The Australian Airports Association (AAA) is a non-profit organisation that was founded in 1982 in recognition of the real need for one coherent, cohesive, consistent and vital voice for aerodromes and airports throughout Australia.

The AAA represents the interests of over 380 members. This includes more than 260 airports and aerodromes Australia wide – from the local country community landing strip to major international gateway airports.

The AAA also represents more than 120 aviation stakeholders and organisations that provide goods and services to airports.

The AAA facilitates co-operation among all member airports and their many and varied partners in Australian aviation, whilst contributing to an air transport system that is safe, secure, environmentally responsible and efficient for the benefit of all Australians and visitors.

The AAA is the leading advocate for appropriate national policy relating to airport activities and operates to ensure regular transport passengers, freight, and the community enjoy the full benefits of a progressive and sustainable airport industry.
# CONTENTS

<table>
<thead>
<tr>
<th>1</th>
<th>Executive summary</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1</td>
<td>About the airports industry</td>
<td>3</td>
</tr>
<tr>
<td>1.2</td>
<td>The AAA’s primary position</td>
<td>4</td>
</tr>
<tr>
<td>1.3</td>
<td>The AAA’s approach to this submission</td>
<td>9</td>
</tr>
<tr>
<td>2</td>
<td>Airport charges, airline costs and airfares</td>
<td>11</td>
</tr>
<tr>
<td>2.1</td>
<td>Airport charges and airline costs</td>
<td>12</td>
</tr>
<tr>
<td>2.2</td>
<td>Airport charges and airfares</td>
<td>15</td>
</tr>
<tr>
<td>2.3</td>
<td>A naive estimate of demand elasticity with respect to airport charges</td>
<td>17</td>
</tr>
<tr>
<td>2.4</td>
<td>So how do airfares actually relate and respond to airport charges</td>
<td>19</td>
</tr>
<tr>
<td>2.5</td>
<td>Why neoclassical elasticities over estimate demand response to a change in airport charges</td>
<td>22</td>
</tr>
<tr>
<td>3</td>
<td>Aeronautical prices and profits</td>
<td>25</td>
</tr>
<tr>
<td>3.1</td>
<td>Some high level pricing principles</td>
<td>25</td>
</tr>
<tr>
<td>3.2</td>
<td>How aeronautical prices are set</td>
<td>34</td>
</tr>
<tr>
<td>3.3</td>
<td>Aeronautical prices</td>
<td>37</td>
</tr>
<tr>
<td>4</td>
<td>Benchmarking airport performance</td>
<td>51</td>
</tr>
<tr>
<td>4.1</td>
<td>Why might benchmarking reveal abuse of market power?</td>
<td>51</td>
</tr>
<tr>
<td>4.2</td>
<td>Quality of service</td>
<td>53</td>
</tr>
<tr>
<td>4.3</td>
<td>Airport costs</td>
<td>56</td>
</tr>
<tr>
<td>4.4</td>
<td>Investment</td>
<td>61</td>
</tr>
<tr>
<td>5</td>
<td>Airport market power</td>
<td>67</td>
</tr>
<tr>
<td>5.1</td>
<td>What services at what airports may present market power issues</td>
<td>67</td>
</tr>
<tr>
<td>5.2</td>
<td>Market characteristics that ameliorate airport market power</td>
<td>68</td>
</tr>
<tr>
<td>5.3</td>
<td>Airport leases restrict exercise of market power</td>
<td>74</td>
</tr>
<tr>
<td>5.4</td>
<td>Airports lack legal capacity to enforce pricing and other outcomes</td>
<td>76</td>
</tr>
<tr>
<td>5.5</td>
<td>Behavioural issues</td>
<td>80</td>
</tr>
<tr>
<td>5.6</td>
<td>Concluding comments</td>
<td>81</td>
</tr>
</tbody>
</table>
### 6 Dispute resolution and future regulatory options

- **6.1 Policy responses to abuse of market power**
- **6.2 Dispute resolution – the current state of play**
- **6.3 Alternative dispute resolution arrangements**
- **6.4 Future monitoring arrangements**

### 7 Car parking and ground access market power

- **7.1 Airports do not hold substantial market power in car parking services**
- **7.2 Airports have not used any market power in car parking services**
- **7.3 Airports have not exercised any market power in landside access**
- **7.4 Conclusion**

### 8 Other Issues relevant to the Inquiry

- **8.1 Jet fuel supply arrangements**
- **8.2 Ground transport planning and access**
- **8.3 Future aviation security arrangements**
- **8.4 Revised approach to providing border services at new and redeveloping airports**

**Bibliography**
1 Executive summary

The Australian Airports Association (AAA) is pleased to make this submission to the Productivity Commission’s fourth inquiry into airport regulation.

1.1 About the airports industry

The AAA is the national industry voice for airports in Australia. The AAA represents the interests of more than 300 airports and aerodromes Australia-wide – from local country community landing strips to major international gateway airports. It has a further 130 corporate members who provide goods and services to airports. The AAA has recently commissioned a report from Deloitte Economics on the economic contribution of Australia’s airports which is available on its website.1

Despite the recent campaign of disparagement by sections of the airline industry, the Australian airports industry is regarded as one of the most customer focused transport and economic and social infrastructure sectors in Australia, as shown in Figure 1.1.

Figure 1.1 Customer focus of the Australian transport and infrastructure sector

Source: Newgate (2016).

There are around 155 airports in Australia with regular public transport (RPT) services and more than 2000 smaller airfields and landing strips around the country, of which about 75% are located in regional and remote areas. Overall, activity is dominated by the ten largest airports servicing about 140 million domestic and international passengers, accounting for around 90% of the overall passenger traffic in 2017. The monitored airports – Brisbane, Melbourne, Perth and Sydney – accounted for 72% of total passengers in that year.

Australia’s ten largest airports are privately operated under leases from the Australian and Queensland governments. They have an enterprise value of around $60 billion. About one third of this is provided by debt capital which makes the sector’s gearing low compared to other infrastructure sectors – this is a reflection of the risk born through exposure to passenger volumes, particularly in their aeronautical businesses. To a significant degree, the regulatory policy of successive Australian governments has underpinned the investment grade credit ratings achieved by Australian airports set out in Table 1.1. Such ratings are necessary to fund ongoing investment in capacity.

Table 1.1  Credit ratings of global airports

<table>
<thead>
<tr>
<th>Issuing airport</th>
<th>Country</th>
<th>Rating</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avinor AS</td>
<td>Norway</td>
<td>A1</td>
<td>Stable</td>
</tr>
<tr>
<td>Cesky Aeroholding a.s.</td>
<td>Czech Republic</td>
<td>A1</td>
<td>Stable</td>
</tr>
<tr>
<td>Flughafen Berlin Brandenburg GmbH</td>
<td>Germany</td>
<td>A1</td>
<td>Stable</td>
</tr>
<tr>
<td>Royal Schipol Group N.V.</td>
<td>Netherlands</td>
<td>A1</td>
<td>Stable</td>
</tr>
<tr>
<td>Australia Pacific Airports (Melbourne) Pty Ltd</td>
<td>Australia</td>
<td>A3</td>
<td>Stable</td>
</tr>
<tr>
<td>Aena S.A.</td>
<td>Spain</td>
<td>Baa1</td>
<td>Stable</td>
</tr>
<tr>
<td>Aeroporti di Roma</td>
<td>Italy</td>
<td>Baa1</td>
<td>Negative</td>
</tr>
<tr>
<td>Birmingham Airport (Finance) plc</td>
<td>United Kingdom</td>
<td>Baa1</td>
<td>Stable</td>
</tr>
<tr>
<td>Brisbane Airport Corporation Pty Ltd</td>
<td>Australia</td>
<td>Baa1</td>
<td>Stable</td>
</tr>
<tr>
<td>Brussels Airport Company NV/SA</td>
<td>Belgium</td>
<td>Baa1</td>
<td>Stable</td>
</tr>
<tr>
<td>Manchester Airport Group Funding plc</td>
<td>United Kingdom</td>
<td>Baa1</td>
<td>Stable</td>
</tr>
<tr>
<td>Sydney Airport Finance Company Pty Ltd</td>
<td>Australia</td>
<td>Baa1</td>
<td>Stable</td>
</tr>
<tr>
<td>Aeroports de la Cote d'Azur</td>
<td>France</td>
<td>Baa2</td>
<td>Stable</td>
</tr>
<tr>
<td>Copenhagen Airports A/S</td>
<td>Denmark</td>
<td>Baa2</td>
<td>Stable</td>
</tr>
<tr>
<td>New Terminal Financing Company Pty Ltd (Adelaide)</td>
<td>Australia</td>
<td>Baa2</td>
<td>Stable</td>
</tr>
<tr>
<td>Perth Airport Pty Ltd</td>
<td>Australia</td>
<td>Baa2</td>
<td>Stable</td>
</tr>
<tr>
<td>Azzura Aeroporti s.r.l</td>
<td>Italy</td>
<td>Baa3</td>
<td>Stable</td>
</tr>
<tr>
<td>Copenhagen Airports Denmark ApS</td>
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<td>Baa3</td>
<td>Stable</td>
</tr>
<tr>
<td>Heathrow Finance plc</td>
<td>United Kingdom</td>
<td>Baa1</td>
<td>Stable</td>
</tr>
</tbody>
</table>


The AAA estimates Australian superannuation funds – those registered by the Australian Prudential Regulation Authority – provide around 47% of the equity of Australia’s private airports. Another 25% is provided by other private Australian investors. Whilst this is dominated by portfolio investors in Sydney Airport (some of which may be held in self-managed superannuation funds), it includes private investors such as the Perron Group and the Snow Family, as well as general investors on the stock exchange and retail managed funds such as the AMP Capital Core Infrastructure fund. The Future Fund holds around 9% of equity in Australia’s airports whilst 19% is held by foreign investors – the largest of which is Schipol Airport which has invested in Brisbane Airport since privatisation.

1.2 The AAA’s primary position

Despite recent ill-informed global debate led by the International Air Transport Association (IATA) about the merits of airport privatisation, long serving departmental secretary Mike Mrdak AO has said “Australian airport privatisations were still seen as exemplars by the rest of the world”. Part of the reason for this was the policy design process at the time of privatisation – principally, full private ownership; long term leases; and separately owned airports with multiple owners potentially competing in product and capital markets.

But of equal importance has been the light handed regulatory framework that has been in place since 2002. The price control arrangements put in place at the time of privatisation, whilst well-conceived (for example preferring a tariff-basket price cap rather than a revenue cap), were poorly implemented, particularly in regard to necessary new investment. The Australian Competition and Consumer Commission (ACCC) regulatory conduct demonstrated that its primary focus was clearly on restricting price increases rather than facilitating efficient investment outcomes, especially in relation to necessary security investment.

In the face of these outcomes the then Australian Government (with the support of the Labor Opposition) accepted the key recommendation of the Commission in 2002 to replace price controls for Australia’s mainland capital city airports with a light-handed regime based on, but not exclusively constituted by, the monitoring regime. Over time the number of the airports covered has been reduced following assessments by the Commission of both their market power and observed behaviours. The system has remained largely unchanged for fifteen years, other than for the introduction of the “line in the sand” valuation approach in 2007. This regulatory stability has been the bedrock of the airport sector’s impressive investment performance.

Since 2002 Australian airports have invested over $15 billion in infrastructure, of which around $10 billion has been in aeronautical assets. These investments have been necessary to improve safety, security and amenity for passengers as well as provide the necessary capacity to allow total airport passenger throughput to grow from 76 million in 2002 to 159 million in 2017 (Figure 1.2).

A survey by the AAA indicates major privatised airports plan to invest $20.6 billion over the next 10 years. This will comprise $15.1 billion to deliver essential aeronautical infrastructure to support the continued growth of the aviation and tourism sectors such as new runways and terminals. This will improve the efficiency of airport operations for the benefit of travelers and other consumers. A further $5.4 billion in non-aeronautical assets is also projected for car parks, retail precincts, logistics facilities etc.

**Figure 1.2** Historic and forecast airport investment and passenger movements 1998-2027

Source: BITRE(2018a), AAA analysis, total passenger growth beyond 2017 assumed to be 3.5% per annum.
Policy reform solely designed to reduce prices, as opposed to enhance efficiency, such as that witnessed in the recent past in relation to electricity transmission and distribution, will place future investment at risk. In such circumstances airports will prioritise investments in security, safety and asset maintenance. The consequence would be to delay investment in new capacity, stifling competition and entrenching the incumbent airlines’ market position leading to higher fares and less choice of destinations for passengers. Innovation to enhance passenger experience is also likely to be adversely affected.

The AAA freely acknowledges that airport charges have risen since 2002. Significant increases were expected by the Commission when price controls were removed in 2002, but these were dwarfed by the decision of the ACCC to allow prices at Sydney Airport to increase by nearly 100% in 2001 before the airport was privatised. Since that time prices have grown modestly in real terms, indeed in the current round of pricing activity, a number of airports are proposing reductions.

But at the same time, airfares have fallen in real terms – the Board of Airline Representatives of Australia (BARA) recently reported that international airfares have fallen on average by 40% in real terms. Data published by the Bureau of Infrastructure, Transport and Regional Economics show domestic (restricted economy) airfares had been in long-term decline until mid 2013 but since that time have risen by around 40% in real terms. These recent increases cannot be attributed to changes in airport charges.

It is a popular claim made globally by those who oppose airport privatisation and propose heavier regulation of airports that higher airport charges lead to higher airfares and less travel. Clearly the Australian experience outlined above is very different. This is not surprising. Airport charges globally make up around 6% of airline costs. In research commissioned by the AAA, InterVISTAS estimate that airport charges in Australia constitute on average between eight to ten per cent of total airfares.

So even a thought experiment involving a 50% reduction in airport charges might only lead to a 5% reduction in airfares, notwithstanding there is no evidence to suggest airport charges in Australia are above efficient levels. Moreover, there is no evidence that any decrease in airport charges would be passed onto passengers, the same as increases have not been. This is because the recent increases in airport charges have largely been the result of the need to fund investments that reduce airline costs (most notably labour and fuel) and at the same time have ensured there have been no bottlenecks that might restrict airline competition.

Rather, what is most likely is that, even if modest reductions were to be imposed by a regulator these would simply enhance the profits of airlines – airlines which are largely foreign owned. Obviously foreign international airlines are foreign owned but both Virgin Australia and Rex are also majority foreign owned companies and even Qantas has foreign ownership of around 40%. Foreign ownership of privatised Australian airports is around 19%.

The Commission has long been concerned about the chilling effect of inappropriate regulation on investment – it is in its DNA. In 2002, it recommended the removal of price controls for this reason. This is a central issue for this Inquiry because it is the investment by airports in capacity to support increased competition in aviation markets that leads to a wider choice of destinations and lower fares. Whilst the AAA is not aware of any proposals to re-introduce formal price controls, an unnecessary or inappropriately designed arbitration framework will have the same effect.

Recent investments in international capacity have been essential in facilitating the competition that has led to significant reductions in international airfares. In relation to domestic markets, the Commission will recall the investments made by Sydney and Melbourne airports in the early years of this century to facilitate the entry of Virgin Blue and Impulse Airlines and the efforts made by the incumbent domestic carriers to frustrate those investments. Similar conduct is evident today in Qantas’ obstruction of new domestic terminal capacity in Townsville.
Qantas’ market power in domestic markets is self-evident. Media coverage in August 2018 of Qantas’ annual results shows that Qantas can restrict domestic supply (so-called “active capacity management”) at the same time as it increases prices – the classic evidence of a firm with market power. It is the AAA’s view that the recent increases in the BITRE’s domestic airfare restricted economy real airfare index have been facilitated by the fact that Australia has one of the most concentrated domestic aviation markets in the world in which Qantas, with a market share of 65% and a profit share of 90%, is dominant.

Major airports are expensive pieces of public infrastructure that are difficult to develop – the decades long controversy over Badgerys Creek is testament to this. Whilst airports do exhibit natural monopoly characteristics, there is reason to believe that incremental costs at major airports are rising.

Largely as a result of decisions made in the Second World War, some major airports have competitors – Melbourne has Avalon, Brisbane has Sunshine Coast and Gold Coast (and maybe Ballina) and most recently Wellcamp. Sydney has Canberra and Newcastle and soon Badgerys Creek. This means that both passengers and airlines have some substitution opportunities although not to the same degree as passengers in London, the English Midlands or even the Scottish Lowlands.

However, there is an emerging body of research from Europe suggesting that this is a somewhat limiting notion of substitution when thinking about airports. It is possible to conceive of major Australia airports being in competition for long-haul flights from Asia, the Middle East and North America. Low cost carriers have no location loyalty so Perth and Darwin are in competition with airports around the region for the allocation of capacity by airlines such as Scoot and AirAsiaX. When substitution is thought of in this way, airport market power is significantly less.

The Commission will no doubt recall the observations of Gleeson CJ and Culliman J:

> The essence of power is absence of constraint. Market power in a supplier is absence of constraint from the conduct of competitors or customers.4

Typically the consumer does not bow to the firm, supply does not occur. In such cases where consumption is essential for human existence, like energy or water, governments regulate. But the consumption of airport services is not essential. Rex doesn’t need to fly from Melbourne to King Island, Qantas doesn’t need to fly from Perth to Heathrow direct. Airlines have choices as to how they allocate their aircraft. The decision to reallocate aircraft is likely to have a proportionally larger financial effect on the airport than the airline because the airport’s capital will lie underutilised whereas the airline’s will be deployed. In the case of community owned regional airports, the consequences of the removal of services go beyond the economic performance of the airport and may impact the economic, social and human welfare of the community.

The converse is however not true – major Australian airports can’t choose their airline customers. The conditions upon which airports are leased from the Australian and Queensland governments require them to provide access to all comers on pain of the lease being cancelled. Unless there is a contract in place between an airport and an airline, or the airline has explicitly or implicitly accepted the terms set out in a conditions of use document (see section 5.4.3) airports may face expensive and prolonged litigation to establish and recover what charges are owed to them by airlines. This is not a theoretical legal proposition. The AAA and the Commission are aware of circumstances today where airlines are refusing to pay the full value of invoices issued to them by airports. This significantly reduces airport market power. This includes circumstances where the parties have not concluded a new agreement at the expiration of a prior agreement, and the airport simply continued to invoice at the prior contract price and provided access in line with the agreement. This significantly reduces airport market power.

It comes as no surprise to the AAA that there is no evidence of abuse of market power by major airports. Not only do monitored airports value their obligations to be good corporate citizens, in the words of the former Deputy Chairman of the Commission, the late Professor Snape, the “constable is in the cupboard”. And airport investors, especially industry fund shareholders, strive to deliver long term sustainable returns across a range of public infrastructures and to exploit market power would run contrary to their long term strategic interests.

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As noted above, investment has been strong and supply has expanded. Quality has been maintained or improved. Australian airports are relatively efficient. Airport charges are within global norms, especially when one considers in many other jurisdictions airports are not required to service equity or can finance their activities in a tax preferred way. International profitability comparisons must be treated with care but Australian returns again seem consistent with international norms. More importantly expert economic advice (Attachment 1) shows that, in compliance with the Pricing Principles, the monitored airports are not earning returns in excess of their cost of capital. Indeed, returns in some cases have been falling for most of the period since the Commission’s last review.

The Chairman of Airlines for Australia and New Zealand (A4ANZ) has described Dubbo and Wagga airports as some of the worst monopolies in Australia. The level of regional airfares has been of concern to both the Western Australian Parliament and the Senate. Despite efforts by the likes of Qantas and A4ANZ to attribute high regional airfares to airports, many regional airports struggle to cover their cash costs, often don’t cover normal depreciation, need grant funding for capital maintenance and capacity expansion and hardly ever pay a dividend to their rate-paying shareholders. These traits are far removed from monopoly behaviour involving supernormal profits – regional airports often don’t make a return on capital and require supplementation from rate payers or other levels of government. Indeed, perhaps the Commission should be asking: are regional airport charges inefficiently low and are councils failing to comply with their competitive neutrality obligations in setting airport charges?

That the Commonwealth would legislate to regulate the pricing activity of airports with less than 100,000 passengers per annum is a dubious proposition – the EU Airport Charges Directive, which is in effect a monitoring framework, only applies to airports with more than five million passengers. Councils are acutely aware of the need to provide services to their communities but airport services are only one among many. The recent controversy on King Island illustrates this point. Supporting the operation of the airport currently consumes a little under one quarter of the council’s rate base. The council wishes to eliminate this subsidy over two years so that the revenue from the airport will cover the costs of the airport’s operations (including depreciation). The imposition of an arbitrator into this case would not be about restraining abuse of market power, it would be a direct Commonwealth intervention in the fiscal decisions of the elected local government of King Island.

A somewhat less laughable proposition that has been advanced by A4ANZ is the imposition of a negotiate-arbitrate framework to resolve disputes. Curiously, of the relatively few intractable disputes the AAA is aware of, most relate to the use of market power by Qantas. That said, dispute resolution is an important issue. The AAA’s view is that in the vast majority of cases airports and airlines sort things out and the imposition of an arbitration regime would distort conduct in ways the Commission has documented on many occasions. Further, the National Access Regime is alive and well and available to airlines in exactly the same way it was when Virgin Blue had the Competition Tribunal declare Sydney Airport in 2005.5

Declaration is not meant to be easy. Airlines should, like other infrastructure users, have to make out their case for access to an arbitration regime in the same way users of the Port of Newcastle recently have or that Virgin Blue had to in 2005. Indeed, given reforms to the timeframes for declaration arising from past Commission inquiries and the High Court’s views on residual discretion in the Pilbara Railways case, declaration is a more attractive proposition to airlines than it was in 2005.

At the time of writing of this submission, the AAA is not aware of the details of the matters that have motivated calls for an airport specific arbitration arrangement. However given the position taken by the Commission in its 2013 National Access Review, subsequently endorsed by the Harper Review and the Government, logic would dictate that for the Commission to adopt an alternative position there must be material matters that have emerged in recent times. If such evidence emerges during the course of this Inquiry, the AAA may make further submissions to the Commission.

The fact that airports and airlines are in dispute over commercial terms should not be a surprise – it is a necessary consequence of a contractually based access framework. Policy intervention in disputes must be limited to significant matters in which there is a material public interest, such as the delay of delivery of capacity to facilitate competition. Access to arbitration must not be automatic but allowed only when it is clear both parties have acted in good faith and negotiations are unlikely to proceed. The arbitration framework must not only have regard to the interests of the parties but also to efficiency and the interests of others, especially other airlines which also use the facilities and have in good faith reached agreement.

The AAA’s view is that Part IIIA does exactly that. If the Commission considers an alternative dispute resolution framework is required then it must either demonstrate that Part IIIA is no longer effective in dealing with the sorts of disputes that were before the Australian Competition Tribunal when it declared certain services at Sydney Airport in 2005 or clearly identify the sorts of disputes it feels require a dispute resolution framework and demonstrate that the expected benefits of such a framework outweigh the costs including the risk of regulatory error.

The AAA supports, broadly in its current form, the continuation of the monitoring regime of aeronautical services and the ongoing periodic examination by the Commission of the potential use of market power by Australian airports. Despite the annual round of inflammatory and misleading commentary from successive chairmen of the ACCC, the AAA does believe that the public and policy makers should have a degree of transparency with regard to the four largest airports in the nation and this transparency is a constant reminder to airports of the position they occupy in Australia’s economy. Monitoring is an effective policy tool – it has constrained the use of market power by major Australian airports since 2002 and is now an important part of the Morrison Government’s policy armoury for dealing with market power abuse in retail electricity markets.

However, what we would ask the Commission to consider is whether the monitoring of service outcomes for passengers could be reformed to reduce cost by using the ASQ framework and quality for airlines be better aligned with the service standard arrangements that are being developed by airports and their airline customers. Finally, we do not believe there is a basis for continuing the monitoring of ground access and car parking and ask the Commission to recommend the abolition of this unnecessary regulatory burden.

### 1.3 The AAA’s approach to this submission

The primary issue for this Inquiry is the future regulation of Australia’s airports. The Commission must be guided by section 8(1) of its Act. In this regard, the AAA considers the following to be the most relevant considerations:

a) to improve the overall economic performance of the economy through higher productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community; and

b) to reduce regulation of industry (including regulation by the States, Territories and local government) where this is consistent with the social and economic goals of the Commonwealth Government; and

c) to encourage the development and growth of Australian industries that are efficient in their use of resources, enterprising, innovative and internationally competitive;

For the purposes of this Inquiry it is the AAA’s view that the performance of the Australian economy can largely be seen as being advanced by the facilitation of growth of air travel. The AAA does understand there are externalities associated with air travel arising primarily from emissions from aircraft and noise impacts on communities surrounding airports but these are not matters covered by the Terms of Reference of this Inquiry.

Whilst the AAA acknowledges the importance of freight and general aviation to the Australian economy, these are not issues that are central to this submission. In relation to freight, the bulk of freight is carried in passenger aircraft – in the case of international airfreight, more than 80%. As such the activities of RPT operators are likely to drive outcomes for airfreight and any issues are likely to be related to local issues about aircraft parking, access to airside areas and availability of sites for freight terminals.
The Commission will be aware that there are significant concerns about the future of general aviation in Australia – the AAA shares these concerns. General Aviation (GA) is a diverse sector which motivates the continuing operation of the majority of the AAA’s members. However, it is not the focus of this Inquiry. If significant issues emerge over the course of the Inquiry in relation to GA, or indeed freight, the AAA will make a further submission to the Commission.

The AAA does not feel that it should delay the Commission with the presentation of publicly available material on the development of the Australian aviation sector – the Commission will undoubtedly undertake that analysis for itself. As such, this submission moves straight to the substance of the AAA’s arguments.

Chapter 2 of this submission examines consumer issues. Primarily, it addresses the relationship between airport charges, airline costs, airfares and demand. It finds that the relationship between these factors is weak and at best episodic. Further, it shows that increases in airport charges in Australia in the past have not impacted on demand and as such reductions are unlikely to have the opposite effect.

Chapter 3 examines airport charges and measures of airport profitability. Despite the fact that changes in charges may not be passed on to consumers, excessive pricing may lead to allocative inefficiency. This chapter discusses a number of issues in relation to how airport charges are set in Australia, compares major airport charges with peers overseas then considers a number of approaches for the assessment of airport profitability. The discussion concludes with an assessment of the performance of the four monitored airports against the Pricing Principles.

Chapter 4 draws on benchmarking data to highlight the relative performance of the major airports and examine issues that may evidence abuse of market power including quality, airport efficiency and investment.

