BAC Submission to PC Public Hearings

INTRODUCTION

Brisbane Airport Corporation (BAC) welcomes the Productivity Commission's (the Commission's) Draft Report into the Review of Price Regulation of Airport Services.

The privatisation of Australia's airports is recognised as one of the most successful privatisation processes in the world, in terms of the sale proceeds received by the Federal Government, the regulatory framework established and the post-privatisation results – in particular the quality of service at airports, and more recently the appropriateness of levels of infrastructure investment and the improvement in airport/airline relationships.

The latter relationships were hampered by regulatory uncertainty during the early years of privatisation and still, as the Commission points out, by lack of clarity/perceived fairness in relation to a number of matters, principally, the definition of aeronautical services (at the margin) and the appropriate asset values to be adopted for pricing purposes.

The Commission's Draft Report attempts to address these matters, encouraging further investment by airports and potential improvements in airport/airline relationships over the next few years.

BAC has already announced a 10 year forecast program of investment in terminals, roads and runway infrastructure. Without certainty over financial returns this investment will not proceed.

Whilst BAC may have preferred different recommendations in some areas, it recognises that the draft report is a balance of the practical and theoretical to enable the industry to move forward.

This submission addresses the draft recommendations and in addition provides additional information to the Commission to refute some of BARA's assertions in their recent submission.

The Department of Transport and Regional Services (DoTARS) in its submission (page 11) states that "*Clear pricing principles and guidelines are needed as a basis for commercial negotiations to establish pricing outcomes that are fair to both parties*".

BAC agrees that clear guidelines on asset valuations and rates of return for pricing purposes are essential if the industry is to move forward. Our views on these issues are detailed below.

BAC historically has negotiated charges significantly below a fair return and over the next five years and in the future only ever seeks to achieve fair outcomes in negotiations with airlines.

For the five years from 2007, BAC:

1. Would like to see a clear and fair "line in the sand" starting point for asset values (refer comments under 6.1 below) and

2. Will accept a Weighted Average Cost of Capital for pricing purposes of 10.8% (the last ACCC rate approved for Brisbane Airport), providing this is reviewed in 2012, based on the economic circumstances at the time, despite the Commission's comments that higher rates may be justifiable.

COMMENTS ON THE DRAFT REPORT

BAC's comments below are provided to assist the Commission to finalise its report to Government:

Draft Recommendation 4.1 – A modified airport price monitoring regime should apply for five years from July 2007.

We fully support this recommendation.

Draft Recommendation 4.2 – The new price monitoring regime should apply to Adelaide, Brisbane, Canberra, Melbourne, Perth and Sydney Airports. Darwin should not be subject to monitoring once the current arrangements lapse.

No comment.

Draft Recommendation 5.1 – The new price monitoring regime should continue to operate on a dual till basis. The services covered should be those specified in the current proposal from the Department of Transport and Regional Services to align the relevant parts of the Airports Act and the directions pursuant to the Trade Practices Act giving effect to airport price monitoring.

This results in additional services (principally those that were the subject of a Federal Airports Corporation (FAC) lease, licence or authority prior to privatisation) now being treated as aeronautical, contrary to the Government's statements at the time the airports were sold.

This change represents a (potential) rent transfer to airlines, at the expense of airports. In the interests of moving forward BAC is nevertheless prepared to support this change.

BAC however, still believes that further work needs to be done by the Commission and DoTARS perhaps in consultation with a small group of airport and airline representatives to ensure that there is no further confusion over the definition of aeronautical services.

In particular, BAC believes there are a number of services included in Appendix C4 of the Draft Report where the DoTARS definition is either unclear or inequitable. These are:

- Airside freight handling – is not (we assume) intended to include freight sheds on the landside/airside boundary, which are subject to separate leases. More clarity is required on this issue.

- Aircraft light and emergency maintenance site and buildings – further clarification is required as to precisely what sort of facilities this refers to.

- Telecommunication Infrastructure – BAC has invested in a significant network of IT and telecommunications infrastructure on the airport site only a small part of which is used by airlines. Given that conduct and pricing of such activity is subject to the Telecommunications Act we cannot understand why there is a need to further regulate this activity, which may have the effect of curtailing future investment by airports in this asset class. Airlines are free to use any telecommunications carrier they wish to, providing those carriers comply with the requirements of the Telecommunications Act.

- Office space and facilities in terminals or airside for airline staff – In Brisbane's case this appears to include the Qantas and Virgin domestic terminal leases. At other airports, where Qantas only leases land and Qantas owns the terminals, the leases may be excluded. Again, more clarity is required on this issue.

