BAC Australia

Brisbane Airport Corporation Pty Ltd

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Submission to Productivity Commission's Issues Paper

on Price Regulation of Airport Services

28 July 2006

This report contains 52 pages

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Executive summary

This submission is Brisbane Airport Corporation's (BAC's) formal response to the Productivity Commission's ('the Commission') request for submissions into its review of price regulation of airport services in Australia (2006 Review).

BAC believes that both the privatisations of airports and the move to a light-handed regulatory regime have been a success, particularly in the context of achieving the government's objectives. BAC strongly supports the continuation of price monitoring for Brisbane Airport.

The privatisations of the airports provided a significant financial return to the government. At the time of privatisation, the sale of the airports on a dual till basis led to airports' expectations that they would be allowed a reasonable return on their investment, specifically on the value of the aeronautical assets, while at the same time airport operators would be encouraged to be innovative in the development of non-aeronautical business.

The price monitoring has achieved the government intentions, namely:

- Charges for aeronautical facilities and services at Brisbane Airports are determined on a commercial basis, through negotiation between airports and airport users;
- Negotiations have resulted in a fair price for aeronautical facilities and services, with charges only increasing marginally over the past few years;
- BAC regularly consults with airport users on a wide range of matters including quality of services, airport operations, and the need for, design and timing of major aeronautical investments;
- BAC consistently provides high quality services, with Brisbane Airport's overall performance rating, as reported by the Australian Competition and Consumer Commission, increasing year on year; and
- BAC has developed, and continues to build, a commercial relationship with its airport users.

BAC believes that price monitoring works, and that the current light-handed regulatory regime should be retained, with only fine-tuning of the current definition of aeronautical services, and continuation of the dual till philosophy and negotiated outcomes between airport users. However, there are a number of improvements that could be made:

- Reporting on profitability of aeronautical activities at major airports on a fair and more clearly defined basis;
- The ACCC's price monitoring role should be limited to price, revenue and profit monitoring of aeronautical services only. BAC believes that clarification of the ACCC's role could be achieved with the introduction of clear guidelines for the nature and content of their annual reports on prices;

- BAC supports the continuation of quality of service monitoring to facilitate a balance between service levels and aeronautical charges. However, BAC believes this function would be better managed by the Department of Transport and Regional Services (DoTARS), as its role as the industry's technical regulator means it has a better understanding of the technical and operational aspects of airports;

- BAC believes there may be merit in developing industry guidelines, which clarify matters used in the building block methodology for establishing airport charges, namely:

  - Support for a fair return on aeronautical assets for airports; and

  - Confirmation of the use of DORC as an appropriate "line in the sand" valuation for aeronautical assets and opportunity cost for land; and

- Dispute resolution on all matters, including pricing, should be a matter for services agreements between the airports and the users, as would be the case in any commercial agreement between two parties.

1 Introduction

This submission is Brisbane Airport Corporation's (BAC's) formal response to the Productivity Commission's ('the Commission') request for submissions into its review of price regulation of airport services in Australia (2006 Review).

In preparing our response to the Commission, we have been cognisant of the Review Principles generally, and the Government's objectives for the regulatory regime as set out in the Scope of Inquiry:

> *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 that the regulatory regime should:*
>
> *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).*[1]

In general, this submission focuses on particular issues of most concern to BAC, however many of the questions raised in the Issues Paper require responses generic to the airport industry in Australia.

This chapter provides information on Brisbane Airport and its operating environment leading up to the Commission's 2002 Review[2]. The remainder of this submission is structured as follows:

- Chapter 2, which outlines BAC's operating environment since the 2002 Review;
- Chapter 3, which provides responses to specific questions raised in the Commission's Issues Paper[3];
- Chapter 4, which discusses BAC's preferences for future regulatory arrangements; and
- Chapter 5, which concludes with a summary of BAC's performance against the Review Principles and our preferred arrangements going forward.

[1] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.3.
[2] Productivity Commission, *Price Regulation of Airport Services*, Report No.19, January 2002.
[3] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006.

1.1 Brisbane Airport

Brisbane Airport is Australia's third largest airport, and is now the country's second largest airport in terms of non-Australian visitors. Brisbane Airport is one of the principal generators of economic growth and employment for the South-East Queensland region.

Brisbane Airport is a 2,700 hectare site, with a curfew free aeronautical business operating 24 hours a day, 365 days a year. Brisbane Airport aeronautical assets include a main runway (01/19), a cross-runway (14/32), associated taxiway infrastructure, roads, and separate domestic and international terminals. At the domestic terminal, Qantas and Virgin Blue each have long-term leases over their terminal areas, and manage the operation of these terminals. A domestic common user terminal operated by BAC separates the two leased terminal areas. BAC manages the operation of the International terminal.

Brisbane Airport was privatised in July 1997, when BAC purchased the long-term lease for the airport from the Federal Government, and took over management and operations of the airport. The government sold the airports on a dual-till basis (i.e. an aeronautical business and a non-aeronautical business), and airport operators paid a substantial premium for non-aeronautical business such as car parking, retail and commercial property.

BAC has a clear vision for the future:

> *"…to transform Brisbane Airport from a city airport to an "Airport City", and to build a prosperous airport business community."*

BAC outlined its long-term development objectives for Brisbane Airport in the 2003 Masterplan, which was been approved by the Department of Transport and Regional Services (DoTARS). The main focus of development is to facilitate safe passenger, freight and aircraft movement, and to meet future capacity needs. BAC is committed to generating economic growth, maintaining sound environmental management, and balancing economic benefit and environmental impact. BAC strongly encourages and facilitates complimentary business and industry development. Future development plans also focus on providing efficient on-airport surface transport systems and off-airport transport interfaces, and maintaining and improving the quality of services provided.

In 2005, Brisbane Airport won the International Air transport Association's (IATA's) "Eagle Award" for the world's best privatised airport. In IATA's words, Brisbane Airport:

> *"… has achieved strong growth in a de-regulated environment by offering a good consultation process, customer satisfaction and low charges in comparison to other airports in its country."*[4]

This award reflects BAC's commitment to productivity improvements at the airport, a meaningful consultation process with airlines, transparency in the information presented to the airlines, cost reflectively in pricing and equitable charging structures.

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[4] IATA, *Eagle Awards for Airservices Australia, Changi and Brisbane Airports*, Press Release, 15 May 2005.

1.2 Pre 1 July 2002 environment

While the terms of reference specifically relate to the effectiveness of the current form of price regulation of airports it is important that any consideration of the future regulatory environment also considers the experiences of the previous regulatory regime which directly followed privatisation.

BAC's aeronautical business was subject to a "CPI minus X" price regulation regime for the first five years following privatisation. The regulatory regime also incorporated cost pass-through provisions for necessary new investment (NNI) and government mandated security charges, and quality of service monitoring.

1.2.1 FAC starting prices

The starting prices for Brisbane Airport were those inherited from the FAC, which had been set on a "single-till" and network basis. Furthermore, no comprehensive review of asset values was undertaken at that time. Consequently, starting prices beared little or no resemblance to the value of the aeronautical assets at the airport or the cost of service provision. These starting prices were not sufficient to provide for efficient aeronautical investment on a dual till basis.

Further, the "X" factors applied to the airport were not appropriate. Prior to the privatisation of the Phase 1 airports, the ACCC undertook modelling to determine the appropriate values for "X". In a draft report[5] dated May 1996, the ACCC acknowledged that in nearly all scenarios modelled, "X" values at Sydney, Melbourne, Brisbane and Perth should be positive – and therefore generate real increases in aeronautical charges – in order for investor acceptable rates of return to be achieved.

Given the existence of this analysis, and given the ACCC has acknowledged that it did provide advice to the Commonwealth Government on the setting of "X" values, BAC found it surprising that the "X" values set by the Commonwealth Government were all negative.

BAC contends that the basis for determining the original prices did not relate to estimating the efficiency potential within each airport.

For Brisbane Airport, the X-factor was set at negative 4.5%, which saw real charges fall by 2.2% per annum for the domestic landing charge and 5.1% per annum for the international passenger service charge over this period. The real charges under the CPI-X regime are presented in the following two graphs.

[5] ACCC, *The Inclusion of Non-Aeronautical Contributions and their Impact on the Level of Price Caps – Options for Consideration*, May 1996.

Figure 1. International Passenger Service Charge under Price Cap

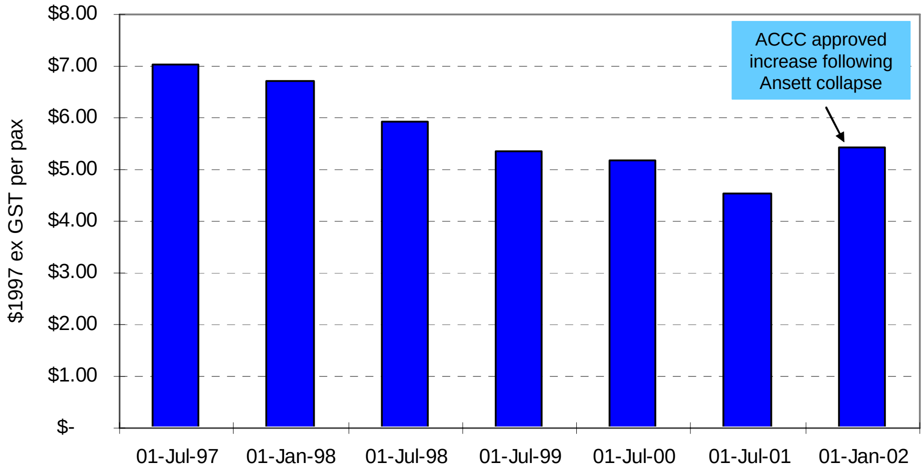
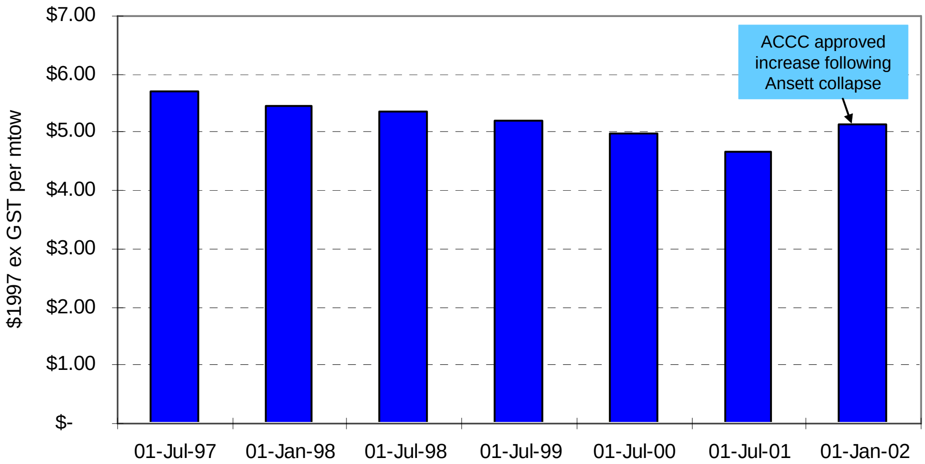
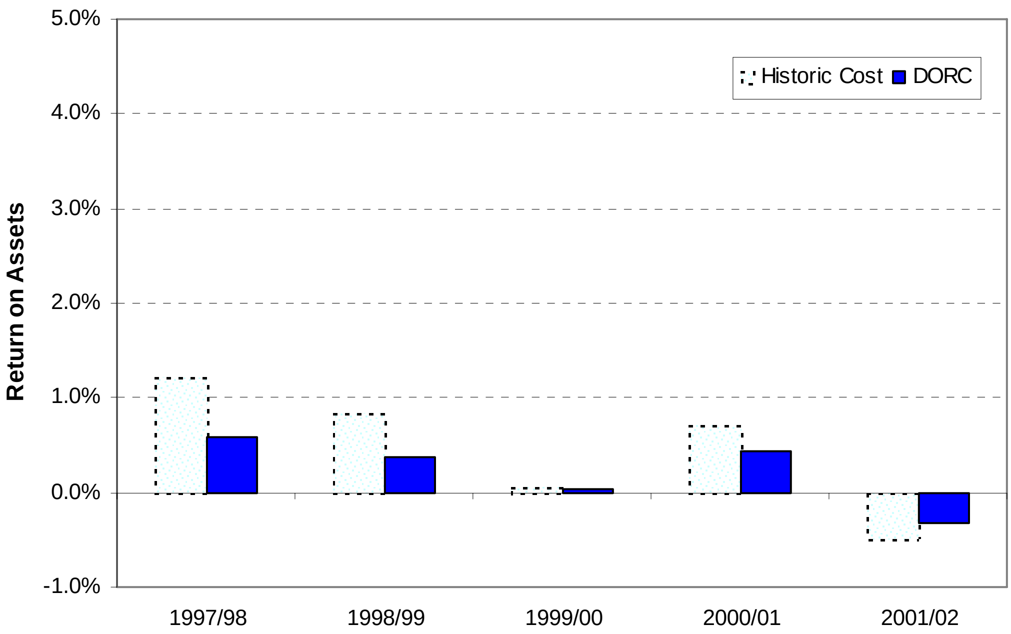


Figure 2. Domestic Landing Charge under Price Cap



Combined with the artificially low starting prices, these prices produced a negative return (-0.5%) on assets in 2001/02 based on a depreciated historic cost basis for assets, as shown in Figure 3 below.

