Adelaide Airport Limited response to the Productivity Commission Inquiry into Airport Services

AAL is pleased to provide a submission to the PC Inquiry into the price regulation of airport services and the effectiveness of the current light-handed regulatory regime for airport pricing, having regard to:

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

Summary

International and Regional routes serviced from Adelaide Airport are dominated by very marginal 'thin' routes, which are highly sensitive to airport charges and consequently AAL has very limited market power in the provision of airport services in these market segments. AAL currently offers regional and international airlines a level of airport prices which are below long run average costs and also offers incentives for growth. AAL's ability to exercise any market power is heavily curtailed by the difficult nature of its international and regional markets.

In the larger and highly concentrated domestic airline market, there could be a theoretical potential for market power, but this is heavily curtailed by the strong countervailing power of airlines. When airport charges were last negotiated in 2002, the airlines counter-offered charges 28% below the cost-based prices being sought by AAL. (The counter-offer ended up being the prices agreed).

AAL also offered a choice of charges based on passenger (pax) or tonnes, to give airlines added flexibility depending on their business model.

Airlines have mobile assets that can be redeployed on more profitable routes at very short notice or withdraw services entirely. For example, at short notice Qantas Link commenced operations in Adelaide in December 2005 with 36 services per week, and in June 2006 had ceased operation.

Adelaide Airport has been highlighted in ACCC and other reports as having a 76 percent increase post the CPI-X regime. This was from a very small and artificially derived base from the Federal Airports Corporation (FAC) pre-privatisation on a network service basis (the 2002 increase moved prices from approximately $2.00/pax to approximately $3.50/pax).

The charges for the New Terminal agreed under the light handed regime use the same methodology as approved by the ACCC under the previous heavy handed regime – that methodology used a very conservative estimate of the asset beta, so these prices represent excellent value for money, given the exceptional quality of the new facility.

The negotiations leading to commencement of construction for the New Terminal were conducted in less than half the time taken under the old NNI regime. This indicates that AAL and airlines can work together constructively to invest in improved services at a

reasonable price. A tour of Adelaide Airport will quickly confirm the great advances that have occurred under the light handed regime.

Compliance costs with ACCC reporting and monitoring whilst not exorbitant is an unnecessary cost for a company of AAL's size. In any case, monitoring is not required. AAL takes great pride in the quality of its New Terminal and has natural incentives to maintain this quality to a high standard, regardless of ACCC quality monitoring. AAL is also transparent in publishing pricing and financial data on its web site – this self regulation is just good business sense and not something the ACCC needs to duplicate.

Combined with the strong negotiating power of its large corporate customers, and a general desire on both sides to get on with business, there is no need for ACCC to continue monitoring prices or quality at Adelaide Airport or to undertake financial reporting. AAL has been a model citizen over the past 5 years and feels there is no need for it to continue to be 'on probation'.

1. EFFICIENT OPERATION OF AIRPORTS

Efficient Pricing

Efficient prices should reflect the long run cost of providing aeronautical services. AAL uses a building block approach, based on a depreciated optimised replacement cost (DORC) model to support its position in aeronautical pricing negotiations. Using an appropriate risk-adjusted cost of capital against aeronautical assets which are valued on a DORC basis (dual till) ensures that long range prices generate returns that are in line with the long run costs of efficiently providing aeronautical services, including promoting an appropriate level of capital investment.

In mid 2002, as part of its open dealing on pricing negotiations, AAL provided to the airlines a pricing model, including expert reports on asset valuations and traffic forecasts. Ultimately, negotiations led to agreed landing charges (for the use of aeronautical services, excluding terminals) which were approximately 28% below the 'allowable revenue' justifiable in accordance with the financial model and consistent with previous pricing decisions by the ACCC.

AAL was not able to unilaterally impose its view on pricing. Given the strong negotiating position of the airlines, the commercially agreed outcome was some considerable distance below AAL's view.

Regional airline charges at Adelaide are among the lowest for capital city airports in Australia.[1] AAL is mindful of the importance of regional airlines to the State economy. and offers the lowest regional charges among the major capital city airports.

Passenger Facility Charges for the use of Terminal 1 for International airline passengers are also below average cost, though above marginal cost, as discussed in detail later in this submission. This is complicated by the common nature of the facilities.

Investment Outcomes

The negotiated outcomes have promoted both the efficient use of airport infrastructure and better provided for the investment required to sustain and enhance services over the longer term **relative** to the previous arrangements.

