- Virgin Blue had negotiated and accepted Condition of Use under which it would use the Airside Service, and accordingly was not in the situation where it had been unable to agree with SACL the terms and conditions on which it used those facilities;
- SACL had purpose built the Domestic Express Terminal to provide domestic terminal services to Virgin Blue which facilitated its speedy commencement of services to and from Sydney Airport; and
- commercial negotiations, while robust on both sides, were then being actively and productively pursued by both parties to provide Virgin Blue with further domestic terminal services through the former Ansett terminal. Those negotiations were also marked by the commencement of litigation by Virgin Blue against SACL and a hostile media campaign by Virgin Blue targeted against SACL's major shareholder ("Macquarie: What a Bunch of Bankers").

Following agreement between SACL and Virgin Blue on the terms of use of the former Ansett terminal (now known as Terminal 2), Virgin Blue discontinued its legal proceedings against SACL, ceased its media campaign and withdrew its application for declaration in respect of the Domestic Terminal Service.

In the circumstances, it may well be that Virgin Blue's application in respect of the Domestic Terminal Service was simply one of several "negotiating tactics" employed by Virgin Blue in an attempt to extract more favourable commercial terms in the Terminal 2 negotiations.

Despite withdrawing its application in relation to the Domestic Terminal Service, Virgin Blue continued to pursue its application in relation to the Airside Service, with the apparent intention of seeking to re-establish direct regulatory intervention in aeronautical pricing.

Decision of the Parliamentary Secretary and by Virgin Blue's application to the Tribunal

On 29 January 2004, the Parliamentary Secretary to the Treasurer decided to accept the NCC's recommendation not to declare the Airside Service at Sydney Airport on the basis that Virgin Blue's application did not satisfy the mandatory criteria for declaration specified under subsections 44H(4)(a) or (f) of the TPA (that is, the promotion of competition and public interest criteria).

Virgin Blue applied to the Tribunal for a review of this decision. Although it did not make any written submissions to the NCC, Qantas took an active role in the Tribunal proceedings and supported Virgin Blue's application for review of the decision. The Tribunal proceedings were a complete re-hearing / merits review of the decision of the Parliamentary Secretary and involved 44 witness statements, 11 days of hearing and 1135 pages of transcript.

On 9 December 2005, the Tribunal set aside the decision of the Parliamentary Secretary and declared the Airside Service for the period from 9 December 2005 to 8 December 2010.

The consequence of declaration is that, if SACL and a user of the Airside Service are unable to agree "on one or more aspects of access" to that service, either party can notify the Australian Competition and Consumer Commission ("**ACCC**") that an access dispute exists. The ACCC is then able to make a binding arbitral determination in relation to that dispute (i.e. the ACCC can determine the terms and conditions upon which access to the service must be provided). In making its determination, the ACCC is able to consider any matter relating to access to the service, including matters that were not the basis for notification of the dispute and matters which have previously been agreed by the parties.

SACL's application for judicial review of the Tribunal's determination

SACL has applied to the Federal Court for judicial review of the Tribunal's determination. Although SACL disagrees with a number of the Tribunal's findings of fact and the conclusions drawn from those findings of fact, the judicial review proceedings do not provide for further merits review of the Tribunal's decision. Accordingly, the proceedings are limited to considering whether or not the Tribunal made any jurisdictional or other error of law.

A hearing was held by the Full Federal Court on 2-3 May 2006. The Court's decision is pending and SACL is hopeful that judgment may be delivered in the last quarter of 2006.

The Tribunal's decision

As mentioned above, SACL has a number of concerns in relation to both:

(a) the interpretation of section 44H(4)(a) of the TPA adopted by the Tribunal, which SACL believes has significant potential to undermine the benefits of the Government's approach to light-handed regulation and the policy intent of Part IIIA more generally; and

(b) certain findings of fact by the Tribunal and the conclusions drawn from those facts, in particular the conclusion that certain matters involved a "misuse of monopoly power" by SACL and therefore justified regulatory intervention.

Further details in relation to each of those concerns are set out below. The matters referred to in (a) above are subject to the Federal Court proceedings. However, because the Court is limited to considering whether the Tribunal erred in law, its factual findings cannot be contested before the Court, although SACL disagrees with them in some significant areas.

<u>The Tribunal's interpretation of section 44H(4)(a) of the TPA</u>

Section 44H(4) of the TPA provides that the designated Minister (and therefore the Tribunal) cannot declare a service unless he or she is satisfied of each of the matters set out in sections 44H(4)(a)–(f).

In its submissions to the Tribunal, SACL did not dispute that the matters set out in sections 44H(4)(b)-(e) of the TPA were satisfied in respect of the Airside Service – that is:

- it would be uneconomical for anyone to develop another facility to provide the service: section 44H(4)(b);
- the facility is of national significance having regard to its size, importance to constitutional trade or commerce, or importance to the national economy: section 44H(4)(c);
- access to the service can be provided without undue risk to human health or safety: section 44H(4)(d); and
- access to the service is not already the subject of an effective access regime: section 44H(4)(e).

However, SACL submitted that, the Tribunal could not be satisfied that access (or increased access) to the Airside Service would promote competition in another market as required by section 44H(4)(a) in circumstances where:

- SACL has not denied any request for access to the Airside Service;

- SACL is not vertically integrated and therefore has no incentive to deny or restrict access to the Airside Service[9];

- in accordance with the *Airports Act 1996 (Cth)*, SACL's lease from the Commonwealth requires SACL, except in very limited circumstances, to provide access to the airport for international, interstate and intrastate air transport; and

- SACL is effectively constrained by both the Government's clearly articulated threat to introduce heavier price controls if airports behave in a manner which is inconsistent with the Government's light-handed regulatory Review Principles and the substantial countervailing power of its airline customers (particularly in the duopoly domestic market).

SACL further submitted that the Tribunal could not be satisfied that "*access (or increased access) to the [Airside Service]… would not be contrary to the public interest*": section 44H(4)(f), because it was contrary to the aims of the light-handed regulatory regime.

Given that sections 44H(4)(b)-(e) are likely to be satisfied by any large natural monopoly (unless there is already a State-based access regime in place), the interpretation of section 44H(4)(a) is crucial unless declaration, and therefore potentially regulated pricing and non-pricing outcomes, under Part IIIA of the TPA is intended to be the inevitable consequence for all natural monopoly facilities in Australia.

In its determination, the Tribunal disagreed with SACL and found that section 44H(4)(a) of the TPA was satisfied in respect of the Airside Service on the following bases (all emphasis added):

- Virgin Blue was seeking ***different*** terms and conditions for the use of the Airside Service, being, or involving, the opportunity for arbitration by the ACCC under Part IIIA of the TPA ("**arbitration right**") and this was therefore a case of ***increased*** access[10];

- as "increased access" equates to a ***change*** in the terms and conditions of use of a service which has the effect of enhancing the rights, abilities or opportunities to use the service, and the creation of the arbitration right ***itself*** constitutes such a ***change*** in the terms and conditions of use, declaration would result in increased access to the Airside service[11];

- increased access would occur because, following declaration, airlines would have an ability to challenge any term or condition in relation to gaining or continuing use of the Airside Service and, if it could not be negotiated to a mutually acceptable resolution, airlines could refer it to the ACCC for arbitration[12];

- in the absence of declaration, SACL had acted (and would therefore be likely to continue to act) in a manner which would not occur in a competitive market

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9 This is consistent with the Productivity Commission's findings in *Price Regulation of Airport Services*, Inquiry Report No. 19 (2002) at page 216, where the Commission identified only a limited number of circumstances in which an airport would have an incentive to deny access.

10 Tribunal's reasons, paragraph 143.

11 Tribunal's reasons, paragraphs 143 and 581.

12 Tribunal's reasons, paragraph 144.

(which the Tribunal termed a "misuse of monopoly power"). However, if declared, SACL would be constrained from "misusing its monopoly power" because commercial negotiations would be conducted in the knowledge that, in default of agreement, independent arbitration is available[13]; and

- competition in the dependent market would be promoted, not because the exercise of the arbitration right would inevitably result in different terms and conditions of access to the Airside Service, but because airlines would have the arbitration right[14].

SACL's concerns in relation to the Tribunal's broad interpretation of section 44H(4)(a)

SACL believes this broad interpretation of section 44H(4)(a) is inconsistent with the underlying policy intent of Part IIIA and, in the particular context of airports, creates a clear tension between the operation of Part IIIA and the Government's stated policy on the light-handed regulation of airports.

In particular, given the wide-ranging circumstances in which Part IIIA is said by the Tribunal to operate, it raises a significant risk that airlines may use Part IIIA as a method of seeking "regulated" terms and conditions in relation to their use of airport services, rather than engaging in genuine commercial negotiations as intended under light-handed regulation. In this regard, the Tribunal's decision has the consequence that:

- each time an airline customer demands different terms and conditions, this could potentially be viewed as a request for "increased access". SACL readily agrees that it would not be unusual, in any industry, for customers to express a preference for lower prices or other terms of supply (in fact, SACL would prefer to receive lower prices and/or different terms from many of its own suppliers). However, this does not mean that there is an "access" issue which should be resolved by potentially binding regulatory intervention;

- declaration (and the resulting possibility for ACCC arbitration) will always be viewed as promoting competition in a downstream market if the decision-maker is able to identify individual terms and conditions of use or other matters which it considers would not occur in a competitive market. However, in SACL's view, the clear difficulty with this interpretation is that natural monopoly facilities do not, by definition, operate in a competitive market and therefore many of the efficiencies and other benefits to the economy provided by natural monopoly infrastructure would be forfeited if infrastructure owners were only permitted to act in accordance with a hypothetical competitive standard[15].

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13 Tribunal's reasons, paragraph 516.

14 Tribunal's reasons, paragraphs 581 and 582.

15 See the comments of the Supreme Court of the United States in *Verizon Communications Inc v Law Offices of Curtis V. Trinko,* LLP 540 US 398 (2004) (at 407-408): "The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices – at least for a short period – is what attracts "business acumen" in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive *conduct*".

For example, it is generally accepted that for investment to be sustainable, infrastructure providers facing economies of scale should charge to cover all of their costs including cost of capital, rather than the standard competitive market model of marginal costs, in order to cover their average costs. This is clearly recognised in the Government's Review Principles which advocate long-run efficient costs as the appropriate measure for aeronautical pricing.

Another difficulty with this interpretation is the Tribunal's views as to what matters would not be expected to take place in a competitive market and therefore constitute a "misuse of monopoly power" (see below); and

- the availability of arbitration can ***itself*** be viewed as increasing access and promoting competition in a dependent market. Given that the kind of arbitration contemplated by the Tribunal (i.e. the ability for users to challenge any term or condition and potentially substitute for them terms and conditions viewed as appropriate by the arbitrator) is only available in the context of a regulatory arbitration, this leads to the incongruous situation that the potential availability of arbitration under Part IIIA of the TPA would itself satisfy section 44H(4)(a). Put another way, the availability of a regulatory outcome if the service is declared is itself a justification for regulatory intervention. In SACL's view, this is not consistent with any sound principle of market regulation. More importantly, because it would justify declaration of every natural monopoly without more, it is contrary to the underlying policy that facilities should be declared only where there is an actual or effective denial of access.

Given the consequences of declaration – that is, a direct ability for parties to seek regulated pricing and operational outcomes – SACL believes that the Tribunal's current approach to the interpretation of Part IIIA involves a heavy-handed regulatory environment that is inconsistent with both that general policy objective and the Government's stated objectives for light-handed regulation or airports.

<u>Access regulation and light-handed regulation can operate together</u>

SACL believes that there does not necessarily need to be any inconsistency or tension between the application of Part IIIA of the TPA to airports and the Government's policy on light-handed regulation.

Consistent with its submissions to the Federal Court in the judicial review proceedings (and the policy intent of Part IIIA), SACL believes that the relationship between airports and airlines should be governed primarily by commercial negotiations undertaken by both parties in good faith. Those negotiations would be conducted within the framework of light-handed regulation (which, in turn, involves the threat of heavier price controls or other regulation if airports act in a manner that is inconsistent with the Government's Review Principles). Part IIIA of the TPA should only be invoked if the applicant is able to demonstrate an actual or effective denial of access to the service and that increased access to the service would be likely to promote competition in another market.

Not all terms and conditions of use raise a matter of access or increased access (particularly when viewed in isolation). SACL believes that Part IIIA should not be concerned with individual terms of use unless those terms (whether price or non-price) amount to a refusal (or constructive refusal) to supply, or restriction on the supply of, the service. Whether or not particular matters do, in fact, involve such a restriction on access (and whether increased access would promote competition in the downstream market) needs to be assessed on a case-by-case basis.

In short, SACL believes that the "access regime" should be directed towards ensuring ***access*** to services provided by way of nationally significant natural monopoly facilities, and not be open to use simply as a *de facto* method of seeking regulated pricing or regulatory intervention in other operational / commercial issues in circumstances where access is readily provided.

SACL believes that this interpretation is not only consistent with the wording of section 44H(4)(a) of the TPA, but also enables the access regime to operate consistently with the Government's policy on light-handed regulation of airports. That is, Part IIIA would continue to operate as a safeguard against airports damaging competition in the downstream market by implementing terms and conditions which operate as a restriction on access by airlines, rather than as a method of first resort for airlines to seek regulated pricing outcomes and regulated determination of airport operational and commercial issues.

In contrast to SACL's view on the interpretation of section 44H(4)(a), Virgin Blue submitted in the Federal Court proceedings that section 44H(4)(a) simply requires the decision-maker to undertake a hypothetical comparison of the state of competition in the dependent market with a right or ability to use the service and the state of competition in the dependent market without any right or ability to use the service. Put another way, according to Virgin Blue, section 44H(4)(a) merely asks, in respect of the Airside Service, "do airlines need to use the Airside Service in order to compete in the airline market?".

The Federal Court's decision is currently pending. However, if the Court affirms the interpretation adopted by the Tribunal, or accepts the even broader alternative interpretation proposed by Virgin Blue (which will always be satisfied where the service is provided by means of a facility that is not capable of economic duplication), there is a substantial risk that the policy underlying Part IIIA will not be implemented generally and that, in the airport sector specifically, the benefits of light-handed regulation will be undermined and the incentives for airlines to engage in genuine commercial relationship with airports will be fundamentally altered.

The outcome of the Federal Court's decision has substantial potential consequences for all major infrastructure providers in Australia. Accordingly, depending on the outcome of that decision, SACL believes that it may be necessary for further amendments to Part IIIA of the TPA to ensure that it is interpreted to give proper effect to the Parliament's general and airport-specific intentions. In particular, SACL believes that it may be necessary for further amendments to clarify the applicability of the access regime in circumstances where the facility owner is not vertically integrated and already provides access to all potential users.

<u>The Tribunal's findings in relation to "misuse of monopoly power"</u>

The Tribunal also made findings of fact that SACL had, in the past, "misused" its monopoly power by:

- replacing the MTOW-based charge with the Domestic PSC; and
- intimating to Jetstar that it would not be allowed to use the Airside Service unless Jetstar signed an agreement which contained terms to which Jetstar objected.

The Tribunal defined "misuse of monopoly power" as "an exercise of power in a manner which would not occur in a competitive environment"[16].

SACL has significant concerns in relation to those two findings and believes that they do not provide an appropriate basis for considering whether increased regulatory intervention is necessary, either under Part IIIA of the TPA or otherwise.

(i) Replacement of MTOW charges with the Domestic PSC

SACL firmly believes that, rather than constituting a misuse of monopoly power, passenger-based charges represent an efficient form of pricing which does not discriminate between users and which provides appropriate pricing signals in relation to the use of an increasingly capacity-constrained resource (see Box 1 below).

Further details in relation to SACL's concerns with the Tribunal's findings on this matter, and SACL's views in relation to the appropriateness of passenger-based charges, are set out in Appendix B. However, in summary, SACL has substantial difficulty with:

- the Tribunal's finding that passenger charges are inappropriate in that they are not related to associated costs, being runway wear and tear. In practice, high fixed costs including land make runway wear an almost irrelevant cost driver. The impact on and length of runways is also not necessarily correlated with an aircraft's weight, but also to wheel loadings and take-off characteristics.

- the Tribunal's suggestion that, despite the substantial fixed costs involved in providing the Airside Service, MTOW-based charges reflect SACL's underlying cost drivers better than passenger-based charges. Neither passenger-based charges nor MTOW-based charges accurately or completely reflect SACL's underlying fixed cost structure (see Box 1 below). Both forms of charging simply represent different methods of recovering those largely fixed costs and it is highly problematic, from an economic perspective, to suggest that any single price structure is "correct" to the exclusion of others, that one non-discriminatory price structure restricts access more than another, or that one non-discriminatory price structure promotes competition in a downstream market more than another. SACL does however believe that passenger-based charges, while not perfect, provide a more efficient method of recovering its costs than weight-based charges;

- the Tribunal's finding that the Domestic PSC discriminates against low cost carriers relative to full service carriers (purportedly by "softening" competition in the downstream market)[17]. The Domestic PSC is a non-discriminatory charge that applies to all domestic carriers. In SACL's view, facility owners should not be expected to conduct a definitive economic enquiry into whether or not a particular charging methodology might impact differently on different customers or

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16 Tribunal's reasons, paragraph 30. The term "misuse of monopoly power" having this meaning is not a concept that appears in the TPA and certainly does not form part of the legal test set out in section 44H(4)(a). Rather than providing any insight into whether or not the provision of a service should be regulated (or whether there is a genuine access issue), this label merely re-states the inevitable consequence of a natural monopoly market structure – that is, it will not always be efficient or profitable for natural monopoly facilities to mimic the outcomes which would be expected in competitive markets. This is neither a "misuse" of monopoly power or a reason of itself to regulate.

17 Tribunal's reasons, paragraphs 518 and 525.

competition in another market depending on how those customers (presumably both existing and potential) choose to structure their respective businesses. This is not information to which a facility owner is ordinarily privy (nor, in the case of a vertically integrated facility owner that competes with its customers in a downstream market, information to which the facility owner should necessarily be privy).

The Tribunal's decision also fails to give sufficient weight to the logical conclusion that, if a PSC discriminates against low cost carriers, then a MTOW-based charge must correspondingly discriminate against full service carriers. It is not apparent to SACL why, according to the Tribunal, the former is a "misuse of monopoly power", yet the other is an economically efficient pricing structure which appropriately reflects SACL's cost drivers; and

- the Tribunal's finding that SACL introduced passenger-based charges for domestic services simply because Qantas wanted that method of charging. As documented in the evidence filed by SACL in the Tribunal, there were a number of economic and business reasons why SACL introduced passenger-based charges[18]. Those independent business reasons were also supported by the fact that its major customer, Qantas, also had a preference for passenger-based charging. In these circumstances, SACL strongly disagrees with the Tribunal's finding on this point in reliance on part only of the evidence before it and the implications drawn by the Tribunal in relation to the introduction of passenger-based charges for domestic flights[19].