Draft Recommendation 5.2 – The Government should consider asking the Australian Competition and Consumer Commission to separately monitor charges for car parking and other landside vehicle services at the major airports.

The market power of airports in relation to public car parks is no different to that at hospitals, rail stations, or CBD car parks. There is no reason why airports should be singled out for price monitoring. Airport car parks compete with taxi, limousine, bus and train services and significant off-airport car park operations. Should the Government accept the Commission's recommendation it is appropriate that other car parks be included to ensure that airports are compared to owners of similar assets with similar market power, rather than in isolation.

Draft Recommendation 5.3 – Monitoring of service quality under the new regime should be limited to the reporting by the Australian Competition and Consumer Commission of commentary sought from airports and their customers on overall quality outcomes and particular quality problems, and any information provided by them to support that commentary.

BAC supports this recommendation.

Draft Recommendation 5.4 – Price and service quality monitoring outcomes should be combined in a single report, published every two years. To align with the proposed end-of-period review in 2011 (see draft recommendation 5.5), the first of these reports should be published in early 2009 and cover outcomes during 2006-07 and 2007-08. To accommodate this new reporting arrangement, there should be no separate review of outcomes for the final year of the current price monitoring regime.

BAC supports this recommendation.

Draft Recommendation 5.5 – The new price monitoring regime should be reviewed in 2011 to determine what arrangements should apply thereafter. Assessments under that review, and the operation of price monitoring in the intervening period, should be governed by an overarching set of principles. These should be the current "Review Principles", augmented to specify that:

- **The benefits of improved productivity at the price monitored airports should be shared between airport operators and their customers; and**
- **Future asset revaluations should not generally provide a basis for higher charges (see draft recommendation 6.2).**

The Draft Report provides little guidance on how the benefits of improved productivity might be shared between airports and airlines. Further clarification is required on how this would operate in practice.

Whilst understanding the idea that future asset revaluations should not provide a reason for unfair windfall gains to airports, this issue should be revisited in the next review.

Draft Recommendation 6.1 –Under the new price monitoring regime, the value of an airport's asset base for monitoring purposes should be:

- **The value of tangible (non-current) aeronautical assets reported to the Australian Competition and Consumer Commission as at 30 June 2005, adjusted as necessary to reflect the proposed service coverage of the new regime (see draft recommendation 5.1);**
- **Plus new investment (at values agreed with customers);**
- **Less depreciation and disposals.**

BAC notes that this is a compromise proposal designed to resolve the disagreement over appropriate asset valuations for pricing/reporting purposes. However, this recommendation will result in arbitrary outcomes due to the different approaches to asset valuation adopted by each airport. This in turn may reduce the effectiveness of the ACCC monitoring reports, as comparisons between airports would need to be qualified.

Whilst BAC is prepared to support the Commission's proposed compromise values based on 30 June 2005 ACCC regulatory accounts, it is clear that BARA and airlines will not support this, resulting in continued disputes about the fairness of the basis. In the event of arbitration, it is not clear on what basis a dispute would be considered. In the circumstances, the Commission may wish to reconsider their position on this matter.

There appear to be four logical dates for establishing an asset base for price and profit monitoring purposes:

1. The dates the airport leases were acquired;
    - July 1997 – Brisbane, Melbourne and Perth
    - July 1998 – Adelaide and Canberra
    - July 2002 – Sydney

    [historic cost basis]

2. That date that airport charges were deregulated;
    - July 2002 [enables fair comparisons between all airports]

3. The date from which all airports began reporting results under new international reporting standards (AIFRS).
    - July 2004 [ease of monitoring going forward]

4. The start of the next regulatory period;
    - July 2007

Given the different accounting treatments at different airports, BAC proposes that if not already available there be a "line in the sand" valuation undertaken for each of the price monitored airports, and that this valuation be undertaken on a depreciated optimised replacement cost (DORC). This is consistent with the ACCC's approach to electricity

transmission regulation, and that commonly adopted by jurisdictional regulators for other regulated infrastructure.

There are two other issues that require further clarification:

Firstly, It is unclear whether it is the Commission's intention that asset values should be grown by an appropriate inflation measure to reflect the time value of money.

Secondly, it is not clear what the Commission intended by the words "at values agreed with customers". This leaves open the possibility that an airline (or airlines) that do not have expansion plans at a particular airport could seek to block necessary expansion at an airport by refusing to agree the value of or need for an investment for no other reason than strategic competitive behaviour against other airport users.

We would recommend that this wording be amended to "at fair values supported by independent cost consultants" or similar.