AAL has invested heavily in airport infrastructure during the price monitoring regime and has been able to do so by commercial agreement with airlines. Table 1 highlights the significant increase in capital expenditure post regulation. The large increase in expenditure came mainly from building Adelaide's new terminal. This investment had taken many years to agree under the adversarial necessary new investment (NNI) system, eventually stalling after the Ansett collapse. Under the light handed regime, commercial negotiations were concluded promptly and construction commenced.

While it could be argued that the New Terminal would have happened even if the regulatory regime had not changed in 2002, our experience demonstrates that investments were extremely difficult to progress under the NNI regime and the New

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[1] See Australian Competition and Consumer Commission (2006a), *Price Monitoring and Financial Reporting — Price Monitored Airports, 2004-05*, ACCC Publishing Unit, Canberra.

Terminal progressed more rapidly under the new regime – the results speak for themselves.

Table 1: AAL Aeronautical Investment ('000s)

	1999	2000	2001	2002	Total	2003	2004	2005	2006	Total
Environmental	274	243	34		551					
Runways	1,038	1			1,039			120		120
Taxiways			375	10	385					
Aprons & Related Infrastructure		3,418	1	1,466	4,885	55		1,076	516	1,647
Domestic Terminal						1,560	85	50		1,695
International Terminal	3	535	1,389	9	1,936					
New Terminal	1,474	2,401	7,226	2,475	13,576	3,046	46,250	148,299	54,050	251,645
RTA Maintenance Capex		525			525	18			568	586
	2,789	7,123	9,025	3,960	22,897	4,679	46,335	149,545	55,134	255,693

AAL's experience under heavy handed Price Regulation was that there were very long lead times to decisions and with both parties taking 'theoretical' maximum/minimum positions with the regulator and 'waiting' for the umpires decision. Regulatory decisions often involved excruciating detail on minor issues. As an example of some of the trivial issues that absorbed a great deal of time (and associated compliance costs for government and the industry), the following quote is taken from the ACCC MUIT decision of October 1999 (under the heavy handed regime). The amount of regulatory effort spent on analysing and arriving at an allocation of the cost of this escalator most likely exceeded the cost of that escalator:

Floor plans of Level 3 of the MUIT provided to the Commission indicate that stairwells, escalators and corridors which appear to link non-aeronautical activities such as offices, a retail food area, an observation deck and airline lounges have been classified as aeronautical. AAL argues that this allocation is appropriate because the general public will have free access to these areas which are not for the exclusive use of retail customers. AAL has also put the view that the airlines will construct their own escalators to service their member lounges. This implies that the escalators provided by AAL will predominantly be used by passengers using the aeronautical facilities (such as the proposed observation deck of the MUIT's upper level) rather than nonaeronautical facilities (such as retail facilities and lounges provided by airlines for passengers with loyalty scheme memberships).

In responding to the Commission's Draft Decision, AAL put the view that escalators ought to be considered exclusively aeronautical as the Treasurer's Declaration lists escalators as a facility providing aeronautical services. Northern Territory Airports made the comment that:

> *The ACCC's approach is also quite contrary to the Treasurer's Declaration No.84 and Direction No.13, which include all public areas and escalators in declared aeronautical services covered by the price cap. There is no exclusion based on allocation by floor area or by any other arbitrary method.*

The Commission's view is that it is only aeronautical services provided by the listed facilities should be regarded as "aeronautical". Some of the listed facilities will have aeronautical and nonaeronautical components.

The Commission's view is that there is a case for nominating as non-aeronautical a percentage of the cost of the stairwells, escalators and corridors which provide access between the second and third levels. While any allocation of common costs is

necessarily arbitrary a more equitable approach may be to base the allocation on the non-aeronautical percentage of floor space on the third level (excluding the airline lounges). For the purposes of the Draft Decision, the Commission nominated the cost of one of the two escalators running between the second and third floors as being "non-aeronautical" and therefore its cost was excluded from the PFC. This "50 per cent" allocation was consistent with the Commission's estimate of the relative floor space providing aeronautical services on the third level (excluding the airline lounges) and has been maintained in the Decision.