Chapter 5 draws together the factual material in chapters 3 and 4 and concludes there is no evidence that airports have abused their market power in recent time. It then proceeds to discuss the reasons why this should not be seen as surprising.

Chapter 6 discusses the future of airport regulation in Australia. It discusses why certain proposals regarding arbitration are both unnecessary and undesirable. Some additional modest reforms to the monitoring of aeronautical services are also discussed.

Chapter 7 addresses issues relating to the provision of car parking and ground access services at monitored airports. It concludes that whatever market power airports have in car parking is diminishing and has not been misused. Further, the claims of the ACCC that airports may manipulate ground access arrangements to their own commercial advantage are demonstrated to have no merit. On these bases, the AAA is suggesting that the Commission recommend the termination of the monitoring of car parking and ground access as it constitutes an unnecessary regulatory burden.

Finally, chapter 8 addresses the other issues contained in the terms of reference and several other matters the Commission may wish to consider. The AAA believes that there have been significant improvements in the planning of land transport linkages in recent times and supports the framework proposed by BARA to improve competition and pricing outcomes in the market for jet fuel.
2 Airport charges, airline costs and airfares

In commenting on the release of the ACCC’s 2018 Airport Monitoring Report, its Chairman Rod Sims observed that high levels of aviation revenues were being passed onto passengers in the form of higher airfares.6 Not only was this claim made without any evidence in the report to sustain it – the report presents no data on airfares – it is simply wrong in fact.

BARA recently reported that international airfares have fallen by 40% in real terms since 2006.7 Domestic airfare data regularly published by the BITRE shows a general decline in real restricted economy airfares until 2014 with a rising trend since8, although there were sharp increases in 2017 (on the back of capacity reductions orchestrated by the major carriers). Confronted with these propositions, Mr Sims observed, again without evidence, that airfares would be even lower if airport charges were lower.9

In 2011 the Commission formed the view that the relationship between airport charges and airfares is weak.10 Even in the most price sensitive market segments, the Commission observed that the evidence suggests that if increases in airport charges are passed on fully to customers, such increases are unlikely to significantly impact on the ticket prices paid by consumers, limiting travel reduction and associated welfare losses.11 Similarly, in 2006 the Commission found the consequences of any ‘overcharging’ for aeronautical services on the efficient level of air travel are likely to be small. Rather, the main effect will be a shift in profits between airports and airport users.12

As discussed in section 3.3, major Australian airport charges have risen modestly in real terms since the Commission’s last review, in line with agreements airports have entered into with airlines. At the same time, airfares have generally fallen, international airfares particularly so, with the difference largely attributable to a greater level of competitive tension found in international markets compared to the effective domestic duopoly. As such, it is simple arithmetic that the proportion of airfares accounted for by airport charges has risen. In 2011, the Commission cited a proportion of around 4-8% for Sydney to Melbourne – this estimate was not particularly robust.13 More extensive research undertaken for the AAA by InterVISTAS (Attachment 3) covering a much broader range of routes than Sydney-Melbourne provides a better, more current estimate, of 8-10% depending on the market segment of interest.

This chapter explores the relationships between airport charges, airline costs, airfares and demand. If the relationship between airport charges and final demand is weak, or non-existent, then policies designed to reduce airport charges, such as the imposition of a single till, price controls or potentially arbitration frameworks, will not deliver benefits to consumers. Rather, they will simply transfer profits between airports and airlines and in lowering the return on capital, risk undermining investment incentives. In other words, there will be no short-run efficiency gains and a risk of long-run welfare losses resulting from potential discouragement of investment.

Further, the Commission has previously identified that access regulation “is not an appropriate vehicle for pursuing distributional outcomes”.14 Whilst these comments were made in the context of the distribution of income between end consumers, it applies equally to the distribution of incomes in the value chain.

The remainder of this chapter shows:

» airport charges are a relatively small and stable proportion of airline costs;

» airport charges are a relatively small proportion of airfares;

» using a neoclassical estimate of elasticity, the demand response to a change in airport charges is very low; and

» why the actual demand response to changes in airport charges can be expected to be even lower than estimated.

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6 Sydney Morning Herald 24 April 2018 ‘Travellers paying more to fly because of airport fees: ACCC’.
7 Board of Airline Representatives of Australia May 2018 ‘Light Handed Economic Regulation’.
8 BITRE (2018b).
9 Business News Australia 26 April 2018 David Simmons; ACCC: Airport Monopolies Forcing up the Price of Air Travel.
10 PC (2011, p xxvi).
11 PC (2011, p 92).
13 PC (2011, p xxvi).
2.1 Airport charges and airline costs

Airport charges contribute to the cost base of airlines. Globally, in 2017 IATA estimated that the share of airport charges in total airline costs was around 6.2% (see Figure 2.1). Similar data produced by IATA in 2013 shows the airport charges share of total costs at 5.0%.15

The composition of airline cost bases can be expected to vary between countries and airlines depending on relative input costs, business models and the regulatory, market and institutional circumstances that may apply. How airlines report their costs also makes direct comparisons difficult, especially as airport charges tend to get aggregated with other costs items and cost categories are aggregated differently by different airlines.

Figure 2.1 Composition of global airline costs base 2017

One might expect these proportions to vary through time. However this does not seem to be necessarily the case in Australia. While data with similar granularity as Figure 2.1 is not published by Australian airlines, airline annual reports using similar categories are informative. Figure 2.2 shows the share of airline costs accounted for the disclosed cost category likely to contain airport charges.

The sharp increase in Qantas’ costs attributed to the category containing airport charges is likely to be attributable to a reduction in other costs resulting from a vigorous cost reduction program. It is interesting though to note that the level has remained. But beyond this these data show quite a steady share, suggesting airport charges, even if they are growing in real terms, are unlikely to be placing strain on airline cost structures. Figure 2.3 shows data from a study undertaken for ACI-Europe by consultancy ICF that demonstrates a similar stability for a range of both full service and low cost European carriers.

Figure 2.2  Share of Australian airline costs attributable to cost category containing airport charges

Notes: Estimates are based on a share of the cost item containing airport charges as reported in the annual report or data book of the airline. Airport charges are a significant but not dominant component. For REX this is Flight and port operation costs (excluding fuel); Airport charges, navigation and station operations for Virgin Australia; and Aircraft Operating Variable for Qantas.

Source: Airline annual reports.

Figure 2.3  Share of European airline costs attributable to airport charges category

We explain in section 3.3 why Australian airport charges have increased in real terms in recent times, particularly given the need to fund new capacity. On the other hand airlines have benefitted from a number of developments that have enabled them to improve efficiency and deliver services at ever-decreasing costs. This can be seen from figure 2.4.

Technological improvements to aircraft and their engines have enabled costs per seat-kilometre to drop significantly. New business models that developed after deregulation have also enabled carriers to deliver services at lower costs. Improvements in air navigation services allowed aircraft to fly more fuel efficient flightpaths. Labour represents a relatively high proportion of total airline costs, and airlines have managed to increase efficiencies in this area as well. In real terms, the price of flying is far below what it had been 50 years ago and continues to fall. Such dynamic efficiency has not been a characteristic of the airports industry globally.

It is likely therefore that over time, properly measured, the proportion of airport charges within airline costs will drift up – this seems to be the case with the data presented above. Whilst some might say that airlines are driving costs out of their businesses whilst airports are lazy monopolists, the correct interpretation is rather that technological advancement in relation to aircraft is driving lower costs in a way not available to the airport industry.

Figure 2.4  Technology drives improvements in airline costs

2.2 Airport charges and airfares

It is not uncommon to see airfares in the market that are below the cost of provision. Tigerair for instance recently offered $1 fares between Canberra and Melbourne.\(^\text{16}\) So care must be taken when comparing airport charges with airfares. In the Tiger case, given airport charges would have exceeded the advertised fare, it can be seen as a market promotion and branding device. How many tickets were actually sold at this price or what arrangements had been entered into with the two airports involved is not known.

This is an example of a broader methodological issue, namely, how airfares are to be measured. BITRE’s survey collects specific fares on a certain day of the month – a Thursday. These fares may reflect multiple fares classes and no attention is given to the volume of fares actually purchased. Fares are typically higher on Mondays and Fridays when demand is higher. This collection methodology may also be gamed by airlines – that is they can create an impression of offering cheaper fares than is actually the case on average across the week.

Airlines increasingly levy passengers for “ancillary services”. Care must therefore be taken not to underestimate the passenger’s cost of travel, especially when comparisons are being made between different markets. Globally these revenues are estimated to exceed 10% of total airline revenues.\(^\text{17}\) In Australia, the primary amenities broken out of the base fare as ancillary services are checked baggage, seat pre-selection and meal options. These are offered as optional services that passengers can choose to add to their fare – passengers on some airlines may also make on-board decisions in relation to the purchase of food and drinks whereas others may have these provided as part of their fare depending on their ticket class. In the past, a fuel surcharge has also been added when fuel prices are high, though this is not an optional purchase and should be considered an airline fee.\(^\text{18}\)

Also, as noted in section 3.1.5, the published charges of airports, so called ‘rack rates’, may not reflect the actual charges airlines are paying. This is certainly the case in Australia where domestic charges are discounted by as much as 48% and international charges by as much as 55%.

Attachment 3 presents new research by global aviation consultancy InterVISTAS commissioned by the AAA. It examines various relationships between airfares and airport charges. In particular it sets out estimates of the share of airport charges in airfares in a range of categories using a methodology designed to address, or at least ameliorate, the challenges set out above.

The data presented in section 6 of Attachment 3 shows airport charges compose about 8% of domestic and trans-Tasman airfares and 11% on other international return flights (of which 7% is attributable to Australian airport charges). Figure 2.5 provides two examples of the various components of airfares on two sample routes. It is important to note that these data do not include any discounts that might be provided by either airport but rather represent rack rates so the true shares are likely to be much lower.

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\(^\text{18}\) Airline fuel surcharges are no longer in effect, though they had been used in the past and represented about 10% of the “all-in” airfare. See example from: Australian Business Traveller, Fees and Charges Exploded: where your airfare actually goes, Dan Warne, 17 March 2011.
Adjusted Average All-in Economy Airfare SYD-YVR

- Base Airfare (one way, average of all airlines): A$1,179
- Airline: Baggage Fee (Includes 2 checked bags): A$0
- Airline: Seat Selection Fee (average of QF/VA): A$18
- Airline: Meal Fee: A$0
- Airline: Other Ancillary Fees: A$0
- SYD: International Passenger Charge (Departing): A$29
- YVR: Landing fee: A$7
- AU: Federal Passenger Movement Charge: A$60
- AU: Federal Good and Services Tax: A$0
- Total Ticket Price: A$1,293

SYD-YVR Airport Fees and Charges 2.8%

Adjusted Average All-in Economy Airfare YVR-SYD

- Base Airfare (one way, average of all airlines): A$1,140
- Airline: Baggage Fee (Includes 2 checked bags): A$0
- Airline: Seat Selection Fee (average of QF/VA): A$18
- Airline: Meal Fee: A$0
- Airline: Other Ancillary Fees: A$0
- SYD: International Passenger Charge (Arriving): A$29
- YVR: Passenger Terminal Charge (Arriving): A$52
- YVR: Airport Improvement Fee: A$20
- CA: Federal Good and Services Tax: A$1
- Total Ticket Price: A$1,247

YVR-SYD Airport Fees and Charges 4.9%

Adjusted Average All-in Economy Airfare MEL-PER

- Base Airfare (average one way fare): A$251
- Airline: Baggage Fee (1 checked bag per JQ): A$24
- Airline: Seat Selection Fee (per JQ): A$7
- Airline: Meal Fee: A$15
- Airline: Other Ancillary Fees: A$0
- MEL: Domestic Passenger Charge (Departing): A$7
- MEL: Security Charge (Departing): A$0.2
- MEL: Airfield and Infrastructure Charge (Departing): A$4
- PER: Airfield Usage (Arriving): A$4
- PER: Terminal Usage (Arriving): A$14
- AU: Federal Good and Services Tax: A$33
- Total Ticket Price: A$359

MEL-PER Airport Fees and Charges 8.2%

Adjusted Average All-in Economy Airfare PER-MEL

- Base Airfare (average one way fare): A$251
- Airline: Baggage Fee (1 checked bag per JQ): A$24
- Airline: Seat Selection Fee (per JQ): A$7
- Airline: Meal Fee: A$15
- Airline: Other Ancillary Fees: A$0
- Airline: Fuel Surcharge: A$0
- MEL: Domestic Passenger Charge (Arriving): A$7
- MEL: Airfield and Infrastructure Charge (Arriving): A$4
- PER: Pax and Bag Screening Charge (Departing): A$6
- PER: Domestic Airfield Charge (Departing): A$4
- PER: Terminal Usage (Departing): A$14
- PER: ACUS Charge (Departing): A$0.05
- PER: Security Recovery (Departing): A$6
- AU: Federal Good and Services Tax: A$33
- Total Ticket Price: A$366

PER-MEL Airport Fees and Charges 9.9%

Source: InterVISTAS (2018b)
Table 2.1 provides InterVISTAS estimates for the proportion of airfares accounted for by the ten largest Australian airports. Rack rates have been adjusted for the average level of discounting for international and domestic charges.

<table>
<thead>
<tr>
<th></th>
<th>Domestic</th>
<th>International</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sydney</td>
<td>7%</td>
<td>4%</td>
</tr>
<tr>
<td>Melbourne</td>
<td>8%</td>
<td>3%</td>
</tr>
<tr>
<td>Brisbane</td>
<td>8%</td>
<td>5%</td>
</tr>
<tr>
<td>Perth</td>
<td>6%</td>
<td>4%</td>
</tr>
<tr>
<td>Adelaide</td>
<td>8%</td>
<td>3%</td>
</tr>
<tr>
<td>Cairns</td>
<td>5%</td>
<td>3%</td>
</tr>
<tr>
<td>Darwin</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>Hobart</td>
<td>8%</td>
<td>No international service</td>
</tr>
<tr>
<td>Gold Coast</td>
<td>6%</td>
<td>3%</td>
</tr>
<tr>
<td>Canberra</td>
<td>8%</td>
<td>Data not available</td>
</tr>
</tbody>
</table>

Source: InterVISTAS average airfares for international and domestic destinations – one way.

2.3 A naïve estimate of demand elasticity with respect to airport charges

As the Commission noted in 2002, the demand for airport services is a derived demand from the demand for air travel. Assuming that airlines were to pass through to passengers the entirety of any reduction in airport charges, an assumption challenged below, then the demand elasticity for air travel with respect to airfares can be easily shown to be the elasticity with respect to airfares multiplied by the proportion of airfares accounted for by airport charges.

InterVISTAS surveyed a wide variety of sources for demand elasticity estimates, including the various estimates compiled by the BITRE. That literature review, discussed in section 7 of Attachment 3, did not identify any robust current estimates for Australian aviation markets. The most recent BITRE estimates rely on data from the late 1980s and early 1990s which are not considered suitable given the significant structural change that has occurred since.

Accordingly, the core of the elasticity analysis was based on the demand elasticities estimated by InterVISTAS in a 2007 study completed for IATA using three data sets covering different global geographies and using three different methodologies. This resulted in a set of elasticities by region and level of aggregation shown in Table 2.2.
### Table 2.2 Demand elasticities with respect to airfares

<table>
<thead>
<tr>
<th>Route/Market Level</th>
<th>National Level</th>
<th>Supra-national Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Elasticity Estimate</td>
<td>-1.4</td>
<td>-0.8</td>
</tr>
<tr>
<td></td>
<td>Short-haul</td>
<td>Long-haul</td>
</tr>
<tr>
<td>Intra North America</td>
<td>-1.54</td>
<td>-1.40</td>
</tr>
<tr>
<td>Intra Europe</td>
<td>-1.96</td>
<td>-1.96</td>
</tr>
<tr>
<td>Intra-Asia</td>
<td>-1.46</td>
<td>-1.33</td>
</tr>
<tr>
<td>Intra Sub-Sahara Africa</td>
<td>-0.92</td>
<td>-0.84</td>
</tr>
<tr>
<td>Intra South America</td>
<td>-1.93</td>
<td>-1.75</td>
</tr>
<tr>
<td>Trans-Atlantic</td>
<td>-</td>
<td>-1.68</td>
</tr>
<tr>
<td>Trans-Pacific</td>
<td>-</td>
<td>-0.84</td>
</tr>
<tr>
<td>Europe-Asia</td>
<td>-1.39</td>
<td>-1.26</td>
</tr>
</tbody>
</table>

Source: InterVISTAS (2018b).

An update to the 2007 report completed in 2014 for ACI-North America only updated estimates for North America, but its key findings are still applicable. That update found that there have been no fundamental changes to the nature of air travel demand elasticities in North America over that period. It is InterVISTAS’ view that the estimates made in 2007 are still valid and the stability of estimates is likely to hold true for Australia as it is unlikely fundamental changes have taken place in Australia that were not replicated in North America and vice versa.

The short-haul intra-Asia elasticity was used to proxy the Australian domestic elasticity, long-haul intra-Asia for Trans-Tasman services and long-haul Europe-Asia for other international services. Using InterVISTAS’ estimate of share of airport charges in the “all-in” fare in each market segment, the demand elasticity with respect to airport charges, as opposed to airfares, can be calculated as set out in Table 2.3.

### Table 2.3 Demand elasticities with respect to airport charges for Australian air travel

<table>
<thead>
<tr>
<th>Sector</th>
<th>Passenger Airfare Elasticity</th>
<th>% Share of Airport Charges</th>
<th>Airport Charges Elasticity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>-1.46</td>
<td>7.7%</td>
<td>-0.11</td>
</tr>
<tr>
<td>Trans-Tasman</td>
<td>-1.33</td>
<td>11%</td>
<td>-0.14</td>
</tr>
<tr>
<td>International</td>
<td>-1.26</td>
<td>11%</td>
<td>-0.14</td>
</tr>
</tbody>
</table>

Source: InterVISTAS (2018).

These are elasticity estimates for the route or market level. The concentration of passengers at the monitored Australian airports – some 72% in 2017, suggests these elasticity estimates represent an upper (more elastic) bound. A change in pricing at one of these airports is likely to impact a significant share of the market (in Sydney’s case 28%), rather than a smaller route or market subset. While this would not be the same impact as a national level change in charges (or taxes), the effect at specific airports could be more inelastic than the estimates provided here. If national elasticities were applied, the domestic, trans-Tasman and international elasticities would be -0.06, -0.08 and -0.08 respectively.

Applying the elasticity estimates in table 2.3, table 2.4 provides estimates of the increase in passenger traffic if airport charges (across the board) were reduced.
Table 2.4  Estimated demand increase from reducing airport charges

<table>
<thead>
<tr>
<th>Increased Passenger Traffic (Thousands)</th>
<th>10%</th>
<th>50%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>610</td>
<td>3,050</td>
<td>6,100</td>
</tr>
<tr>
<td>Trans-Tasman</td>
<td>79</td>
<td>295</td>
<td>790</td>
</tr>
<tr>
<td>International</td>
<td>410</td>
<td>2,050</td>
<td>4,100</td>
</tr>
<tr>
<td>Total Traffic Gained</td>
<td>1,100</td>
<td>5,500</td>
<td>11,000</td>
</tr>
<tr>
<td>Total Traffic in Australia (2016)</td>
<td>89,000</td>
<td>89,000</td>
<td>89,000</td>
</tr>
<tr>
<td>Increased Traffic as % of Total</td>
<td>1.2%</td>
<td>6.2%</td>
<td>12.4%</td>
</tr>
</tbody>
</table>

Source: InterVISTAS (2018b).

On the basis of these elasticity estimates, even if a 10% reduction in airport charges was passed on fully to airfares, it would result in a negligible 1.2% increase in demand. If the government were to nationalise airports and make their use free, demand might rise by 12.4% — about three or four years of long run traffic growth.

2.4  So how do airfares actually relate and respond to airport charges

There is very little peer reviewed research on the relationship between airport charges and airfares and demand, and similarly on airport services supply elasticity. However, there is a range of industry based research, and publicly available data, that would tend to support the view previously expressed by the Commission that these relationships are weak. The AAA is of the view that this material suggests demand responses are likely to be less than suggested by the naïve analysis set out in section 2.3.

2.4.1  Some Australian evidence

As the Commission is aware, price controls were removed at smaller Australian airports in October 2001 following the collapse of Ansett. Larger airports were allowed a one-off price increase between 6.2% and 7.2% with the exception of Sydney which was allowed a price increase of almost 100% by the ACCC in 2001. Price controls at Sydney, Melbourne, Brisbane and Perth were removed on 1 July 2002 as part of the Howard Government’s acceptance of the recommendations of the Commission’s 2002 review. Figure 2.6 shows the development of prices (measured by aeronautical revenue per passenger) at major airports around that time.

![Figure 2.6](image-url)  Average aeronautical revenue per passenger for selected Australian airports

Figure 2.7 below shows the development of domestic airfares and total domestic passengers over a ten year period centred around the removal of price controls and accompanying airport charges increases shown in Figure 2.6. In particular, it shows that:

» the gentle growth in business and full economy fares was unaffected by the increase in airport charges;
» the downward trend of discount fares actually continued after the airport charges increases of 2002; and
» the rate of growth of total domestic passengers seems to have accelerated after 2002.

Figure 2.6  Indices of Australian domestic airfares and passengers

These data show that the largest shock experienced in Australian airport charges had little impact on domestic airfares and domestic travel volumes. The data are consistent with the notion that in the face of a fare increase, airlines can effectively price discriminate between customer segments. If this increase in airport charges was not passed through to airfares, then it seems unlikely that any reductions in airport charges that might come about from further policy intervention would be passed onto consumers in the form of lower airfares.

It seems that airport charges are not the only element of the airline cost base that is weakly related to airfares. Figure 2.8 shows the development of the price of fuel, the level of domestic airfares and domestic passenger numbers. It seems that the reductions in fuel costs in 2015 were not passed through to restricted economy airfares despite the willingness of airlines to impose fuel surcharges in the face of increasing fuel costs between 2009 and 2011. Indeed, the failure of Qantas to pass through full cost reductions was the subject of an ACCC investigation.20 Thus, it is difficult to see why, if airlines do not pass through significant reductions in fuel costs to passengers, they will pass through much smaller potential reductions in airport charges.

It might be suggested that airlines are able to hedge fuel costs in a way they are unable to with respect to airport charges. However, this claim needs to be considered in the light of the fact that increasingly airport charges are largely set in real terms over a five to ten-year period. We would also note, particularly for the period set out in figure 2.7, Qantas was largely operating through terminals originally leased from the Commonwealth in 1988 which effectively hedged a large proportion of their airport costs and gave them control over terminals that their competitor after the collapse of Ansett in September 2001, Virgin Blue and then Virgin Australia, did not enjoy.

Source: BITRE (2018a, b).

2.4.2 Some international evidence

Figure 2.9 is drawn from a recent report by the consultancy ICF for ACI-Europe. It shows percentage changes of average airport charges, for the year in which the change was implemented, on the horizontal axis against the corresponding percentage changes in average fares observed at the airport. It should be noted there are multiple data points for some airports reflecting price changes in different years.

There appears to be very little correlation between changes in airfares and changes in airport charges. Indeed there are more observations showing a negative rather than a positive relationship between airport charges and airfares – fares go down more often than up when charges increase – perhaps reflecting removal of a capacity constraint. Whilst not necessarily demonstrating a negative relationship between charges and airfares, this analysis suggests no clear evidence of airport charges being passed through to airfares, at least not in the short term.

Figure 2.10 shows components of the lowest return airfares offered by British Airways between May and June 2018 between two London airports, Heathrow and Gatwick, and New York and Las Vegas. It can be assumed that the difference in distance from the two London airports to the United States destinations is insignificant. Two things are noteworthy. There is very little difference between the fares in each case from the two London airports – indeed it is curious that the difference in each case is £2. This lack of difference is despite the fact that Heathrow’s airport charges are £31 greater. In other words on both routes, the £29 difference in airport charges is being pocketed by British Airways rather than passing it through to passengers using Gatwick.

 ![Figure 2.10](componentsofairefaresbetweenLondonandtheUnitedStates.png)

Source: ICF (2019).

### 2.5 Why neoclassical elasticities overestimate demand response to a change in airport charges

A clear inference from the examination of key elements of airlines’ cost bases is that airlines set airfares in a dynamic fashion in relation to demand, not in relation to their cost base, particularly in the short run.

As airlines sell fares for periods of up to one year in advance through to the day of travel, there can be a wide range of fares actually paid by the passengers on any given aircraft flight. Figure 2.11 shows the range of such fares on a number of European routes. The important thing to note is that, over the range of fares, airport charges are constant. What is also of interest is that the ranges are in all cases a number of times larger than the airport charges at the airports concerned.
Figure 2.11  Airfare ranges on selected European routes


The ability of an airline to set fares independently of its cost structure and the preferences of its customers will depend on its market power. Figure 2.12 shows differing fares offered by British Airways on differing routes where it faces varying degrees of competition.

Figure 2.12  British Airways fares on routes where it has competition

The importance of this to the Australian context is clear as Australia has a relatively concentrated aviation sector. Figure 2.13 identifies the ten densest routes in Australia and their annual passenger numbers. Against these are plotted the passenger numbers for the ten densest routes in the United States and Europe (treated as a single market). The numbers on the top of each bar indicate the numbers of independent carriers (the AAA does not consider Qantas and Virgin to be independent of Jetstar and Tiger respectively) operating on each route.

**Figure 2.13  Route concentration**

<table>
<thead>
<tr>
<th>Busiest Australian City Pairs</th>
<th>MEL-SYD</th>
<th>BNE-SYD</th>
<th>BNE-MEL</th>
<th>OOL-SYD</th>
<th>ADL-MEL</th>
<th>MEL-PER</th>
<th>ADL-SYD</th>
<th>MEL-OOL</th>
<th>PER-SYD</th>
<th>HBA-MEL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Passenger Numbers (million)</td>
<td>12</td>
<td>8</td>
<td>6</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: AAA analysis.

Market power not only helps an airline extract concessions from airport operators but also allows it to retain the benefits of those concessions rather than pass them on to its passengers. Airlines can and do discriminate between different passengers. On one level, they do this on their product offering. Business class passengers get better service than those in economy. Virgin Australia has recently introduced a new cabin product – Economy X – which provides economy passengers with greater leg room and locker space and where available more rapid boarding and check-in procedures. These passengers will generally have less elastic demand than passengers on discounted economy fares so that when faced with a cost increase, be it from airport charges or from some other source (say costs of aircraft financing), airlines can increase charges for less elastic passengers and ameliorate, if not eliminate, any impact on demand.