Figure 3. Brisbane Airport Return on Aeronautical Assets



The rates of return shown in the above graph are aeronautical earnings before interest and tax (EBIT) on the average value of tangible aeronautical assets for the year and, thus, represent a pre-tax nominal return on assets. The rates of return achieved are even lower if expressed on depreciated optimised replacement cost (DORC), which is the most appropriate asset valuation methodology.

Asset valuation is discussed further in Section 3.7.

1.2.2 Necessary new investment

The NNI provisions were designed to ensure there were sufficient incentives for airports to undertake investment necessary for the provision of efficient aeronautical services. The concern was that, under a price cap regime, airports would not receive an adequate return, thus discouraging such investments. As emphasises by DoTRD in its Pricing Policy Paper:

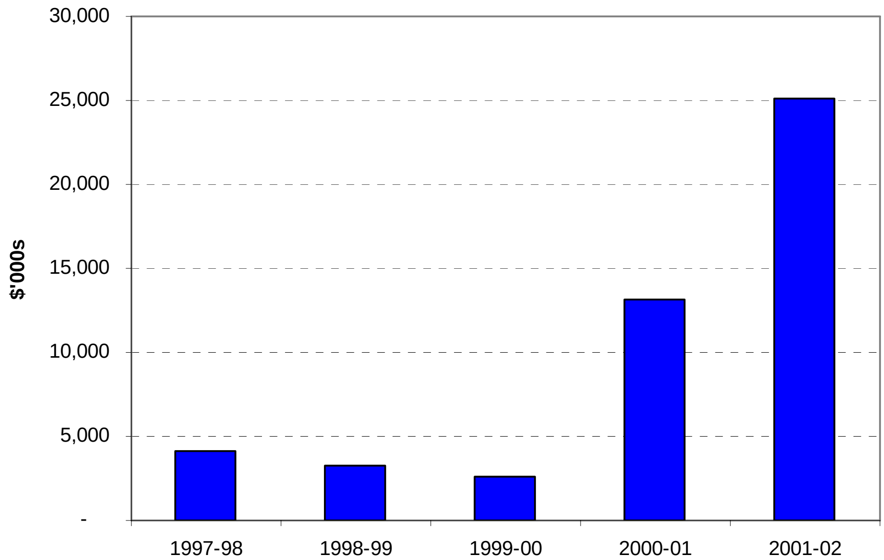
> *"While price caps on aeronautical charges are directed towards ensuring that there is no abuse of the potential market power of the airport operators, price oversight arrangements dependent solely on these price caps may restrict the timely development of necessary new aeronautical infrastructure.*
>
> *As a result, some flexibility is afforded airport operators to rebalance charges outside the price cap. In particular, operators need sufficient incentive to invest in new infrastructure, and the ability to meet the costs of necessary new investment." (DoTRD 1996, p. 4)*

Although it was clearly the Government's stated intention that aeronautical charges could be increased outside of the price-cap it was not until April 1999 that DoTRS issued a letter clarifying the position. Until that time, the airlines had been using their significant market power and refusing to agree to price increases outside of the price cap. Even then it was not until April 2000 that ACCC finalised a suitable definition of "Necessary New Investment".[6]

This enabled Brisbane Airport, along with Perth Airport, to be the first airports to reach agreement with the airlines and ACCC to increased charges outside of the price cap in respect of necessary new investment, some 34 months after privatisation.[7] There was limited incentive to invest prior to an NNI decision by the ACCC, as there was too much uncertainty as to whether a project or capex program would be approved and, if it was, what the level of cost recovery would be.

This is illustrated in the following graph, which shows that BAC undertook only minor capital expenditure projects prior to BAC's first NNI decision in April 2000.

Figure 4. Brisbane Airport Aeronautical Capital Expenditure, 1997-98 to 2001-02



In the first three years of the price cap, BAC undertook less than $5 million of capital expenditure per annum. Following its NNI decisions in April 2000, June 2001 and January 2002, BAC's capital expenditure program was ramped up significantly. However, the total capital expenditure during the five-year price cap period is significantly lower than that already undertaken during the price monitoring regime (see Section 3.8).

[6] Australian Competition and Consumer Commission, _New Investment Costs Pass-through_, Position Paper, April 2000.
[7] Brisbane Airport's first NNI approval was obtained in April 2000.

A similar situation occurred with the airport operator's ability to recover costs in respect of Government mandated charges.

In December 1998, DoTRS mandated that airport operators are to be responsible for international passenger and baggage screening at international terminals by 1 October 1999 and 1 June 2000 respectively. It was not until March 2000 that the ACCC finalised the definition of cost recovery for these purposes.

As part of the Commissions' 2002 Review, the provisions for NNI pass-through were examined. The Commission concluded that the NNI provisions had *"not promoted the commercially negotiated outcomes that were envisaged by the architects of the regime"*, and highlighted some fundamental deficiencies in the scheme:

- the lack of transparency regarding what investment was considered to be included in the base aeronautical prices and what was to be covered by necessary new investment, with resultant effects on incentives to invest;
- the incentives for some participants to approach the regulator rather than achieve commercially-negotiated solutions;
- the high costs of complying with the regime; and
- the regulatory risk due to the uncertainty and delays introduced by the need to have every investment-related price increase vetted by the regulator.[8]

Submissions to this Commission's 2002 Review indicated there was an incentive for incumbent airlines to attempt to delay investments by airport operators if they considered the investment would benefit potential new entrants. The ability to stall the NNI application processes largely arose out of the assessment criteria incorporating 'support from airport users' as a factor for consideration.[9]

BAC's experience with the NNI process reflected the above sentiment. During the price cap period, BAC submitted three NNI applications. Compared to the current process, BAC found the NNI process to be difficult and time-consuming. As noted previously, this ultimately delayed investment at the airport.

1.3 Commission's 2002 Review findings and recommendations

In accordance with the intentions set out in the Department of Transport and Regional Services Development's Pricing Policy Paper, the Government requested the Commission to review the regulatory arrangements in 2001.

The key recommendations from the Commission's final report were that:

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[8] Productivity Commission, *Price Regulation of Airport Services*, Report No. 19, January 2002, p.LI.
[9] Clause 6 of Direction No.13 (22 May 1998) set out the criteria to guide the ACCC's assessment of NNI applications. Criteria (c) was *"support from airport users with a significant interest in the investment for the operator's proposals, including in relation to charging changes"*.

- price caps should be replaced by mandatory price monitoring arrangements for a probationary five-year period;

- quality monitoring should continue at all airports subject to price monitoring; and

- all airports should be subject to the generic provisions of the National Access Regime in Part IIIA of the *Trade Practices Act*.[10]

In its response to the 2002 Review, the Government accepted the Commission's recommendations, stating that it envisaged that the lighter-handed regulatory framework would:

> *"… provide airports with greater scope to undertake efficient aeronautical investment and more flexibility to respond to a changing aviation environment …*
>
> *[and] … encourage negotiated pricing outcomes based on efficient costs and an adequate return on capital."*[11]

BAC interpreted the Government's stated intention that airports and airlines should commercially negotiate pricing outcomes as an acknowledgement that airports could, and indeed that there was a need to, rebalance aeronautical charges to reflect efficient costs and an adequate return on capital.

Further, BAC understood that:

- aeronautical charges should be an outcome of commercial negotiations with airport users;

- the ACCC's price monitoring would be fair and balanced, and focus on prices, profits and returns within the price monitoring period only;

- with greater scope to undertake aeronautical investment, there was an expectation that quality of services would improve over time; and

- there were regulatory interventions available to airport users (via Part IIIA), which required the airport to act in a "good corporate manner" in its negotiations with the airlines.

In anticipation of the Commission's recommendations, BAC engaged a consultant in 2001 to determine what the aeronautical charges would be for 2002/03 to 2006/07 based on the commonly used building block methodology (see Section 2.2), and developed a draft services agreement and commenced commercial negotiations with airport users in late 2001 (see Section 2.1).

BAC negotiated charges with the airlines that were lower than those allowable using a building block methodology. BAC believes it acted in a reasonable and appropriate manner throughout these negotiations, and has continued to do so in subsequent dealings with airport users.

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[10] Productivity Commission 2002, *Price Regulation of Airport Services*, Report no. 19, AusInfo, Canberra, p.XLVIII
[11] Minister for Transport & Regional Services and Treasurer, *Productivity Commission Report on Airport Price Regulation*, Joint Press Release, 13 May 2002.

2 Post 2002 PC environment

This section of our submission details the operating environment for BAC under the price monitoring arrangements, and highlights the significant achievements to date.

2.1 Aviation Services & Charges Agreement

One of the Government's Review Principles was that:

> *"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."* [12]

BAC's operations since the removal of the price cap have been consistent with this principle. Specifically, BAC has a commercially negotiated agreement for access to Brisbane Airport.

In the lead-up to airport price de-regulation, BAC consulted and negotiated extensively with airlines and airline representatives. The outcome of these negotiations is the Brisbane Airport Aviation Services & Charges Agreement, which is effective for 5 years from 1 July 2002 to 30 June 2007.

Numerous individual meetings took place to discuss the terms and conditions of the first Aviation Services & Charges Agreement (see Appendix A).

The terms and conditions of the 5 Year Aviation Services & Charges Agreement were endorsed by BARA and Virgin Blue (the latter not being a member of BARA at that time).

> **From:** Warren Bennett [mailto:barainc@bigpond.com]
> **Sent:** Friday, 2 August 2002 3:36
> **To:** Tim Rothwell
> **Subject:** BACL aero contract
>
> Tim
>
> I've left a message for you to phone me on Tuesday - that's not really necessary. I've gone thru the contract changes and they look OK to me. I have already advised BARA members who attended our general meeting yesterday that BARA commends the BACL agreement to them for execution (or acceptance if you don't require formal execution) - subject to the usual rider that they should have their own legal advisers check over the document. I will advise the wider membership today - not all members attend the general meeting.
>
> For the sake of completeness I found 1 typo - delete "us" in the first line of clause 11.6(c).
>
> Regards,

[12] Minister for Transport & Regional Services and Treasurer, *Productivity Commission Report on Airport Price Regulation*, Joint Press Release, 13 May 2002.

Warren Bennett
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Mob: 0403 034 634

A copy of the proposal provided to industry stakeholders is included in Appendix B.

Following this agreement, pricing consultation has been bi-annually for the first few years of de-regulation. This is as a result of the five-year agreement introduced on 1 July 2002 including the pricing framework and charges for the five years to June 2007. Charges negotiated with airlines in 2002 included estimated CPI increases and estimated minor capital expenditure. BAC has born the risk in both these categories, as well as the risk associated with fluctuations in the volumes of passengers and landed tonnes.

The five year agreement includes an incentive scheme, aimed at encouraging airlines to grow their services and passenger volumes at Brisbane Airport:

> *"We will apply the Aviation Charges incentive rebate to the Aviation Charges payable by you if you achieve during any year of the Term (except the first year of the Term – 1 July 2002 to 30 June 2003) more than 105% of your immediately preceding years volume of Airport activity. The Aviation Charges incentive rebate available is 50% of the amount of Aviation Charges that are applicable to that volume of Airport activity which exceeds the 105% threshold."*[13]

This incentive scheme has seen BAC repay $7.8 million to airlines in the form of annual rebates during the first three years of the scheme.