The above quote is illustrative of the long and tortuous meetings and the preparation of detailed submissions required under the NNI regime, to determine whether one escalator was 50% aero, or 100% aero, or some other number. Significant amounts of management time were spent on trivial issues such as these under the heavy handed regime. After incurring those compliance costs, the final decision to 'split the difference' at an arbitrary 50% shows that regulatory intervention, while well intentioned, is not omnipotent in its ability to determine the correct basis for airport charging. It is interesting how often regulators end up using an arbitrary 50% allocation of costs, yet the resulting prices are portrayed as being the undeniable truth. In the final outcome the building design was significantly altered to meet the needs of the emerging market demands of airlines and to accommodate a fast track design and construct project. The prospect of long periods of regulatory oversight would severely mitigate against fast track design and construct processes.

Any move back to heavy handed, arbitrated outcomes or government guidelines will ultimately involve a large amount of effort leading to arbitrary 50% allocations, which add little value (and significant compliance costs) to the decision making process of airport investments.

The MUIT decision took 12 months from the initial proposal under the NNI regime. While, under the light handed regime, the final version of New Terminal documents took approximately half that time to conclude.

AAL and the airlines negotiated the landing fees in 5 months – and bearing in mind this was the first major negotiation under 'Price Monitoring' and included an Agreed Terms of Use document. It is expected that the negotiations next time around should be at least half that time.

Contribution to State Economy

Airport businesses are a significant contributor to jobs. In South Australia under the light handed monitoring regime there has been a 68% increase in direct jobs created by airport businesses totalling approximately 7,700 direct jobs and 8,200 indirect jobs.

Price Changes under the Light Handed Regulatory Regime and Moving Forward

The Australian Competition and Consumer Commission (ACCC) price monitoring report for 2004-05 indicated that since 2000-01, AAL had a 76 percent increase in the adjusted aeronautical revenue per passenger revenue, while unadjusted aeronautical revenue per passenger increased by 142 per cent. At the same time operating expenses per passenger increased by 18 per cent and aeronautical operating margin per passenger has increased from -$0.33 in 2000-01 to $2.43 in 2004-05.

These conclusions are misleading. The 76 percent increase was from a very small and artificially derived base from the Federal Airports Corporation (FAC) pre-privatisation on a network service basis (approximately $2.00/pax to approximately $3.50 i.e. an increase of $1.50 per pax). That said, returns are at best average and generally below average relative to the other price monitored airports, and generally below that for non-aeronautical services.

Prima facie, some may argue that AAL has used market power to increase charges by more than could be justified on the basis of costs. However, AAL has been very transparent in the provision of financial information to airlines to assist in the commercially developed outcomes on pricing.

AAL has, at significant expense obtained independent third party expert reports on traffic, capital costs, and operating costs and provided detailed financial models to support the finally agreed pricing outcomes. The cost (not including legal fees) of developing the passenger facility charge (PFC) model was approximately $100k. While the initial landing fees consultation cost approximately $120k.

Given the opportunity to develop pricing on the basis of a proper economic model, prices have increased only by CPI in the last four years, by agreement with airlines.

Responsive to User Needs

AAL offers all airlines a choice between tonnage and passenger based landing charges. Airlines have the ability to annually select the pricing basis that suits them.

Under Price Monitoring AAL has been able to develop market growth incentives for airlines as well as incentives for new destinations that are applied without differentiation. By offering passenger based charges, AAL is willing to share risks with airlines on new routes. AAL treats all airlines equally with universally available incentives.

Regional and international airlines are offered very modest airport charges, due to the low-margin airline market and highly price sensitive nature of regional and international routes at Adelaide. AAL's position with respect to Regional Airlines has received positive commendation from State Government. AAL believes it is appropriate to positively price discriminate in this way, with regional and international routes being charged a price close to marginal cost, with the high margin domestic routes being charged a price that is closer to (though about 28% below our estimates of) average cost. International airlines charges at Adelaide still appear high by comparison to industry averages. This is entirely due to the fact that there are significant costs associated with maintaining an airfield for Code E size aircraft and secure customs areas in the terminal, given the modest volume of international airline traffic to Adelaide. In addition the curfew at Adelaide restricts the operating hours that Adelaide has to service air traffic.

In terms of incentives, AAL offers a 50 per cent rebate on landing fees for any growth that exceeds 5 per cent of the previous year base. This applies to every airline.

Quality of Service, Consultation Mechanisms & Commercial Relations

Under Price Monitoring AAL has negotiated significant Service Level Agreements with Airlines that represent the majority of passenger traffic through the airport that cover every important aspect of airline and passenger processing and displays its charges in an open and transparent manner on its web site. AAL also publishes its annual report on its web site, and it is usually available many months before the ACCC accounts.

