



21 July 2006

Ms Jill Irvine
Productivity Commission
PO Box 80
Belconnen
ACT 2616

Dear Ms Irvine

Inquiry into Price Regulation of Airport Services

I refer to the above inquiry and Jill Henderson's email to Ross Wilson on 14 July 2006 notifying the Productivity Commission that Qantas Airways Limited ('Qantas') would file its submission by 21 July 2006.

Accordingly, please find attached:

- a submission cover sheet;
- a public version and a confidential version of the submission made on behalf of Qantas; and
- a public version and a confidential version of a report on the effectiveness of the regulation of airport services prepared for Qantas by NERA, Economic Consulting ('NERA Report').

Please note that the Qantas submission and NERA Report contain some information that is commercially sensitive and confidential. Such material is provided in the full confidential versions (clearly marked 'In Confidence') but has been removed from the public versions for the purposes of posting on the Commission's website.

If the Commission has any questions, please do not hesitate to contact me or Jill Henderson (02 9691 5799).

Yours sincerely

Brett Johnson
General Counsel



**QANTAS AIRWAYS LIMITED
ABN 16 009 661 901**

**SUBMISSION TO THE
PRODUCTIVITY COMMISSION**

**INQUIRY INTO CURRENT ARRANGEMENTS FOR THE PRICE REGULATION OF AIRPORT
SERVICES**

21 JULY 2006

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Key Points

- Major airports in Australia are monopoly service providers, with monopoly power over provision of airport services. Airport users (such as Qantas) lack sufficient countervailing power to negotiate reasonable terms for supply of those services.
- In 2002, the Government withdrew the Prices Surveillance regime and the deemed ability for airport users to refer access disputes to the ACCC. It replaced those safeguards against an airport operator's ability to abuse its monopoly power with the current monitoring regime and some Review Principles.
- At the time it was introduced, Qantas was concerned that the current regime would be unable to meet the Government's objectives and constrain airport operators' ability to abuse their monopoly power. Experience has shown this to be the case. Some airports have exploited the current position by:
 - increasing charges and introducing new charges 'hidden' from monitoring;
 - revaluing aeronautical assets for pricing and/or monitoring purposes; and
 - imposing unreasonable/uncommercial non-price terms and conditions or failing to negotiate reasonable terms and conditions, neither of which are scrutinised under the monitoring arrangements or the Government Review Principles.
- For the purposes of this inquiry, Qantas has accepted the Government Review Principles and the desire to retain a light handed approach to regulation. Thus, whilst there are a number of regulatory or legislative means available as a solution to the current untenable situation, where possible Qantas has suggested non-legislative solutions.
- In accordance with Paragraph 4(b) of the PC's Terms of Reference, Qantas' approach seeks ultimately to reduce reliance on regulation. This can be done by encouraging **constructive engagement** between airports and airport users. This has been a key strategy of the UK Civil Aviation Authority in carrying out its functions and there are lessons for Australia in that strategy, in that:
 - the CAA recognised that disagreements between airports and airport users existed and could overwhelm negotiations on price and service quality issues; and
 - even in the relatively 'heavy handed' regulatory context of price control the CAA understood the need to positively require airports and airlines to engage constructively with each other and to set out a framework for that to occur.
- In Australia, as in the UK, positive action is required to foster constructive engagement. Airports and airport users will engage in constructive commercial negotiation of terms of access to services in good faith **if** there is full and transparent information exchange and binding independent dispute resolution in the event that agreement cannot be reached – these two elements significantly reduce the possibility of either party acting unreasonably. This is termed the 'Core Principle'.
- There are at least three alternatives to implement the Core Principle:
 - Declaration under Division 2 of Part IIIA of the TPA.

- Airports could be encouraged to lodge access undertakings incorporating the Core Principle by 'deemed' declaration of airport services for the purposes of Part IIIA.
- An access code could be developed as envisaged by Part IIIA. The access code would in turn provide a reference point for airports to develop individual airport access undertakings and streamline their approval, minimising up-front costs.
- The necessity for price and quality of service monitoring of an airport would fall away if the Core Principle is implemented by any of these alternatives.
- One of the most intractable issues facing airports and airport users relates to aeronautical asset revaluation. This issue may overwhelm efforts to encourage constructive engagement unless it can be resolved. In accordance with Paragraph 3 of the PC's Terms of Reference, the Government should provide guidance in relation to asset revaluation by specifying:
 - starting aeronautical asset bases (SAABs) for Sydney Airport, Phase I and II Airports as at the date of sale;
 - that SAABs should be 'rolled forward' based on depreciation, actual necessary new investment and disposal of assets; and
 - any revaluations of existing aeronautical assets should be treated as income (or negative depreciation) for the purposes of calculating revenue required from aeronautical charges.
- Guidance as to asset valuation together with the adoption of one of the suggested alternatives to implement the Core Principle will result in an environment where the prospect of constructive engagement between airports and airport users is maximised and the necessity for price and quality of service monitoring would ultimately fall away. This is preferable to the costly, inefficient and time consuming alternative of individual parties seeking declaration under Part IIIA of airport services provided at various airports – which will inevitably occur unless some circuit breaker is introduced.

1. Introduction

Qantas Airways Limited (Qantas) welcomes the opportunity to make a submission to the Productivity Commission (PC) in relation to its inquiry into current arrangements for the price regulation of airport services. Qantas has also engaged NERA Economic Consulting to assess the effectiveness of the current regulatory regime and its report, *Effectiveness of the Regulation of Airport Services* (NERA Report), should be read in conjunction with this submission.

Qantas is the major user of services provided by Australian airports. [CONFIDENTIAL]. Accordingly, Qantas' customers – including but not limited to passengers and users of air freight services – are directly affected by both the price and non-price terms and conditions imposed by Australian airports.

It is widely accepted that Australian airports possess substantial market power and are natural monopolies¹. Without effective regulation, there is no constraint on airport operators' ability to exercise their market power. At major airports, airlines, including larger airlines such as Qantas, lack countervailing power in respect of the use of airport services. In simple terms this is because airlines have no choice but to use the services of airports located in the destinations to which customers wish to fly. As a general rule, airlines do not have alternatives available to them – there is usually only one airport which can service customers who wish to fly to a particular destination. If a person in Sydney has a meeting in Brisbane, Qantas must fly a plane from Sydney's Kingsford Smith Airport to Brisbane Airport and utilise the airport services supplied by the operators of those airports.

The current prices monitoring regime and the Government Review Principles have been inadequate to effectively constrain the ability of airport operators to exercise their monopoly power in relation to the provision and pricing of airport services. The deficiencies of the current regime include:

- there is no ability to refer access disputes for resolution to an independent third party (as was the case prior to the expiry of deemed declaration of the major airports under section 192 of the *Airports Act 1996*);
- a lack of clarity and guidance on pricing and reporting principles (including on aeronautical asset valuation), which means that airport operators have the incentive and ability to withhold information from the regulator;
- the lack of a comprehensive definition of 'aeronautical services' so that the scope of airport services which are subject to prices monitoring is too narrow to be effective; and
- the lack of any effective monitoring of or mechanism for dealing with non-price access issues to determine whether there is a spirit of negotiation or intention to reach arrangements on 'normal' commercial terms.

Some airport operators have exploited those deficiencies to impose unjustified price increases (including by revaluing aeronautical assets and/or introducing new charges for access to the same facilities) and unreasonable terms and conditions for the provision of airport services.

Notwithstanding the Government's policy that '*airlines and airports ... operate under commercial agreements and in a commercial manner, and ... negotiate arrangements for access to airport*

¹ This conclusion has been recognised by a variety of economic regulatory bodies including the Prices Surveillance Authority (Report No. 48, 1993); the ACCC (Draft Guide to Section 192 of the Airports Act and Submission to the Productivity Commission dated May 2001); the Australian Competition Tribunal (*Sydney International Airport* [2000] ACompT 1 and *Virgin Blue Airlines Pty Limited* [2005] ACompT 5); and the National Competition Council (Final Recommendation on the application from Virgin Blue for declaration of the airside service at Sydney Airport, January 2004).

services² commercial negotiations have been the exception, not the norm. Because the monopoly power of airports is not effectively constrained, airports have no incentive to engage in a commercially constructive way with airport users. Not surprisingly, airports have in many cases focussed on their profitability and not paid the degree of regard to the interests of airport users as would be expected in a competitive context. In a competitive environment, a supplier has economic incentives to engage constructively with customers. However, given the monopoly nature of the supply of airport services in Australia, appropriate regulation is necessary to bring about constructive commercial engagement between airports and airports users.

In accordance with Paragraph 4(b) of the PC's Terms of Reference, Qantas' approach to this problem seeks ultimately to reduce reliance on regulation by encouraging **constructive engagement** between airports and airport users. This has been a key strategy of the UK Civil Aviation Authority³ in carrying out its functions and there are lessons for Australia in that strategy, in that:

- the CAA was not surprised that disagreements between airports and airport users existed and could overwhelm negotiations on price and service quality issues; and
- even in the relatively 'heavy handed' regulatory context of price control the CAA understood the need to positively require airports and airlines to engage constructively with each other and to set out a framework for doing so.

In reviewing the success of constructive engagement in the UK, the Managing Director of Gatwick Airport in London recently commented⁴:

I believe that in the long run this approach will help airports and airlines to work more effectively together by cultivating more open and respectful relationships on a more commercial basis, as far as this is possible within a regulatory framework.

In Australia, as in the UK, positive action is required to foster constructive engagement. Airports and airport users will constructively engage in commercial negotiation of terms of access to services in good faith **if** there is full and transparent information exchange and binding independent dispute resolution in the event that agreement cannot be reached – required to inject an element of reasonableness. Qantas terms this the 'Core Principle'.

There are several alternative avenues by which that Core Principle can be given effect. If the principle can be made binding between an airport and airport users then price and quality of service monitoring will no longer be necessary at that airport. There are at least three alternatives to implement the Core Principle at an industry-wide level:

- declaration under Division 2 of Part IIIA of the TPA;
- airports could be encouraged to lodge an access undertaking incorporating the Core Principle by 'deemed' declaration of airport services for the purposes of Part IIIA; or
- an access code could be developed as envisaged by Part IIIA. The access code would in turn provide a reference point for airports to develop individual airport access undertakings and streamline ACCC approval, minimising up-front costs.

One of the most intractable ongoing issues between airports and airport users relates to aeronautical asset revaluation. This issue may overwhelm efforts to encourage constructive

² Government Review Principles in response to Recommendation 6, Productivity Commission, *Price Regulation of Airport Services* (2002).

³ See section 4.1 of this submission for details.

⁴ Letter from Mr Paul Griffiths (MD, BAA Gatwick) to Dr Harry Bush CB (Group Director, CAA) dated 2 November 2005 (<http://www.caa.co.uk/default.aspx?categoryid=5&pagetype=90&pageid=5734>)

engagement unless it can be resolved. In accordance with Paragraph 3 of the PC's Terms of Reference, the Government needs to provide guidance in relation to asset revaluation.

Structure of this Submission

- Section 2 outlines the current regulatory framework, including the Government's stated policy objectives and intended policy outcomes for privatisation and regulation.
- Section 3 outlines the lack of constructive engagement between airports and airport users, as shown by Qantas' dealings with airports since the introduction of the current regime in 2002.
- Section 4 outlines what constructive engagement means and suggests the necessary 'Core Principle' to encourage constructive engagement between airports and airport users.
- Section 5 identifies a key commercial issue facing airports and airport users; namely aeronautical asset revaluation and suggests ways in which it can fairly be resolved to allow constructive engagement.

2. Privatisation and the Current Regulatory Regime

Summary

- **The Commonwealth Government intended the benefits of airport privatisation to be shared between the Government, airport users and passengers.**
- **In implementing the current regulatory regime in 2002, the Commonwealth Government sought to:**
 - **facilitate direct commercial negotiations between the airport operators and airport users under which there would be agreement on:**
 - **the capacity and quality of aeronautical infrastructure to be provided;**
 - **the capital and operating expenditure necessary to deliver agreed levels of capacity and quality; and**
 - **non-price terms and conditions, including service level agreements and information sharing.**
 - **achieve agreed capital expenditure on a dual till basis; and**
 - **ensure that all essential aeronautical infrastructure is subject to effective constraints on the abuse of market power.**
- **The Commonwealth Government aimed to achieve these objectives by relying on ACCC price monitoring as the only basis to evaluate the conduct of airports.**

2.1 The Objectives of Privatisation

The privatisation of Australian airports was unique compared with both the privatisation of other Australian infrastructure industries and overseas airports.

The Commonwealth Government's stated objective in privatising Australian airports was broader than just seeking to maximise the sale price of the airport leases. It was intended that the benefits of the sale be shared between the Government, airport users (including airlines) and passengers.

At the time of privatisation, the policy intentions of the Government were summarised to bidders as:

'... to promote operation of the airports in as efficient and commercial manner as possible. Pricing is fundamental to the efficient use of airport infrastructure. It is in the interests of airport users in particular, and in the interest of the national economy in general, that commercially-driven decisions be made about maintaining existing airport infrastructure, and building new infrastructure'

And:

*'... the arrangements should also aim to protect airport users from any potential abuse of market power by airport operators.'*⁵

2.2 Privatisation – Phase I and Phase II Airports

In promoting these objectives, some of the key elements of the regulation of Phase I and II airports⁶ were:

- a five year CPI-X price cap on aeronautical prices;
- deemed declaration of 'airport services' under Part IIIA for a specified period, pursuant to section 192 of the *Airports Act 1996*, which allowed airport operators and airport users to refer access disputes to the ACCC for arbitration;
- airport development commitments. The sale included a commitment from the lessee to a specified amount of capital expenditure on aeronautical infrastructure development over the first 10 years of the lease;
- cost pass-through provisions for 'necessary new investment' and government-mandated security services;
- quality of service monitoring;
- inherited contracts. As a consequence of privatisation, airport operators inherited various contracts in place between airport users and the former Federal Airports Corporation (FAC). These contracts covered various services, including common user check-in counters in the international terminals, aeronautical land for aircraft refuelling facilities, and lease agreements associated with domestic terminals. The anticipated revenue streams from these contracts were factored into the sale value of the airport leases. However, the revenues from these contracts were excluded in implementing the CPI-X price cap on aeronautical prices; and
- the CPI-X cap was applied to the network on the prices adopted by the former FAC with no analysis of costs at the time. As noted by Brisbane Airport Corporation Limited (BACL):

*'FAC charges on 1 January 1997, as subsequently reduced by CPI-X, were used as a basis for the first five years. These charges were the former network charges of the FAC adjusted in the 1996-97 financial year in a move towards airport-specific charges.'*⁷

The imposition of a CPI-X price cap based on existing prices, capital expenditure commitments and cost pass-through arrangements clearly influenced the sale value of the airport leases. The Government could have increased the sale value of the airport leases by adopting a different regime for the provision and pricing of aeronautical infrastructure. For example, the Government could have encouraged higher bids from potential buyers by directing the ACCC to value the aeronautical assets of Phase I and II airports prior to sale and adopting a 'dual till' pricing regime on the revalued assets (much as it did prior to the sale of Sydney Airport in 2002).

Instead, the Government implied an asset base value for aeronautical assets at the point of sale by determining a price path for aeronautical services for the first five years. All potential bidders were aware of these price paths prior to sale and would have incorporated the prices into their valuation of the aeronautical business of each airport. In doing so, the airport operators, airlines and passengers shared in the benefits of privatisation. That is, with chosen pricing, some of the

⁵ Commonwealth Department of Transport and Regional Development Pricing Policy Paper referred to in PC Report *Price Regulation of Airport Services Inquiry Report No 19*, 23 January 2002, p. 46.

⁶ Prior to 1997, the Federal Airports Corporation (FAC) operated all major Australian airports. Leases were sold in 1997 and 1998 to Phase I (Brisbane, Perth and Melbourne) and Phase II airports (Adelaide, Darwin, Canberra, Alice Springs, Gold Coast, Hobart, Launceston and Townsville).

⁷ Brisbane Airport Corporation (BACL), Transcripts to the Productivity Commission, 3 April 2001, p. 197

potential sale value of the leases was not obtained by the Government, but rather transferred to the airport operators via a lower purchase price and to the airport users and passengers via lower aeronautical charges over the initial 5 year period.

It is crucial to remember that the purchasers of these airport assets made their investment decision based on these factors. They are not entitled to a windfall gain from revaluing these assets and seeking a return on the uplifted valuation.

2.3 Privatisation – Sydney Airport

The privatisation of Sydney Airport was different to that of Phase I and II airports. Unlike the Phase I and II airports, which were deemed declared under Part IIIA pursuant to section 192 of the *Airports Act 1996* from 1997/1998 until June 2002, Sydney Airport was deemed declared for only 24 hours after its privatisation on 28 June 2002. The Government clearly structured the sale to maximise proceeds.

Sydney Airport's aeronautical assets were valued by the ACCC prior to sale as part of the ACCC's May 2001 pricing decision. The pricing decision established valuations for both fixed assets and aeronautical land. In contrast to Phase I and II Airports, the Government also increased the sale value of Sydney Airport by implementing a 'dual till' pricing regime on revalued assets prior to sale. Under the 'dual till' approach aeronautical and non-aeronautical services are treated as distinct, meaning that the aeronautical aspects of an airport's operations are not offset by non-aeronautical revenues. Further the non-aeronautical aspects of an airport's operations are not subject to prices monitoring.

One would expect any prudent bidder to have assumed that aeronautical prices would be based on the ACCC's valuation of aeronautical assets. Southern Cross Consortium, Macquarie Airports and Sydney Airport Corporation Limited (SACL) have all indicated that in valuing the aeronautical side of the business of Sydney Airport they used the ACCC's May 2001 valuation of aeronautical land and fixed assets.

2.4 Removal of Direct Price Controls

On 13 May 2002, the Government announced its new regulatory policy for airports and accepted the PC's recommendation that, although Brisbane, Sydney, Canberra, Melbourne, Adelaide, Perth and Darwin airports at least had considerable market power in some airport services, direct aeronautical price controls should be removed and be replaced with prices monitoring for a probationary five year period.

The key elements of the Government's policy indicated that it:

- (a) considered that 'lighter-handed regulation of airports' was now appropriate, but that price monitoring arrangements would only apply for a probationary period of five years with an independent review to be conducted towards the end of that period 'to determine whether there have been unjustifiable price increases that warrant reimposition of price controls';
- (b) would maintain a reserve right to bring forward that review, or conduct a separate review, if it appears 'that there have been unjustifiable price increases' and, if such a review reveals evidence of unjustifiable price increases, 'the Government could decide to re-introduce price controls';
- (c) agreed with the PC that 'quality of service monitoring is a useful adjunct to price monitoring, as it helps to ensure that airport operators are not obtaining improved productivity through running down assets or reducing their standards of service below levels reasonably expected by stakeholders'. The Government accepted that quality of service outcomes should be published on an annual basis as part of the broader

reporting requirements under price monitoring and that such outcomes 'should also be taken into account in the review of airport price regulation, which is to be completed towards the end of the five-year regulatory period';

- (d) supported the notion that commercial agreements should be encouraged and assisted; and
- (e) expressly supported the continuing application of the generic provisions of Part IIIA of the *Trade Practices Act 1974* to airports.

In its statement, the Government made it clear that it regarded the threat of re-regulation as a key component in constraining the ability of airport operators to abuse their market power. The Government stated, however, that it '*would only consider re-introducing price controls on an airport if it formed the view that the airport had operated in a manner inconsistent with*' the Government Review Principles.

The key features of the Review Principles (which are also set out in the Government's media release of 13 May 2002) can be summarised as follows:

- (a) for airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services on a dual till basis;
- (b) prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved;
- (c) price discrimination and multi-part pricing that promotes efficient use of the airport is permitted;
- (d) airports with significant capacity constraints could introduce efficient peak/off-peak prices which exceed the production costs incurred by the airport;
- (e) quality of service outcomes should be consistent with users' reasonable expectations, and consultation mechanisms should be established with stakeholders to facilitate the two-way provision of information on airport operations and requirements; and
- (f) the Government's expectation is that airlines and airports primarily operate under commercial agreements and in a commercial manner and that airport operators and users negotiate arrangements or access to airport services.

2.5 Intended Outcomes of the Move to Prices Monitoring

The Government was seeking to:

- Facilitate direct commercial negotiations between the airport operators and airport users, including airlines. It was expected that airports and airlines would agree upon:
 - the capacity and quality of aeronautical infrastructure to be provided;
 - the capital and operating expenditure necessary to deliver agreed levels of capacity and quality; and
 - non-price terms and conditions, including service level agreements and information sharing.

- Achieve agreed capital expenditure on a dual till basis; and
- Ensure that all essential aeronautical infrastructure is subject to effective constraints on the abuse of market power.

The Government aimed to achieve these objectives relying on the ACCC's airport price monitoring reports as the only basis to evaluate the conduct of airport operators against the Review Principles.

3. Qantas' Experience

Summary

- **At the time of the last PC inquiry and the Government's response, Qantas was concerned that the proposed light handed approach would be insufficient to constrain the monopoly position of airports.**
- **Qantas' fears about the current regulatory regime have been borne out with commercially constructive engagement between airport operators and Qantas being the exception, not the rule.**
- **Some airport operators have exploited the current position by:**
 - **Increasing charges and introducing new charges hidden from monitoring;**
 - **Revaluing aeronautical assets for pricing and price monitoring purposes; and**
 - **Imposing unreasonable non-price terms and conditions, which are not scrutinised under the monitoring arrangements or the Review Principles.**
- **Qantas' experience demonstrates the failure of the monitoring regime to achieve what the Government hoped for.**

3.1 Introduction

It is five years since Qantas made its submission to the PC's first inquiry into price regulation of airport services. In relation to the prospect, viewed in July 2001, that the Government would rely on price monitoring alone, Qantas predicted⁸:

First, there would be little or no effective constraint on airport operator's pricing decisions.... Secondly, there will be strong incentives for the monopoly firm to withhold information from the regulator. As the regulator will have no formal powers over the regulated firm, it will be extremely difficult for the regulator to enforce adequate and transparent information disclosure. Thirdly, negotiations between airport users and airport operators will not be commercially based ... Furthermore, the airport operator will have the advantage of information asymmetries, and will have further incentives to withhold information from airport users.

In this climate, commercial negotiations will be conducted in an atmosphere of mistrust and information disparity. Such an outcome will contrast with outcomes usually achieved in competitive markets. Today, commercial negotiations in infrastructure industries between companies that have comparable bargaining power are marked by transparency and openness. Indeed, it is common for commercial transactions to be negotiated on an 'open book' basis, and for the price of services to be determined having regard to costs of supply. Efficiency gains are frequently shared between service provider and acquirer.

Unfortunately, as the material presented in this section and in the NERA Report shows, Qantas' predictions have come true.

⁸ Qantas Submission to Productivity Commission's Inquiry into Price Regulation of Airport Services (July 2001) p33.

The expectation of the Review Principles was that airlines and airports would operate under commercial agreements and act in a commercial manner, and that airport operators and users would negotiate mutually acceptable commercial arrangements for provision of airport services. Qantas' experience is that reasonable commercially negotiated outcomes between airports and airport users have been the exception rather than the rule. It is evident that there has not been sufficient incentive for airports to reach reasonable commercially negotiated outcomes with their customers.

Set out below is a brief summary of the status of long term commercial agreements regarding aeronautical services between major Australian airports and Qantas.

| Airport | Negotiated Agreement | Negotiation process | Binding independent dispute resolution |
|----------------|-----------------------------|----------------------------|---|
| Sydney | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Melbourne | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Adelaide | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Brisbane | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Perth | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Canberra | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Darwin | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Alice Springs | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Cairns | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Gold Coast | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Hobart | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |
| Launceston | [CONFIDENTIAL] | [CONFIDENTIAL] | [CONFIDENTIAL] |

The material presented in this section demonstrates that the regulatory settings chosen by the Government have not worked to lead to constructive engagement. This section outlines Qantas' experience with particular reference to:

- difficulties with the definition of aeronautical services;
- the valuation of aeronautical assets; and
- the non-price terms and conditions of supply imposed by airports.