The five year Aviation Services and Charges agreement includes a process for consultation in relation to major aeronautical capital expenditure during the period. Such consultation has been frequent during the last twelve months (see Appendix C), as demand for aeronautical infrastructure begins to exceed capacity and BAC enters a period of anticipated significant capital expenditure to extend infrastructure capacity.

An extract from the Aviation Services & Charges Agreement is included in Appendix F with the full version available on BAC's website (www.brisbaneairport.com.au).

2.2 Pricing methodology

As part of the negotiation with airports prior to the removal of the price cap, BAC engaged external consultants to advise on the appropriate weighted average cost of capital (WACC), the development of a building block model to determine appropriate aeronautical charges, and to

[13] BAC, *Brisbane Airport Aviation Services and Charges*, 26 June 2006, p.22

undertake a depreciated optimised replacement cost (DORC) valuation of the aeronautical assets.[14]

The building block methodology used to determine the aeronautical charge is consistent with that applied by the ACCC in its NNI and Sydney Airport[15] decisions, as well as the ACCC's Statement of Regulatory Principles, which it applies to determine the required revenue for regulated gas and electricity transmission businesses.

Specifically, the return on assets component of the building blocks was determined using:

- a pre-tax nominal WACC of 10.8%, which was the rate of return approved by the ACCC in BAC's last two NNI decisions (in June 2001 and January 2002, respectively); and

- an opening asset base valued using a DORC methodology, which is that accepted by the ACCC for electricity transmission assets.[16]

The asset base included capital expenditure for minor projects, which were set out in the services agreement. Price increases for large capital expenditure projects are determined for each individual project using a process similar to the NNI process, in consultation with airport users.

As noted previously, the pricing outcomes under the price cap resulted in unsustainably low returns on assets for Brisbane Airport – the prices were simply inappropriate. Therefore, BAC chose to seek advice on what economically efficient prices should be.

The aeronautical charges estimated using the building block model provided the basis for the negotiation with airlines on the first services agreement. The model and demand forecasts were provided to the airport users as part of the negotiations.

While this provided theoretically maximum prices, the actual (lower) pricing outcomes were determined through negotiation with users.

As a result the current return on assets is still below what would be considered fair. Section 3.2 presents the prices negotiated with airport users, and the resultant returns on assets, under the price monitoring regime.

BAC is applying the same approach in negotiations with airport users on the second Aviation Services & Charges Agreement, scheduled to commence from July 2007. That is, BAC engaged KPMG in early 2006 to determine aeronautical charges for the five year period commencing 1 July 2007 using the same building block methodology.

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[14] KPMG advised on the WACC and the building block methodology, while Rushtons undertook the independent valuation of aeronautical assets.
[15] ACCC, *Sydney Airports Corporation Ltd – Aeronautical Pricing Proposal*, Decision, May 2001.
[16] Under international financial reporting standards (IFRS), the revaluation of aeronautical assets has been reversed. The asset values as reported by the ACCC in its annual price monitoring reports is now the historic value (rather than the DORC value used in the building block methodology).

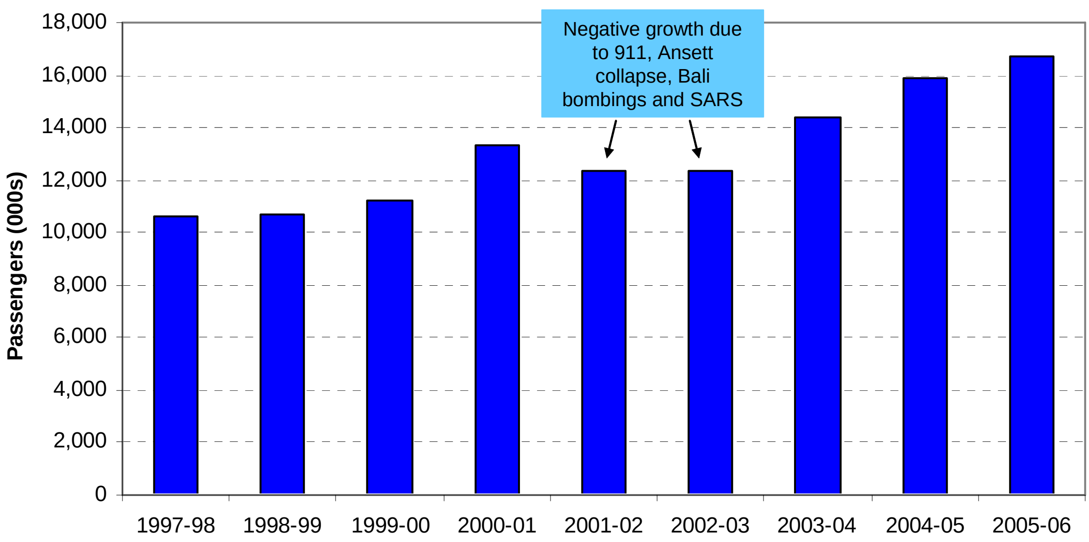
Further, BAC has since July 2002 committed to using an ACCC methodology to determine pricing for new major capital expenditure projects. BAC consults with users on airport development needs and how this translates into prices. To date only one project (expansion of the international terminal apron) has resulted in increased prices, of 32 cents per international passenger from 1 January 2007.

2.3 Demand at the airport

During the price cap regime, the average compound growth rate in passenger volume was 0.5% per annum for international passengers and 5.0% per annum for domestic passengers. Since the introduction of price monitoring, passenger volumes have been growing at an average rate of 8.7% per annum for international passengers and 7.8% per annum for domestic passengers, despite limited growth in 2002-03 due to SARS and the Bali bombings.

Figure 5 below presents the total passenger numbers at Brisbane Airport since privatisation.

Figure 5. Total Passengers, 1997-98 to 2006-07



The strong growth in passenger numbers since the introduction of price monitoring has benefited both the airport and the airlines. This is due to higher load factors and an increase in the number of routes.

2.4 Service quality standards

Since the commencement of airport privatisations in 1997, service quality at the price-monitored airports has been monitored by the ACCC under Part 8 of the *Airports Act 1996*.

Regarding quality, the Government set out the following Review Principle in its response to the Commission 2002 Review:

> *"Quality of service outcomes should be consistent with user's reasonable expectations, and consultation mechanisms should be established with stakeholders to facilitate the two way provision of information on airport operations and requirements."*[17]

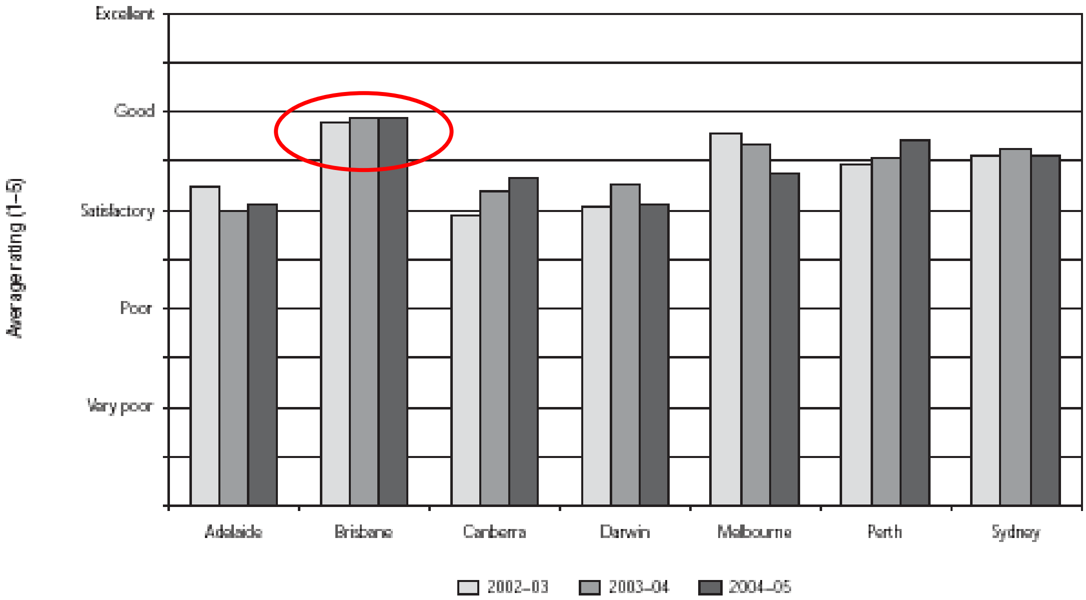
BAC has more than met this expectation, having incorporated service quality into its commercial agreements with the airlines and having established forums for regular consultation with airport users.

Quality of service reporting is based on perception surveys of passengers and airline customers, as well as Australian Customs Services, and assesses availability and standard of a range of measures. The ACCC's 2004-05 Quality of Services survey reports that Brisbane Airport's overall quality of service has been consistently high since privatisation.

2.4.1 Brisbane Airport's performance

For Brisbane Airport, the overall airport rating (as reported by the ACCC) has improved year on year, as shown in the following graph.

Figure 6. Overall Airport Ratings



Source: ACCC, *Quality of Service – Price Monitored Airports 2004-05*, November 2005

[17] Minister for Transport & Regional Services and Treasurer, *Productivity Commission Report on Airport Price Regulation*, Joint Press Release, 13 May 2002.

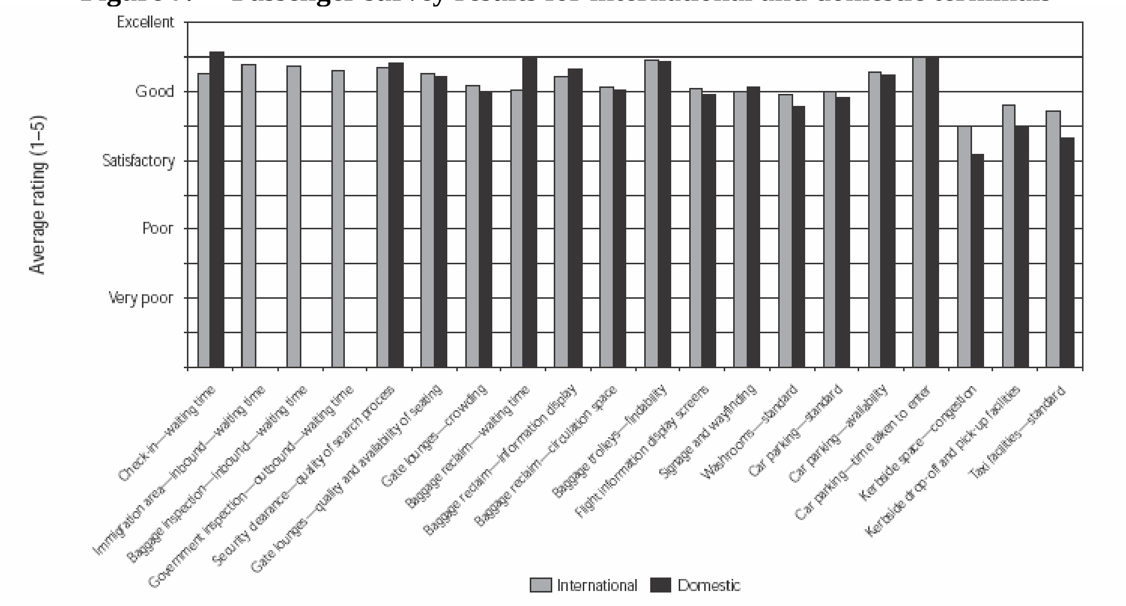
For the three periods from 2002-03 to 2004-05, BAC was the top-ranked airport amongst the price monitored airports, achieving the overall airport rating[18] of "good" in each year.

2.4.1.1 Passenger survey

In 2004-05, BAC engaged a market research firm to survey airline passengers using Brisbane Airport. More than 500 passengers were interviewed within the terminals with a further 75 interviewed near taxi ranks.

The results from the survey show that the ratings for the international and domestic terminals are similar, with all terminal facilities rated "above satisfactory" and many facilities rated "good" and "excellent".