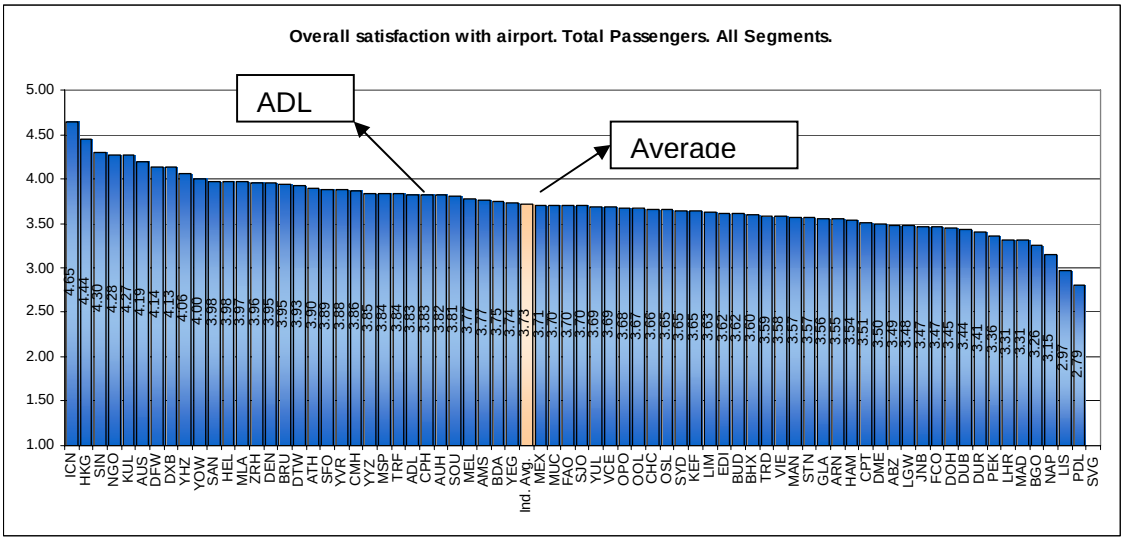
As a private company AAL is not required to publish annual reports, but does so in the interests of openness and transparency. If AAL was removed from ACCC reporting requirements AAL would continue to post annual reports and pricing schedules on its web site. This self regulation makes AAL pricing and financial information easily accessible, thus making ACCC reporting redundant.

Quality of Service surveys conducted every six months on the range of measures as required under the *Airports Act 1996* Schedule 2 of the Airport Regulations indicate that the service provision is in the satisfactory to high range on a constant basis. These survey results are based on the former two terminal operations at Adelaide Airport. The first full period of operation in the new terminal, T1 will be available on 31 July.

The Quality of Service surveys have been conducted on a regular basis for about 8 years and there have been no significant problems highlighted. Anything of a minor nature has been addressed in the construction and operation of T1.

Apart from the delays caused by the Ansett collapse and to a lesser degree the terrorist activities that occurred on September 11, 2001, the new terminal building and apron infrastructure was delivered on time. Equipment associated with the newly constructed fuel pipeline was damaged due to contamination which prevented the pipeline from being able to be used until mid Feb 2006. International Airlines commenced operations from the New Terminal in October, Regional Airlines commenced in December and Domestic airlines exercised their prerogative to not move to the new terminal until February.

In conjunction with the commissioning of T1, AAL entered into a contract with Airports Council International (ACI) to facilitate Airport Service Quality surveys and benchmark against airports of similar size throughout the Asia Pacific region and the world.
The results from the first quarter indicate that Adelaide Airport is amongst the top three Airports in several measures and has achieved the highest overall ranking of Australian airports represented in the survey.



Regardless of whether the ACCC conducted quality monitoring, AAL has made significant investments in the airport and takes great pride in the excellent quality of airport services. AAL thus has a natural incentive to see that these assets are maintained and operated in excellent condition. This is essential for protecting investment and makes good business sense - and makes ACCC monitoring redundant.

AAL will continue to obtain similar accredited quality of service monitoring (and publish same on it's website) even if removed from the ACCC reporting requirements.

Airport Operating Committees provide the forum for a two way exchange of information. AAL has requested airlines to provide some information (such as day of departure and information on numbers of passengers aboard each flight) that will potentially make more efficient use of common user facilities. Despite benefits to both sides airline information often only comes retrospectively and it is limited.