The examples provided are merely illustrative of the problem and are not exhaustive.

Where possible, reference is made to findings of fact by the Australian Competition Tribunal in Virgin Blue's application for declaration of airside services at Sydney Airport. This is not because problems have arisen only at Sydney Airport. Rather, it is because the PC can take comfort from the Tribunal's rigorous approach to evidence that the material presented is, in effect, independently verified. The approach is also consistent with Paragraph 5(a) of the PC's Terms of Reference.

Schedule 1 summarises the key findings of fact made by the Tribunal about non-price terms and conditions at Sydney Airport. Ultimately, the Australian Competition Tribunal found as a fact that absent declaration under Part IIIA negotiations between the operator of Sydney Airport and the airlines as to non-price terms and conditions of access would continue *'to be protracted,*

*inefficient, and may ultimately be resolved by the use of monopoly power producing outcomes that would be unlikely to arise in a competitive environment.*⁹

3.2 Aeronautical Services

Most of the financial information about airports available to airport users is obtained through the airports financial reporting requirements under the Airport Regulations and prices monitoring. Part 7.03 of the *Airport Regulations* 1997 requires each airport to prepare consolidated financial accounts and financial statements for the provision of 'aeronautical services' and 'non-aeronautical services' separately. Direction 27 (issued pursuant to Section 95ZF of the *Trade Practices Act 1974*) also refers to 'aeronautical services'. It directs the ACCC to undertake formal monitoring of prices, costs and profits related to the supply of 'aeronautical services' at the seven mainland capital city airports.

There are problems with the definition of 'aeronautical services' which undermine the effectiveness of the current prices monitoring regime, notably:

- there are two different definitions of 'aeronautical services' – one under Part 7 of the *Airport Regulations 1997* (regulations made under the *Airports Act 1996* (Cth) (*Airports Act*)) and another under Direction 27, neither of which adequately covers all the essential infrastructure required by airlines to provide passenger and freight air transport and ancillary services; and
- the narrow definition of 'aeronautical services' allows airport operators to introduce charges for access to aeronautical services and facilities and classify those charges as 'non-aeronautical' revenue, thereby concealing this new revenue stream from reporting in the ACCC Prices Monitoring reports.

The key differences between the 'aeronautical services' definitions under Part 7.03 and Direction 27 are that:

- 'aircraft refuelling facilities' are defined as 'aeronautical' under Direction 27, but are 'non-aeronautical' under Part 7.03; and
- 'check-in counters and related facilities' are defined as 'aeronautical' under Part 7.03, but are 'aeronautically-related' under Direction 27.

There is no rational explanation for these facilities not being within the scope of prices monitoring because:

- Aircraft refuelling services are key aeronautical infrastructure needed to provide fuel to aircraft. Both the ACCC and the PC have concluded that airport operators have moderate to high market power in imposing charges on aircraft refuelling facilities. In addition, aircraft refuelling services should be clearly defined to include all associated infrastructure used for the supply of aviation fuel to aircraft: supply pipelines, storage, hydrant and into-plane facilities included.
- Check-in counters and related facilities are essential facilities needed to process passengers. Despite claims by the PC that airport operators have the least market power over check-in counter charges, evidence suggests otherwise. As shown by the Financial Accounts lodged with the ACCC, airports are earning very high margins over check-in counters, as moving all check-in counters off site is neither practical nor commercially viable.

⁹ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 477.

Direction 27 also states that 'aeronautical services' do not include 'the provision of a service which, on the date the airport lease was granted, was the subject of a contract, lease, licence or authority given under the common seal of the Federal Airports Corporation'.

The key former FAC contracts inherited by the airport operators relate to the domestic terminals, check-in counters in international terminals and land for aircraft refuelling.

In Qantas' experience, airport operators use the ambiguous definition of aeronautical services and the exemption for FAC contracts to obscure charges from ACCC prices monitoring.

Case Study – Fuel Throughput Levies (FTLs)

Qantas has consistently opposed the imposition of FTLs by airport operators. This opposition is on the basis that such levies constitute indirect charges levied on airlines and collected by aviation fuel suppliers. These levies are imposed without any service return. In submissions to the ACCC prior to the removal of price controls, airport operators (including Brisbane and Perth Airports) sought to justify FTLs on the basis of the CPI-X price cap on aeronautical services and low returns on aeronautical assets.

Brisbane Airport Corporation Limited (BACL) argued that:

The need for such return is related more to the CPI-X obligation and additional costs associated with running a privatised airport rather than falling revenues associated with the 'Asian crisis'.¹⁰

And:

BACL's contractual entitlement to impose the levy is sufficient justification for imposing it if it has a need for revenue to generate a reasonable return on its investment.¹¹

BACL also sought to justify the FTL on the basis of the costs it would incur in upgrading Brisbane Airport. Perth Airport fully supported BACL's position.

BACL now charges a FTL of \$[CONFIDENTIAL] per litre on fuel supplied at Brisbane Airport. Due to Qantas' fuel consumption at Brisbane Airport, Qantas pays close to \$[CONFIDENTIAL] per year in fuel throughput levies. Because the original lease for the fuel facility is an old FAC lease, this amount is not recognised as 'aeronautical' or 'aeronautical related' revenue and is not subject to the ACCC prices monitoring regime.

WAC now charges a FTL of \$[CONFIDENTIAL] per litre on fuel supplied at Perth Airport. Due to Qantas' fuel consumption at Perth Airport, Qantas pays approximately \$[CONFIDENTIAL] per year in fuel throughput levies. Because the original lease for the fuel facility is an old FAC lease, this amount is not recognised as 'aeronautical' or 'aeronautical related' revenue and is not subject to the ACCC prices monitoring regime.

With the removal of direct price controls and the introduction of a dual till approach to prices, the economic reasons put forward by airport operators to justify maintaining FTLs are no longer valid. All costs associated with the provision of aeronautical services and facilities are recovered directly through aeronautical charges levied on the airlines.¹²

¹⁰ Brisbane Airport Corporation Limited (BACL), *Discussion Paper – Fuel Throughput Levies Submission to the ACCC by Brisbane Airport Corporation Limited*, 14 August 1998, p. 3.

¹¹ BACL 1998, p. 3.

¹² For further discussion see Board of Airline Representatives of Australia (BARA) Position Paper, 'Fuel Throughput Levies imposed by Brisbane Airport Corporation Limited and Westralia Airport Corporation', September 2003.

Further, airport operators sometimes 'create' new charges for services previously provided, which are then (sometimes arbitrarily) classified as non-aeronautical revenue. The narrow definition of 'aeronautical services' and the ability to distinguish between aeronautical, aeronautical-related and non-aeronautical for the purposes of prices monitoring allow airport operators to 'hide' aeronautical revenue by classifying new charges for access to aeronautical facilities as non-aeronautical or concessions revenue. Dual-till pricing can be monitored only if aeronautical, aeronautical-related and non-aeronautical facilities and services are appropriately defined and are rigorously audited to ensure correct allocation of costs and revenues between the tills.

Qantas has direct experience of airport operators 'hiding' charges from price monitoring. For example, SACL indicated to Qantas that it intended to impose new charges on ground handlers for access to airside facilities (airside aprons) and would classify these new charges as 'airport concessions' (non-aeronautical) revenue, rather than aeronautical revenue. Such a classification is clearly incorrect and is designed to avoid the prices monitoring regime applying to aeronautical infrastructure. It is also important to note that airlines already pay for access to the airside aprons as part of the passenger service charge they pay to the airport. This view is borne out by the analysis of the evidence (including SACL's evidence) by the Australian Competition Tribunal which concluded¹³:

We are satisfied that, without declaration, SACL will seek to increase its revenues by reference to charges imposed either directly or indirectly on airlines by creating specific new charges calculated to increase revenue in a manner which will not be the subject of supervision or control and will be implemented in a manner which would not otherwise occur in a competitive environment.

Case Study – SACL's New Charges

Even since the hearing by the Australian Competition Tribunal in late 2004, SACL has continued to find new ways to charge. For example:

- **Imposition of charges for essential aircraft movement information:** In April 2006 SACL introduced a charge of \$200 per month on inter-plane fuelling agents, such as the Airport Fuel Service, which operate the trucks used to fuel and defuel aircraft. This new charge is for SACL providing information on aircraft movements (which has always been provided through existing infrastructure to inter-plane agents). The information, indicating the time and location an aircraft will be parking whilst being 'turned around', is necessary for the provision of refuelling services.
- **Imposition of airside driving licence fee:** Airports around Australia have different licensing regimes for issuing airside drivers licences. In Sydney, Brisbane, Melbourne, Perth, and Hobart, Qantas has had an 'issuing authority' which allows it to train staff and issue its own licences for staff to drive airside. SACL has amended its operations manual so that, from 1 January 2005, only SACL can train drivers and issue airside driving licences. After candidates have completed a theoretical and practical examination, SACL will issue a two-year licence at a cost of \$70 per person. Qantas previously conducted the training and issued those licences at no cost.

These examples illustrate the ability of airport operators to create new charges for services that are already covered by existing charges and to 'hide' those charges from the monitoring regime.

The full range of new fees and charges airport operators could introduce over time is unknown. It is apparent, however, that the range could be extensive, affecting not only ground handling

¹³ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 366.

services, but other third parties such as caterers requiring access to aeronautical infrastructure which is already funded by the airlines and the flying public through landing and terminal charges.

Case Study – Miscellaneous Charge Increases

Some further examples are:

- imposition by Canberra Airport of a facility licence fee (equivalent to a fuel throughput fee) and fuel trucking fees;
- imposition by Alice Springs Airport of fuel throughput fees;
- Canberra Airport seeking to impose charges for being nominated as an alternate airport for emergency landings;
- increased charges for electricity network by SACL which operates the on-airport electrical network at Sydney Airport. This network is an 'exempt network' under the NSW electricity legislation. SACL charges its own on-airport network tariff, which provides for the recovery of costs to operate the on-airport electrical network plus upstream network charges imposed by Energy Australia. These tariffs have generally exceeded the equivalent off-airport distribution network tariffs by over 100%. SACL states that its network charges are higher on the airport compared to off-airport charges due to Energy Australia employing a cost reflective network pricing methodology and as the demand exceeds 10MW for the total site. However, Sydney Airport is not a single large load, but it is actually made up of many smaller loads.

3.3 Aeronautical Asset Valuation

The issue of asset valuation is analysed in detail in the NERA Report. For present purposes, airport operators are exploiting a lack of clarity in the current regulatory policy and revaluing their aeronautical assets without accounting for changes as income and not reflecting revaluation gains as part of the aeronautical returns to the shareholder when determining aeronautical prices. Such revaluation of assets allows airports to suppress measured rates of return on **actual** investments. This not only undermines the effectiveness of the price monitoring regime but is itself compelling evidence of the lack of constraint on airport operators.

The stated value of aeronautical assets is critical to the robustness of any prices monitoring regime. The Review Principles allow a return on 'appropriately defined and valued' assets (including land), but no guidance is given as to what is 'appropriate' in this respect.

Currently, the ability for the Government to scrutinise pricing behaviour is largely limited to the stated rate of return on aeronautical assets. Importantly, the values stated in the prices monitoring reports reflect the airport operators' interpretation of what constitutes appropriately defined and valued assets for pricing and price monitoring purposes.

As noted by the ACCC¹⁴:

this measure of profitability... has the disadvantage of being reliant on the airport operator's valuation of its assets. ... [A] number of airports have effected upward revaluations of their assets, which has the effect of lowering the return on assets. While such revaluations may be in accordance with relevant accounting standards,

¹⁴ ACCC, '2003-04 Prices Monitoring and Financial Reporting - Price-Monitored Airports', February 2005, p. 11.

... the approach taken by an individual airport operator may not reflect an economic approach to valuing assets.

The total level of additional aeronautical asset revaluations sought by Australian airports to date exceeds \$1 billion.

Since the removal of prices notification, price increases in Phase I and II Airports have ranged from 30% to 117%. The ACCC's 2003/04 Prices Monitoring Report, released in 2005, states Canberra, Perth and Brisbane airports have all undertaken significant aeronautical asset revaluations. Perth Airport increased the stated value of its aeronautical asset base by 105% in 2003-04 from \$86.7m to \$178m. Canberra International Airport (CIA) paid \$66.5m for the lease over all aeronautical and non-aeronautical assets at Canberra Airport. CIA has since revalued its aeronautical assets by some \$94m, far exceeding the total purchase price of the airport lease. Brisbane Airport has revalued by \$275m.

Case Study – [CONFIDENTIAL]

3.4 Non-price Access Issues

As monopoly service providers, airport operators have the ability to restrict or delay (and in some cases constructively refuse) access to airport services and facilities in a way that reduces the volume, quality and range of the services airlines and other airport users can provide to their customers. This is why, as part of its current policy, the Government indicated that during the probationary five-year period, airport operators' behaviour would be evaluated against the Review Principles.

The ACCC Airport prices monitoring reports are the primary source of information which the Government can use to evaluate the airports' conduct against the Review Principles. However, the reports focus almost exclusively on pricing conduct and no direct reference is made to the commercial behaviour of airports or non-price terms and conditions of access. As such, there is no information contained in the prices monitoring reports upon which the Government can form a view about whether an airport is acting in accordance with the Review Principles in relation to non-price issues.

The quality of service monitoring regime referred to in the Review Principles (which is conducted under Part 8 of the *Airports Act 1996*) is directed at general aspects of airport activities, and is inadequate to deal with problems involving the negotiation of commercial agreements (such as the long term pricing agreement currently under negotiation with SACL) and the kinds of detailed disputes airlines often have with airports. There are no explicit service quality standards with which airports must comply and no system of penalties for poor performance. Airports operators are under no obligation to retain an agreed quality service level.

It is not surprising, therefore, that the Review Principles have had little (if any) effect in constraining the conduct of airport operators. In Qantas' experience, access problems have frequently arisen at airports. These problems have usually taken one of two forms – either access is denied or frustrated, or access is provided on unreasonable commercial terms (both price and non-price).

Airport operators may threaten to deny or frustrate access in order to resolve a dispute with an airport user or to force an airport user to sign unreasonable terms and conditions of access.

Case Study – Making Life Difficult on the Launch of Jetstar

An example occurred in relation to the launch by Qantas of Jetstar.

In October 2003, Qantas announced the establishment of its own low cost carrier, Jetstar and in February 2004 Qantas announced that Jetstar would commence flying various routes on 25 May 2004. The launch by Qantas of routes serviced by Jetstar was and remains an important expression by Qantas of competitive conduct in the domestic air passenger market.

SACL was unwilling to negotiate with Jetstar in respect of the terms and conditions of access to the Airside Service at Sydney Airport and was willing to refuse access to Terminal 2 necessary for preparatory work prior to its launch.

Based on the evidence before it (including SACL's evidence), the Australian Competition Tribunal concluded¹⁵:

We take the view that the sequence of negotiations between SACL and the airlines over conditions of use demonstrates the intransigent attitude of a monopolist – SACL – exercising its monopoly power without the constraints of a competitive environment, which would otherwise have generated a more compromising negotiating position in order to keep the airlines' business and not lose it to a competitor.

These kinds of non-price access issues arise at almost all major Australian airports. Agreements with airport operators regularly include (almost as a matter of course) unreasonable, non-commercial terms – the kinds of terms which one would not expect to find in a contract with anyone other than a monopolist and which shift risk from airport operators to airport users (see, for example, ACT finding number 9 in Schedule 1).

For example, although some airport operators have entered into agreements with airport users, those agreements often contain terms which:

- (a) provide operators with the unilateral right to increase charges for services, including aeronautical services;
- (b) have minimal (if any) service levels (see the case study below);
- (c) even where some service levels are included, have no penalty for the airport operator if it fails to meet those service level obligations;
- (d) contain no binding dispute resolution procedures; and
- (e) exclude the airport operator from liability for loss suffered in connection with the use of the airport or as a result of closure of the airport, even if that loss or damage is the result of the airport operator's own negligence or recklessness.

Case Study – Lack of Service Levels

A specific example which is useful to illustrate the problem is again found in the Australian Competition Tribunal's consideration of evidence of Qantas' attempts over time to extract some commitment from SACL to minimum service standards. Qantas' attempts have continued for more than five years. The history can be summarised as follows:

- In April 1999, SACL provided Qantas with a draft of the Sydney Airport Conditions of

¹⁵ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 398

Use. The draft Conditions of Use contained a page headed 'A Message from the Chief Financial Officer'. The message recognised that the Conditions of Use were limited in scope and said that the 'next major step' was for SACL to develop with the airlines 'a Service Charter for inclusion in future versions of the Conditions of Use'. In the more than seven years that have elapsed since this statement was made, SACL has never done what it then said it would do.

- In September 2000, as part of its Revised Draft Aeronautical Pricing Proposal, which was submitted to the ACCC, SACL stated that the revised draft proposal would assist the development of service level agreements with the airlines and that it had initiated a discussion with airline customers on the issue of service level agreements. In the more than five years which have elapsed since this statement was made, SACL has not entered into a service level agreement with Qantas or any other airline.
- In October 2000, SACL confirmed that it had begun development work on service level agreements. In the more than five years which have elapsed since this statement was made, SACL has not entered into a service level agreement with Qantas.

To date, no service level commitment has been given by SACL. In fact, the very first occasion upon which SACL even proffered any arrangement concerning minimum service standards was two weeks prior to the commencement of the Tribunal's hearing of Virgin Blue's proceedings in 2004.

Based on the evidence before it, the Tribunal made the following comment about SACL's argument that quality of service monitoring was adequate to safeguard the interests of airport users notwithstanding SACL's failure to commercially agree any minimum service level commitment¹⁶:

SACL also submitted that the lack of a service level agreement of the kind described by Qantas should be considered in the light of SACL's quality of service reporting requirements to the ACCC pursuant to the ACCC Airports Reporting Guideline: Information Required under Part 7 of the Airports Act 1996 and section 95ZF of the Trade Practices Act 1974 (revised March 2004). This guideline indicates that the Commonwealth Government actively monitors SACL's aeronautical charges and quality of service. However, we note that this guideline tends to focus on financial, accounting and charging data. In any event, such a monitoring regime by a regulator is no substitute for an explicit statement of service levels in a commercially negotiated agreement between the parties.

The current prices and quality of service monitoring regime is unable to address these kinds of non-price access issues, and airport users have little or no recourse when negotiating with airport operators – other than capitulating. The consequences of these access problems can be significant from an efficiency and public interest perspective.

Case Study – A Faulty Baggage Belt

The baggage belt at the Sydney International terminal is continually breaking down, which causes extensive delays to aircraft and has resulted in thousands of bags failing to be loaded onto aircraft.

The cost to the airlines of the ongoing failures of the baggage handling system are substantial. For example, since 2004, the additional labour costs to Qantas alone have totalled \$[CONFIDENTIAL].

¹⁶ Virgin Blue Airlines Pty Limited [2005] ACompT 5 at para 441.

Airlines pay for the provision of this facility as part of the Passenger Facilitation Charge (PFC or “terminal” charge). However, SACL refuses to compensate airlines for the failure of this essential service and the cost such failures cause airlines. Qantas understands that the Board of Airline Representatives Australia (BARA) has repeatedly asked SACL to provide the airlines with performance data for the baggage belt (such as monthly reports on the percentage of time the system was not operational, the number of breakdowns, the reason behind each breakdown and the details of action plans to fix system breakdowns and failures). This data would give the airlines a better understanding of the problems with the baggage handling system and provide a basis for a cooperative approach to minimise (and hopefully eliminate) further failures.

SACL has refused to provide this information.

There is no readily available mechanism under the current regime which allows airport users to refer access disputes to a third party decision-maker. This leaves airport users exposed to situations where an airport operator can adopt a ‘take it or leave it approach’ rather than constructively engage with its customers. As it stands, unless or until a service is declared under Part IIIA of the Trade Practices Act, airport operators can and do exploit their monopoly position.

4. The Solution

Summary

- The approach of the CAA in the UK to foster "constructive engagement" between airports and airport users provides a valuable lesson for Australia.
- In Australia, as in the UK, positive action is required to foster constructive engagement. Airports and airport users will engage in commercial negotiation of terms of access to services in good faith if there is full and transparent information exchange and binding independent dispute resolution in the event that agreement cannot be reached. This is termed the 'Core Principle'.
- The prospect of binding dispute resolution is fundamental to inject an element of reasonableness into negotiations between airport operators and airport users so that resort to the dispute resolution process itself might never be necessary.
- There are at least three alternatives to implement the Core Principle on an industry-wide level:
 - Declaration under Division 2 of Part IIIA of the TPA.
 - Airports could be encouraged to lodge access undertakings incorporating the Core Principle by:
 - the promise of 'deemed' declaration of airport services for the purposes of Part IIIA in the event that an access undertaking incorporating the Core Principle is not accepted within a defined timeframe; or
 - immediate deeming of declaration of airport services for the purposes of Part IIIA with removal of that deeming effect in the event that an access undertaking incorporating the Core Principle is accepted.
 - An access code could be developed as envisaged by Part IIIA. The three steps are:
 - establish an Industry Body, including representatives of the airports, airlines and other airport users, and prescribe it for the purposes of Part IIIA;
 - the industry body formulates an access code containing Government mandated 'baseline' principles for access to airport services (including at least the Core Principle) for the ACCC to accept under s44ZZAA; and
 - each airport operator to lodge an access undertaking under s44ZZA which will be subject to streamlined acceptance by the ACCC to the extent it conforms to the access code.
- The necessity for price and quality of service monitoring of an airport would fall away if the Core Principle can be implemented by any of these alternatives.
- The PC should explore the attitude of airports to lodgement of access undertakings.

4.1 Constructive Engagement

Encouragement of 'constructive engagement' between airports and airport users has been a key strategy of the UK Civil Aviation Authority. Constructive engagement has been designed by the Civil Aviation Authority to assist it to compile a comprehensive and robust evidence base for its price control review; the CAA has looked to airports and airlines to provide inputs where they are best placed to do so and where constructive engagement offers the prospect of reaching agreement¹⁷:

In this way, the normal business of commercial airport / airline interaction should be reinforced by the regulatory process, rather than interrupted by it.

The CAA has left it largely to airports and airlines to determine how to carry out the requirements, but there are some mandatory matters 'enshrined' in the process of constructive engagement, including:

- establishment of working arrangements including senior level engagement and fora for negotiations; and
- airport / airline dialogue with information exchange.

In the UK the goal of encouraging constructive engagement has been to improve regulatory outcomes in a price control context. At the outset, the CAA noted that¹⁸:

the interplay between airports and airlines at a number of the designated airports is not without its issues or disagreements. Whilst this is not surprising, the nature and depth of the disagreements appeared to vary substantially between airports, and potentially calls into question whether an approach based on increased airport / airline discussion could produce meaningful agreement in all cases at each of the four designated airports. It would be irresponsible for the CAA to facilitate negotiations between a designated airport and its user airlines where there was no, or very limited, possibility of meaningful commercial discussion, let alone agreement, taking place.

For that reason, a review was undertaken and the CAA appears to be pleased with the progress of constructive engagement to date¹⁹. Indeed, the ramifications and possibilities of the policy beyond the immediate price control context have been broadly acknowledged. For example, the Managing Director of Heathrow Airport has commented that²⁰:

It also seems likely to result in improved relationships between [Heathrow Airport] and the airlines and so to lay foundations for the regulatory review and a better functioning of the industry in future.

There are valuable lessons for Australia in the approach taken by the CAA to fostering 'constructive engagement'. In particular:

¹⁷ See UK Civil Aviation Authority, *Airport Regulation: the process for constructive engagement* (May 2005), p6. Matters to be agreed as part of the process include identifying volume and capacity requirements, the nature and level of service outputs, opportunities for operating cost efficiencies, the nature and scale of investment programs, the revenues from non-regulated charges by the airport to airlines and financial incentives which should be attached to service quality.