Figure 7. Passenger survey results for international and domestic terminals

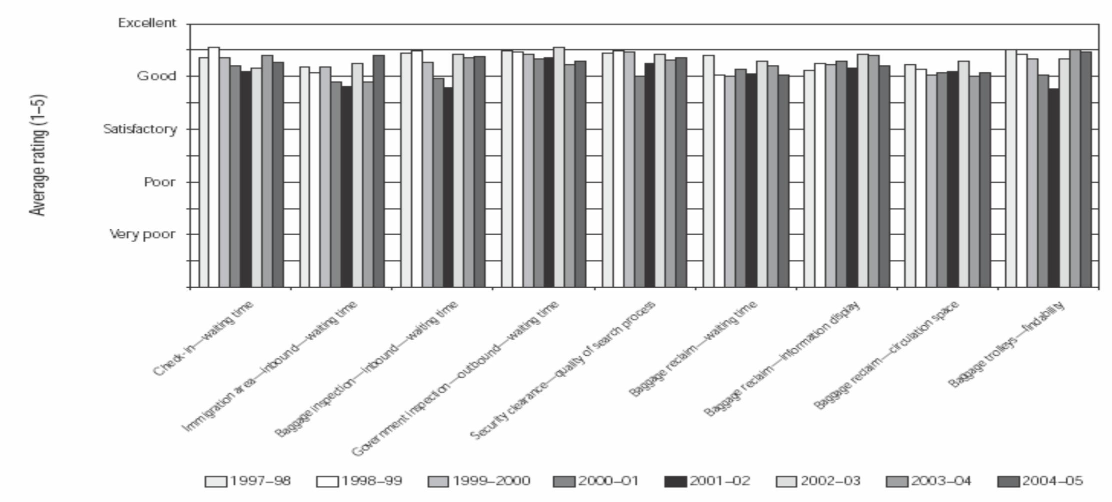


Source: ACCC, *Quality of service— price-monitored airports*, 2004-05, November 2005, p 29.

BAC also performed well in international terminal immigration inspection and baggage reclaim with most results between "good" and "excellent". The same can also be said for the passenger survey result for international terminal general facilities and car park. Refer to the following two figures.

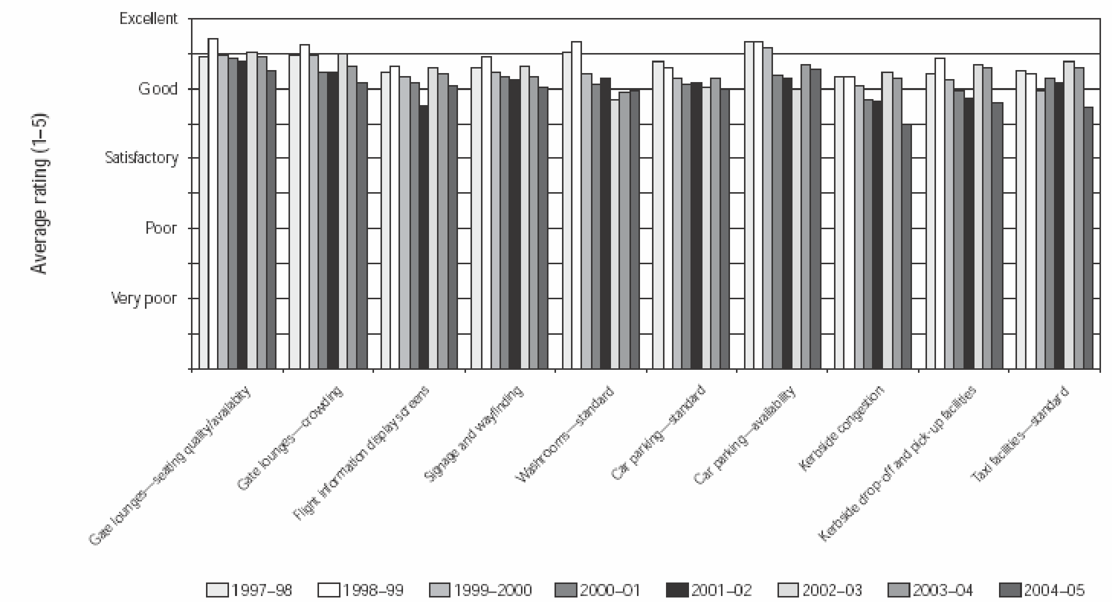
[18] Results of each airport have been aggregated to derive an overall view of the quality of service provided by airport operators.

Figure 8. Passenger survey results for the international terminal immigration inspection and baggage reclaim



Source: ACCC, *Quality of service— price-monitored airports*, 2004-05, November 2005, p 30

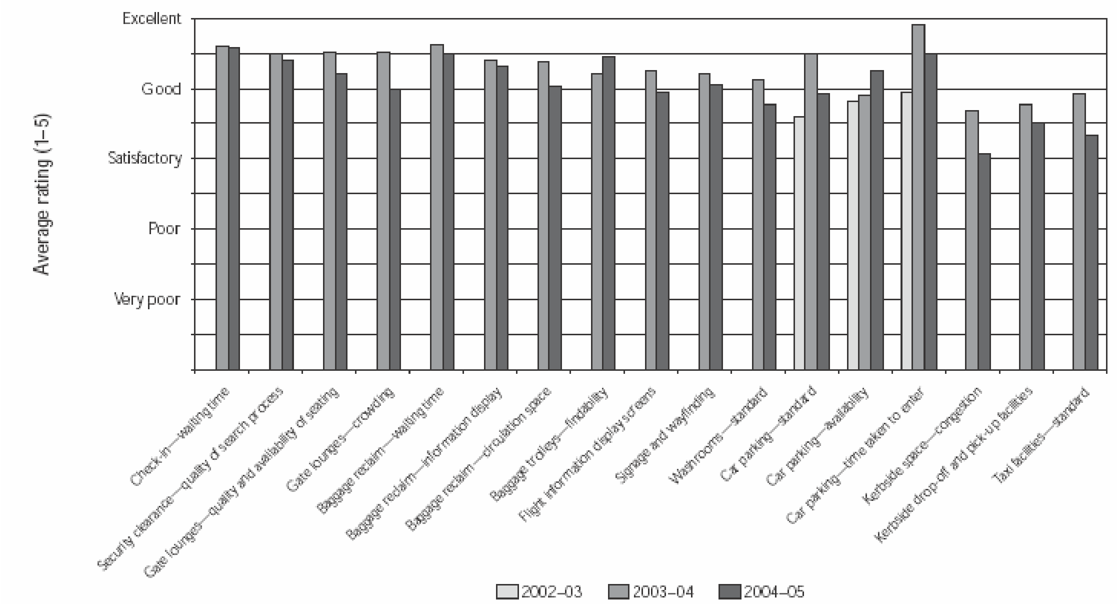
Figure 9. Passenger survey results for the international terminal general facilities and car park



Source: ACCC, *Quality of service— price-monitored airports*, 2004-05, November 2005, p 30

The passenger ratings for the domestic terminal facilities have remained fairly stable at "good" with the exception of kerbside and taxi facilities which were rated as "satisfactory". This is shown in the figure below.

Figure 10. Passenger survey results for domestic terminal facilities



Source: ACCC, *Quality of service— price-monitored airports*, 2004-05, November 2005, p 30

In general, for the periods between 2002-03 and 2004-05, BAC's average passenger ratings for international terminals facilities have been consistently rated at "good". This result is fairly similar to the results of the Melbourne, Sydney and Perth airports. Furthermore, it is a good result given the significant passenger growth in 2003/04 and 2004/05 increased security measures and the resultant strain placed on facilities.

For the average passenger ratings of domestic terminal facilities, BAC has also performed strongly over the same period with consistent ratings of "good".

2.4.1.2 Airline survey

The average airline rating for domestic airside facilities at Brisbane Airport has been consistently "good". The surveyed airlines have also given BAC ratings of between "satisfactory" and "good" for its international terminal facilities and management responsiveness.

2.4.1.3 Australian Customs Service survey

The ratings given by the Australian Customs Service (ACS) for BAC's facilities have improved in 2004/05 over 2003/04 results, ranging from "satisfactory" to "good". In the survey, ACS also mentioned that BAC has undertaken a proactive approach in responding to ACS's concerns.

2.5 Communication with stakeholders

BAC communicates and consults regularly with all industry stakeholders and airline partners on a wide range of business matters, including operations and pricing. Consultations and meetings are on both a formal and informal basis, as is the case in most commercial business partnering relationships. Airline involvement and contribution to airport decision making is a crucial part of ensuring a safe and efficient airport operation.

2.5.1 Examples of communication with stakeholders

In addition to the quarterly Aviation Services & Charges meetings, BAC communicates regularly with its stakeholders through a number of forums:

- **Airport Operators Committee (AOC) Meetings:** The AOC is a forum hosted by the local Airline Operators. The committee is chaired by an elected member from the airlines and meetings are held monthly at Brisbane's ITB. Membership is open to all airlines and operators and the majority of operators at the ITB are represented. BAC attends to discuss operational issues and receive feedback from the airlines on any concerns that they may have. The meeting is attended by BAC senior and operational management. Minutes are distributed after each meeting for follow up.

- **Quarterly Meetings with Major Airlines:** BAC hold separate formal quarterly meetings with its two major airline partners: Qantas and Virgin Blue. These meetings are held to discuss airline specific matters in relation to Brisbane Airport.

- **Other Regular meetings:** Other regular meetings held with the Airlines are the weekly and bi-monthly:

  - FAL (facilitation) meetings to discuss facilitation in the terminal, including matters such as passenger processing times and bay allocation;

  - CUTE Club to discuss issues with the Common User Terminal Equipment (hosted by the Airlines), such as boarding pass readers, bag tag printers and the terminals at the check-in and boarding gates;

  - the Baggage Sub-Committee which reports to the CUTE Club regarding baggage handling matters; and

  - ITBX Airline Focus Group to discuss the ITB expansion project.

The purpose of these other forums is primarily to ensure that there is consultation on operational quality of service.

2.5.2 Aviation Services & Charges Consultation Meetings

BAC meetings are held primarily with Qantas, Virgin Blue, BARA and the Airport Operators Committee, but are open to any interested airline. More recently, Emirates, Singapore Airlines, Japan Airlines and Air New Zealand often attend. IATA is also represented.

BAC is now meeting at least quarterly with airlines partners and representatives. Consultation meetings have been scheduled to occur monthly from May 2006 for the foreseeable future, and will be used primarily as a forum to discuss the need for, design, and timing of infrastructure expansion, and to negotiate the associated aeronautical charges. BAC is seeking to negotiate a second five-year Aviation Services & Charges agreement with the airlines, to be effective from 1 July 2007 to 30 June 2012. Appendix C provides a summary of the Aviation Services & Charges consultation meetings held since December 2002 and Appendix E provides detailed information for the meeting held on 24 May 2006 as an example of the openness with which BAC conducts such consultation.

The last consultation meeting was held in Brisbane on 11 July 2006, and the following airlines and airline representatives attended:

- Qantas
- Jetstar
- Virgin Blue
- Singapore Airlines
- Korean
- Emirates
- Air New Zealand
- Malaysian Airlines
- BARA (Board of Airline Representatives of Australia)
- IATA (International Air Transport Association)
- Airport Operators Committee

BAC communicates openly with its airlines partners at these consultation meetings. Project specific information supplied includes construction contract costs, floor-plans / project drawings, detailed pricing models, detailed pricing assumptions, detailed passenger and movement forecasts, forecast operating costs, alternative solutions and do-nothing scenarios.

BAC as expert airport operator makes a recommendation on the project, and presents all relevant information. BAC is completely transparent and open with the airlines in relation to aeronautical capital expenditure and aims to provide all necessary information. If airlines as a majority disagree with the scope or need for a project, the project is unlikely to proceed or alternative solutions would be progressed. Clearly, individual airlines may oppose projects for their own commercial reasons (e.g. no expansion plans for Brisbane) so 100% agreement is not always possible.

An example of a current project being discussed with airlines is the International Terminal Building Expansion (ITBX) project. Appendix E provides examples of the information that was presented to and discussed with airlines at several consultation meetings.