For at least the last decade increases in airport charges in Australia have occurred either to meet new security requirements, replace aged assets or expand airport capacity. Starkie (2004) has argued that congested airports subject to regulatory oversight will often charge prices below those necessary to clear the market but that a profit maximising airline will maintain its fares at an appropriate market clearing level. The countervailing market power of airlines in Australia, coupled with long term contracts and the application of the Pricing Principles is likely to have the same effect.

This mark-up is, in effect, a scarcity rent and was estimated by Frontier Economics to represent a premium of 18% at Heathrow and 7% at Gatwick. The presence of such rents means that reductions in airport charges will almost certainly not lead to reduced airfares. As new investment in capacity rebalances supply and demand, these rents will be competed away and new equilibrium found. Providing the revenue required by the airport to fund the new investment is less than the rent in question then the new equilibrium may actually involve higher airport charges and lower fares. Obviously, other market dynamics might be in play and swamp the airport charges effect but what is clear is that charges increases motivated by funding new capacity will not have a simple relationship with airfares.

3 Aeronautical prices and profits

Abuse of market power is most commonly seen through increasing prices to enhance profitability. Since the Commission’s last Inquiry, Australian airport charges have risen modestly in real terms. However, over the same period, the returns on aeronautical assets at monitored airports have generally trended down. This downward trend can largely be understood to be the result of substantial increases in capacity at the same time the cost of capital has fallen.

Recently, both the ACCC and A4ANZ have sought to imply that the growth in aeronautical revenue per passenger and levels of EBIT and EBITDA margins are in some way evidence of systematic abuse of market power by airports. Putting aside the fact that airports cannot unilaterally determine pricing outcomes (as discussed in chapter 5) levels of, and movements in, prices and margins cannot of themselves constitute evidence of market power abuse. Rather, in this case, they reflect underlying business characteristics. Benchmarking undertaken by InterVISTAS indicates, if anything, that the higher levels of profitability of Australian airports identified by the Commission in its 2011 Inquiry have abated and margins are similar to airports in jurisdictions where airports receive implicit or explicit government support – this is consistent with the general downward trend in aeronautical returns.

3.1 Some high level pricing principles

3.1 The Pricing Principles

The Australian Government, on the advice of the Commission, established Pricing Principles (box 3.1) (the Principles) for aeronautical services and facilities as defined in Part 7 of the Airports Regulations 1997 (Cth) to judge the conduct of monitored airports. The Government has indicated these Principles should be seen by all Australian airports as strong guidance for their pricing behaviour. Established when prices notification was removed in 2002, the Principles were amended to include the “line in the sand” asset valuation approach in 2007 and remained unchanged as a result of the Commission’s 2011 Inquiry.

The Issues Paper indicates “while the previous Commission reports will be an input into the inquiry, the Commission has no predetermined position on airport regulation arrangements”.22 Whilst the AAA accepts this is an appropriate basis for the general conduct of the Inquiry, it is important that the Principles, having been promulgated by the Australian Government as the basis by which airports will be assessed for any abuse of market power at least as far as pricing and returns are concerned, be used by the Commission to draw conduct conclusions in this regard in this Inquiry.

It is entirely reasonable that if, during the course of the Inquiry, the Commission forms a view that the Principles are no longer fit for purpose it should propose a new approach to the Government. If the Government accepts any such proposals, of course the AAA’s members will comply with them going forward. However, it would be both a denial of natural justice and poor regulatory conduct, if having developed a new framework (not yet accepted by Government) the Commission was to use it to make adverse findings against one or more airports which were compliant with the current Principles.

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22 PC (2018, p2).
The current principles are:

a) that prices should:
   (i) be set so as to generate expected revenue for a service or services that is at least sufficient to meet the efficient costs of providing the service or services; and
   (ii) include a return on investment in tangible (non-current) aeronautical assets, commensurate with the regulatory and commercial risks involved and in accordance with these Pricing Principles;

b) that pricing regimes should provide incentives to reduce costs or otherwise improve productivity;

c) that prices (including service level specifications and any associated terms and conditions of access to aeronautical services) should:
   (i) be established through commercial negotiations undertaken in good faith, with open and transparent information exchange between the airports and their customers and utilising processes for resolving disputes in a commercial manner (for example, independent commercial mediation/binding arbitration); and
   (ii) reflect a reasonable sharing of risks and returns, as agreed between airports and their customers (including risks and returns relating to changes in passenger traffic or productivity improvements resulting in over or under recovery of agreed allowable aeronautical revenue);

d) that price structures should:
   (i) allow multi-part pricing and price discrimination when it aids efficiency (including the efficient development of aeronautical services); and
   (ii) notwithstanding the cross-ownership restrictions in the Airports Act 1996, not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher;

e) that service-level outcomes for aeronautical services provided by the airport operators should be consistent with users’ reasonable expectations;

f) that aeronautical asset revaluations by airports should not generally provide a basis for higher aeronautical prices, unless customers agree; and

g) that at airports with significant capacity constraints, peak period pricing is allowed where necessary to efficiently manage demand and promote efficient investment in and use of airport infrastructure, consistent with all of the above Principles.


The AAA considers that compliance with the Principles is likely to establish prices that are below efficient levels for three reasons:

- incremental costs are increasing (see section 3.3.4) so current average costs will be lower than long run marginal costs (LRMC) which are seen as efficient in the Principles;

- the monitoring process presents asset values on a depreciated historic cost (DHC), basis (subject to the line in the sand principle) which is likely to under estimate the economic value of the service provision they provide - the current economic service value would approximate depreciated optimised replacement cost (DORC) but airlines oppose such an approach. In the context of rising LRMC, this means that price increases would be greater than would be the case if services were being priced on an average cost basis using DORC rather than DHC; and

- even when new assets enter the asset base, irrespective of how existing assets are valued, prices will be below LRMC.

23 For determining aeronautical prices through commercial negotiations, these should be long-run costs unless another basis is acceptable to the airports and their customers.
As such, it is almost certain that an airport with a substantial capital program pricing efficiently is likely to seek to increase its charges at the end of each contracting period. That said, the AAA is aware of some airports with relatively unconstrained newish terminals making pricing offers well below prices set five to seven years ago. For example, Perth Airport has recently announced a reduction of 35% in the price for the use of its dedicated regional terminal, Terminal 2.24 This is largely attributable to a low maintenance and expansion capital requirement coupled with a significant reduction in the cost of capital over the period post the Global Financial Crisis.

3.1.2 Pricing structures

Airports provide a range of services to airlines (primarily airfield, aircraft parking, terminals and security services), and other aviation businesses (airfield and aircraft parking services, hangars). Airservices Australia also levies charges at those airports where it provides terminal air navigation and aviation rescue and firefighting services as well as charges for en-route services in controlled airspace.25

It is the current practice at Australia’s major airports that charges relating to the processing of arriving and departing passengers by airports (for example terminal use and security screening) as well as charges for the use of airfield assets such as runways, taxiways and aprons, are levied upon and paid by airlines, even if the amount to be paid may in part or whole be calculated in reference to the number of passengers on the aircraft. That said, there are variations between airports as shown in box 3.2.

Box 3.2 International charges at Australia’s largest airports

Australian airports typically publish a set of “rack rate” prices that apply to airlines operating on a “Conditions of Use” basis. Most airlines however operate at airports on a contractual basis that will often have different prices and also provide for discounting for new routes and large volumes. This makes direct comparison of published airport charges difficult. This is complicated further by the fact that different airports have different pricing structures for the provision of very similar services as can be seen from the international charging structures for Australia’s two busiest international airports.

Sydney Airport:
» Passenger charge of $32.35 per passenger (covering terminal and runway)
» Passenger and airfield security charge of $4.93 per passenger
» Check-in desk charge of $26.88 per desk per hour
» CUTE charge of $0.14 per passenger
» Aircraft parking of $38.50 per 15 minutes up to three hours then $55.00 per 15 minutes)

Melbourne Airport:
» Passenger charge of $23.64 per passenger (covering terminals, runways and parking)
» Passenger security charge of $0.21 per departing passenger
» Passenger and bag screening charge of $4.95 per departing passenger
» Check-in desk charge of $37.42 per desk per hour
» CUTE check-in desk charge of $0.29 per departing passenger
» CUTE departure gate charge of $0.20 per departing passenger

Sources: Charges schedules on airport websites as at 14 July 2018. Prices include GST.

The most notable exception to this are the costs incurred by Qantas operating through terminals leased to Australian airlines for 30 years by the Commonwealth from December 1988. Only three of these remain – at Melbourne, Perth and Brisbane, with the remainder either ending with the Ansett administration or as a result of new commercial arrangements between airports and Qantas. These leases provide for a number of revenue streams (that vary by airport) that are largely independent of passenger volumes. The AAA does not have access to the details of these leases but understands that where they remain, airports are in active discussions with Qantas in relation to arrangements to prevail from their expiry on 30 December 2018.

25 Details of Airservices Australia charges can be found at www.airservicesaustralia.com/services/charges-and-costing.
In the period immediately after privatisation of the FAC, major Australian airports used similar structures to those currently used by regional airports (box 3.3). During this period, international terminal charges were also based on a tonnage basis as airports did not have passenger data to levy charges on. However, after the removal of price controls in 2002, major airports, in large part due to requests from both Qantas and international airlines, moved to a pricing structure that also levied airfield charges on a per passenger basis.

This was not without controversy culminating in the attempt by the then Virgin Blue to have Sydney Airport’s airside services declared under Part IIIA – it is interesting to note Virgin Blue did not resist similar pricing policies at other airports. The AAA understands from its members that airports’ primary motivations at the time were to attach their revenues to a faster growing cost base (passenger numbers tend to grow more quickly than landed tonnage) and promote more efficient use of airfield assets. Airlines (other than Virgin Blue then closely resembling a traditional LCC) were seeking to avoid paying commissions on part of the ticket cost and to transfer some passenger volume risk to airports, especially in relation to the establishment of new services and those exhibiting significant seasonality.

Most regional airports (and especially those operated by councils) have a pricing structure (see for example box 3.3) that consists of:
» a landing charge levied on the maximum take-off weight (MTOW) of the aircraft, for use of the airfield;
» a passenger services/facilitation charge levied on a per-passenger basis, for use of the terminal; and
» one or more security charges, usually levied on a per departing passenger basis, to recover the costs incurred by the airport in screening passengers and their bags, and perhaps other matters, in accordance with the relevant aviation security standards.

### Box 3.3 The cost of using Mackay Airport

Since 1 October 2016, the following charges (exclusive of GST) have applied to passenger services using Mackay airport:
» Landing charge of $10.30 per tonne MTOW;
» Passenger charge of $10.50 per passenger; and
» Security charges:
  » Security charge (passenger screening) of $4.15 per departing passenger;
  » Security infrastructure charges of $0.16 per departing passenger; and
  » Checked bag screening infrastructure charge of $2.02 per departing passenger.

So how much does an airline pay to use Mackay airport? The best way to make comparisons is in terms of the total cost of an aircraft turnaround (that is an arrival and departure) and the cost per passenger. This requires knowledge of the aircraft being operated and an assumption of the load factor (percentage of seats occupied) of the aircraft. Consider a Qantas Q400 aircraft with a load factor of 75% – this aircraft has an MTOW of 28.998 tonnes and a seating capacity of 74.

<table>
<thead>
<tr>
<th></th>
<th>Arriving aircraft cost</th>
<th>Departing aircraft cost</th>
<th>Total cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Landing charge</td>
<td>298.86</td>
<td>-</td>
<td>298.86</td>
</tr>
<tr>
<td>Passenger charge</td>
<td>582.75</td>
<td>582.75</td>
<td>1,165.50</td>
</tr>
<tr>
<td>Security charge</td>
<td>112.11</td>
<td>112.11</td>
<td></td>
</tr>
<tr>
<td>Security infrastructure charge</td>
<td>8.88</td>
<td>8.88</td>
<td></td>
</tr>
<tr>
<td>Checked bag screening infrastructure charge</td>
<td>230.33</td>
<td>230.33</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>881.61</strong></td>
<td><strong>934.07</strong></td>
<td><strong>1,815.68</strong></td>
</tr>
</tbody>
</table>

So the total amount paid to the airport by the airline for the turnaround of this aircraft is $1,815.49. On the assumption of 55.5 passengers arriving and departing (74x0.75), the average cost per arriving and departing passenger is the turnaround cost divided by 111, namely $16.36.

There is significant academic, regulatory and industry literature on the structure of airport prices that largely relates to the efficient use of infrastructure (often highly congested) at major airports. More recently European airports have moved the basis of their airfield charges from a tonnage basis to one that reflects the environmental performance of the aircraft. For example, Heathrow levies airfield charges on the basis of the noise rating and NOx emissions of the aircraft.

It is the AAA’s view that this debate is of little consequence to understanding the setting and impact of airport charges in Australia. This is largely because the various charges are small in relation to airline cost and it is generally the case that once an airline chooses to use an airport, it has little discretion in the combination of aeronautical services it will use. To the extent that airport charges are relevant to airfares, demand and the identification of any abuse of market power, the predominant issue is the per passenger cost incurred by airlines.

### 3.1.3 The single till

Across scholars, policy makers and market participants, the most enduring debate in relation to the setting of aeronautical services prices is that of the single till. Put simply, the question is whether, as under a single till, the setting of prices for aeronautical services should involve consideration of the costs and revenues of some or all of the other business activities undertaken by the airport operator at the airport concerned. Or alternatively, should the setting of aeronautical charges be done only having regard to the direct and attributed costs of aeronautical services?

The AAA notes that neither the Terms of Reference nor the Issues Paper raise this issue. That said, it is an issue that airlines often turn to in an attempt to find a device to reduce aeronautical charges. It has recently been an issue of some controversy in Europe and has been revisited on many occasions by regulators particularly the Civil Aviation Authority in the United Kingdom in relation to the regulation of prices in the south-east of England.

This issue first entered the policy debate in Australia in 1993 when one of the ACCC’s predecessors, the Prices Surveillance Authority, commented that the pricing approach of the FAC:

> …whereby prices for individual services are not assessed in relation to their separable costs and revenues from all airport activities are aggregated and used to meet all expenditure (airport or network) plus a reasonable margin, conflicts with economic efficiency… The current approach where the pricing of aeronautical services (as defined in the Act) are largely determined on a residual basis will contribute to inefficient use of existing aeronautical and non-aeronautical activities and distort incentives for investment.27

Despite this warning, charges levied by the FAC were not restructured. However, as the Commission noted in 2002, the then Australian Government gave an explicit undertaking during the sale process that the single till would not be mandated. The Commission went on to note that a reversion to a single till, even a partial one, could stifle risk-taking, innovation and airport development as well as raise issues of sovereign risk. These risks remain unchanged after 16 years.

The single till was not a major issue in the Commission’s 2007 or 2011 inquiries, however the importance of the principle of setting access charges in relation to their own costs can be seen in the Pricing Principles contained in section 44ZZCA of the CCA which were enacted as a result of recommendations made by the Commission in its 2001 National Access Regime inquiry. These principles require the ACCC, when dealing with access undertakings or arbitrations under Part IIIA of the CCA, to set prices “so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services” – namely, in an airport context, on a dual till basis.

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26 There is also a debate regarding the setting of prices in the context of a group or network of airports but this is not an issue in Australia and as such is not explored in this submission.

27 PSA (1993, pp169-170).

Advocates of the interests of airlines prefer a single till approach because it would lead to lower airport charges in most cases. That said, and given the discussion in chapter 2, this is unlikely to be to the benefit of travellers but rather airline shareholders. Suggestions that a single till approach might mitigate any market power possessed by airports in relation to non-aeronautical services should be dismissed – all the single till does is transfer any rents associated with market power from airport to airline shareholders. But if the rents are involved are of a locational nature, then the reallocation of such rents is likely to be inefficient.

The primary effect of the single till is to set aeronautical prices at levels below their incremental cost – as the CAA noted many years ago, “the incremental costs of additional capacity are generally significantly above single till levels”.39 As noted above, the AAA considers that the current airport Pricing Principles are likely to be leading to inefficiently low prices already – a single till would exacerbate this.

One argument advanced in favour of the single till is that efficiency can be enhanced because non-aeronautical services are compliments to aeronautical services. The naïve version of this proposition advanced by airlines is often of the form “airlines bring passengers to airports so they should get a cut of the retail and car parking revenues”. But arguments about perceived entitlements are not arguments about efficiency. With the exception of perhaps very basic food and beverage services, airport retailers compete with retailers elsewhere in the departure city, in the destination and increasingly online. As discussed in chapter 7, airport car parks are operating an increasingly workably competitive environment so in both cases, any rents that accrue to these activities are locational in nature.

Despite popular myth these passenger related revenues are a relatively small proportion of airport revenues. As discussed later in this chapter, unlike their international peers, many privatised Australian airports possess significant land holdings that are not required for future aviation. Figure 3.1 illustrates this point. This land has been developed for a range of airport compatible uses such as office parks, logistics facilities and manufacturing – individual airport submissions will no doubt outline these. These activities are neither complements nor substitutes for aeronautical activities. To the extent that they are relevant to the pricing of aeronautical services:

» they may place demand on some core airport infrastructure such as water, energy and road services. Given how costs are allocated for aeronautical pricing purposes in Australia, this will generally remove costs from the aeronautical cost base; and

» by providing the airport lessee with a source of income largely uncorrelated with passenger numbers, unlike retailing and car parking, the diversification of revenue should support credit ratings.

Figure 3.1  Airport revenue by source 2016-17, Australia’s ten largest airports

![Figure 3.1](image-url)

Source: AAA analysis.

3.1.4 Pre-funding (sic)

In its 2014 Public Infrastructure Inquiry Report the Commission drew a very clear distinction between the notions of funding and financing infrastructure. It correctly described funding as the sourcing of resources to develop and operate the infrastructure in question and identified three sources – governments, users and the recipients of positive externalities. Financing was seen largely as an activity that managed the mismatch of the revenues and expenses of the project through time and other risks of the project.

In this nomenclature, the situation where airlines pay for infrastructure before it is available for use should properly be referred to as pre-financing, as is correctly done in Forsyth (2018) and which we follow in this discussion.

For the purposes of this discussion, and reflecting the industry reality in Australia at major airports, it is assumed that there is only one source for funding and that is user charges, namely, those levied on airlines. In the normal course of events, airports will finance infrastructure from equity (contributed capital and retained earnings) and debt. As noted in section 1.1, about one third of capital in the Australian sector is provided by debt but the financing of major new infrastructure will typically involve more debt than the average on the balance sheet with subsequent leverage decreasing over time.

As the Commission will be aware, the substantial capital programs delivered by major airports are typically made up of a small number of large capacity or refurbishment projects and a large number of much smaller “business as usual projects”. For pricing purposes, each of these smaller projects’ cash flows are included in the building block model. These then contribute to the allowable revenues in each year and smoothed over the term of the model. Depending on the distribution of the cash flows over the life of the agreement, there may be an element of pre or post financing.

Increasingly for large projects, and especially relating to capacity, airlines are seeking to avoid the impacts on prices of the project until the project is delivered. Airlines seem to object to pre-financing on the basis that they should not have to pay for infrastructure before they can use it and that airlines helping finance the infrastructure may not actually be airport users when the services of the infrastructure become available. Further, it is also the case that if the price increase is agreed in advance, the airport is incentivised to deliver the project as soon as practicable to gain access to the revenue associated with it.

One could also conceive of a situation where a dominant airline that perceived that the airport had financing challenges may object to pre-financing if the project concerned was going to remove a capacity constraint that would facilitate entry and thereby undermine its dominant position.

However, in the event that a project is expensive and takes a long time to deliver it may not be possible for the airport to finance the project during the construction period. In such cases, airports may seek an increase in charges paid by airlines before delivery of the project to provide early positive cash flows for the project so it can be financed in the same way as business as usual projects. In such cases, airlines pay earlier than they would have and pay less than they would have once service commences – hence this is a financing and not a funding issue.

Provided airlines agree, the Commission found such an approach in its 2011 report acceptable. In his recent paper, Professor Forsyth of Monash University found that pre-financing generally enhances allocative efficiency, especially in the absence of capacity allocation mechanisms. That pre-financing is efficiency enhancing should not be surprising, indeed it is consistent with the Pricing Principles. The need to develop new capacity is created by the development of congestion. The effect of pre-financing is to raise prices during the construction period—the time when congestion is likely to be at its greatest. Further, if the total revenue stream for the project is fixed in present value terms, prices once the capacity is available will be lower than they would have otherwise been.

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30 The AAA notes and accepts that new infrastructure at small regional airports is often funded by the Commonwealth or state governments on a grant basis but this is not germane to this discussion.

31 Forsyth (2018)
Most interestingly, Professor Forsyth also found that airports subject to light handed regulation had no particular incentives to pursue pre-financing. On this basis, one would conclude that an Australian airport pursuing pre-financing had a genuine need to do so, and in doing so, was enhancing efficiency.

3.1.5 Discounts

Airports provide various forms of discounts on their published ‘rack rate’ fees and charges, including:

- temporary discounts to support the establishment of new routes or the expansion (either by increased frequency or larger aircraft) of existing routes – these are more common on international than domestic routes although a number of smaller regional airports are seen to be doing so;
- discounts for total passenger volume delivered by an individual airline or all airlines to the airport – these typically operate on a sliding scale and are more common in the domestic markets; and
- discounts in the form of penalties for poor service quality or late delivery of infrastructure by airports.

These discounting structures vary between airports and individual airlines using a given airport. That arrangements vary between airports should not be surprising. That they vary between airlines reflects the fact that larger carriers (especially domestic ones) will have a greater capacity to extract concessions from airports. It is interesting to note that there is no strong relationship between the level of discounts and the size of the airport. Another key factor is that as air transport markets are dynamic, airlines enter markets and establish services over time so varying arrangements to some extent is a reflection of the circumstances faced by the negotiating parties at the time.

A survey conducted by AAA shows that for major airports, international charges are on average discounted by 9.8% (the range being 1.0% to 55%) and domestic charges are discounted on average by 24% (the range being 1.6% to 48%). The survey also showed that the level of discounting has increased since the Commission’s last inquiry as depicted in Figure 3.2.

Figure 3.2: Discounting at Australia’s major airports

Source: InterVISTAS (2018b).

The discounting estimate is based on the practices of the ten largest Australian airports, excluding Canberra. Hobart is excluded from the international average as they did not have international service in the given year.
Hence, the actual charges paid by airlines at any given airport will be lower than those indicated by published charges, and in many cases significantly so. On the basis of engagement with its international colleagues and advisors, the AAA believes that the level of discounting in Australia is significantly higher than elsewhere in the world (see box 3.4). This is in part because the price discrimination given effect to by discounting may be illegal in some other jurisdictions. For example, whilst the legality of price discrimination under general European competition law needs to approached on a case by case basis, the EU Airport Charges directive places significant restrictions on price discrimination by airports. No such restrictions exist in Australian law – as the Commission will be aware the general prohibition against price discrimination contained in s49 of the Trade Practices Act 1974 (Cth) was removed by the Competition Reform Act 1996 (Cth) and there are no industry specific provisions in law relating to airports nor are such prohibitions suggested by the Principles.

It is the AAA’s view that discounting by Australian airports can be seen as:

» a natural consequence of the light handed regime that encourages direct commercial arrangements between airports and individual airlines;

» improving allocative efficiency by better matching the actual level of charges with individual airlines preparedness to pay, especially in relation to new entrants;

» encouraging competition in the market for air transport that leads to lower fares and a wider range travel options; and

» seeking to enhance airport profitability by increasing asset utilisation and leveraging greater revenues from passenger related non-aeronautical activities.

It is no surprise that large domestic airlines have been able to frustrate this sort of procompetitive by requiring “terms no less favourable” provisions in contracts. Some AAA members in more recent negotiations have resisted the continuance of these “terms no less favourable” clauses on the basis that they are not good for their businesses nor the travelling public but also reflecting legal advice that, by being an anti-competitive arrangement, they may constitute a breach of section 45 of the Competition and Consumer Act 2010 (Cth) (CCA).

33 See Geradin and Petite (2005).
Box 3.4  InterVISTAS observations regarding aeronautical discounting

The AAA retained global aviation consultancy InterVISTAS to undertake a global benchmarking study, the reports of which is included as Attachments 2 to this submission. InterVISTAS makes the following observations regarding discounting by airports internationally:

» “Based on our experience and a number of interviews with airports, we believe that the degree of discounting is higher for Australian airports than others, but it is present to some degree at an increasing per cent of airports globally.

» “Most airports today, large and small, offer incentives for new services.

» “Some offer incentives for existing services based on quantity discount concepts. The economics here is that a high proportion of airport costs are fixed and thus once an airport’s major carriers provide a base of annual revenue, additional traffic does not drive proportional incremental cost and thus a lower fee per unit beyond a base level of traffic can be rationalised. This also means that airport fee schedules do not need to be adjusted annually, as these types of quantity discounts will constrain airport revenue growth.

» “We are aware of discounting at some North American airports beyond incentives, although some city government operated airports in the U.S. may be constrained from discounting beyond incentives for new services.

» “In Europe, we are advised that fee discrimination is prohibited by the European Commission regulations. However, many airports do offer incentives for new services and some airports do seem to have broader discount policies. These might not be transparent but are equitably available to carriers and non-discriminatory in that sense.”

To address these challenges, InterVISTAS first provides airport fee benchmarks for selected aircraft types on specific routes based solely on rack rates. Second, they note that these comparisons will likely overstate Australian airport charges relative to their peers. Third, they caution that any econometric benchmark based findings that purport to measure market power of airports in Australia likely produce overstated measures of market power, as they are not based on actual fees paid by carriers, but rather on the rack rates.

3.2  How aeronautical prices are set

3.2.1  Contractual frameworks

As discussed in section 5.3, the absence of statutory frameworks (such as those that exist in the United Kingdom and New Zealand) that enable airports to establish and enforce terms and conditions of access (including charges) means that such terms and conditions need to be established in some other way. The most common, desirable and consistent with government policy means is for airports and airlines to enter into contracts covering those issues relevant to the airline’s use of the airport. These contracts significantly curtail the ability of airports to exercise any market power they might have during their term and in virtually all cases, arrangements for the resolution of disputes relating to these contracts are contained in the contracts themselves – there is no need for an external dispute framework.