¹⁸ UK Civil Aviation Authority, *Airport Regulation: The process for constructive engagement* (May 2005), para 1.10

¹⁹ See UK Civil Aviation Authority, *Airports Review – policy update* (15 May 2006), para 16 (Executive Summary).

²⁰ Letter from Mick Temple (MD, BAA Heathrow) to Harry Bush CB (Group Director, CAA) dated 2 November 2005 (<http://www.caa.co.uk/default.aspx?categoryid=5&pagetype=90&pageid=5734>)

- the CAA was not surprised that disagreements between airports and airport users existed and could overwhelm negotiations on price and service quality issues – that is consistent with Qantas' experience as outlined in section 3; and
- even in the relatively 'heavy handed' regulatory context of price control the CAA understood the need to require airports and airlines to engage constructively with each other and to set out a framework for that to occur.

These lessons reiterate a fundamental reality that has been borne out by Qantas' experience: without competitive constraint airports do not have economic incentives to engage constructively with airport users in negotiating the terms and conditions of supply. Positive action is required to achieve a degree of meaningful commercial engagement which would more closely mimic the commercial environment which could be expected to exist if airports faced workable competition.

4.2 The Core Principle

There is one baseline – or core – principle, which must be implemented to advance constructive engagement between airports and airport users in Australia.

Core Principle

Airports and airport users must engage in commercial negotiation of terms and conditions of access to services in good faith with full and transparent information exchange, supported by binding independent dispute resolution in the event that agreement cannot be reached.

Underpinning negotiation of access to services provided by infrastructure with the option of binding independent dispute resolution, is essential where there are limited or no alternate suppliers of the service. The Productivity Commission in reviewing light handed forms of regulation within the National Gas Access Regime found that (recommendation 8.3)²¹:

... the proposed monitoring regime should include at a minimum:

- *processes for negotiating access*
- *dispute resolution procedures (including provision for binding commercial arbitration)*

As has been noted by the Productivity Commission previously²² and by the Australian Competition Tribunal²³, the fact that negotiations for a service are underpinned by the possibility of binding independent resolution of disputes will inevitably condition those negotiations. That conditioning effect is achieved by all parties knowing that should negotiations break down the bargaining power is effectively transferred to an independent arbitrator. Hence, the possibility of arbitration and the unbiased nature of the arbitrator are likely to have an immediate positive effect on negotiations and change the parties' bargaining behaviour and the outcomes of negotiations even when arbitration does not actually occur.

²¹ Productivity Commission, Review of the Gas Access Regime, p355.

²² See for example Productivity Commission, *Enquiry into National Access Regime* (2002), p199

²³ The Tribunal noted in the context of Part IIIA that 'Increased access does not mean that an airline will inevitably be able to alter, vary or modify the terms upon which it is given access to the Airside Service. Rather, it means that the commercial environment will change and the airline will have the opportunity to seek to achieve such alteration, variation or modification by independent arbitrated determination in default of a negotiated solution' (para 582).

The prospect of binding dispute resolution would inject an element of reasonableness and commerciality into negotiations between airport operators and airport users so that resort to the process itself might never be necessary. Indeed, during the 3 - 4 year period for which Phase I and II airports (including Melbourne, Brisbane and Perth airports) were deemed declared under Part IIIA, no party sought arbitration of a dispute. The ability to appeal to a third party arbitrator (who would take the reasonableness of each party's conduct into account), was enough to encourage constructive engagement.

The airport services which must be covered by the Core Principle are those provided by means of facilities at an airport which users seek in order to provide services in connection with the carriage of passengers and/or goods by air. It is appropriate to move away from an approach which experience suggests will lead to lawyers over-analysing and disputing meanings of prescriptive definitions (for example, of 'aeronautical service', 'aeronautical-related service' and even the 'Airside Service' that has been declared at Sydney Airport²⁴) and inevitable dispute. Instead, the Core Principle should be viewed as one directed to the improvement of the relationship between airports and airport users generally insofar as those users wish to use the airport as an airport.

To summarise, introduction of the Core Principle is a fundamental prerequisite to successful encouragement of constructive engagement between airports and airport users. There are several regulatory alternatives to ensure that the Core Principle is binding on dealings between airports and airport users, including:

- declaration under Division 2 of Part IIIA of the TPA (considered in section 4.3).
- encouraging airports to lodge access undertakings under Part IIIA giving effect to the Core Principle, by deeming declaration under Part IIIA, which has the advantage of simplicity although some legislative change may be required (considered in section 4.4); or
- development of an access code as envisaged by Part IIIA which would provide a reference point for development of individual airport access undertakings incorporating the Core Principle and streamlined ACCC approval, minimising the up-front costs involved which is a little more complicated but has the advantage that no legislative change is required (considered in section 4.5).

The necessity for price and quality of service monitoring would fall away once the Core Principle applies in any of those scenarios.

4.3 Declaration under Div 2 of Part IIIA

Declaration under Part IIIA is, it must be remembered, not contrary to Government policy. In fact, in its media release in 2002, the Government expressly supported the continuing application of the generic provisions of Part IIIA to airports.

Declaration under Part IIIA is one way of applying the Core Principle. As the Australian Competition Tribunal has made clear²⁵:

Division 3 of Part IIIA of the TPA sets out the regime for arbitration of access disputes by the ACCC in relation to declared services. Arbitration is not an inevitable consequence of declaration of a service, but arbitration under Div 3 is only available upon the service being declared under Div 2. Declaration of a service opens it up to the possibility of regulation by arbitration. However, it does not follow inexorably that arbitration, and

²⁴ See section 3.2 above.

²⁵ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 69.

therefore regulation, will occur. The parties are still free to negotiate a commercial resolution of their outstanding access issues.

Constructive commercial engagement about terms and conditions for the provision of airport services is likely to be encouraged by the availability of the arbitration 'circuit-breaker' in Div 3 of Part IIIA.

Unfortunately, the Part IIIA regime fails to efficiently apply the Core Principle because the process of declaration to 'open the door' is inefficient, requiring excessive time and resources to be invested in a process with an uncertain outcome and which must be duplicated in respect of each airport and potentially each service at each airport. Evidence of this inefficiency and uncertainty is the application made by Virgin Blue Airlines Pty Limited in 2002 for the declaration of airside services at Sydney Airport. More than three and a half years have since passed and the parties are now awaiting judgment of the Full Federal Court on an application for judicial review of the Australian Competition Tribunal's decision to declare some services provided at Sydney Airport.

There are preferable options to implement the Core Principle than the costly, inefficient and time consuming option of private parties seeking declaration under Part IIIA of airport services provided by various airport operators in Australia.

4.4 Access Undertakings Backed by Deemed Declaration under Part IIIA

A simpler, although arguably heavier handed approach, would implement the Core Principle more efficiently than multiple individual declaration applications and thereby encourage a greater degree of constructive engagement between airports and airport users. Under this approach airports would be encouraged to lodge individual access undertakings under Part IIIA (incorporating the Core Principle) within a relatively short defined time frame.

That encouragement could occur either by:

- the promise by the Government of 'deemed' declaration of airport services for the purposes of Part IIIA in the event that an access undertaking incorporating the Core Principle is not accepted within a particular defined timeframe; or
- immediate deeming of declaration of airport services for the purposes of Part IIIA with removal of that deeming effect in the event that an access undertaking incorporating the Core Principle is accepted²⁶.

That approach has the advantage of simplicity although some legislative change would be required if there is to be an actual deeming of declaration, along the lines of old s192 of the *Airports Act 1996*.

The necessity for price and quality of service monitoring would fall away once the Core Principle applies as between an airport and airport users by virtue of a binding access undertaking.

Deeming that Part IIIA applies to airport services at major Australian airports avoids the slow, complex and very expensive process of having airport services declared via the National Competition Council, the responsible Minister and the Australian Competition Tribunal with review by the Federal Court. Any delay is clearly to the advantage of the monopoly service provider, who can continue to frustrate constructive engagement, exploit monopoly power and potentially earn monopoly rents for the three-four year period until the service is declared.

Airport operators often contend that declaration will significantly increase regulatory costs, as airport users will refer all disputes to arbitration rather than attempting to first reach a

²⁶ This proposal is very similar to that put in the SACL 2001 Submission referred to in section 4.5.

commercial outcome. However, during the period that major Australian airports were deemed declared under Part IIIA, no disputes were referred to arbitration. Further, following the declaration of ramp handling services at Sydney Airport there was no resort to arbitration under Part IIIA²⁷.

The mere declaration encourages 'normal' commercial negotiation.

While this alternative is in some respects more heavy handed than the first option, it is not inconsistent with the Government's approach to airport regulation. The Government intended that airport operators and airport users would negotiate commercially under the price and quality of service monitoring provisions. This was the rationale for the removal of deemed declaration of 'airport services' at Phase I and Phase II airports under section 192. On that basis, it would not be inconsistent with Government policy to reintroduce deemed declaration because history shows the Government's desired outcomes for commercial negotiations have not been achieved under the current regime.

4.5 An Airport Services Access Code

An effective and efficient way to encourage constructive engagement between airports and airport users is through the development of an access code as envisaged by Part IIIA. The access code would, in turn, provide a reference point for development of individual airport access undertakings and streamlined approval, minimising the up-front costs involved. This approach would require no legislative change.

The three key steps would be:

- establish an industry body including representatives of the airports, airlines and other airport users, and prescribe it for the purposes of Part IIIA;
- the industry body would formulate an industry-wide access code containing Government mandated 'baseline' principles for access to airport services (including at least the Core Principle) which the ACCC will accept under s44ZZAA if it meets the statutory criteria; and
- each airport operator to choose whether to lodge an individual access undertaking under s44ZZA which will be subject to streamlined acceptance by the ACCC if it conforms to the accepted access code.

Where an access undertaking is accepted then declaration under Part IIIA will no longer be possible (by virtue of s44G(1) and s44H(3) as Part IIIA currently stands²⁸) and the Government should remove price and quality of service monitoring in respect of those services.

The Explanatory Memorandum for the *Trade Practices Amendment (Industry Access Codes) Bill Act 1997* which introduced the mechanism for access codes into Part IIIA noted various shortcomings with the original form of Part IIIA and stated that²⁹:

The Bill will address these shortcomings by setting out a process whereby the Commission can accept industry access codes, following public consultation. Each access code would set out rules about access for the industry. Once the Commission has accepted an access code, the Commission can accept access

²⁷ See acceptance of this analysis by the Australian Competition Tribunal in *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 592.

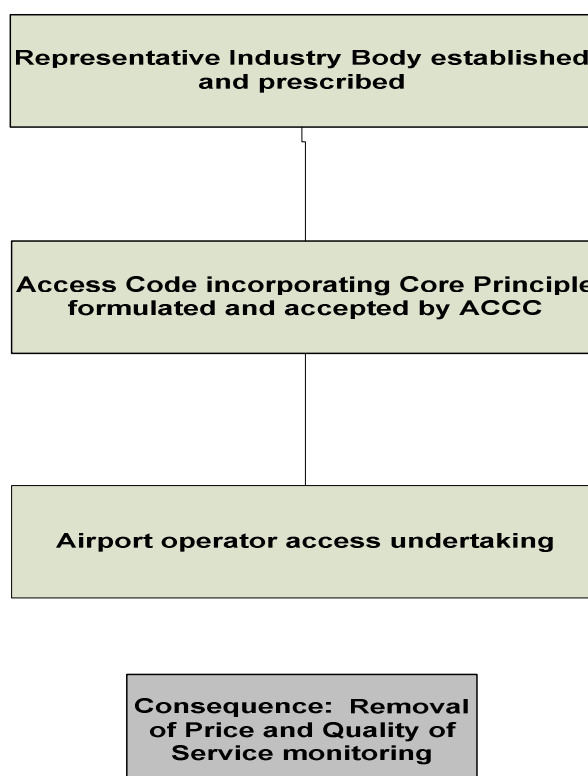
²⁸ See also proposed new Division 6 of Part IIIA to be inserted by the *Trade Practices Amendment (National Access Regime) Bill 2006*, item 91.

²⁹ Explanatory Memorandum to the *Trade Practices Amendment (Industry Access Codes) Bill 1997* (Cth) (taking account of amendments made by the Senate to the Bill as introduced), pp1-2.

undertakings in accordance with the code without the need for further public consultation. This process allows for the development of coherent access arrangements through a single consultation process.

Government facilitation of the development by the industry of an airport services access code under Part IIIA offers an efficient and appropriately light handed way of encouraging constructive engagement between airports and airlines and offers the prospect that price and quality of service monitoring may ultimately be removed without endangering markets which depend upon airport services. Efficiency is achieved through streamlined acceptance by the ACCC of access undertakings which accord with the access code.

Three Key Steps for Development of an Access Code Solution



Step 1

The design of an industry body appropriate to facilitate development of an access code is a matter of obvious importance. Consistent with the lack of constructive engagement between airports and airport users to date, there is no current industry body which fits the bill. An industry body should be established and prescribed for the purposes of developing an access code in accordance with section 44ZZAA.

There is little doubt given the difficult history of relationships between some necessary participants that there will be challenges to the smooth development of an access code. For several reasons, however, these difficulties are surmountable:

- First, at least some participants are likely to have experienced the fruits of constructive engagement on a bilateral basis to achieve reasonable commercial outcomes and that experience will encourage a similar multilateral approach.

- Second, ACCC and DOTARS participation and periodic reporting as well as the involvement of a respected independent chair will have a 'chilling effect' on unreasonable approaches.
- Third, Government guidance as to 'baseline' principles for an access code will limit the scope of potential differences.
- Fourth, the scope of an access code need not 'cover the field' of all access terms and conditions but may instead simply cover baseline principles (including most importantly the Core Principle) and establish processes to provide a better basis for bilateral negotiation.

Step 2

The TPA allows the Government, quite properly, to specify principles for an access code in a particular industry, by allowing for specific regulations to be made under section 44ZZAA(3)(e). It is under this provision that the Core Principle (and any other key principles) should be articulated, requiring the ACCC to have regard to them when deciding whether to accept an access code. This could be achieved in the same regulatory instrument as the prescription of an 'industry body'³⁰.

Guidance on the 'baseline' will inevitably condition the approach of airports and airport users and encourage participants in the industry body to reach consensus by reducing the ambit of potentially contentious issues. Elaboration of the Core Principle into a negotiation framework and dispute resolution protocol is a task for which the proposed industry body is well suited. Qantas envisages that the industry body will be able to nut out an industry specific negotiation framework and dispute resolution protocol which balances the interests of airports and airport users and encourages constructive engagement. Such a protocol could then form the basis of individual access undertakings by airport operators.

Qantas suggests the industry developed negotiation framework and dispute resolution protocol would include:

- a framework for commercial negotiations giving content to 'good faith' and providing two-sided information disclosure;
- a dispute resolution body other than the ACCC;
- powers for the dispute resolution body equivalent to s44V of the TPA;
- a flexible dispute resolution process depending on the nature of dispute;
- criteria for the resolution of disputes at least equivalent to s44X (together with the generic pricing principles to be included in new section 44ZZCA) and specification of the principles for asset valuation; and
- determinations to be made public to avoid multiplication of disputes.

It is interesting to note in this context that the ACCC did not fault the dispute resolution process which Melbourne Airport offered in its Part IIIA access undertaking in 1998, although the access undertaking as a whole was ultimately rejected³¹.

³⁰ See definition of 'industry body' in section 44ZZAA(8).

³¹ ACCC *Access Undertaking – Melbourne Airport, Draft Determination* (May, 1998), pp28-30. The main aspects of the Melbourne Airport proposed dispute resolution mechanism were: (i) a method for the initiation of the dispute resolution process, (ii) the constitution of the dispute resolution body, including

Step 3

Where an access code is successfully developed elaborating on the Core Principle, it will be open to, but not of course compulsory for, an airport operator to lodge an access undertaking under section 44ZZA.

In a statutory sense, the key effect of acceptance of an access undertaking as provided for by Part IIIA is to render services covered immune from declaration³². That would be a considerable incentive for airport operators. In addition, if an access undertaking is given by an airport that implements the Core Principle so that it is accepted by the ACCC, then it would be appropriate to remove price and quality of service monitoring obligations from that airport (in respect at least of services covered by the undertaking). Obviously the cost and time savings of that removal would be an additional incentive for airports to lodge access undertakings in accordance with the access code.

The likely approach and attitude of airports to lodgement of access undertakings is something that Qantas strongly encourages the PC to explore in the current enquiry.

Some insight into that likely attitude may be gleaned from the past. For example, both Melbourne and Perth airports were willing in early stages of privatisation to formulate access undertakings under Part IIIA, although these were not ultimately accepted³³. Those undertakings were offered in the context of s192 of the *Airports Act* which at that time effectively 'deemed' declaration of certain airport services for the purposes of Part IIIA.

One potential drawback of the 'undertaking' approach is the magnitude of up-front costs associated with developing an undertaking and gaining its regulatory approval. The proposed access code approach would to a large extent avoid those drawbacks. The access code would provide a reference point for development of undertakings and their approval. There is a high degree of flexibility in the scope of an access undertaking under s44ZZA. Provided an access undertaking is in accordance with the industry access code, streamlined acceptance by the ACCC will be appropriate, avoiding multiple public consultations³⁴. As the ACCC states in its Guide to Access Undertakings³⁵:

Under s44ZZAA, industry bodies may prepare and lodge an access code with the Commission on behalf of their constituents. This allows acceptance of an industry-wide access code with a single public consultation process. This legislative change reflects the fact that in some cases industry codes are more appropriate than individual undertakings. The functions of a code are to streamline the approval process for undertakings where it is advantageous for a number of access providers to provide access in a substantially similar way.

Finally, it is interesting to note that SACL suggested to the Productivity Commission in 2001 that undertakings be considered as part of potential 'light handed' airport regulation (if SACL's primary submissions were not accepted). The suggested approach was to amend s192 of the *Airports Act* so that deemed declaration under that section would not apply if a so-called 'Prices and Quality Undertaking' was approved. In that context, the SACL 2001 Submission stated:

nomination of members, (iii) the scope of disputes for determination, namely, any dispute regarding access issues covered by the access undertaking and (iv) the requirement that the dispute resolution body give effect to the access undertaking.

³² Section 44H(3).

³³ See APAC, *A Submission to the review of the National Access Regime* (December 2000) at p4 for a description of Melbourne Airport's experience.

³⁴ Section 44ZZA(4A). See also the Explanatory Memorandum to the *Trade Practices Amendment (Industry Access Codes) Bill 1997* (Cth).

³⁵ ACCC, *Access Undertakings – A guide to Part IIIA of the Trade Practices Act* (1999), p17.

As the application of Part IIIA is considered regulatory 'overkill' for airports, it is envisaged that most major airports would choose to have a Prices and Access Undertaking approved.

While Qantas would understandably depart from the proposition that the application of Part IIIA to an airport is 'overkill', the substance the SACL proposal for a 'Prices and Quality Undertaking' is similar to what is suggested in this submission.

5. Asset Revaluation

Summary

- The Government Review Principles provide no guidance as to what is 'appropriate' for valuation of aeronautical assets.
- There is apparently intractable disagreement between airports and airport users about asset revaluation which, unless resolved, may overwhelm efforts to encourage constructive engagement.
- The Government should provide guidance in relation to asset valuation by specifying:
 - starting aeronautical asset bases (SAABs) for Sydney Airport, Phase I and II Airports as at the date of sale;
 - that SAABs should be 'rolled forward' based on depreciation, actual necessary new investment and disposal of assets; and
 - any revaluations of existing aeronautical assets should be treated as income (or negative depreciation) for the purposes of calculating revenue required from aeronautical charges.
- The appropriate basis for determining SAAB:
 - at Sydney Airport uses the ACCC-approved starting asset value for the aeronautical assets and aeronautical land at the time of sale, as per the May 2001 pricing decision; and
 - at Phase I and II Airports uses the depreciated historic cost of the aeronautical assets contained in the first set of Financial Reports lodged with the ACCC in relation to each airport.

5.1 Introduction

As set out in section 3.3 and the NERA Report³⁶, there has been significant disagreement between airport users and airports over the valuation of aeronautical assets at many airports, with some airport operators apparently considering that they are entitled to increase aeronautical charges based on periodic asset revaluations (without accounting for those revaluations as income).

The Review Principles allow a return on '*appropriately defined and valued*' assets (including land), but no guidance is given as to what is '*appropriate*' in these respects.

Airport operators are exploiting a lack of clarity in the current regulatory policy and revaluing their aeronautical assets so as to suppress measured rates of return on actual investments. As noted by the ACCC:

'However, notwithstanding the advantages in this measure of profitability, it has the disadvantage of being reliant on the airport operator's valuation of its assets. As detailed in sections 2 and 3 of the report, a number of airports have effected upward

³⁶ See p 14-17 of the NERA Report.

revaluations of their assets, which has the effect of lowering the return on assets. While such revaluations may be in accordance with relevant accounting standards, such standards allow a variety of accounting treatments and the approach taken by an individual airport operator may not reflect an economic approach to valuing assets.³⁷

Currently the total level of upward aeronautical asset revaluations by Australian airports exceeds \$1 billion.

Constructive engagement will not be able to flourish unless there is guidance as to what is 'appropriate' in terms of the proper principles of valuation of aeronautical assets. In particular, there are two issues to address in considering the issue of aeronautical asset valuation:

- (a) the starting aeronautical asset base (SAAB), or 'sale value' of the aeronautical assets under the airport leases; and
- (b) the ability to revalue the SAAB over time.

5.2 Starting Aeronautical Asset Base of Phase I and II Airports

One of the largest determinants of aeronautical prices is the SAAB. Planned capital expenditure is added to the SAAB to calculate aggregate depreciation (return of capital) and return on capital.

The proposed revaluations referred to in section 3.3 and the NERA Report are primarily due to the inappropriate use of new entrant or replacement cost-based valuations. For example, some airport operators have applied the 'opportunity cost' principle as if they are in a position to dispose of any surplus land or to redeploy aeronautical land for other purposes and so revalued aeronautical land for pricing purposes. That is incorrect because the terms of the leases of Phase I and II airports and Sydney Airport require the operator to continue to provide aeronautical services and do not allow the divestment of land for alternative uses. The airports' approach has usually involved estimating either:

- the 'next best alternative use' of the existing aeronautical land minus 'make good' costs ('exit cost' approach); or
- the cost of purchasing a similar parcel of land in the general proximity of the existing airport plus the cost of any aeronautical improvements to the existing airport land ('entry cost' approach).

Airport operators have argued that such approaches to valuing aeronautical land are both consistent with the principles advocated by the PC and endorsed by the Government as part of the removal of direct price controls.

Unless these revaluations are treated as a form of income (or negative depreciation) and so netted off the required revenue to be derived from aeronautical services,³⁸ this causes significant problems for airport users (including the airline industry and passengers); namely that:

- At ACCC determined rates of return and average depreciation levels, these revaluations create a windfall gain to the airport operator and a potential cost impact to Qantas and passengers of approximately \$[CONFIDENTIAL] per year in additional aeronautical charges.

³⁷ ACCC, '2003-04 Prices Monitoring and Financial Reporting - Price-Monitored Airports', February 2005, p. 11.

³⁸ No airport operator has proposed to adopt this approach in its discussions with Qantas over aeronautical charges.

- The \$[CONFIDENTIAL] will increase even further with the continued periodic revaluation of aeronautical assets and adjusted charges. In undertaking the revaluations, airport operators appear to have an expectation of earning their cost of capital (some on a nominal as opposed to real basis meaning that inflation is effectively included twice) on the revalued assets over the medium to longer term without any recognition that the revaluations bear no resemblance to actual historic cost and are, themselves, a form of income. This means that the airport operators will be likely ultimately to seek to base aeronautical prices on the revalued assets, as is already occurring in the case of Perth Airport.
- The effectiveness of the prices monitoring regime is undermined, as the ACCC is unable to effectively perform its monitoring function by being unable to adequately conclude whether airport operators' returns are justified.
- It creates inconsistency in how aeronautical charges are calculated. Currently when prices and returns for services generate excessive returns (for example, FTLs and check-in counter licences), airport operators are quick to claim that these are assumed 'rights' based on forecast revenue streams as part of the sale process. Yet they reverse tack for aeronautical infrastructure (asset values based on forecast cost and revenue streams), whereby they state that assumptions made as part of the privatisation process are 'no longer relevant' and 'almost 10 years old'. Therefore they conclude that they need to set an 'efficient' price based on revalued assets to ensure 'optimal resource allocation'.