2.6 Summary

In summary, BAC believes it has behaved in a manner consistent with the Government's Review Principles and expectation since the removal of the price caps. Specifically, BAC has:

- Negotiated with its airport users on a fair and reasonable basis;
- Adopted sound economic principles to assess the long run costs of efficiently providing airport services, consistent with the ACCC approach;
- Achieved a commercially negotiated outcome, which is reflected in the first five year agreement with airport users;
- Increased demand for its airport services;
- Maintained a consistently high level of quality of services; and
- Implemented regular consultation forums with airport users.

BAC is currently negotiating the next five-year agreement with airport users, and is applying the same principles and processes to this negotiation.

3 PC Review Issues

This section of the submission provides responses to specific issues raised in the Issues Paper.

3.1 ACCC price and quality monitoring reports

The Commission is seeking feedback on the adequacy of the data published by the ACCC in its annual price and service quality monitoring reports. Specifically, the Commission seeks responses to the following questions:

> *"How adequate are the data in the ACCC's price and quality monitoring reports for judging whether airport operators have acted in a manner consistent with the Government's Review Principles and the effectiveness of the price monitoring regime? What are the major gaps in that information base and can they be practically remedied?"*[19]

> *"More broadly, is the information that the ACCC currently collects the most useful and relevant? Could the ACCC have usefully devoted more time to evaluating the information provided to it? Has there been appropriate recognition in the monitoring process of the linkages between quality enhancement and the higher charges often necessary to provide for such enhancement? Have variations in the way that airports report their performance to the ACCC hampered interpretation of the outcomes of price and quality monitoring?"* [20]

BAC contends that the ACCC's price and service quality monitoring reports are not adequate for assessing whether the airports have acted in a manner consistent with the Review Principles. The primary reason for this is that the ACCC has consistently presented on performance issues beyond their brief.

Under Direction No. 27, the ACCC is to *"undertake formal monitoring of the prices, costs and profits related to the supply of aeronautical services and aeronautical related services"* at Brisbane, Melbourne, Perth, Sydney, Adelaide, Canberra and Darwin airports.[21]

This clearly limits the ACCC's role to the aeronautical and aeronautical related services, i.e. a dual till approach. However, as noted by the Commission, the ACCC has *"chosen to report more broadly on total airport revenues, costs and margins and rates of return, as well as on outcomes for aeronautical and related services"*.[22]

The two reasons provided by the ACCC for this are:

- the difficulty in cost allocation between aeronautical and non-aeronautical; and

[19] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.16.
[20] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.19.
[21] Commonwealth of Australia, Direction No 27 under the Prices Surveillance Act 1983, 26 June 2002.
[22] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.12.

- the complementarities between the two sets of services.[23]

In early 2005, BAC engaged KPMG to critique the ACCC's draft report, *Airport price monitoring and financial reporting 2003-04*. In this report, the ACCC used the same reasons as above for justifying its single till approach to price monitoring. In its critique, KPMG highlighted the flaws with the ACCC's reasoning:

- The difficulties' argument is contradictory, as it suggests that the ACCC does not accept their own regulatory accounting guidelines. These are the guidelines used by the airports to undertake their regulatory reporting; and

- The 'complementarities' argument is irrelevant on the basis the Government has directed a 'dual till' approach to airport regulation.

BAC notes that the ACCC has never raised any concerns with the cost allocation methods adopted by BAC. Further, the cost allocation has been signed off every year by BAC's auditors to be consistent with the regulatory accounting guidelines.

The ACCC also suggests that significant changes would be required for it to report on a dual till basis:

> *"If the ACCC were to report solely on aeronautical and aeronautical-related services, it considers that a number of changes to the regulatory regime would be required. These would include considering the definition of the aeronautical till, a stricter form of accounting separation between the aeronautical till and the non-aeronautical till and appropriate legislative powers to enforce such an accounting separation."*[24]

BAC strongly contests this assertion. In the first instance, the dual till is already defined in Direction No. 27. While it may be argued that these definitions could be fine-tuned, there is no need to do so to enable the ACCC to report on a dual till basis. Secondly, the ACCC's *Airports Reporting Guideline* already provides for appropriate cost allocation rules between aeronautical and non-aeronautical services. A stricter form of accounting separation implies additional intrusion by the ACCC and higher compliance costs for airports, with little benefit.

BAC has repeatedly expressed its concerns to the ACCC in its responses to the ACCC's draft annual reports. The most recent opportunity was for the draft report for 2004/05, which was provided to BAC in December 2005. BAC's frustration with the ACCC and its process is reflected in the opening paragraphs of our response to the ACCC:

> *"BAC welcome the opportunity to review the draft extract of the Airport price monitoring and financial reporting 2004-05 document (the draft extract).*
>
> *In saying this BAC are extremely concerned about the process in which the Australian Competition and Consumer Commission (ACCC) has gone about preparing this document and distributing it for review. In particular, the time frame in which you have*

[23] ACCC, *Airports price monitoring and financial reporting 2004-05*, February 2006, p.11
[24] ACCC, *Airports price monitoring and financial reporting 2004-05*, February 2006, p.12

> *provided us to consider and respond to the draft extract is inappropriately short and unfair in relation to the time the ACCC has had to prepare the document.*
>
> *Further, given the history of the ACCC's approach in preparing its annual price monitoring report, we are genuinely concerned that you will pay no regard to the substantive issues raised below. Rather, our previous experience suggest this review process is merely a 'tick-box' exercise, and while this continues to be our feeling based on the draft extract provided, BAC hopes this impression is wrong and the ACCC go forward with a balanced and fair approach to its price monitoring reporting."*[25]

BAC's specific concerns with the ACCC's most recent price monitoring report are:

- the timeframe in which the ACCC provided BAC to review and respond to the draft report was insufficient;
- the ACCC does not appear to take into account BAC's substantive concerns and the annual reporting is merely a 'tick the box' exercise;
- the reports should only include pricing and financial information for the year under review, and possibly one prior year as a reference;
- the ACCC text is biased in such a way that, in some instances, it does not fully explain adjustments in prices and revenues; and
- the ACCC reports on areas outside its jurisdictions detailed in Ministerial Direction 27,[26] particularly that it comments on total return to equity and return on assets for each price monitored airport.

3.2 Price levels

In its Issues Paper, the Commission asks the following specific questions about price levels at Australian airports:

> *"Have increases in charges for airport services under the price monitoring regime been consistent with the efficient operation of airports and the Government's Review Principles? To what extent is the experience to date indicative of what might happen in the future? How do recent increases in charges for aeronautical services at the price monitored airports compare with those at other Australian airports and at comparable airports overseas?*
>
> *Is there evidence that the price monitored airports have used market power to increase charges by more than could be justified on the basis of costs, new investment requirements, and/or other enhancements to service quality?"*

[25] BAC, Response to Draft Extract of Airport price monitoring and financial reporting 2004-05, 22 December 2005, p.1

[26] "*to only undertake formal monitoring of prices, costs and profits relating to supply of aeronautical services and aeronautical related services*"

The Commission reports that aeronautical revenue per passenger at Brisbane Airport increased by 48% between July 2002 and June 2005. However, it also correctly reports that BAC started from a negative base and that returns on aeronautical assets remains low.[27]

The Federal Airports Corporation (FAC) charges on 1 January 1997 were used as a basis for the first five years (under the price cap). These charges were the former network charges for FAC, adjusted in the 1996/97 financial year in a move towards airport specific charges. No comprehensive review of asset values was undertaken at the time and consequently starting charges bore little or no relationship to the value of the assets utilised by the airlines.

There was an expectation that prices would be rebalanced at the commencement of the price monitoring period to reflect the fact that the pricing outcomes under the price cap were unsustainable as a result of the low growth in passengers numbers during the first five years combined with the low starting prices.

As noted previously, charges at Brisbane Airport are set consistent with the Government's Review Principles. That is, charges are negotiated between BAC and airport users and are below the maximum charges determined on a long-run, dual till basis.

The pricing agreement introduced by BAC in 2002 saw moderate increases in aeronautical charges, with BAC committed to earning a fair return on its aeronautical assets over time (not instantly).

The following graphs demonstrate that there have been only marginal real growth in the aeronautical charges at Brisbane Airport since 2001/02 and a real growth of only 1.6% per annum between July 1997 and July 2006 for international charges and 2.9% per annum for domestic charges. BAC has maintained these very low growth rates in charges in recent years despite the significant capital expenditure projects undertaken since the removal of the price caps.

[27] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, pp.16 - 17.

Figure 11. Brisbane Airport International Charges – Real Dollars

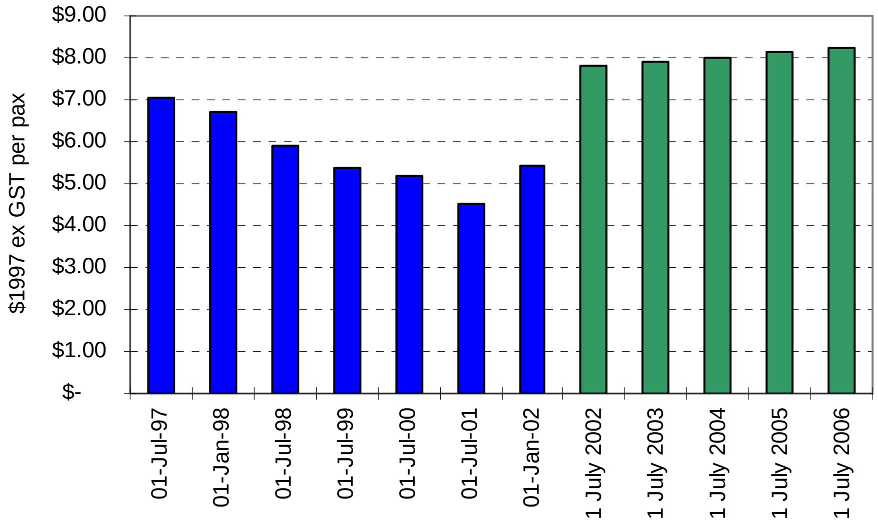
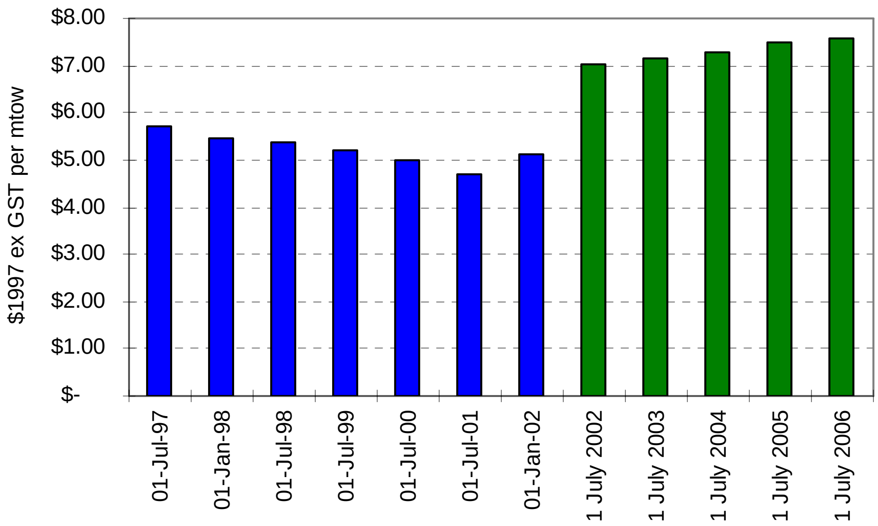


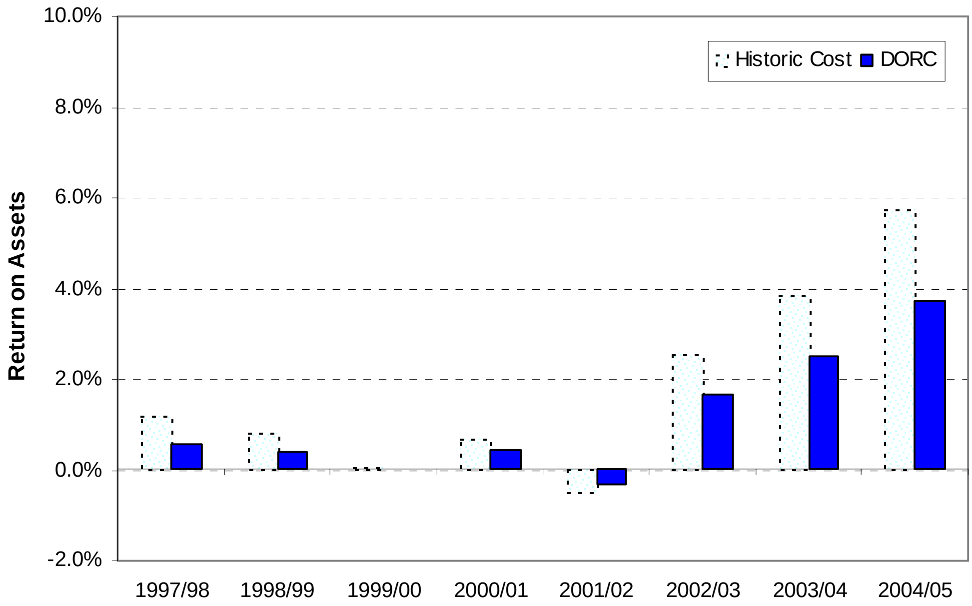
Figure 12. Brisbane Airport Domestic Charges – Real Dollars



The return on assets has improved following the introduction of price monitoring. However, the current return on aeronautical assets is around 5.8% (historic cost) still well below a level which would be considered fair.