Consultation with airlines on new routes and improvements to existing routes is a constant part of the partnering approach to doing business. AAL has in place signed contracts with its major airline customers covering:

- passenger processing fees including agreed methodology for calculating future changes;
- priority use areas;
- agreed rules for allocation of common user facilities;
- service level agreements covering all aspects of airline and passenger processing with agreed response and fix times;
- agreed terms of use for aeronautical services; and
- dispute resolution procedures.

These agreements have all been settled in the period post price regulation and are evidence of the airport and airlines working together well.

Prior to 2002 there had not been any fully negotiated/signed agreements with any airlines (apart from buying back the Ansett facilities from the Administrator) – only ACCC decisions in relation to pricing and NNI. All contractually binding agreements have been finalised post regulation. And while AAL has negotiated dispute resolution mechanisms with all airlines pursuant to either the Standard or Agreed Terms of Use or specific contracts, there have not been to date any disputes that have needed to be resolved via the dispute mechanisms in the contracts.

Pricing expectations

The BARA PC Submission dated June 2006 refers to "Adelaide Airport's expectation of CPI-1% going forward". This was extracted from an ANZ analyst report in 2000. The actual context was that AAL had used an assumption of CPI-1% for the purpose of a banking financial model (for the purpose of debt sizing, for forecasting debt service

coverage and for reviewing credit rating) and a sensitivity to test the exposure of AAL to scenario of CPI-4%. It is standard practice for financial analysts to use sensitivity analysis when analysing the credit worthiness of a debt. A continuation of the FAC network pricing with CPI-X was certainly appropriate at the time for determining AAL's borrowing capacity – but does not reflect an efficient pricing level. At the time of the ANZ analysis, scenarios of continued heavy handed regulation at CPI-1% and CPI-4% were a conservative basis for assessing the capacity of AAL to cover the interest on its' borrowings. BARA have been misleading in characterising AAL's banking base case as its expectation of appropriate airport pricing going forward.

2. THE USER COST OF CAPITAL

Under a light handed regime, parameters such as the asset beta and land value, and how these feed into an agreement on pricing, are a matter for direct negotiation between airlines and airports. Under the probationary period, AAL and the airlines have been able to reach agreement on a range of pricing and new investment issues. AAL believes that this is the most appropriate regime going forward and that AAL no longer needs to be 'on probation'.

However, in the event that regulation takes a backward step towards heavy handed determinations or guidelines, or where past ACCC decisions arrived at inappropriate parameters, which are subsequently used as precedents in a probationary 'shadow regulation' system, this section sets out AAL's view on the appropriate parameters for determining prices.

Efficient prices should allow a return on (appropriately defined and valued) assets commensurate with the commercial risks involved. Arguably, the most important determinant of this return is the asset beta. Moreover, the determination of asset beta is probably the most contentious issue arising in the consultation process. This is compounded by the fact that AAL is not a listed company thus directly estimating its asset beta is not possible. In the most recent pricing negotiations, AAL used an asset beta which was the same as that which the ACCC handed down in its decision with regard to AAL's MUIT proposal during the heavy handed regime (β=0.61). While AAL feels this low beta causes it to shoulder a disproportionate amount of risk, the probationary feature of the current system allowed little room to move in the negotiations.

AAL is of the opinion that a light handed approach, where pricing can be determined in consultation with the airlines, will deliver speedier and more efficient outcomes and investments only proceed if they are beneficial to all sides. Under NNI, intervention by the regulators to determine parameters such as the asset beta increases the risk of error and doesn't necessarily arrive at a price level that is fair to all sides.

Regulatory discretion involved in setting individual parameters (rather than looking at whether the overall deal seems fair) restricts the service providers' ability to respond to changes in the market environment. Perceptions that regulatory decisions tend to be biased in favour of airport users tends to create an artificial constraint on commercial negotiations. In particular, if the regulator has a tendency to err on the low side for each individual parameter (resulting in a low asset beta, a low land value, the inclusion of only 50% of common costs, and so forth) the combined effect of these generates a price that

is at the lower bound of any reasonable confidence interval of the 'right price'. This in turn causes the airport to take on a disproportionate amount of risk.