Dispute over starting asset bases is not unique to airports and has been fiercely debated in regulated industries including electricity, gas and telecommunications. The choice of an appropriate asset valuation methodology requires a degree of judgement and, in the case of Australian airports, should be consistent with the Government's stated policy objectives and the privatisation process.

Qantas proposes that:

- for Sydney Airport, the SAAB be calculated using the ACCC-approved starting asset value for the aeronautical assets and aeronautical land at the time of sale, as per the May 2001 pricing decision. These could then be 'rolled forward' for actual necessary new investment, disposal of assets and depreciation. Any proposed revaluations, which are not necessary, should be treated as income for the purpose of determining aeronautical charges; and
- for Phase I and Phase II airports, the SAAB be calculated using the depreciated historic cost of the aeronautical assets contained in the first set of Financial Reports lodged with the ACCC. These could then be 'rolled forward' for actual necessary new investment, disposal of assets and depreciation (1997-98 for Phase I airports and 1998-99 for Phase II airports), again with any revaluations to be treated as income.

5.3 Sydney Airport

Sydney Airport is different to the Phase I and II airports as, prior to sale, the ACCC established valuations for both fixed assets and aeronautical land and the Government implemented a '*dual till*' pricing regime.

As such, the ACCC-approved starting value provides a fair return on assets and is the most reasonable method for Sydney Airport as the ACCC approved starting value was set out in the May 2001 pricing decision and clearly understood by the bidders for Sydney Airport. The ACCC has therefore accepted these starting values and the values can be verified. These values could then be 'rolled forward' for actual necessary new investment, disposals of assets and depreciation. Any revaluation of existing assets should be treated as income (or negative depreciation) for the purpose of determining aeronautical charges.

This method has been accepted by the operators of Sydney Airport in their representations to various stakeholders. For example:

- in a presentation to the Annual General Meeting of BARA in August 2002, the new owner of Sydney Airport emphasised that traffic growth would be the engine for profit growth, not increases in aeronautical prices specifically stating:
 - Sydney Airport was already very profitable;
 - profit growth would be underpinned by traffic growth through:
 - + attracting new business;
 - + building relationships with existing customers; and
 - + retail and property initiatives.
 - priorities for SACL were agreed capital works recovery and Government-mandated security and insurance costs.
- in 'Sydney Airport Acquisition Assumptions' (July 2002), Macquarie Airports described how it valued the aeronautical side of the business, namely:
 - 'Valuation assumptions [are] consistent with previous regulatory framework (ACCC May 2001 decision); and
 - Increases in charges are approved to reflect the cost of Necessary New Investment and increased security and insurance charges.'
- the independent review of the financial forecasts³⁹ in Macquarie Airports' *Prospectus*, which stated that:
 - '... Southern Cross Holding has proposed a policy of "shadow regulation" and consultation with its airline partners. That is, forecast aeronautical charges have been estimated as if Sydney Airport was still being regulated.'
- when Virgin Blue sought to have certain services provided by SACL at Sydney Airport declared under Part IIIA of the *Trade Practices Act 1974* in 2002, SACL was quick to point out that declaration was not warranted because SACL had accepted the ACCC's May 2001 pricing decision:

*'Although having a difference of opinion on a number of aspects of the ACCC pricing decision, SACL accept[s] the judgement of the ACCC, even though this delivered charges lower than had been proposed. Evidence of this is SACL's pricing behaviour since deregulation on 1 July 2002, with SACL not having made any substantive increases in charges. Price adjustments, of several cents, since that date have reflected the outcome of a process for financing new capital works, endorsed by airline users in a consultative committee that includes Virgin Blue.'*⁴⁰

³⁹ Deloitte Touche Tohmatsu, 15 July 2002, Independent Review of Financial Forecasts, p. 114, in Macquarie Airports Prospectus, 18 July 2002.

⁴⁰ SACL submission to NCC, 28 February 2003, p. 5.

5.4 Phase I and Phase II Airports

The Phase I and Phase II airports are different to Sydney because:

- there was no ACCC valuation prior to sale; and
- the Government specified a CPI-X price path for the first five years, thereby foregoing the opportunity to put in place a replacement cost-based valuation for airport assets and to revise prices accordingly. Instead it transferred the benefits of the arrangements at the time to the airport operators via a lower purchase price and to the airport users and passengers via lower aeronautical charges over the initial 5 year period.

Therefore the potential options available to value existing aeronautical assets in all Phase I and Phase II airports are:

- Cost-based valuation, including:
 - depreciated historic cost; and
 - depreciated optimised replacement cost (DORC).
- Revenue-based valuation, including:
 - net present value of anticipated revenues and costs; and
 - ‘fair value’⁴¹.
- Valuation on a case-by-case basis.

Qantas considers each of those options below.

Depreciated Historic Cost

In view of the difficulties associated with revenue-based approaches for industries such as gas and electricity, regulators in Australia and overseas have usually applied some form of cost-based approach to asset valuation. For Phase I and II airports, the values contained in the first set of Financial Reports lodged with the ACCC represent a reasonable allocation of the purchase price of the lease between aeronautical, non-aeronautical and the lease premium.

These were subject to a CPI-X price cap based on single till prices. Consistent with single till pricing outcomes, these prices do not recover the full cost (including a reasonable rate of return) of providing aeronautical infrastructure on a stand-alone basis.⁴² As such, when valued on a stand-alone or dual till basis, one would not expect these aeronautical asset values to be as high as the historic cost. This is because the value of aeronautical assets must fall to a point where the discounted value of the expected costs and revenues equals the airport operator’s cost of capital. The use of the historic values actually exceeds the implicit ‘sale price’ of the aeronautical assets and that there is in fact a benefit of a rent transfer to the airport operator in basing aeronautical prices on such values.

Although these represent a significant benefit transfer from Qantas to the airport operators, in the interests of reaching agreement with airport operators, Qantas has not objected to the use of the aeronautical asset value contained in the first set of Financial Reports lodged with the ACCC. These could then be ‘rolled forward’ for actual necessary new investment and depreciation (1997-98 for Phase I airports and 1998-99 for Phase II airports), with any

⁴¹ Fair value is the amount for which an asset could be or has been exchanged between knowledgeable, willing parties in an arms-length transaction.

⁴² The CPI-X cap also intended to encourage reduction in costs and improve efficiency in order for airports to improve returns.

subsequent revaluations treated as income for the purpose of determining aeronautical charges.

Depreciated Optimised Replacement Cost (DORC).

A DORC valuation is based on the minimum replacement cost of the asset if a competitor were to provide an equivalent service.

The key reasons generally put forward in support of the use of DORC are:

- inconsistency of past accounting practices;
- structural change in the industry;
- similar assets in different networks having different historic values due to different purchasing practices; and
- attempts to inflate historic costs to current costs being fraught with difficulties and frequently resulting in much higher values than a DORC valuation based on modern equipment of equivalent capacity.⁴³

In the early 1990s, economic regulators (both the ACCC and State-based bodies) were seeking a valuation technique for a number of government-owned infrastructure assets, which had not been traded in the market (for example, through privatisation, long-term leases or franchises). As a consequence, there was a recognised need to adopt a consistent cost-based asset valuation technique across all such assets for the purpose of price setting and performance monitoring. As argued by the Steering Committee on National Performance Monitoring of Government Trading Enterprises (GTEs):

‘One means of improving the efficiency of GTEs is to subject them to a regime of on-going performance monitoring. The proper determination of certain of the financial indicators adopted by the Steering Committee (e.g. return on assets, return on equity etc) calls for the urgent resolution of a number of issues associated with asset valuation, depreciation and maintenance.’⁴⁴

DORC was considered appropriate for Government-owned assets for both consistency reasons and to address concerns over redundant assets, which could be removed from the asset base for pricing purposes through the ‘optimisation’ process.

While the ACCC may have considered the application of DORC appropriate for certain infrastructure utilities (within government ownership), going forward DORC cannot be recommended to determine asset valuation for aeronautical infrastructure as:

- the airports have been sold through the privatisation process, therefore an arm’s length valuation has already been established;
- DORC is inconsistent with the key elements of the Government’s policy objectives and the objectives of the privatisation process:
 - it was the Government’s stated objective that airlines and passengers would enjoy part of the benefits of privatisation.⁴⁵ This was achieved through the imposition of the CPI-X price cap on starting point prices in Phase I and II airports;

⁴³ ACCC, May 1999, pp.41-42.

⁴⁴ Steering Committee on National Performance Monitoring of GTE, October 1994, “Guidelines on Accounting Policy for Current Valuation of Assets”, p. 16.

⁴⁵ DOTARS’ Pricing Policy Paper noted that Pricing oversight arrangements at airports post-leasing have been designed to achieve an appropriate balance between public interest and private commercial objectives.

- as discussed earlier, the CPI-X price cap on starting point prices suppressed the sale value of the airport leases. By applying a DORC valuation subsequent to the sale process, and not treating this gain as a form of income, the airport operator effectively achieves a windfall gain equivalent to the difference between the amount the Government obtained for the lease over the aeronautical assets and the cost that would be incurred by a new efficient entrant providing a parallel service;
- the setting of a SAAB through the DORC methodology simply unwinds and transfers rents from the airport users and passengers to the airport operators. If the Government had intended that aeronautical charges by Phase I and II airports should be based on a DORC valuation, then such a valuation would have occurred prior to sale. This value could then have been incorporated into the purchase prices paid to the Government by the airport operator.
- the ACCC appears not to endorse revaluation. For example, in its statements regarding pricing by Phase I and II airports post July 2002, it said:
 - ‘...the Commission does not consider that existing aeronautical prices at privatised airports should be revisited using a cost-based methodology (as adopted by Sydney Airport).’

And:

 - ‘...there is nothing to suggest that any commitments were made to airport bidders during the sales process to reset price’.⁴⁶
- revaluation of aeronautical land must be considered unacceptable because:
 - while each airport operator has the rights to access the aeronautical land, this does not extend to ownership. Therefore the Government is the recipient of any gains or losses in land value at the end of lease and not the airport operator. As such, the airport operators are not entitled to any benefit (detriment) associated with increases (decreases) in aeronautical land values; and
 - as stated in the *Airports Act 1996*, the land must be used for the purposes of an airport. Therefore the ‘next best alternative use’ approach is not valid.
- the Financial Reports lodged with the ACCC must conform to Australian accounting standards. Australian accounting standards, in broad summary, permit revaluation of assets to ‘fair value’. Fair value can be estimated using future income or depreciated replacement cost. However in the case of aeronautical land, the accounting standards suggest that leasehold land should not be classified as a fixed asset and should instead be defined as an operating lease as:
 - payment (cost) represents the prepaid lease payments;
 - title is not expected to pass to the lessee by the end of the lease term.
- airport operators’ arguments that they need to use DORC to prevent aeronautical prices being so low that they stifle any incentive a third party may have to build a second airport are invalid. An airport operators’ revaluation or non-revaluation of aeronautical assets will have little or no effect on a third party’s decision to develop another airport. Namely because there is little practical ability for an independent third party to establish a major new airport in the catchment areas of Australia’s capital cities. There are significant barriers to entry in establishing a second airport, including:
 - basic airport infrastructure, such as runways and taxiways, must be used as a package and thus requires a single provider;

⁴⁶ ACCC, May 2001, Submission to the Productivity Commission’s Inquiry into Price Regulation of Airport Services, P69 and p109.

- there is evidence of economies of scale in the provision of airfield services;
 - most major aeronautical assets typically cannot be used for other purposes and these ‘sunk’ costs may deter new entrants by raising the cost of failure;
 - airports require very large land allocations and buffer zones for environmental and safety reasons and this may make duplication prohibitively costly in convenient locations;
 - there are substantial regulatory approvals required to construct and operate an airport, which effectively prevent the construction of an airport by private interests without full government endorsement and backing;
 - network connectivity is critical for connecting flights and airlines such as Qantas invest in building up networks which rely on connectivity of flights at particular points. That limits an airline's ability to transfer some of its operations to a second airport; and
 - in the case of Sydney Airport, under the sale arrangements Southern Cross Consortium has the right of first refusal to build and operate any second major airport within 100 km of Sydney's central business district. Therefore there will be no effective competition in the provision of airport services for the Sydney market.
- similarly, airport operators' arguments that they need to use DORC to prevent aeronautical prices being so low that there will be excessive use of the airport by general aviation can be addressed by setting minimum charges per aircraft landing, a practice already adopted by some airport operators. Arguably, the Government Review Principles would encourage this kind of price discrimination in order to promote efficient use of airport facilities.

Revenue-Based Valuation

Due to the issue of ‘circularity’,⁴⁷ most regulators have rejected the use of revenue-based approaches for monopoly infrastructure especially in the case of ‘fair value’. The ACCC has noted that ‘the practical difficulty in making this assessment for regulated monopoly businesses is that the future revenue derived from the assets is itself determined by the regulator’.⁴⁸

However, as part of the privatisation process it appears that the Government specified the key variables necessary to determine the implied or ‘sale value’ of the aeronautical assets. Such variables include the price path (CPI-X price cap) and capital commitments. As such, one could apply a revenue-based approach to determine the implicit value of the aeronautical assets at the point of sale. The ACCC could then ‘roll forward’ these amounts based on actual levels of investment in aeronautical infrastructure as submitted by airport operators as part of the prices monitoring process. This would likely produce the most robust value as it would produce an asset valuation most consistent with the price paid by the airport operators.

That being said, a revenue-based approach is not suggested as the relevant information to undertake a revenue-based approach to asset valuation may not be available⁴⁹ or able to be disclosed.

⁴⁷ Circularity is the practical difficulty in making an assessment of the net present value of expected future cash flows generated from a regulated monopoly's assets, when such revenues are determined by a regulator.

⁴⁸ ACCC May 1999, Draft statement of Principles for the Regulation of Transmission Revenues, p.39

⁴⁹ Qantas was not privy to the information shared between the Government and prospective buyers during the privatisation process

Valuation on a Case-by-Case Basis

If a consistent method is not possible for all Phase I and Phase II airports, then it will be necessary for the Government to adopt a case-by-case approach to assessing SAABs by airport operators. However, as an overarching principle, the burden of proof should be on the airport operator to justify why an increase in the SAAB does not generate monopoly rent transfers (compared to the implicit sale value of the assets at the time of sale) and the airlines should have full transparency throughout. Some issues for consideration include:

- were any of the assets effectively 'gifted'? CIA's extraordinary increase in value may be explained in part by the transfer of former Royal Australian Air Force assets, which may not have been reflected in the sale price. However, there is clear regulatory precedent that precludes the inclusion of gifted assets for pricing purposes;
- does the increase in asset values reflect increases in construction costs through time? The use of DORC is likely to generate continual increases in aeronautical asset values simply because average construction costs rise over time. If construction costs have risen at the same rate as CPI, this effectively results in applying a nominal rate of return to an indexed asset base – not an approach endorsed by economic regulators;
- were there material errors in the values contained in the first set of Financial Accounts lodged with the ACCC? Perth Airport claims to have 'found' assets some three or four years after obtaining the lease over the airport. Why is it appropriate to include such assets for pricing purposes if knowledge of the assets was not known at the time of sale?
- why do current prices charged not generate sufficient returns? Airport operators were free to set prices after the removal of direct price controls. Does the current gap between stated returns and ACCC-determined rates of return (assuming these represent a 'fair' return on assets) for some airport operators represent price increases beyond that rationally contemplated? If so, the current aeronautical asset value should be written down so that stated returns on the revised value reflect the airport operator's cost of capital; and
- will a case by case basis cause inconsistency between airports and create problems for the ACCC to effectively monitor and draw conclusions on different airport operators' profitability?

5.5 Further Revaluations

After the SAAB has been determined, an issue then arises in terms of further revaluations in the future.

As a matter of mechanics, there are regulatory precedents for both 'locking-in' asset values at a particular point in time for pricing purposes, and for updating asset values for movements in consumer price inflation or replacement values. Qantas' preference is that, once established, asset values are 'locked-in', since this has the benefit of simplifying the range of issues that need to be addressed in negotiations over aeronautical charges. It is also consistent with the financial investment nature of the leases that govern the management and ownership of airports.

Such an approach was endorsed by the ACCC in respect of Airservices Australia:

'The ACCC notes Airservices' agreement to the approach suggested by participants in the ISC [Industry Steering Committee] that no further asset valuations will be undertaken that would adjust prices within the pricing period or at the beginning of the next cycle. Further to this, Airservices has agreed in principle to track the value of its asset base accounting for its actual capital spend, depreciation and asset disposals.'

The ACCC endorses this approach and considers that the value of Airservices' asset base can now be used as a reference point for future notifications, taking into account new, efficient investment.⁵⁰

Qantas supports this approach because it:

- does not allow airport operators to achieve windfall gains by revaluing assets at the expense of the airlines and the travelling public;
- enhances the ability of the ACCC to perform its monitoring function and adequately judge whether airport operators' returns are justified; and
- gives airlines relative certainty over cost benefit assessments of proposed airport capital programs. For example if revaluation was allowed, airlines may agree to investment in taxiway infrastructure to improve the efficiency of aircraft operations at the airport. However, assuming construction costs increase through time, the effect of revaluations will be to substantially increase the asset value and prices charged to airlines and the travelling public with no reflection of actual cost. As a consequence, it may be that the airlines will not agree to works because the benefits of the project are eroded through continual revaluations for pricing purposes. This situation again highlights the inherent conflict within some airport operators' arguments that they should be allowed to earn a reasonable return on their actual investments and the continual increases in prices and returns associated with the periodic revaluations of aeronautical assets. Economic regulators have overcome this problem by locking in the SAAB, and the same sensible approach should be applied to aeronautical assets.

Nevertheless, in the event that the value of existing aeronautical assets were to be updated or revalued, it is critically important to recognise that any such increase is a form of income (or negative depreciation) accruing to airport operators, and so must be taken into account as such in setting future aeronautical charges. This is not only consistent with regulatory practice in those sectors where asset values are updated over time but also avoids the potential for windfall gains for airport operators overshadowing the successful development of the commercial negotiation regime.

⁵⁰ ACCC, Preliminary View – Airservices Australia, November 2004, p. 43.

Schedule 1: Australian Competition Tribunal – Findings on Non-Price Terms and Conditions

This table outlines factual findings regarding non-price terms and conditions of access to Airside Services at Sydney Airport made by the Australian Competition Tribunal on the basis of the evidence before it in Virgin Blue Airlines Pty Limited [2005] ACompT 5.

| No. | Finding | Reference |
|-----|---|--------------|
| 1. | Negotiation of terms and conditions is enhanced where an airport operates in a competitive environment, such as Melbourne airport. | [392] |
| 2. | SACL's refusal to negotiate terms and conditions of access with Jetstar demonstrates how monopolistic power is used in a diminished competitive environment. | [392] |
| 3. | SACL exercised its monopoly power to force Jetstar to agree to Conditions of Use it would not have accepted in a competitive environment. | [390], [393] |
| 4. | The negotiation of Conditions of Use between SACL and the various airlines demonstrates 'the intransigent attitude of a monopolist – SACL – exercising its monopoly power without the constraints of a competitive environment'. | [398] |
| 5. | SACL's right to unilaterally increase aeronautical service charges under the Conditions of Use is incompatible with a competitive environment in which a user can change service providers. | [408] |
| 6. | In a competitive environment, the Conditions of Use would include an arbitration process for the resolution of disputes. | [419] |
| 7. | The draft Aeronautical Services Agreement would allow SACL to act in a monopolistic manner. It lacks an effective dispute resolution process – with recourse to independent arbitration / determination – and excludes many commercial matters from the dispute resolution process. | [420] |
| 8. | The force majeure clause in the Conditions of Use is an example of the monopolistic imposition of an unreasonable condition of use, which requires an airline to guarantee the airport's revenue where events occur which are beyond either party's control. | [423], [431] |
| 9. | Under the force majeure clause in the Conditions of Use, risk is shifted away from Sydney airport to the airlines. This would act as a disincentive for existing airlines to open new routes and for new airlines to enter the market for passenger air travel services. | [433] |
| 10. | In the absence of declaration, negotiations between SACL and the airlines as to non-price terms and conditions of Airside Services would continue 'to be protracted, inefficient, and may ultimately be resolved by the use of monopoly power producing outcomes that would be unlikely to arise in a competitive environment.' | [477] |

21 July 2006

Effectiveness of the Regulation of Airport Services

A Report for Qantas

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1. Introduction

1.1. Purpose of this report

NERA Economic Consulting has been asked by Qantas Airways Limited ('Qantas') to evaluate the effectiveness of current arrangements for the negotiation and monitoring of aeronautical charges at Australia's major airports. This report has been prepared for submission by Qantas to the Productivity Commission ('the Commission') in the context of its inquiry into the economic regulation of airport services.

The Commission has been asked to review the performance of the existing commercial negotiation and price monitoring arrangements that have applied at Australia's major airports since 2002. In undertaking its assessment, the Commission is to have regard to the Government's objectives for the regime and the 'review principles' set out by the Government at the time the arrangements were instituted. The Commission is also instructed to consider whether alternate regulatory arrangements would improve aeronautical service charging outcomes.

The terms of reference for the inquiry require:¹

The Commission is to report on whether airport operators have acted in a manner consistent with the Government's Review Principles and on effectiveness of the current form of prices regulation of airports having regard to the objectives [of the regulatory regime].

Our approach to evaluating the effectiveness of the current regulatory regime is to examine the analysis and conclusions of the Commission's 2002 inquiry into the regulation of airport services and to determine the extent to which those conclusions remain valid, particularly in light of experience since 2002. In so doing, we examine the available evidence on prices, revenue and costs, and the experiences of Qantas itself, to determine the extent to which airports have been constrained in the exercise of their market power.

To the extent that the current regulatory arrangements are not constraining the exercise of the market power of airports in determining both the price and non-price terms for airport services, there are likely to be good reasons to consider reforms to the current regulatory arrangements. We recommend a number of reforms to the existing regulatory regime that are expected to resolve the identified problems.

1.2. Structure of this report

The remainder of the report is structured as follows:

§ Chapter 2 sets out the motivations behind the 2002 inquiry into price regulation of airport services by the Commission, the reasoning underlying the Commission's recommendations and the Government's objectives for airport regulation. This allows us to examine the effectiveness of the commercial negotiation, price and quality monitoring regime against these expectations later in the report;

¹ Government's Terms of Reference for the Productivity Commission Inquiry.

- § Chapter 3 provides an overview of the experiences of Qantas in operating within the commercial negotiation, price and quality monitoring regulatory regime since 2002 and examines the available data on charges, revenue, costs and asset valuation for the major airports;
- § Chapter 4 analyses the effectiveness of the commercial negotiation, price and quality monitoring regulatory regime by reference to the reasons for the Commission's 2002 recommendations. In particular we examine whether airports have unconstrained market power, through analysing the evidence presented in Chapter 3, and whether non-aeronautical revenues, the countervailing market power of airlines and/or price discrimination can, or do, constrain the exercise of this market power. Finally in Chapter 4 we identify factors that determine the effectiveness of commercial negotiation, price and quality monitoring to deliver efficient aeronautical charges; and
- § Chapter 5 considers how the current commercial negotiation, price and quality monitoring regime can be modified to resolve some of the problems identified in Chapter 4. We consider the importance of requiring the development of binding dispute resolution mechanisms to provide an incentive for airports and airlines to negotiate effectively and also to address problems surrounding the valuation of aeronautical assets for the purpose of determining charges.