The contracts usually have terms of five to ten years although shorter (typically less than a year or two) “hold over” agreements are sometimes put in place if parties have not been able to finalise the details of the next long term contract, often because of uncertainty related to major projects.
These contracts, which typically run from around 60–100 pages cover a range of matters beyond contractual “boiler plate” including a grant of licence to use the airport, acknowledgement of the airport’s official capacity, the services to be provided and their quality, consultation regarding the operation and development of the airport, sharing of information between the parties, payment arrangements, risk and indemnity, insurance, confidentiality and publicity, and dispute resolution.

Most important for this discussion is that they contain arrangements for varying prices over the life of the contract. There are two basic categories of charges – those that apply to the use of infrastructure and those that relate to the recovery of direct contract costs, typically security costs. The latter typically involve a periodic reconciliation of revenue against costs with prices for the following period being adjusted for any under-and over-recovery. Airports generally do not earn margins on these sorts of recovery charges.

It is infrastructure charges where airports generate revenue to remunerate debt and equity providers. Airports will typically levy separate charges for the airfield and different terminals although these sometimes might be aggregated, especially where two services are consumed jointly by a large user group. At the start of the contract, a price will be specified for each service and then a mechanism established for how prices will evolve over the contract life. This usually involves indexation at CPI (either market based or assumed) with provision for step changes for the delivery of significant new capacity – major terminal expansions and new runways are the most common in current negotiations. Increasingly these step changes will not take effect until airlines have access to the new capacity, although the value will be agreed in advance.

It is important to understand that the normal indexation path will be predicated on a “business as usual” capital program to fund asset replacement and refurbishment, service improvements and minor capacity expansions which in themselves are subject to extensive consultation and can run to many tens if not hundreds of millions of dollars.

**Building block model**

The building block model (BBM) was developed by Australian and overseas regulators to calculate the maximum allowable revenue of regulated utilities.\(^{34}\) Despite the use of other approaches by the ACCC prior to 2002 (largely based on cash flows), major airports and airlines have reached a consensus to use the BBM to motivate their discussions about long-term price paths for aeronautical prices, especially when large capital programs are involved. It is important to note that the outcomes of these models are not binding but rather act as a tool for exploring the relationship between capital and operating costs and prices.

Essentially, the maximum allowable revenue is the sum of:

- Efficient operating costs;
- Return of capital (depreciation);
- Return on capital (the amount of capital\(^{35}\) multiplied by the weighted average cost of capital (WACC)); and
- An allowance for tax (including in Australia the impact of dividend imputation).

Once revenue is determined, it is allocated to pricing categories on the basis of expected demand. For example, if there is only one category, expected demand is 20 and the allowable revenue is $100, then the price will be $5. In practice, there are usually multiple charging categories (see box 3.2 above) and prices are set to deliver revenues over a number of years. A diagrammatic representation of the model which includes inflation adjustment of the asset base (which is standard practice) is provided in Figure 3.3.\(^{36}\)

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\(^{34}\) In more recent times this approach has become known as the post-tax revenue model (PTRM) in the Australian energy industry.

\(^{35}\) Some models include an allowance for working capital, others use property, plant and equipment.

### 3.2.3 Some observations on price setting at regional airports

The implementation of a BBM is a complex task. Major airports often retain specialist consultants to develop and/or validate such models as well as provide advice on its various inputs, particularly the WACC. The AAA understands that for major airports the cost of such advice will often run to in excess of $1 million to support negotiations that can take over a year to conclude. This should not necessarily be seen as a failure or abuse of processes (although poor behaviour can delay the process and increase cost) but rather as a thorough examination of proposals involving hundreds of millions of dollars of revenue and billions of dollars of nationally significant infrastructure investment. That said, responses to a 2017 survey of regional airports conducted by the AAA suggests around one-third of regional airports use some form of modelling to motivate charges discussions with airlines, albeit the AAA expects at lower levels of complexity than that described in section 3.2.2.

Whilst some regional airports, especially those that are privately operated, use such models (often with support from their shareholders to mitigate costs), the majority of regional airports tend to set their prices using much simpler methods. Around 70% of respondents to the AAA’s survey rely on existing council budgeting processes to set and publish airport charges. Overall, communications with the airlines appear to be robust with 47% of airports discussing charges periodically with airlines (without detailed modelling) while 32% provide more detailed modelling and cost and revenue data. Only 22% set charges without detailed discussion. The AAA believes that the lack of discussion largely reflects no pricing activity by the airport concerned or disinterest on the part of airport users.

The survey research did not go to the point of investigating the data behind pricing outcomes. The recent controversy with respect to King Island Airport suggests that there is an expectation on behalf of the relevant auditor general that lower bound pricing (namely covering cash costs and depreciation) is expected – this would be consistent with the requirements of other council provided services by local authorities such as water services in regional Queensland. Even this approach encounters resistance (box 3.5). Some council owned airports, such as Dubbo, seek to pay a modest dividend to their council owners.
In the financial year ending 30 June 2018, King Island Airport received $458,149 in income from a range of sources, primarily landing charges. It incurred cash costs of $514,657, meaning it had a small cash loss of $56,508. In addition it incurred depreciation charges of $415,146, leading to an operating loss of some $471,654. This constituted some 23% of the rates collected by the council.

The Chair of its Audit Panel, a panel constructed under the relevant Tasmanian law, advised the council as follows:

The Audit Panel has requested the Council to report its Airport operations as a separate Financial Statement and raised its concerns about the significant operating losses being reported since that information was forthcoming. The KI Council Audit Panel has commended council on its aims to bring the Airport’s Operations to a more sustainable level, in the 2018/19 budget.

Council’s strategy is to increase landing charges by 19% and impose a per passenger charge of $7.50 (including GST) per arriving and departing passenger – this compares with charges at other small island airports such as Flinders Island ($9.90) and Lord Howe Island ($34.84). Overall, this represents an increase of just less than $19 or around 2% of the flexible fare to Melbourne, or 4.3% of a standard fare to Burnie.

The issues associated with airport pricing at small airports are fundamentally different to those at major airports. Pricing changes such as the example of King Island reflect decisions of the Council regarding the allocation of resources between different community services, the airport being one of them, rather than any attempt to abuse market power.

### 3.3 Aeronautical prices

The AAA commissioned InterVISTAS to undertake a benchmarking analysis of aeronautical prices charged by Australian airports and compare them with similar airports in other countries. The methodology and the complete results are contained in Attachment 2.

The data presented in the remainder of this section are based on published rack rates. The significance of discounting is discussed in section 3.1.5. Whilst the AAA is able to provide the Commission with aggregate discounting data, it is not able to do so in relation to individual airports. The extent to which that information will be shared with the Commission will become apparent from individual airport submissions.

Based on industry discussions and industry knowledge, InterVISTAS has indicated that the magnitude of rate discounting in Australia exceeds that of airports in Europe, North America and Asia. Thus ranking on the basis of rack rates will very likely place Australian airports in a less favourable light than would a ranking based on actual rates negotiated and paid by airlines.

### 3.3.1 International charges

Figure 3.4 and 3.5 sets out aeronautical charges for a Boeing 777-300ER “turn around” (arrival and departure) operating international services at a number of Australia’s largest airports in constant prices over the period since the Commission’s last inquiry. Sydney and Cairns have the highest cost per turn in each of the years measured, and whilst Sydney has grown at the same rate as Australian airports over the period, the rate of growth at Cairns has been somewhat slower.
Figure 3.4  777-300ER Aircraft international charges – larger Australian airports

[Bar chart showing airport charges per B777-300ER turn for SYD, MEL, BNE, PER, ADL, and Average for years 2012 to 2017.]

Source: InterVISTAS (2018a).

Figure 3.5  777-300ER Aircraft international charges – mid-sized Australian airports

[Bar chart showing airport charges per B777-300ER turn for CNS, DWN, OOL, and Average for years 2012 to 2017.]

Source: InterVISTAS (2018a).

The Gold Coast and Perth are the cheapest, perhaps reflecting a larger presence of low cost carriers than other airports or perhaps simpler and/or older facilities. Sydney’s relatively high cost is largely attributable to the its much higher land value (including the cost associated with having to reclaim parts of Botany Bay for each of its primary runways). Cairns’ position is largely a reflection of very peaky demand but also the presence of substantial excess capacity – in the mid 1990s Qantas withdrew almost all international capacity from Cairns and despite replacement by Jetar and others, international passenger volumes are 15% lower than in 2006. Again, it should be kept in mind that these data represent rack rates and do not include any discounts.
International charges have grown modestly in real terms. What growth has occurred is generally associated with changes in security costs and increased investment. The average cost per turn for this aircraft type at Australia’s five largest airports has increased by 17%, in real terms, during the five years measured. International discounts as a percent of the rack rate increased by 7% in this period, so the real growth of charges is likely better represented as 10%, or some 1.9% per annum.

Figures 3.6 and 3.7 show that international charges at Australian airports are broadly consistent with those levied at airports in other developed economies.

**Figure 3.6**  International airport charges (per turn) for A330 aircraft - larger Australian airports 2017

Source: InterVISTAS (2018a)

**Figure 3.7**  International airport charges (per turn) for A330 aircraft - mid-sized Australian airports 2017

Source: InterVISTAS (2018a)
For the Commission’s 2011 inquiry, Melbourne Airport commissioned Leigh Fisher to undertake a benchmarking exercise of international airport charges that covered Australia’s major international airports. Whilst there are some methodological differences between the work done by InterVISTAS for the AAA and Leigh Fisher’s approach, the AAA nevertheless considers the work of Leigh Fisher to be authoritative. One advantage it has over the work the AAA has commissioned is that it covers a much larger set of airports but on the other hand, it only contains one Australian airport, namely Sydney.

Figure 3.8 presents the most recent benchmarking of airport charges undertaken by Leigh Fisher. It shows that Sydney Airport is in the second quartile in terms of price index that Leigh Fisher (and before it TRL) has used for many, many years. It is interesting to note that a number of airports that have higher index values than Sydney, such of those in the United States, are not required to service the value of the land they occupy and have access to concessional finance through tax preferred borrowing and not having to remunerate their owners at equity market rates of return. It should also be noted that Leigh Fisher’s analysis does not account for discounts, the impacts of which would see Sydney’s position in all likelihood move to the right of the graph materially.

Figure 3.8  International airport charges index, 2016


3.3.2 Domestic charges

As noted in section 3.1.5, domestic airport charges in Australia are subject to heavy discounting. The AAA understands that most heavy discounting is to the benefit of the largest two domestic airline groups. Further, the data here do not relate to aircraft using terminals leased by Qantas which the AAA estimates account for around 25% of domestic passengers. The AAA understands that the overall cost incurred by Qantas under the domestic terminal leases is lower than current levels of charges, largely as a result of the age of the facilities and the leases themselves, and as such the data presented here should be seen as the upper bounds of average charges paid by domestic airlines in Australia.

The cost of the turnaround of a domestic B737-800 aircraft is provided in figures 3.9 and 3.10.
Most notable is the relatively high level of charges at Perth Airport reflecting the development of new
domestic terminal capacity in Terminal 1 for Virgin Australia and the development of Terminal 2 for services to
regional Western Australia. The increase at Hobart is largely attributable to changes in rack rates that the AAA
understands have not flowed on to RPT operators.

On average, charges at major airports increased by 12% in real terms, although given the increase in domestic
discounting discussed in section 3.1.5 the actual increase is likely to be more like 5%, or some 1% per annum.
Figures 3.11 and 3.12 compare the prices charged by Australian airports and their international peers. Overall, Australian airports appear to be within range of their peers for domestic services. Attachment 2 contains similar findings for other aircraft types commonly used at these airports, although the relative rankings and who is at the top and bottom ends may change for different aircraft.

Again, the results are based on rack rates not on the actual discount rates airlines pay. The relative positions of the Australian airports are therefore expected to be better than indicated.

**Figure 3.11** Domestic airport charges (per turn) for 737-800 aircraft - larger Australian airports 2017

![Bar chart showing domestic airport charges for larger Australian airports](source)

**Figure 3.12** Domestic airport charges (per turn) for 737-800 aircraft - mid-sized Australian airports 2017

![Bar chart showing domestic airport charges for mid-sized Australian airports](source)
3.3.3 Prices at regional airports

The AAA’s recent survey indicated around 50% of regional airports index their charges to inflation whilst more than 25% have not had a price increase in the last five years, which would represent a real price reduction in excess of 10% over that period. A small number of airports reported they had reduced charges in nominal terms under pressure from airlines to maintain existing services or incentivise new ones. Some airports reported moving to charging on a full cost recovery basis to help fund airport improvements but have been encountering airline resistance, following years of charges being held constant in nominal terms.

Despite the impression created by some that regional airports are continually increasing charges, in its recent survey of regional airports, the AAA learned that 68% of the airports surveyed had been approached by airlines to provide some form of discounting. Around 25% of regional airports reported they had been asked for a reduction in charges on the back of a threat to reduce services. A further 23% were asked for reductions as part of a new services incentive, while 23% were also asked to help airlines reduce airfares.

3.3.4 Why aeronautical prices might be rising

Aeronautical charges have increased since the Commission’s last review. There are structural and cyclical reasons to expect the price of aeronautical services to have increased over the last decade.

Demand for air travel has grown steadily through the period, necessitating substantial capital investment in new and upgraded terminals. The most significant investments made by the four airports include:

» the development of new international terminal infrastructure and a major northern access road at Brisbane Airport;
» an ongoing construction of a new parallel runway at Brisbane Airport;
» the expansion of international capacity at Perth Airport’s Terminal 1 and the construction of a new pier to facilitate Virgin’s domestic operations;
» Perth Airport’s new Terminal 2 to facilitate regional and low cost domestic operations;
» Melbourne Airport’s redevelopment of the 1970’s Terminal 2; and
» Melbourne Airport’s significant expansion of its discount and regional airline terminal, Terminal 4.

The ACCC suggested in its 2017 monitoring report that airports’ ability to spread the cost of capital investment across more passengers may be expected to put downward pressure on the average cost per passenger. However, the extent of the increase in passenger numbers over the past decade is, for most airports, a fraction of the increase in capital investment that has taken place. In particular:

» Brisbane has increased its capital invested in aeronautical assets by 7%, in the face of a 27% increase in passenger numbers;
» Melbourne has seen a 51% increase in passengers, but its capital assets have increased by more than three times this figure;
» Perth served 79% more passengers in 2015-16 than 2006-07, compared with a 280% increase in its aeronautical assets; and
» finally, in contrast, Sydney experienced passenger growth of 31% compared with asset growth of 8%, but experienced greater international passenger growth.

It is clear from the extent of these differences in rates of passenger growth and capital investment that increasing passenger numbers over the last decade are not yet sufficient to enable all airports to fund capacity expansion projects without some near-term increases in passenger charges.

Initial asset values of three of the monitored airports (not Sydney) were affected by the Australian Government’s decision to adopt a ‘line in the sand’ approach to the valuation of aeronautical assets. Further, as discussed in section 3.1.1, the aeronautical asset valuations developed since 2005 on a DHC basis are unlikely to represent that value of the asset base’s current service capability. It follows that the addition of capacity at current values, or the refurbishment of existing capacity, will place upward pressure on prices.

37 ACCC (2017, p 10)
It is likely that the incremental cost of aeronautical capacity has increased over the last decade. In particular:

» major new investments, such as Perth’s Terminal 1 Pier and Melbourne’s Terminal 4, offer much greater amenity than existing assets, and this can be expected to be reflected in higher construction costs;

» the cost of construction significantly increased during the decade, on account of pressures flowing from the resources construction boom;

» space constraints can result in increasingly expensive projects – for example, Brisbane Airport is constructing a new runway on the site of the old river delta, which requires costly surcharging of the land, affecting both the cost and timing of the project;

» capacity expansions that respond to peak demand growth that is more rapid than average demand growth will tend to have a higher cost per total airport passenger throughput than the asset base as a whole;

» when airports are operational, the construction of additional capacity must be undertaken while flights are still landing and departing, with this requirement contributing substantially to the incurrence of costs over and above the value of the existing assets; and

» much of the capacity development in the past decade (with its strong emphasis on terminals) involved upgrading existing – and in some cases quite old assets, as was the case with the redevelopment of Melbourne’s Terminal 2 – which is inherently more expensive than capacity deployed at greenfield sites.

3.4 Assessing aeronautical profitability

3.4.1 Some invalid approaches

3.4.1.1 Aeronautical revenue per passenger

In its 2011 report the Commission used aeronautical revenue per passenger basis as a proxy for airport prices. Whilst this metric has some uses it is of limited use in assessing whether airports have abused any market power they may possess. It is curious that even though the ACCC has previously acknowledged this, its Chairman continues to place great store in its movements, including those aggregated over time and airports.

In its 2011-12 Airport Monitoring Report the ACCC noted that:

> It is difficult to aggregate all services and prices into a single average price of aeronautical services for monitoring purposes. The lack of a single aggregate price complicates the task of establishing trends over time and comparing prices across airports.38

At the release of its 2017 monitoring report the ACCC contended that over a ten-year period airlines made $1.57 billion in ‘additional payments’ to airports because prices have been higher than they would have been if they had only grown by inflation – no similar reference was made in the 2018 report when this measure was $1.29 billion. This is derived by reference to an estimate which assesses the change in revenue per passenger – the ACCC’s chosen ‘proxy measure for average airport prices’. The ACCC establishes its proxy by dividing the annual aeronautical revenue by the number of passengers passing through the airports’ gates each year. Its estimate is not the result of any direct assessment of aeronautical charges and how they have changed over time.

Whilst airport charges have risen in real terms the most significant factor causing revenue per passenger to increase over the past decade is the fact that international passenger numbers have increased much more quickly than domestic passengers. International passengers receive more extensive services than domestic passengers, involve greater costs for the airports and generally pay much higher aeronautical charges. This too has been acknowledged by the ACCC in its 2017 monitoring report:

> The costs to an airline of landing a domestic flight are likely to differ from those associated with landing an international one, because of differing security and processing requirements and other factors.39

38 ACCC (April 2013, p xxii).
The increasing proportion of international passengers means that the ACCC’s simple measure of ‘revenue per passenger’ is an upwardly biased estimate of the price growth in aeronautical services.

The ACCC acknowledges the effect that the changing mix of passengers may have on its proxy for prices, and recognises that an ideal measure would assess prices directly. It suggests that constructing a new airport price index would ‘involve a number of complexities’, but takes no steps to develop such a measure. Rather, the ACCC seeks to compare increases in airport charges to the fare price growth of airlines, even though airports provide very different services from airlines and face quite different cost drivers. Houston Kemp’s expert report (Attachment 1) examines recent movements in this measure in more detail.

Beyond the challenges associated with interpreting movements over time in aeronautical revenue per passenger, care must also be taken in cross-country comparisons. The particular problem is airports in different countries provide different sets of aeronautical services – for example aviation rescue and fire fighting services are not provided by Australian airports but are provided by airports in many other countries. Also airports in jurisdictions with low tax rates, or that are not required to earn commercial returns, can be expected to have lower levels of revenues reflecting these cost advantages. Nevertheless, for comparative purposes, aeronautical revenue per passenger is shown in Figure 3.13.

The aeronautical revenue per passenger results for the Australian airports is within range of their peer airports. Also included is the comparison where currencies are adjusted using purchasing price parities (PPP) rather than exchange rates. While the relative pattern varies somewhat (and LHR becomes an outlier), the key finding is unchanged.

**Figure 3.13  Aeronautical revenue per passenger fiscal year 2015-2016**

Source: InterVISTAS (2018a).
3.4.1.2 Margins

At the time of writing of this submission, the only evidence A4ANZ has advanced in support of its claims of excessive pricing by airports, other than movements in aeronautical revenues per passenger, has been a brief discussion of profit margins measured as EBITDA as a share of total airport revenue. The conclusion it draws is that, because margins for airport businesses as a whole are higher for Australian airports than their overseas peers there must be an abuse of market power by those Australian airports.

This analysis is fundamentally flawed. EBITDA is a measure of the resources available to the company to provide for the return on and of capital and pay taxes. Thus, EBITDA margins will be higher for businesses that are more capital intensive, are required to pay normal market returns, and operate in relatively highly taxed jurisdictions with no tax concessions.

Australian airports can generally be expected to operate with higher EBITDA, and EBIT, margins for a range of reasons including:

» They don’t provide labour intensive services such as terminal navigation, ARFF, ground handling and fuel supply (box 3.6);

» Perhaps with the exception of Sydney, Australian airports have substantial surplus land holdings which will generate income with relatively low operating costs;

» They are not the beneficiaries of free access to land;

» As the Qantas CEO has recently observed, Australian tax rates are high by global standards. Further, Australian airports are not afforded tax concessions available in other countries;

» Australian airports must earn a normal return on invested capital.

Box 3.6 Margins don’t indicate profitability

Consider two airports – both have an asset base of $250 million with an average life of 25 years, a cost of capital of 10% and aviation operating costs of $10 million per annum. One of them operates a ground handling business with annual costs of $4 million from which it adds a margin of 25%.

The airport with the ground handling business has a higher level of both EBITDA, EBIT and return on assets – $36 million, $26 million and 10.4% respectively, as compared to the other business, $35 million, $25 million and 10%.

However, the airport without the ground handling business has higher EBITDA and EBIT margins – 77.8% and 55.6% respectively, when compared to the airport with a ground handling business – 70.6% and 51.0%.

Margins are a poor indicator of profitability and not a basis for identifying potential abuse of market power.

To the extent that EBITDA and EBIT are of relevance, EBIT is the more relevant for capital intensive businesses as it provides for depreciation. Further, movements in EBIT per passenger are more instructive than margins. Figure 3.14 below compares the real EBIT generated by Australia’s five largest airports, measured on a per passenger basis.
Figure 3.14  EBIT per passenger (2017 prices)

![Bar chart showing EBIT per passenger for different airports from 2012 to 2017.](chart1.png)

Source: InterVISTAS (2018a).

For the four monitored airports data are available for their aeronautical businesses that are the focus of this inquiry. Figure 3.15 shows the growth in aeronautical EBIT per passenger since 2003, in real terms. The general upward trend reflects the additional cash required to service the strong investment outcomes experienced by the industry.

Figure 3.15  Aeronautical EBIT per passenger (2017 prices)

![Line chart showing growth in aeronautical EBIT per passenger for different airports from 2003 to 2017.](chart2.png)

Source: InterVISTAS (2018a).

As financial information for overseas airports’ aeronautical businesses is not generally available, benchmarking comparisons must be made on a whole of airport basis. Figure 3.16 and 3.17 show the enterprise EBITDA and EBIT per passenger for five Australian airports with their peer group. Although the ranking of the Australian airports changes, the overall results compared to their peers are the same for EBITDA and EBIT. The Australian airports fall within the range of the peer airports, with the most profitable Australian airport, Sydney, being exceeded by Heathrow, Auckland and Zurich.
This analysis shows clearly that Australian airports continue to exhibit generally high margins as they have in the past. This is largely attributable to the factors outlined earlier in this section.

**Figure 3.16** Enterprise EBITDA per passenger (Fiscal year 2015-2016)

![Enterprise EBITDA per passenger (Fiscal year 2015-2016)](image1)

Source: InterVISTAS (2018a).

**Figure 3.17** Enterprise EBIT per passenger select (2015-2016)

![Enterprise EBIT per passenger select (2015-2016)](image2)

Source: InterVISTAS (2018a).
3.4.1.3 Return on capital measures

LeighFisher (2017a) includes three different return measures: return on capital employed, return on shareholder funds, and return on invested capital. There is ambiguity in the way these returns are measured especially given the differences in accounting treatment of equity in different jurisdictions and where airports are fully or majority government owned and/or not-for-profit organisations.

Figure 3.18 below shows the return on capital employed for the four Australian airports included in the LeighFisher (2017a) analysis, as well as the average for all of the airports in the analysis. Return on capital employed is calculated as EBIT divided by total capital. The Australian airports all fall below the global average for return on capital employed. The four Australian airports perform better than the (local authority run) North American airports on average, but are below the average for the European airports, which are generally operated for profit, included in the analysis.

Some observations are important in terms of the main influences on the returns for private airports:

- There is an impact from the original purchase price to acquire the airport on an airport company. Some bidders will have won with undervalued bids, while others may have overpaid compared to the actual value of the airport or airport company. This initial “starting point” value materially affects measures of return on equity and return on invested capital, and these initial starting points varied significantly within Australia.

- The financing structure of the airport company has an impact. Some airport companies are structured as a single entity, simplifying analysis and interpretation. Others are financed via holding companies and other arrangements; the analysis and interpretation of the return on equity/invested capital for the actual company operating the airport may seem high or low then, depending on whether the computation is done based on the financial structure and leverage of the overall corporate group or at the level of the specific airport operating entity.

Figure 3.18  Return on capital employed 2014-2015

3.4.2 The approach required by the Pricing Principles

The Pricing Principles make it abundantly clear that the relevant metric for assessing the presence of excess returns is the return on tangible, non-current assets. The AAA commissioned leading Australian economic consultancy Houston Kemp to undertake an assessment of the four monitored airports since the removal of price controls against these criteria. This analysis, and its methodology, is set out in depth in Attachment 1 to this submission.

The essence of Houston Kemp’s profitability analysis is the derivation of an annual comparison of:

- the rate of earnings before interest and tax (EBIT) as a percentage of the aeronautical asset base for each of the four airports, in each year since 2003 through to 2017, using data disclosed by the ACCC in its annual airport price monitoring reports; and

- an estimated range for the pre-tax nominal, weighted average cost of capital (WACC) for a benchmark Australian airport, derived using readily available upper and lower bounds for each WACC parameter, as drawn from either airport or other infrastructure service provider decisions made by the ACCC – noting that, as far as the value of beta is concerned, the range established by earlier ACCC airports decisions remains consistent with more recent studies.

This analysis is summarised in Figure 3.19.

**Figure 3.19 Return on aeronautical assets of monitored Australian airports**

![Graph showing return on aeronautical assets of monitored Australian airports](image)


Key factors from the analysis are that:

- the rates of return on aeronautical services by the monitored airports have fallen within the bounds of the estimated costs of capital for a benchmark Australian airport; and

- Perth and Brisbane have reported rates of return below the mid-point of the lower and upper WACC range while Melbourne and Sydney have reported rates of return above the mid-point.

Houston Kemp concludes that:

these results strongly support a conclusion that none of the four airports can be said to have set prices or achieved levels of profit that can be said to reflect the exercise of any market power. Further, although not the focus of our report, the Productivity Commission’s 2011 findings in relation to rates of productivity growth and trends in service quality achieved by the airports are also consistent with the conclusion that there has been no exercise of market power in the provision of aeronautical services.”