Prior to the Ansett collapse, the prevailing view was that airports were a relatively low risk investment and traffic provided a steadily growing revenue stream – effectively an "annuity". What is now clear is that new entrants come and go, low cost airlines change routes at short notice and one-off events such as SARS, the Bali Bombings and the Tsunami can cause significant fluctuations in traffic. AAL shares the downside with airlines and provides discounts for growth. Investing in long-term infrastructure (such as a new terminal or runway upgrade) in this context involves significant risk.

Once an infrastructure investment is made and operating well, it can also be very difficult for customers or regulators to differentiate between genuine monopoly rents and upside profits accruing to the facility owner. The possibility of earning above normal profits (if the project turns out to be successful) will generally enter the calculus of any investment decision to balance the possibility of losses in the event the project fails. This is particularly the case for institutional investors (such as superannuation funds), which view the returns on an airport investment in the context of its portfolio of investments. As a consequence, if there is an expectation that regulators, who are seeking to curb monopoly rents, will also remove or reduce the upside gain from a successful project (without any compensation for potential losses from a failed project), some new commercially viable investments are likely to be deferred or not pursued.

What is more, even successful projects will not generally generate positive profits in the earlier years post investment. Thus above normal profits in later years when demand increases exist to compensate the facility owner for losses in earlier years. However, if the earnings each year are capped, the possibility of earning these 'compensating' supernormal profits over the life cycle of the asset will be removed or reduced, again having adverse consequences for incentives to invest.

The current light handed approach, for the most part, is able to circumvent these concerns by determining prices through direct negotiation between airports and airlines, provided those negotiations are not constrained by the probationary feature of the current regime.

3. THE VALUATION OF AIRPORT LAND

Periodicity of revaluations

For the purposes of taxing the airport, AAL is subject to annual revaluations of the improved value of the site. For the purposes of aeronautical pricing, some argue that revaluations should not occur. Over time, this will result in rising taxes offset by constant revenues.

Method of valuing airport land

At the last negotiation of airport pricing, AAL put forward a proposal based on an historical cost land valuation (based on the ACCC's May 2001 decision). While it was noted at the time that an opportunity cost based land valuation would be more appropriate, in light of the (then) recent ACCC ruling on Sydney an historical cost valuation was adopted at Adelaide. Airlines responded with a counter proposal, placing

aeronautical charges some 28% below the AAL proposal. As a result, airport pricing at Adelaide is lower than would be supported by either historical cost or opportunity cost.

Land values vary from location to location, for example, land that is closer to the city tends to be more valuable. This valuation of the land is precisely the opportunity cost of using it for the purposes of siting an airport. It is to the community's benefit to use airport land as productively as possible. To do otherwise (i.e. not price land at opportunity cost) will result in an inefficient allocation of resources.

As noted in the Access Economics October 2005 paper on *The Value of Airport Land:*

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.

… The other major development at Australian airports in recent years had been non-aeronautical property developments (including offices, retailing, hotels, light industrial and the like). 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 almost all cases, the current opportunity cost is the current market value. This automatically takes account of any wear and tear on the asset as well as any improvements in technology that may make it less productive compared to currently available alternatives, and other changes that make it more valuable than it was originally, e.g. because of an increase in demand for the goods or services that the asset is used to produce.

AAL proposes that a land value consistent with the above is a suitable basis for determining the value of the asset base, as an input into commercial negotiations of airport pricing.

It is noted that as a consequence of the application of the Australian equivalents to International Financial Reporting Standards the value for land (or for that matter other aeronautical assets) recorded in the financial accounts is unlikely to be the same value as that used for aeronautical pricing purposes.

4. FACTORS THAT RESTRICT THE USE OF MARKET POWER

Countervailing Power of Airlines

Airlines operating at Adelaide have considerable negotiating strength. Presently, Qantas has 54 per cent of the Adelaide domestic market share; Virgin has 35 per cent and Jet

Star 11 per cent. Together, Qantas and Jet Star control almost two-thirds of the Adelaide market which make them a formidable force at the bargaining table.[2]

This buying power acts as a countervailing force where Adelaide Airport might have some degree of pricing power and in other cases allows airlines to inefficiently force down the prices they pay. At Adelaide aeronautical pricing is below any reasonable measure of the shadow regulatory 'allowable maximum'.

As noted by Access Economics:

To the extent an airport has pricing power because of its location – being a desirable site in terms of access and other factors that are valued by airlines and ultimately end-users (passengers and freight operators) – the rent accruing from that location could not be used to reduce the prices of aeronautical services without leading to distorted incentives for investment and use of assets. The ability to capture land rents should not be confused with market power.