BAC revalued operational land and assets in 1999/00. However, all asset revaluations have since been reversed, and all operational assets and land will from 2005/06 be shown on a depreciated historic cost basis under AIFRS. Comparatives for 2004/05 will be adjusted to be on the same basis.

Figure 13. Brisbane Airport Percentage Return on Assets



The rates of return shown in the above graph are pre-tax nominal returns based on both the depreciated historic cost value and DORC values for operational assets and indexed land values for the aeronautical assets. When determined using a DORC value for the aeronautical asset base, the pre-tax nominal return is just 3.7% for 2004/05. BAC believes the comparison of return on assets using depreciated historic costs is not relevant, as BAC supports the use of DORC asset values for pricing and reporting purposes.

As noted above, the initial price increase following the move to price monitoring was to adjust for the fact that the FAC starting prices were not appropriate – such one-off price increases are not expected to be repeated. Following this initial price increase, there have been marginal real increases in aeronautical charges, which have been negotiated with the airlines. This practice is expected to continue into the future as a result of the significant investment program over the next 10 years.

BAC deliberately limited the marginal price increases to minimise the price shocks to airport users. While there was a significant increase in charges in 2002/03, this increase was insufficient to bring the return on assets to a fair and reasonable level – it was still below 3% in that year. Instead of one very large price increase in 2002/03, BAC adopted a price path that will achieve a fair and reasonable commercial return over time. This is reflected in the rates of return, which have been steadily increasing since 2001/02, but are still well below what would be considered a fair and reasonable commercial return on assets.

BAC believes that it has been managing price increases in real terms as best as possible, and to the benefit of the airlines. The ACCC's persistence in highlighting the total change in aeronautical charges since 2001/02 (rather than on a year-to-year basis) gives a misleading perception of the actual real price increases in recent years.

3.3 Charging structures

In its Issues Paper, the Commission asks the following specific questions about the structure of charges:

> *"How has the structure of charges for airport services changed under the price monitoring regime? Have such changes been facilitated by the more light-handed approach to prices oversight?*
>
> *Is the current structure of charges broadly consistent with the efficient provision of airport services and the Government's Review Principles? If not, what changes would be required to deliver more efficient outcomes?"* [28]

BAC believes that a charging structure (whether it be MTOW or passenger based) is consistent with the Review Principles if it is agreed with airport users through commercial negotiation and results in revenue (price times volume) that does not significantly exceed the long run cost of service provision. BAC has met both of these conditions.

BAC recognises that there are advantages and disadvantages to each charging basis, as summarised in the following table.

Table 1: Advantages and Disadvantages of MTOW vs Passenger-based Charges

Charging Structure	Advantages	Disadavantages
MTOW	As fixed cost per aircraft, it provides certainty of total cost to airlines. To some extent, stronger relationship with cost of providing runways, taxiways and aprons at the airport.	Charges remain fixed when there is a reduction in passenger numbers, particularly so for short term fluctuations.
Passenger	Direct relationship with the cost of providing terminal facilities. Greater commercial risk sharing between airports and airlines, particularly in the event of declining load factors. Encourages competition and entry of new airlines, particularly for full-service airlines which tend to have lower passenger numbers in the start up phase.	Less certainty for both airports and airlines, as charges will fluctuate with actual passenger numbers. For new airlines using a low cost carrier model, the new entrant will be subject to higher costs per aircraft, compared to airlines with first and business class services.

There has been recent debate over the use of passenger-based charges for airside services, such as runways, taxiways and aprons, as highlighted in the Australian Competition Tribunal's (the

[28] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.18.

Tribunal's) recent decision to declare airside services at Sydney Airport. The Tribunal found no evidence to support that a passenger based charging policy was more efficient than an MTOW based charging policy for airside services.[29]

BAC does not agree with the Tribunal's conclusion on this matter. The Tribunal considered passenger-based charging policies in isolation of other aeronautical services provided at the airport. In Brisbane Airport's case, the commercially negotiated Aviation Services & Charges Agreement is a bundled product, encompassing airside and terminal facilities, quality of services, dispute resolution, etc.

Further, BAC currently uses a combination of MTOW-based charges (for the domestic landing fee) and passenger-based charges (for the International Passenger Service charge). These charges were agreed with airport users through commercial negotiations, consistent with the Government's Review Principles. BAC adopted a pricing structure that, at the time, met the needs of BAC and airport users as best as possible. BAC has found that international airlines generally prefer passenger based charges.

BAC notes that MTOW is not necessarily the most efficient pricing mechanisms for landing charges, particularly for the use of airside facilities, such as runways, which there is a diverse mix of aircraft using the airport. The reason for this is that small, general aviation aircraft are less efficient users of the available airspace and runways. Thus, in theory, a more efficient pricing mechanism than MTOW for landing would be a measure that reflects how efficiently the aircraft utilises the airspace. While there are advantages and disadvantages associated with both MTOW and passenger based charges, charging the general aviation sector at a higher rate than larger commercial aircraft on the basis of airspace efficiency is not feasible for commercial reasons.

BAC recently received support from the International Air Transportation Association (IATA) for moving to passenger based charging for common airside costs, on the basis of non-discrimination between international and domestic passengers.[30]

BAC has proposed adopting passenger-based charges for the domestic landing charge for 2007, if supported by the airlines and through commercial negotiations.

3.4 Quality of services

In its Issues Paper, the Commission asks the following specific questions about quality of services:

> *"How responsive have the price monitored airports been to users' service needs and preferences? Have changes in service quality been noticeable on a year to year basis? Are there any significant quality problems for services under the control of the airports that are not being addressed? Have necessary new investments generally been made in a timely fashion? How does the quality of service at the price monitored airports compare with comparable airports overseas?*

[29] Virgin Blue Airlines Pty Limited [2005] ACompT 5, 9 December 2005.
[30] IATA, Letter to Tim Rothwell (BAC), 16 June 2006

> *What role has the monitoring undertaken by the ACCC played in sustaining/enhancing service quality? Has some of the information used by the ACCC to gauge quality — for example, passenger surveys — encompassed services not directly under the control of the airports? If so, has the 'overlap' been appropriately handled in the interpretation of the information concerned?"* [31]

BAC contends that it has been very responsive to the airlines' needs and service preferences. This is reflected in the fact that our Aviation Services & Charges Agreement, which was commercially negotiated with airport users, specifically includes quality of service standards, and the methodology by which Brisbane Airport's performance will be measured on an annual basis. Further, it commits to consultation with airlines *"to determine the most appropriate methods of conducting research and the services that we will provide to users of Brisbane Airport that will be the subject of the research"*.[32]

BAC does not support "penalty" clauses for poor service as the complex nature of operations will inevitably mean that failures are a result of various factors, some of which may be outside the control of the airport operator. Where BAC is clearly responsible for failures through its negligence, it is agreeable to compensate airlines.

BAC has also undertaken to introduce specific service level agreements if requested to do so by the airlines as a result of failures since 2002.

BAC is committed to addressing, and has addressed, any quality of service issues promptly with the airlines. The airlines have not formally raised any quality of service issues in the last four years, for which they have sought compensation from BAC. BAC is open to introducing meaningful service level agreements if required by the airlines.

3.5 Dual till approach

BAC contends that pricing at airports, and thus the monitoring of those prices, should continue to be on a dual till basis, using the current definition of aeronautical and non-aeronautical services, consistent with the Government's intention at the time of privatisation.

Further, in its response to the 2002 Review, the Government confirmed that a dual-till approach should apply through the first of its Review Principles:

> *"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."*[33]

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[31] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.18.
[32] BAC, *Brisbane Airport Aviation Services and Charges*, 26 June 2006, p.8.
[33] Minister for Transport & Regional Services and Treasurer, *Productivity Commission Report on Airport Price Regulation*, Joint Press Release, 13 May 2002.

In relation to the consideration of whether a single or dual till approach should apply, the Commission also requests feedback on whether the coverage of specific services should change:

> *"Has the market power enjoyed by the major airports in the delivery of particular services changed since the current arrangements were put in place? Does this suggest a need to alter the range of price monitored services?"*[34]

Any change in the coverage of services implies a re-think on which services and facilities are categorised as aeronautical, and which are classified as non-aeronautical. BAC contends that the reason why airports and airlines generally have poor relationships around the world is that the definition of aeronautical and non-aeronautical activities has been unclear. However, at the time of privatisation, the Department of Transport and Regional Services (DoTARS) is to be congratulated on establishing a (largely) clear definition of aeronautical activity specifically to provide clarity for the bidders. This created an environment in which airports can conduct normal commercial arrangements and any further confusion would simply put this process back further contrary to stated Government policy.

BAC purchased Brisbane Airport based on definitions for aeronautical and non-aeronautical that, based on Government representations at that time, it considered would remain in perpetuity. Any change in these definitions would require BAC to consider the commercial implications, as BAC paid a significant premium to the government for the non-aeronautical assets (such as car parking and duty free). Any moves to change this now would be considered a breach of good faith.

The Commission specifically requests comments on the classification of car parking facilities and fuel throughput levies. BAC provides comments on these, as well as check-in counters in the International terminal, in the following sections

Car parking facilities

Car parking activities at airports generate no greater profits than car parking businesses elsewhere that exhibit locational rents, such as car parks at hospitals and CBD locations.

Car parking at airports is a discretionary activity in the delivery of aeronautical services at airports. Clearly, there are many other supply side options instead of on-airport car parking available to airline passengers, from public transport and taxis to off-airport car parking. BAC has recently experienced such an increase in competition through the introduction of the AirTrain, which offers rail services from Brisbane Airport to the Brisbane CBD and Gold Coast.

Prices for car parking at Brisbane Airport are established based on competitive off-airport car parks and the cost of alternative forms of transport to the airport. This competitive approach to pricing ensures Brisbane Airport cannot be accused of taking advantage of its position.

[34] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.24.

Fuel throughput levies

BAC did not enter into the contract with the oil companies. It was the FAC, a government owned enterprise, which deliberately entered into the contract, that provided for a fuel through-put fee. This contract, which provided significant benefits to the oil companies was signed in April 1997 just as final bids were being negotiated to purchase the airports. Given that the FAC would have no future involvement in the airports, it is inconceivable to think that it was not the Government's intention that the sale price would rise if this contract was in place prior to privatisation.

Representations were made to all airport bidders during the privatisation process that fuel throughput levies and ground facilities fees would be considered non-aeronautical in nature, and therefore excluded from the price cap. Specifically, fuel throughput arrangements were negotiated on a commercial basis between the FAC and aircraft refuelling companies prior to the privatisation process occurring.

Bidders were specifically told they were contractually entitled to activate the charging mechanism, and that this revenue stream would be outside of the aeronautical price cap. This was confirmed in the initial Direction No.13 (for price caps) and the subsequent Direction No. 27 (for price monitoring).

In 2003-04, Shell disputed a fuel throughput levy increased proposed by BAC. Shell and BAC were unable to come to an agreement on the appropriate levy amount, and the matter was escalated to official mediation, in accordance with the Agreement between the parties. Both parties were bound by the decision of the Expert appointed, which found in BAC's favour and resulted in the airlines paying a higher levy than had been offered by BAC to settle the dispute.