Airports have an obligation and a strong desire to work in good faith with airlines to develop infrastructure proposals that are operationally and cost-efficient, but ultimately the airport has to decide and is obliged under the airport lease to provide an appropriate level of capacity and quality at the airport to meet market demand.

Draft Recommendation 6.2 – The principles governing the operation and end-of-period review of the new price monitoring regime should stipulate that, unless agreed with customers, further asset revaluations should not provide a basis for higher charges for monitored aeronautical services.

Refer to 5.5 above.

Draft Recommendation 7.1 – An airport-specific arbitration regime, or a requirement that agreements between airports and airlines include provision for binding independent dispute resolution, should not be introduced at this time.

BAC agree with this recommendation. For your information, we set out below the dispute resolution procedures included in the Brisbane Airport Aviation Services & Charges Agreement which were agreed to by BARA (on behalf of its members) and Virgin Blue.

Clause 21

21 Dispute resolution

21.1 Procedure

If either party considers that a controversy or dispute has arisen in connection with or under these standard conditions (including the Attachments) ("**Issue**"), then the parties must follow the procedure set out in this clause 21 to resolve the Issue. In particular, the parties must, before commencing court proceedings, refer the Issue to the Management Committee in accordance with clause 21.2, and thereafter proceed in accordance with clauses 21.3 to 21.6.

21.2 Referral to Management Committee

If an Issue remains unresolved for 14 days, either party may refer the Issue to the Management Committee immediately or within such longer period as they may agree.

21.3 Management Committee to meet

The Management Committee must meet at least twice at our offices (or such other place as the parties may agree) within 14 days of having the Issue referred to it under clause 21.2 to discuss the Issue in good faith with a view to resolving the Issue by agreement between the parties.

21.4 Failure to agree

If the Issue remains unresolved for 60 days after the Management Committee met (or should have met), or such longer period as the parties may agree, either party may refer the Issue to the Chief Executive Officers of the parties.

21.5 Referral to CEOs

The Chief Executive Officers or their nominee ("**CEOs**") must, within 14 days of one party notifying the other of the existence of the Issue, meet at our offices (or such other place as the parties may agree) and discuss the Issue in good faith with a view to resolving the Issue.

21.6 Mediation

If an Issue remains unresolved for 60 days after the CEOs have met, (or should have met), then the parties agree that the Issue will be referred to mediation under the then current rules for mediation used by the Australian Commercial Disputes Centre in Brisbane, Australia. Unless otherwise agreed by the parties, the mediation will take place in Brisbane, Australia. Each party will bear their own legal and other costs and expenses of the mediation.

21.7 Aviation Charges and Government Mandated Charges

If the Issue relates to the calculation and payment of Airport Charges or Government Mandated Charges, we agree that you do not have to pay the amount of any Airport Charges or Government Mandated Charges that are the subject of a bona fide dispute unless and until and from such time as the Issue is resolved in accordance with this clause. You otherwise agree to pay any amount of Airport Charges or Government Mandated Charges that are not in dispute at the time specified for doing so under these standard conditions.

21.8 Legal proceedings

Nothing in this clause 21 prevents either party from commencing legal proceedings for urgent interlocutory relief.

COMMENTS BY BARA, IATA AND OTHERS IN RELATION TO BRISBANE AIRPORT'S POST 2007 PRICING INTENTION.

Concerns have been expressed by IATA, BARA and Qantas in their submissions on the draft PC Report that BAC intends to use asset revaluations to justify significant price increases. The facts (as is often the case with BARA submissions and newsletters) are somewhat different.

It is disappointing to see BARA's attitude change so rapidly. BAC believed that it had a good relationship with BARA, but that appears to count for little as long as BARA can keep prices down. In 2005 BAC was awarded the IATA award for the World's best privatised airport based on its good relationships with airlines. BAC is a principled organisation that chose in 2002 to negotiate lower charges with its airline customers than most airports on the basis that it would, over time, move towards a fairer return on its investment in Brisbane Airport (as compared to some other airports that did so immediately in 2002). Rather than being commended for this approach, BARA has taken the opportunity to try to brand Brisbane Airport, in the eyes of the Commission, as an airport that is behaving unreasonably simply because it continues to expect to move toward fair pricing levels over the next few years.

It appears that BARA is less interested in the principles of commercial relationships, looking only for any outcome that delivers low airport charges for its members.

It is revealing to see that BARA appears to see fairness as inappropriate in pricing – Page 17 "*Indeed Brisbane Airport's main argument is not economic efficiency but fairness*" (BARA Submission p.17). BARA believe it would be unreasonable for prices at Brisbane Airport to be "fair" but reasonable for BARA if prices are low.