International carriers and Adelaide Airport's lack of market power

Unlike the eastern seaboard, South Australia's major international markets are the mature long-haul markets of UK, Europe and North America. In 2005, they accounted for nearly 68 per cent of South Australia's visitors, compared to 35 per cent nationally. South Australia faces considerable challenges in attempting to tap into emerging Asian markets with their expanding numbers of middle class travellers.

In the 12 months to December 2005, South Australia attracted 334,500 visitors and around 6.4 million international visitor nights. The state's 'market share' – the proportion of overseas visitors to Australia who visit SA – was 6.7 per cent (compared with 8 per cent in 1998) while its share of nights was 4.7 per cent. Between 1998 and 2005, the average annual growth rate in visitor numbers to SA was 1 per cent, lagging the national growth rate of 4 per cent by a considerable margin. It is clear from the above numbers that Adelaide and South Australia have to work very hard to retain market share in the Australian international tourism market.

According to research by Tourism Queensland, the destination choices of potential visitors from long-haul markets (US/UK/Europe) are primarily motivated by their desire for an overall Australian experience. These visitors are more likely to take in a number of destinations in various States and Territories during their stay in Australia. Conversely, potential visitors from short-haul markets (Asia/Japan/New Zealand) are more likely to have a preference for a specific destination. Australia competes with Hawaii, Guam and Saipan for Japanese visitors; with Europe, USA and Asian countries for other Asian visitors; and the South Pacific, Fiji, Hawaii, Europe and UK for visitors from New Zealand. Among domestic destinations, Japanese travellers prefer Sydney and the Gold Coast while other Asian visitors prefer Sydney, Melbourne, the Gold Coast and Perth. Only among New Zealanders is Adelaide considered a leading destination, alongside Sydney, Melbourne and Perth.

[2] Based on last three months publicly available schedule information and estimate of seats per aircraft

South Australia's performance relative to other states is compounded by the challenges faced by Australia as a whole. International arrivals into Australia have been volatile in the last several years, due to various factors such as the September 11, 2001 terrorist attacks, the prevailing sense of uncertainty on many fronts (economic, political, social, environmental), ongoing international security issues, weakness in the global economy, the war in Iraq, SARS and concerns about potential pandemics such as avian flu. These factors acted to dampen demand for travel worldwide and to Australia between 2001 and 2004. Australia's attractiveness as an international travel destination has also been negatively impacted by a relatively strong Australian dollar.

South Australia's ability to attract more international travellers has direct consequences for Adelaide Airport. The airport is currently utilized by just six international carriers: Air New Zealand, Cathay Pacific, Garuda Indonesia, Malaysia Airlines, Qantas and Singapore Airlines. Direct flights are only available on a few days each week between Adelaide and Auckland, Bali (being suspended in September 2006) , Hong Kong and Kuala Lumpur, and there is one daily flight between Adelaide and Singapore.!

Adelaide Airport is keen to attract and retain international carriers as customers. However, it has to compete for international services with other airports such as Melbourne's Tullamarine. The international routes to Adelaide are 'thin' routes characterized by marginal economics. Adelaide Airport's monopoly power in setting airport fees and charges is thus heavily curtailed by the price sensitivity of the international services that utilize the airport. The bargaining strength of these airlines derives in part from their ability to re-route flights away from Adelaide to other Australian and overseas tourist destinations. That is, their 'outside options' when bargaining with Adelaide Airport are much stronger than the airport's.

Adelaide Airport offers 50% reduction in landing fees to freighter aircraft and has invested in freight handling equipment in conjunction with the freight industry in order to grow and retain very important freight business into Adelaide.

5. COMPLIANCE COSTS

Annual price monitoring compliance costs for AAL amount to approximately $35,000 per annum. If AAL were compelled to continue to report information in the manner set out in the ACCC price monitoring reports AAL does not consider the level of information required and its presentation to be unduly onerous. It is suggested that the face schedule for profit & loss and the supporting schedules providing detailed analysis of account level allocations between Aeronautical and Non-Aeronautical costs and the subsequent breakdown of Aeronautical costs into Aircraft and Passenger handling might be more efficiently dealt with in a single step presentation. That is as follows:

Description	Method of allocation	Aircraft Handling	Passenger Handling	Total Aeronautical	Non-Aeronautical	Total costs
		A	B	C	D	E
Where				= A + B		= C + D

Income arising from the recovery of government mandated security costs should not be included in aeronautical income. It is only a recovery of costs on behalf of the

Government. A separate schedule could be provided to show income and costs and any carry over of under/over recoveries to enable monitoring.