Box 1: Passenger-based charges

The following is an extract taken from "Airline Views" published by BARA in June 2006 which demonstrates that even the representative organisation for international airlines disagrees with a number of the Tribunal's conclusions in relation to passenger-based charging.

> *"BARA has consistently maintained the view that passenger-based charges are a more efficient pricing structure for international airline operations. The costs of providing international terminal services and most security services are more closely aligned to passenger numbers than other airport charge metrics, such as aircraft weight.*
>
> *The question of whether passenger-based charges reflect the cost of providing airfield services can only be addressed by a detailed analysis of the cost drivers associated with providing runways, taxiways and parking aprons for different types of aircraft. On this basis one could then compare the cost of the service to the revenues obtained under various charging structures. BARA notes, however, that in some cases aeronautical land represents a substantial amount of the overall airfield asset base for pricing purposes. It is difficult to find a meaningful cost driver, by aircraft type, in the case of aeronautical land".*

SACL believes that this difficulty applies not only to aeronautical land, but also to a number of other aeronautical facilities and services.

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18 Those reasons are summarised in Appendix B.

19 The Tribunal's judgment refers to oral evidence given by SACL's witness, Mr Schuster, to the effect that SACL introduced the Domestic PSC "because Qantas preferred it". Immediately following the release of the Tribunal's judgment in December 2005, Mr Schuster disputed this, stating that his evidence was that SACL "didn't do it because Qantas preferred it". The transcript tapes were not clear and the Tribunal declined to amend the transcript.

(ii) The Jetstar Conditions of Use

SACL accepts that, in certain circumstances, the imposition of terms and conditions by a monopolist may evidence the use of market power. However, this does not mean that monopolists should be required either to accede to the terms and conditions proposed by prospective customers or to allow customers to commence use of the relevant services in circumstances where that customer has not given any indication that it is willing to accept any terms and conditions of use. To suggest otherwise would hold monopoly infrastructure owners to a standard that does not apply to any other operators in the Australian economy.

However, in finding that SACL misused its monopoly power in relation to the Jetstar Conditions of Use, SACL believes that the Tribunal effectively held SACL to that artificial standard. Further details in relation to SACL's specific concerns with the Tribunal's findings are set out in Box 2 below.

Box 2: Jetstar Conditions of Use

In February 2004, approximately 3 months prior to the launch of Jetstar, the Acting Chief Financial Officer of Jetstar confirmed to SACL that Jetstar would agree to be bound by the COU previously agreed by its parent company, Qantas.

Although Qantas subsequently advised SACL that, as a matter of law, Jetstar would not be covered by the COU signed by Qantas, SACL continued to offer the same terms and conditions to Jetstar (as a separate agreement between SACL and Jetstar).

Based on the advice received from Jetstar's Acting Chief Financial Officer, SACL quite reasonably proceeded on the assumption that Jetstar was prepared to accept the same terms and conditions set out in the Qantas COU.

On 5 May 2004 (20 days before the proposed launch date for Jetstar services), SACL contacted Jetstar and sought formal confirmation that Jetstar would be bound by the same terms and conditions previously accepted by Qantas.

Jetstar responded on the same day, stating that Jetstar would either agree to be bound by the Qantas COU or sign a new COU agreement to be agreed with SACL within the next 2 days. Jetstar subsequently indicated that it had concerns with certain clauses in the Qantas COU and sought changes to those clauses. Those changes were not commercially acceptable to SACL.

On 17 May 2004, 8 days before the proposed launch date, SACL met with Jetstar to discuss the COU that would govern its use of the relevant aeronautical facilities and services at Sydney Airport. At that meeting, SACL indicated that it was already seeking to negotiate new long term aeronautical services agreements with airlines and their representative body (BARA). Accordingly, SACL did not wish to risk disrupting those negotiations by agreeing a further interim version of the COU. However, SACL reiterated its offer that, pending the new agreement, Jetstar could accept either the standard COU (which apply to the majority of airlines at Sydney Airport) or the COU agreed with Jetstar's parent, Qantas.

At that meeting, SACL made it clear to Jetstar that it would need to accept one of those versions of the COU before commencing operations from Sydney Airport.

Notwithstanding that Jetstar had not formally acknowledged that it would be bound by any version of the COU, SACL had, in good faith, allowed Jetstar to undertake works at Terminal 2 in order to prepare for its launch. However when, 5 days before the proposed launch, Jetstar had still not confirmed its acceptance of any COU, SACL required Jetstar's contractors to cease work at Terminal 2 until the COU issue was resolved. This was intended to emphasise to Jetstar that accepting a COU was a genuine requirement of SACL's before flights commenced. This was an entirely reasonable position for SACL to take having regard not only to ordinary commercial practice

but also, especially, the inherent risks of airline operations,

Jetstar acknowledged that it would be bound by the Qantas COU later that day.

The Tribunal found that these circumstances demonstrated the "intransigent attitude of a monopolist"[20]. However, SACL believes that any claim by Jetstar that it believed that it could have commenced operations at Sydney Airport without acknowledging any terms and conditions lacks credibility. It is also common and prudent commercial practice for any business to require agreement as to terms and conditions before permitting others to use its facilities.

In circumstances where Jetstar led SACL to believe that it would be bound by the Qantas COU and then chose to identify its concerns with the Qantas COU less than 3 weeks before the date on which it wished to launch its new airline, SACL has substantial difficulty with the Tribunal's conclusions that SACL "misused its monopoly power" and that the commercial negotiations could have (or should have) been resolved by regulatory intervention.

The Tribunal's other findings

Although not expressly categorising them as a "misuse of monopoly power", the Tribunal was also critical of a number of individual terms and conditions contained in the existing Conditions of Use between SACL and its airline customers and in the draft Long Term Aeronautical Services Agreement in the form in which it was then being negotiated between SACL and the airlines, and found, in support of its conclusion that declaration and the potential availability of arbitration would promote competition, that those terms would be unlikely to occur in a competitive market.

SACL has substantial concerns with both the Tribunal's findings in relation to those terms and conditions and the apparent use of those terms and conditions as justification or support for potential regulatory intervention.

First, SACL believes that it is not appropriate to focus on individual terms and conditions for the purpose of assessing whether or not regulatory intervention (or declaration under Part IIIA of the TPA) might be justified. Terms and conditions can only be assessed in the wider context of the whole bargain struck between the parties. Any agreement, whether in a highly competitive market or a monopolistic market, is likely to contain some terms and conditions that are not optimal from the perspective of one or more (or indeed both) of the parties to the agreement. Accordingly, the mere existence of certain terms or conditions which an airline would prefer to be amended, when viewed in isolation, cannot of itself provide any justification for regulatory intervention.

Second, even if an assessment of individual terms and conditions were to be viewed as an appropriate exercise, SACL believes that it was inappropriate for the Tribunal to focus on draft terms and conditions as they stood at that time as part of an uncompleted and iterative negotiation. It is only at the conclusion of negotiations, or when they have irretrievably stalled, that a proper judgment can be made as to whether the final requirements of one party or another involved a misuse of monopoly power.

Third, and again even if an assessment of individual terms and conditions were to be viewed as an appropriate exercise, it is difficult to understand how a number of the

[20] Tribunal's reasons, paragraph 398.

terms and conditions identified by the Tribunal are inconsistent with what might occur in a competitive environment. For example:

- the Tribunal found that "*SACL's right to increase charges for aeronautical services unilaterally… is a right that would, if it existed in a competitive environment, be difficult to exercise because in a competitive market the user of the service would have the opportunity, if dissatisfied with the increased price, to switch to an alternative supplier*"[21]. However, in SACL's experience, unilateral rights to vary charges exist in a number of competitive markets (e.g. banks and professional service firms) especially where an agreement provides for ongoing supply and acquisition. This is particularly the case where the commercial relationship involves the supply of services for an indefinite term. In such circumstances suppliers cannot commercially agree to supply services for an indefinite period with the only ability to vary prices being dependent on obtaining their customers' agreement)[22]. In addition, the existence of a unilateral right says nothing about whether that right has been or will be exercised unreasonably;

- the Tribunal also found that the "force majeure" clause in the draft Long Term Aeronautical Services Agreement "*is another example of the monopolistic imposition of an unusual and unreasonable condition of use which would be unlikely to be insisted upon in a competitive market*"[23] and considered that the draft clause provided a "*strong signal*" as to how SACL could be expected to behave if to was not declared[24]. However, in SACL's view, the "force majeure" clause is neither:

    - an example of monopolistic imposition – as part of its negotiations in relation to the draft Long Term Aeronautical Services Agreement, SACL agreed first to amend the clause so that it provided reciprocal rights to each of SACL and its airline customers and then, subsequently, to delete the clause in its entirety; or

    - unreasonable or unusual – viewed in the context of a fixed price contract for 5 years, the clause merely sought to provide an ability for SACL (or the airlines) to review prices if one of the fundamental assumptions underpinning the price proved to be incorrect by more than 20%. Given that SACL cannot feasibly stop supplying the services to airline customers, SACL does not believe that this was an onerous or unreasonable draft term.

The Tribunal was also critical of the fact that the existing Conditions of Use do not contain an arbitration process to resolve disputes and postulated that "in a competitive environment it would do so"[25]. The Tribunal also suggested that without declaration, the absence of an independent arbitration clause would allow SACL to "act in a monopolistic manner"[26]. There are a range of dispute resolution methods that are frequently adopted in commercial agreements, including internal escalation to Chief Executive level, independent expert reports, external mediation, binding third party arbitration, and the commencement of legal proceedings. The current

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21 Tribunal's reasons, paragraph 408.

22 The proposed Long Term Aeronautical Services Agreement provides for an initial fixed price period of 5 years and, given that certainty as to duration, SACL has not sought to retain during that period any right to increase charges unilaterally.

23 Tribunal's reasons, paragraph 431.

24 Tribunal's reasons, paragraph 434.

25 Tribunal's reasons, paragraph 419.

26 Tribunal's reasons, paragraph 420.

Conditions of Use provides for external mediation in the event that there is a dispute between the parties and SACL is currently negotiating with airlines in relation to the appropriate mechanism for dispute resolution under the proposed Long Term Aeronautical Services Agreement. It is far from clear to SACL why independent arbitration should be viewed as an inherently superior form of dispute resolution[27].

Notably, neither the current Conditions of Use nor the draft Long Term Aeronautical Services Agreement seeks to exclude the ultimate form of independent arbitration through the courts.

Conclusion in relation to the Tribunal's findings in relation to SACL's conduct

In summary, SACL believes that the Tribunal's very expansive views in relation to the matters that would not take place in a competitive environment (which views fundamentally underpinned its conclusion that declaration would increase access to the Airside Service and promote competition in the airline market) have significant potential to undermine both the general policy underlying Part IIIA and the benefits of light-handed regulation of airports in particular. The Tribunal's expansive approach creates a substantial risk that Part IIIA will remove any incentive for access seekers to negotiate genuine commercial arrangements and will instead be used increasingly as a method of first resort to seek regulated price and other operational outcomes.

The Tribunal's determination effectively "lowers the bar" by increasing the incentives for users to seek declaration under Part IIIA in order to address any pricing or other matters in respect of which it holds a different view to the access provider, regardless of whether or not it has first sought to engage in genuine commercial negotiations. This avenue to obtain regulated outcomes effectively mandates heavy-handed regulation.

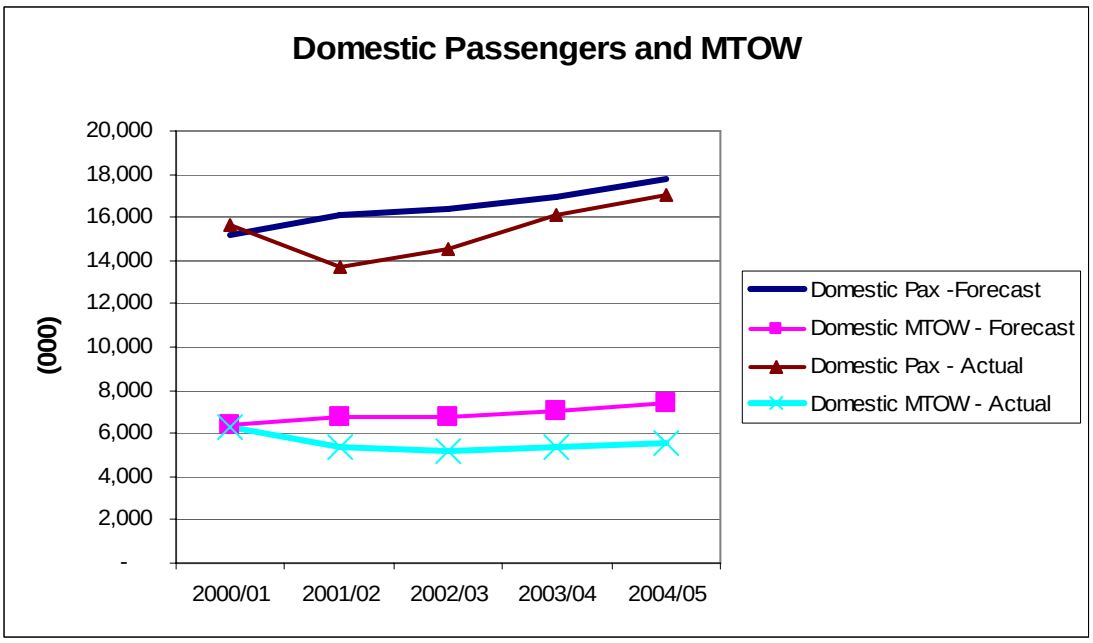
SACL believes that this is neither an appropriate use of Part IIIA generally nor a desirable outcome having regard to the Government's stated objectives under light-handed regulation of airports. SACL believes that it has acted in accordance with the Government's publicly articulated expectations under light-handed regulation and that the Tribunal's concerns in relation to SACL's potential pricing conduct absent declaration (or other heavier-handed regulation) are simply not borne out by SACL's conduct since the introduction of light-handed regulation in July 2002.

[27] The Tribunal also suggested that delays in the negotiation of minimum service standard would not be expected to occur in a competitive environment. However, SACL believes that this remains a matter for commercial negotiation between airports and their users, and that the absence of contractual minimum service standards forms a poor basis for drawing any conclusions about the merits or (or need for) regulatory intervention.

Introduction of Domestic Passenger-Based Charges

In August 2001, SACL applied to the ACCC for approval to convert both international and domestic runway charges from a MTOW basis to a charge levied on a per-passenger basis. While the ACCC approved the conversion of international charges with support from BARA, it considered that it did not have sufficient time to assess the domestic application, particularly having regard to Virgin Blue's assertion that the change would impact its operations, and did not approve the implementation of a domestic passenger based charge.

Before the structure of domestic charges could be resolved, there ensued a period of upheaval in the domestic aviation industry, with the collapse of Ansett in September 2001 and its final demise in March 2002. The following chart shows the impact of this significant market event on domestic passengers and aircraft tonnage using Sydney Airport. While passenger demand remained relatively high, the collapse of the second full service domestic carrier led to a large reduction in domestic capacity and corresponding reduction in tonnes landed and taking off, while load factors on the remaining carriers (Qantas and Virgin Blue) increased.



A consequence of this for SACL was a substantial under-recovery of the costs of providing domestic airfield services, as measured against the ACCC's assessed 'allowable revenue'. This under-recovery in 2002 was in the order of $10 million.

SACL remained of the view that passenger based charges represented a superior approach to levying charges for domestic airfield services. Accordingly, once it considered that a degree of stability had returned to the domestic market, SACL began consultation with domestic carriers regarding a move to a passenger-based charges, which were implemented from 1 July 2003.

SACL considers that the adoption of passenger based charges was warranted because:

- establishing charges for airfield use essentially involves determining an approach to sharing the high fixed costs of the land, runway and taxiway assets, where the average cost of use far outweighs marginal costs;
- passenger-based charging provides a transparent approach which ensures that airlines pay the same for equivalent levels of service and that passengers using Sydney Airport facilities pay the same in airport charges, regardless of which airline they fly with or the type of aeroplane on which they fly;
- they provide a better measure of airport utilisation than weight-based charges, as they reflect underlying demand for passenger travel to and from Sydney while remaining neutral to an airline's choice of aircraft;
- they provide for a sharing of risk between airports and airlines, as landing charges are based on passenger loads rather than simply the scheduled weight of the aircraft which will vary over time;
- the introduction of passenger-based charges would be a step towards reducing SACL's significant under-recovery against allowable revenues following the collapse of Ansett;
- weight-based charges implicitly disadvantage users of large aircraft and, given the limit on the number of aircraft movements at Sydney Airport each hour, it was (and remains) important for SACL to send the correct signals to airlines about the use of larger aircraft; and
- it was desirable to bring its domestic charges into line with the framework that applies at the majority of the major airports in Australia and to the rest of SACL's airline customers.

It was clear to SACL that the domestic market had stabilised at a higher level of passenger load factors than had existed at the time that its domestic charges were set and that, as a result, either the tonnage based charge needed to be reset or an alternative form of charging adopted. The resilience of passenger demand following the collapse of Ansett implied that passenger numbers provided the more stable and appropriate metric for charging purposes.

Importantly, SACL was not endeavouring to shift its exposure to traffic risk to airlines through this change, nor to recoup lost revenue. The move to passenger-based charges at a rate based on that initially proposed to the ACCC was a way of ensuring that, from the point at which the passenger charge was adopted, SACL shared with airlines the risk of fluctuations in passenger traffic.

While Virgin Blue objected to the introduction of passenger-based charges as it would increase its share of total revenues paid at the airport relative to Qantas, this was only arguable if assessed against the paradigm of tonnage-based charges. A comparable case could be mounted that Qantas paid a higher proportion of revenues under tonnage-based charges than would be applicable if charges were levied on a passenger basis and was thereby cross-subsiding Virgin Blue operations.

SACL also had regard to the widespread adoption of passenger-based domestic charges at other airports in Australia. Virgin Blue had not been able to enunciate why it did not object to passenger-based charges at other Australian airports, but opposed their introduction at Sydney, other than by asserting that it had received

offsetting concessions at other ports, such as with regard to terminal fees. Given Virgin Blue had earlier negotiated a concessionary fee structure at the former Ansett terminal at Sydney (now known as Terminal 2) that provided it with reducing charges as traffic throughput increased, and SACL had identified a range of other measures to assist Virgin Blue's growing business, it was not clear to SACL that there were material differences between the adoption of passenger-based charges at Sydney and other airports.