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41 Houston Kemp (2018, piii)
4 Benchmarking airport performance

The Commission’s Issues Paper contains a number of information requests relating to the use of benchmarking data for assessing the performance and potential misuse of market power by airports. This chapter addresses some general issues relating to benchmarking and presents some data relating to quality, operating efficiency and investment.

Chapter 3 provided data relating to aeronautical prices and airport profitability. Taken together, these two chapters provide a solid basis for concluding that it is unlikely that monitored Australian airports have systematically abused any market power that they may have since price controls were removed in 2002.

The main conclusion from the InterVISTAS benchmarking report (Attachment 2) on the operating performance metrics for the monitored airports is that they are within the range of their international counterparts. It was noted in the Commission’s 2011 Report that “Australian airports’ aeronautical charges, revenues, costs, profits and investment look reasonable compared with (the mostly non-commercial) overseas airports.”

The discussion below, that in Chapter 3, and the analysis contained in Attachment 2 reach the same general conclusion, especially given that some peer airports are subsidised, or may have a single till regulatory scheme which may inefficiently suppress prices (as discussed in chapter 3).

The correct choice of peer airports is critical to an analysis of this kind, given how different the operating environment, ownership structure and strategy of different airports can be – even if they superficially look alike. The peer airports were selected on the basis of their traffic profile in comparison with ten Australian airports, including passenger mix, freight, and aircraft movements. In addition, the peer airports cover a number of countries, ownership and regulatory categories. While care has been taken to match the airports as closely as possible, there are characteristics of some airports that are difficult to replicate precisely. The full list of peer airports is contained in Attachment 2.

4.1 Why might benchmarking reveal abuse of market power?

The ACCC over many years has suggested that the monitoring results point to some airports exercising their market power although it has never made a definitive finding in relation to such conduct. The evidence that Australian airports have charged excessive prices and thereby earned excessive returns is discussed in Chapter 3. Evidence of Australian airports exercising market power by allowing quality of service to erode is discussed in section 4.2. Evidence relating to Australian airports exercising market power by inefficiently allowing costs to rise is discussed in section 4.3. Section 4.4 looks at the potential for market power to be exercised by airports inefficiently under investing to drive up prices or passing on unnecessary capital costs.

4.1.1 Benchmarking – Theoretical and practical issues

The Commission has acknowledged the difficulties in benchmarking airport performance, centred on comparability difficulties across airports, data limitations, and differing methodologies. This is common across most infrastructure sectors as identified in the Commission’s Inquiry into Electricity Network Regulation.

This is simply illustrated by the wide variations in revenue compositions between global regions as shown in figure 4.1.

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42 PC (2011, p.xx).
43 InterVISTAS (2018a, p20).
44 PC (2011, p42-45).
45 PC (2013a) especially chapters 4, 5 and 8.
Bezerra and Gomes’ (2016) literature review on airport performance measurement echoes the Commission’s previous call for more comprehensive approaches. Airport performance analysis over the past decade has focused on benchmarking measures of efficiency. However, airport performance measurement encompasses a broader array of indicators that are often interrelated. By limiting the scope of analysis to one or two performance measures, often rigidly-defined, most studies have avoided the inherent complexity involved in any airport business, regardless of how the airport is regulated or owned. Further, the lack of any standardised or systematically defined method of analysing a performance measurement makes it difficult to compare findings across studies. As noted by Liebert and Niemeier (2013, p175) “application of different methods and data are likely to affect the results...“.

The key issues surrounding benchmarking studies can generally be categorised as follows:

- airport selection criteria;
- the feasibility of comparability adjustments among the selected set of airports;
- selection of performance parameters; and
- how to interpret the results.

In relation to the benchmarking results presented here, these issues are discussed in section 2 of Attachment 2.

4.1.2 Some other benchmarking studies

In addition to the academic literature cited in Attachment 2, there are a number of publicly available studies that benchmark different aspects of airport performance:

- Airports Council International has an annual benchmark programme ranking airports based on service quality (ACI Airport Service Quality (ASQ)). The airports included in the benchmark are voluntary and ranked, based on the results of passenger surveys.46 Section 4.2 utilises some of this material.

46 See www.aci.aero/Customer-Experience-ASQ/Homepage.
LeighFisher produces two annual benchmark studies; one study focuses on airport charges and the other benchmarks airports based on different financial and operational metrics. These studies provide benchmarking on specific aspects of airports, looking at partial indicators for comparison rather than a holistic view of the airports. Sydney was the only Australian airport included in the most recent charges benchmarking report, and was ranked 14th out of the 50 airports included. Financial and operational metrics are provided for Sydney, Melbourne, Brisbane, Perth and Adelaide. LeighFisher has prepared bespoke reports for Australian airports in the past that have been provided to and cited by the Productivity Commission as authoritative.

The Air Transport Research Society (ATRS) undertakes a global benchmark of airport productivity and efficiency. This annual study compares over 140 airports worldwide and measures performance in terms of partial productivity, cost competitiveness, and financial performance while also developing a total productivity index to make overall comparisons. InterVISTAS considers this approach as highly unreliable and fundamentally flawed. One of the most egregious methodological errors is that the study seeks to estimate a variable cost function even though such a function can only be estimated if there is a measure of the airport’s capital stock – ATRS has no measure of capital stock.

The World Economic Forum provides a periodical ranking of the competitiveness of countries around the world for travel and tourism. Although airport charges are included in their analysis, it is mixed with other charges and taxes, making any conclusion on competitiveness difficult. While it is a useful report to look at the general ranking of a country for travel and tourism, there are difficulties in interpreting the results for airport charges specifically. Australia ranked 7th overall for travel and tourism, but for ticket charges and taxes, it ranked much lower (94th out of 136 countries).

The World Airport ranking by Skytrax is also noteworthy. What is significant is that the four monitored airports have improved their rankings over the last seven years (see Box 4.1).

4.2 Quality of service

A firm may exercise market power by allowing the quality of its output to decline whilst maintaining or enhancing its profitability. As will be evidenced in submissions to this Inquiry, Australian airports have invested in expanding capacity and maintaining and improving quality over many years. It is not intended to restate those examples here but rather to focus on statistical measures of quality with a focus on passenger experience.

Pursuant to Part 8 of the Airports Act 1996 (Cth) (AA), the ACCC has collected and published quality of service data since 1998. The most recent data was released in April 2018. Figure 4.2 shows overall airport quality for the currently monitored airports for the last decade.

Given sample sizes and the underlying statistical methodology involved, small movements in overall quality may not be statistically significant. What can be concluded from these data is that service quality broadly has been maintained over the last decade despite significant increases in airport throughput and that it remains generally good. Perth Airport’s significant improvement in quality of service ratings over the past three years has coincided with a substantial investment program, particularly in relation to Virgin Australia’s move from Terminal 3 to Terminal 1 and the development of a dedicated regional terminal (Terminal 2) to support airline operations to resources-based and other regional destinations.

49 PC (2011, p.55).
51 InterVISTAS (2018a, p5).
53 Ibid.
The data presented in Figure 4.2 include a broad range of experiences some of which may be correlated more with airline experiences than airports. It also includes, in a non-transparent way, survey responses from airlines. The AAA and its members do not dispute that service outcomes experienced by airlines is an incredibly important issue, but it is concerned that small sample sizes and the potential for gaming makes the inclusion in a broad statistical measure problematic. As discussed in chapter 6, the AAA has come to the view that airline quality outcomes are better addressed through contractual arrangements agreed by airlines and airports on an airport by airport basis. The AAA understands that information collected and published by the ACCC in respect of airline quality outcomes is of very little utility to parties contracting for the provision of aeronautical services, for policy makers or members of the general public with an interest in the performance of the airports being monitored.

**Figure 4.2** Overall airport quality

![Figure 4.2 Overall airport quality](image)


Figure 4.3 shows satisfaction ratings for passengers departing through monitored airports as collected for ACI’s ASQ program. The ASQ Survey is the airport industry’s standard for measuring passenger satisfaction. In this global programme, the passengers’ satisfaction levels are measured while they are at the airport. ASQ surveys are currently conducted at over 330 airports worldwide, covering more than half of the world’s 7.6 billion annual passengers. The ASQ Survey covers 34 key service areas and includes eight major categories, such as access, check-in, security, airport facilities, food and beverage providers and more. All participating airports use the same survey questions.

It is a superior measure for understanding passenger’s satisfaction as it removes the airline impact discussed above and covers a wider range of the passenger experience than that of arriving passengers. The ASQ methodology is statistically more robust than that currently used and the AAA understands that movements of less than 0.05 may be significant for larger airports. What is clear is that passengers rate their departure experiences at monitored airports as good and there have been significant improvements since 2012.
As is the case with airlines, there is a range of third party ratings of airport quality. One such rating service is Skytrax (box 4.1). Again, this shows continuing improvement in passenger outcomes.

**Box 4.1**  
**SKYTRAX Australian airport quality of service increasing**

International air transport rating organisation, SKYTRAX is a specialist Research and Quality Advisor to the air transport industry, advising airlines and airports around the world on quality improvement and quality leadership issues. The Skytrax annual ’World’s top 100 airports’ list is based on voting by international air travellers. The data shows an unambiguous continual improvement in performance ranking by consumers:

- Perth improved its ranking from 80 in 2011 to 59 in 2018;
- Sydney improved its ranking from 40 in 2011 to 20 in 2018;
- Melbourne improved its ranking from 43 in 2011 to 27 in 2018; and
- Brisbane improved its ranking from 34 in 2011 to 22 in 2018.

These types of rankings while informative can also subject to externalities such as events and effects outside an airports’ control such as traffic congestion or construction works impacting traveller experiences.

4.3 Airport costs

As discussed in the next section, airports are primarily capital intensive businesses and their efficiency largely depends on their investment activities. As such their long term pricing behaviour is less dependent on operating cost outcomes than other businesses, such as airlines.

In addition to the benchmarking challenges discussed in Attachment 2, trying to identify inefficiencies in the provision of aeronautical services in Australia by way of comparisons with airports in other countries is hampered by the fact that data on aeronautical services are not generally available for overseas comparator airports. The data that are available relate to the activities of airports as a whole and include costs related to property, retail and carparking as well as a range of aeronautical activities not undertaken at Australian airports.

4.3.1 Recent developments in Australian airport costs

Total airport costs include operating costs, labour, and financing (interest and depreciation). They do not include tax payments or payments to providers of equity.

Figure 4.4 compares the total costs per passenger incurred by Australia’s five largest airports, measured on a per passenger basis. Historically, Perth has had the highest total cost, although this has been falling over the past five years. Sydney has the second highest costs per passenger which have drifted down in recent years.

Broadly costs have remained constant in real terms since the Commission’s last Inquiry. Whilst some improvement may have been expected if operating costs are largely fixed, this will have been offset by increasing capital (associated with investment) and security costs.

Operating costs remove the costs of financing from total costs – they represent the cash costs incurred from running an airport outside the return on and of capital and taxation. This is the best measure of operating efficiency although this average measure will be higher for those airports with a higher proportion of international passengers ceteris paribus – this contributes to Sydney Airport’s slightly higher level compared to other large airports. Perth Airport currently features the highest operating costs per passenger, as shown in Figure 4.5. Overall, the Australian airports examined have experienced small but steady increases in real operating costs during the past five years, probably due to increasing security costs, maintenance costs associated with aging assets, and economy-wide increases in energy costs.
This general trend has been exacerbated at Perth Airport by the slowing of both interstate and regional traffic in recent years coinciding with the end of the resources construction boom. There is some overseas evidence to suggest that operating costs do rise as airports grow particularly when they are congested.\textsuperscript{54}

**Figure 4.5** Operating costs per passenger (2017 prices)

<table>
<thead>
<tr>
<th>Year</th>
<th>SYD</th>
<th>MEL</th>
<th>BNE</th>
<th>PER</th>
<th>ADL</th>
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<td>12.57</td>
<td>12.57</td>
<td>12.57</td>
<td>12.57</td>
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</tbody>
</table>

Source: InterVISTAS (2018a).

**Figure 4.6** Staff costs per passenger over the past five years. Airports are capital intensive and labour costs are a small portion of both total costs and operating costs. Limited weight should be attached to relative levels of staff costs as they can be affected by outsourcing decisions made by individual airports and regional variations in relative wages.

<table>
<thead>
<tr>
<th>Year</th>
<th>SYD</th>
<th>MEL</th>
<th>BNE</th>
<th>PER</th>
<th>ADL</th>
<th>Average</th>
</tr>
</thead>
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<td>1.23</td>
<td>1.23</td>
<td>1.23</td>
</tr>
</tbody>
</table>

Source: InterVISTAS (2018a).

\textsuperscript{54} Starkie and Thompson (1985), Bottasso and Conti (2012).
4.3.2  International benchmarking of operating costs

Leigh Fisher produces a number of measures that provide useful comparisons of whole of airport operating costs. In terms of operating costs per passenger for instance, Australian airports perform very strongly, ranking around 50% or less of the global average on this measure.

Figure 4.7 and Figure 4.8 summarise the results generated by InterVISTAS for the five largest Australian airports compared to their peers in terms of total costs and operating costs. Australia’s largest airports have lower operating costs per passenger than the average of their international peers. It is also interesting to note that many of the airports with higher operating cost per passenger are much larger than Australian airports suggesting that, beyond some point, there are decreasing returns to scale with respect to operating costs.

Financing, depreciation and other costs appear to be higher at the Australian airports compared to their peers. This can be explained by recent major capital expenditures that have had to be funded by debt and equity that does not attract any preferential treatment. Many overseas airports are owned and supported directly or indirectly by governments, are subsidised and were provided land at no cost. In Australia and other jurisdictions (most notably in Europe) which have fully privatised airports, the airports are responsible for all of their costs and financing needs.

Figure 4.7  Total airport costs per passenger for selected airports (Fiscal year 2015-2016)

Source: InterVISTAS (2018a).
4.3.3 Aeronautical costs at Australian airports

In its 2015-16 Airport Monitoring Report the ACCC stated that higher aeronautical charges have been used to both cover increasing costs per passenger and to grow profit margins. The ACCC recognises that the airports have had to invest significantly over the decade to keep up with passenger growth, but contends that this growth should have enabled airports to share infrastructure facilities between more people, putting downward pressure on average fixed costs per passenger and therefore questions the incentives to reduce costs.56 This lack of understanding of the underlying cost structures of airports is discussed further in chapter 3 and Attachment 1.

Data is available for the aeronautical operating costs for the four monitored airports since privatisation. Figure 4.9 shows aeronautical operating costs in real terms at the four monitored airports since price controls were removed. All airports have seen a real increase in per passenger costs over the past 15 years, ranging in real terms from 0.1% to 4% annually, on average.

Source: InterVISTAS (2018a).

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56 ACCC (2017, pxii).
Figure 4.9  Aeronautical operating costs per passenger (2017 prices)

Source: InterVISTAS (2018a).

Figure 4.10 shows the growth in aeronautical staff costs over the period. With the exception of Perth, staff costs have remained fairly stable over the years, though the trend shows increases after 2012.

Figure 4.10  Aeronautical staff costs per passenger (2017 prices)

Source: InterVISTAS (2018a).
4.4 Investment

The Commission notes in the Issues Paper that airports could exercise their market power either by under investment leading to congestion and poor service quality or over-investment that could increase the costs of aeronautical services above the level users are prepared to pay.57

Of the issues examined in this chapter, or indeed chapter 3, the appropriateness of investment outcomes is probably the one that is least amenable to benchmarking. The individual capacity and quality requirements of passengers and airlines vary between airports. The actions required by airports too will vary and in many instances will be dependent on planning decisions made several decades in the past. Costs will vary for cyclical and locational reasons.

4.4.1 Benchmarking of investment and the capital stock

In the 2016 financial year, Australian airports’ investment performance was similar to that of their peers. However, an examination of only one year of investment does not accurately portray the longer lifecycle associated with airport investment. Airport investments are large and the investment programs may take many years to unfold. Hence, comparing single year investment levels has limited usefulness. Instead it is more helpful to compare multi-year investment programs, which would more accurately reflect the cyclical nature of airport capital investments. Looking at more than one year of data provides a better comparison across airports if they are not at the same point in their investment cycles. Figure 4.11 shows that Australian airports have invested in line, or slightly more than their peers.

Figure 4.11 Capital expenditure per passenger, Fiscal Year 2015-2016

This is broadly consistent with similar data generated by Leigh Fisher measuring capital expenditure per passenger. It showed Melbourne (ranked 2nd), Brisbane (ranked 3rd) and Perth (ranked 4th) having the highest capex per passenger of all international comparator airports with the exception of Calgary. Sydney came in midfield, ranking 23rd. 58

57 PC (2018, p8).
58 Leigh Fisher (2017b, p156).
The longer-term investment performance of airports might be revealed in the extent of assets deployed for each passenger (Figure 4.12). That said, it could well be spurious as it might reflect the relative age of assets, the cost of land (and particularly dredging and reclamation) and costs of asset construction. Also, airports with large property holdings that are not related to the air transport of passengers or freight may exhibit higher asset values per passenger. Not much store should be placed on this measure.

**Figure 4.12** Total assets per passenger, Fiscal Year 2015-2016

Source: InterVISTAS (2017b).

### 4.4.2 How much does airport capacity cost?

The cost of new capacity varies dramatically between airports. This is not just an issue for international comparisons but also domestic ones. The new runway proposal at Perth Airport, currently subject to public consultation, carries an estimated cost of $520 million. The estimated cost of the runway currently under construction at Brisbane Airport is $1,300 million. The two projects will add similar amounts of capacity to each airport. The cost difference is largely attributable to the fact that site preparation at Perth Airport largely involves clearing of remnant coastal plain vegetation whilst in Brisbane it has been necessary to drain a mangrove swamp, fill it and literally create the land on which the runway will be built.

Other factors that will lead to variations in costs include:

- Relative levels of productivity in the construction sector. The Commission considered this issue in its 2014 Inquiry into Public Infrastructure. Of particular interest for this Inquiry is the finding that, based on independent advice from highly reputable quantity surveyors, the cost of building airport terminals in Australia is comparable to other developed economies.59

- Whether the site is brownfield or greenfield. Costs are significantly higher when works need to be undertaken on an operational airfield or in an operational terminal.

- The design specifications needed to meet quality expectations of passengers and airlines – full service international carriers and their passengers will have quality expectations that will lead to terminal costs much higher than those that would be incurred for a terminal developed for a low cost carrier.

- Construction costs are cyclical and differ from location to location.

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All that said, the data presented in box 4.2 suggests capital costs incurred at Australian airports are broadly consistent with those in other OECD countries. These are consistent with the data presented by the Commission in its 2014 Public Infrastructure Inquiry in relation to the cost of airport terminal construction.60

### Box 4.2 Costs of airport capacity

There are some interesting figures available on the costs of providing increased airport capacity:

- ACI-Europe has indicated that European airports spent €53 billion over ten years to increase capacity by 177 million passengers. This works out to be €300 ($472) per “annual passenger”;

- Denver International Airport was built in 1995 at a cost of US$4.8 billion in 1993 prices. This corresponds to a cost of $13.1 billion in current exchange rates and Australian prices. With an initial capacity of roughly 50 million annual passengers, this is $262 per annual passenger of capacity;

- In Australia, the AAA estimates that over the past ten years, airports incurred AUD$12.3 billion to increase capacity by 36 million annual passengers. This works out to be $342 per annual passenger, close to the cost of additional capacity in Europe;

- Western Sydney Airport is projected to have a construction cost of AUD$5.3 billion with an initial capacity of 10 million annual passengers. This is $530 per annual passenger. This however does not fully account for the fact that these costs include site and airfield capacity beyond 10 million passengers; and

- Perhaps the current upper limit of airport capacity cost per passenger would be that for the proposed 3rd runway at London Heathrow Airport. This runway is expected to eventually increase airport capacity by 260,000 movements per year implying 42.6 million incremental passengers if today’s passenger per movement ratio of 164 is maintained (average aircraft size may fall when additional capacity is made available, especially if Heathrow reserves some slots for regional UK services). These figures, when converted to Australian dollars amount to AUD$585 per incremental annual passenger.

4.4.3 Regulatory and contractual arrangements likely to enhance investment efficiency

The AAA accepts that in theory a firm with market power may over invest and pass those costs onto users. Nevertheless, a robust analysis needs to also consider the institutional and contractual circumstances in which investment occurs.

The AA requires ministerial approval of a major development at an airport leased from the Commonwealth (see Box 4.3). The Minister may only approve a major development once it has been through a public consultation process, the airport concerned has considered any public comments and the airport has provided the Minister with its responses to those comments.

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60 PC (2014, pp374-375).
Box 4.3  What is a major development?

Section 89 of the Airports Act 1996 (Cth) defines a major airport development as:

(a) constructing a new runway; or
(b) extending the length of a runway; or
(ba) altering a runway (other than in the course of maintenance works) in any way that significantly changes:
   (i) flight paths; or
   (ii) the patterns or levels of aircraft noise; or
(c) constructing a new building wholly or principally for use as a passenger terminal, where the building’s gross floor space is greater than 500 square metres; or
(d) extending a building that is wholly or principally for use as a passenger terminal, where the extension increases the building’s gross floor space by more than 10%; or
(e) constructing a new building, where:
   (i) the building is not wholly or principally for use as a passenger terminal; and
   (ii) the cost of construction exceeds $20 million or such higher amount as is prescribed; or
(f) constructing a new taxiway, where:
   (i) the construction significantly increases the capacity of the airport to handle movements of passengers, freight or aircraft; and
   (ii) the cost of construction exceeds $20 million or such higher amount as is prescribed; or
(g) extending a taxiway, where:
   (i) the extension significantly increases the capacity of the airport to handle movements of passengers, freight or aircraft; and
   (ii) the cost of construction exceeds $20 million or such higher amount as is prescribed; or
(h) constructing a new road or new vehicular access facility, where:
   (i) the construction significantly increases the capacity of the airport to handle movements of passengers, freight or aircraft; and
   (ii) the cost of construction exceeds $20 million or such higher amount as is prescribed; or
(i) extending a road or vehicular access facility, where:
   (i) the extension significantly increases the capacity of the airport to handle movements of passengers, freight or aircraft; and
   (ii) the cost of construction exceeds $20 million or such higher amount as is prescribed;

Note: Some items have been omitted as they do not relate to aeronautical services defined under the regulations.

The practical effect of this definition is to require Ministerial approval for all substantial aeronautical projects (perhaps with the exception of aprons) an airport may wish to undertake to expand capacity. Further, the processes involved gives airlines ample opportunity to express their views to the Minister of the need (or not) for major projects. In making a decision to approve the development, the Minister, among other things, must consider “the extent to which carrying out the plan would meet the future needs of civil aviation users of the airport, and other users of the airport, for services and facilities relating to the airport.” 61 Furthermore, some projects, and in particular new runways, are also subject to environmental impact assessment. Again, this is an extensive public process as can been seen from Perth Airport’s public consultation on its new runway. 62

61  Section 94(3)(a) of the AA.
The AAA is therefore of the view that, save for a substantial administrative error on the part of the Minister (which is reviewable by the Administrative Appeals Tribunal), it is highly unlikely that a project that was of the “gold plating” nature that may constitute a misuse of market power would survive the major development process.

Evidence the Commission will receive during this Inquiry will show the existence of multi-year capital programs involving substantial amounts being undertaken by airports that fall outside the definition of a major airport development. A large proportion of this investment is to replace and refurbish existing assets. As airports will indicate to the Commission, these investment programs are subject to intensive scrutiny by airlines. Further, as discussed in chapter 5, because airports cannot unilaterally impose pricing outcomes, the ability to exercise market power in this way, or indeed any other, is highly limited. Indeed, there are examples where, despite a project having been approved by the Minister, it has not proceeded because of a single airline group’s refusal to support the project (see box 4.4).

**Box 4.4**  
**Airline obstruction of investment at regional airports**

The civilian operations at Townsville Airport were leased by the Commonwealth Government in 1998. The airport lessee company is owned by Queensland Airports Limited (QAL), which also operates Mt Isa, Gold Coast and Longreach airports. QAL is owned by a group of sophisticated institutional investors.

On 5 July 2017, the Joint Standing Committee on Northern Australia received evidence regarding delays associated with redeveloping the Townsville terminal. The Committee was told the terminal was undersized by around 40%. An expansion project is being supported with concessional funding from the Queensland Government to assist with necessary airfield development and Virgin Australia agreed to the development plan and to pay a price increase in September 2015. The relevant Commonwealth Minister approved a Major Development Plan on 11 January 2016.

Mr Kevin Gill, the Chief Operating Officer of QAL, indicated the company would have liked to have started work on the redevelopment “years ago” and that the only reason this had not happened was because Qantas would not agree to an increase in charges of $3 per passenger. The Committee was informed by the Deputy Mayor of Townsville that “Qantas said they would not pay whatever the charge was”.

On 30 August 2017, in response to public criticism by the Mayor of Townsville, Qantas was reported in the *Townsville Bulletin* to be considering reducing services to Townsville.

Clearly Qantas has the power and preparedness to resist modest price increases even from very large regional airports; and even when its competitors are prepared to pay them. On 2 January 2018, the lowest fare for travel from Townsville to Brisbane quoted on the Qantas website was $212.


4.4.4 Some observations about investment at regional airports

In its submission to the Senate Inquiry on Regional Airfares, the AAA set out a range of investments that have been undertaken in recent years.\(^{63}\) Obviously the scale of these investments is often orders of magnitude smaller than those contemplated by major capital city airports but often their impacts on charges are similar if not greater. It is regularly the case that increases in capacity or improvements to amenity need to be funded by grants from state governments or the Commonwealth (see Box 4.5).

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\(^{63}\) AAA (2018, p20).
Box 4.5 Cloncurry

Cloncurry Airport operates FIFO and RPT services five days a week. A major terminal upgrade in 2016 included significant building improvements, with the addition of security screening equipment, check-in facilities and a baggage carousel. Cloncurry Shire Council also constructed a new carpark and landscaped the airport grounds.

The Queensland Government provided a total of $1.3 million for terminal, taxiway and apron upgrades, while the Cloncurry Shire Council contributed the remaining $6.9 million. The upgrades have seen Virgin Australia introduce twice-weekly direct flights from Brisbane to Cloncurry, and with it the potential to boost tourism in the region.

Despite initial reluctance by the airlines about an increase in passenger fees, the council worked collaboratively with Qantaslink and Virgin Australia on the project to ensure improved facilities for airlines and passengers were delivered.