Check-in desks

In its submission to the Commission the Board of Airline Representatives of Australia (BARA) argues that *"the provision of check-in counter facilities by airport operators should be classified as an aeronautical service"*.[35]

Similar to the fuel throughput facilities, check-in desk facilities at the International terminal were the subject of a contract between the FAC and airlines prior to the privatisation of Brisbane Airport. As such, the prices for these facilities are also excluded from prices monitoring under Direction No.27.

BAC believes that the inclusion of these facilities in the price monitoring regime is appropriate when this agreement is re-negotiated.

It is BAC's view that agreements that were in place at the time of sale in 1997 (specifically domestic terminal leases, check-in counter agreements and fuel levies) should continue to be excluded from aeronautical revenue until such time as these agreements are renegotiated. At that time they should be reported as aeronautical. This is likely to occur soon for check-in counters due to technology changes and no later than 2018 for the domestic terminal leases.

[35] BARA, *Submission to the Productivity Commission's Inquiry into Price Regulation of Airport Services*, June 2006, p.4.

3.6 Market Power

In its first submission to the Commission's 2002 Review, BAC defined market power as

> *"… the actual ability of a firm (or group of firms) to raise and maintain prices above the level that would prevail under competition, resulting in reduced output and loss of economic welfare. The extent to which airports do possess market power, this will depend upon the degree to which they possess (natural) monopoly attributes, being:*
>
> - *Barriers to entry;*
> - *Substitutability between air transport and other transport modes; and*
> - *Existence of economies of scale and scope.*
>
> *BAC notes however, that the mere existence of these attributes does not necessarily indicate that airports have the actual ability to raise and maintain prices above the competitive price level. Further, BAC contend that there is little scope for airports to abuse their theoretical market power, and there is no evidence during the years since privatisation to indicate that they have done so. This is due to:*
>
> - *Competition between individually operated airports in Australia, that takes the form of:*
>   - *competition to attract new airline services (both passengers and freight);*
>   - *competition for a role as a hub airport and for transfer between hubs;*
>   - *competition between airports within urban areas, specifically for General Aviation users; and*
>   - *competition for the provision of services at airports.*
> - *Significant countervailing market power from the major users of airports; and*
> - *Airports inability to withhold service."*

In its response to the 2002 Review, the Government agreed with the Commission's findings that, while Sydney, Melbourne, Brisbane and Perth have considerable market power, *"due to commercial constraints, the potential for abusing that power does not warrant a heavy-handed regulatory regime"*[36] BAC contends that the same commercial constraints still apply to Brisbane Airport.

In particular, Brisbane Airport competes with unregulated, privatised regional airports, such as Coolangatta, Ballina and Maroochy, for domestic services, as well as major airports (Sydney, Melbourne, Cairns and Coolangatta) for some international services.

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[36] Minister for Transport & Regional Services and Treasurer, *Productivity Commission Report on Airport Price Regulation*, Joint Press Release, 13 May 2002.

The Commission found that, while countervailing power at the margin, of airlines appears limited for major airports, there are circumstances where this is not the case:

> *"… airlines may have a degree of countervailing power even at those airports where there is scope for airport substitution (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."*[37]

Airlines continue to hold countervailing power at the margin, having the option to withdraw or reduce the number of services. Further, international airlines are increasingly using code share (or similar) arrangements to create efficiencies by reducing the number of flights on certain routes. This countervailing power is not perceived, it is actual, and BAC is cognisant of this in its negotiations with the airlines.

A current example is the plan by Qantas and Air New Zealand to jointly determine the services they provide between Australia (Brisbane, Sydney, Melbourne) and New Zealand (Auckland, Christchurch and Wellington). This plan includes a reduction in the number of flights between the two countries, thereby increasing passenger load factors and cutting excess capacity.[38] These decisions are commonly made by the airlines without any discussion with the airports affected.

Airlines sometimes argue that they must fly to the destinations requested by their customers. While this is true to certain extent (particularly for domestic routes), airlines do have flexibility with their routes. For example, airlines that find themselves with spare capacity (i.e. a spare aircraft) will commonly "shop around" for the best deal, playing the airports off against each other to see who will give them the best deal on airport charges. BAC's market power, assuming it has any, is irrelevant in such circumstances.

Internationally, Qantas (including Australian Airlines) had a market share of 31.3% at October 2005. On the domestic front, Qantas (including QantasLink and Jetstar) had a market share of 66.1% at October 2005.[39] Virgin Blue is believed to account for the majority of the balance of the Australian market. This indicates that the market, particularly for domestic services, is highly concentrated and that significant countervailing power rests with the major airlines.

3.7 Asset valuation

The Commission has been asked to *"review aeronautical asset revaluation practices and dispute resolution mechanisms at each of the price monitored airports and advise on improvements that would be consistent with the Government's Review Principles"*.[40]

An asset valuation was undertaken after Brisbane Airport was privatised.

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[37] Productivity Commission 2002, *Price Regulation of Airport Services*, Report no. 19, AusInfo, Canberra. p.XLIX.
[38] Davis, M., 'Qantas faces backlash over Air NZ deal', *Australian Financial Review*, 6 June 2006, p.1.
[39] Qantas, *Qantas Results for the half Year ended 31 December 2005*, Media Release, Available at: http://www.qantas.com.au/infodetail/aout/investors/2005HYMediaRelease.pdf, Accessed 11 July 2007.
[40] Productivity Commission, *Price Regulation of Airport Services*, Issues Paper, May 2006, p.4.

BAC undertook a revaluation of aeronautical assets in June 2000, as part of the development of the Aviation Services & Charges Agreement. This was considered an appropriate time to undertake the asset valuations as it coincided with negotiations of the new agreement.

The valuation was undertaken on a DORC basis by an independent valuer (Rushtons). A DORC valuation was accepted by the ACCC as appropriate in its decision for Sydney Airport in 2001. Further, in that decision, the ACCC reiterated the advantages of the DORC approach from the viewpoint of economic efficiency, quoting its own (then draft) Statement of Regulatory Principles which advocated the use of DORC values for determining opening asset bases for regulated electricity transmission businesses.[41]

BAC has undertaken further revaluations of its aeronautical assets since then. To assess the profitability of aeronautical activity, BAC used the 2000 DORC valuation, rolled forward using the standard principles, consistent with the ACCC's Statement of Regulatory Principles.[42] Thus, BAC has used a "line in the sand" DORC valuation to establish the opening asset base at the end of the regulated period, which has then been rolled forward by adding indexation adjustment and capital expenditure and subtracting depreciation and disposals.

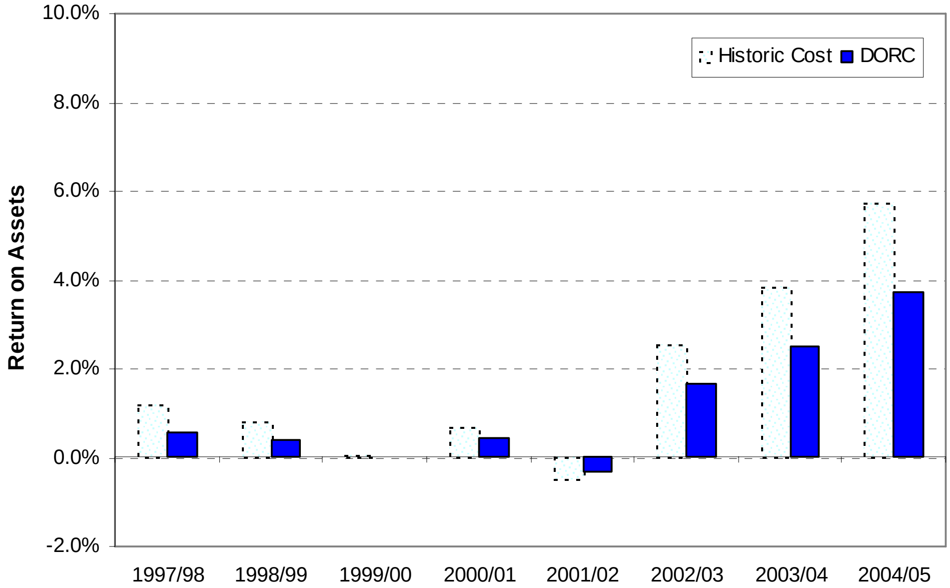
Aeronautical land at Brisbane Airport has been valued on the basis of opportunity cost, consistent with the Commission's finding in its 2002 Review that opportunity cost remains the most appropriate approach to land valuation.[43] BAC recognises the difficulty in determining the opportunity cost for airport land. Therefore, BAC uses indexed historical cost to measure profitability.

As a result of the introduction of International Financial Reporting Standards (IFRS), BAC has reverted to using the 1997 historical land and operating asset values for reporting to the ACCC. This results in returns on assets being overstated relative to the returns on assets based on DORC and indexed land values.

A comparison of profitability in these two different bases is shown below:

[41] ACCC, *Sydney Airports Corporation Ltd – Aeronautical Pricing Proposal*, Decision, May 2001, pp.
[42] ACCC, *Statement of Principles for the Regulation of Electricity Transmission Revenues*, Decision, December 2004.
[43] Productivity Commission 2002, *Price Regulation of Airport Services*, Report no. 19, AusInfo, Canberra. p.286

Figure 14. Comparison of Profitability, Indexed Historic Cost versus DORC

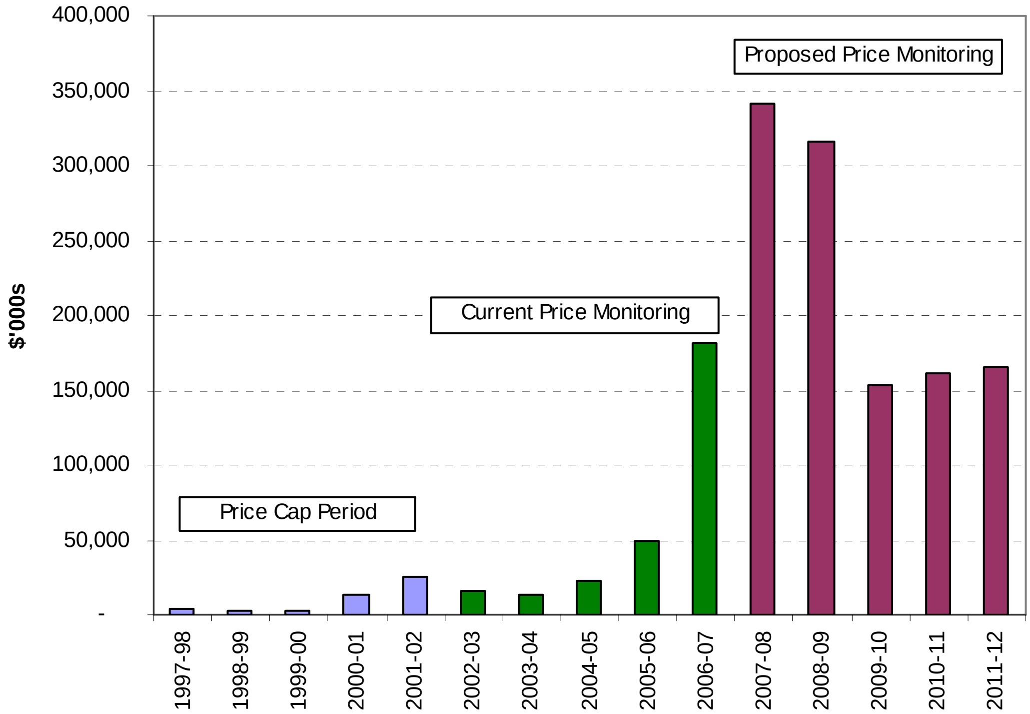


Clear guidelines from government are needed on what it considers to be the fairest method of measuring airport profitability over time and between different airports.

3.8 Investment at the airport

Aeronautical investment at Brisbane Airport has increased significantly following the removal of the price cap, the onerous NNI process and by negotiated agreements with airlines. Furthermore, capital expenditure is expected to continue at a much higher rate during the five years of the next services agreement with airport users, as shown in the following graph.