Appendix C

Implementing an Opportunity Cost Valuation of Airport Land

Report Prepared by Access Economics Pty Ltd

IMPLEMENTING AN OPPORTUNITY COST VALUATION OF AIRPORT LAND

REPORT BY
ACCESS ECONOMICS PTY LIMITED

FOR

SYDNEY AIRPORT CORPORATION LIMITED

14 JULY 2006

ACCESS ECONOMICS

TABLE OF CONTENTS

SUMMARY REPORT

Key points

Valuing an asset is usually achieved by analysing the Discounted expected future Cash Flows (DCF). In a regulatory pricing context, this is circular. An 'arms length' benchmark is required to break this nexus, while retaining the flavour of DCF analysis.

The concept of opportunity cost (a DCF valuation of the asset if put to its highest and best alternative use) is widely regarded as the most appropriate concept to define such a benchmark, but its practical implementation is subject to debate.

Scarcity should not be confused with monopoly. Airport charges that reflect the scarcity of Sydney land are appropriate and have nothing to do with monopoly power.

The highest and best alternative use for Sydney Airport's aeronautical land is a mix of residential, commercial and light industrial development. The opportunity cost of the land is what a property developer would be prepared to pay (in the absence of transaction costs) for the aeronautical component of the site.

Deducting demolitions costs from land value creates a 'double tax' problem – demolition costs would be deducted from aeronautical revenues 'as you go' and would be incurred again 'at the end' when demolition actually occurs. Deducting demolition costs from land value also creates disincentives to invest – the demolition of any improvements are subsequently deducted from the land value.

Indeed, if there are end-of-life demolition costs associated with providing airport services, the NPV of these (which is probably too small to bother with) should be ***added***, not subtracted from the cost base used to determine airport pricing, so that airlines contribute to these end-of-life clean up costs as they go.

Transaction costs such as stamp duty and relocation costs are relevant to business decisions and the cost of **converting** the land to an alternative use, but are not relevant for determining the value of the land **in** an alternative use. Conversion costs are not normally included in a DCF framework when valuing a going concern.

Holding costs reflect the value of having an airport 'ready to go' which is the value to the airport of the land in its 'first best' use (for accounting purposes), but are not relevant to the value of airport land in its second best use (for regulatory purposes).

Airport land is not sunk. The recent closures of Hoxton Park Airport and the Bankstown Airport cross runway demonstrate that airport land in Sydney is convertible.

Leasehold versus freehold title makes no difference to the intrinsic value of the asset nor the price signals that make best use of the community's resources.

Interfering in the price of air transport (or indeed any product market) to achieve distributional aims is usually welfare destroying. It is particularly futile when the bulk of airline shareholders and passengers are foreign residents. If distributional issues must be taken into account by the PC, it appears there are no distributional issues of substance that would justify prices based on anything but a normal rate of return on the opportunity cost of land.

At a congested airport such as Sydney there are barriers to entry (a lack of spare slots and bilateral restrictions on the Sydney-Los Angeles route), which causes any rents from under priced land to accrue to airlines rather than passengers. Attempts to hold aeronautical prices artificially below opportunity cost, in order to favour airline shareholders over airport shareholders, achieves little.

Background and concepts

Valuing an asset is usually achieved by analysing the Discounted expected future Cash Flows (or DCF). In a regulatory pricing context, a DCF valuation becomes circular – the price charged influences the land value which in turn influences the calculation of price. To break this nexus an 'arms-length' method of valuing airport land is required. The concept of opportunity cost arises from the need to find a suitable arms-length comparator. Opportunity cost does this by estimating the DCF valuation of the land if put to its ***next best*** use – also referred to as its ***highest and best alternative*** use.

While 'breaking the nexus' of a DCF valuation is important, it is not necessary to completely pulverise the nexus. The concepts and outcomes of a valuation of airport land should be as close as possible to the concepts underpinning (and outcomes yielded) by a DCF analysis, with the only departures from DCF occurring where it is necessary to avoid a circularity.

The ***next best*** use of the land is invariably lower than its intrinsic value as an airport, resulting in a conservative valuation. That is, a valuation based on opportunity cost already has built-in conservatism, by being based on the second highest use. The 'true' value in its first best use as an airport is likely to be somewhat higher again than what an opportunity cost land valuation would yield. Hence, airlines (and in turn their passengers), faced with prices based on an opportunity cost land valuation, implicitly receive a discount on airport prices compared with the underlying true 'first best' value of the land as an airport.

While 'opportunity cost' is a logical, arms-length, conservative conceptual basis to underpin a valuation, there is considerable disagreement surrounding the appropriate methodology for the practical implementation of the concept of opportunity cost. This report aims to build on the previous Access Economics report *The Value of Airport Land* by clarifying a number of matters.

Scarcity and monopoly

At the outset, it is important not to confuse a land valuation that reflects an asset's scarcity with the exercise of monopoly power. Gold is valuable because it is scarce, not because of the actions of a monopoly. Land is no different. Land in Sydney is particularly scarce, due to constraints on new land release in the greater Sydney area.

Most scarce commodities, such as gold, diamonds or airport land, have one 'right' price which sends all the 'right' signals to market participants for investment, production, purchase and sale.

To value airport land, various authors have proposed different criteria, such as 'incentives to relocate' or 'incentives to build a second airport', which give rise to a number of transaction costs specific to that criteria, and hence different valuations. Each criteria results in a different way of implementing the concept of opportunity cost and hence a different land valuation, some of which can differ markedly from the 'right' price. Prominent valuation methodologies include Inflated Historical Cost, Entry Price and Exit Price (these are defined and discussed in detail in the main body of the report).

As a result, a concept as clear and succinct as 'opportunity cost' ends up being interpreted and implemented in many different ways. These problems appear to stem from difficulties in separating observed market transactions (which are distorted by a range of transaction costs) from the underlying value of land, and a discomfort over the overall magnitude of the resulting land value (and hence possible 'distributional' consequences).

Transaction costs – example 1

Consider a household, in possession of an existing dwelling, contemplating how best to optimise their living standards. Suppose they face three options: they could renovate their current house; undertake a knock-down-rebuild, or move house. Each of these options involves different collections of transaction costs, including: demolition costs, renovation costs, stamp duty, moving costs, agent fees, temporary accommodation and inconvenience. Some of these transaction costs are site specific (for example, the magnitude of renovation costs will depend on the exact condition of the existing dwelling) while other transaction costs are generic and apply to any property transaction in the economy (for example, stamp duty and agent fees). The relative magnitude of these various transaction costs will certainly be influential in that household's decision of whether to move, renovate or knock-down-rebuild **but has no impact on the intrinsic value of the land**. Once that household has made and implemented its decision, the value of the land would be measured by the enjoyment and amenity of the house less the value of structures built on the land. While transaction costs are important (and they do influence the price at which any given property would transact), they do not impact on the underlying intrinsic value of the land. Airport land is no different, just on a much larger scale.

When looking at observed market transactions (such as real estate auction clearance data) it is often difficult to separate the intrinsic value of the land from the improvements, demolition costs, stamp duty, agent fees and various other transaction costs that have distorted the observed market transaction. But separating these concepts is central to the exercise of calculating the value of airport land.

Transaction costs – example 2

Consider two adjacent residential blocks of land that are as identical as possible except that one is vacant and the other has a dilapidated house on it. They have the same unimproved capital value, eg for rating purposes. A purchaser wants to buy a block and erect a new house. He is otherwise indifferent between the blocks but will be prepared to pay more for the vacant block because if he bought the other block he would have to pay to have the existing house demolished (unless he could remove some fixtures and fittings from the existing house and sell them, in which case he could be prepared to pay more for the block with the house on it).

But in either case, the intrinsic value of the two pieces of land is the same, as reflected in the Unimproved Capital Value (UCV). The costs of converting the land to a state where a new house can be erected should not be taken into account – the demolition costs have a bearing on the market transaction that occurs, but not the value of the land once it is in its alternative use.

Of course, the blocks do not need to be residential. They could be the last two (identical in size, access, etc) tracts of privately-owned land needed to complete a national park. One is pristine while the other has been developed. The community has decided that the highest value use of the land is as a national park. The piece of land that has been developed will need some work to allow it to return to a wilderness state. But that does not change the intrinsic value – the opportunity cost – of that piece of land compared to the other one. The values are the same.

Transaction costs – a discussion

Our conceptual anchor is a DCF valuation, and we only depart from this when necessary to break the circularity that arises in a regulatory pricing context. A DCF valuation does not consider the transaction costs that would be incurred to convert land to an alternative use – a DCF values the assets in their current use, so stamp duty and agent fees are irrelevant. Demolition costs (or other terminal values) would only be incurred in a few decades' time, so would be very small once discounted back to present day dollars.

In spite of this, many people have argued that when considering what an airport site could fetch if sold and put to its highest and best alternative use, various transaction costs should to be factored into the price. Regardless of whether the economic incidence of these costs would fall entirely on the vendor, in discussions of airport land valuations, it is argued that transaction costs should be deducted from the valuation – implicitly assuming 100% of the economic incidence of these costs should fall on the airport owner.

Aside from the incidence of these costs, are they relevant at all? Sydney Airport regularly faces decisions about how to best develop the current site and at some future point may wish to evaluate its Right of First Refusal to develop the Badgerys Creek site. Like the household above, these business decisions will presumably be influenced by transaction costs such as demolition costs, relocation costs and stamp duty. But to embed these transaction costs in the valuation of land seeks to take these decisions out of the hands of the airport owner.

Doing this results in a return to government-imposed decisions – the land valuation implicitly becomes a mechanism for dictating the factors the airport should take into account when making business decisions on how to best develop the site or whether to relocate to a new site. Normal private sector decision making would start with a land valuation free from these distortions, allowing the airport to decide which transactions costs are appropriate to take into account, depending on the decision being made.

In applying the concept of 'opportunity cost' we should seek to find the value of land ***in*** its highest and best alternative use (as this most closely mirrors the DCF concept). We should not seek to find the ***residual value*** of land ***net of the cost of conversion into*** its highest and best alternative use, which involves deducting various transaction costs. That noted, transaction costs and transfers are certainly not frictionless or irrelevant – the airport would monitor these and consider these carefully when making decisions – but to avoid double counting and distorting signals to invest, the regulator needs to use a land value free from these distortions. Similarly, in a light-handed context, a land value free from these distortions should be the basis of price negotiations with airlines.

The inclusion of demolition costs seems to send particularly perverse incentives to conduct improvements – any new improvement made to the land would subsequently have a demolition component deducted from the land value (essentially creating a tax on investment). There is also an element of 'taxing as you go' and 'taxing on the way out' – that is, demolition costs are deducted from the land value (and thus aeronautical revenues) during operations, then paid for again when a relocation eventually occurs.

Furthermore, it seems illogical to give airlines a discount due to end-of-life demolition costs related to the provision of airport services. If anything, airlines should pay an additional levy, to fund the discounted expected future cost of any end-of-life clean up (though as noted above, this will be small in NPV terms, so may be negligible).

In summary, with regard to **demolition costs**:

- Demolitions costs can be viewed as a transaction cost associated with converting the site to another use. They can also be viewed as an end-of-life cost associated with the costs of providing airport services.
- Demolition costs (when viewed as a transaction cost for an alternative use) are not normally included in DCF valuations, or (when viewed as end-of-life costs) are many decades into the future, so would be small when discounted to present day dollars.
- For pricing purposes, the inclusion of demolition costs creates a 'double tax' problem.
- This would create a disincentive to invest, as any improvements are immediately penalised through a reduction in land value.
- The discounted expected future costs of end-of-life clean up are part of the operating costs of an airport, so should be ***added*** to, not subtracted from, the prices paid by airlines (it is difficult to see why airlines should get a discount for this).

Proliferation of valuations

Aside from the treatment of transaction costs in airport land valuations, the other area of concern is the sheer variation in the valuations of Sydney Airport land. Of course, variations in economic measurement are nothing new. For example, the Australian Bureau of Statistics puts great effort into ensuring the three measures of production, GDP(E), GDP(I) and GDP(P), all sum to the same number.

It is difficult to conceive of a reason why the same parcel of land can have such vastly different valuations depending on the purpose, intention or criteria that underpinned the valuation. The main reasons for the differences appear to stem from:

- the inclusion of transaction costs such as 'holding costs' or 'demolition costs' as part of the intrinsic value of an asset; and,
- significant differences due to measurement errors, flawed indexation methods, differing assumptions or data problems.

Curiously, when these various data errors and flawed methodologies result in different land values, rather than going back and checking the calculations, practitioners often seize on this as being due to an important 'philosophical' difference in the true value of the land.

Errors in valuations

In summary, the errors, data problems and transaction costs causing divergent estimates of land value are as follows:

- Adding holding costs (these relate to the first best, rather than second best use);
- Subtracting demolition costs (which cause a double tax problem, resulting in the whole of life costs of operating an airport to be under recovered);
- Stamp duty and various other taxes (these are just transfers from one part of the economy to another);
- Agent fees (these are costs incurred in **converting** land to an alternative use – not relevant to its value **in** an alternative use)
- Indexing land at CPI, without adjusting for population density, productivity, the inverse of WACC or other such drivers of land value (which does not reflect the long term drivers of land value); and,

- Using a large number of arbitrary assumptions when applying historical land valuation (which cause the estimate to be surrounded by a wide error margin).

Importantly, site-specific transaction costs (such as demolition costs) and generic transaction costs (such as stamp duty and holding costs) if measured at all, should be clearly identified, separately from the intrinsic valuation of land, in order to estimate the value ***in***, rather than ***converting to***, the highest and best alternative use.

Distributional aims

Interfering in market prices for the purpose of achieving distributional aims is usually welfare destroying. Air travel is a business input (for business travellers) and a luxury consumer item (for leisure travellers). Unlike food, shelter or schooling, it is not a basic necessity of life. Air travel does not need to be supplied at below its cost of provision due to some market failure or aspirations for ubiquitous provision.

If the price of airport services need to increase to reflect the opportunity cost of land, some members of the community would inevitably benefit more than others. In the first instance, the owners of airports, largely ordinary Australians through their superannuation and investment funds, would gain at the expense of airlines and airline passengers. That is because the airlines and their passengers have to date been the recipients of 'windfall gains'. Where capacity constraints and bilateral restrictions are present, the 'windfall gains' accrue only to airlines – a lack of spare slots prevents competition from new entrants, which prevents the 'windfall' from being passed on to passengers.

Where do distributional effects flow? SACL currently has over 60% Australian ownership as defined and calculated for purposes of the Airports Act (1996) (with a foreign cap of 49%). Qantas is 55.1% Australian owned (with a foreign cap of 49%). Virgin Blue's ownership is currently in transition following the Toll takeover, though is likely to retain majority Australian ownership to ensure bilateral air rights (there have been indications that up to 40% may be owned by the foreign Virgin Group once the Toll merger is bedded down).

Most other airlines operating at Sydney are entirely foreign owned, many by foreign governments. Weighting aeronautical revenues by the percentage of foreign ownership of the respective airlines indicates that 35% of aeronautical revenues from airlines translate to 'distributional' effects on Australian airline shareholders, while 65% of aeronautical revenues translate to 'distributional' effects on foreign airline shareholders. International passenger movements at Sydney are currently made up of 52% foreign residents, 48% Australian residents.

Of domestic air travel trips taken by Australians in 2005, Tourism Research Australia reported that 19% of trips were taken by those earning over $150,000 per annum and 51% earn over $78,000 per annum (the other 49% included 20 percentage points who 'refused to answer' or 'didn't know').

Unless there are strong government policy reasons why airport pricing should be distorted in such a way as to benefit the 65% foreign airline investors, at the expense of the over 60% Australian airport investors, attempts to suppress airport pricing below an efficient level for 'distributional' aims seems a particularly futile exercise. Equally, airports should not charge prices that generate above-normal expected returns on fairly valued assets.

Where there is a policy aim of providing access to regional NSW routes or protecting the flag carrier airline, this should be done transparently as a Community Service Obligation government outlay rather than through operational restrictions or other 'hidden' protections

(such as undervaluing airport land). This way, the costs of the CSO could be explicitly and transparently measured and reviewed through the annual Expenditure Review process of government. Undervaluing land benefits all airlines equally, so is not well-targeted protection for Regional airlines or Qantas, if protection was justified at all.

While there was clearly a regulatory error in the 2001 valuation of Sydney Airport land, some argue this should never be rectified, ensuring that the distortions created in the pricing of airport services, as a consequence of that error, are perpetuated indefinitely. In any case, the possibility of a future change in land valuation (either favourable or unfavourable) was one of a number of future upside and downside uncertainties purchased as a package deal at the time of privatisation (along with traffic risk, interest rate risk, etc). Regulating with the benefit of hindsight, to remove the upside parts of that package deal, is fraught with danger.

Check list for valuing airport land

- Determine the highest and best alternative use to use as the 'arms-length' benchmark. This may be a mixed residential/ commercial/industrial development for Sydney airport, or farmland if located a long distance from the CBD (such as Badgerys Creek).
- Determine the amount a developer (or farmer) would be willing to pay to secure the land for its second highest use. This may involve a hypothetical staged development scenario.
- To avoid 'double tax' problems and a heavy-handed specification of airport decision making, the hypothetical development should be free from all transaction costs (such as stamp duty and demolition costs).
- If airport operations do require end-of-life demolition costs, the discounted present value of these costs should be ***added***, not subtracted, to the long run (whole of life) operating costs of the airport, and recovered from airlines through airport charges (though these are likely to be small in NPV terms).
- To avoid double counting, remove any items that also appear in the non-land (depreciable) asset base, such as sea walls.
- The land valuation for regulatory pricing purposes is different in concept and intent than the land valuation for accounting purposes. For the purposes of a land value for accounting purposes, holding costs could be added to the regulatory land value to determine its value to the airport in its 'first best' use.
- Land valuations should be conducted periodically to ensure aeronautical prices continue to reflect reality. A five-yearly revaluation is recommended.

Our expectation is that implementing the above checklist, drawing on expert advice from a property valuation specialist, should probably arrive at a land valuation below the levels previously proposed by SACL (as it would exclude holding costs and other transaction costs), though somewhat higher than the historical cost valuation conducted by the ACCC (as it would avoid heroic assumptions about land purchased before 1947). Both land valuation methodologies previously used by SACL and the ACCC had shortcomings and the truth lies somewhere in between. Properly implementing an opportunity cost land valuation according to the principles and checklist in this paper is expected to lead to more efficient pricing of airport services.

