BARA
BOARD OF AIRLINE REPRESENTATIVES OF AUSTRALIA INC

Our Ref.: Let.1780

14 August 2006

Price Regulation of Airport Services Inquiry
Productivity Commission
PO Box 80
Belconnen ACT 2616

Dear Sir/Madam

The Board of Airline Representatives of Australia (BARA) has perused various submissions by airport representative organisations to the Productivity Commission (PC) review of airports' pricing arrangements. Based on that perusal BARA would like to offer the following further comments to the PC.

BARA understands that, with the removal of direct price controls, the Government expected airport operators to manage their businesses efficiently and thereby earn a commercial rate of return on their aeronautical investments. Airport operators were also expected to enter into balanced, commercial contracts with airlines. The contracts were to cover both price and non-price terms including indemnities, consultation on operation of the airport, dispute resolution procedures and service level commitments. These basic principles have guided BARA's assessment and response to airports' price and non-price terms and conditions at international airports.

The regulatory environment generated a spectrum of responses and behaviour from airport operators. BARA members have experienced airport behaviour across the spectrum, from relatively reasonable to intransigent monopoly behaviour.

At one end of the spectrum, for example, is the existing Melbourne Airport agreement, which was at least based on a fair and reasonable assessment of what was expected by Government. At the other end of the spectrum, the price offer from Sydney Airport was absurdly inflated. Further, non-price terms and conditions proposed by SACL were, in many instances, a step backwards from the previous draconian Conditions of Use document.

Not surprisingly, negotiations with SACL have been slow and, although the parties have been in discussions since July 2004, the parties have as yet failed to reach an agreement.

BARA considers there is a clear case for re-imposing price controls on the provision of international air services at Sydney Airport. A failure to properly deal with the abuse of monopoly power by SACL will undermine the credibility of the current regime.

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BARA also presents three more comments in relation to SACL.

- The first comment relates to SACL's claim that it is being a model corporate citizen and substantially under-recovering on aeronautical revenue compared with that allowed by the ACCC in its May 2001 price decision for Sydney Airport. In fact, the current shareholders of SACL purchased the lease over the airport long after the September 2001 downturn. The resultant lower traffic volumes, presumably the cause of the aeronautical revenues being lower than those approved by the ACCC, simply would have been reflected in the bid price, which would have been based upon lower traffic forecasts and expected lower aeronautical revenues.

- The second comment relates to SACL's claim that agreement with airlines is essentially "all but reached" over price and non-price terms and conditions. BARA does acknowledge that SACL's revised offer in October 2005 was an improvement over its opening offer in the second half of 2004. However, the standard for comparison was extremely low and the flicker of hope of an agreement quickly expired. Airlines maintain that SACL's revised offer remains an unjustified increase in charges. It also calls for continual asset revaluations, underpinning unrealistic expectations over future pricing arrangements. Further, the revised SACL offer was also deficient in terms of non-price outcomes. However, due to the strict confidentiality obligations SACL has placed on airlines in relation to these negotiations, the airlines and BARA are prevented from commenting in any detail on the SACL proposal. BARA believes the behaviour of SACL in proposing continual asset revaluations for pricing purposes and failing to negotiate over key non-price terms of the agreement represents a clear breach of the Government's Review Principles, specifically [a] and [e].

- The third comment relates to SACL's claim that "SACL already provides access to its aeronautical facilities on terms that have been accepted by airlines". The reality is that SACL has imposed upon airlines a Conditions of Use document which was never formally accepted by BARA or BARA's member airlines. SACL merely deems that airlines accept the Conditions of Use because they continue to operate to Sydney Airport.

Adelaide, Brisbane and Perth airports all sit somewhere in between the spectrum set by Melbourne and Sydney. For example, at Perth Airport aeronautical charges have been set based on revalued assets and there is a general lack of consultation (as highlighted in BARA's original submission. Similarly, Brisbane Airport proposes DORC valuations and the opportunity cost of land as the basis for setting aeronautical charges.

BARA considers that, to varying degrees, all airports apart from Melbourne suffer from three main misconceptions in relation to pricing.

The first misconception is that efficient aeronautical prices need to be based on DORCed asset values. Yet the PC, in its review of the National Access Regime, noted that:

> *"to the extent that the assets are sunk, the facility owner will continue to supply infrastructure services so long as the regulated value exceeds scrap value."*

The various and complex provisions of the airport leases suggest that the scrap value of the aeronautical assets are likely to be low.