2. Background

This chapter briefly discusses the privatisation of airports in the late 1990s and summarises the principal findings of the 2002 Productivity Commission airports review. It provides the context for airport regulation in Australia and establishes the basis upon which to consider the effectiveness of the current regulatory arrangements.

Its main conclusions are that:

- § the Commission's 2002 review found that at least four airports had significant market power; but that the scope for the exercise of market power was constrained by the potential impact on revenue in the related market for non-aeronautical services;
- § the Government implemented price monitoring in reliance on the Commission's recommendations and views. To the extent that the basis for those recommendations is not borne out, this draws into question the effectiveness of the price monitoring regime; and
- § there is no evidence that the Government intended to bring about a fundamental change in the way assets were valued at the phase I and II airports, post-privatisation.

2.1. The airport privatisations

Under the price regulation arrangements introduced by the Government upon the privatisation of the Phase I and II airports in 1997 and 1998, privatised airports were 'deemed to be declared' for the purposes of the Part IIIA access regime,² and aeronautical prices at each privatised airport were subject to a five year CPI-X price cap. These price caps were not established by reference to any explicit assessment of either the services to be provided, or current or prospective costs.

Rather, to the extent that the initial price caps had any implied rationale, it was that existing services would continue to be provided at existing prices, with provision for an annual productivity adjustment.³ To accommodate the inevitable need for either capacity or service quality to be expanded, airports were permitted to apply to the Australian Competition and Consumer Commission (ACCC) to approve price increases over and above the CPI-X caps, in order to meet the cost of 'necessary new investments' (NNI).

Sydney airport continued to be government-owned until June 2002.⁴ Prior to Sydney airport's privatisation, a fundamental review of its aeronautical charges was undertaken by

² All privatised airports designated as core-regulated airports under the Airports Act were subject to an access regime under Section 192 of the Airports Act, under which the airports were to submit access undertakings to the ACCC within a designated period. Since no undertakings were accepted by the ACCC during the period, the Minister determined that airport services at all privatised core-regulated airports were 'deemed to be declared' for the purposes of Part IIIA of the Trade Practices Act 1974 (Productivity Commission, 2002, *Inquiry Report*, p60).

³ An individual X-factor was determined for each of the Phase I airports: 4.0% for Melbourne, 4.5% for Brisbane and 5.5% for Perth (ACCC, 1997, *Administration of Airport Price Cap Arrangements*). This variation was dependent on the expected traffic growth at each airport (Forsyth, P., 2004, "Replacing Regulation: Airport Price Monitoring in Australia", *The Economic Regulation of Airports: Recent Developments in Australasia, North America and Europe*, p4).

⁴ Prices at Sydney airport were regulated through the ACCC's prices surveillance powers, under the Prices Surveillance Act 1983.

reference to the provisions of the Prices Surveillance Act. This review established (substantially higher) prices by reference to an explicit assessment of the services to be provided, the cost of provision, and a valuation for aeronautical assets.

This process stands in sharp contrast to that which took place prior to the privatisation of phase I and II airports. The fact that the Government did not instigate a price review process (similar to the approach subsequently taken prior to Sydney airport's privatisation) suggests it was not its intention to bring about a fundamental change in the way assets are valued (and so prices are determined) at the phase I and II airports, post-privatisation.

The operation of the existing regulatory regime at the phase I and II airports encountered a number of difficulties in the period immediately after privatisation. The basis for the initial price caps was not clearly specified, including the extent to which forward looking expenditure requirements were or were not included in the price cap. The ACCC was required to make thorough assessments for all investments that subsequently arose under the NNI provisions. In some cases these assessments were seen as unwarranted interventions into the commercial decision-making process.

The price cap regime, and not least the ambiguous circumstances under which it was developed, was seen as a significant contributor to these difficulties. Further, the very existence of a price cap, and the pervasive role of the ACCC in determining new investment issues, did not sit well with the Government's policy emphasis on commercial negotiation of access issues and lighter handed forms of regulation (where appropriate) more generally.

Consistent with this relatively poor experience, when the Government defined the terms of reference for the Commission's review of price regulation in 2001, it stipulated that the CPI-X price cap would no longer operate, and that prices regulation should facilitate "commercially negotiated outcomes in airport operations." The Commission was instructed to consider whether there was a need for price regulation of airports to counteract the exercise of market power, and what the form of any such regulation should be.

2.2. Findings of the Productivity Commission's 2002 Review

The Commission found that four airports (Sydney, Melbourne, Brisbane and Perth) possessed substantial market power.⁵ The principal basis for these findings was the natural monopoly characteristics shared by airports generally (such as significant barriers to entry, and declining costs over reasonable range of capacity) and the lack of substitution possibilities for either airlines or passengers.⁶

However, the Commission also found that the scope for airports to exercise that power would be constrained by 'commercial pressures and opportunities' - chiefly the potential effect of the monopoly pricing of aeronautical services on revenue in the related market for non-aeronautical services.

⁵ The market power of these airports was strongest in facilities for aircraft movements (runways, taxiways, aprons) and 'front-door' vehicle access.

⁶ According to the Commission, this lack of substitution possibilities resulted from the high proportions of passengers travelling to these airports for business reasons, or to visit friends or relatives.

The primary constraint on airport market power was said by the Commission to be derived from ‘non-aeronautical’ income, ie, revenue from ancillary services such as retail facilities, hospitality and car-parking. The Commission observed that revenue from these non-aeronautical activities made up a substantial proportion of total airport revenue. It considered that the opportunity to earn non-aeronautical revenue would give airports an incentive to increase passenger throughput. This incentive would reduce the profit-maximising level of aeronautical charges. Specifically, the Commission found that “the substantial non-aeronautical income to be had from promoting airline passenger traffic” would reduce airports’ incentive to raise aeronautical prices, and thereby constrain airports’ exercise of their market power. According to the Commission’s Finding 7.1:⁷

... there is an incentive for airports to temper prices for aeronautical services ... improve quality and/or increase aeronautical capacity to encourage passenger growth and non-aeronautical revenue. ... the effects on aeronautical prices would be significant.

Similarly, the Commission concluded that airports’ exercise of market power would be constrained by the airports’ commitment to long-term growth strategies aimed at increasing tourism and international visitor numbers.

The Commission appears to have taken the view that the identified constraints would balance the bargaining power between airports and airline operators, such that commercial negotiations would be likely to result in efficient outcomes, without the need for ‘heavy handed’ regulation.

The Commission also identified a further constraint arising out of its proposed price monitoring regime. It considered that in the event a price monitoring regime was introduced, it would constrain airports’ pricing decisions indirectly, through⁸ “moral suasion, providing customers with better information, publicity, and the threat of stricter forms of price regulation being re-introduced.”⁹

The Commission considered that airlines would have some, albeit limited, countervailing power in their dealings with airports.¹⁰ However, the extent of any airline countervailing power does not appear to have been a major consideration in the Commission’s reasoning. According to the Commission’s Finding 7.2:¹¹

The countervailing power of airlines in their dealings with major capital city airports appears limited. However, airlines may have a degree of countervailing power ... where there is scope for airport substitution ..., where airlines form alliances and bargain as a group, or where selective threats can be made to reduce services that are highly profitable to airports...

⁷ Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, p188.

⁸ Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, pXXXIII.

⁹ Relevant considerations in this regard include both the ACCC’s price monitoring role and the Government’s expressed intention to review the regime after five years, and to intervene before the planned review date in the event that airport conduct justified such intervention.

¹⁰ The Commission thought the degree of countervailing power would be stronger with respect to the smaller airports, but its finding was *not* restricted to the smaller airports.

¹¹ Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, p197.

Finally, the Commission took the view that the efficiency losses arising from any exercise of market power would be mitigated by airports' use of price discrimination, ie, the charging of different prices to different groups of customers, such that the more price-responsive customers are offered a lower price. Such pricing may be less distortionary than a single inflated price charged by a monopolist, since a lower price may be charged to marginal users who would not have used the service at the monopoly price. According to the Commission's Finding 7.4:¹²

Airport operators have a strong incentive to discriminate in pricing... such pricing is likely to reduce any efficiency losses arising either from the need to cover the fixed costs of providing aeronautical services or from the exercise of airport market power.

Given its finding that airports would be constrained in their use of market power, and the benefits of more 'light-handed' forms of regulation in the context of airports, the Commission's preferred approach was for the introduction of a light-handed regulatory regime. Accordingly, it recommended that formal price controls should be replaced with mandatory price monitoring by the ACCC for Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin airports, for a five year 'probationary period'. It also recommended that an independent public review should be conducted towards the end of the five year probationary period.

2.3. Government objectives for the price monitoring arrangements

The price monitoring arrangements were instituted in 2002 and the Government set out a number of objectives for the regime, including that it should:¹³

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

The Government also drew attention to the constraining role provided by the ongoing threat of regulatory intervention. It committed not only to review the price monitoring regime at the end of the five year monitoring period, but also to intervene before the expiry of the five year period "if there is evidence of unjustifiable price increases".¹⁴ Further, as part of its response to the Commission's inquiry report the Government released 'review principles' (relating largely to the efficient operation of airports), and stated that it would consider re-introducing price controls (on a case-by-case basis) if it formed the view that an airport had operated in a manner inconsistent with these principles.

¹² Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, p202.

¹³ The objectives of the regime can be found in the Terms of Reference for the current review. Productivity Commission, 2006, *Price Regulation of Airport Services: Issues Paper*, May, p 3.

¹⁴ Joint Press Release, Minister for Transport & Regional Services, Treasurer, 13 May 2002.

In announcing the new regime, the Government specifically acknowledged the ‘commercial constraints’ identified by the Commission as the justification for its replacement of price regulation with lighter-handed regulatory arrangements, noting:¹⁵

... Sydney, Melbourne, Brisbane and Perth airports have considerable market power ...
However, due to commercial constraints, the potential for abusing that power does not warrant a heavy-handed regulatory regime. The Government considers that lighter-handed regulation of airports is now appropriate. In particular, it appears that airport operators have strong commercial incentives to increase passenger throughput...

Since the Government implemented the price monitoring arrangements in reliance on the Commission’s recommendations and views, to the extent that the basis for those recommendations is not borne out by subsequent experience, this draws into question the effectiveness of the price monitoring regime.

¹⁵ Joint Press Release, Minister for Transport & Regional Services, Treasurer, 13 May 2002, *Government Response to the Productivity Commission Report on Price Regulation of Airport Services*.

3. Airport Charges and Practices Since 2002

In this chapter we consider Qantas' experience of the existing regulatory arrangements in the period since their introduction. This experience provides the basis for our subsequent discussion on the effectiveness of the negotiation/price monitoring regulatory regime in chapter 4.

In preparing this chapter we have drawn on both the ACCC's monitoring reports and on information provided by Qantas. The material set out in this section ranges from the experience of commercial negotiations between Qantas and airports through to airport profitability and the valuation of assets.

Our principal conclusions from this analysis are that:

- § negotiations with airports have tended to be protracted and ineffective, with only a few long term commercial pricing agreements being completed since 2002;
- § all but one airport have been unwilling to accommodate Qantas' requests for binding dispute resolution provisions,¹⁶ and price increases and new non-aeronautical charges have often been imposed without transparent explanatory information on either the underlying level of or changes to costs;
- § airports have demonstrated 'intransigent' negotiating conduct that is consistent with the exercise of market power, eg, Sydney Airport Corporation Ltd (SACL) was unwilling to negotiate on the terms and conditions of use to be applied to Jetstar at Sydney Airport and was willing to refuse access to Terminal 2 unless Jetstar agreed to the terms preferred by SACL. Access to Terminal 2 at that time was necessary for preparatory work prior to the launch of Jetstar;
- § the ACCC's 'price monitoring' regime can better be characterised as a *revenue* reporting regime, because the range and level of charges for aeronautical services has become increasingly opaque, thereby requiring the ACCC to use average aeronautical revenue per passenger as its primary measure of aeronautical charges;
- § reported aeronautical revenue per passenger (a proxy for prices) and operating margin per passenger have increased substantially at all airports as a result of increases in revenue in the absence of corresponding cost increases, particularly in 2002–03, the first year since the removal of formal price controls;
- § at several airports the value of assets reported under the ACCC's monitoring regime has been increased significantly through revaluations since 1998–99, and has resulted in:
 - increases in aeronautical prices (particularly at Perth airport);
 - friction in airline / airport relationships (particularly at Sydney and Canberra airports);
 - reductions in the reported rate of return on assets in the monitoring reports; and

¹⁶ The only exception is Cairns airport. The dispute resolution clause in the agreement with Cairns airport provides for a binding expert determination.

- the use of inflated asset values to draw attention to the inadequacy of rates of return being earned on these assets (particularly at Brisbane airport).

The remainder of this chapter explains these conclusions in more detail.

3.1. Commercial negotiations with airports

One of the ‘review principles’ accepted by the Government in the course of its response to the Commission’s 2002 inquiry report was that airports and airlines should negotiate and operate in a proper commercial manner:¹⁷

It is expected that airlines and airports will primarily operate under commercial agreements and in a commercial manner, and that airport operators and users will negotiate arrangements for access to airport services.

After the Government removed the pricing controls it had previously imposed on airports through the CPI-X price cap regime, Qantas engaged with each of the previously regulated airports with the objective of reaching a long term commercial agreement for the provision and pricing of aeronautical services.

The outcome of this process is that Qantas has negotiated functioning, long term aeronautical services agreements with only three of the twelve major airports in Australia; namely, Melbourne, Adelaide and Cairns (see table 3.1 below). Qantas has not reached agreement on long term pricing with any of the other airports to date.¹⁸

Moreover, even where Qantas has been able to sign commercial agreements with airports, it has often been under duress. For example, Qantas’ signature to an agreement on check-in counter licences with SACL in 2005 was accompanied by a letter of protest. In that letter, dated 14 June 2005, Qantas referred to a previous letter from SACL dated 10 May 2005, which stated:

[I]f Qantas was not to sign the Licence by 15 June 2005 then:

1. Qantas will not be entitled to any further permanent or temporary change or increase in their current seasonal allocation of counters, and
2. Qantas will receive the lowest priority allocation of counters

Qantas’ letter stated that SACL’s actions left it “with no real choice”,¹⁹ and highlighted a number of areas of dissatisfaction within the licence. Such outcomes are not indicative of a well functioning commercial relationship.

¹⁷ Joint Press Release, Minister for Transport & Regional Services, Treasurer, 13 May 2002.

¹⁸ In most cases, negotiations are continuing. Despite the absence of formal agreements, Qantas continues to operate at all major airports, under various arrangements. At some airports, informal arrangements have been made. For example, at Perth airport, Qantas operates under an unsigned ‘accord’. At other airports (eg, Canberra), there is ongoing disagreement over price and/or conditions of service.

¹⁹ Qantas has informed us that this episode is not unusual; for example, it signed the Melbourne Aeronautical Services Agreement in circumstances involving similar forms of coercion, ie, the airport in 2002 made threats to delay or leave incomplete works required by Qantas to accommodate its new A330 aircraft, until Qantas signed the agreement.

[Confidential information omitted]

In the course of negotiating commercial agreements with airports, Qantas has in each case sought to include provision for binding dispute resolution of some description. Qantas takes the view that, while such dispute resolution is likely to be invoked only infrequently, its presence is valuable for encouraging constructive engagement. Accordingly some form of binding dispute resolution framework is a standard feature of almost all other long term commercial agreements to which Qantas is a party.

Almost all airports have so far been unwilling to accommodate Qantas' requests for the inclusion of binding dispute resolution provisions in the commercial agreements governing aeronautical services. While some of the agreements reached to date contain provision for *non-binding* mediation or expert determination, none contain arrangements for recourse to binding commercial arbitration, or any other form of binding dispute resolution.

The conduct of airports in negotiations with airlines has also been inconsistent with the nature of balanced commercial negotiations in a number of other respects.

One example of 'intransigent' negotiating conduct occurred in relation to the launch by Qantas of Jetstar. In October 2003, Qantas announced the proposed establishment of its low cost carrier subsidiary, Jetstar, and in February 2004 Qantas announced that Jetstar would commence flying various routes on 25 May 2004. The announcement by Qantas of routes to be served by Jetstar was an important expression of its market and brand-building intentions in the domestic air passenger market. However, the prior announcement of Jetstar's launch date increased its vulnerability to 'hold-up' conduct by airports.

Qantas' experience was that SACL was unwilling to negotiate in respect of the terms and conditions of use to be applied to Jetstar at Sydney Airport and was willing to refuse access to Terminal 2, which was necessary for preparatory work prior to Jetstar's launch, unless Jetstar agreed to the terms preferred by SACL. Based on the evidence before it, the Australian Competition Tribunal found that:²⁰

Jetstar had been forced to agree to the conditions of use put forward by SACL in conditions that it would not otherwise have to accept if it was not dealing with a monopoly service provider.

The Tribunal concluded:²¹

We take the view that the sequence of negotiations between SACL and the airlines over conditions of use demonstrates the intransigent attitude of a monopolist – SACL – exercising its monopoly power without the constraints of a competitive environment, which would otherwise have generated a more compromising negotiating position in order to keep the airlines' business and not lose it to a competitor.

More generally, it has been Qantas' experience that most airports have ceased to provide meaningful information about costs in the course of negotiating increases in aeronautical charges. Initially, airports were generally prepared to explain the need for price increases by

²⁰ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 393.

²¹ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 398.

providing information about changes in costs, including information on the cost/revenue balance with respect to any proposed price or price change, and the total cost/revenue balance. However, most airports have ceased to provide such information for more recent price increases. One consequence is that it has become increasingly difficult to determine the relationship between airport pricing and revenue, and airports' efficient costs.²²

The opinion that airport conduct (to be precise, Sydney airport's conduct) in negotiations with airlines has been inconsistent with what can be expected from balanced commercial negotiations (and the desirability for appropriate dispute resolution arrangements) is shared by the Australian Competition Tribunal, which in the Sydney airport case²³ found as follows:

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

3.2. Aeronautical revenue, costs and operating margin

One of the 'review principles' adopted by the Government in its response to the Commission's 2002 inquiry report was that airports' revenue should reflect long run efficient costs. The latter principle was expressed as follows:²⁴

At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long run costs of efficiently providing aeronautical services (on a 'dual-till' basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.

Since the current price monitoring arrangements began, reported aeronautical revenues have increased substantially at a number of airports. The increases largely occurred immediately after the removal of price caps. As the ACCC observes:²⁵

Melbourne, Perth and Brisbane all experienced substantial increases in aeronautical revenue (53 per cent, 85 per cent and 38 per cent, respectively) after CPI-X price caps applying to those airports were removed in June 2002.

The ACCC has adopted average aeronautical revenue per passenger as a proxy for aeronautical prices.²⁶ It has used this as its primary measure of aeronautical prices because

²² This information would be necessary for determining whether airports have adhered to the Government's review principles.

²³ *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at para 17.

²⁴ Joint Press Release, Minister for Transport & Regional Services, Treasurer, 13 May 2002

²⁵ ACCC, *Airport price monitoring and financial reporting: 2004–05*, p10. Sydney airport experienced its highest increase in aeronautical revenue in 2001–02, corresponding to the price increases approved by the ACCC in its major aeronautical price notification.

²⁶ ACCC, *Airport price monitoring and financial reporting: 2004–05*, p12

differences in the charging arrangements between airports, and changes in those arrangements over time, make it difficult to measure and summarise changes in aeronautical charges directly.²⁷

Reported annual aeronautical revenue per passenger and aeronautical operating expenses per passenger for the four airports identified by the Commission as possessing substantial market power (Sydney, Melbourne, Perth and Brisbane), since the removal of price cap regulation in 2001-02 are as follows:

- § Sydney - a 13 per cent increase in reported aeronautical revenue per passenger, as compared with a 16 per cent *decrease* in aeronautical operating expenses per passenger;²⁸
- § Melbourne - a 66 per cent increase in reported aeronautical revenue per passenger²⁹, as compared with a 1.5 per cent increase in aeronautical operating expenses per passenger;³⁰
- § Perth - an 80 per cent increase in reported aeronautical revenue per passenger, as compared with a 21 per cent increase in aeronautical operating expenses per passenger;³¹
- § Brisbane - a 48 per cent increase in reported aeronautical revenue per passenger,³² as compared with a 2.2 per cent increase in aeronautical operating expenses per passenger;

Accordingly, aeronautical operating margin per passenger has increased substantially since the price monitoring arrangements began. We note the following results for Sydney, Melbourne, Perth and Brisbane since the removal of price caps in 2001-02:

- § Sydney - increase from \$2.91 in 2001-02 to \$5.22 in 2004-05;³³
- § Melbourne - increase from \$0.49 in 2001-02 to \$3.05 in 2004-05;³⁴
- § Perth - increase from \$0.23 in 2001-02 to \$2.78 in 2004-05;³⁵
- § Brisbane - increase from -\$0.17 in 2001-02 to \$1.52 in 2004-05;³⁶

²⁷ The ACCC states at p19 that “while the ACCC would prefer to use price indexes to measure changes in prices charged by the price-monitored airports, construction of price indexes is complex and issues such as changes to the bases of charging and bundling of charges make construction problematic.”

²⁸ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p123

²⁹ Note that these revenue figures include expenditure on security. Since price monitoring commenced security revenue per passenger has increased by \$0.08, while the overall increase in aeronautical revenue (adjusted) per passenger was \$1.47. ACCC, *Airport price monitoring and financial reporting*: p 90.

³⁰ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p93

³¹ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p108

³² Note that these revenue figures include expenditure on security. Since price monitoring commenced, security revenue per passenger has increased by \$0.31, while the overall increase in aeronautical revenue per passenger was \$1.77. ACCC, *Airport price monitoring and financial reporting: 2004-05*, p46

³³ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p123

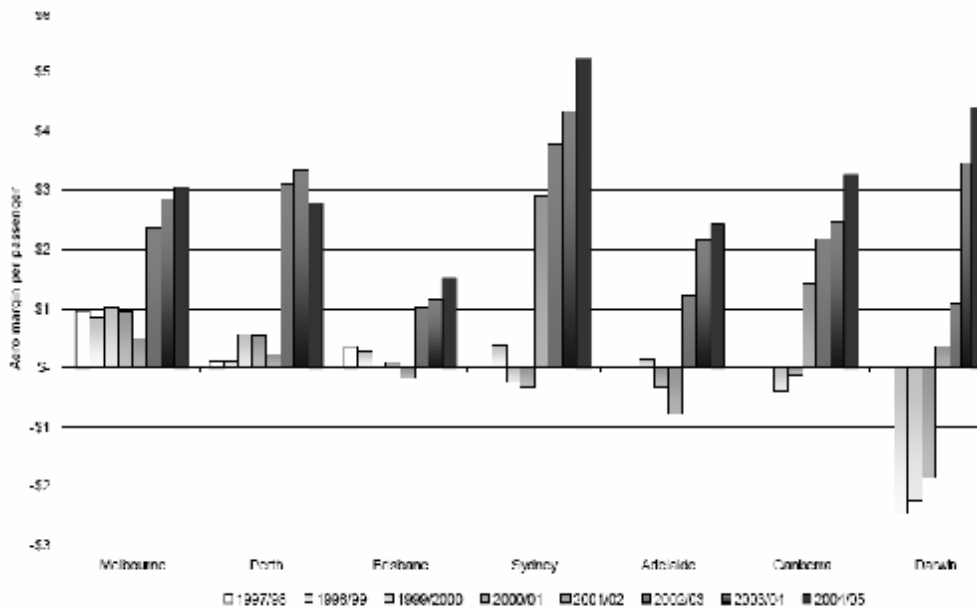
³⁴ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p93

³⁵ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p108

³⁶ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p49

Figure 3.1 shows changes in aeronautical operating margin per passenger from 1998–99 to 2004–05 for each of the seven price monitored airports.³⁷

Figure 3.1
Aeronautical operating margin per passenger



Notes: Passenger numbers for Darwin for 1999–00 and 2000–01 are estimated based on the passenger-aircraft ratio from 2001–02 because Darwin did not provide actual figures.