The Commission will no doubt receive a raft of claims by airlines and A4ANZ about so called “gold plating” of regional airport infrastructure. Whilst it not helpful to anticipate the details of such claims in this submission (although the AAA may reply to them at a later time), we would suggest the Commission keep in mind:

» Regional Express operates relatively small and old aircraft. It has given no indications as to what aircraft it will operate once its current fleet is retired, if indeed it will continue to operate in Australia at all. It is prudent therefore for council airports to consider upgrading their runways to handle larger aircraft in the event that Rex was to withdraw for whatever reason – such upgrades would of course provide potential for greater competition. The prudency of such actions is reinforced at times when councils are considering the need to undertake runway works for compliance or maintenance reasons.

» Australians living in, and travelling to, regional areas are entitled to some basic level of amenity from the airports they use. This extends to air conditioning, basic seating and so on. Many terminal buildings are old and need replacing. Many others have and will require significant structural and services modification to accommodate new aviation security requirements. From a construction cost perspective, it is often cheaper to attend to these compliance issues at the same time as any minor increases to capacity are required.
**5 Airport market power**

Previous chapters examined, on the basis of publicly available information, whether it can be reasonably concluded that Australian airports have exercised any market power they may have in a way that might damage economic efficiency. This chapter is largely concerned with the legal and institutional constraints that limit the exercise of market power by airports. However, it first revisits the economic analysis of these issues previously undertaken by the Commission.

The analysis proceeds on a basis similar to that undertaken by the Commission in the past and reaches the same conclusion, namely, that there is no systematic evidence of abuse of market power by the Australian airports monitored by the ACCC.

Of course, this does not constitute evidence of an absence of market power or indeed a need to remove the current monitoring regime. It does however suggest that further regulatory intervention may not be required. It is the view of the AAA that the monitoring regime coupled with potential declaration under Part IIIA of the CCA, the potential for regulatory intervention under Part VIIA of the CCA (both discussed in chapter 6), and the legal and structural characteristics of the industry (discussed in this chapter) all act to constrain whatever market power may be possessed by airports.

Data is very limited for those airports not monitored by the ACCC. Alternative sources, such as the material published by Leigh Fisher, make some references to Adelaide but there is a paucity of material about smaller airports beyond pricing data. The AAA has gathered some supplementary material on prices and investment to provide industry-wide aggregates for the largest ten Australian airports.

The AAA is aware that some non-monitored privatised airports will make submissions to the Commission and provide evidence similar to that which is publicly available. The AAA is confident that that material will lead the Commission to conclusions similar to those the AAA has drawn from chapters 3 and 4.

**5.1 What services at what airports may present market power issues**

In its 2002 Inquiry report, the Commission identified four conditions by which a natural monopoly may be identified – indivisible investment, economies of scale, sunk costs and economies of scope.\(^{64}\) It drew a range of conclusions on the extent of market power held by individual airports and the range of airport services where such power might be exercised. The Commission concluded that those services for which airports are most likely to possess market power accord broadly with aeronautical services as defined in the regulations made under Part 7 of the AA.

In subsequent inquiries the Commission has re-examined this analysis. In its 2011 Inquiry report, it noted that certain technological improvements may have reduced the market power an airport has over the check-in process. During this Inquiry, AAA members will document examples of how they are further deploying these technologies to improve outcomes for both passengers and airlines that reinforces this trend. That said, the AAA endorses the Commission’s 2011 view that the benefits of fine tuning the monitoring regime to reflect such advances are unlikely to outweigh the attendant costs associated with adjusting the monitoring regime. The AAA considers that the Commission’s assessment of service coverage in 2011\(^{65}\), as it was in 2007 and 2002, remains valid today — namely, that changing service coverage definitions is unlikely to yield a net benefit.

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\(^{64}\) PC (2002, p96).  
\(^{65}\) PC (2011, pp 82-85).
5.1.1 Economies of scale may be being exhausted

As discussed in section 3.3.4 there are strong reasons to believe that monitored airports may be experiencing increasing incremental capacity costs. That airports might exhaust their apparent scale economies was first noted by Starkie and Thompson (1985) in relation to BAA’s London airports prior to their privatisation. In its 2007 report, the Commission opined that academic studies suggested increasing returns to scale might be exhausted at around 3.5 million passengers with decreasing returns setting in around 12.5 million. The research cited by the Commission in 2007 is now somewhat dated and there is little new analysis of this topic.

Notwithstanding these caveats, at some point the contention that airports are natural monopolies, namely they exhibit scale economies, will break down. This may have occurred already in Perth, Melbourne and Brisbane as exemplified by their increasing congestion which has necessitated the additions of significant terminal capacity and new runway developments. The development of Badgerys Creek is proof positive that diseconomies of scale had set in at Sydney Airport some time ago. Once open, Badgerys Creek would certainly call into question the extent of Sydney Airport’s natural monopoly characteristics.

The AAA acknowledges that duplicating an airport is not like opening a new coffee shop. As the Badgerys Creek development has demonstrated, there can be significant legal, planning and development barriers to entry. However, the development of the Toowoomba (Wellcamp) Airport and numerous other private developments to support resources construction and extraction activities demonstrate that entry into the market may be easier in regional contexts where the scale of entry is relatively modest. The reconfiguration of existing airports such as Sunshine Coast and Busselton may also be viewed, in part, as attempts to enter the markets occupied by Brisbane and Perth respectively.

5.2 Market characteristics that ameliorate airport market power

While there may be some characteristics of the supply of aeronautical services that suggest airports have a degree of market power, it is equally important to examine the incentives for airports not to exploit such power and also the ability of airlines to resist the same. Section 5.3 discusses how the legal framework in which Australian airports operate constrains their ability to exercise market power. This section canvasses the manner in which the commercial incentives faced by airports and the demand characteristics of relevant air transport markets mitigate against the exercise of airport market power. In past inquiries, these issues have been discussed under the banner of countervailing market power.

The underlying cost economics that confer a degree of market power on airports also provide incentives to increase throughput. A consequence of the extent of aeronautical margins discussed in chapter 3 is that in many cases, the incremental cost incurred by an airport providing services for a marginal flight is very low, perhaps zero, and as a result, the margins are very high. Moreover, depending on the market segment and the individual passengers involved, there will be additional revenues extracted from retail and ground access services. As such, a profit maximising airport operator (especially one that can price discriminate) is likely to price its services at the margin to encourage the utilisation of any surplus capacity.

As noted in chapter 2, there is little evidence that airfares are related to airport charges, although it is the experience of AAA members that airlines are much more sensitive to pricing outcomes than passengers. This is easily understood. First, if airport charges do not affect airfares or demand then debates about airport charges are debates about profit share in the value chain – higher charges lead to lower airline profits ceteris paribus. Second, airlines have a fixed amount of aircraft capacity to allocate between different routes and at the margin, airport charges can affect the relative profitability of differing routes. That said, airlines’ preferences for airport services are not monodimensional and often extend to quality and/or strategic considerations.

For the analysis of any market power that airports might possess, it is the AAA’s view that the ability of airlines to substitute routes, and therefore airports, is as germane as the ability of individual passengers to substitute airports in their travel choices.

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5.2.1 International markets

In its 2002 report, the Commission observed the significant potential for substitution by international carriers between airports on the eastern seaboard. Since that time, international passenger numbers have grown from 16.7 million to 37.6 million passengers per annum. Over the same period, Qantas group’s market share has fallen from 33.5% to 25.5% and whilst there has been significant churn in airlines with the likes of Lufthansa and Lauda Air having left the market, airlines such as Qatar and AirAsia X have entered giving Australians not only more choices of direct and connected destinations but also lower fares and a broader range of in-aircraft products.

To a significant degree, this growth has been facilitated by the international air services policies pursued by successive Australian governments on a bipartisan basis. Such policies have not only seen greater carrier diversity but also the development of services at smaller international airports, notably Adelaide and the Gold Coast, but also more recently Canberra. In its 2015 international tourism research paper, the Commission recommended further liberalisation of Australia’s gateways. The AAA supports this approach as it will further increase international aviation competition and thereby improve outcomes for Australian travellers, tourism and other industries.

The potential for competition between airports identified by the Commission in 2002 has come to pass as illustrated by the changes in airports’ market shares between 2002 and 2017 shown in figure 5.1. There are a few reasons for this:

- the general growth in demand has meant that it is now profitable for airlines to operate more services directly to Australian cities rather than triangulating through Sydney;
- airlines have taken the opportunity to use non-curfew airports to better match slot availability in the northern hemisphere;
- the decreasing availability of sets of slots available across the week at the same time has made less congested airports more attractive from a scheduling perspective; and
- all airports have developed sophisticated marketing activities in partnership with state governments and tourism bodies that have raised the general level of competition for new international services. Individual airports will outline these activities in their individual submissions.

**Figure 5.1** International market shares of Australian airports

As noted, the margins earned on incremental passengers are likely to be high, particularly once associated non-aeronautical revenues are considered. Retail revenues from international passengers are much higher than those for domestic passengers, reflecting the length of time passengers dwell at the airport, the range of goods on offer for purchase and the tax free status of those goods. If anything, the incentive to grow international passenger numbers is greater than in domestic markets.

The Commission observed in its 2011 Inquiry report that the growth of overseas national airlines and low-cost carriers had reduced the potential for airports to exploit their market power. These carriers have little loyalty to the Australian market or particular routes and are likely to have a far wider range of substitute routes on which to operate their aircraft. This seems to have now extended to Australian airlines’ international operations. Apart from some ad hoc services to Singapore in July 2014 and seasonal services to Auckland from December 2014 to April 2015, between May 2014 and June 2015 Qantas did not operate any international mainline services from Perth.

Airports competing for international traffic have incentives to provide high quality, reliable services. Pleasant terminals are likely to lead to higher retail sales. Inefficient airport operations are likely to lead to higher airline costs which, like airport charges, will be relevant to the decision making of airlines to maintain or add capacity. Thus, airports have incentives to not abuse their market power and international airlines have significant capacity to respond to outcomes that are not commercially attractive to them.

5.2.2 Domestic markets

For the purposes of this discussion, domestic markets are those between Australia’s capital cities and major population centres. The observations made about airports seeking to maximise revenue in international markets hold true for domestic markets. While retail revenues are likely to be lower, maximising car park throughput is likely to be a stronger motivator.

As demonstrated in figure 2.12 Australia has a highly concentrated domestic market both in terms of routes but also carriers. This, to some extent, reduces the ability of airports to identify new routes and customers. However, the ability of airlines to discipline airports’ behaviour through reductions in services, or down scaling of aircraft size, remain.

Similarly, the opportunities for substitution in domestic markets are less than in international markets. That said, conditions continue to develop in south-east Queensland for competition within the greater Brisbane area, Avalon continues to snap at Melbourne’s heels and Hobart, Devonport and Launceston compete with each other and the Spirit of Tasmania in the Tasmanian fly-drive market. Badgerys Creek will provide significant competition to Sydney Airport for passengers, especially those in the western suburbs.

Domestic market concentration, and in particular Qantas’ dominance, significantly reduces airport market power and can facilitate attempts to limit competition in air transport markets. In a recent decision, the European Commission decision cited the observations of European airlines as follows:

“Controlling a large slot portfolio and the operations associated therewith also enables airlines to exercise significant pressure on the respective airport. LH Group [Lufthansa] has for instance used its market share at FRA [Frankfurt Airport] to criticize FRA’s openness to low cost carriers and has criticized FRA for trying to become more independent of LH Group. In addition it has announced that it will grow at other hubs. This can be understood as LH Group’s message to airports to minimize their incentives to new airlines as they would otherwise need to fear upsetting their main customer. Such behaviour clearly limits the commercial freedom of the airports, potential new airline entrants and thus ultimately the choice of customers – individual passengers and tour operators alike.”

Another air carrier notes that “a dominant airline has numerous possibilities to use its influence at an airport in order to foreclose the airport for competitors”, notably using its negotiating power “this influence to develop the airport’s infrastructure even more in its own favour”.69

68 PC (2012, p82).
69 Case M.8633 – LUFTHANSA / CERTAIN AIR BERLIN ASSETS Commission decision pursuant to Article 6(1)(b) in conjunction with Article 6(2) of Council Regulation No 139/20041 and Article 57 of the Agreement on the European Economic Area at (172-173).
In Australia only Sydney Airport is slot controlled, but the experiences of the AAA’s members in dealing with Qantas are consistent with these observations. In particular, attempts to minimise incentives for entry can be seen in Qantas’ historic insistence on aeronautical services agreements containing “no less favourable terms and conditions” clauses. From its work in international trade policy, the Commission will recognise these as akin to most favoured nations clauses. The AAA understands that in recent times other domestic carriers have become less insistent on these clauses and they seem to be of little concern to international carriers.

The effect of these clauses is to attempt to restrict airports from undertaking efficient price discrimination. Practically, whilst provisions vary, such clauses require an airport to reduce Qantas’ charges in the event the airport negotiates cheaper outcomes for other airlines. Their purpose is clear – they seek to restrict airports from encouraging competition against Qantas. As agreements often cover both domestic and international services, they can, in some cases, extend into international markets. Qantas is able to procure these outcomes because of its dominance in relation to the aeronautical revenues of most airports coupled with its ability to avoid payment of charges it does not agree with (discussed below). On the other side of the ledger, Qantas increasingly gains significant volume based discounts leading to a lower average per passenger cost than that of its smaller competitors.

Given the above, it is in the interests of Australian airports that Virgin Australia remains a viable competitor to Qantas. Any use of market power that damaged Virgin’s interests would not be in an airport’s best interests. The preparedness of Australian airports to facilitate domestic entry are best seen from the efforts made to facilitate the entry of Virgin Blue and Impulse and the efforts to support Virgin’s growth after the collapse of Ansett. This has been followed by the support airports have given Virgin to transition from an LCC to a full service domestic carrier.

5.2.3 Regional markets

For the purposes of this discussion regional markets are those whose origin or destination are not a mainland state capital.

One important feature of Australia’s regional aviation market is its high level of concentration. Only nine of the top 50 regional routes identified by the BITRE in 2017 feature four airlines, and only one of those has a participant outside of the domestic airline duopoly. Of the 15 routes where there are three airlines, only three have a true ‘third carrier’. Between 2007 to 2016, the market share of airlines not part of the domestic duopoly fell from 9.2% to 5.0%.70

Rex’s network is also very concentrated. As at 21 January 2018, Rex was the sole operator on 78 of the 92 routes it operated. It had one competitor on a further 11 routes, and two competitors on four others. In some cases, this is because Rex is the only operator prepared to fly the route. In others, its position is protected by regulation, at least until the next tender.

Using a dominant position to limit competition is not limited to Qantas. Rex is currently in negotiation with Mt Gambier Airport over a five-year partnership program. One of Rex’s requirements is that the agreement would terminate were a competitor to offer services to either Melbourne or Adelaide.71 Given that the proposal involves a reduction in airport charges of $2 in exchange for a price reduction on advanced purchase and on the day fares from $177 to $129, it would appear the principle concession sought by Rex from the Council is monopolisation of the route rather than a small reduction in airport charges. Such conduct is consistent with Rex’s previous attempts to obstruct runway works that would allow other RPT operators to use the airport thereby providing competition to Rex and also ensuring that, in the event Rex ceased operating, the community could gain access to air services from another airline.

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70 www.anna.aero/2016/10/20/qantas-is-averaging-30-percent-passenger-share-in-its-top-international-markets/
71 “Rex Airlines’ plan for $129 tickets for Mt Gambier passengers rejected, more negotiation needed, council says”, Adelaide Now, August 7.
All but two of the top 50 regional routes (Cairns-Townsville and Alice Springs-Darwin) involve a mainland state capital airport. Many regional services pose operational challenges for major airports:

- inbound travellers may come from airports where screening is not required, either requiring inbound screening or segregation from other domestic passengers;
- passengers walking on aprons present additional safety risks;
- the smaller aircraft used on many regional services require more apron area per passenger than larger domestic aircraft;
- slots are allocated on an aircraft basis, with regional aircraft carrying fewer passengers per slot than a larger one; and
- smaller aircraft move more slowly and are more affected by turbulence, so will typically need greater separation distance than other large aircraft.

On balance regional operations tend to reduce the overall operational efficiency of an airport. That said, major airports recognise their obligations to provide efficient and cost-effective services to the whole community and do not seek to discriminate against regional airlines. The best example of this is Perth Airport’s development of Australia’s only dedicated regional terminal (discussed in Box 5.1).

**Box 5.1  Perth Airport supports regional services**

Regional destinations serviced by flights from Perth Airport include: Exmouth, Broome, Kununurra, Kalgoorlie, Geraldton, Albany, Onslow, Esperance, Port Hedland, Karratha, Newman, Leinster and Leonora. Other mine sites and resource centres are serviced by charter flights.

Over 35,000 services departed Perth Airport last financial year from all of Perth Airport’s terminals and the general aviation precinct.

The new Terminal 2, built at a cost of $116 million, is the only purpose built regional terminal at a major Australian airport. It includes 16 check-in counters, centralised passenger security screening zone, dedicated pick-up and drop-off lanes at the front of the terminal, and room to park 56 aircraft accessible by eight boarding gates. Regional services also use Perth Airport’s new Terminal 1 Domestic Pier.

This new capacity has provided regional airlines affiliated with Qantas room to grow in Terminals 3 and 4. Despite this record investment in regional aviation infrastructure, the number of passengers flying between regional centres and Perth has fallen from just over 4.8 million when the Terminal was opened to just under 4.0 million in the last five financial years.

Despite this, Perth Airport has recently announced a 35% reduction in terminal charges for this facility.
Circumstances vary between major airports, but the vast majority of regional passengers are carried by the domestic duopoly airlines and as such gain access to airport services on the same basis as the parent airline and indeed, often count towards the calculation of volume discounts.

Regional airports vary substantially. A number, typically larger, are privately owned whilst the vast majority are owned and operated by local councils. The former are run for profit, whereas the latter are better viewed as constituting one of a range of services provided by councils to their communities. A business activity cannot be inefficiently using market power if it is not earning super normal profit. Box 5.2 sets out the general financial condition of council owned airports.

Box 5.2  Councils struggle to fund airports

ACIL Allen’s 2016 study provides an analysis of the financial challenges regional airports face in operating and maintaining their facilities. That report and also the AAA’s 2017 survey confirm that, despite being critical infrastructure for regional communities, on average regional airports across Australia do not have adequate funding to maintain or improve their existing infrastructure, with the problem worsening over time.

ACIL Allen found:

- Australia’s regional airports expect an annual budget deficit of at least $17 million per year, equating to a $170 million shortfall in essential infrastructure and maintenance funding at regional airports over the next decade;
- RPT regional airports surveyed had an average of $2.28 million in revenue in 2014-15 compared with an average expenditure of $2.36 million. This equates to a 3.4% funding gap, which means these airports do not have the funds to invest in new capacity or meet any new security requirements;
- nearly 40% of Australia’s regional airports expect persistent budget deficits over the next 10 years; and
- the cost of operating a regional airport is expected to rise by 38% over the next decade, adding to the already difficult financial environment.

Simply maintaining a regional airport in a compliant condition often creates significant financial stress. This can be further compounded by upgrades to meet future aviation needs or new security requirements. The actual extent of the financial challenge facing the sector is likely to be even greater than is indicated in the ACIL Allen report, which assumes assets will simply be maintained at the status quo. However, for many airports, infrastructure upgrades will be required as aircraft fleets evolve and regulatory standards change, combined with runways, aircraft parking aprons, taxiways and lighting systems reaching end-of-life.

Some regional airports experiencing persistent funding gaps will find themselves under increasing financial pressure that might ultimately result in their closure and cessation of operations and service provision.


For many regional airports, a single airline provides services and there is uncertainty about whether another airline would step in if that service was withdrawn. This empowers both small and large airlines. While the airport may have some other revenue sources, airline revenue is likely to be orders of magnitude larger and without it, the airport could become financially unviable or require substantial supplementation from council at the expense of other council services. Indeed, that loss of revenue may inhibit the ability of the airport to finance facilities needed for the operations of a replacement carrier. Further, if services are withdrawn, the community may lose its only means of accessing essential services and any tourist activity is likely to be harmed. From the point of view of the airline, the aircraft involved will be deployed on another, albeit perhaps a slightly less profitable, route.
Professor (now Commissioner) Stephen King described countervailing market power in the following way in advice for the ACCC that was provided to the Productivity Commission:

To determine if countervailing power is relevant, the analyst needs to consider the bargaining position of buyers and sellers. In particular, it is important to consider which parties will lose most from any failure to reach an agreement to trade the relevant product. For countervailing power to exist in a market that otherwise is deficient in competition, any losses from a break-down in bargaining need to be predominantly borne by the seller.\(^{72}\)

It is the AAA’s view that in the vast bulk of disputes between airlines and council-owned airports, the potential for the withdrawal of services means the party that has to most to lose is the community that owns the airport concerned.

### 5.3 Airport leases restrict exercise of market power

Some 21 airports are leased from the Australian Government under the AA. Cairns and Mackay are leased from the Queensland Government under similar terms and conditions. The leases under the AA place obligations on airport lessees that in practical terms limit the exercise of any theoretical market power.

In considering restraints on the exercise of any market power arising from the lease requirements that operators must provide access to the airports, it is instructive to have regard to the meaning of market power under section 46 of the CCA. Section 46 prohibits as anti-competitive particular types of unilateral conduct.

Some section 46 cases have failed on the threshold requirement that the corporation in question has a substantial degree of market power\(^{73}\), the most relevant being *Pacific National (ACT) Limited v Queensland Rail* [2006] FCA 91 (*Pacific National*). In this case the court found that contractual restrictions on Queensland Rail’s (QR) ownership rights meant that it did not have substantial market power despite its ownership of natural monopoly infrastructure. This case concerns the Acacia Ridge Interstate Container Terminal (AR terminal) which was owned by QR but had been leased exclusively to an occupant for several years. While the Court found that access to the AR terminal was necessary in order to compete effectively in the East Coast Linehaul Market and that whoever controlled access to, and use of, the AR terminal had a substantial degree of power in the relevant market, it also found that:

\[\text{[It] does not follow that QR had, at the time of the impugned conduct, a substantial degree of power in the market for providing access to the relevant infrastructure at the AR terminal. This is because QR ceded exclusive possession to NRC on 5 April 1993 and, since that date has been an owner without any right to possession or control of the AR terminal.} \]

\[\text{...} \]

\[\text{QR owned the relevant infrastructure, but the terms of NRC’s occupation, that is to say as a tenant with the right of exclusive possession and control, was inconsistent with the existence of market power residing in QR. The market is for the supply of access to the infrastructure. QR had no powers in that market. It had no ability to ask, let alone raise, prices for the supply of that service.} \]

\[\text{...} \]

\[\text{Alternatively, any power arising from QR’s ownership of the AR terminal was constrained by the grant of exclusive possession to NRC...} \]

\(^{72}\) PC (2002, p192).

\(^{73}\) See, for example, *Singapore Airlines v Taprobane Tours WA Pty Ltd* (1992) ATPR 41-159; *Dowling v Dalgety Australia Ltd* (1992) ATPR 41-165; *Eastern Express Pty Ltd v General Newspapers Pty Ltd* (1992) 35 FCR 43.
The Pacific National decision demonstrates the critical importance of accounting for the impact of contractual or other legal restrictions when determining whether a corporation has substantial market power. Other section 46 cases, outside of the context of access to infrastructure, have also accepted the relevance of contracts and legal arrangements when determining whether a corporation has substantial market power.74 Accordingly, the rights and obligations on airport operators under the lease agreement are a relevant consideration in assessing whether an airport operator has substantial market power.

5.3.1 Denying and restricting access

Unlike most other businesses, leased airports in Australia must continue to supply access services to aircraft operators even where those customers indicate they are not prepared to pay for those services or have not paid for them in the past. Whilst drafting can vary slightly, leased airports must at all times (save for force majeure events) provide access to the airport by intrastate, interstate and international air transport. If access is denied other than in accordance with the lease (as described below) the Australian Government is entitled to terminate the lease and the lessee must vacate the airport site. Clearly this destroys all equity in the airport lessee’s business and as such airports will not deny access unless it is permitted to do so under the lease.

The leases provide for two circumstances where access can be denied. The first relates to demand management schemes under the AA.75 Part 13 of the AA establishes a framework to declare capacity at an airport, determine that a demand management scheme is required and determine which type or types of schemes specified in the AA are to be applied. Decision making is entirely in the hands of the Minister after consultation with the affected airport (and others).

Airports do implement gate allocation arrangements at terminals, especially where terminals have multiple users – such as international terminals. These outcomes are arrived at through discussion with airlines on the basis of established industry principles. Day to day capacity allocation decisions are typically made by an independent entity such as Airport Co-ordination Australia.76 In no sense can demand management schemes be seen as a device by which capacity can be limited either in total or with respect to individual airlines as an exercise of market power by an airport.

The other circumstance that an airport may deny access is in the event that an aircraft operator has failed to pay an invoice. Specifically access can be denied:

(i) where the owner or operator of the aircraft has failed to pay the Lessee within twenty-one (21) days after the due date any amount due to the Lessee by the aircraft owner or operator for the use of the Airport Site; and

(ii) where the Lessee has notified the Lessor of its intention to refuse access at least fourteen (14) days in advance of the first day on which it intends to refuse access.

To the best of the AAA’s knowledge these provisions have not been used by any leased airport since the first leases were granted on 1 July 1997. The AAA’s legal advisors have advised, based on opinion from senior counsel, that from a practical perspective the utilisation of these provisions would require first that the airport would need to establish in a court what debt was actually due.

74 See, for example, Dowling v Dalgety Australia Ltd (1992) 34 FCR 109, in which the court accepted that market power can be gained through agreements, arrangements and understandings. By logical extension, contracts and legal arrangements should also be relevant in considering whether a corporation’s market power is constrained by (rather than gained through) those contracts and legal arrangements.

75 These provisions do not apply to Sydney (Kingsford Smith) Airport as it is subject to the Sydney Airport Demand Management Act 1997 (Cth). The AAA understands the lease relating to Sydney Airport contains similar provisions referencing this Act.

76 For more information see www.airportcoordination.org.
An airport operator is likely to be able to establish the amount due and therefore deny access for non-payment or short-payment where an airline has entered an Aeronautical Services Agreement (ASA), which sets out the charges payable or a charging methodology. In the absence of an ASA, an airline accepts the Conditions of Use (which sets out standard charges payable) by its conduct. That is, it chooses to accept aeronautical services, is aware of the Conditions of Use and does not expressly reject the prices imposed by those conditions.