Access Economics
14 July 2006

1. BACKGROUND

Sydney Airport Corporation Limited (SACL) commissioned Access Economics to report on an appropriate methodology for implementing an opportunity cost valuation of airport land. It builds on previous work by Access Economics for the Privatised Airports Group of the Australian Airports Association, which discussed the appropriate conceptual basis for valuing airport land.[1]

A great deal has been written on this topic, no doubt much of which the Productivity Commission (PC) is already aware, so some familiarity with this literature is assumed. This paper focuses on some key areas of debate and questions raised in the PC Issues paper, namely distributional issues, demolition costs and other conversions costs, historical cost, whether airport land is sunk, leasehold versus freehold and holding costs.

1.1 GLOSSARY

Prior to discussing the appropriate methodology for valuing airport land, we note some terminology that has evolved in relation to airport land valuation:

- An **Entry Price** land valuation aims to estimate the land component of the cost of entering the airport business. This reflects the cost of acquiring a parcel of land of equivalent size and amenity to the site being valued. The valuation is made in a market situation, where the hypothetical airport investor would be competing to buy land by bidding head-to-head with developers interested in buying the land for its next highest and best purpose. The valuation draws on benchmarks in the surrounding real estate market, trends in land sales and the like.
- An **Exit Price** valuation estimates the land component of the value obtained by exiting the airport business at the current site and selling it off, drawing on benchmarks in the surrounding real estate market, trends in land sales and the like. This valuation concept measures the amount a hypothetical developer would be willing to pay to develop the old airport into its highest and best alternative use.
- An **Inflated Historical Cost** valuation estimates the value of the current site (which may have been purchased in several parcels over many years) based on the purchase price paid for those parcels at the time, inflated to current day prices.

This report commences with a review of the economic principles relevant to the valuation of airport land, in the context of an airport's pricing, in particular the prices of aeronautical services. In the past, this has been done in a heavy-handed context where prices are set by a regulator, but it is also relevant in a light-handed context where the land valuation is used as part of justifying airport pricing during commercial negotiations with airlines.

The report then addresses how these principles can be implemented in practice and the preferred methodology for determining the value of Sydney Airport land for the purposes of negotiating aeronautical pricing in a light-handed regime.

[1] http://www.accesseconomics.com.au/reports/aaa%20airport.pdf

The report is organised as follows:

- Section 2 provides some background on land valuation principles and reviews the reasons why a land valuation based on opportunity cost is desirable;
- Section 3 addresses distributional issues;
- Section 4 reviews past criticisms of how opportunity cost has been implemented;
- Section 5 examines the application of indexed historical cost and other alternatives;
- Section 6 discusses the preferred methodology and issues of convergence in the various land valuation methodologies; and,
- Section 7 documents references.

2. LAND VALUE PRINCIPLES

Valuing an asset is usually achieved by analysing the Discounted expected future Cash Flows (or DCF). In a regulatory pricing context, a DCF valuation becomes circular – the price charged influences the land value which in turn influences the calculation of price. To break this nexus an 'arms-length' method of valuing airport land is required. The concept of opportunity cost arises from the need to find a suitable arms-length comparator. Opportunity cost does this by estimating a DCF valuation of the land if put to its ***next best*** use – also referred to as its ***highest and best alternative*** use.

While 'breaking the nexus' of a direct DCF valuation is important, it is not necessary to completely pulverise the nexus. The concepts and outcomes of a valuation of airport land should be as close as possible to the concepts underpinning (and outcomes yielded) by a DCF analysis, with the only departures from DCF occurring where it is necessary to avoid the circularity that arises in a regulatory context.

The opportunity cost of using any resource is what has to be forgone by not being able to use the resource in another way. Land is no different in this respect from other resources, and airport land is no different from other land.

When land is used to site an airport, what is forgone depends on where the airport is. If it is in a rural area, then the land may have been usable for growing crops. If that was its most productive alternative use, then the crop forgone is the cost of the land. If the airport is in an urban area, as in the case of Sydney Airport, then the alternative uses would result in the community placing a higher value on the land, e.g. for building residences and for light industrial activities. That is the community's valuation of the land and it is called the opportunity cost. It is to the community's benefit to use airport land as productively as possible. To do otherwise is to waste resources, to ignore the land's opportunity cost.

In a competitive market, the opportunity cost of land is automatically taken into account by a business, because the business wants to make best use of each of its resources and ultimately will shift the business if its land could be sold off and put to a more valuable use. If a competitive market does not exist, setting prices consistent with what a competitive market would generate (that is, prices that reflect costs) are likely to optimise the use of the community's resources. Though an airport operator may not be able to expand its present site or shift to a new site in the short to medium term, there are many alternatives for developing the current site.

What is at stake in the first place is efficient use of an existing airport site. Unless the land is valued at opportunity cost, the operator will have no incentive to make the most productive decisions about how to allocate land to different uses, e.g. for aeronautical purposes versus non-aeronautical uses (such as retailing or hotels). If capacity at the airport is constrained by a shortage of land, the problem will be exacerbated by the risk of using land for purposes that are valued less highly by the community.

In the second place, signals about the need for a second airport (in the case of Sydney) or a parallel runway (in the case of most other capital city airports, which have land reserved for future expansion) will be misleading if land valuations are not properly reflected in airport prices. Underpricing will result in overuse and excess demand, artificially bringing forward the point at which capacity is reached at the primary site. This causes a hiatus in investment, where the primary site is at capacity, but the secondary site is not viable because it cannot compete with the underpriced primary site.

3. DISTRIBUTIONAL ISSUES

There is a difference between scarcity and monopoly. Land is scarce and as a result it is valuable. Particularly if it has water frontage, proximity to the CBD or other such desirable features. Whether it is gold, diamonds, Mickey Mantle's rookie card or airport land, it is important not to confuse a price commensurate with the scarcity of the asset with the exercise of monopoly power. Setting prices below cost, allowing the value created by scarcity to accrue to someone other than the airport, distorts behaviour and can exacerbate scarcity. An example of such a distortion is the infamous 'Rent Control' apartments in New York, where the value created by scarcity is artificially assigned from the property owner to the tenant.

A large increase in Sydney Airport aeronautical pricing was introduced in May 2001, prior to privatisation. This resulted in prices that were closer to, but still below, the costs of providing airport services. As a result, airlines (and to a lesser extent, passengers) have benefited from relatively cheap airport pricing for the past 5 years. Fixing up this problem will cause a one-off shift in the distribution of revenues.

Whether more of the intrinsic value of Sydney Airport should accrue to the shareholders of airlines rather than the shareholders of the airport should be a subordinate issue to the task of ensuring efficient prices. However, it is an issue that keeps coming up and is explicitly raised in the PC Issues Paper.

3.1 DISTRIBUTIONAL EFFECTS AT A CONGESTED AIRPORT

So-called 'windfall gains', due to increasing aeronautical charges to a level that reflects the cost of providing airport services, is an emotionally-laden expression for the distributional consequences of correctly valuing airport land.

If the price of aeronautical services needs to increase to reflect the opportunity cost of land, some members of the community would inevitably benefit more than others. In the first instance, the owners of airports, largely ordinary Australians through their superannuation and investment funds, would gain at the expense of airlines and airline passengers. That is because the airlines and their passengers have to date been the recipients of 'windfall gains'. Where capacity constraints are present, the 'windfall gains' accrue only to airlines – a lack of spare slots prevents competition from new entrants, which prevents the 'windfall gains' from being passed on to passengers.

3.1.1 RESPONSE TO BARA SUBMISISON

In the BARA Submission to the PC, dated June 2006, BARA implies that Access Economics has argued for "unjustified increases in aeronautical charges" to "bolster the returns of superannuation companies". This is an inaccurate representation. As noted above, Access Economics proposes that airport prices should be set at a level that provides a normal rate of return on the opportunity cost of providing airport services. This is eminently justifiable. If, in correcting for past underpricing, this results in higher returns to airports (which in turn are largely owned by Australian investment and superannuation funds) rather than airlines (which in turn are largely owned by foreign companies and foreign governments), then distributional issues are unlikely to warrant a move away from efficient pricing. To reiterate, we do not support a situation where airport pricing is set at excessive levels, so as to

generate average returns that exceed a normal rate of return on the opportunity cost of the assets employed.

BARA also note an apparent inconsistency in arguing that "aeronautical charges … do not influence demand in any meaningful way" and that "'under pricing' of aeronautical assets significantly influences demand".

This apparent inconsistency may be due to mistaking passengers' elasticity of demand in the market for airline services as being the same thing as the airlines' elasticity of demand in the market for airport services. The airport's elasticity of supply in the market for airport services is also relevant. The markets for airline services and airport services are different markets, with different characteristics and different elasticities. This seems an obvious point, but is often forgotten.

While airlines act (as the agent) on behalf of passengers (as the principal) in the market for airport services, in cases where airlines themselves are protected by slot constraints, bilateral restrictions on routes such as Sydney-Los Angeles, or have monopolies on routes such as Sydney-Canberra, it reduces the degree to which the interests of airlines align with the interests of passengers – this is known as the 'principle-agent problem' in the economics literature. Even where there are no such restrictions, the factors that enter the decision making of airlines (when purchasing airport services) are different to the factors that enter the decision making of passengers (when purchasing airline services).

In the market for airline services, at an aggregate level, if the price of air travel on all routes increased by a uniform amount over and above general inflation (for example, due to a fuel surcharge), changes in quantities demanded are likely to be modest. The fact that airlines were able to introduce across-the-board fuel surcharges to increase total revenues indicates that aggregate demand for air travel is inelastic. Since airport charges are only a small proportion of airline charges, it follows that passenger demand would be similarly inelastic to a uniform increase in airport charges.

But putting to one side the market for airline services, a different interaction occurs in the market for airport services. When airlines make decisions on routing, hubbing, frequency and the like, passenger demand is one consideration. But airport pricing is relatively more important in the market for airport services than it is in the market for airline services. This is typical of any downstream market, where impacts tend to be diluted compared with the upstream market where the transaction actually takes place.

A flow-on effect of correctly pricing Sydney airport services is that some passengers could be advantaged by the advent of more direct flights and less use of hubbing as air routes adjust to the real costs of providing airport services. Past experience has shown that (for example) Sydney was over-used as a hub in the late 1990s and went close to reaching full capacity. When aeronautical pricing moved some way towards opportunity cost in 2001, and closer to a sensible level relative to neighbouring airports, airlines responded to this price signal with a range of hub-busting flights (such as NTL-BNE, NTL-MEL, CBR-OOL, CBR-PER, ADL-AKL and BNE-LAX). The advent of low-cost airlines, which tend to be more responsive to airport price signals by offering flights to secondary locations (such as Avalon and Newcastle), enhances the mechanisms through which airport pricing signals transmit to achieve behavioural change in the market for airport services, often with positive flow-on effects for passengers in the market for airline services.

That is, while airport charges are only a small component of total travel costs in the market for airlines services, they can have a larger bearing on airline routing and hubbing decisions at the margin, in the market for airport services. Based on the recent experience with hub-

busting flights and competition between airports to secure new routes, there may be further scope for aeronautical charges to align with opportunity cost, to ensure congested primary airports are used for the highest valued use – namely time-sensitive originating and terminating passengers rather than connecting passengers or less time-sensitive leisure passengers.

The other major development at Australian airports in recent years has been non-aeronautical property developments (including offices, retailing, hotels, light industrial and the like). This is relevant to the supply elasticity of airport services. The under-pricing of airport land creates strong incentives to (as far as practicable) minimise the amount of land dedicated to aeronautical purposes, so as to maximise non-aeronautical development opportunities (in some cases, as far as closing the cross runway or a taxiway), which may bring forward capacity constraints. Synergies between aero and non-aero revenues can partially reduce these perverse incentives, but cannot remove the case for pricing based on the opportunity cost of aeronautical land (and other assets) to provide positive incentives for efficiency.

In summary, the elasticity of demand in the market for airline services is only one part of the story. In the market for airport services (which is different to the market for airline services) additions to airport capacity have to compete with other uses of the land. There is a significant cross-price effect between using land for additional airport capacity and using it for retailing, business parks and the like. The airline demand for airport services is also relatively elastic, given the range of hub-busting routes and alternative destinations available.

So, in response to the apparent inconsistency raised by BARA, responses to changes in airport prices can indeed be both elastic and inelastic. It depends on the market in question.

3.2 FOREIGN OWNERSHIP

Claims of 'windfall gains' – particularly when associated with a revaluation in airport land which is correcting for past underpricing – are at best misleading, if not factually wrong.

No matter how any so-called 'windfall gains' end up being distributed – which at a congested airport, looking through to the ultimate beneficiary, is to either the owners of the airport or the owners of the airlines – society overall would be better off as a result of the more efficient use of its resources.

Qantas and Virgin Blue are both majority Australian owned and Qantas has a minority stake in Air Pacific. Rex is also partly Australian owned (though exact data is difficult to obtain). The other airline customers of Sydney Airport are entirely foreign owned. This includes Air New Zealand, Cathay Pacific, Singapore Airlines, United Airlines, Japan Airlines, Emirates, Korean Air, Thai and Malaysia Airlines (among many others). A congested airport has limited slot availability, which in turn creates barriers to entry and reduces competitive pressures on the incumbent airlines. This tends to cause the 'windfall' from underpricing aeronautical services to gravitate to the shareholders of these airlines. The following table summarises the ownership structures of the largest airline customers at Sydney Airport, which account for 94% of all aeronautical revenues.

Hence, airlines operating at Sydney Airport are all entirely foreign except for Qantas, Virgin Blue, Rex and Air Pacific (via its Qantas shareholding). Weighting aeronautical revenues by the percentage of foreign ownership of the respective airlines indicates that **35%** of aeronautical revenues from airlines translate to 'distributional' effects on **Australian shareholders**, while **65%** of aeronautical revenues from airlines translate to 'distributional' effects on **foreign shareholders**. See Table 3.1 for details.

Under the Airports Act, Australian airports must be at least 51% Australian owned. Sydney Airport is currently well above this, at over 60% Australian ownership, based on Airport Act definitions.

Where there is a policy aim of (say) providing access to regional NSW routes or protecting the flag carrier airline, this should be done transparently rather than through operational restrictions or other 'hidden' protections. For example, if (for social policy reasons) regional airlines need assistance to be able to afford slots at a congested airport, this could be done through an explicit Community Service Obligation government outlay, rather than by a 'ring fence' operational restriction. This way, the costs of the CSO can be explicitly and transparently measured and reviewed through the annual Expenditure Review process of government, rather than being a subsidy with a 'hidden cost', which is difficult to evaluate.

TABLE 3.1: SYDNEY AIRPORT'S MAJOR AIRLINE CUSTOMERS AND OWNERSHIP STATUS

Qantas*	44.9% foreign owned (Company Statement 10 May 2006)
Virgin Blue*	Virgin Group owned 25% prior to the Toll takeover. Ownership is in transition. Based on previous Toll announcements, a further 15% may be sold to Virgin Group or Singapore Airlines, taking it to 40% foreign
Air NZ	Foreign owned, with 80% held by the NZ government
Singapore	Foreign owned, with a majority held by the Singapore Government
Cathay	Foreign owned, by various investment funds
Emirates	Foreign owned, by the Dubai Government
United	Foreign owned, emerged from Chapter 11 reorganisation in Feb 2006
JAL	Foreign owned, by Japanese financial institutions and other investors
British	Foreign owned, by private investors and staff
Malaysia	Foreign owned, of which 97% is Malaysian owned
Thai	Majority owned by the Thai Government (Ministry of Finance)
Air Pacific	Majority owned by the Fiji Government (51%) and Qantas (46.3%)
REX*	Started by a group of Singaporean investors and Australian private investors, IPO to raise $35m in Oct 2005. No further info available.
Korean	Foreign owned, primary shareholders Cho Yangho (chairman of Hanjin Transport and, chairman and CEO of Korean Air), Hanjin Transport Group and the Korean Government National Pension scheme
Virgin Atlantic	Foreign owned, 51% Virgin Group, 49% Singapore Airlines
Air Canada	Foreign owned, emerged from bankruptcy protection in Sept 2004, with ACE Aviation Holdings (a Canadian company) the parent company
Asiana	Foreign owned, primarily by South Korean Kumho industrial (32%) and Kumho Petrochemicals (15%)
Gulf Air	Foreign owned, by the Kingdom of Bahrain and the Sultanate of Oman
Air China	Foreign owned, majority by China National Aviation Holding Company, with Cathay Pacific also maintaining a significant holding
China Eastern	Foreign owned, the Chinese government is the majority shareholder
Vietnam Airlines	Foreign owned, by the Vietnam Government

** Qantas group includes Jetstar and Eastern. Virgin Blue group includes Pacific Blue but not Virgin Atlantic. REX group includes Regional Express and Airlink. The above list accounts for 94% of SACL's aeronautical revenues.*

Similarly, a desire by government to protect Qantas for national policy objectives may be better achieved through an explicit CSO rather than underpricing airport land. The latter

benefits all airlines equally, so is not well-targeted protection for Qantas, if protection was justified at all.

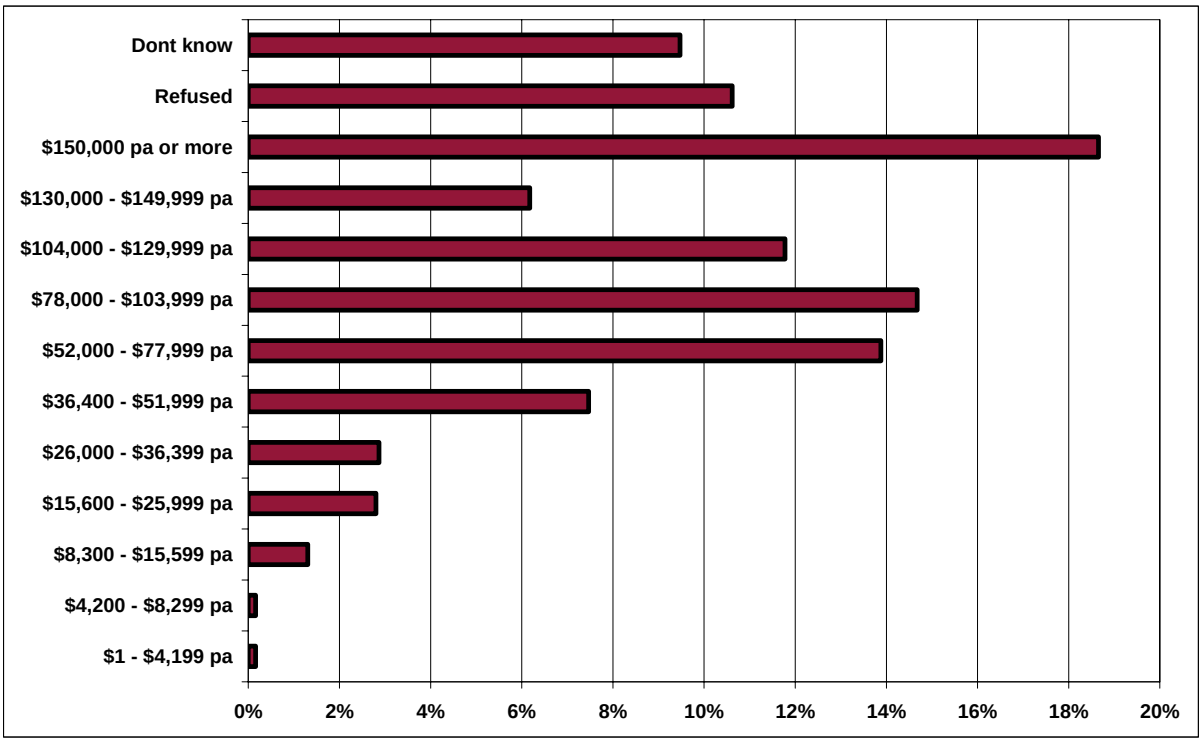
In the absence of capacity constraints, spare slots reduce barriers to entry, ensuring any 'windfall' from underpricing aeronautical services is more readily competed away, and so the 'windfall' is passed on to passengers. Based on ABS Overseas Arrivals and Departures data, of all international passenger movements in 2004-05 at Sydney Airport (Kingsford Smith), 52% were foreign visitors and 48% were Australian residents.