This measure does not include an allowance for return on capital.

Relying on clause 3 in direction 27, reported revenues for Perth, Brisbane and Sydney exclude revenue from fuel throughput services. Brisbane advised that in 2004–05 fuel throughput revenues had been incorrectly reported as aeronautical revenues in previous years and that it is now relying on the clause 3 exemption to exclude this item from its aeronautical revenue. As a result, adjustments have been made to aeronautical revenues reported in 2002–03 and 2003–04 to exclude fuel throughput revenues.

Two important observations can be drawn from these data. First, as the ACCC observes, operating margin per passenger has increased at all airports since 2002–03, “as a result of increased activity that has seen revenues increase while costs have remained largely fixed.”³⁸ The rate of increase in operating margin per passenger for Sydney, Adelaide, Canberra and Darwin appears to be particularly large. The ACCC observes that there were³⁹ “sharp increases” in reported aeronautical revenue per passenger in 2001–02 and 2002–03, when price caps were removed. These ranged from approximately 9 per cent to over 100 per cent.

³⁷ ACCC, *Airport price monitoring and financial reporting: 2004–05*, Chart 2.7, p25. Aeronautical operating margin per passenger is the difference between the average aeronautical revenue per passenger and average aeronautical operating expenses per passenger.

³⁸ ACCC, *Airport price monitoring and financial reporting: 2004–05*, p25

³⁹ ACCC, *Airport price monitoring and financial reporting: 2004–05*, p1

Second, at Sydney airport, the largest single year increase in operating margin occurred in 2001-02, reflecting the impact of the ACCC's 2001 pricing determination for Sydney airport. For the other three airports identified by the Commission as possessing substantial market power (Melbourne, Perth and Brisbane), the largest single year increase in operating margin occurred in 2002-03, the first year since the removal of formal price controls and the introduction of the price monitoring arrangements.

3.3. Asset revaluation

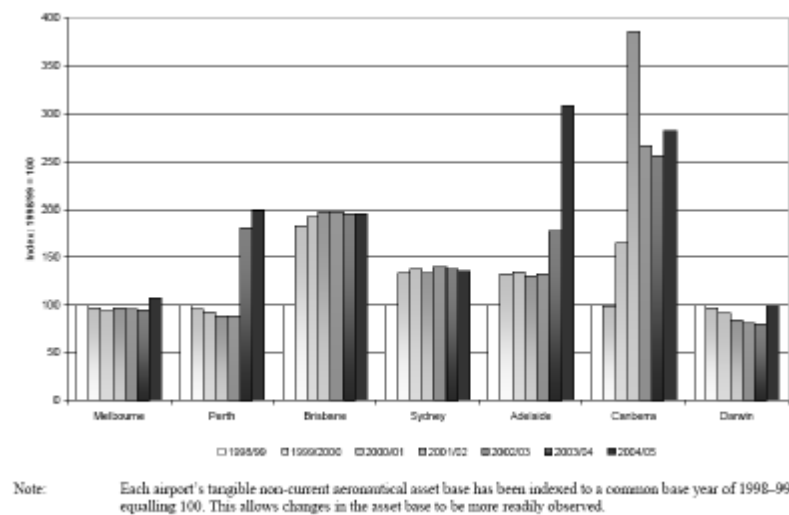
One of the 'review principles' established by the Government as part of its response to the Commission's inquiry report was that:⁴⁰

...Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.

However, no guidance was given on how the principle that aeronautical assets should be "appropriately defined and valued" should be interpreted or implemented.

Figure 3.2 shows changes in the value of the aeronautical asset base from 1998-99 to 2004-05 for each of the seven price monitored airports, including both new investment and asset revaluation.⁴¹

Figure 3.1
Tangible non-current assets (indexed)—aeronautical



Asset revaluations (as opposed to new investment) have been responsible for a significant proportion of these changes at some airports, including:⁴²

⁴⁰ Joint Press Release, Minister for Transport & Regional Services, Treasurer, 13 May 2002

⁴¹ ACCC, *Airport price monitoring and financial reporting: 2004-05*, Chart 2.10, p28

⁴² ACCC, *Airport price monitoring and financial reporting: 2004-05*, p28

- § at Perth airport, where assets have been revalued upwards by \$109.7 million, an increase of approximately 110 per cent;
- § at Canberra airport, where assets have been revalued upwards by \$108.5 million, an increase of approximately 180 per cent;⁴³ and
- § at Brisbane airport, where assets have been revalued upwards by \$275 million, an increase of approximately 95 per cent.

New investment is also a cause of major changes in aeronautical asset values at some airports. At Adelaide airport, for example, major investment in a new terminal is responsible for the large increase in asset value in 2004-05 (although Adelaide has also undertaken a revaluation of its existing assets).⁴⁴

3.3.1. Asset revaluation and aeronautical charges: Perth airport

Perth airport's average aeronautical revenue increased from approximately \$4.30 per passenger in 2001-02 to approximately \$7.10 in 2002-03 (a 67% increase), largely as a result of increases in aeronautical charges.⁴⁵ These increases gave rise to much greater aeronautical revenue, thereby increasing the airport operator's rate of return on its existing assets (before any revaluation is taken into account).

[Confidential information omitted]^{46, 47}

3.3.2. Asset revaluation and airport/airline relationships: Canberra airport

Asset revaluation has been the principal basis for a number of protracted and unresolved disputes between airports and airlines over many matters. Disputes arising in the context of Canberra airport provide a good example of this problem.

Canberra airport was purchased at privatisation for \$65.89m, while the book value of the assets transferred from the Federal Airports Corporation (FAC) was \$24.1m.⁴⁸ Since privatisation, the airport has increased the book value of aeronautical assets (published in the ACCC's regulatory accounts) a number of times, as set out in the following table.

⁴³ The ACCC has broken this figure down as follows: "Revaluations of land over this time added some \$63 million to the value of aeronautical land. Revaluations of aeronautical buildings were also significant, increasing by around \$45.5 million, with \$14.5 million of this increase occurring in 2004-05. Canberra also reclassified approximately \$73 million in assets from aeronautical to non-aeronautical over 2002-03 and 2003-04." ACCC, *Airport price monitoring and financial reporting: 2004-05*, p28

⁴⁴ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p28. Over the period 2003-04 to 2004-05 Adelaide invested \$181.3 million in aeronautical assets in constructing its new integrated international, domestic and regional terminal. Adelaide also revalued aeronautical land and buildings by \$28.8 million during 1999-00.

⁴⁵ This increase also reflected the inclusion, for the first time, of revenue from the former Ansett terminal, which accounted for 11 per cent of this increase (ACCC, *Airports Price Monitoring and Financial Reporting 2004-05*, p107).

⁴⁶ [Confidential information omitted]

⁴⁷ [Confidential information omitted]

⁴⁸ Report of the Australian National Audit Office on the sale of "Phase II" airports, June 1999. The \$24.1m represents FAC assets and not the airfield assets transferred by the RAAF.

Table 3.2
Increases in the value of aeronautical assets at Canberra airport

| | Point of sale | 1998-99 Regulatory Accounts | 1999-00 Regulatory Accounts | 2000-01 Regulatory Accounts | 2001-02 Regulatory Accounts |
|-----------------------------|------------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
| Aeronautical asset value | \$24.1m (includes non- aero) | \$58.0m | \$56.9m | \$95.1m | \$223.2m |

The principal reason for the change in aeronautical asset values has been the revaluation of existing assets. According to the ACCC, the value of the aeronautical asset base at Canberra airport has increased by \$108.5 million through revaluations since 1998–99.

Qantas has advised that these asset revaluations have been a central element of a number of unresolved issues between Qantas and the airport, despite several years of negotiations.

Canberra airport is one of the airports with which Qantas has not been able to reach a formal agreement in relation to the provision of aeronautical services. The parties have been unable to reach formal agreement on either a proposed new terminal or the setting of landing charges.⁴⁹

Since privatisation, the airport has increased its landing charges substantially. For example, the landing charge was increased from \$2.49 to \$4.91 per arriving and departing passenger (excluding GST) in October 2001. This date followed closely the ending of the price cap but occurred before the commencement of price monitoring. Further increases have been the subject of unresolved negotiations. According to Qantas, the asset revaluations carried out by Canberra airport since privatisation have been one of the primary drivers of the increases in landing charges imposed by the airport.

3.3.3. Asset revaluation and the rate of return on assets: Brisbane airport

In some cases, airports have revalued their asset base upwards but have not, to date, applied that value to determine increased prices. This raises the possibility that the airport may seek to increase its charges in line with that increased asset value at some future date. Brisbane airport provides an example where there are indications that such conduct is likely.

The value of Brisbane airport's aeronautical asset base has been increased by \$275 million through revaluations since 1998–99.⁵⁰

In the context of taking an opportunity to “dispel some myths” about airport profitability, Brisbane airport has claimed that it is earning a 3 per cent return on its aeronautical assets (EBIT/Net Assets). This point was made in a presentation to airlines and BARA in 2005 at

⁴⁹ Although the parties have signed a general MOU with respect to the terminal.

⁵⁰ ACCC, *Airport price monitoring and financial reporting: 2004–05*, p28

their bi-annual consultation meeting on services and charges, in a chart entitled “Comparison with airline profitability (compared to book value of assets)”.⁵¹

The ACCC has expressed concern about the “downward impact” of asset revaluations on the rates of return reported at the airports concerned,⁵² noting that:

[T]his measure of profitability... has the disadvantage of being reliant on the airport operator’s valuation of its assets. ... [A] number of airports have effected upward revaluations of their assets, which has the effect of lowering the return on assets. While such revaluations may be in accordance with relevant accounting standards, ... the approach taken by an individual airport operator may not reflect an economic approach to valuing assets.

[Confidential information omitted]

⁵¹ Brisbane Airport Aviation Services and Charges Six Monthly Consultation Meeting, 4 April 2005

⁵² ACCC, *Airport price monitoring and financial reporting: 2004–05*, p27

4. Effectiveness of Price Monitoring

The 2002 Productivity Commission review of airport regulation found that the airports at Brisbane, Melbourne, Perth and Sydney had a high degree of market power compared to the remaining, at that time, core-regulated airports. Adelaide, Canberra and Darwin airports were found to have moderate or moderate to low degree of market power.

While finding that these airports had a high degree of market power, the Commission also concluded that the scope for exercising that market power in the setting of aeronautical charges was effectively constrained by commercial pressures and opportunities. In particular, the Commission identified the potential negative effect on profits from non-aeronautical services, such as car parks and retail space, of the exercise of market power in aeronautical services.

The existence of these constraints on the exercise of market power was the single most important element cited by the Commission in reaching its finding that a light-handed form of regulation – specifically, commercial negotiation supported by price monitoring - was warranted and appropriate. The Commission’s recommendation also took into consideration the benefits arising from the flexibility associated with a light-handed form of regulation, as compared with the potential risks associated with the exercise of market power.

As a general principle, ‘commercial negotiation’ will lead to efficient pricing outcomes in circumstances where the bargaining power is relatively equal between airports and airlines. However, as indicated in chapter 3 above, the evidence suggests that since the instigation of the new regulatory arrangements in 2002, the bargaining positions between airports and airlines⁵³ have in practice been rather unequal. Commercial negotiation in the context of the current regulatory arrangements has not prevented airports from being able to exercise their market power in the setting of aeronautical charges.

This chapter examines the effectiveness of the commercial negotiation regime, supported by price monitoring, as a regulatory approach to deliver efficient aeronautical charges. In so doing, it examines the extent to which the Commission’s 2002 recommendations are based on presumptions about the constraints on market power that, in light of the experience and analysis undertaken since 2002, cannot now be considered appropriate.

To assist with this analysis, the chapter briefly outlines the economics of market power in the context of the provision of airport services. This is followed by an assessment of the potential constraints on market power as identified by the Commission in its 2002 review. We then consider the evidence of price changes and other non-price conduct since 2002 and consider the potential reasons for these outcomes. We conclude by examining factors that are likely to influence the effectiveness of commercial negotiation in the context of a price monitoring regime, and evaluate the current arrangements against these factors.

⁵³ Prior to the new regulatory arrangements being implemented in 2002, section 192 of the *Airports Act 1986* deemed airports as declared services for the purposes of Part IIIA of the *Trade Practices Act 1974*. This provided airlines and airports with access to the dispute resolution mechanisms of Part IIIA, thereby creating a more equal bargaining position within the price cap regime. This was particularly important for negotiating non-price terms and conditions associated with access.

The main conclusions following from our analysis are that:

- § airports in all of the major capital cities have significant market power in setting the price and non-price terms for aeronautical services;
- § the constraint on the exercise of that market power imposed by the existence of non-aeronautical revenues is not effective at any reasonable level of aeronautical charges, and so there remains considerable scope for airports to raise charges beyond an efficient level;
- § airlines do not have sufficient countervailing market power to curb the exercise of market power in the setting of aeronautical charges or the negotiation of non-price terms and conditions by airports in the major capital cities;
- § price discrimination is an impracticable and so ineffective constraint on the negative consequences of the exercise of market power;
- § the evidence since 2002 confirms that airports have unequal bargaining power compared with airlines, because:
 - charges at the main capital city airports have increased significantly, relative to likely changes in costs during that time;
 - the main airports have all re-determined the financial value of their aeronautical assets and, in the case of Perth airport, this has led to an increase in charges and associated windfall gains;
 - the process for negotiating commercial agreements between airlines and airports has been unnecessarily protracted, and many remain incomplete at this time;
- § for commercial negotiations to take place effectively:
 - both parties must have an incentive to negotiate in good faith;
 - bargaining power must be relatively equal, with no opportunity for either party to exercise any significant market power that it may enjoy; and
- § in practice, there have been insufficient incentives for airports to negotiate in good faith, and there has been an imbalance of bargaining power. There is no reason to expect that these arrangements will lead to efficient outcomes for aeronautical charges or non-price terms and conditions.

The remainder of this chapter develops and discusses these conclusions in greater detail.

4.1. The economics of market power⁵⁴

It is well established that when examining the potential for market power, the starting point is to define the relevant market. This involves an assessment of the demand and supply side

⁵⁴ For a complete discussion of the economics of market power see American Bar Association Section of Antitrust Law, (2005), *Market Power Handbook*, February. See also King, S., (2001), *Market power and airports*, Report to the ACCC, January.

characteristics of the relevant product or service, with a particular focus on the extent of substitution possibilities both for buyers and sellers in the market.

For any relevant market, the market power of one or more suppliers can be defined as the ability to price without constraint, ie, to 'give less and charge more'.⁵⁵ An alternative but consistent interpretation of market power is to consider whether a firm's conduct amounts to that which would occur if it was subject to a competitive constraint.⁵⁶

When a firm is constrained by its competitors, it cannot unilaterally raise its price (profitably), since to do so would cause a loss of profitable sales to rival suppliers. Material price changes that occur in the presence of a competitive constraint are therefore the consequence of external forces affecting the entire market; such as an event causing an industry-wide change in forward looking efficient costs.

It is widely held by economists that competitive markets deliver efficient outcomes, thereby providing benefits to market participants and the economy as a whole. However, few if any markets meet the theoretical conditions for competition to be 'perfect' and so, in practical terms, the reference point for assessing the state of competition in markets is generally taken to be whether or not competition is effective, or workable. Where it is not, the question arises as to whether or not some form of regulatory intervention is capable of improving the prospects for outcomes that are consistent with effective competition.

The main considerations affecting the competitiveness of any market are:

- § the existence of any barriers to entry by new suppliers, and exit by existing suppliers;
- § whether there is a sufficient number of buyers and sellers such that no individual party can set prices without constraint;
- § the extent to which different products or services are able to substitute for one another; and
- § the extent to which market participants are informed of the potential choices available to them, including the cost and/or price of alternatives.

It is clear that many of the conditions likely to give rise to effective competition do not hold for the provision of airport services to airline operators. In particular there is typically only one seller of airport services in most capital cities in Australia. There are significant barriers to entry due to the natural monopoly characteristics of airports, and problems regarding the provision and availability of market information, particularly on comparable charges between airports. These characteristics suggest that the provision of aeronautical services cannot

⁵⁵ The High Court in *Boral Besser Masonry Ltd v ACCC* [2003] HCA 5 said that "a firm's ability to 'give less and charge more' is an expression of the central idea involved in the concept of market power" and "market power in a supplier is absence of constraint from the conduct of competitors or customers". The phrase 'give less and charge more' is derived from *Re Queensland Co-operative Milling Association Ltd* (1976) 25 FLR 169 at 190.

⁵⁶ Kaysen and Turner, in *Antitrust Policy* (1959) said that: "A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions." In *Millers Annotated Trade Practices Act*, 2004, p.322.

generally be expected to be subject to effective competitive constraints. In other words, most Australian airports enjoy a degree of market power.

Although it is appropriate to presume that the provision of aeronautical services by airports involves a degree of market power, a number of potential constraints on this market power have been cited. In its 2002 review, the Commission identified two such constraints. These were the impact on non-aeronautical revenues, and the extent of countervailing power by airlines. In addition, the Commission identified airports' ability to price discriminate in the setting of aeronautical charges as a factor mitigating the efficiency losses arising from the exercise of market power. We consider these factors in greater detail in the following section.

The Commission concludes in Finding 5.3:

Of the core-regulated airports, Sydney, Melbourne, Brisbane and Perth have most market power. Adelaide Airport is likely to have a moderate degree of market power. Canberra and Darwin airports also are likely to have a moderate degree of market power, though they appear to face stronger substitution possibilities than Adelaide Airport.

Core-regulated airports that do not appear to have significant market power (due mainly – except for Townsville – to the scope for effective inter-airport competition) are Alice Springs, Coolangatta, Hobart, Launceston and Townsville.

To summarise, many airports have significant potential to exercise market power in the setting of charges for aeronautical services. This potential arises because of the natural monopoly characteristics of airports, the significant barriers to entry, and the absence of effective substitutes in many geographic locations, such as the major capital cities of Australia.

The degree of market power held by airports is critical to the consideration of the appropriate form of regulation to apply to aeronautical services, if any. Where market power is not present or where it is effectively constrained, the current commercial negotiation and price monitoring framework is likely to bring about efficient charging outcomes. However, if airports' market power is not effectively constrained, then a key presumption underlying the current regulatory arrangements may not be valid, thereby raising the prospect that some additional form of regulatory constraint may be warranted. The following section therefore considers the effectiveness of the potential constraints on airports' market power.

4.2. Constraints on the exercise of market power

In its 2002 review, the Commission analysed a number of factors that, in its view, could constrain the exercise of market power by airports, because of 'commercial pressures and opportunities'.⁵⁷ These factors included:

- § concern about the impact on non-aeronautical revenues and overall profits;
- § the extent and impact of countervailing airline market power; and
- § the scope for airports to discriminate in the setting of aeronautical charges.

⁵⁷ Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, Report No. 19, January, p xvi.

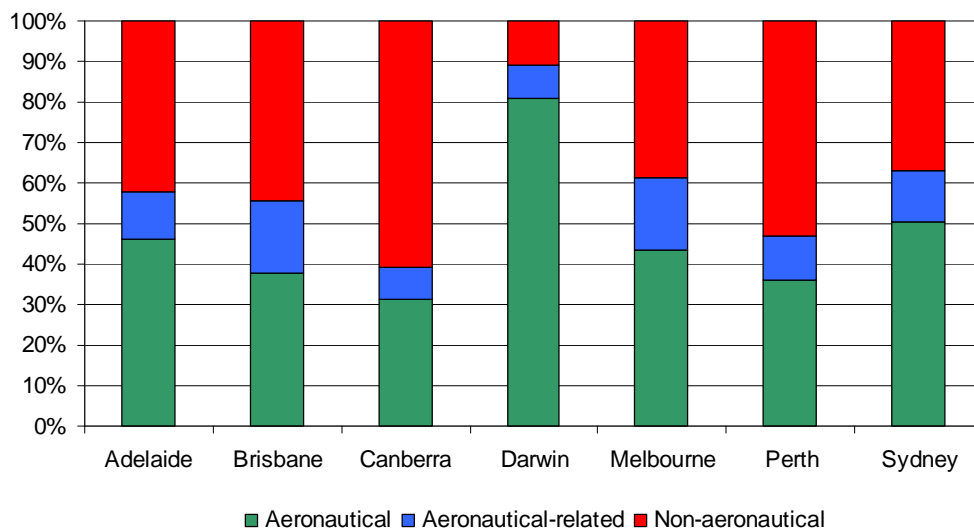
In examining each of these factors, the Commission appears to have relied most heavily on the role of non-aeronautical revenues as an effective constraint on the exercise of airports' market power in reaching its decision to recommend a negotiation framework with price monitoring.

The remainder of this section considers the effectiveness of each of these factors in light of the evidence since the introduction of price monitoring in 2003.

4.2.1. Maximising revenues from non-aeronautical service market

The principal consideration of the Commission in drawing its conclusion on the constraints applying to airports was that associated with the negative effect on income in the related market for non-aeronautical services. These services predominately involve the provision of retail space and car parking, and at some airports comprise a very significant proportion of overall revenue (Figure 4.1).

Figure 4.1⁵⁸
Proportion of revenue by source - year ending 30 June 2005



Non-aeronautical services were considered by the Commission to provide a constraint on aeronautical charges because of the effect that increases in airport charges might have on revenue from these related market services. If aeronautical charges rise such that overall demand for use of the airport falls, this reduces the capacity to earn income in the non-aeronautical services market. This is because demand for non-aeronautical services is linked to demand for aeronautical services. In simple terms, as less passengers use an airport, the scope to charge high rents for airport retail space and car parking facilities reduces. This relationship between aeronautical and non-aeronautical charges means that the incentive for airports to exercise their market power in aeronautical service charges is reduced.

⁵⁸ Derived from data contained in Appendix A, ACCC, (2006), *Airport price monitoring and financial reporting: 2004–05*.

For the complementary relationship between aeronautical and non-aeronautical services to be an effective constraint on airports' market power in aeronautical services a number of assumptions must hold. These are:

- § changes in aeronautical charges must have a material effect on the demand for airport services - in other words, the own-price elasticity of demand for airport services to changes in aeronautical charges must allow for a material demand response to price increases; and
- § changes in aeronautical charges must have a material effect on the demand for non-aeronautical services⁵⁹ - in other words, the cross-price elasticity of demand for non-aeronautical services must involve a material demand response to changes in aeronautical charges.

In its 2002 review, the Commission undertook a comprehensive analysis of the likely demand elasticity for aeronautical services. Because airport service demand is a derived demand it identified four factors that are likely to influence the price elasticity of demand for aeronautical services:⁶⁰

- § the elasticity of demand for air travel to that destination;
- § alternative sources of supply for a particular airport's services;
- § the proportion of airfares (or freight charges) and airline costs that airport charges comprise; and
- § the elasticity of supply (supply responses) of other input providers, such as airlines.

The Commission found that (finding 5.2):

The price elasticity of demand for the services of a particular airport is influenced by a number of factors. Although the typically low proportion of airport charges in airfares and airline costs suggests low price sensitivity, this will be mitigated by any potential for destination, modal and airport substitution, and the supply responses of other input providers to changes in airport charges.

Airports that face more significant substitution possibilities will face more price-sensitive demand (and hence have lower market power).

This analysis implies that the own-price elasticity of demand for aeronautical services, at least for the main capital city airports, is likely to be very low, since the potential for modal or destination substitution is low.

⁵⁹ Since the demand for airport services is derived from the demand for air travel, the price elasticity of demand for airport services will be derived from that for air travel, adjusted by the proportion that the costs of airport services are of the cost of air travel.

⁶⁰ Page 107, Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, Report No. 19, January.

Furthermore, aeronautical charges are typically only a small proportion of total ticket price. This suggests that air passengers are not likely to respond significantly to changes in aeronautical charges.