6. DEFINITION OF AERONAUTICAL SERVICES

AAL is of the opinion that the Regulations to the Airports Act should be replaced with Treasury Direction 27 amended only to include landside roads into the definition of aeronautical related

7. ADEQUACY OF ACCC DATA

The ACCC price and quality monitoring reports do not use the same approach in retrospect that the ACCC preferred template does for prospectively setting prices. The retrospective review looks at accounting information and does not allow recognition of the Goodwill Premium investment in the aeronautical assets acquired. Therefore the reports use revenue information that is set using established economic principles and compares it to accounting cost information. The price monitoring reports do not recognise the cost of capital in investment in aeronautical assets.

AAL has consistently argued that Government Mandated Security Costs should not be included as part of aeronautical revenue or costs as these have a tendency to distort the result. AAL notes that CTFR recovery costs as from 1 January 2006 are no longer required to be paid by airports (and therefore not recouped via the Government Mandated Security Charges) and that this will result in reductions of aeronautical revenue being recorded in the 2005/06 year.

AAL proposes that, if it is required to submit monitoring reports, that those items defined as Aeronautical Related should only need to have their price monitored. The exercise of determining the cost of providing such services is relatively arbitrary. Rarely, if ever, do the ACCC comment on this aspect of the price monitoring report and therefore its usefulness is very questionable.

Some of the information used by the ACCC to gauge quality (for example, passenger surveys) encompassed services not directly under the control of airports – particularly in the areas of queuing for check in and border control. In other instances, particularly in the case of Adelaide, the sample size among airlines is very small and the survey can be very biased according to the ‘whim’ of the interviewee.

Airports, including Adelaide, provide extensive counters for airline and border agency services who tend to underutilize the facility allegedly due to budget and staffing level constraints affecting the service quality outcome.

More precisely, the Primary Line counter in T1 (at the request of the border agencies) was set at 12 staff positions. As far as is known to AAL the maximum number of staff ever used on these positions has been five since operations began in October 2005. To highlight further, a recent international traveller who passed through Adelaide airport on

the 1st of May, 2006 made the following complaints indicating shortcomings in the Customs and Quarantine area, which is not in the control of AAL:

- *It took nearly two hours to clear Adelaide Airport. The plane landed at 7.45 am and we finally got into a cab at 9.40 am.*
- *There are 12 passport desks and only 4 of them were manned. We had to wait 25 minutes in a passport queue.*
- *There are only 2 X-Ray machines; therefore it takes a long time to process all the bags on the flight.*
- *Don't forget this was only a B767 not a 747ER with even more passengers on board.*

Similarly, road transport (taxis and public busses) are dictated by other agencies even though the drop off and pick up infrastructure has been provided to meet demand.

While AAL plays a coordination role and communicates with the various agencies to avoid bottlenecks and to promote the overall efficient operation of the New Terminal, ultimately, AAL has limited ability to influence the operational decisions of the individual agencies.

It is the opinion of AAL that this 'overlap' has not been appropriately handled in the interpretation of the information concerned – the explanatory notes provided with our annual report rarely, if ever, are included in the ACCC report.

Finally, benchmarking exercises among Australian Airports provide doubtful results. The sample size is insufficient given the geographic diversity and traffic volume/mix differences.

8. CONCLUSION

Price Monitoring has delivered the right outcomes. The industry is very dynamic with airports having accepted risks associated with airlines failures, cancellation of services, and extraneous factors such as SARS. Airline assets are mobile and able to react to the market forces. Airport assets are immobile and their cost basis has a significant fixed component which makes for greater potential risk when traffic is falling.

Under Price Monitoring there have been significant commercial outcomes negotiated resulting in a large amount of capital investment in aeronautical assets.

Under Price Monitoring there has been a healthy growth in passenger traffic, stimulated by a joint focus of commercial parties being airlines and airports that was not evident under Price Regulation.

It is AAL's opinion that the current light handed regime has successfully achieved its intended goals and should therefore be retained. AAL is of the view that is no longer needs to be 'on probation', as it has acted in an honourable manner under the probationary period of price monitoring. AAL also has adequate self-regulation of quality in place and is transparent in publishing pricing and financial information on its web site. This does not need to be duplicated by ACCC reporting of the same information.

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