Whilst this is not something we would have wanted to waste the Commission's time on, it is important that the Commission is not misled by these comments. Therefore, a brief history of the negotiations at Brisbane Airport may assist the Commission.

In October 2001, BAC provided BARA and its major airline customers with information on what it believed to be fair prices based on the principles and levels of return that ACCC deemed appropriate a few months earlier in a New Investment Decision.

BAC negotiated lower prices with the airlines, compared to most other airports, with prices increasing by a further 5% in each of the next four years to gradually move towards a fairer return on aeronautical assets (see Table 2.4 of draft PC report). Whilst BARA (on behalf of its member airlines) and Virgin Blue reached agreement with BAC, Qantas was not prepared to agree on the same terms and conditions. Instead they required additional terms, a number of which were perceived by BAC to be anti-competitive. BAC was not prepared to discriminate between airlines and provide special terms (including imposing domestic passenger based runway charges) for one airline and disadvantage others.

In any event, Qantas has paid charges, were pleased to accept growth rebates and acted generally in accordance with the agreement since 2002.

Consistent with its 2002 – 2007 agreement BAC, in 2006 proposed to the airlines that prices be increased by 5% p.a. from 2007 for the next five years and for major new investment, using ACCC NNI principles based on a 10.8% return. BARA and the airlines rejected the proposal, despite the fact that BAC would still not be achieving a 10.8% return on its aeronautical assets, even on a historic cost basis.

Instead, they indicated that they wanted a five year pricing agreement (incorporating all forecast projects in the period) which delivered a constant rate of return of 10.8% over the period.

As BARA indicated in a recent email to BAC: " *The apparent adoption by BAC of the notion of an NNI-type price adjustment for the ITBX (international terminal expansion) project is not acceptable to airlines. NNI-type adjustments to charges are seen by airlines as a relic of the CPI-X price regime. They do not belong in the current pricing regime. You would be aware that airlines expect aero charges to be re-assessed about every five years (or the term of contractual arrangements agreed between airlines and the airport operator). The basis of that re-assessment is the asset value at the commencement of the agreement (determined by privatisation date asset values depreciated going forward, plus additions and disposals), the value of the capital program over the term of the commercial agreement and efficient operating costs. The aero charge going forward and the cost recovery for the ITBX project should be set on this basis*."

This approach advocated by BARA in fact, generates higher prices for (especially international) airlines than those prices proposed by BAC in the first place. Consistent with Government intentions of airports and users achieving a commercially negotiated outcome, BAC have indicated their willingness to adopt the airlines preferred pricing methodology.

Whilst we are yet to receive a formal response to the information we have provided, BARA has indicated that they are now not happy with this proposal either.

BARA's principal concern has now switched to how BAC has established the historic cost of aeronautical assets at Brisbane Airport.

This view may be based on incorrect information in Attachment 6 of the DoTARS submission to the Commission which states that BAC's assets were revalued in 2000. This is only part of the story.

In fact, the situation was similar to Perth Airport with the 1997 breakdown of the airport purchase price restated in BAC's 2000 Annual Report based on independent external valuations of certain assets, an exercise that was not undertaken in 1997/98.

Attachment 1 is an extract from the ACCC Regulatory Accounting Statement for year ended 30 June 2000. In terms of aeronautical assets, the increase of $274 million comprised a restatement of the 2 July 1997 values (net of depreciation from 1997/98 to 1999/00) of $190 million and a revaluation (based on the increased value of assets between 1997 and 2000 of $84 million). Refer Statement 1.2 of Attachment 1. The ACCC chose not to include this information in their Regulatory Report for 1999/00, despite it being provided to them, so it is not surprising that DoTARS did not note this in their submission to the Commission.

For the information of the Commission in 1997, a desk-top valuation exercise was undertaken to determine opening asset values for the newly formed Brisbane Airport Corporation in its 30 June 1998 Annual Report. It was not until 2000 that a detailed engineering evaluation with full breakdown of runway, taxiway and apron asset values was undertaken. The 1997 values adopted are therefore generated from valuation reports prepared in both 1997 and in 2000 (at 1997 values).

All valuations were undertaken by appropriately qualified external valuers, and the valuations are fully supported by the valuation reports. Valuations were reviewed and signed off by BAC's directors and external auditors. Copies have been provided to BARA.

BARA also contends that Brisbane Airport's financial returns are excessive and that increased prices are not justified, often quoting Melbourne Airport as one airport with fair returns on assets.