For example, at Sydney airport the implied total aeronautical charge per passenger in 2004/05 was \$9.56,⁶¹ averaging across both international and domestic passengers. Given Qantas' estimates that aeronautical charges comprise around 5 per cent of total costs, then a substantial increase in aeronautical charges will have only a small impact on the passenger cost of air travel. It is therefore difficult to imagine that even substantial changes in aeronautical charges would have a large effect on the demand for airport services, thereby significantly affecting revenue for non-aeronautical services.

It follows that any potential loss in non-aeronautical revenues resulting from aeronautical service charge increases is likely to be small. The scope for revenues from non-aeronautical services to act as a constraint, which are likely to have an own-price elasticity that is many times greater than that for aeronautical services, is therefore also small. In other words, the financial gains from increasing aeronautical charges are likely substantially to outweigh any potential loss in net revenues from non-aeronautical services.

This conclusion is consistent with the findings of the Australian Competition Tribunal in considering the potential declaration of domestic airside services at Sydney airport:

We are satisfied that the ability of SACL to exercise monopoly power in relation to the airlines' use of the Airside Service is not subject to any effective constraints. We do not consider that ... SACL's ability to derive non-aeronautical revenues operates as a sufficient constraint on SACL's monopoly power.

The Tribunal concluded that while the existence of non-aeronautical revenues might reduce charges compared to the unconstrained monopoly pricing outcome, it does not prevent an airport operator from being willing to increase charges well beyond the efficient level. The Tribunal observed that:⁶²

There was general agreement among the economic experts that ... the constraining effect of non-aeronautical revenues was not significant. For example, Mr Houston, who was called by SACL, accepted that the existence of non-aeronautical revenues alone was not sufficient to eliminate SACL's incentive to increase the charges for the Airside Service above their current level. It appeared that the existence of non-aeronautical revenues might be relevant if SACL sought to set its Airside Service charges at the profit-maximising price. However, it was apparent from the modelling carried out by the economic experts that this profit-maximising price was significantly above the current level of Airside Service charges.

... If there was to be any constraint as a result of non-aeronautical revenues, that would only occur if the Airside Service charges were raised to levels substantially higher than they are presently set at.

In our view, existing aeronautical charges at all Australian airports are likely to be well below the level at which non-aeronautical revenues could become an effective constraint. This is

⁶¹ This figure excludes revenue from charges related to security services. ACCC, (2006), *Airport price monitoring and financial reporting: 2004-05*, p119.

⁶² *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at paras 511 - 512.

because the own-price elasticity of aeronautical services will be substantially lower than the own-price elasticity of non-aeronautical services, since the cost of aeronautical services represents only a modest proportion of the cost of air travel. Consequently, there is no basis to conclude that the effect on non-aeronautical revenues offers any effective constraint on the exercise of market power in the provision of aeronautical services.

4.2.2. Extent and impact of countervailing power of airlines

The second factor examined by the Commission as a potential constraint on the exercise of market power in the setting of aeronautical charges was the extent of countervailing power held by airlines. Airline countervailing power may arise either through an arrangement of mutual dependence, where both parties face a similar degree of loss where that arrangement is sub-optimal, or it may arise because both parties have recourse to ‘outside options’.

For airline countervailing power to be an effective constraint, both parties must have similar, or relatively balanced bargaining power. This was identified by Professor King in a submission to the 2002 inquiry.⁶³

To determine if countervailing power is relevant, the analyst needs to consider the bargaining position of buyers and sellers. In particular, it is important to consider which parties will lose most from any failure to reach an agreement to trade the relative product.

Economic theory that examines the efficiency of negotiation and bargaining indicates that if one party has greater bargaining power, then this inequality can result in a less efficient negotiated outcome compared to a circumstance where both parties have equal bargaining power.

A good example of countervailing market power is the long term relationship between a retail shopping complex owner – like Westfield – and a major retailer – like Coles Myer. In these circumstances the shopping complex owner is dependent on securing a major retailer to occupy space because it enhances the retail value of other space within the complex. Similarly, a major retailer also wants to be co-located within a large complex since this is likely to attract more potential customers. At the outset of a major retailer’s location decision, the relative bargaining strength can be presumed to be fairly equal, with negotiation resulting in efficient charges for retail space.

The critical characteristics that influence the relative bargaining power of any two parties include, but are not limited to:

- § the availability of information on the market and its participants;
- § the relative magnitude of the benefits to be gained through negotiation between the parties; and
- § the opportunity to choose to negotiate or not with the participant.

These characteristics are similar to those identified by the Commission in determining relative bargaining power. In particular they identify the options available to airlines and

⁶³ Page 192, Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, Report No. 19, January.

airports in a particular situation, the profitability of routes to airlines, the impact of any reductions in demand on airport profitability and the relative size and financial position of airports and airlines.

In assessing the presence of countervailing market power at Australian airports the Commission found at Finding 7.2:

The countervailing power of airlines in their dealings with major capital city airports appears limited. However, airlines may have a degree of countervailing power even at those airports where there is scope for airport substitutions (for example, entry ports for international flights), where airlines form alliances and bargain as a group, or where selective threats can be made to reduce services that are highly profitable to airports.

For smaller core-regulated airports, airline countervailing power is likely to be stronger, due to the commercial strength of major airlines relative to smaller airports, the market segments served by those airports and greater scope for airport competition.

In practice, for airlines like Qantas that operate a network of passenger and freight transport services covering all major cities, walking away from negotiations with a single airport is not practicable. As we discuss in greater detail in section 4.4 below, this substantially limits the extent of any countervailing power. The formation of negotiating alliances with other airlines is unlikely to change the fundamental absence of ‘outside options’ for airlines negotiating with any of the capital city airports.

While countervailing power is likely to be stronger at smaller, regional airports where there are potentially more alternate options, in practice, where there are few direct substitutes then airlines will still operate services while they remain profitable. This means that there is still likely to be some scope, however diminished compared to capital cities, for smaller airports to exercise market power.

It follows that the existence of any ‘countervailing power’ arising from the fact that airlines are large, well resourced and reasonably well informed customers of monopoly suppliers of aeronautical services is better characterised as a factor to consider when determining the appropriate form of regulation, rather than whether it has the potential to act as a direct constraint on the exercise of market power.

4.2.3. Airport price structures and price discrimination

In addition to its finding that the exercise of market power by airports is constrained by the existence of non-aeronautical revenue and by other factors, the Commission found that any efficiency losses arising from the exercise of market power would be minimal. The basis for this finding was the ability of airports to price discriminate between different airlines or different destinations, thereby limiting any loss of efficiency in the use of airport services. Price discrimination in this context would take the form of differences in the charges set for similar services across different customers, such that the more price-responsive customers are offered a lower price.

Price discrimination arises when different prices are charged to different customers who receive the same or similar good or service. For price discrimination to be effective it requires a supplier to be able to segment the market into groups on the basis of their willingness to pay for the good or service. To the extent this is practicable, the supplier is

able to extract some of the ‘consumer surplus’ associated with the provision of the good or service to customers with a higher willingness to pay, without affecting the utilisation of the good or service by the marginal customer with the lowest willingness to pay. By segmenting the market in this way, a supplier will increase its overall profits.

To the extent that price discrimination is feasible, it reduces the loss of efficiency that otherwise arises when a supplier exercises its market power by means of a uniform inflated price. Efficiency losses are minimised through price discrimination since a lower price is charged to marginal users, who would not otherwise have used the service.

However, it is important to recognise that while price discrimination (if feasible) might encourage the efficient use of *existing* resources, it does not necessarily lead to efficient outcomes in the long run. Assuming for the moment⁶⁴ that airports can effectively price discriminate, allocative efficiency in the use of aeronautical services by airlines would not be distorted. However, price discrimination does not necessarily serve the interests of other dimensions of economic efficiency, ie, productive (maximising output from given inputs) and dynamic efficiency (maximising improvement to productive and allocative efficiency over time).

Specifically, if price discrimination is applied to input goods, such as in the provision of aeronautical services to airlines, it is likely to reduce the incentives of airlines to invest and develop the provision of services to their own customers. This is because any consumer surplus that would otherwise be earned by the airline is extracted by the airport, thereby eliminating any incentive to increase final good demand. Consequently, while airport price discrimination might result in the efficient use of existing resources, it is likely to compromise innovation and investment by airlines, and so lead to inefficient outcomes in the longer run.

Given the demanding informational requirements of *perfect* price discrimination, the Commission instead considers discrimination for broad groups of consumers. This approach is commonly referred to as third degree price discrimination, or market segmentation, where the market is split into groups of customers and arbitrage between these groups is prevented.

However, when set alongside a uniform monopoly pricing regime, market segmentation is *not* necessarily more efficient,⁶⁵ since market segmentation is not certain to increase the quantity supplied; this is because the reduction in demand in the low elasticity market might outweigh the increase in demand in the high elasticity market.

As for perfect price discrimination, for market segmentation to be successful, the supplier must know the demand characteristics of the groups into which the market is to be segmented. Moreover, a supplier must have access to sufficient information on an ongoing basis to be able to adjust prices for changes in the demand characteristics of the various segments. These

⁶⁴ As we outline in section 4.2.3.1 this assumption is not likely to be valid for airports.

⁶⁵ Church and Ware, *Industrial Organisation, a Strategic Approach*, McGraw-Hill, 2000, Chapter 5. Market segmentation is unambiguously less efficient than uniform monopoly charging if total output decreases, however even if total output increases, it is not necessarily more efficient, because the consumer surplus may be distributed between consumers inefficiently.

requirements are non-trivial. The efficiency of market segmentation is limited significantly to the extent that such information limitations exist.

4.2.3.1. Price discrimination in aeronautical charges

A critical limitation on the scope for price discrimination in aeronautical charges is that such practices cannot directly affect the airfares paid by individual passengers, because airports have no direct relationship to passengers. As the ACCC has observed:⁶⁶

To perfectly price discriminate an airport must be able to not only distinguish between particular airlines and particular flights, but also distinguish between individual travellers on each flight. The information requirements to enable such pricing behaviour are obviously extremely high.

In its assessment of this point, the Productivity Commission has taken the view that “reasonably effective price discrimination” may result from a combination of airport charging practices and discrimination among passengers on particular flights by *airlines*. The Productivity Commission found that airlines will treat landing charges as a fixed cost, and allocate that cost across passengers in such a way that passengers with a higher willingness to pay for the flight bear more of the cost. The Commission concludes that:⁶⁷

[W]eight-based aeronautical charges combined with airline yield-management can result in reasonably effective price discrimination.

This highlights the dependence of effective price discrimination, in the context of aeronautical charges, on two separate pricing relationships, that between the airport and airlines, and that between the airline and its passengers. The Commission’s conclusion will only be valid to the extent that price discrimination is achievable in *both* of these relationships.

In our view, the scope for effective price discrimination is limited in both cases.

In developing their own pricing policies, airlines do not have full knowledge of the demand characteristics of their customers, and so are limited to imperfect approximations, such as the distinction between business and economy passengers, and restricted or unrestricted tickets. In any case, it seems reasonable to conclude that airlines are already seeking all available opportunities to segment passenger demand for air travel and are setting prices accordingly, irrespective of the ability of airports to do this through aeronautical charges.

Airports are in any case likely to be limited in their ability to segment the market with respect to their airline customers, say, into full service and low cost carriers, or by destination. For effective price discrimination, airports would be required to adjust aeronautical charges to changes in the marginal value of these potentially different services to different customer types. This value is likely to be dependent on a range of constantly changing circumstances in the market for airline services, including both seasonal effects and those affecting the

⁶⁶ Australian Competition and Consumer Commission, 2001, *Submission to the Productivity Commission’s Inquiry into Price Regulation of Airport Services*, p54.

⁶⁷ Page 200, Productivity Commission, 2002, *Price Regulation of Airport Services: Inquiry Report*, Report No. 19, January.

specific circumstances of each individual airline. Airports are unlikely to have sufficient ongoing information on airline willingness to pay for aeronautical services at each point in time to have the ability to adjust aeronautical charges in response.

4.2.3.2. Price discrimination by airports in practice

Finally, when considering the potential for price discrimination by airports to minimise the impact on efficiency, it is useful to consider whether price discrimination is in fact practiced by any airport when determining aeronautical charges. As far as we understand, aside from the different rates that in some cases apply for domestic as distinct from international passengers, airports in Australia set uniform charges for aeronautical services.

Moreover, to the best of our knowledge, airports elsewhere in the world also do not price discriminate in the setting of aeronautical charges. This suggests that the effectiveness of price discrimination as a means to minimise efficiency impacts should be considered with some caution.

In 2002 the Commission considered the scope for price discrimination under a non-uniform, passenger-based charging system, through the adoption of various practices including:

1. charging based on the time of day;
2. different charges for international as compared with domestic flight services; and
3. start-up and other incentives to encourage marginal airlines.

None of these practices, however, may properly be characterised as price discrimination. Time of day charging seems more likely to be a form of price differentiation than price discrimination, the purpose of which would be to reflect the higher costs of providing peak-time capacity so as to manage airport congestion. There are also cost differences as between domestic and international flights, with the former not generally involving the use of terminal space, which is often provided by airlines directly under long term lease agreements.⁶⁸ Consequently, to the extent there are such cost differences, these pricing methods do not amount to actual price discrimination.

In principle, price discrimination between customers can reduce the efficiency impacts of higher charges to segments of the market. However, in practice, it is generally very difficult to implement. In our opinion, the scope for price discrimination in aeronautical charges is quite limited; hence any contention that it is capable of reducing significantly the inefficiencies caused by the exercise of airport market power lacks credibility.

4.2.4. Summary

The factors identified by the Commission as placing constraints on the exercise by airports of their market power in the setting of charges for aeronautical services are not likely to be sufficient to place an effective constraint on the exercise of market power.

⁶⁸ For example, Qantas has informed us that price differentiation between international and domestic flight services is largely driven by differences in aeronautical costs between these service categories.

The following section considers the evidence since 2002 to determine the extent to which airports have acted without constraint in their approach to the setting of both the price and non-price terms for aeronautical services.

4.3. Evidence on the ability to act without constraint

Chapter 3 sets out our conclusion that, since the change to commercial negotiation with price and quality monitoring as the regulatory framework for determining aeronautical charges at the major airports, there have been significant increases in these charges.

For example, average reportable aeronautical revenue per passenger (a proxy for average aeronautical prices) at the four airports identified by the Commission as possessing substantial market power (Sydney, Melbourne, Perth and Brisbane), has increased by more than 50 per cent since the removal of price cap regulation in 2001-02. Operating margins per passenger have also increased significantly during the period, suggesting that the price increases cannot largely be explained by cost increases.

In our view, this evidence suggests the airports have the ability and incentive to act without the constraints that would normally be implied by effective competition. It is also consistent with our view that, having considered the factors identified by the Commission, the constraining factors identified by the Commission in 2002 do not, in fact, amount to an effective constraint.

Nevertheless, there are several potential explanations for these observed changes in the charges and operating margins per passenger. For example, it may be the case that:

- § the efficient cost of providing the services has increased;
- § prior to the change in the regulatory regime, charges were below those required for the recovery of efficient costs;
- § increases in particular charges have arisen because of changes in the allocation of costs between charges; or
- § the quality of service has improved.

This section considers these other potential explanatory factors. We conclude that they are not sufficient (together or alone) to explain the evidence presented in section 3, and so the observed price changes can only be explained by the ability of airports to act without constraint.

This conclusion is reinforced by the two case studies discussed in section 3, ie, the conduct of SACL in the context of negotiations with Jetstar, and the asset-valuation inspired increases in aeronautical prices at Perth airport. Both these examples amount to unambiguous instances of the exercise of market power by airports.

4.3.1. Quantitative evidence

Section 4.1 above explains that market power amounts to the ability to price without constraint, for a sustained period.

At section 3 we presented evidence of increases in reportable aeronautical revenue per passenger since the removal of price cap regulation in 2001-02. These included a 13 per cent increase at Sydney airport; a 66 per cent increase at Melbourne; an 80 per cent increase at Perth and a 48 per cent increase at Brisbane. The ACCC observes that there were⁶⁹ “sharp increases” in reportable aeronautical revenue per passenger in 2001-02 and 2002-03, when price caps were removed. These ranged from approximately 9 per cent to over 100 per cent.

Moreover, operating margin per passenger has increased at all airports since 2002-03, “as a result of increased activity that has seen revenues increase while costs have remained largely fixed.”⁷⁰ For Melbourne, Perth and Brisbane airports (all of which were identified by the Commission as possessing substantial market power), the largest single year increase in operating margin occurred in 2002-03, the first year since the removal of formal price controls and the introduction of the price monitoring arrangements.

This evidence suggests that airports have continued to be able to exercise their market power, despite the price monitoring arrangements.

4.3.2. Consistency of quantitative evidence with other explanations

Nevertheless, there are several alternative potential explanations for these observed changes in the charges and operating margins per passenger.

4.3.2.1. An increase in the efficient cost of provision of services

If the underlying efficient cost of the provision of aeronautical services had increased aeronautical charges could be expected to increase during the period. Such a scenario would be consistent with the Government’s review principles, which state that airport revenue should not be “significantly above the long-run costs of efficiently providing aeronautical services...”⁷¹ Moreover, if the efficient cost of the provision of services had increased, then an increase in charges would not be likely to bring about a substantial increase in operating profits.

The evidence suggests there have been both some increases and some decreases in aeronautical costs. For example, at Perth airport costs increased by 21 per cent while for Sydney airport they decreased by 16 per cent. The cost of aeronautical service provision for Melbourne and Brisbane airports also increased, by 1.5 and 2.2 per cent respectively.

However, the extent of these cost changes are modest when compared with increases in aeronautical revenue per passenger since 2001-02 of 13 per cent at Sydney airport, 66 per cent at Melbourne, an 80 per cent increase at Perth and a 48 per cent increase at Brisbane. It follows that, even if the costs incurred had been universally efficient, they would not account for the entire change observed in revenue since 2002.

⁶⁹ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p1

⁷⁰ ACCC, *Airport price monitoring and financial reporting: 2004-05*, p25

⁷¹ Joint Press Release, Minister for Transport & Regional Services, Treasurer, 13 May 2002

We conclude that it is not possible to explain the observed increases in aeronautical revenue and operating margin per passenger by reference to increases in the efficient cost of provision of services.

4.3.2.2. Inefficiently low charges prior to the price monitoring regime

It might be contended that, prior to the move to price monitoring, charges were below those required for the recovery of efficient costs. In that circumstance, an increase in charges could be consistent with the principle that revenue should not be above long-run efficient costs, and would not result in supra-competitive profits.

In the absence of a material increase in new investment of recurrent costs, a contention that charges were inefficiently low prior to the introduction of price monitoring amounts to a claim that returns on existing assets should be increased or, equally, that those existing assets should be revalued upwards for the purposes of determining future prices.⁷²

Setting aside the economic pros and cons of adopting a higher value for existing assets for the purposes of determining aeronautical prices, as we discuss in section 5.3, upward revaluations of regulatory asset values should also be accounted for in the determination of the revenue required to be earned from aeronautical charges. Any revaluation of aeronautical assets base that is not also netted off the revenue sought to be earned from those assets amounts to the securing of a windfall gain to the airport, at the expense of its customers. Such windfalls gains are only able to be secured through the exercise of market power.

In our view, to the extent that charges could be shown to be inefficiently low prior to the price monitoring regime (and this itself is highly debateable), the unilateral imposition of such a change would not be possible unless the airport was able to set prices without any material constraint.

4.3.2.3. Changes in the allocation of costs between charges

The need for increases in individual charges may arise from changes in the extent to which individual services are to be priced separately from others – such as the introduction of fuel throughput charges or taxi access fees. Such developments may also arise from changes in the allocation of costs between charges. However, such developments would normally be associated with reductions in other charges, as costs are reallocated and changes made to the degree of pricing granularity between services.

Such developments would not normally give rise to increases in total revenues, since cost reallocation or new pricing policies should have an offsetting impact.

It follows that changes in the allocation of costs between charges are not able to explain either the observed increases in aeronautical revenue per passenger or the observed increases in operating margin per passenger.

⁷² We discuss the issue of revaluations and the implication for efficiency in greater detail in section 5.2. This issue is also discussed further in the context of the case study of asset revaluation at Perth airport below.

4.3.2.4. Improvements in the quality of service

Increases in aeronautical charges could be expected to be observed in the absence of the exercise of market power if the quality of service has improved. Quality improvements consistent with the needs of customers – and the commensurate price increases - would not indicate an ability to act without constraint.

An evaluation of the extent to which this may explain the price increases discussed above would require an assessment of the extent to which there have been substantial improvements in the quality of services provided.

Since the commencement of airport privatisations the ACCC has monitored airport service quality through passenger and airline surveys. The most recent report indicates that service quality for the monitored airports has ranged from satisfactory to good, with little change over the three year period.⁷³

Given that the ACCC has not identified any significant change in the quality of service provision that might explain significant changes in aeronautical charges, we conclude that improvements in the quality of service are not sufficient to explain the quantitative evidence presented in section 3.

4.3.2.5. Summary

The alternative explanatory factors examined above are not sufficient to explain the quantitative evidence presented in section 3. Consequently, we conclude that airports have increased charges substantially in excess of those implied by the legitimate explanations discussed above. It follows that the observed changes in aeronautical operating margin per passenger and revenue per passenger are consistent with airports being able to act without constraint, and so having secured these outcomes through the exercise of their market power.

4.3.3. Consistency of case studies

The above conclusions on the ability of airports to act without constraint are reinforced by evidence presented in the two case studies in section 3.

In particular, Perth airport was able to impose a substantial increase in its prices (following a unilateral decision to increase substantially the value of its aeronautical assets), apparently without constraint, even though there had not been a change in its forward-looking efficient costs of anything like the same magnitude. Similarly, and consistently with the findings of the Competition Tribunal, SACL was able to adopt an approach to its negotiations with Jetstar that involved exercising its monopoly power without any apparent constraint.

4.4. Effectiveness of price monitoring and commercial negotiation

The current light-handed regulatory regime for airports has two principal features, ie:

⁷³ Australian Competition and Consumer Commission, 2005, *Quality of service – price monitored airports*, November.

- § it provides for the commercial negotiation of terms and conditions for the provision of aeronautical services by airports to airlines, including charges for those services; and
- § it requires airports to provide information to the ACCC for the purpose of undertaking price and service quality monitoring.

This regime differs from the previous, ‘heavier-handed’ regulatory framework that featured direct price controls for aeronautical services for core-regulated airports within a CPI-X revenue cap. Additionally, under the previous regime airports were deemed declared for the purposes of Part IIIA of the *Trade Practices Act 1974*, pursuant to section 192 of the *Airports Act 1996*. The consequence was that airlines had recourse to the arbitration provisions of Part IIIA in the event that negotiations became frustrated in any way.

To evaluate the effectiveness of the current regulatory regime it is useful to compare it with the characteristics and expected outcomes that would ensue if airports and airlines operated in an effectively competitive market. Effective competition is a useful benchmark for assessing regulatory arrangements, and is widely recognised by economists as an appropriate basis for regulatory design. Professor Alfred Kahn states for example:⁷⁴

... the single most widely accepted rule for the governance of the regulated industries is to regulate them in such a way as to produce the same results as would be produced by effective competition, if that were feasible.

The cost of deviations from the effectively competitive outcome needs to be assessed against the potential benefits of enhancing the current framework, given all of the specific circumstances applying in the airport industry. In undertaking such an evaluation, the potential costs of the existing commercial negotiation regulatory regime with price and service quality monitoring need to be balanced against the potential benefits from an alternative regime that seeks to resolve some of the identified deficiencies.

4.4.1. Characteristics of effectively competitive markets

A common approach to determining the price or value of a good or asset in an effectively competitive market is to determine the price a ‘willing but not anxious’ buyer would be prepared to pay, and compare that with the price a ‘willing but not anxious’ seller will accept.⁷⁵ The resultant price is considered to be that which reflects an effectively competitive market.

Justice Isaacs explained the principle as follows, in the context of land valuation:

To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either

⁷⁴ Kahn, A., 1988, *The Economics of Regulation, Principles and Institutions, Volume I – Economic Principles*, Massachusetts Institute of Technology, p17..