If an airline chooses not to enter into an ASA and expressly rejects the Conditions of Use, then an airport operator would likely face great difficulty in proving that a particular amount it seeks is legally due and, therefore, that non-payment of that amount (or short-payment) entitles it to deny access. In such circumstances the amount payable by the airline would be determined by a court under a quantum meruit claim (see section 5.4.4).

5.3.2 Constraints on degrading quality

The contractual and regulatory arrangements surrounding the airport lease constrain the airport operator from allowing the quality of services and infrastructure to deteriorate over the term of the lease. The lease agreements require the airport operators at their own cost to:

» invest in airport infrastructure (e.g. terminals, runways, taxiways, aprons, roads, etc) consistent with being a major airport, having regard to current and anticipated demand and the quality standards expected of such an airport;

» develop the airport site having regard to good business practices expected of an airport operator (which includes providing appropriate facilities for comfort, ease of access, quick movement and efficient use of the airport site by passengers and other users);

» keep and maintain the airport site in ‘good and substantial repair’;

» maintain the environment at the airport in accordance with any obligations imposed by legislation; and

» provide any information requested by the Commonwealth concerning any matter under the lease agreement.

If the Australian Government believes that an airport operator is not complying with its obligations to invest, it may request that airport operator provide it with detailed plans to bring the airport site up to the standard required. If the airport operator fails to comply with the agreed plan, the Government can give effect to the plan and be indemnified by the airport operator for all costs, losses or damages suffered or incurred.

The Department of Infrastructure, Regional Development and Cities actively monitors the compliance by airport operators with these lease requirements. Airport operators have made significant investments in their facilities to ensure that the quality of services is maintained. As discussed in chapter 4 there is no evidence that the quality of aeronautical services has been reduced.

5.4 Airports lack legal capacity to enforce pricing and other outcomes

5.4.1 Airports leased from the Australian Government have no statutory right to charge

Queensland and Australian Government legislation confer no statutory capacity on leased airports to set or enforce charges. This is not the case in comparable jurisdictions or indeed in Australia in the past (Box 5.3). Similarly airports leased from the Australian Government lack the statutory capacity to regulate a range of operational activities that in other countries are established under by-laws, as was the case prior to privatisation. The consequence of this is that airports must rely on contract and common law methods to underpin not only charging outcomes but also to establish frameworks for the orderly and efficient use of the airport by airlines.
Section 4 of the *Airport Authorities Act 1966* (NZ) sets out a range of powers conferred on public and private airport operators – privatised airports covered by these provisions include Auckland, Wellington and Christchurch. Section 4A sets out an airport’s capacity to impose charges:

1. Subject to *section 4B* [an obligation to consult], every airport company may, notwithstanding the provision of any regulations in force under *section 38* or *section 100* of the *Civil Aviation Act 1990*, set such charges as it from time to time thinks fit for the use of the airport operated or managed by it, or the services or facilities associated therewith.

2. Any charges set under this section may be charged to persons or classes of persons owning or operating aircraft, or to persons or classes of persons using or otherwise enjoying the benefit of the airport, services, or facilities, or to any other persons.

In the United Kingdom, airports with a turnover in excess of £1 million are licenced to determine and enforce airport charges under the *Airports Act 1986* (UK). Recent amendments now place consultation and reporting obligations on airports with over five million passengers consistent with those contained in the European Union Charges Directive. Failure to comply with these obligations can lead to enforcement action by the Civil Aviation Authority.

The *Federal Airports Corporation Act 1986* (Cth) governed the operation of leased airports prior to privatisation. Section 56 set out procedures by which charges were to be set but the power of the Corporation to unilaterally determine charges is clear in section 56(2) which states “subject to this section, the Corporation may, from time to time, make determinations fixing or varying aeronautical charges”.

### 5.4.2 State legislation provides for enforcement but is not used

Victoria, South Australia and Tasmania have enacted Aerodrome Landing Fee Acts which allow any aerodrome operator to fix fees for certain activities. Once fixed, an aerodrome operator may, by commencing court proceedings, recover the fee as a debt owing to the aerodrome operator from the person liable under the legislation to pay the fee.77 Airports operated by local governments in New South Wales and Queensland have an ability to impose and recover fees as posted for the use of the local airports under the relevant Local Government Act.78 It appears local government operated airports in Western Australia do not have a statutory power to recover airport charges.

Despite the opportunities provided by legislation, these statutory provisions have not been widely used – for example Melbourne and Launceston airports have chosen not to post prices despite legislation being available to them since 2003 and 2002 respectively. Similarly, a range of council owned RPT airports have not posted charges which suggests airports do not see these as an effective mechanism for enforcing charging outcomes and more importantly, that this legislation cannot be seen as being used by airports to enforce unilaterally determined outcomes.

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77 *Aerodrome Landing Fees Act 2003* (Victoria); *Aerodrome Fees Act 1998* (South Australia); *Aerodrome Fees Act 2002* (Tasmania).

78 Ss 608 and 695 *Local Government Act 1993* (NSW) and ss 134 and 262 of the *Local Government Act 2009* (Qld).
5.4.3 Enforcing conditions of use

Many of the Australian airport operators now publish Conditions of Use, which set out the standard terms and conditions (including prices) for use of aeronautical services. The Conditions of Use purport to apply to any airline which receives aeronautical services (subject to any contrary terms in an aeronautical services agreement (ASA)), including airlines which have not executed an ASA. The Conditions of Use are generally available on the airport operators’ websites and are also periodically distributed to the airlines.

A key issue is whether the Conditions of Use constitute a contract, the terms (including prices) of which are enforceable against the airlines in the absence of an executed ASA. This issue depends largely on how airlines have responded to the Conditions of Use. Under contract law, an enforceable contract exists only if there is an offer by the airport operator that is accepted by the airline.

The Conditions of Use is likely to constitute an offer by the airport operators to provide aeronautical services to the airline on the terms and conditions set out within the document.

The key issue for an airport operator is in establishing an acceptance of the offer by the airline. Acceptance can be express or implied by conduct – continuing payment of charges contained in the conditions of use without objection is strong evidence of acceptance.

The Conditions of Use are not signed by the parties and the airlines do not usually expressly accept them. Accordingly, it is likely that the airport operator would need to show that the airline impliedly accepted the offer by its conduct.

There are very strong arguments that an airline will have accepted the terms and conditions in the Conditions of Use by its conduct if it begins receiving aeronautical services at an Australian airport, is aware of the existence of the Conditions of Use, and says nothing about its acceptance or rejection of the Conditions of Use.

However, airport operators may face difficulty in establishing the terms upon which an airline is using aeronautical services in circumstances where that airline has previously acquired aeronautical services under an ASA and/or is negotiating a new ASA, or in circumstances where the airline expressly states that it does not accept or agree to the Conditions of Use or the prices sought to be imposed by such conditions.

Proving acceptance by an airline of the Conditions of Use is a hurdle in any legal enforcement proceedings, including actions to obtain payment from an airline, which means that it is far more onerous than legal proceedings relating to the enforcement of a bilateral agreement. The additional time and legal costs pose barriers to airports taking legal proceedings in these circumstances. In addition, there is significant uncertainty as to the outcome of any such legal proceedings. Even though the court is likely to find that an airline must pay the airport for use of airport facilities and services, if the court finds that the Conditions of Use has not been accepted by the airline and therefore does not apply, it will likely determine charges on a quantum meruit basis which is difficult to predict.

5.4.4 Quantum meruit claims

Where the parties agree to the provision of the services but not the price payable for those services, the airport operator may have a claim that the airline should compensate the airport operator on a quantum meruit basis. Quantum meruit means ‘what the job is worth’ or ‘as much as deserved’. It is based on the principle that a person receiving the benefit of services should pay as much as the service provider deserves or merits for those services. Quantum meruit is used to prevent the unjust enrichment of one party at the expense of another in the absence of a valid contract.
To succeed in a *quantum meruit* claim, an airport operator would need to establish the following elements (which are based on principles of unjust enrichment):

- the airline was enriched by the receipt of a benefit. In these circumstances, the benefit would be access to the airport and the receipt of aeronautical services, which was accepted by the airline and had economic value to the airline;
- the benefit was gained at the expense of the airport operator. In these circumstances the expense of the airport operator is the failure to pay for the service (potentially including short payment); and
- it would be unjust to allow the airline to retain the benefit. It would be necessary to point to an established basis for injustice. The injustices may be the airport operator confers the benefit of the aeronautical services because of the requirement in the lease agreement to provide access and that this amounts to compulsion, or in many cases that others are paying for the benefit of the services and not to pay confers a competitive advantage on the airline, especially if it itself has a degree of market power.

While an airport would be likely to be successful in establishing the elements above, doing so in the context of legal proceedings would be resource intensive and time consuming. Once it is established that the airport operator is entitled to make a *quantum meruit* claim, the court would determine what the airline should be required to pay for the aeronautical services provided. However, as the court will consider a number of factors, it is uncertain what sum an airport operator would recover from an airline under a *quantum meruit* claim.

The AAA is aware of examples where airlines have not paid invoices issued by airports and have expressly refused new pricing arrangements. The AAA understands that individual airports will bring these matters to the Commission during the course of this Inquiry. Some of these examples occur in jurisdictions where there are state laws to facilitate recovery of aeronautical charges. The AAA expects that amounts of money owing range from several hundreds of thousands of dollars to many millions depending on the length of short payment and the size of the airport. Some of these disputes amount to nothing more than an airline refusing to pay charges increases based on changes in the relevant consumer price index. In many cases airports have been able to agree outcomes with a range of users but one airline holds out. That airline is usually Qantas.

The AAA is aware that some airports involved in these sorts of disputes are considering taking legal action of the type described above. But as the Commission will understand from its landmark work on access to justice, and especially given the lack of robust precedents, such litigation is likely to be very expensive and involve a high level of uncertainty. It is likely therefore that a small private or council owned airport, even if it was owed many hundreds of thousands of dollars, may ultimately not seek redress for the courts.

The AAA is not seeking a mechanism to resolve such disputes beyond that provided in the current law but rather to highlight that Australian airports in many cases lack the legal capacity to unilaterally impose charging outcomes and where they might have some capacity, outcomes are so uncertain that such actions have not been pursued.

This view is shared by a major Australian airline (say airline X) that has short paid hundreds of thousands of dollars over the period of at least a year in respect of invoices issued by a AAA member (say airport Y). X said:

> X’s use of a privately owned [the airport is actually leased] monopoly asset does not constitute acceptance of imposed pricing or Conditions of Use. Neither X nor Y has any right to unilaterally impose pricing, or Conditions of Use, on the other.

If an airport cannot readily enforce pricing terms and conditions, unless they have been explicitly agreed to by the airline, cannot terminate services to those who are not prepared to pay the set prices, and an airline can determine the price it pays for years on end because of the costs and risks of litigation, then that airport has very little capacity to determine outcomes independent of its customers. Accordingly, any market power the airport may be found to possess after consideration of issues discussed in sections 5.1 and 5.2 above would be significantly curtailed if not eliminated.
5.5 Behavioural issues

Airlines regularly use the media to gain leverage over airports in debates about access arrangements. The Commission will be aware of the recent inflammatory comments made by both Qantas and A4ANZ in relation to alleged piracy by Canberra Airport and the somewhat more temperate, but no more accurate, accusations by Qantas that the quality of the terminal at Canberra Airport has been detrimental to passengers using that airport.79

Similarly, Rex regularly uses local media to influence outcomes in its dealings with councils – King Island, Mt Gambier and Wagga have been recent recipients of its ire. Such conduct is rarely seen from BARA and Virgin Australia. As box 5.4 shows, these public behaviours seem broadly consistent with the negotiating experiences of the AAA’s regional members.

Box 5.4 What regional airports say about airlines

As part of the AAA’s survey of regional airports, airport operators were asked to share their insights on their relationships with airlines. The following is a selection of quotes from the survey responses.

“I think the current Qantas Group negotiation would be an excellent case study of bullying…….”

“We find them [Qantas] aggressive and dismissive. We are currently in negotiations with them on a wide range of matters including a major capital development. They currently have a clear message in the public arena that airport charges at every regional airport are the highest in the country with no accountability on them making these unfounded statements. This is big brother at work, an organisation 30,000 strong being intimidating to regional airports with a staff of 12.

“Rex descended to threats to cut services “

“Jetstar very difficult to deal with, with threats to reduce services...”

“Virgin is a good operator but Rex plays hard ball – getting aggressive on airport charges and sustaining its services.”

“Rex is more community minded with some sponsorship of community events, while QF has pulled back on these aspects which are very important in the community.”

“Rex are our sole RPT... no reduction in airfares has ever been offered....”

During this Inquiry, and the run up to it, the AAA has become aware of a instances where Qantas and Rex have sought to use the inquiry process to gain leverage in commercial negotiations. In a letter that is broadly available, and we note has been provided to the Commission by Rex, Rex wrote to King Island Council, stating:

As you may be aware, the Productivity Commission has this month announced that it will be undertaking an inquiry into the economic regulation of airport services. The actions demonstrated by the King Island Council provide sound justification why such an inquiry is imperative and Rex will be sure to reference your actions to the Commission.

It is the case that this Inquiry has arisen from a recommendation the Commission made in 2011, but it highlights the preparedness of a foreign owned airline to bully one of the least well-resourced airport operators in Australia which is simply attempting to implement lower-bound pricing at the encouragement of its auditors.

5.6 Concluding comments

Disputes are not evidence of abuse of market power. On the other hand, airlines not entering agreements may be evidence of airlines exercising market power to the detriment of competitors, airports and the travelling public – Qantas’ behaviour in Townsville is a salient example of this.

It has been established in chapters 3 and 4 that there is no systematic evidence of abuse of market power by monitored airports. Given that airport market power is likely to decrease with size, we suggest that on examination of the evidence (rather than assertions) presented to this Inquiry, the Commission will form a similar view in relation to the behaviour of the vast bulk of smaller Australian airports. The AAA will not be surprised if there are isolated examples of poor behaviour by its members. Airport managers are human, have competing priorities and even occasionally behave badly. But this is far removed from systemic, egregious abuses of market power that would warrant a regulatory response.

This chapter outlines why these conclusions are unsurprising. Indeed, for the first time, the Commission has before it systematic analysis that demonstrates that airports are not in a position to unilaterally determine outcomes. AAA members will provide the supplemental evidence from their individual experiences that demonstrates this is the case.
6 Dispute resolution and future regulatory options

The Commission has considered dispute resolution frameworks in all three of its previous airport reviews as well as its 2001 and 2013 reviews on the National Access Regime. On each occasion, despite the urgings at various times by airlines and the ACCC, the Commission has not recommended an airport specific regime owing to legitimate concerns about not undermining the contractually based framework that has underpinned the success of the airports sector in Australia since 2002. Such concerns have not abated.

Contractual negotiations between airlines and airports are often hard fought contests between highly sophisticated actors. It is understandable that, from time to time, airlines are unhappy with what is offered by airports, or ultimately consider that they have arrived at outcomes that diverge from their preferred position. Airports feel this too from time to time – this is the to and fro of modern commerce.

From the perspective of the privatised airports, the return on shareholders' funds is an important consideration — a factor not relevant for many overseas publicly owned airports. That said, in providing resources to airports, local councils must raise community charges or divert resources from elsewhere. Moreover, airports must:

» provide services to a range of users with different and sometimes competing needs;
» adhere to strict obligations under a range of planning, safety and security statutes; and
» have a reasonable expectation to be able to conduct their businesses in accordance with their own objectives, not those of any particular airline.

None of this constitutes an abuse of market power, but rather reflects basic property rights. Sweeping claims in relation to monopolies and Qantas' recent fallacious attack on Canberra Airport regarding gold-plating, do not exemplify the character of disputes that require policy attention. Examples of disputes will likely be brought to the Commission's attention in response to its Issues Paper, many of which will be asserted to be abuses of market power that justify policy intervention. The AAA and its members will review each of these and may provide a response to the Commission accordingly.

In relation to material disputes, the AAA considers that declaration under Part IIIA remains a potent remedy. This is notwithstanding that, until recent changes to the competition test based on the advice of the Commission, meeting the criteria would have been easier. This can be seen in the reasoning of the Tribunal in considering the declaration of the Port on Newcastle with a simple substitution of a major airport name for PNO and substituting runway services for those considered by the Tribunal. The Tribunal said:

the Service providing access to the shipping lanes is a natural monopoly and PNO [Port of Newcastle Operations] exerts monopoly power; the Service is a necessary input for effective competition in the dependent coal export market as there is no practical and realistically commercial alternative; so access to the Service is essential to compete in the coal export market. In the circumstances ... s 44H(4)(a) must have been satisfied.80

This was the prevailing interpretation from 2006 until 2017. Leading access lawyers DLA Piper have observed that this interpretation led to the “criterion (a) hurdle set to zero”.81 Given that only one airport related declaration application (by Tiger) was made during the period, despite Qantas telling the Commission it regularly considered making declaration applications82, it is open for the Commission to assume that in general airport conduct has been such that arbitration under Part IIIA would not have seen outcomes different to those arrived at under the light handed regime.

80 Glencore Coal Pty Ltd [2016] ACompT 6 (113).
81 DLA Piper (2016) “Open Season on access – implications of the declaration of the Port of Newcastle”.
82 Qantas (2013).
6.1 Policy responses to abuse of market power

In previous inquiries, significant effort has been put into developing mechanisms under which regulatory options might be deployed by administrative means. While the Government did not consider the “show cause” mechanisms proposed in the Commission’s 2011 review were warranted, the fact remains that regulatory options remain available to the Treasurer to deploy at any time.

These options are contained within Part VIIA of the CCA:

» More intrusive prices monitoring: The ACCC could of its own volition (because it establishes the details of the framework), or at the direction of the Government, require a broader information set, or perhaps require the information to be produced more frequently. The Government could extend the range of airports, including those operated by councils and those leased from the Queensland Government. For airports leased from the Australian Government, such actions could be supplemented by regulations made under Parts 7 and 8 of the AA.

» Prices inquiry: The Government could instruct the ACCC to undertake a prices inquiry into one or more airports. This would give the ACCC much broader powers of information gathering. During the term of a prices inquiry the airport(s) concerned could not increase its prices.

» Prices notification: An airport subject to notification could only increase prices once it has provided a notice to the ACCC and the ACCC had considered the merits of the increase. The Treasurer may give directions to the ACCC as to matters it must have regard to. The ACCC’s considerations in such matters can be extensive, and would involve significant input from airlines, as was the case in relation to Sydney Airport in 2000.83

On each occasion the ACCC has delivered an airport monitoring report it has been open to it to make a recommendation that the Government undertake one of the above actions, but it has not done so. Moreover, the Government can undertake such actions at any time of its own volition. Hence, if there was a serious dispute between an airport and one or more airlines regarding prices, these tools remain available to resolve such disputes or restrain the alleged use of market power. Given the absence of such action by government over the last 15 years, despite representations by airlines about airport behaviour, it would seem that there has not been a pricing dispute that successive Australian governments have considered of sufficient import to warrant intervention.

The lack of action taken by the ACCC and successive governments has led the ACCC and various airline advocates to argue that monitoring is not an effective tool in dealing with market power. This is clearly in stark contrast with the views of the Australian Government. In relation to issues in retail electricity markets the Prime Minister, when Treasurer, said:

... the Treasurer will direct the ACCC to hold an inquiry into prices, profits and margins in the National Electricity Market. The inquiry will run until 2025 and include monitoring of retail prices and margins, wholesale bids and conduct and contract market liquidity.

The ACCC will prepare ongoing reports [at least six-monthly] and identify any cases where outcomes are unacceptable. Businesses will have the opportunity to explain and rectify issues raised by the ACCC. Where issues are not resolved, the ACCC will have the power to recommend a proportional and targeted response for the Treasurer’s determination.

The range of enforcement remedies and responses that could be applied if the ACCC identifies problems would include:

» A public warning notice issued by the Treasurer or ACCC;

» A court enforceable undertaking, as currently used by the ACCC in other contexts;

» Converting the default market offer into a binding cap price;

83 See http://registers.accc.gov.au/content/itemphml?itemId=978120&nodeId=47121da3c023548ab0d05d3f8830b925&fn=ACCC%27s%20Decision.pdf.
» Tightening guidelines for how the AER sets the default market offer to further drive down the default electricity price;
» Fines and other financial penalties;
» Extending market making obligations beyond South Australia, which is a form of structural separation; and
» Ordering divestiture of assets or parts of an energy business (as a last resort).84

The reason why such actions have not occurred in respect to airport services is simple – the abuse of market power that has clearly plagued retail energy consumers in recent times has not been evident in the provision of services by the AAA’s members. The absence of action by governments is due to the lack of evidence of abuse, not an absence of policy tools.

6.2 Dispute resolution – the current state of play

Beyond lobbying for the sort of administrative regulatory interventions discussed above, airports and airlines have available to them currently a wide range of options to deal with disputes. Disputes can occur in two contexts – within existing contracts and over the formation of contracts. Subsection 6.2.1 addresses the first of these, the remaining subsections in this section address potential solutions for disputes about the formation of contracts.

6.2.1 The agreements in place between airports and airlines contain extensive dispute resolution frameworks

In its submission to the Commission’s 2011 Inquiry, the AAA indicated that, based on a sample of airports, the majority of ASAs contained dispute resolution clauses. The AAA understands that such clauses are now almost universal within the Australian airports industry.

Typically, these processes involve one party notifying the other of a dispute to initiate discussions. Where necessary, matters in dispute may be escalated to CEOs and even resolved by mediation or arbitration by an expert or arbitrator. In some cases, legal action may be stayed during this process, in others the parties may retain the right to seek remedies from the courts.

To the AAA’s knowledge these clauses have been used sparingly with the parties generally preferring to work through issues outside these frameworks. The AAA is not aware of any litigation relating to the enforcement of contracts on foot but were this to occur, it should be seen not as a failure of the light handed framework, but rather a natural consequence of it.

Beyond provisions to resolve actual disputes, agreements between airports and airlines contain a range of provisions that act to facilitate engagements (thereby reducing the risk of disputes in the first place) or provide mechanisms to provide airlines with immediate relief in the event that airport service standards do not meet agreed benchmarks (see box 6.1).

Box 6.1 Engaging with airlines at Melbourne Airport

In the most recent series of ASAs agreed by airlines with Melbourne Airport a number of mechanisms have been put in place to improve engagement, reduce the risk of disputes and provide speedy relief for sub-standard airport performance.

» A Quarterly Consultation Forum to specifically review and share data on airline on-time-performance (OTP) issues. Melbourne Airport chairs the forum and ground handlers are included, noting their critical impact on day of operations. The forum is currently in operation.

» A commitment to Airport Collaborative Decision Making (A-CDM) process to improve airline turnaround and pre departure sequencing process. A-CDMs are used in Europe to improve operations outputs.

» A Capital Consultation Group to report and involve airlines in the scope of major projects. The purpose is to have airline input for major projects. The Group includes representatives of domestic and international airlines, the airport and an independent engineer who review major project costs for pricing purposes.

» An Annual Price Reset if actual expenditure falls short of planned expenditure, reducing the risk to airlines of any under-investment.

» An Immediate Service Failure Rebate if Melbourne Airport’s equipment is not available for use and causes an OTP issue in excess of 15 minutes.

The Commission will of course form its own view about the need for any alternative arbitration framework. Any future regulatory framework should not impinge on or supersede the normal operation of contract law where the parties have mutually agreed dispute resolution mechanisms, including the option for judicial determination or resolution under commercial dispute resolution legislation (see section 6.2.5).

6.2.2 Airline holdout

As discussed in sections 5.3 and 5.4 for commercial and legal reasons airports are severely constrained in their ability to unilaterally determine commercial outcomes – an ability often ascribed to firms with market power. Thus to achieve their desired outcomes in the face of determined airline resistance, airports must bring costly and risky legal proceedings, or buckle to airline demands to achieve agreement. As the Commission will understand from its landmark work on civil justice, given the risk of adverse cost orders in the event of failure and only partial cost recovery in the event of success, airports will not bring proceedings except when the monies involved are substantial. This suggests that airlines will generally prevail during minor disputes, or that long periods of time may elapse before the costs of litigation become financially justified.

6.2.3 Part IIIA continues to play an important role in airport regulation

As the Commission noted in 2007 “Part IIIA was always intended to be an operative part of the light handed approach for overseeing airport behaviour”.85 This remains as much the case today as it was when the Commission first recommended against an airport specific access regime in 200286, a view it restated as recently as 2013.87

87 PC (2013, pp275-276).
The threat of declaration under Part IIIA, especially when the 2005 decision of the Tribunal is properly understood, remains a credible deterrent to any major airport abusing market power when negotiating and providing access to airlines.

A4ANZ claims it has legal advice to the effect that, as a result of the passage of the *Competition and Consumer Amendment (Competition Policy Review) Act 2017* (Cth) that there is:

now effectively no regulatory provision in Australian competition law that constrains a monopolist from exerting its power to extract monopolist rents, fees and charges for deficient services.\(^8\)

The AAA presumes A4ANZ is referring to the amendments made to the *CCA* by way of the insertion of new section 44CA containing the declaration criteria that the NCC, the relevant Minister and the Tribunal must have regard to. These amendments give effect to the Commission’s recommendations 8.1, 8.2 and 8.4 in its most recent review of the National Access Regime.

In particular, the AAA can only surmise that A4ANZ is referring to the amendment to criterion (a) – the so-called competition test. The Government’s policy intention with this amendment is clear from its response to the Commission’s report:

The Government agrees that this criterion should be a comparison of access under the current situation versus access on reasonable terms and conditions through declaration as this is the most meaningful, realistic measure. In effect, this would re-establish the pre-2006 interpretation of criterion (a).\(^9\)

The 2006 interpretation refers to the decision of the Full Federal Court in relation to the declaration of airside services at Sydney Airport.\(^9\) In relation to criterion (a) in that decision the Full Federal Court replaced the interpretation used by the Tribunal in *Virgin* with its own view. In common parlance, this had the effect of significantly “lowering the bar” for declaration.