However, as noted in BARA's original submission, all capital expenditure is priced on a dual till basis. Consequently, the reality is that the current prices more than compensate Phase I and II airports for their initial purchase of the lease over the aeronautical assets. The use of DORC is nothing more than a vehicle to obtain rent transfers far above the actual amount paid for the lease over the aeronautical assets. It is certainly not a necessary condition for appropriate levels of investment.

BARA also refers to the PC's finding in 2001 that the monopoly power of airports is tempered by non-aeronautical revenues. Experience has shown this not to be the case. For example, in *Re Virgin Blue Airlines*[1] the Australian Competition Tribunal found, after reviewing substantial evidence from the parties, that the constraining effect of non-aeronautical revenue on airport aeronautical pricing was weak. If there was a constraining effect, then airport operators would invest at very low aeronautical prices. This is because not investing in aeronautical infrastructure to support current and future traffic volumes would threaten non-aeronautical revenue growth. BARA does not consider airport behaviour to be consistent with such a case.

The second misconception is that, if required to arbitrate on prices, the ACCC would actually endorse the use of DORC in setting prices. Previous submissions by the ACCC make it clear that that there is nothing to suggest any commitments were made to the airport bidders during the sales process to reset prices through DORC valuations.

The third misconception is that aeronautical assets should be revalued on a periodic basis for pricing purposes. This approach is contrary to the stated position of economic regulators. There is also an inherent conflict in the argument of some airport operators. On the one hand airports argue that they should be allowed to earn a reasonable return on their actual investments. On the other they consider that they are entitled to continual price increases associated with periodic revaluations.

BARA's basic proposition to the PC is this: with the move to light handed regulation, Phase I and II airport operators were afforded considerable pricing flexibility. They also enjoy considerable monopoly power. One can, therefore, reasonably assume that the price increases obtained by airport operators after the removal of direct price controls were **at least** sufficient to sustain their commercial interests in the assets. That is, the prices generated returns at least equal to the airport operator's cost of capital on the implicit value of the aeronautical assets.

Pricing expectations of Phase I and II airports post 2002 are difficult to find. However, the limited evidence obtained by BARA suggested that most phase I and II airport operators expected a continuation of the CPI-X price cap, with perhaps a reduction in the X factor. The price increases actually obtained far exceed such assumptions.

BARA does not argue that charges should be reset based on the price caps implemented back in 1997. However, one "free" bucket of rent to airport operators is enough. Going forward, profits should be earned through efficiencies and the effects of growing demand during the course of a commercial agreement with the airlines.

[1] Re Virgin Blue Airlines [2005] ACompT5 at [511] and [512].

In the case of Sydney Airport, clear statements were made by investors over expected aeronautical charges and aeronautical asset values. BARA has taken these public statements at face value.

BARA urges the PC to carefully scrutinize the pricing expectations claimed by some airport operators and seek factual evidence in support of those claims.

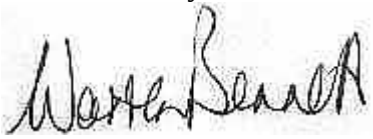
BARA considers that the challenge for the PC is to find the appropriate balance within a prices monitoring regime. A better constructed and well understood prices monitoring regime might provide a worthwhile constraint on aeronautical charges. However, a key element of any regime is a willingness of Government to intervene and re-impose price controls if an airport operator abuses its monopoly power. It is on this basis that BARA made recommendations in its original submission for a number of improvements to the existing regime.

BARA considers that:

(a) Prices monitoring should be reviewed in another five years.
(b) Such relatively new approaches to economic regulation need to be reviewed at suitable intervals to assess outcomes and the appropriateness of existing arrangements.
(c) Any concerns regarding the incentives for investment in airport infrastructure or concerns that previous investments should not be arbitrarily written down simply because they have become sunk are not warranted because under BARA's proposal, all capital expenditure by airports would be priced on a dual till basis and existing asset values would be based on the prices and revenues put in place after the removal of direct price controls. Such values far exceed expectations at the time of sale.
(d) BARA's proposed recommendations are consistent with a light handed regulatory regime. The ACCC initial role is not expanded beyond the collection of the current financial information and some enhanced performance quality data.
(e) Under BARA's proposed arrangements, airlines would have to demonstrate to the Government that an airport operator was not behaving in accordance with the Government Review Principles. The decision to initiate an inquiry or price controls would reside with the Government. The suggested approach is not dissimilar to those proposed by other submissions to the current PC review of airport pricing.

Please contact the undersigned should there be any requirement for additional information in relation to any matters raised above.

Yours sincerely



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