⁷⁵ The test of a ‘willing but not anxious’ buyer and seller was developed by Justice Isaacs in *Spencer v The Commonwealth* (1907) 5 CLR 418 in the context of considering the appropriate valuation for compensation arising from the compulsory acquisition of land in North Fremantle by the Commonwealth.

advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to person best capable of forming an opinion, of a rise or fall for whatever reason in the amount which one would otherwise be willing to fix as the value of the property.

While this formulation of the appropriate approach to valuing land has been widely adopted in subsequent cases and various legislative instruments as the test for land valuation, it can also be usefully applied to describe the characteristics of an effectively competitive market. These can be summarised as follows:

- § voluntary bargaining between the parties;
- § willingness to undertake a trade;
- § not so anxious as warranting the overlooking of any ordinary business consideration; and
- § the provision of sufficient information to make an appropriate valuation.

In a market with many buyers and sellers, all of these characteristics are ordinarily satisfied. Bargaining between the parties is voluntary since buyers and sellers have choices over with whom they transact, and so neither party need become anxious about transacting with any specific party.

There is generally a willingness from both parties to undertake the trade since the benefits are not gained unless the transaction occurs. Ordinary business considerations will not be overlooked since no individual has sufficient market power such that ordinary business considerations are required to be overlooked to ensure the trade occurs. Finally, there is sufficient market information to allow an informed decision about the benefits and costs associated with any given transaction.

We now turn to a consideration of these factors in the context of the market for aeronautical services.

4.4.2. Characteristics of aeronautical services markets

By contrast to an effectively competitive market, the provision of aeronautical services at capital cities is characterised by a single seller that, as we discuss in section 4.3 above, has market power as a consequence of its geographic location and the limited alternative options available to its users. In that circumstances, airlines are unlikely to be ‘willing but not anxious’ purchasers of aeronautical services. This is because:

- § meeting the needs of passengers requires they fly to each major city, for which they have limited or no opportunities to transact with alternative airports to supply aeronautical services;
- § previously sunk investments in airport-specific infrastructure, such as maintenance facilities, mean that the cost of relocation is potentially high;
- § the need to negotiate with airports across a wide range of potentially unconnected issues means that ordinary commercial considerations in one area may be forced to be traded against the need to finalise agreements in other areas, despite a lack of willingness if negotiating circumstances were different; and

- § the lack of recourse to effective dispute resolution procedures in the event that disputes arise.

These features of the negotiation of terms and conditions associated with aeronautical services suggest that airlines, all other things being equal, are likely to be more willing to concede on issues that, had ordinary commercial conditions prevailed, would not be conceded. This is particularly the case if dispute resolution mechanisms are unavailable.

These problems are compounded by the apparent absence of airports' willingness to negotiate because:

- § there are incentives not to finalise negotiations and agreements, since an airport generally receives the benefits of the transaction in any case – this is compounded by the fact that current operational arrangements were already in place prior to the implementation of commercial negotiation with price monitoring;
- § the existence of unconstrained market power and the fact that airlines that must use the services in any case eliminates the commercial imperative to conclude negotiations.

The observation that airlines are likely to be anxious in negotiating terms and conditions for the provision of aeronautical services, and that airports cannot be expected to be willing to finalise negotiations suggests that there is unequal bargaining power between the parties. Such circumstances can be expected to give rise to prices that are higher, and non-price terms that are less favourable than would be the case if the market was effectively competitive.

These observations also suggest that modifications to the regulatory arrangements are warranted to provide incentives for airports to undertake negotiations and finalise commercial agreements, and to ensure that airlines are not forced to negotiate away elements that would ordinarily be included in a commercial agreement.

For the current price monitoring arrangements to provide effective incentives for airports to seek a negotiated outcome, the related threat of re-regulation arising from outcomes that are not consistent with effectively competitive markets must be credible. The credibility of the threat of re-regulation is affected by the clarity of understanding of the line between acceptable and unacceptable conduct, in combination with clear, open and transparent institutional arrangements for implementing regulation in the event that the line is crossed.

In the absence of clarity regarding the basis for and processes by which the threat of re-regulation may come about, any threat of re-regulation will lack credibility, and therefore effectiveness.⁷⁶ The consequence is that the incentive for airports to negotiate with airlines and agree to charges approaching a competitive level is seriously compromised.

In the case of current price monitoring arrangements for airport charges, although there have been some statements regarding the threat of re-regulation,⁷⁷ in practice the threat has lacked

⁷⁶ See, for example, NERA, 2004, *Alternative Approaches to 'Light-Handed' Regulation*, Report for the Essential Services Commission, Victoria, pp25–29.

⁷⁷ The Government indicated that it would re-introduce price controls at the end of the probationary five year period of price monitoring if it found that airports had operated inconsistently with the regulatory objectives outlined in section 2.3, Treasurer and Minister for Transport & Regional Services, *Joint Press Release: Government response to the Productivity Commission Report on Price Regulation of Airport Services*, 13 May 2002.

credibility. This is because the line between acceptable and unacceptable changes in charges is not known, and the process of implementing re-regulation is not clear, open and transparent. Importantly, the decision to re-regulate aeronautical charges is also likely to be heavily influenced by political considerations, rather than by means of dispassionate, independent analysis of the relevant issues.

Assuming that price monitoring is effective at providing incentives for airports to undertake commercial negotiations with airlines, as noted above it represents only half of the relevant picture for efficient outcomes. The other half requires airlines to have sufficient bargaining power to not concede issues in a negotiation that would otherwise be incorporated in an ordinary commercial agreement. While the Commission contended that there are constraints on airports' ability to exercise market power, as we outline in sections 4.2 above, these constraints are unlikely to be effective. Since they are not effective, airlines can best be characterised as 'willing but anxious' buyers of aeronautical services. This is not expected to deliver efficient outcomes.

As we outline in section 4.3 above, the evidence suggests that airports have sufficient market power to dominate negotiations, such that the negotiated charge or terms and conditions are unlikely to be commensurate with an efficient charge arising from a balanced negotiation.

Two examples in particular from the evidence since 2002 allow us to infer that commercial negotiations have, in practice, not been effective. First, there have been ongoing debates between airports and airlines about the asset values to use when determining aeronautical charges. In ordinary commercial negotiations based on relatively equal bargaining power, the parties normally agree the underlying assumptions upon which negotiations proceed. Because airports and airlines were already in a relationship for the provision of services at the introduction of price monitoring, there was little incentive for airports to agree to the asset base to use for the purpose of determining charges. In addition, there has been no agreement as to the process of recovering new capital expenditure through charges, or the treatment of re-valuations to the asset base.

Questions surrounding the asset value and approach to modifying it through time have been the single most significant issue hindering negotiations for aeronautical service agreements between airports and airlines. As we discuss in section 3.3 above, the asset bases of a number of airports have been significantly increased since 2002. We discuss the implications of this in chapter 5 below.

Second, despite ongoing negotiations, there have been few long term commercial pricing agreements finalised between Qantas and airports, see Table 3.1 above. The protraction of commercial negotiations has arisen because there is currently no scope for commercial arbitration in the negotiation process, and airports have little incentive to finalise these agreements since airlines are required to pay aeronautical charges for using airport services, regardless of an agreement being reached. In other words, the uneven bargaining power, lack of a credible threat of re-regulation or recourse to dispute resolution means that airports in general have little incentive to negotiate an efficient charging outcome.

4.4.3. Constructive engagement

The incentives of airports not to negotiate, and for airlines to concede elements within negotiations that would not be conceded if airports and airlines had equal bargaining power, has also been identified in other international contexts.

Specifically, the UK Civil Aviation Authority (CAA) has recently developed a regulatory approach that it has termed ‘constructive engagement’. An important objective of this approach is to reduce the transactions costs associated with period reviews of aeronautical charges.⁷⁸ Constructive engagement in that jurisdiction involves a facilitated negotiation between airlines and airports on many of the regulatory parameters used in the determination of airport services, such that only matters of dispute between the parties are brought before the regulator for determination.

It is important to note that constructive engagement is being implemented within a managed framework where parties are able to seek decisions from the CAA on matters that are unresolved.

4.4.4. Addressing the effectiveness of the current regime

In our opinion, there are two principal aspects of the current commercial negotiation and price monitoring regime that result in its effectiveness being diminished.

The first is the lack of an effective incentive of airports to engage in constructive negotiations on the terms and conditions of aeronautical services. The current price monitoring regime does not, in itself, provide a sufficient basis to balance the degree of unconstrained market power currently possessed by the major airports. The result is an imbalance of negotiating power between airports and airlines.

In our view, this imbalance could be addressed, and the incentives for commercial negotiation substantially improved, through the mandatory introduction of a binding dispute resolution mechanism that was able to be invoked by one or other party, as a circuit breaker if negotiations break down. This is discussed further in section 5.

Second, the existing threat of re-regulation and the Government’s associated objectives or principles for determining airport charges lack both clarity and credibility. Neither aspect of the current arrangements represents an effective or efficient mechanism for addressing the imbalance of negotiating power that currently exists between airports and airlines. The need for clarity on the approach to asset valuation in particular is also discussed in section 5.

⁷⁸ Civil Aviation Authority, 2005, *Airport Regulation – the process for constructive engagement*, May.

5. Recommendations for Further Reform

Chapter 4 of this report finds that airports have, in practice, been able to operate without constraint in the determination of price and non-price terms for aeronautical services. This finding underlines that the existing price monitoring regime is not effectively constraining airports from exercising their market power.

The absence or ineffectiveness of constraints on airports' market power has led to a position of imbalance in the commercial negotiation of aeronautical charges, and this in turn has led to protracted delays and the unilateral imposition of outcomes that would not be expected if both parties were engaging on a willing but not anxious basis.

The two features of the current regulatory regime that have led to negotiation/price monitoring not being effective at achieving efficient aeronautical charges include:

- § the lack of incentives for airports to approach the negotiation of airport charges as if they were subject to an effective, outside constraint; and
- § the absence of agreement between airports and airlines on the underlying assumptions to use when determining charges, particularly the value of the asset base.

This chapter focuses on identifying further reforms that are capable of bringing about a more effective regulatory regime. These reforms include:

- § amending the regulatory framework to provide for binding dispute resolution arrangements to apply during the commercial negotiation phase, so as to create incentives for airports and airlines to negotiate effectively; and
- § establishing an initial asset value for the purposes of determining aeronautical charges and facilitating the development of a methodology for how asset value changes through time are included in charges.

5.1. Binding dispute resolution

Binding dispute resolution procedures are a common feature of contractual relations where one or both parties have committed substantial resources, which are dependent upon the contracted arrangements being maintained. The reason for the inclusion of binding dispute resolution procedures is a desire to have simple, cost effective methods for resolving disputes in circumstances when 'walking away' is not an attractive option for either party. The unattractiveness of options outside the services being bought or sold under the contract usually arises because the parties have each made investment commitments that are specific to the services provided by or to the other – such as a long term lease for retail space.

In ordinary commercial negotiations there is generally no need to have formal dispute resolution mechanisms to assist with the initial process of finalising a commercial agreement. This is because the presence of many potential buyers or sellers at the time the agreement is entered into (such as the point at which a retailer or commercial tenant selects space over which it plans to take a long term lease). However, in the context of negotiating access to monopoly infrastructure, there may be limited or no opportunities to negotiate with alternative suppliers of the infrastructure service and so, without some form of regulatory

oversight or circuit breaker, the purchaser of such services may not be in a position to negotiate a role for binding dispute resolution.

It is for precisely this reason that the focus of access regulation is on the role of dispute resolution procedures for disputes involving the terms and conditions of access to essential infrastructure industries. For example, in the context of reviewing light-handed forms of regulation within the National Gas Access Regime, the Productivity Commission found that (recommendation 8.3):⁷⁹

... under the proposed monitoring regime should include at a minimum:

§ processes for negotiating access

§ dispute resolution procedures (including provision for binding commercial arbitration).

This recommendation was made to ensure that gas pipeline access providers have incentives to negotiate in good faith with potential access seekers within a proposed light-handed monitoring regime.

Similar principles in support of including dispute resolution procedures are incorporated in the Competition Principles Agreement (clause 6.4) and have subsequently been developed in the access provisions of Part IIIA of the *Trade Practices Act 1974* (the 'TPA'). A central tenant of these provisions is that access seekers have recourse to binding arbitration in the event that negotiations prove unsuccessful.

The current price monitoring and commercial negotiation regime provides no arrangements for dispute resolution in the event that agreement cannot be reached in the course of negotiations. The almost universal absence of any binding dispute resolution mechanism (other than that provided for under the 'declaration' provisions of Part IIIA) results in airports having little or no incentive to conclude commercial agreements, particularly where some compromise is required between airports and airlines for their resolution (as would be the case in a competitive market).

In our opinion, the current arrangements should be modified so as to provide for independent dispute resolution in the event that price or non-price terms for the provision of aeronautical services cannot be agreed between an airport and airline. Such an arrangement would not involve compromising the objectives that apply to the current regime, ie, to facilitate commercial negotiation between airports and airlines. Rather, its role would be to increase the effectiveness of the current regime by improving the underlying incentives of airports and airlines to reach agreement.

5.2. The importance of resolving asset value uncertainty

A crucial task in the development of more effective negotiation framework between airports and airlines is resolution on the approach to the valuation of aeronautical assets for pricing purposes. Disagreement on the approach to aeronautical asset valuation is the single most important issue stalling the finalisation of commercial agreements on aeronautical charges at

⁷⁹ Page 355, Productivity Commission, Review of the Gas Access Regime.

most airports. Its fundamental significance to pricing outcomes tends also to infect negotiations on a wide range of related matters between airports and airlines.

In ordinary commercial negotiations, the parties usually agree the basis upon which prices for services will be reviewed during the term of the contract. This includes the principles to be applied and, for infrastructure assets subject to regulation, the basis on which the value of assets will be determined and re-determined. A fundamental problem with the current airports regulatory framework is the absence of clear guidance on this issue. In consequence, disputes over the approach to the valuation of aeronautical assets both dominate and impede negotiations between airports and airlines.

The financial value of aeronautical assets is equal to the expected value of the revenue stream from aeronautical charges less the cost of providing services. A financial value approach to valuing current assets means that asset values can only increase if revenue is expected to rise relative to costs. A unilateral increase in revenue without any corresponding increase in costs is only sustainable if the business has market power.

In general there are three regulatory problems that arise from asset valuation. These are:

- § establishing the initial asset base;
- § updating it over time for new investment, depreciation, etc; and
- § the potential revaluation of existing assets to account for changes in economic circumstances, such as consumer price inflation or any asset-specific effects.

Once the initial asset base has been established it should be relatively straightforward to update it through time by making adjustments for new capital investment, depreciation, disposals, and capital contributions. In addition, it may also be appropriate to allow for the revaluation of existing assets, so long as the prospect or reality of such revaluations are taken into account (by means of a credit) in determining the revenue collected from charges. Changes in the value of the asset base that do not reflect these changes in costs, or are not appropriately accounted for in determining the revenue to be collected from charges, will result in a windfall or supra-competitive gain to the owners of airports, to the detriment of airlines and their customers. Such windfall or supra-competitive gains can only accrue if airports are exercising market power.

We consider each of these problems in greater detail below.

5.2.1. Establishing the initial asset base

There are a number of different potential methodologies for determining the value of aeronautical assets (including land) for the purpose of determining aeronautical charges. The most appropriate approach will depend on the economic conditions facing the airport services provider, and the incentives for economic efficiency that are most relevant to those conditions.

In general, the opportunity cost of airport assets is an appropriate basis for determining the value of assets for pricing purposes where economic efficiency is a concern. However, opportunity cost itself is capable of a range of reasonable interpretations, and also depends on the facts and circumstances of each airport. By way of example, determining the value of airport land on the basis of its value in alternative use is likely to be appropriate when

establishing the asset value for pricing purposes of a government-owned airport operating near capacity, prior to its privatisation. This was the approach adopted for Sydney airport.

The phase I and phase II airports, and Sydney airport, were each privatised by means of a long term lease of both the land and associated facilities for the provision of airport services. The terms of that lease require the operator to continue to provide aeronautical services, and prevent the divestment of land for alternative non-airport related uses. On its face, the nature of these long term arrangements limits the extent to which alternative uses represent realistic opportunities for an airport operator. It follows that the relevant opportunity cost for the phase I and phase II airports post-privatisation is not necessarily the same as that applying to Sydney airport pre-privatisation.

The process of privatisation itself gives rise to an alternative measure of opportunity cost, being the price paid for an airport (and the aeronautical assets component of that airport) at the time of its sale to private investors. The purchase price obtained through a competitive sale process reflects the value of airport assets in their current use given expected revenues from aeronautical charges at the time of privatisation. Where privatisation sale value information is relatively recent and readily available, this would be an appropriate basis on which to value aeronautical assets where the regulatory arrangements did not involve any alternative, explicitly-derived regulatory asset value.

A number of alternative valuation methodologies are also consistent with an opportunity cost principle, including depreciated optimised replacement cost or DORC (the opportunity cost to a new entrant), scrap value (the opportunity cost of exit) and historic cost (the opportunity cost to investors).

The need to define and value the asset base at the instigation of commercial negotiation with price and quality monitoring regime was identified by the Productivity Commission in the price principles developed as part of its 2002 review and subsequently adopted by the Government. These principles indicate that:

At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a dual-till basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.

These principles contemplate that aeronautical assets would be defined and valued, to allow a return to be earned commensurate with the underlying risks. At the time of the privatisation of the phase I and phase II airports, the value of aeronautical assets is likely to have been based on the expected revenue that could be generated from those assets. The prospect of a windfall gain through the subsequent upward revaluation of those assets would not have been consistent with the regulatory and commercial risks at the time of privatisation. On that basis, in our opinion the regulatory value for the aeronautical assets of the Phase I and II airports should be derived from the price paid for those assets at the time of their privatisation, apportioned between the aeronautical and non-aeronautical elements of the total sale value.

Such an approach would be consistent with that taken in relation to Sydney airport, where the Government in its capacity as owner of the airport sought and gained approval from the ACCC for a substantial increases aeronautical charges, and a revised valuation of

aeronautical assets for pricing purposes. In essence, the ‘windfall’ gain arising from this process fell to the Government in the form of the higher privatisation proceeds than would otherwise have been the case. Given the approach undertaken for the Sydney airport privatisation, it is difficult to contemplate that the Government, when privatising the phase I and II airports, envisaged a circumstance where any windfall gains arising from fundamental change to the way assets were to be valued should subsequently fall to the private owners of those airports.

5.2.2. Updating the asset base through time

Once an initial asset base is established, there needs to be a process and principles for updating that valuation over time. Different approaches are possible, but the most common arrangement for Australian-regulated infrastructure - such as electricity, water and gas - is to adopt a roll-forward methodology. This is also the approach adopted by the ACCC when examining forward-looking revenues and costs in its decision on aeronautical prices to apply at Sydney airport prior to its privatisation.

This approach provides for the asset base to be updated by:

- § adding new capital investment;
- § subtracting depreciation;
- § subtracting the disposal of assets; and
- § subtracting any contributed assets.

The roll-forward methodology provides a basis for ensuring that a regulated business earns an appropriate rate of return on the assets employed in the delivery of regulated services.

The roll-forward methodology can include an allowance for inflation (by indexing the value of existing assets), so as to maintain the financial value of the asset base in real terms. Where an allowance for inflation is included in the value of assets for price setting purposes, then it is appropriate for those assets to earn a rate of return that is net of any inflation allowance.

The alternative approach is to account for inflation through the provision of a nominal rate of return on an asset value that is not adjusted for changes in inflation. The approach most commonly used in other regulated industries is to adjust the regulated asset base for inflation and use a real rate of return to account for the effects of inflation on asset values.

5.2.3. Revaluing the asset base

The indexation for inflation of the value of assets for price setting purposes is not the only approach that may be taken to updating the value of such assets. From an efficiency perspective, it may be appropriate to reflect in updates to the valuation of assets for pricing purposes any changes in economic circumstances that affect the value of such assets. The most common change is that associated with the value of land in its alternative use, since the land surrounding airports typically appreciates (or depreciates) according to economic circumstances. However, the economic case for making such changes may also be affected by the extent to which the airport owner has genuine choices in relation to the disposal or acquisition of airport land. To the extent that airport operators’ lease terms prevent them

from divesting land to be used for alternative forms of economic activity, the need to update asset values to reflect the value of those opportunities is diminished.

In any case, it is important to note that upward changes in the value of the assets⁸⁰ for the purposes of determining aeronautical charges form one element of the return (in the form of capital appreciation) earned by airport owners for the provision of aeronautical services. This is no different from many other investments that include both a rental cash return, and a return associated with the growth or appreciation in the overall value of the asset. It is also consistent with (but the mirror image of) the inclusion of capital asset depreciation as a cost to be recovered from the users of assets.

The rate of return that an airport owner earns from its investment should therefore reflect the underlying risks associated with the investment, and include both the cash return and the return associated with capital growth. This means that if the asset value grows because of changes in economic circumstances, the revenue earned by aeronautical charges should be adjusted downward to ensure that the overall return reflects the underlying risks.

In that circumstance, the revenue requirement from aeronautical charges should therefore equal an allowance for:

- § operating and maintenance expenses;
- § depreciation of the existing asset base;
- § corporate taxes (assuming a post tax rate of return is adopted); and
- § return on capital;

less any:

- § asset revaluations.

In practice, the process for incorporating any revaluation gains in charges may be operate by reference to expectations of future changes, or by means of an ex post wash-up of past changes, depending on what is intended or agreed for any particular price determination process. Significant or structural changes in asset values – arising, say, where it was desired to bring about a fundamental change in asset values post-privatisation for efficiency reasons – can be smoother over a number of years so as to minimise the scope for charges to fluctuate between years.

Nevertheless, the precise way in which asset revaluations are incorporated into the price-setting process over time is less important than the fundamental principle that upward changes in asset values represent a form of income to the provider of infrastructure services and so need to be netted off from the revenue that is to be recovered from charges for the use of those assets.

⁸⁰ It should be noted that the extent of any upward change may be assessed either on an expected or out-turn basis, with each approach implying a different allocation of forecast risks as between users and infrastructure owner. This same principle applies to increases in asset values due to new capital expenditure, and decreases due to depreciation.

5.2.4. Guidance on asset valuation methodology

Given the significant impact the approach to the valuation of the capital assets can have on aeronautical charges, and the intractable nature of this issue in negotiations to date between airlines and airports, it is crucial that the current impasse be resolved so as to allow commercial negotiation in other areas to develop.

The most appropriate means for achieving progress on this issue would be for the Commission and then the Government to provide specific guidance on the approach to determining the initial asset base, roll-forward methodology and approach to revaluations, for the purpose of negotiating aeronautical charges. One possible method of providing this guidance is through the development of principles to be used in any dispute resolution process developed as part of the regulatory regime, as adopted from the guidance provided above.

The discussion in the early chapters of this report highlight the incentives faced by airlines and airports and suggest that these matters are unlikely to be resolved under the current commercial negotiation framework with price and quality monitoring. For this reason specific guidance is necessary.

5.3. Conclusions

These proposed modifications to the existing regulatory framework for the commercial negotiation of aeronautical charges will retain the light-handed nature of the regulatory regime, while resolving some important problems that have arisen since its inception.

The inclusion of a requirement to develop a binding dispute resolution mechanism will improve the incentives for negotiation to occur, thereby improving the likelihood that the negotiation process will be efficient and effective, in terms of both process and outcomes.

By providing guidance on the opening asset value and methodology for changing asset values through time, a major stumbling block in the effective negotiation for aeronautical charges will be resolved. Again, this reform is expected to improve the performance of the negotiation/price monitoring regulatory framework, while retaining its key flexibility benefits.

Both these proposed modifications to the existing regulatory regime are relatively minor and should not be difficult to implement or achieve. However, the benefits are expected to be significant, and will arise through improving the effectiveness of the regulatory structure in providing appropriate incentives for the efficient determination of aeronautical charges.

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