In the case of Sydney, the likelihood of passengers benefiting (from holding down land values and hence aeronautical charges) seems unlikely, particularly on some routes such as the profitable Sydney-Los Angeles route, where Qantas is protected by both bilateral air rights and the overall capacity constraints at Sydney.

It seems clear that, with bilateral route restrictions and a high domestic market share, the 'windfall gains' generated by undervalued land at Sydney are currently accruing to airlines.

Of domestic air travel trips taken by Australians in 2005, Tourism Research Australia reported that 19% of trips were taken by those earning over $150,000 per annum and 51% earn over $78,000 per annum (the other 49% included 20 percentage points who 'refused to answer' or 'didn't know'). Chart 3.1 summarises the distribution of domestic air traveller incomes. The data is for all domestic air routes, but since Sydney Airport is at one end of 45% of all domestic city pair passenger movements, it is expected to be similar to the average.

CHART 3.1: INCOME DISTRIBUTION OF DOMESTIC AIR TRAVELLERS



Source: Tourism Research Australia, overnight trips only (breakdown not available for day trips)

In summary, it is difficult to imagine why distributional concerns should be given much weight in the valuation of airport land or the pricing of airport services, and certainly not given priority over efficiency concerns, noting that:

- 65% of airline shareholders (weighted by their share of Sydney aeronautical revenue) are foreign;
- 52% of international passengers are foreign;
- 51% of domestic passengers earn over $78,000 per annum;
- Sydney Airport's shareholders are over 60% Australian, largely superannuation funds and investment funds;
- undervaluing airport land as a means of protecting Regional airlines or Qantas is poorly targeted protection and lacks transparency; and,
- if regulatory errors have been made in the past, resulting in airport services being under priced, perpetuating these mistakes will only continue to cause inefficiencies in the market for airport services. At some point these past mistakes will need to be rectified to ensure an optimal level of land use in the production of aeronautical services – ignoring the problem now will not make it go away.

Sources: ABS Overseas Arrivals and Departures, Bloomberg, Tourism Research Australia, SACL (ownership structure and aero revenue by airline).

4. IMPLEMENTING OPPORTUNITY COST VALUATION

There is broad support for (some form of) opportunity cost land valuation to be used as the basis of airport pricing. The difficulties tend to arise in the implementation.

From the ACCC:[2]

> *Whilst opportunity cost is in principle an appropriate approach to valuing land, its application is not straightforward. As already noted, opportunity cost is never directly observable. There are therefore several possible approaches to estimating the opportunity cost of land, …*

From the Productivity Commission's previous review of airport pricing:[3]

> *If regulation of Sydney Airport aeronautical charges continues to involve prices set by the regulator on a production-cost basis, aeronautical land should be valued at its opportunity cost rather than at indexed historical cost.*

From the New Zealand Commerce Commission:[4]

> *Valuing airfield land at opportunity cost provides appropriate signals either to continue operating the land in its existing use (as an airfield), or put the land to alternative use and relocate the airport. It also provides the appropriate incentives for new investment. Opportunity cost should be determined based on the highest alternative use value of airfield land, with that being the higher of the value with or without the sealed surfaces (the latter being after the costs of removing the sealed surfaces).*

Where there is disagreement, it seems to focus on the issue of how best to implement a valuation based on opportunity cost, rather than whether opportunity cost is the correct concept in the first place.

4.1 VALUATION CRITERIA AND TRANSACTION COSTS

The ACCC Decision (2001) noted several criteria for an appropriate valuation:

- signals to operate the site as an airport;
- signals for relocation;
- signals if there were a second airport;
- signals for use of land in aeronautical or non-aeronautical uses; and
- incentives for new investment.

[2] ACCC *Sydney Airport Corporation Ltd Aeronautical Pricing Proposal Decision* (2001)

[3] Productivity Commission *Price Regulation of Airport Services* (2002)

[4] New Zealand Commerce Commission *Final Report Part IV Inquiry into Airfield Activities at Auckland, Wellington and Christchurch International Airports* (2002)

Other criteria that could be considered include:

- signals to encourage originating and terminating traffic rather than hubbing traffic; and,
- signals to create more land (through reclamation).

The subtext of these different criteria is that a different valuation of land should be adopted depending on the criteria given most weight by the regulator or legislator. This unnecessarily complicates the logic by mixing valuations with transaction costs.

In fact, there is one 'right' price which provides all these signals simultaneously.

For example, if an ounce of gold is US$600, but I have to travel across town in order to buy it (incurring a round trip travel cost of US$50), my willingness to pay would need to be at least US$650 per ounce before I would make the purchase.[5] But this doesn't change the underlying value of the gold from US$600. Once the transaction is concluded, the value of the ounce of gold I have purchased remains US$600 to a potential purchaser, but I would not be willing to sell it for less than US$650, due to my individual circumstances. Suppose instead, the ACCC regulated the selling price so as to net out my transaction costs, so that the gold price was regulated to US$550 per ounce. Aside from creating opportunities for arbitrage for those with lower transaction costs, I would now be able to buy gold at a price (inclusive of transaction costs) that equals the world gold price, but this is not an efficient price – there would be excess demand and disincentives to invest in new gold mines.

As an example more closely aligned with land values, consider a household, in possession of an existing dwelling, contemplating how best to optimise their living standards. Suppose they face three options: they could renovate their current house; undertake a knock-down-rebuild, or move house. Each of these options involves different collections of transaction costs, including: demolition costs, renovation costs, stamp duty, moving costs, agent fees, temporary accommodation and inconvenience. Some of these transaction costs are site specific (for example, the magnitude of renovation costs will depend on the exact condition of the existing dwelling) while other transaction costs are generic and apply to any property in the economy (for example, stamp duty and agent fees). The relative magnitude of these various transaction costs will influence that household's decision of whether to move, renovate or knock-down-rebuild. Once that household has made and implemented its decision, the value of the land would be measured by the enjoyment and amenity of the house less the value of structures built on the land. While transaction costs are important (and they do influence the price at which any given property would transact), they do not impact on the underlying intrinsic value of the land. Airport land is no different, just on a much larger scale.

When considering what an airport site could fetch if sold and put to its highest and best alternative use, various transaction costs tend to be deducted from the price. In the case of site-specific transaction costs, the economic incidence is likely to fall on the vendor (provided there is a reasonable turnover of other properties free from such costs). However, the economic incidence of generic costs (i.e. those applying to all property transactions) is likely to be shared roughly equally between the vendor and the purchaser – the exact incidence depends on the relative elasticities of demand and supply. In many discussions of airport land valuations, it is suggested that all transaction costs should be deducted from the

[5] Or perhaps around US$675 if all potential purchasers faced similar transaction costs, causing some of the economic incidence of these transaction costs to fall on the vendor.

valuation – implicitly assuming 100% of the economic incidence of these costs should fall on the airport owner.

But are transaction costs relevant at all? Sydney Airport regularly faces decisions about how to best develop the current site and at some future point may wish to evaluate its Right of First Refusal to develop the Badgerys Creek site. Like the household above, these business decisions will presumably be influenced by transaction costs such as demolition costs, relocation costs and stamp duty. But to embed these transaction costs in the valuation of land seeks to take the decision out of the hands of the airport.

The attraction of a light-handed regulatory regime stems from the freedom and incentives faced by the airport in making decisions about how to develop the site. Where a range of transaction costs are netted out of the land valuation, it is an attempt to return to a heavy-handed regime, where the regulator usurps the business decisions of the airport, dictating how it should make decisions about developing the site (specifically, which transaction costs it should consider).

Or put another way, in applying the concept of 'opportunity cost' we should seek to find the value of land ***in*** its highest and best alternative use. We should not seek to find the ***residual value*** of land ***net of the costs of conversion into*** its highest and best alternative use, which involves deducting all transaction costs and taxes – these are transfers from one group in the community to another with little relevance to optimising the use of the community's resources.

A related suggestion is to deduct the relocation costs of building a new airport at another site from the land value (and hence aeronautical revenues) of the original site. This would create a signal to incur those costs and relocate to the second site sooner than would be optimal if the original site was properly priced. Artificially suppressing (effectively taxing) the rate of return on the original airport certainly makes a relocation to a new site more appealing, but forcing a reallocation of resources in this way would make the community worse off overall.

4.2 ASYMMETRY IN CONSEQUENCES

Before addressing the issue of how best to implement the concept of opportunity cost, this section reviews the consequences of regulatory error.

The asymmetry of responses to alternative land valuations is an important consideration when seeking to maximise the expected future welfare of the community.

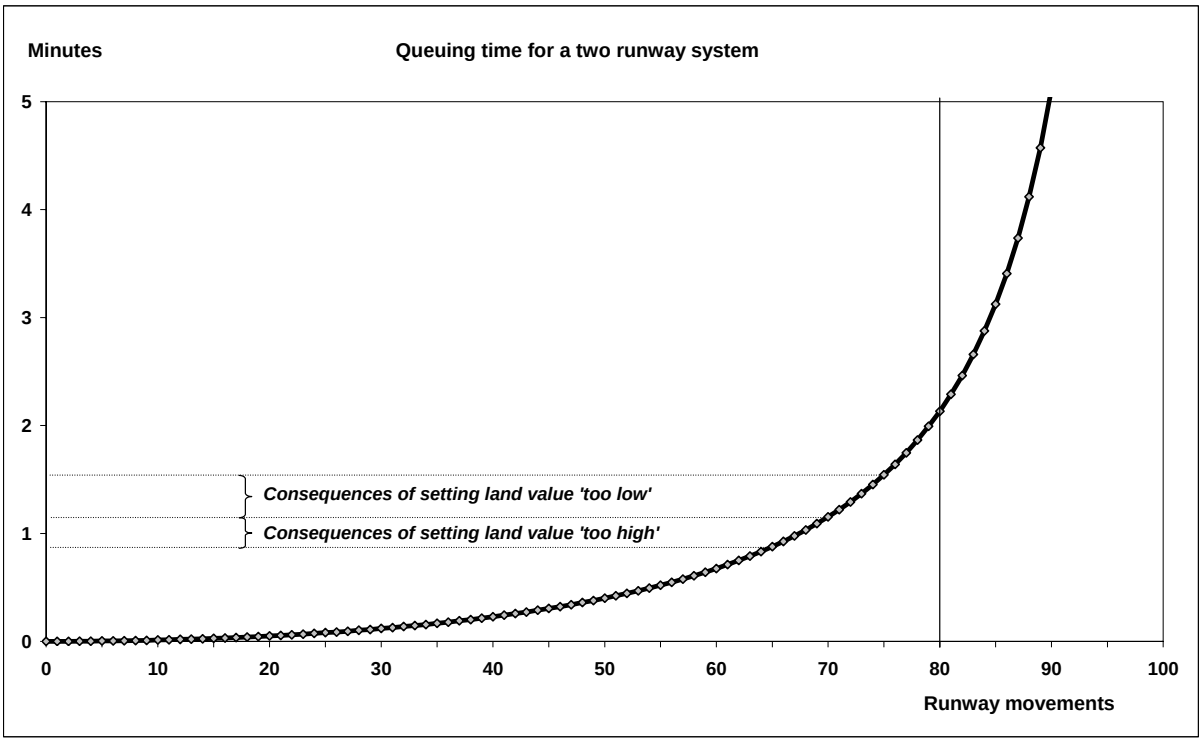
Where regulators strike prices that are too low, the consequences are reduced incentives to use the land for aeronautical purposes, increased congestion and bottlenecks, the costs of which increase exponentially as demand approaches capacity. Where regulators strike prices that are too high the consequences are more modest – a 'triangle' of deadweight loss and some distributional effects as described in Section 3. The asymmetric consequences of the regulator 'getting it wrong' suggest that adopting land valuations that are a more reasonable 'mid range' estimate, rather than the current approach of erring on the low side, may be consistent with maximising the expected value of economic outcomes, when making decisions faced with uncertainty.

Chart 4.1 illustrates the exponential nature of the effect of capacity constraints on costs. The chart is based on queuing software produced by the University of Alberta, which in turn is based on well-established queuing theory. The parameters used to construct the chart are for an airport such as Sydney operating in parallel runway mode, with a physical capacity of 100 movements per hour (with an 80 movement cap marked with a vertical line on the chart)

with a random arrival process (based on a Poisson probability distribution). Costs are measured in terms of queuing time. They fall on airlines and ultimately on passengers. The chart illustrates that due to the exponential nature of queuing costs at a congested airport, the consequences of setting prices that result in demand being (say) 5 movements per hour too high are smaller than the consequences of setting prices that result in demand being (say) 5 movements per hour too low. The degree of asymmetry increases as movements approach technical capacity (as opposed to legislated capacity).

Ensuring that prices of aeronautical services reflect the opportunity cost of land will not of itself solve congestion (more targeted methods such as peak pricing is a better tool). But underpricing aeronautical services by basing prices on land values that fail to reflect its opportunity cost can only accelerate and exacerbate congestion. If price rationing is not sufficient to align demand and supply, to clear the market, quantity rationing (such as queuing, delays and congestion) will occur instead at a congested airport.

CHART 4.1: ASYMMETRIC CONSEQUENCES OF REGULATORS 'GETTING IT WRONG'



4.3 CONFUSION OVER OPPORTUNITY COST

The opportunity cost of land is its value in its highest and best alternative use. This is very straightforward, but nevertheless confusion reigns as to how to implement it. The reasons seem to be largely as follows.

First, in practical terms the possible alternative uses of most land are constrained by land use decisions as manifested in zoning, as well as by historical developments in the local area and perhaps further afield. In particular, once an airport has been built its land is often ostensibly required, e.g. by licence conditions, to continue to be used for an airport. This leads to the mistaken belief that its opportunity is reduced by the fact that in the short term – and perhaps for much longer – it could not be sold off and developed for high value uses, such as for residences.

The mistake here is that we need to consider opportunity cost from the community's point of view, because that is the perspective that will lead to the most efficient allocation of resources, including land, for the community's benefit. And from the community's point of view, the best alternative use of airport land is not constrained by licences, zoning decisions or transaction costs such as stamp duty, because the community can change all those things. From the community's perspective the unconstrained alternative uses should be assessed and the best one – the one of highest value – chosen.

There is, however, a limit to how unconstrained alternative uses are from the community's point of view. Actual land use patterns, as they have developed over time with the growth of a city, and indeed with the development of an airport and its associated support services, cannot be ignored. With the benefit of hindsight it is possible to imagine that the pattern of metropolitan development could have been entirely different from what has actually taken place in the piecemeal manner of reality. But the community does not now have the ability to restructure the metropolis from scratch. It does, however, have control over land use decisions in any particular location.

Second, in actually estimating the opportunity cost, and therefore in assessing the best alternative use, typically consideration is given to the process of converting the land to that alternative use. This is because, for example, a buyer of airport land wishing to use it for a different purpose will only be prepared to pay a price that leaves him with his required rate of return on the total project investment after taking into account any and all costs associated with that investment, including costs of changing the land use. This leads to a process of working back from what that developer could ultimately sell the land for to determine what he would be prepared to pay for it.

Where this can lead to mistakes is if the value of the land itself is confused with decisions about converting it to an alternative use. Examples of the types of confusion that have arisen are provided below.

4.4 THE 2002 VALUATION OF SYDNEY AIRPORT LAND

Jones Lang LaSalle valued Sydney Airport as at 28 June 2002[6] using the Entry Price methodology described in Section 1:

> *The aeronautical land has been valued on the basis of the costs which SACL would have incurred had it had to acquire an equivalent parcel of land in terms of functionality in the open market…*

The analysis resulted in a land value at 28 June 2002 of $105 per square metre, plus the value of avoiding holding costs that would otherwise be required to acquire the site and construct an airport, resulting in a total valuation of $150 per square metre.

The valuation was based on the amount an airport investor would have needed to bid in an auction of a parcel of land equivalent to the current site, so as to just match the next highest bid. The next highest bid was characterised as the amount a developer would be willing to bid to secure that parcel of land to use in its highest and best alternative use – a mixture of residential, commercial, light industrial, roads and open space. The amount the next-best bidder could afford to bid was estimated by residual cash flow analysis of the hypothetical development.

[6] Jones Lang LeSalle *Valuation of Sydney Airport as at 28 June 2002* (2003)

4.5 HOLDING COSTS

Holding costs were added to the JLL valuation to reflect the value to the airport owner of having an airport 'ready to go' rather than having to acquire a parcel of land which might take 5 years to develop into an airport.

The holding costs involved five years of compounding at 7% per annum. This results in a multiple of $1.07^5 = 1.40$ being applied to the estimated purchase price of the land. Holding costs thus add 40% to the valuation.

The justification of including holding costs is to make the hypothetical potential entrant into the airport industry indifferent between buying an airport that is ready to commence operations on 1 January 2006, versus having to carry the cost of the land for five years while waiting for construction to be completed.

In adding this additional source of value, it results in the valuation reflecting the first best use as an airport, rather than a second best use.

In summary, holding costs should be excluded from airport land valuations for pricing purposes, though holding costs are relevant when valuing the airport site in its first best use for accounting purposes.

That noted, simply taking the 2002 JLL valuation methodology and removing holding costs (to arrive at a land valuation of $105 per square metre) is not appropriate either. A number of other improvements to the methodology are discussed in the remainder of this report.