For the information of the Commission, set out below is a comparison of the assets and returns at the two airports:

$000's	***Melbourne***	***Brisbane***
Cost of aeronautical assets at 2 July 1997	463,058	531,308

Note:

1. *Brisbane Airport's assets above are based on independent external valuations as at 2 July 1997.*
2. *Additions since 1997 at the two airports are similar except that Melbourne assets may need to be increased for the cost of the Ansett terminal acquired in 2002, probably resulting in similar asset values at the two airports now.*

Given that Brisbane's runways and domestic terminal were built in 1988 and the international terminal in 1995, all much newer than Melbourne, the relative written-down replacement values at 2 July 1997 do not appear to be unreasonable.

In terms of the most recently published ACCC regulatory reports aeronautical returns are set out below:

($000's)	***Melbourne***	***Brisbane***
Aeronautical revenue	134,635	86,496
Costs - depreciation	18,459	20,462
- operating costs	51,801	42,495
Margin	64,375	23,539

Note 1: Melbourne Airport's figures presumably include revenue and costs in relation to the former Ansett terminal.

It is hard to understand how BARA, IATA or Qantas would seriously put forward an argument that current returns at Brisbane Airport are excessive or even unreasonable compared to other airports.

In response to some of the other comments in BARA's recent submission:

Page 1:

"*It is critical that the Commission make clear its expectations over future pricing behaviour by Brisbane and Canberra airports. Both airports are likely to implement further price increases for existing assets based on their booked 30 June 2005 asset values*".

As noted below, 30 June 2005 Regulatory Accounts values rather than 2 July 1997 independent values would add between $6 million and $7 million to annual charges (around 40 cents per passenger) even if sought by BAC.

***Page 7*:**

BARA claims that "*the (Commission's) method mechanically gouges hundreds of millions in rent when used in conjunction with its (Brisbane's) 30 June 2005 asset value*" is just plain nonsense.

Adopting the PC's proposed compromise in respect of asset values based on BAC's 30 June 2005 regulatory accounts would add less than $60 million to the asset base. Based on a 10.8% return, this is hardly (even if increases based on 30 June 2005 book values were proposed by BAC) – "gouging hundreds of millions of rent????"

***Page 16*:**

"Brisbane Airport has clearly signalled its intention to significantly increase prices for existing assets in its next pricing agreement."

In fact, as demonstrated above it is BARA that has actually requested a pricing proposal which delivers higher prices than those put forward by BAC in the first place.

"*BARA considers that, under the PC's proposed arrangements, the only meaningful numerical measure of pricing conduct is going to be pre-tax return on assets*".

BAC supports BARA's views on this.

Page 17:

"*Brisbane Airport is simply seeking to capture this discount through setting prices on revalued assets". "BARA considers the economic efficiency justification for Brisbane Airport to continue to increase prices for existing assets is as weak as the justification for increasing prices based on further revaluations*".

BAC is not proposing to increase prices using post 2 July 1997 values.

In other words, BARA supports a five year building block approach to pricing based on historic cost of assets where it delivers price reductions, but not if it justifies higher prices.

BAC can sympathise with the Commission's challenges in reporting to Government on Price Regulation of Airport Services in the face of such blatant hypocrisy.

It is really disappointing to see BARA's comments on BAC's pricing intentions, which are purely driven by a desire to see the lowest (rather than fair) charges in place at Australian airports.

To summarise our comments in relation to the above points raised by BARA (and others) in relation to likely future behaviour by Brisbane Airport, BAC believes their commentary is both inaccurate and not relevant for the purposes of the Commission's current review. These comments do not reflect BAC's intentions (other than its intention to earn a fair return on aeronautical assets over time), and BAC has not proposed increasing prices based on revaluation of assets, only based on independent valuations as at 2 July 1997, which BARA is at liberty to go to arbitration on. Nor do they reflect BAC's behaviour during the current five year monitoring regime.

BAC is not surprised by the strong reaction to the Draft Report by Qantas, Virgin Blue and BARA. It is clear that these groups are taking the opportunity of the PC Inquiry to lobby as strongly as possible for outcomes which are heavily in their favour. It is our experience that BARA and Qantas in particular, are interested only in outcomes which produce the most favourable commercial results for themselves, with no regard to fairness or appropriateness of methodology throughout the industry as a whole. They appear to have no interest in the achievement of the Government's aims for the regulatory regime, only in the achievement of a regulatory regime which delivers the lowest prices and highest possible value outcome to their shareholders – which was historically the case prior to privatisation.

CONCLUSION

BAC welcomes the Productivity Commission Draft Report into the Review of Price Regulation of Airport Services and is prepared to clarify any of its comments if this would assist the Commission to finalise its report to Government.