Figure 15. Brisbane Airport Aeronautical Capital Expenditure



As noted previously, minor capital expenditure projects are included in the services agreement negotiated with the airport users, and are reflected in the prices in the agreement. Charges for major capital expenditure projects are negotiated with airline operators using the same process as the ACCC's NNI provisions under the price cap regime. That is, the appropriate charges for each individual project are determined using a building block methodology, with a pre-tax nominal WACC of 10.8%. This is the WACC approved by the ACCC in its last NNI decision for Brisbane Airport. In August 2005, BAC's consultants advised that an appropriate WACC for Brisbane Airport would be 11.47%.[44]

BAC consults with airport users on each major project and provides them with all relevant information pertaining to each project.

The next services agreement will follow a similar process, with minor projects incorporated into the agreement and major projects negotiated on an individual basis.

Between 2002 and 2007 there has been only one price increase of 32 cents per international passenger from 1 January 2007 in respect of expansion of the international terminal apron.

[44] KPMG, *Weighted Average Cost of Capital*, Report prepared for Brisbane Airport Corporation Limited, August 2005.

4 Future arrangements

In undertaking the 2006 Review, the Commission is required to *"identify relevant alternatives to the current arrangements and the extent to which these alternatives would better achieve the Government's objectives in privatising the airports and moving to a light-handed pricing regulatory regime"*.[45]

BAC contends that the current price monitoring arrangements have met the Review Principles set out by the Government. That is, BAC is now operating under a commercial agreement negotiated with airport users, which sets out (amongst other things) forecast capital expenditure projects, quality of service expectations and dispute resolution processes. BAC consults regularly with airport users on airport operations and requirements. Further, the prices negotiated with users are are starting to approach efficient levels, and allow for an appropriate return on assets commensurate with the regulatory and commercial risks involved.

Therefore, BAC believes that the current light-handed regulatory regime should be retained, with a continuation of the current definition of aeronautical services and the dual till philosophy. However, there are a number of improvements that could be made. These are set out in the following sections.

4.1 Price monitoring

As noted previously, BAC has a number of concerns with the ACCC's practical application of its price monitoring functions, particularly its single till approach which clearly contradicts the requirements of Direction No 27. The ACCC's price monitoring role should be limited to price, revenue and profit monitoring of aeronautical services.

The ACCC's price monitoring role needs to be clarified and BAC believes that this could be achieved with the introduction of clear guidelines for the nature and content of their annual reports on prices.

4.2 Service quality monitoring

In its response to the 2002 Review, the Government agreed with the Commission 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. Quality monitoring of regulated services may also identify whether airports are investing appropriately, for example, by upgrading infrastructure or investing in new facilities to improve levels of service or facilitate increased demand."*[46]

BAC agrees that there is merit in public reporting of service quality indicators in conjunction with price monitoring, and remains committed to the commercial negotiation of quality of

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[45] Productivity Commission, *Regulation of Airport Services*, Issues Paper, May 2006, p.5.
[46] Minister for Transport & Regional Services and Treasurer, *Productivity Commission Report on Airport Price Regulation*, Joint Press Release, 13 May 2002.

service expectations with airport users. This will ensure that there is a balance between the service levels provided (and the infrastructure investment this entails) and the aeronautical charges incurred by airport users.

However, given the concerns we have with the ACCC's practical application of its monitoring functions, BAC believes this function would be better managed by the Department of Transport and Regional Services (DoTARS).

DoTARS is the technical regulator for the aviation and airport industries and BAC also reports to this agency on technical and operational matters. Therefore, DoTARS has a better understanding of the technical and operational aspects of airports, compared to the ACCC, which is an economic regulator. BAC believes that DoTARS would provide an impartial view in its reporting on quality of service at the price monitored airports.

4.3 Pricing and profitability guidelines

Since the removal of the price cap, BAC adopted a "building block" methodology to determine the appropriate level of charges going forward and has used this as the basis for its price and service negotiations with the airlines.

BAC believes there may be merit in developing industry guidelines, which clarify certain matters used in the building block methodology for establishing airport charges. That is, it would set out appropriate methodologies and principles for establishing the building blocks, including:

- Weighted average cost of capital (WACC), particularly the adoption of WACC parameters that result in a fair and reasonable return on assets; and

- Valuation of the aeronautical asset base, particularly the confirmation of DORC as an appropriate "line in the sand" valuation for aeronautical assets and opportunity cost for land, consistent with the Commission's findings in its 2002 Review.

The approach adopted by BAC is already consistent with generally accepted regulatory principles, such as those applied by the ACCC in its 2001 Sydney Airport decision and in the ACCC's Statement of Regulatory Principles. Therefore, BAC believes that such guidelines would ratify the policies and procedures it has adopted as industry best practice.

This approach would assist measurement of airport profitability over time and between airports.

4.4 Dispute resolution

In its Issues Paper, the Commission questions whether there would be value in industry guidelines for commercial negotiations:

> *"Would there be value in the Government and key stakeholders developing some general guidelines or a code of practice for commercial agreements governing access to airport services?"*[47]

BAC believes that dispute resolution should be a matter for services agreements between the airports and the users, as would be the case in any commercial agreement between two parties.

The Brisbane Airport Aviation Services & Charges Agreement includes a dispute resolution process, which incorporates the following steps:

- The issue is initially referred to the Management Committee, who are required to meet at least twice within 14 days of having the issue referred to it.

- If the issue cannot be resolved following two meetings of the Management Committee, the issue is escalated to the Chief Executive Officers (CEOs). The CEOs are required to meet within 14 days of having the issue referred to them.

- If the issue remains unresolved for 60 days after the CEOs have (or should have) met, the issue is referred to mediation under the current rules for mediation used by the Australian Commercial Disputes Centre in Brisbane.

This dispute resolution has worked well for Brisbane Airport, with no issues to date escalated to the formal mediation level.

[47] Productivity Commission, *Regulation of Airport Services*, Issues Paper, May 2006, p.29.

5 Conclusion

BAC has operated in a manner consistent with the Government's Review Principles, in particular:

a) 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.

BAC, which historically has not had any significant capacity constraints, has determined what the efficient prices would be on a dual till basis using a building block methodology. These provided the basis for negotiation with airport users.

Current prices are still below the long run costs, however, BAC has chosen to implement a price path that avoids significant price shocks for users. Between July 1997 and July 2006, real growth in charges was just 1.6% per annum for international charges and 2.9% per annum for domestic charges.

b) Price discrimination and multi-part pricing that promotes efficient use of the airport is permitted. This may mean that some users pay a price above the long-run average costs of providing aeronautical services, whereas more price-sensitive users pay a price closer to marginal cost.

Despite enormous pressure from many airlines, BAC attempts to ensure that pricing does not discriminate against different airport users. Pricing that relates to assets utilised by the airlines concerned is BAC's general aim wherever possible, given the complexity and inter-relationship of airport operations.

c) At airports with significant capacity constraints, efficient peak/off-peak prices may generate revenues that exceed the production costs incurred by the airport. Such demand management pricing practices should be directed toward efficient use of airport infrastructure and, when not broadly revenue neutral, any additional funding that is generated should be applied to the creation of additional capacity or undertaking necessary infrastructure improvements.

This currently does not apply to BAC as it does not have significant capacity constraints. However, BAC is approaching a capacity-constrained environment and will consider the appropriateness of peak / off-peak pricing, subject to negotiation with users.

d) Quality of service outcomes should be consistent with user's reasonable expectations, and consultation mechanisms should be established with stakeholders to facilitate the two way provision of information on airport operations and requirements.

BAC has retained an overall airport rating of "Good" for the past three years under the ACCC's quality of service monitoring arrangements. This is the highest overall rating for the seven price monitored airports.

BAC communicates with airport users on a regular basis through a number of forums.

e) 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.

BAC has a negotiated commercial agreement with airport users, and this is published on BAC's website. BAC has recently commenced discussions with airport users on the next Aviation Services & Charges Agreement, scheduled to commence on 1 July 2007. The terms of this agreement are not expected to be substantially different to the current agreement.

In terms of the future regulatory arrangements, BAC:

- Endorses current government policy and regulation, with only fine-tuning of the current aeronautical services definition, and continuation of the dual-till philosophy and negotiated outcomes between airport users;

- Supports reporting on profitability of aeronautical activities at major airports, but on a fair and more clearly defined basis;

- Believes that there should be clarification of the ACCC's price monitoring role and clear guidelines for the nature and content of their price monitoring reports; and

- Supports quality of service monitoring, although by an organisation such as DoTARS which is more competent than ACCC to conduct such monitoring.

A Consultation meetings on the development of the Aviation Services & Charges Agreement

< *Commercial in Confidence* >

B Circulation of proposed BAC Aviation Services & Charges Agreement

< *Commercial in Confidence* >

C Aviation Services & Charges Consultation Meetings with airport users

< *Commercial in Confidence* >

D Summary of Aviation Services & Charges Consultation Meeting held on 24 May 2006

< *Commercial in Confidence* >

E International Terminal Building Expansion Project

< *Commercial in Confidence* >

F Aviation Services & Charges Agreement

The following extract from the BAC Aviation Services & Charges Agreement sets out our Service Charter. The full text of the Agreement is available on BAC's website:

http://www.bne.com.au/content/standard.asp?name=FeesAndCharges

Our Service Charter and Service Performance

2.1 Our service philosophy

Our major business goal is to develop a prosperous Airport business environment for all of Brisbane Airport's stakeholders. To achieve this we embrace a partnership approach in any dealings we undertake with a clear commitment towards having "Win-Win" outcomes for all parties concerned.

2.2 Our Commitment to you and others using Brisbane Airport

We are committed to operating a safe, secure and efficient Airport providing world class facilities and services to the general public, airline travellers, airlines and aircraft operators, government agencies and associated businesses. To this end, we propose this Service Charter as the basis for establishing the general performance principles, criteria and Performance Measures important for the successful delivery of quality customer services to airlines and aircraft operators, and in turn your customers and passengers.

2.3 You and us are part of a team

Given the interdependencies among all parties that contribute to the experience of a passenger and freight customer at Brisbane Airport, we believe that a team approach with reciprocal commitments from all stakeholders will achieve our common objective of satisfied passengers and other users of Brisbane Airport.

As part of the team approach, we would like to meet with you and your senior management team, at least annually (but more often if you would like) to discuss the plans and development that we have for Brisbane Airport and our performance in providing you with Aviation Services. Likewise, we would like to discuss with you your plans for your business relevant to Brisbane Airport and the aircraft, passenger and freight services you offer from Brisbane Airport.

2.4 Our Service Charter is for the whole of Brisbane Airport

Our commitment to the performance principles set out in clause 2.5 and the Performance Measures will cover the whole of Brisbane Airport. This is to ensure that we and all airlines, aircraft operators and other business operators at Brisbane Airport are striving for and monitoring the same performance levels and embracing the same mutually beneficial service philosophy.

2.5 Performance principles

In order to provide world class facilities and Aviation Services, we will take all reasonable steps to apply the following performance principles to guide our activities and development of Brisbane Airport. We will:

(a) maintain and operate a secure, safe and efficient Airport and will, within a reasonable time after a request from you to do so, provide satisfactory evidence of certification of all reasonable or necessary maintenance and safety checks and inspections; and

(b) provide a comfortable and friendly environment to the travelling public; and

(c) to the extent that it is our responsibility, keep all Airport facilities in good repair and condition and effect all structural and other maintenance, replacement, renovations and repairs with respect to the Airport facilities; and

(d) continue to improve Airport facilities and Aviation Services wherever justified and in accordance with our plans; and

(e) ensure that a high standard of cleanliness of public areas and facilities is maintained by our contractors, tenants and concessionaires; and

(f) continue to maintain and improve Airport facilities and Aviation Services (where possible) for special needs passengers; and

(g) maintain the highest environmental standards practicable while balancing economic development; and

(h) ensure that all Aviation Services, whether direct or indirect, comply with occupational health and safety standards in place from time to time; and

(i) respond quickly to enquiries relating to our facilities and Aviation Services; and

(j) continue to work closely with airlines and their representative organisations, aircraft operators and government agencies, individually and through the Airline Operators Committee, to ensure all Domestic Terminal and International Terminal facilities and Aviation Services are supplied and allocated in a mutually beneficial and equitable manner and with the public's best interests in mind.