4.6 AIRPORTS LAND – A SUNK COST?

A number of commentators suggest that governments never change course and once legislation is passed it can never be changed. Pitchford and Waits[7] even liken an airport to a heritage-listed Bavarian Castle. Of course, if the community's priorities change over time, a responsible government will make changes to legislation to reflect that. Even so, the issue of airport land being sunk continues to arise:

> *SACL or its successor may, at some time in the future, decide to either convert parcels of aeronautical land to non-aeronautical purposes, or sell some of the land outright. Such activity is warranted if the land is worth more in the alternative use. It is unclear whether SACL or any future owners will be able to do this, or even if this activity is feasible for the business.*[8]

> *If no second airport is contemplated or an additional airport is to be built but will not operate as a substitute for Sydney airport, then it is inconceivable that the Commonwealth would choose to close SACL and realise the value of the land at Mascot. Hence there is no opportunity cost associated with SACL land. In this case the land must be considered as a sunk cost.*[9]

[7] Pitchford and Wait, *Sydney Airport Land: Appropriate Value for Regulatory Purposes*, Agenda Volume 12, Number 1, 2005

[8] Rohan Pitchford, ANU *Sydney Airport Land Valuation: An Assessment* (2003)

[9] NECG *Sydney Airport Revised Draft Aeronautical Pricing Proposal* (2000)

By focussing only on the proceeds of selling the land, SACL takes no account of the fact that if the land were actually sold, the appropriate opportunity cost measure should also include the realistic costs and benefits of moving and building the new airport. These costs include road infrastructure and other supporting services. The benefits include assessment of better quality services and fewer externalities.[10]

In practice, and as argued by SACL, the Commonwealth owns Sydney Airport and could change the legislative requirement limiting use of the site to an airport. SACL goes on to argue that the land on which Sydney Airport is situated would only be used by the Commonwealth for aviation if this use provides higher returns than any alternatives.[11]

The airport land, for the most part, is sunk in its current use – that is, the land cannot be sold and used for another purpose.[12]

The fact that there is a substantial sunk or unconvertible component of land, regardless of its source, is crucial to our argument that ambient value is not likely to be the correct measure. This irreversibility arises for several reasons. First, once aeroplane manoeuvring space (called "aprons"), runaways and buildings have been installed on the land, substantial reversal of land usage is essentially impractical. Second, now that it has been established, converting the airport is disallowed by regulation or legislation – given the terms of its purchase agreement, the SACL is not free to shut the airport and establish another business on the site or sell all of the land. Such as ban is due to the substantial quantity of related investments in and outside the airport – in such things as transport infrastructure, worker location and airport-supporting business – that have been made as a result of the airport's location. It is, of course, inconceivable that the Federal Government would allow the airport to be shut, or substantially altered in a way that reduces its capacity.[13]

In reality, infrastructure moves around surprisingly frequently. Tullamarine Airport opened in 1970, taking the title of 'Melbourne Airport' from Essendon in 1972. In Brisbane, the city's main airport moved from Archerfield to western Eagle Farm during WWII, then moved again to an adjacent site at eastern Eagle Farm in 1988 – a parallel runway is currently being investigated. Overseas, Osaka airport relocated to Kansai in 1994 and Hong Kong Airport moved from Kai Tak (Kowloon City) to Chep Lap Kok in 1998. Returning to Sydney Airport, the third runway opened in 1994 and an Environmental Impact Statement into a second airport at Badgerys Creek was conducted in 1997. The cross runway of Sydney Airport was scheduled for closure (and redevelopment into non-aeronautical uses) once the parallel runway opened, but this was cancelled due to the Long Term Operating Plan.

Elsewhere in the Sydney region, new roads such as the M5 East and Western Sydney Orbital have recently been constructed and Lane Cove Tunnel is nearing completion. Bankstown Airport has closed its cross runway and plans to redevelop the land for non-

[10] ACCC *Sydney Airport Corporation Ltd Aeronautical Pricing Proposal Decision* (2001)

[11] ACCC *Sydney Airport Corporation Ltd Aeronautical Pricing Proposal Decision* (2001)

[12] Pitchford and Wait, op cit

[13] Ibid

aeronautical purposes. Hoxton Park airport has been closed, with that general aviation activity being relocated to Camden airport. The Sydney Ports Corporation is planning a large expansion of Port Botany, relocating some activity from Port Jackson (Darling Harbour). Even the Royal Easter Show was relocated to Homebush and Qantas has plans to relocate some maintenance activities from Sydney to Avalon.

Clearly cross runways, maintenance bases, sea ports, and even entire airports, can be closed down if the land can be put to a more highly valued use. While Sydney Airport is much larger than Hoxton Park, so a decision to move it would be a massive undertaking, the cross runway or even the entire airport could be relocated if the value unlocked in an alternative use becomes too far out of alignment with its value for aeronautical use.

If in the future, it became sufficiently desirable for the community to move the airport, legislation and leases could be changed to make this happen. If airlines and their passengers are not willing to pay the premium for the high value of land close to the CBD, the development of an airport on cheaper land in an outer suburb (like Badgerys Creek) will become attractive. It is thus quite incorrect that improvements such as runways and aprons make relocation impractical. Given that land does not depreciate and is a non-specialised asset, it is not 'sunk' when used as an airport site. Like the old Hong Kong airport, Hoxton Park in western Sydney and the Bankstown cross runway, airport land can be converted to other uses (or 'unsunk', so to speak) if there is sufficient motivation due to a large valuation differential in its alternative use. A government acting in the interests of its community would be remiss to leave suboptimal legislation in place for the remaining 95 year lease (with options exercised).

Any limitations on the operator's options in relation to use of airport land or investment in an alternative site do not alter the (opportunity) cost to the community of the use of land at the existing site. In addition, pricing based on opportunity cost aids in providing useful information to those who are responsible for deciding when and where an alternative airport should be built. In particular, underpricing the existing site will add to demand and tend to artificially bring forward the point at which capacity is reached if the existing site cannot be expanded.

This highlights the mistake made in many analyses that rely on airport land being sunk. From the perspective of the community, no land is sunk. And the opportunity cost of land to the community is its value in the best alternative use, regardless of any regulatory constraints (which the community can lift whenever it wishes) or land improvements (the cost of removing these are considered below). Trying to argue that airport land should be treated as sunk for valuation purposes because of constraints on the current operator are in reality attempts to deal with distributional issues such as 'windfall gains'. The right incentives and price signals to maximise community welfare will only apply if the airport operator faces the same opportunity costs as does the community.

Pitchford and Wait try to deal with the issue by supposing a publicly owned airport that seeks to maximise community welfare. This leads them to the absurd conclusion that Sydney Airport's optimal size (land area) is smaller now than the land area when it was first established. Incidentally, in their analysis Pitchford and Wait also concede that the airport owners could "choose to locate the airport elsewhere if the land price is too high relative to the benefits". This is completely at odds with their assumption that the land is sunk.

In summary, airport land is not sunk.

4.7 LEASEHOLD VERSUS FREEHOLD TITLE

The International Financial Reporting Standards (which do not allow a leased asset to be revalued during the course of the lease, even when the lease has 95 years to run) have received some attention in the context of the appropriate valuation of airport land. Aside from the fact that the IFRS themselves are unlikely to remain unchanged for the next 95 years, it has always been the case that valuation methods for taxation and accounting are different in purpose and concept compared with valuation methods for regulatory pricing and economic analysis.

As noted by the ACCC:

> *The Commonwealth, as a rational investor, would only continue to use Sydney Airport for aviation purposes if it could not achieve a higher return from an alternative use – even if SACL were a private sector lessee, a mutually beneficial arrangement could be negotiated with the owner of the freehold (the Commonwealth) to return or relocate the lease if returns are not appropriate.*[14]

Regardless of the ownership structures overlayed on the economy, assets such as land have an intrinsic value which should be reflected in airport pricing.

If one person owns a gold ingot outright and a second person leases a gold ingot for 99 years, either way, it has no bearing on the intrinsic value of those two gold ingots.

Whether or not an airport operator actually owns the land on which an airport is sited makes no difference to the case for opportunity cost based pricing. Indeed, it does not matter who owns the land. The case would still be valid, for example if an airport were government-owned and operated. Thus the fact that Sydney Airport's land, for example, is leasehold is irrelevant.

As in all the arguments made against opportunity cost pricing, the fundamental point is that such pricing is necessary to promote efficient use of land and of land vis-a-vis other inputs to airport services. Similarly, whether the airport can sell airport land does not alter the position, as explained in the discussion of a second airport below.

The freehold versus leasehold issue may also be seen as a confusion of accounting and economic principles. The economic principles are, when properly explained, easy to understand and clearly those that are relevant to a perspective on these issues from the viewpoint of what is good for the broader community.

In any case, land valuations in markets with significant areas of leasehold land, for example residential property in Canberra, do not appear to be penalised in any significant way compared with valuations of freehold land just over the ACT/NSW border, in suburbs such as Jerrabomberra, suggesting that in areas where there are observable prices to test assertions about leasehold land values, buyers, in practice, seem to make no distinction between 'freehold' and 'leasehold' land. After all, 95 years is a long time. Even at a low real discount rate, such as the real bond rate with no risk premium (currently around 4% per annum), any terminal value in 95 years would only be given a weight of 2.4% in an NPV calculation.

[14] ACCC *Sydney Airport Corporation Ltd Aeronautical Pricing Proposal Decision* (2001)

The current airport leases expire (with options exercised) in 95 years for Sydney, 92 years for the Phase 2 airports and 91 years for the Phase 1 airports, so in net present value terms, 'freehold' and 'leasehold' land are equivalent.

In summary, the issue of 'freehold' versus 'leasehold' is not relevant to land valuations for pricing purposes.

4.8 DEMOLITION COSTS

Demolition costs have received much attention in the valuation of land, for example:

> *The old terminal and runways may need to be demolished, or might be converted into some other use, such as a shopping mall. The realistic opportunity-cost-of-location measure that forms the basis of the Pricing Proposal's land valuation argument must subtract these costs from the benefits of land sale.*[15]

> *As argued by BARA, the inclusion of holding costs and the exclusion of any demolition or site clean-up costs in the estimation of the land value suggests that SACL has overstated the opportunity cost of the Mascot site.*[16]

Demolition costs do not affect the opportunity cost of land, but they are relevant to decisions about land use.

The point of basing aeronautical prices on the opportunity cost of land and all other inputs to production (remembering that most costs are automatically opportunity costs, being derived from market prices for purchases) is so that (a) the airport operator will face the correct price signals for making the optimal use of airport land (and all other inputs), and (b) the airport users will face the correct price signals for making the optimal use of airport services. This will maximise the benefit of the airport to the community.

In the operator making land use decisions, of course the operator will take account of the costs of converting land from one use to another, whether those costs relate to demolishing facilities that were required for a previous use and cannot be applied to or hinder the new purpose, construction of facilities to serve the new purpose, or anything else. Those costs must be factored into deciding whether a potential different land use will produce higher returns than the current use.

This is just normal business decision-making. But costs and values should be carefully distinguished and brought to account specifically for the purposes of a given decision. Trying to adjust land valuations for things such as demolition costs reflects muddled thinking and risks confusing the decision-making process.

Demolition costs usually come into consideration when valuing land using the Exit Price framework, but should be separately identified from the land value. This is because, as with all methods of valuing land, the aim is to estimate the value of the land itself in its best alternative use, not the land as it has been changed to fulfil its current use or needs to change to meet a new use.

[15] Rohan Pitchford, ANU *Sydney Airport Land Valuation: An Assessment* (2003)

[16] ACCC *Sydney Airport Corporation Ltd Aeronautical Pricing Proposal Decision* (2001)

To use the example of a gold ingot, the workmanship required to transform the ingot into a necklace (or the cost of melting it back down into an ingot) are separate from the underlying value of the gold. A regulator, seeking to emulate a competitive market, or any light-handed regulatory process may find it useful to separate the valuation into the land itself and any associated conversion costs.

It is also important not to include the value of improvements in the land valuation (as they are covered separately in the non-land asset valuation).

4.8.1.1 DYNAMIC IMPLICATIONS OF DEMOLITION COSTS

A further perverse implication of including demolition costs in land valuations arises in a dynamic context. An airport, considering an upgrade (such as the capital works to accommodate the Airbus A380) could be adding to the stock of items requiring demolition if a decision to relocate to Badgerys Creek is made at some future point. Under some valuation proposals, these demolition costs would be deducted from the land valuation, thus penalising the airport for having undertaken this investment during the operating period and the airport owner could potentially incur the demolition costs at the end of the operating period. This creates a 'double tax' problem where the airport owner is 'taxed as they go' and then also 'taxed on the way out'.

By embedding demolitions costs in land values (and hence aeronautical pricing), this seems to generate an inappropriate double counting of demolition costs and a disincentive to develop the airport site, due to the risks of increasing demolition costs (which some argue should be subsequently deducted from the land valuation). Again, it highlights the need to separate the intrinsic value of land from transaction costs and business decisions.

Estimation of demolition costs may still be of interest, for example, so that the shareholders of Sydney Airport can evaluate their Right of First Refusal to develop Badgerys Creek at some future point. However, that is a business decision, separate from the issue of valuing airport land. Any measurement of demolition costs should be separately identified so that the intrinsic value of land can be estimated. Regulators should also focus on valuation and pricing, avoiding the temptation to usurp business decisions.

If end-of-life demolition costs are considered to be part of the costs of providing airport services, it would seem more logical for these to be ***added*** to the airport cost base rather than subtracted, so that airlines face the full life-cycle cost of providing airport services.

In any case, recalling the underlying DCF principles, any future demolition costs will be many decades into the future, so would be very small when converted into present day dollars, so ultimately, is probably trivial.

In summary, demolition costs should not be deducted from the land valuation for pricing purposes.

4.9 OPTIMISATION

In attempts to avoid 'gold plating' regulators (in a heavy handed context) and airlines (in a light handed negotiation context) are interested in ensuring the airport has the minimum amount of land necessary to do the job.

> *The constraint on asset values inherent in DORC - ie, that the net present value (NPV) of revenues expected to be earned should be no more than the efficient long run costs of supply - essentially refers to the minimum efficient costs of an*

> *optimally sized, optimally located airport providing the same services as SACL. This is the highest valuation that would be possible in a competitive market and still prevent inefficient by-pass.*[17]

Sydney has a small land mass for an airport with parallel runways. This is due in part to the water surrounding the parallel runways. At other airports, the space between the parallel runways would often be included as part of aeronautical land. At Sydney these are over water and thus excluded.

In reality, there is probably an opportunity cost for the body of water between the parallel runways. In the absence of the airport, this waterway could be used as a marina, wharf or other such purpose. Due to the existence of the airport, this waterway is less accessible for boating. SACL has not included an opportunity cost for the reduction in usage of this waterway due to airport activities, which probably results in a conservative estimate.

Given the already small size of the site, it is difficult to imagine designing an airport with any smaller footprint, so any attempts to further 'optimise' the site are likely to be immaterial.

It is difficult to know how to assess what 'optimally located' means in this context, as referred to by the ACCC. From the community perspective the optimum location of an airport involves matters such as travel times to and from the airport, which in turn are affected by myriad off-airport land use decisions over many decades. Certainly it could not justify use of land valuations taken from a relatively remote potential airport site. That would result in incentives for overuse of the present site and falsely reduce the apparent viability of the alternative site. The land value will ultimately be specific to its location and prices need to reflect this.

In other regulatory contexts it is not usual to optimise by assuming a completely blank slate. The following discussion by a consulting economist to the ACCC deals with the issue:

> *[D]oes it make sense to attempt to set the regulatory asset base on the basis of the least cost of meeting current demand, without any regard to the past?*
>
> *This issue has arisen in the telecommunications industry where there has been on-going discussion of the merits of the scorched node versus the 'scorched earth' approach. The scorched earth approach determines the efficient cost of a network which provides the same services as the incumbent network, without placing any constraints on its configuration, such as the location of the main switching nodes. The 'scorched node' approach, on the other hand, assumes that the historic locations of the switching nodes cannot be easily changed and won't be in the near future. The scorched node approach, therefore, determines the efficient cost of a network which provides the same services as the incumbent network taking as given the current location of the incumbent's nodes.*
>
> *One enduring regulatory puzzle has been that most regulators say they are trying to determine the efficient costs of a modern replacement network (to prevent inefficient entry), but then proceed to use the scorched node approach. But why is a modern replacement network constrained to use the same switch locations as the incumbent network? . . . . If the regulator used a scorched earth approach it would be effectively ignoring the historic demand patterns which led the*

[17] ACCC *Sydney Airport Corporation Ltd Aeronautical Pricing Proposal Decision* (2001)

> *incumbent to adopt the current network configuration. If the historic legacy were ignored entirely, the resulting change in the regulatory asset base would either leave the incumbent undercompensated (and might deter new investment) or would lead to undesirable fluctuations in prices. Both outcomes are bad. Regulators are left in the slightly awkward position of saying they do one thing, but then doing another.*[18]

Furthermore, if the airport had to be built in some other location, where the option of protruding into Botany Bay was not available, a great deal more land would be required. The additional land would include not only the area of water between the parallel runways, but the additional buffer land in the high noise areas at the southern end of the site (these buffer zones are currently over water).

In conclusion, the footprint of Sydney Airport is already minimal, hence no further 'optimisation' is needed in the valuation.

4.10 AVERAGING

The JLL methodology used in 2002 estimates a value for the entire airport site and then takes a straight proportion of the total, based on the square metres of aeronautical land divided by the square metres of the total airport site. That is, a constant dollar value per square metre is used over the entire site.

This was largely made necessary because there is not a neat boundary between aero and non-aero land – it is a complex boundary line weaving through the site. Furthermore, some parcels (such as terminals) are deemed to be partly aero, so have to be pro rated. That said, the runways and taxiways precinct is a large contiguous area, so the bulk of the aeronautical land can be readily separated out. This is more difficult for the remaining complex boundaries around the terminals, where some pro rating remains necessary.

If the aeronautical parts of SACL land were converted to an alternative use, the main runways could be converted to particularly desirable waterfront real estate or highly valuable container stevedoring terminals. The non-aeronautical parts of the land are mostly less-desirable inland parcels.

As noted above, the waterfront location is also valuable for its use as an airport – the over water approaches allow airlines to conduct some limited operations during curfew and allow improved noise management during non-curfew periods. The value of a waterfront location for an airport and residential development are similarly high.

Uniformly averaging over the entire site thus results in a valuation that does not reflect the true value of the aeronautical component of the Sydney Airport site. If an exercise were conducted where a waterfront development or a container stevedoring terminal were to occur on the parts of the main runways protruding into Botany Bay, and this was not averaged across the entire site, it would result in a valuation that more closely aligned with the true value of the aeronautical component of the site.

As a result, the JLL uniform averaging method used in the 2002 valuation appears to be overly conservative. An approach that more directly values the aeronautical land (rather than averaging across aero and non-aero land) is recommended.

[18] Biggar, *When Investment is 'Lumpy'*, Network, April 2003 (a publication of the Utility Regulators Forum).

5. INFLATED HISTORICAL COST AND OTHER METHODS

Some other valuation methods that could possibly be used to arrive at arms length benchmarks for land valuation:

- inflated historical cost;
- benchmarking against unimproved land values in surrounding areas; and
- book value.

All these methods have shortcomings, as described below.

Historical cost data is patchy – it is difficult to obtain complete and accurate information on the costs of acquisitions and earthworks done many decades ago. If indexation is used, an appropriate index is crucial. CPI indexation is not appropriate for land valuations, or for assets generally. Like most assets, land values are negatively correlated with long term interest rates (lower interest rates equals high asset values). They are also correlated with wealth, which tends to track growth in wages (which over a long time period is approximately CPI growth plus productivity growth).

Using CPI does not account for the increase in wealth due to productivity and ignores the relationship between asset values and long term interest rates. The mathematics of this are discussed in more detail in Section 5.1. Historical cost valuations require a number of assumptions, pro-rating and interpolation to create a current year valuation based on land purchases many decades ago. While this can be done reasonably scientifically if an appropriate land value index is available, it is not as clear cut as the name suggests, nor a simple matter of digging out some old receipts.

An anomaly in the application of an inflated historical cost valuation has been the extent to which the valuations are systematically lower than the current market situation. The valuation begins with a purchase (at market prices) of a parcel of land many years ago, then inflates it to the current day. If the index properly reflects historical changes in land values over time, the result should be equal to current market prices (give or take some statistical noise). When a systematic bias appears, the validity of the indexation method is called into question.

Other issues with the 2001 ACCC indexed historical cost valuation include:

- Incomplete historical records were available for 400Ha of the site acquired before 1947 (nearly half the site), so the ACCC valued these at the (very low) 1921 purchase price.
- With half the site valuation being driven by an inflated purchase price from 1921, the results were very sensitive to a choice of inflation index. CPI data was only available back to 1952, before which a long term trend inflation rate was used.
- Modest (and defensible) changes to the value of these pre-1947 parcels of land result in large changes in the 2001 valuation (due to the effect of compound indexation over eighty years).
- Minor changes to assumptions in the ACCC's indexed historical cost valuation spreadsheet cause large changes to the valuation – it is not a 'hard' number as suggested by the name 'historical cost'. Indeed, the label 'historical cost' lends undue credibility to a valuation that is largely driven by the sum of its assumptions.

Ultimately, insisting on historical cost as the basis for airport charges is a futile attempt to stand still against the rising tide. If land values in the rest of Sydney are rising more rapidly that at the airport, it causes inevitable pressure on the current location.

Unimproved values in surrounding areas have some appeal as a potential arms-length comparator. The methodologies for arriving at unimproved values have evolved over many years and are subject to a high level of ongoing scrutiny and debate, resulting in a readily available and closely monitored benchmark. However, translating the UV of a nearby quarter-acre block into a valuation of an airport site requires a number of assumptions and extrapolations. UV also tends to lag true values and involves a great deal of averaging. That said, more work could perhaps be done on exploring and refining the application of the UV of nearby land to determine the value of airport land, or at least as another cross check.

The **book value** of land is determined by accounting practices, which at the time of acquisition allocated assets to a depreciable asset base, land and a lease premium (goodwill). As noted earlier, book value is an accounting concept that usually bears little resemblance to the economic value of the land and its estimation can be circular, in that firms could bid a higher price, which would increase the book value of land, which would then translate into higher aeronautical charges. Asset valuations based on book value or otherwise linked to bid prices could therefore give inappropriate incentives to overbid.

Similarly to historical cost, book value also attempts to hold land values down, against rising land values elsewhere in the economy.

5.1 HISTORICAL COST – INTEREST RATE RELATIONSHIP

As noted above, the treatment of interest rates in the historical cost methods is a complicated, but important flaw. This section provides a (simplified) algebraic derivation to help explain the problem.

The value of any asset is inversely related to interest rates. The historical cost (inflated by CPI) of a parcel of land purchased at a time when interest rates were 15% does not represent the present day value of that parcel of land when interest rates are 6%.

Using a WACC, based on a specified risk margin above current long term interest rates, multiplied by the historical cost of the land (which reflects the prevailing interest rates at the time) is highly inappropriate if interest rates have changed over that time.

Land values and interest rates

If the historical price of a parcel of land purchased in (say) 1994 reflects the income stream of that land in its next best alternative use at the time (net of the economic incidence of any transaction costs), these concepts can be related to each other using the following annuity identity:

$Purchase\ Price_{1994} = Alt\ Income\ Stream_{1994} / WACC_{1994}$

The alternative income stream cannot be readily observed, though the purchase price and interest rates prevailing at the time are observable, so the alternative income stream can be derived by rearranging the above equation:

$Alt\ Income\ Stream_{1994} = Purchase\ Price_{1994} \times WACC_{1994}$

Presumably the proxy of the opportunity cost at the time of purchase ($Alt\ Income\ Stream_{1994}$) is the concept of most interest to regulators, and the one they are seeking to index over time when applying an historical cost valuation, rather the purchase price itself. Depending on the

location of the airport, *Alt Income Stream*$_{1994}$ could be the revenues from growing crops (if that were the next best use) or for residential development (which is more likely in the case of Sydney).

Using the ACCC method from 2001, this purchase price would be indexed by CPI_{2006}/CPI_{1994}, then the new WACC for 2006 would be applied to determine airport charges. The calculation of airport allowable revenue (substituting the annuity identity above) effectively becomes:
$Allowable\ Revenue_{2006} = Alt\ Income\ Stream_{1994} \times (WACC_{2006}/\ WACC_{1994}) \times (CPI_{2006}/CPI_{1994})$

Now, it could be argued that the CPI-indexed income stream component of this formula is reasonable, that is, the $Alt\ Income\ Stream_{1994} \times (CPI_{2006}/CPI_{1994})$ might be argued by a regulator as being a sensible proxy for the current opportunity cost of land (though see the note below on population growth and productivity).

Of concern is that the ACCC method of using historical cost land values to calculate airport charges results in a downward bias of the amount $(WACC_{2006} / WACC_{1994})$. A more pure measure would back out $WACC_{1994}$ from the land purchase price in 1994 using the perpetual annuity identity above, which simplifies the formula to an inflated benchmark income stream:

$Allowable\ Revenue_{2006} = Alt\ Income\ Stream_{1994} \times (CPI_{2006}/CPI_{1994})$

Depending on the interest rates prevailing at the time of the original purchase, this downward bias in the CPI-inflated historical cost method could be substantial. Coupled with data problems with half the site being valued based on a parcel of land acquired in 1921, creates further doubts about the merits of this approach.

Aside from interest rates, land becomes relatively more scarce as population grows. This suggests a further refinement could be made:

$Allowable\ Revenue_{2006} = Alt\ Income\ Stream_{1994} \times (CPI_{2006}/CPI_{1994}) \times (Pop_{2006}/Pop_{1994})$

Increases in wealth over time (as measured by long term trends in productivity) would also be a factor in the long term price of housing, which could be added to the above equation. Ideally, econometrically estimating the resulting equation (after taking logs) would ensure the indexation method is fitted to observed trends in property prices in Sydney.

5.1.1 INTEREST RATE ADJUSTMENT

An attempt was made by Access Economics to implement the above corrections for trends in WACC, population and productivity. Unfortunately, with so many acquisitions of parcels of land dating between 1921 and 1947, it was difficult to find a consistent timeseries of WACCs over that period. Some historical interest rate data was available in the Butlin database (Reserve Bank Occasional Papers 4A and 8A), but a large number of assumptions and interpolations would have been required to implement this adjustment.

In attempting to create this more sophisticated version of inflated historical cost, the results became so unreliable that we were not confident enough to report them. The practical difficulties and large number of arbitrary assumptions required suggest the result would be better described as 'heroic cost', rather than historical cost.

5.2 OTHER COMMENTS ON HISTORICAL COST

As noted previously by the Productivity Commission:[19]

> *Prices based on the ACCC historical cost valuation do not provide signals to the Government regarding the value that aeronautical users place on the facility compared with its alternative use. The willingness of consumers to pay prices set on the basis of the opportunity cost of using Sydney Airport land (measured by the full market value) would assist the Government in deciding whether an airport is the best use of the land.*

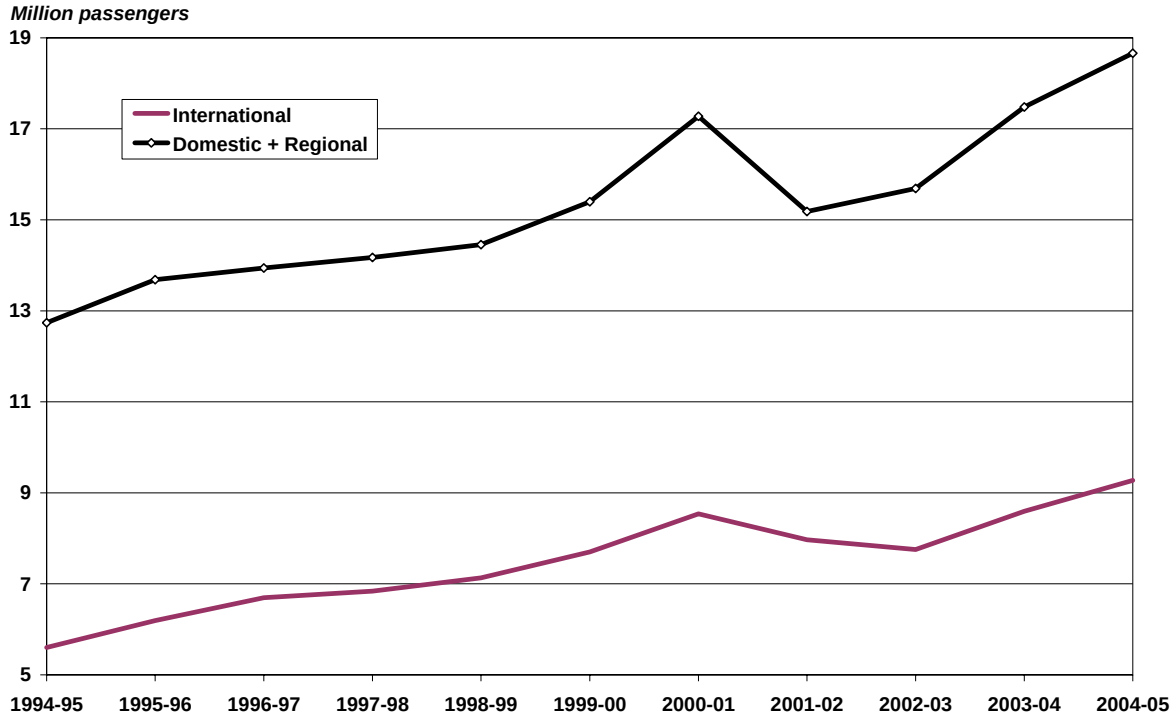
Pitchford and Waits[20] provide a justification of why historical cost might be appropriate. However, their logic depends on the demand for airport services growing at a slower rate than the rest of the economy. Land in Sydney was valuable long before the Wright Brothers flew along the Outer Banks of North Carolina in 1903. More recently, growth in traffic at Sydney has continued at a rapid pace (after a brief pause in growth due to September 11, the Ansett collapse and SARS). The rate of growth in demand for airport services over the period of the historical cost indexation is unlikely to satisfy the assumption as proposed by Pitchford and Waits, expressed algebraically as $\beta < \pi$ in their paper, where β is the growth in demand for airport services and π is the growth in land prices in the surrounding area.

Chart 5.1 provides passenger traffic data for Sydney Airport over the past decade. The Olympic year peak in 2000-01, followed by the Ansett collapse and SARS periods in 2001-02 and 2002-03, respectively, are clearly evident. Abstracting from these one-off events, traffic has grown considerably over the past decade. Compound annual growth rates for Sydney over the past decade have been 5.2% per annum for international passengers and 3.9% per annum for domestic and regional passengers. The CPI averaged growth of 2.3% per annum over the same period (adjusted for the one-off impact of the GST introduction).

[19] Productivity Commission *Price Regulation of Airport Services* (2002)

[20] Op cit

CHART 5.1: SYDNEY AIRPORT PASSENGERS



Source: Bureau of Transport and Regional Economics

Hence, it does not appear that the available evidence supports the parameter condition underpinning the Pitchford and Waits argument.

6. PREFERRED METHODOLOGY

Is it possible to arrive at a single value of land that provides all the correct signals for investment, relocation, a second airport and so forth? Is there one 'right' price for airport land?

Aside from transaction costs, the above methods, if they could be implemented consistently and with the exactly relevant information, should all give the same answer. For example, almost by definition, the 'right' index by which to inflate the historical cost of a parcel of land is that which results in the inflated figure equating to the current market value. The reason they may not converge is likely to be due to measurement errors, data problems or choice of index, rather than any fundamentally different view on what the 'right' price should be to give the right suite of incentives. That is, if all the above concepts could be measured accurately, they should converge to a similar land valuation.

Instead, due to various problems with measurement and data, combined with transaction cost wedges based on the various criteria noted in Section 2, has given rise to a wide floor and ceiling prices around the 'right' price.

Where these measures do not converge, it may be a sign that more work is needed rather than any underlying difference in the value of land.

Variations in economic measurement are nothing new. A similar situation arises in measures of Gross Domestic Product (GDP), which can be measured in three different ways – using income, expenditure or production, hence giving rise to GDP(I), GDP(E) and GDP(P). These are three ways of measuring the same thing: the level of production in an economy. Due to measurement errors and normal statistical deviations, they could result in quite different numbers. However, the Australian Bureau of Statistics goes to some lengths to ensure that statistical discrepancies between the three measures are zero, other than for the most recent few years.

6.1 DUALITY AND VALUATIONS

An alternative way of describing alternative land valuation approaches draws on duality theory, which is comes from the microeconomics literature. 'Duality' for a consumer relates to the equivalence between 'minimising the expenditure required to achieve a given level of utility' versus 'maximising utility to subject to a budget constraint'. For a producer, duality refers to the equivalence between 'minimising the total cost of producing a given level of output' versus 'maximising output given a total cost constraint'.

Why is this relevant? Because (ignoring transaction costs, stamp duty and the like) finding the Exit Price at which a parcel of land could be sold versus the Entry Price at which a parcel could be purchased are essentially just two different sides of the same transaction.

The Entry Price seeks to ascertain the costs of acquiring land in order to construct an airport ready to commence operations at (say) 31 December 2005. This is akin to the cost minimisation problem: given the other demands for the land, find the least cost way of acquiring sufficient land to operate an airport with similar amenity.

The Exit Price valuation looks forward at the likely value realised if the demolition crews rolled in on 1 January 2006, redeveloped the site and sold it off in stages. This is akin to the production maximisation problem: given the other demands for the land, find the most

productive use to which this land could be put. That is, aside from transaction costs, the Entry Price and Exit Price are **dual**.

In the case of an Entry Price valuation, the hypothetical developer is the competing bidder (that the airport has to just out-bid), while for the Exit price, the hypothetical developer is the buyer – but it is effectively the same concept.

If these methods give different estimates it can only be because of differences in assumptions and data. Adding transaction costs (like demolition costs or holding costs) may cause these to diverge further, but as noted above, we question the appropriateness of including these.

Like having GDP(I) align with GDP(E), it seems the Entry Price and Exit Price should be equivalent.

6.2 CONVERGENCE IN METHODS

For an intrinsically valuable asset, such as gold, there is just one price – the gold price. This price sends a signal of when to invest in a new gold mine, when to purchase gold jewellery, when to use it for industrial purposes (such as wiring) and whether to use it for monetary purposes. Some people even put gold leaf on chocolate cakes – so presumably the one world gold price even sends the right signal of when to do that. There is only one 'right' price which serves many purposes. This is the case for most items of value, and land is no different.

Are the differences in airport land valuations (using Inflated Historical Cost, Entry Price and Exit Price) mainly due to important conceptual differences, or is it a case of the treatment of transaction costs, data errors and differing assumptions?

While there have been many reports written explaining why land can be valued in vastly different ways, the more interesting research question is how convergence can be achieved – is it possible to avoid a single asset such as Sydney Airport land having so many values?

6.3 REASONS FOR NON-CONVERGENCE

In summary, the errors, data problems and transaction costs causing divergent estimates of land value are as follows:

- Adding holding costs (these relate to the first best, rather than second best use);
- Subtracting demolition costs (which cause a double tax problem, resulting in the whole of life costs of operating an airport to be under recovered);
- Stamp duty and various other taxes (these are just transfers from one part of the economy to another);
- Agent fees (these are costs incurred in **converting** land to an alternative use – not relevant to its value **in** an alternative use)
- Indexing land at CPI, without adjusting for population density, productivity, the inverse of WACC or other such drivers of land value (which does not reflect the long term drivers of land value); and,
- Using a large number of arbitrary assumptions when applying historical land valuation (which cause the estimate to be surrounded by a wide error margin).

Transaction costs are still important to monitor – they cause 'friction' in the economy, which makes it more difficult for assets to quickly gravitate to the most highly valued use. In a competitive market, the incidence of transaction costs will depend on the relative elasticities of demand and supply. In regulated markets, regulators tend to force the incidence of these costs entirely onto the regulated entity, ensuring airlines benefit from aeronautical prices net of all transaction costs, which is unlikely to be socially optimal.

While monitoring transaction costs is important, care is required when incorporating them into valuations for regulatory purposes.

6.4 PERIODICY OF VALUATIONS

Once a valuation has been undertaken, in theory this could be rolled forward. Like inflated historical cost, errors will eventually compound, resulting in a valuation that no longer reflects reality. Equally, valuations are a time consuming, costly exercise, so may not be necessary to undertake annually. Annual revaluations could also be volatile, moving with short term fluctuations in the property market.

The longer the timeframe between revaluations, the more errors may compound and diverge from reality, which needs to be balanced against the cost of more frequent valuations and price negotiations.

A five yearly time frame for pricing negotiations have evolved over time, as an appropriate way of periodically reviewing pricing, while ensuring airlines have a considerable degree of price certainly for route planning and fleet acquisition.

Revaluing land and reflecting this in airport prices on a five yearly cycle seems to strike a reasonable balance between planning certainty, accuracy and cost.

While there was clearly a regulatory error in the 2001 valuation of Sydney Airport land, some argue this should never be rectified, ensuring that the distortions created in the pricing of airport services, as a consequence of that error, are perpetuated indefinitely. In any case, the possibility of a future change in land valuation (either favourable or unfavourable) was one of a number of future upside and downside uncertainties purchased as a package deal at the time of privatisation (along with traffic risk, interest rate risk, etc). Regulating with the benefit of hindsight, to remove the upside parts of that package deal, is fraught with danger.

6.5 CHECKLIST FOR AIRPORT LAND VALUATION

- Determine the highest and best alternative use to use as the 'arms-length' benchmark. This may be a mixed residential/ commercial/industrial development for Sydney airport, or farmland if located a long distance from the CBD (such as Badgerys Creek).
- Determine the amount a developer (or farmer) would be willing to pay to secure the land for its second highest use. This may involve a hypothetical staged development scenario.
- To avoid 'double tax' problems and a heavy handed specification of airport decision making, the hypothetical development should be free from all transaction costs (such as stamp duty and demolition costs).
- If airport operations do require end-of-life demolition costs, the discounted present value of these costs should be ***added***, not subtracted, to the long run (whole of life) operating costs of the airport, and recovered from airlines through airport charges.

- To avoid double counting, remove any items that also appear in the non-land (depreciable) asset base, such as sea walls.
- The land valuation for regulatory pricing purposes is different in concept and intent than the land valuation for accounting purposes. For the purposes of a land value for accounting purposes, holding costs could be added to the regulatory land value to determine its value to the airport in its 'first best' use.
- Land valuations should be conducted periodically to ensure aeronautical prices continue to reflect reality. A five-yearly revaluation is recommended.

Our expectation is that implementing the above checklist, drawing on expert advice from a property valuation specialist, should probably arrive at a land valuation below the levels previously proposed by SACL (by excluding holding costs and other transaction costs), though somewhat higher than the historical cost valuation conducted by the ACCC (by avoiding heroic assumptions about land purchased before 1947). Both land valuation methodologies previously used by SACL and the ACCC had shortcomings and the truth lies somewhere in between. Properly implementing an opportunity cost land valuation according to the principles and checklist in this paper is expected to lead to more efficient pricing of airport services.

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Appendix D

Financial Reporting Definitions

Correspondence between Sydney Airport Corporation and the Department of Transport and Regional Services

Australian Government
Department of Transport and Regional Services

File Reference:

Mr Dominic Schuster
Manager – Aviation Pricing & Economics
Sydney Airport Corporation Ltd.
Locked Bag 5000
Sydney International Airport
SYDNEY NSW 2020

Dear Mr Schuster

Proposed Definition of Aeronautical Services

Following on from correspondence and meetings last year in regard to, inter alia, aligning the definitions of aeronautical services in the Airports Regulations and Direction 27, and subsequent consultations on revising the definition of aeronautical services, a copy of the proposed new definition is enclosed for your consideration.

Based on our communications with stakeholders, we believe that an approach that incorporates a preamble and statement of intent together with sub-categories listing the key aeronautical services and facilities, best serves the various purposes for which the definition is intended. These include the financial reporting and quality of service monitoring requirements of the Airports Act, as well as the prices, costs and profits monitoring requirements of Direction 27. The definition should also meet the requirements of the major airports and their major users in aeronautical pricing negotiations, as well as assisting in determining compliance with the Government's aeronautical pricing principles. The definition takes into account the view of Treasury and the Australian Competition and Consumer Commission that landside vehicle services, including car parking and taxi rank services, should be price monitored as airports have market power in the provision of these services.

With the above in mind, we seek your organisation's formal written comments on the proposed new definition by 10 February 2006. In consultation with the Department of Treasury we will give regard to comments from stakeholders and, where appropriate, undertake further discussions. The proposed definition will then be finalised and the Airports Regulations and Direction 27 will be amended with a view to implementing the new definition from 1 July 2006.

Exemptions from price monitoring under Direction 27

As foreshadowed in last years discussions, from 1 July 2006 the exemption from price monitoring granted under Direction 27 for services provided under a contract, lease,

licence or authority under the common seal of the Federal Airports Corporation will be rescinded. Airports will therefore be required to adjust their regulatory accounts to include all of the aeronautical services and facilities within the scope of the new definition. We will be pursuing the matter of valuation of the aeronautical assets that will be required to be transferred to the regulatory accounts following finalisation of the definition.

If you have any queries in relation to aspects of the proposed new definition before submitting your organisations formal comments, in the first instance please contact Norman Wuest on Ph. (02) 6274 8072.

Yours sincerely

Cristina Monica
A/g General Manager
Airport Planning and Regulation

12/01/2006

Proposed Definition of Aeronautical Services and Facilities

Preamble[1]

Aeronautical services and facilities are services and facilities provided at airports for the purposes of operating and/or maintaining civil aviation services at the airport including, but not limited to, the items listed below. As the nature of services change, it may be necessary to amend the list of specified items.

Aeronautical costs and revenues are costs and revenues associated with the provision and use of aeronautical services and facilities and which are recovered either directly or indirectly (eg. access charges for ground handling operations, and fuel throughput levies) from airlines.

Sub-heading (a) Aircraft-related services and facilities, including the provision of:	**Sub-heading (b)** Passenger-related services and facilities, including the provision of:
(a)(i) airside roads, grounds, runways, taxiways and aprons	(b)(i) aerobridges (including nose-in guidance systems) and airside buses
(a)(ii) airfield and airside lighting	(b)(ii) departure and holding lounges, and related facilities (excluding club/business lounges)
(a)(iii) maintenance and repair services in relation to (a)(i) and (a)(ii)	(b)(iii) flight information and public-address systems
(a)(iv) airside safety and security services and facilities (including rescue and fire-fighting services and perimeter fencing)	(b)(iv) security systems and services (including closed circuit surveillance systems)
(a)(v) environmental hazard control services and facilities	(b)(v) facilities to enable the processing of passengers through the customs, immigration and quarantine gateways
(a)(vi) services and facilities to ensure compliance with environmental laws	(b)(vi) check-in counters and related facilities (including associated queuing areas)
(a)(vii) airfield navigation services and facilities (including visual navigation aids)	(b)(vii) landside terminal access roads and facilities (including lighting and covered walkways)
(a)(viii) aircraft refuelling services and facilities (including pipelines)	(b)(viii) landside vehicle services and facilities (including public and staff car parking [but not valet parking], and taxi holding and feeder rank services)
(a)(ix) aircraft light maintenance sites (i.e. apron space)	(b)(ix) baggage make-up, handling and reclaim facilities
(a)(x) airside freight handling and storage areas (i.e. apron space)	(b)(x) public areas in terminals, public amenities, lifts, escalators and moving walkways
	(b)(xi) office space in terminals for airline staff who are essential to the airline's operations at the airport

[1] The Definition of Aeronautical Services and Facilities is intended to include all services and facilities at airports that are necessary for efficient civil aviation passenger operations at the airport. Commercial arrangements for the purpose of providing a 'premium' service to a particular subset of airline customers, and commercial property transactions where the airport does not have a high degree of market power are excluded.

Chairman
Chief Executive Officer

Sydney Airport
Corporation Limited

14 February 2006

Mr Michael Taylor
Secretary
Department of Transport and Regional Services
GPO Box 594
Canberra ACT 2601

Dear Mr Taylor,

Proposed Definition of Aeronautical Services

I am writing with regard to the Department's proposed definition of aeronautical services for regulatory reporting purposes.

Sydney Airport Corporation Limited (SACL) notes the Department's aim of aligning the definitions of aeronautical services under the Trade Practices Act and Airports Act in order to simplify the regulatory reporting process. However, SACL has serious concerns regarding the manner in which this task has been approached by the Department. Rather than seeking to align the definitions, the Department has sought to significantly expand the items defined as 'aeronautical' for the purposes of regulatory reporting. This goes well beyond SACL's expectations and understanding of the light handed regulatory arrangements and is not acceptable.

Departmental officers had indicated in discussions that the Department had approached the definitional alignment from a viewpoint of facilities and services for which airports held a high degree of market power. They also observed that the choice of items defined as 'aeronautical' was an information issue and would not be expected to have direct business implications for airports as they were no longer subject to formal price regulation.

Decisions on the items that should be included in an aligned definition of aeronautical services cannot be undertaken in a theoretical vacuum based on market power considerations. In SACL's view, it must have regard to the regulatory environment under which the airports previously operated and the practicalities of the current business environment. The Productivity Commission, in its Inquiry Report into Price Regulation of Airport Services, did not conclude that market power considerations warranted an expansion of the reporting definitions or redefinition of any 'aeronautical related' items as

aeronautical services. The Commission's views on the extent of market power held by airports in relation to specific facilities and services are discussed later in this letter.

Where the Government had formed a view under formal price controls that specific areas of the airports' business did not warrant price regulation, it is difficult to see any justification for now bringing these services within the regulatory reporting framework. Examples of such services are check-in counters, public and staff car parks and airlines office space. An expansion of the services subject to government oversight, in addition to being inconsistent with the stated intention of aligning existing definitions, is also surely out of step with the Government's approach of light handed regulation.

Again, the Productivity Commission's review of Price Regulation of Airport Services recommended that under a light handed environment of price monitoring, that *"information requirements for the seven airports* [Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin] *broadly would be consistent with existing disclosure and reporting requirements."* It further recommended that *"during this probationary period, the regulator would not have the power to alter unilaterally the monitoring regime"* and that *"information requirements would be specified at the commencement of the period and could not be amended without agreement of the parties."*

SACL has a number of specific comments to make in relation to items included within the proposed definition, and these are provided in the attachment to this letter.

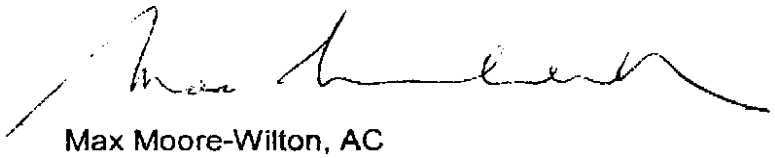
SACL considers that DOTARS' approach fails to recognise the realities of the airports' business environment, where negotiations on aeronautical charges are undertaken adopting a 'shadow regulatory' framework. As such, a decision by Government to include additional items within the definition of aeronautical services will directly influence the approach to pricing those services and airports' overall revenue position. For example, the inclusion of facilities such as public car parking as aeronautical would inevitably lead to calls by airlines for revenues from these services to be set off against justifiable aeronautical revenues, in direct contradiction of the 'dual till' methodology adopted by Government in 2001 and reaffirmed in the 2002 policy pronouncement of light handed regulation.

The revenue and regulatory impacts of this approach are more immediate for SACL, as Sydney Airport remains subject to formal price controls for regional services and domestic airside services have recently been declared for access purposes under Part IIIA of the Trade Practices Act. The definition of aeronautical services adopted by Government would be expected to directly guide the ACCC's approach in considering price notifications for regional services and in arbitrating any disputes that may be referred to it under the Part IIIA access regime.

Furthermore, given that the existing definition will have applied to four of the five years of the light handed regulatory period, and the Productivity Commission is expected to undertake the review of the light handed regime over the course of this calendar year, there seems to be little sense in implementing a change in the reporting definition at this time. SACL submits that a more practical approach would be to allow the Productivity Commission to opine on an aligned reporting definition as part of its review. Accordingly, we consider that the implementation of a revised definition should be deferred pending the Productivity Commission review.

In summary SACL is strongly opposed to the direction that this issue is taking under the scope of administrative action. Sydney Airport was privatised on the basis of a series of interrelated financial / regulatory frameworks. If this is to be changed materially it is a matter of policy which should be considered by Cabinet.

Yours sincerely,



Max Moore-Wilton, AC

Attachment

Comments on Market Power Considerations and the Proposed Inclusion of Specific Facilities and Services with the Definition of 'Aeronautical' Services

Public and Staff Car Parking

The proposed inclusion of public and staff car parking within the definition of aeronautical services is not able to be justified based on market power considerations.

The Productivity Commission found that *"airports appear unlikely to have significant market power in long-term car parking. The market power of airports in car parking is likely to be higher for short-term and possibly staff parking, but there are also factors mitigating the extent of market power in these facilities."* It recommended, in the context of the option of ongoing price controls, that continued price monitoring was warranted for staff car parking as an 'aeronautical related' service, but that public car parking did not warrant ongoing monitoring. This is consistent with the Government's 2001 direction to the ACCC to exclude 'aeronautical related' services from aeronautical revenues.

SACL maintains that it has limited market power in pricing in relation to the provision of public car parking, and its commercial decisions are constrained by competition from off-airport parking providers as well as by the availability of transport alternatives including private vehicle drop off and pick up, taxis, buses and trains.

In terms of staff car parking, SACL does not consider that it holds a high degree of market power as these services can be obtained off-airport without significant reductions in convenience. Staff parking facilities are not typically made available on an individual staff member basis, but as part of commercial terms negotiated with airlines and on airport operators. Staff parking does not need to be provided on airport, and its provision is subject to competing uses for scarce airport land. Accordingly, staff parking facilities are generally provided at remote locations on airport with staff bussed to terminal and key operational facilities. Where SACL sought to impose charges for the provision of staff parking facilities that exceeded market rents, airlines would provide staff parking facilities off airport. While the threshold level of rents would depend on the extent to which airlines valued the perceived convenience of on-airport facilities, given that staff are already generally bussed, additional travel time associated with off-airport staff parking would not be expected to render this option infeasible.

Taxi Holding and Feeder Ranks

In relation to taxi facilities, the Productivity Commission concluded that *"On balance, the market power of airports in providing these facilities appears moderate. The ability of airports to impose charges above efficient levels appears to be limited if access to competing modes is provided on reasonable terms and conditions."*

Sydney Airport introduced a charge for taxi holding and feeder services, as well as for hire cars and shuttle buses, in 2004 to recover the cost of the provision of related infrastructure, access roads and traffic management costs. These assets and costs were specifically excluded from the aeronautical cost base when the ACCC determined aeronautical charges in May 2001.

Any charges imposed on taxis and ground service providers are transparent to users and subject to a high degree of public scrutiny.

In addition, as with public car parks, the inclusion of taxi rank facilities as aeronautical is internally inconsistent with the framework adopted by DOTARS, which according to the preamble seeks to capture services and facilities for which costs are recovered "either directly or indirectly from airlines". Clearly, there is no direct or indirect link between taxi and public parking facilities and payment by airlines.

Check-In Counters

Check-in counters have not previously been subject to regulatory price control and SACL would consider their redefinition as an aeronautical service to represent a significant incursion into its legitimate revenue earning opportunities.

Moreover, traditional check-in facilities are becoming increasingly subject to more convenient alternatives such as web check and off-airport processing.

While the Productivity Commission considered that check-in counters warranted continued price monitoring as 'aeronautical related' facilities based on a "moderate" degree of market power, it also observed that *"of the passenger processing facilities, market power is likely to be least significant for check-in counters."* Paraphrasing, the Commission considered that factors mitigating against the use of market power in check-in pricing were that: airlines may have some scope to reduce their use of check-in counters in response to a significant increase in charges; that airports had an incentive to avoid such reduced use because of the consequences of increased processing times; domestic airlines were able to process transferring international passengers through their own facilities; and that check-in counters are the most likely of the passenger processing facilities to be amenable to off-site provision.

In addition substantial consideration is being given to the use of new electronic technologies which will reduce or obviate the need for traditional check in counters in the future.

Airline Office Space

This category of revenues has not previously been subject to any form of price monitoring or control, and SACL cannot see that any case has been made for its inclusion in price monitoring let alone to define it as an aeronautical activity. Its inclusion in the regulatory reporting regime is not supported by the Productivity Commission's view that *"although airlines require some office space, discretion over the amount procured at airports is fairly high, and airport market power is moderate at most"*.

Airlines make business decisions as to the amount of office space to lease and the numbers of staff to locate on-airport. Attempts by airports to extract above market rents for airport offices would rationally see airlines reduce their leased office areas to that required to accommodate only the minimum operational staff, leaving the airport with significant excess office space. Moreover, to the extent that there is a minimum office space requirement, SACL cannot see how it could provide data against the proposed definition of office space for staff essential to operations without a high degree of administrative complexity and subjectivity.

Aircraft Light Maintenance

Aircraft light maintenance sites would be expected to constitute a combination of common use aeronautical aprons (for pre flight checks) and property facilities held by airlines or service providers, which could be used for a range of purposes including aircraft

maintenance, storage, parking and loading. It is difficult to see how revenues and costs associated with light maintenance sites could be identified and reported in any reliable manner. We would also query whether the magnitude of such revenues would warrant the complexities associated with their reporting.

The Productivity Commission stated that consideration of market power for light maintenance *"predominantly is an issue of access to the site to enable third parties to provide the service. It does not appear that access has been an issue so far."* Indeed, the Productivity Commission cites a submission made by DOTARS at the time which argued that *"airport market power in the provision of light maintenance is low since airlines and third parties, rather than the airport itself, provide the services on a contract or fee for service basis."*

On this basis, SACL cannot see that any justification has been made for the inclusion of light maintenance facilities as an aeronautical service. The pricing and availability of aircraft light maintenance services at Sydney Airport is not a function of the airport's market power but of the market structure and behaviour of private operators on leased premises at the airport.

Airside Freight Handling and Storage Areas

Airside freight handling and storage areas are a combination of common use aprons and storage areas, and commercial property arrangements for which freight operators have practical off-airport alternatives. While freight operators may be prepared to pay a premium for the convenience of on-airport handling and storage areas, ultimately they only need to access aircraft on parking aprons to undertake their business, with freight handling, storage and make-up feasibly undertaken off-site.

The Productivity Commission concluded that airports held "negligible" market power in the provision of freight facility sites and buildings, being facilities for the loading, unloading and short term storage of freight. It was less definitive regarding freight handling equipment storage sites, where it felt the degree of power was related the extent to which they could be located off-airport. It did conclude in relation to equipment storage that the issues are primarily access related and that *"it does not appear that they [airports] currently have an incentive to exercise market power per se in providing access to these facilities."*

Notwithstanding SACL's objection to the inclusion of freight handling facilities for reporting purposes, SACL considers that the definition proposed is unclear as to its coverage, and that a more suitable definition would be "Airfreight freight handling and long/short term staging areas essential for aircraft loading/unloading (i.e. not cargo terminals or ULD/GSE storage areas)".

Exclusion for Pre-existing Contracts

The existing exclusion for services and facilities provided under pre-existing FAC contractual arrangements was inserted in recognition that airports have limited scope to vary charges under existing contractual commitments beyond the terms of those inherited arrangements. SACL is also concerned that the removal of this exclusion provision may have the practical implication of constraining SACL from exercising legitimate contractual rights that it acquired as part of the airport's privatisation.