In its 2005 decision the Tribunal stated:

... the task of the Tribunal is to compare:

» the opportunities and environment for competition in the dependent market if the Airside Service is declared; with

» the opportunities and environment for competition in the dependent market if the Airside Service is not declared.\(^9\)

This is what should be properly viewed as the pre-2006 interpretation and it is entirely consistent with the current criterion (a):

that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service.\(^9\)

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9 Australian Government (2015). It is also interesting that Paragraph 13.8 of the exposure draft of the Explanatory Memorandum for the amending Act observed “the amendments to paragraph 44CA(1)(a) are intended to restore the pre-2006 interpretation of how the criterion was applied” although this statement does not appear in the Explanatory Memo to the final form of the Bill.
90 Sydney Airport Corporation Limited v Australian Competition Tribunal [2006] FCAFC 146 (Sydney Airport).
91 *Virgin* at [153].
92 Section 44CA(1)(a) *CCA*. 
This was confirmed by Edelman J at the hearing of Port of Newcastle’s High Court special leave application when His Honour stated that the 2017 change to criterion (a) “effectively reverses the result of the Full Court in Sydney Airport”. A similar observation was made by Keane J.93

What seems to have escaped A4ANZ is that under this interpretation, it was the decision of the Tribunal in 2005 that the airside service at Sydney Airport should be declared. The Tribunal having established its interpretation of criterion (a) went on (Virgin [166] to [580]) to examine the factual circumstances surrounding the use and conduct of Sydney Airport at the time, concluding:

> It can be seen from our analysis of the factual and the counterfactual that a comparison of the circumstances and state of competition between the factual and the counterfactual discloses that declaration of the Airside Service would bring about increased access (that is, access on different terms and conditions) to the Airside Service at Sydney Airport which would promote competition in the dependent market. The environment for competition in the dependent market will be enhanced if declaration of the Airside Service is made compared to the state of competition in the dependent market if the Airside Service is not declared.94

Therefore, if an application were to be made to have an airport declared today, the sort of analysis undertaken by the Tribunal in 2005 would need to be undertaken by the NCC in forming its recommendation to the Minister. It is clear from the authority of Virgin that a detailed analysis of the conduct of the airport subject to, and at the time of, the declaration application and how it might change as a result of declaration is required to correctly apply criterion (a).

The AAA accepts that the recent amendment to criterion (a) raises the bar for declaration from a level that the Australian Parliament has unequivocally determined was too low based on analysis and advice from the Commission and the Harper Competition Policy Review. However, in returning the interpretation of criterion (a) to its pre-2006 position it is not an insurmountable bar as is clearly established by the Tribunal’s decision in Virgin.

Further, in Virgin the Tribunal went on to observe:

> We accept that we have a residual discretion to decline to make a declaration, but it is extremely limited.95

In the Pilbara Railway Case, the High Court removed the residual discretion identified by the Tribunal saying:

> There is no residual discretion and it follows that, on review, the Tribunal has no residual discretion to exercise. The Tribunal, and the Full Court, were wrong to proceed on the footing that there was a residual discretion to be exercised.96

Thus, with the interpretation of criterion (a) back where it was in 2005 and the residual discretion of decision makers effectively removed, not only is it still possible to have an airport declared but arguably slightly easier.

Thus, declaration under Part IIIA remains as potent a regulatory threat as it was when airside services at Sydney Airport were declared by the Tribunal in 2005. It simply is not the case, as A4ANZ claims, that it is impossible to have an airport declared. A4ANZ has failed to provide any compelling evidence that would justify changing the sound policy hurdles based on competition and efficiency considerations that have been backed by precedents of the Tribunal and reinstated by the Australian Parliament.

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94 Virgin at [584].
95 Virgin at [611].
96 The Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal [2012] HCA 36 at [119].
Moreover, it is important not to lose sight that the threat of declaration may bring disputes to resolution. In 2014 Tiger Airways applied for declaration of a Domestic Terminal Service at Terminal 2 at Sydney Airport, an application it subsequently withdrew. In its application to the NCC Tiger noted that:

Tigerair recognises that prior to the Full Federal Court’s decision, the approach that had been taken by the Tribunal and the Council was to determine whether “declaration” of the relevant service would promote competition. Tigerair considers that regardless of which approach is taken, criterion (a) will be satisfied for the reasons given below.97

In 2014, Tiger on advice from Gilbert+Tobin considered that the circumstances at Sydney Airport’s Terminal 2 would satisfy criterion (a) as it now stands today. Therefore, it is reasonable to conclude the threat of declaration under the current criterion (a) could be effective in resolving a commercial disagreement without recourse to any further regulatory intervention with the accompanying risk of regulatory over reach and error.

6.2.4 Airports can give an access undertaking under Part IIIA

The now repealed section 192 of the AA effectively deemed declared a range of airport services (a broader set than aeronautical services defined in the regulation made under Part 7 of the AA) unless an access undertaking had been accepted by the ACCC under Part IIIA. Melbourne and Perth airports commenced this process but reached a point where the conduct of the ACCC led them to the view that it was an action not worth taking.

Since then, airports have on occasion considered such an approach under Part IIIA. However, the perceived hostility of the ACCC to airports, and the potential for the ACCC to use such an application to advance a broader regulatory agenda, has worked against this approach being pursued. In doing so, airports have considered the contents and operation of access undertakings that have been accepted by the ACCC and state based regulators. Airports have formed the view that these undertakings would represent such an intrusion into their business that they could not justify the benefits that would flow to them.

In principle, voluntary access undertakings could widen the feasible set of dispute resolution options available, especially to airports seeking to develop new facilities in the face of airline intransigence. That said, the observed history of regulators’ conduct stymies the incentive for their use.

6.2.5 Airports and airlines can agree to private mediation and/or arbitration

Uniform legislation exists in each state and territory to regulate the arbitration of commercial matters. Originally legislated in the mid 1980s, these Acts were updated in the early years of this decade. Under these laws consenting parties may agree to submit their disputes to an arbitrator, or a panel of arbitrators, for resolution in accordance with the provisions contained in the legislation. The proceedings of such arbitrations are confidential and the outcomes are enforceable by the courts.

The object of these laws is:

- to facilitate the fair and final resolution of commercial disputes by impartial arbitral tribunals without delay or expense” by ...

  » Enabling the parties to agree about how their commercial disputes are to be resolved ...; and

  » Providing arbitration procedures that enable commercial disputes to be resolved in a cost effective manner.98

To the AAA’s knowledge there are no examples of an airport and airline dispute being resolved using these laws although it is aware of a case where a relatively small airport proposed to have a dispute arbitrated but was rebuffed by the airline. It may be that the airline considered that litigation cost issues would provide it with greater leverage.

98 Section 1C of the Commercial Arbitration Act 2017 (ACT).
6.3 Alternative dispute resolution arrangements

Despite the range of dispute resolution options discussed above, airlines and the ACCC continue to agitate for the creation of an airports specific regime.

Consistent with the structure of the National Access Regime, there are two basic issues that policy makers must address when considering arbitration frameworks: In what circumstances can the system be accessed and following on from that, how are arbitrations to be conducted?

In a well-designed system, these questions are addressed through clearly stated objectives. The absence of such objectives was a deficiency noted in the Commission’s 2001 report on the National Access Regime, which has subsequently been remedied by the Parliament.

Were the Commission to consider that an alternative dispute resolution system was required, it would need to: enunciate the economic problem to be solved; and develop a framework where the benefits demonstrably outweigh its costs, including the long run costs of potential regulatory failure. That parties might not always get what they want or that processes could be drawn out are not of themselves policy-relevant matters.

In the context of this discussion it should be noted that the AAA firmly considers that a new framework is not required because the current framework is clearly capable of delivering appropriate outcomes for the Australian public. Rather, the AAA seeks to identify the challenges with alternative propositions. If other participants propose new dispute resolution frameworks, or indeed A4ANZ provides further detail on its final offer arbitration (FOA) proposal, the AAA may make a further submission to the Commission beyond the observations made later in this chapter.

6.3.1 Gaining access to dispute resolution

A4ANZ has suggested amending the AA so that the services provided by airports which have a substantial degree of market power would be deemed as declared, thereby paving the way for arbitration by the ACCC. It is not clear how this might apply to airports which are not leased from the Commonwealth or how market power is to be assessed.

The Commission noted in its 2006 Inquiry Report of airport regulation that:

... it seems likely that arbitration would come to be viewed by airlines as the default option, with negotiations increasingly centred in a narrow band around previously arbitrated outcomes. The net effect would therefore be a return to ‘institutionalised’ determination of charges and conditions for airport services, with its attendant costs.99

In its 2011 Inquiry Report, the Commission re-examined this matter in relation to specific proposals advanced by airlines and the ACCC for deemed declaration under Part IIIA. It made the important observation that:

... it is not so long since combative airlines and airports focused on getting the best regulated outcome. Having moved to commercially focused negotiations with at least some form of constructive engagement, it would seem retrograde to allow a reintroduction of heavy-handed regulation that could displace commercial negotiations and encourage gaming.100

Indeed, the Commission made a specific recommendation (recommendation 9.7) that an airport specific arbitration regime activated by deemed declaration of airport services under Part IIIA should not be introduced.

100 PC (2011, p203).
The question of an industry-specific framework was investigated yet again in the Commission’s 2013 Inquiry Report on the National Access Regime where it noted:

The Commission also recommended that an airport-specific arbitration regime, activated by deemed declaration of airport services under Part IIIA, should not be introduced as it could undermine light-handed regulation and be a far more intrusive form of regulation. The Commission remains of this view.\textsuperscript{101}

And further:

The Commission does not endorse the use of statutorily deeming a service to be declared. The Commission has previously noted that, in the case of airports, deemed declaration could side-step the checks and balances of the declaration process and undermine the light-handed regulatory regime in place in the airports sector.\textsuperscript{102}

The AAA acknowledges the observation in the Commission’s Issues Paper that it does not see itself bound by its previous views on airport regulation. In drawing the Commission’s attention to its previous views, the AAA’s purpose is two-fold. The first is to indicate that the AAA without reservation supports the Commission’s past conclusions. Second, and largely for the sake of brevity, supporting the Commission’s past reasoning provides well-developed and robust arguments to the merits of the AAA’s position which it shares, at least in the past, with the Commission.

Given that this matter has been assessed in many previous reviews, for such a radical overhaul to be contemplated, there would need to have been a material change in circumstances in the last five or six years. That would demand evidence of a sustained, egregious, systematic abuse of market power by airports and a demonstration of the collapse of commercial negotiations such that Australian aviation infrastructure needs were, to the detriment of the community, no longer being met.

We have demonstrated in chapters 3 and 4 that the Commission’s conclusions regarding abuse of market power in 2007 and 2011 hold true today. The Commission will no doubt gather evidence from AAA members both in meetings and submissions that, whilst negotiations remain understandingly vigorous and substantial, airports and airlines are finding a way through these and outcomes for the traveling public are improving in terms of price, choice and airport service quality. Indeed, despite the alleged conduct of airports, Australian airlines are enjoying record profitability.

\textbf{6.3.2 Alternative arbitration approaches}

A4ANZ is clearly mindful of the views expressed by the Commission in its previous reports on airports that recourse to an arbitrator’s determination could encourage gaming and reduce incentives for parties to genuinely negotiate agreed outcomes. Accordingly, A4ANZ has proposed that consideration be given to a final offer arbitration model (FOA) (also known as baseball arbitration) whereby disputes between parties would be resolved by the ACCC choosing between final offers of settlement made by each party. Removing the possibility of compromise or variation is said to increase the risks from arbitration and hence encourage the parties to negotiate on reasonable terms prior to any arbitration.\textsuperscript{103}

A4ANZ describes the basis for its suggestion as being that:

\begin{itemize}
  \item it is a ‘method commonly used in various sectors in Canada and the United States’;
  \item ‘use of final offer arbitration in Canada is acknowledged to have been effective in fostering a more competitive negotiating environment’;
  \item it ‘increases the incentives for the parties to bargain and negotiate on reasonable terms prior to the regulator’s involvement’;
\end{itemize}

\textsuperscript{101} PC (2013b, p27).
\textsuperscript{102} PC (2013b, p209).
\textsuperscript{103} A4ANZ (2018, p17).
» it creates ‘a highly credible threat of intervention’;
» ‘international evidence has shown that the existence of final offer arbitration as a method used by a regulator has the effect of obviating the arbitration process altogether’; and
» ‘this approach would bring Australia into line with what is regarded as a best-practice approach.’

Beyond these high level observations, the A4ANZ report offers no detailed analysis or reasoning as to why final offer arbitration may be a suitable mechanism for the resolution of disputes between Australian airports and their airline customers.

The AAA understands that the use of FOA may not be as widespread as A4ANZ claims. Beyond its application to remuneration of United States baseball players and other labour market issues in the United States and Chile, as far as the provision of infrastructure services is concerned, it seems its application has largely been limited to the resolution of disputes about rail access charges in Canada and setting water tariffs in Manila – hardly an extensive international experience. We do note that in its 2001 National Access Regime Inquiry report the Commission did find that FOA had not been particularly successful in Canada.104 It therefore seems to have little practical application to the complex disputes that confront airports and airlines in Australia.

A4ANZ’s report references a small number of articles from the economic literature and draws heavily from a report prepared by InterVISTAS for Air New Zealand in 2014.105 Notably, the InterVISTAS report only considers whether final offer arbitration could be used to settle disputes regarding airport charges, and not any other factors such as service levels or other terms of access.

It seems to the AAA that FOA may be suitable where:
» the dimensions of a dispute are limited, and ideally to price alone;
» the relevant product or service does not involve any significant degree of discretion as to the dimensions of quality by which it is provided;
» the scale of the dispute is relatively low, say as compared with the total revenue or costs (including opportunity costs) of the respective parties;
» there is likely to be a significant number of other, perhaps similar transactions that may be available for use as market price benchmarks by one or both parties;
» there is no strong relationship between the price that is to be determined and a cost recovery objective; and
» there are no material, third party implications arising from one or other price outcome.

However, it is clear to the AAA that FOA is likely to be unsuitable in circumstances where:
» there are multiple or complex dimensions that are subject to dispute;
» the scale of the matters in dispute is relatively high, as compared with the total revenue or costs (including opportunity costs) of the respective parties;
» there is a limited number of similar transactions that may be available for use as market price benchmarks by one or both parties;
» there is a strong intended relationship between the price that is to be determined and a cost recovery objective;
» the airport is in dispute with multiple airlines whose final offers cannot be met simultaneously; and
» there may be material, third party implications of one or other price outcome.

The AAA considers that these six points are an accurate characterisation of the majority of negotiations that occur between airlines and capital city and major regional airports in coming to multi-year ASAs that are necessary to underpin current and future investment.

105 InterVISTAS (2014).
It is the AAA’s view that FOA is likely to increase the risk of regulatory error, namely, that prices will be set at a point that deviates from the optimal. In its submission to the Commission in 2001, Australian Pacific Airports Corporation (APAC) set out in some detail how setting airport charges too low has greater consequences from an economic welfare perspective than setting them too high.\(^{106}\) It seems likely that the risk of prices being set in error are greater under FOA than if parties come to a mutual understanding, or if an independent arbitrator is considering the entire context of a negotiation either under a regulatory structure such as Part I I I A or a more commercially focused framework. Further, the AAA believes that, given the long term hostility to airports and the current regulatory regime, it is not unreasonable to conjecture that the ACCC may have a bias toward selecting the offer that contains the lowest price.

The risk to economic efficiency of FOA was identified by the ACCC in 2001. It said in a submission to the Commission that:

> There would be a risk, if pricing were divorced from an understanding of the revenue requirements of a business that the regulator may choose a price with the potential to bankrupt an access provider.\(^{107}\)

The ACCC may have been overstating the consequences of regulation in this case. However, it is the strong view of the AAA that such an outcome could threaten investment in the infrastructure needed to support industry growth and increased levels of service and competition. In particular, given the degree of information disclosure that characterises airport-airline negotiations in Australia, it seems likely that incumbent dominant airlines would make offers just below that necessary to support investment in new capacity so as to protect their congestion-related premiums (see discussion in section 2.5).

FOA is simply unsuitable for aiding the conclusions of complex multi-year, multiparty contractual frameworks that are required to underpin the investment programs faced by Australia’s airports. Given an absence of its application to the airport sector in other jurisdictions, and its limited application to infrastructure access matters more broadly, it is likely that providers of debt and equity would see this as a very risky policy experiment when the only benefits identified over say the use of the existing Part I I I A process are some contended reductions in the cost of arbitration.

### 6.4 Future monitoring arrangements

The AAA supports the continued monitoring of the aeronautical services at Sydney, Melbourne, Brisbane and Perth. Although the AAA does not believe that there is, or has been, any evidence of market power abuse by those airports, and as set out in chapter 5 there is unlikely to be, it does consider that it is appropriate for there be a degree of transparency provided to the community and policy makers regarding the annual financial performance of these important pieces of national infrastructure.

That said, the AAA remains concerned that upon the annual release of the monitoring reports, the ACCC Chairman, and indeed his predecessor, take the opportunity to attack the monitored airports for alleged poor behaviour. As noted in chapter 2, the ACCC’s commentary often strays from matters that are covered by the monitoring reports. Put simply, if the ACCC believes airports are abusing market power they should publicly recommend to government that action should be taken. Of course the reality is that the returns on aeronautical assets that the ACCC publishes, but never features in the media commentary of its Chairman, demonstrates that the monitored airports are fully compliant with the Pricing Principles and have been so since 2002 (see chapter 3). It is unfortunate that airports have to deal with ill-founded slurs on their corporate reputations on an annual basis. In successive inquiries by the Commission and in its public commentary, the ACCC has not be able to make the case for its policy propositions.

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The AAA also supports the ongoing reporting of passenger experiences and notes that many non-monitored airports publish this information. The AAA’s members are working hard to improve outcomes for the travelling public, sometimes in spite of airlines, and as the quality reporting is covered by the general media it demonstrates to the community that improvements are being made. Whilst the AAA notes the statistical issues with comparing quality metrics across airports, the reporting of quality outcomes does create a degree of benchmark competition.

Given the wide-spread and relative international comparability of the ACI-ASQ survey, AAA suggests that the Commission consider whether the compulsory participation in, and publication of results of, the survey might be a more cost effective approach than the separate ACCC process that comes to similar conclusions. If not the ACI-ASQ survey, then an alternative but internationally consistent program could be developed. The AAA would be happy to facilitate engagement with ACI’s survey group or other credible providers, if this would be of assistance to the Commission.

The ACCC collects a very large amount of data pursuant to the regulations made under Part 8 of the AA. It is not clear to the AAA or its members that this information is of any particular use. It relates largely to operational characteristics of airports that are of little interest to the community or airlines nor of analytical value to the ACCC – for example the number of bag drops or the number of gate lounges. The AAA suggests the Commission investigate whether this type of information is required. It is possible that at some point in the past it may have been thought that this information might assist in providing some transparency for airlines negotiating with airports. However, the AAA has been advised by its members that there is no utility in this information for airlines. If the Commission believes that airline service quality issues require a policy intervention, perhaps it should direct its attention to recommending guidance to both airports and airlines much in the way that the Pricing Principles provide guidance as to the limits of any pricing power airports might have.

For reasons discussed in chapter 7, the AAA believes that the continuation of monitoring of car parks and other ground access services is an unnecessary regulatory burden and should be discontinued.
Car parking and ground access
market power

Car parking at airports has been monitored by the ACCC since 1997, but was not formally brought under the airport monitoring regime until 2008, when the government directed the ACCC to monitor the prices, costs and profits relating to the supply of car parking services by Sydney, Melbourne, Brisbane, Perth and Adelaide airports. No abuse of market power has been found.

In relation to car parking and landside access services, the ACCC has collected information since at least 2006 and 2009-10, respectively, on:

» the price of each car parking and landside access service;
» basic information about the service provided, such as the number of spaces available and the throughput of cars at car parks;
» revenues, costs and profits in relation to the provision of car parking and landside access services; and
» customers’ perceptions of the quality of car parking and landside access services.

The ACCC’s annual monitoring reports include extensive commentary on car parking and, at times, the ACCC has taken an aggressive stance in relation to the level of car parking charges at the monitored airports. The ACCC has consistently claimed that the four major airports earn high levels of profits on car parking services. For example, the ACCC stated in its most recent monitoring report that:

Profit margins for car parking remained very high across all airports.\(^{108}\)

Last year, the ACCC Chairman drew the following, in the AAA’s view, incorrect and unsubstantiated conclusion from car parking profit margins:

The returns that the airports get on car parking show that they do not face significant competitive constraints when setting prices.\(^{109}\)

The ACCC has also stated in a previous monitoring report that:

As the sole providers of car parking on airport grounds, the major Australian airports are likely to hold significant market power in the supply of car parking services.\(^{110}\)

In the AAA’s view, the ACCC has consistently taken a highly partisan stance in its commentary on ground access services and charges and the themes it draws of high margins and market power do not stand up to close scrutiny. The similarity between this and the ACCC’s flawed analysis and partisanship on aeronautical services is plain to see.

To ensure analytical consistency across the four monitored airports, each has commissioned expert economists HoustonKemp to undertake an analysis of the extent to which any of the airports:

» can be said to possess substantial market power in car parking services, having regard to the usual structural indicators, such as the range of competing car parking providers and alternative means of travelling to and from the airport;
» are acting to constrain the quantity or quality of car parking facilities available at each airport, or to raise the price of car parking above the competitive level; and/or
» are acting to constrain the availability of ground access facilities, particularly in a manner that might be said to provide a competitive advantage to the airport’s car parking services.

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The AAA understands that each of the monitored airports will provide the HoustonKemp analysis to the Commission as part of their primary submissions. As such, the remainder of this brief chapter draws out the themes of the analysis undertaken by HoustonKemp and the conclusions it draws in relation to car parking and ground access services without representing the data contained in the individual reports produced by HoustonKemp.

The AAA strongly believes that the conclusions that are drawn in relation to the monitored airports apply at least as much, if not more so, to smaller airports that are not monitored.

7.1 **Airports do not hold substantial market power in car parking services**

Several factors suggest strongly that the monitored airports do not have substantial market power in relation to their provision of car parking services. First, there are a number of ‘off-airport’ car parking providers in close proximity to them, each of which offers a door-to-door service for passengers. These operators provide a similar service to the airports’ long-term car parks that use buses to transport passengers to the terminals, but they are usually cheaper.

Second, there are many alternative ways of accessing the airports with varying comfort, speed and cost to suit different people in different circumstances. Passengers generally do not use paid car parking when they travel to airports – about 10% of the time for one airport. Free car parking is used more often than paid, and there is widespread use of taxis, trains (where available), public and private buses, rental cars and increasingly ride-share operators which Australian airports actively facilitate, often in the face of disruptive and co-ordinated actions from the taxi industry.

Third, in recent years the use of paid car parking has been falling across the airports, indicating that passengers are switching to other means of accessing airports. In response airports have continued to innovate in respect to their service and pricing offers but also to expand capacity in a number of product lines.

7.2 **Airports have not used any market power in car parking services**

HoustonKemp’s reports show conclusively that there is no evidence of any form of market power being exercised by the monitored airports in their provision of car parking services.

7.2.1 **No evidence of excessive car parking profits**

The ACCC has consistently reported that the margins (that is profit expressed as a percentage of sales) derived by the major airports in relation to car parking services are high. The AAA notes the ACCC has never suggested what reasonable margins might be, or even a range.

The measure of profit margin adopted by the ACCC is earnings before interest, tax and amortisation (EBITA), expressed as a percentage of revenue. However, this measure is incapable of supporting any conclusion as to the existence of exercise of the market power.

EBITA is an accounting measure of profit that does not take into account the opportunity cost of the capital assets employed in providing the relevant service. By its nature, EBITA as a percentage of revenue will be high for firms providing services that involve relatively high levels of capital (including valuable land) and low for firms providing services that require relatively little capital.

It follows that observations made by the ACCC using EBITA are apt to mislead, particularly where the opportunity cost of the capital assets is substantial. In the context of car parking, an important element of the opportunity cost of the capital assets is the cost of the land upon which the car parks are located. That is to say the failure of the ACCC to consider the revenue forgone by not using the land for another purpose significantly undermines the validity of its analysis.
In order to establish by means of profit-based observations whether an airport has exercised substantial market power through the setting of car parking charges above the competitive level, it is essential to distinguish between two forms of economic rent that may be present. These are locational rents, and rents arising from use of market power, or ‘monopoly rents’. The distinction between the two is that:

- locational rents arise if the space or land available at a preferred location is limited, and users are prepared to pay a premium (though not because of artificial restrictions); whilst
- monopoly rents come about through the use of market power, which arises when a facility owner has the ability to set a price that exceeds the cost of supply (including any locational rent that may exist) or the price that would prevail under workable competition, or to reduce its quality below that which would prevail under workable competition, thus reducing its costs and increasing its margins.

There are many examples of locational rents having a significant role in the economy, including residential land values that increase with proximity to city centres, desirable schools or beaches. Locational rents reflect that the land in premium locations is scarce, and that people are willing to pay more for the land as a result. Unless users of premium land are charged prices that reflect its locational attributes, over-crowding or congestion is inevitable.

The same principle applies to airports, which are centres of commerce in their own right. Land proximate to the terminal is naturally in fixed supply and increasingly heavily utilised, so a premium must be paid to secure such prime locations. Put another way, not everyone accessing an airport can park their car within a short distance of the terminal, because such prime space is intrinsically limited.

The critical, in principle distinction between a locational rent and a monopoly rent is that the former covers the opportunity cost of the land, and no more. This distinction is important, because it has implications for efficiency and for whether market power can reasonably be said to have been exercised because:

- charging for locational rents is consistent with efficient pricing, since they represent the opportunity cost of space or land which is in scarce supply; and
- monopoly rents arise because the owner has set prices above an efficient level, thereby reducing output below the level that would be optimal from a societal perspective, and so creating a dead weight loss.

Locational rents do not justify regulatory intervention since they represent an important component of allocatively efficient prices. In particular, their transfer from airports to airlines via a single till pricing arrangement not only leads to lower than efficient aeronautical charges but also may lead to land being allocated by the airport to other activities thereby reducing car park capacity and increasing congestion.

In practice, the distinction between monopoly and locational rents is a challenging one to assess. The opportunity cost of land can be very high, difficult to measure and may vary considerably by location. Notwithstanding, the absence of any evidence on the location value of airport land is an intrinsic shortcoming in the way in which the ACCC monitors car parking and ground access charges. Because the reported operating margin does not factor in the opportunity cost of land, it provides no indication of whether prices are excessive. Accordingly, past contentions by the ACCC that airports have been charging excessively have no reasonable basis.

Opportunities sometimes present themselves to identify the market value of land. Airports will often conduct competitive tender processes to allocate scarce space available to car rental operators to facilitate the collection and drop of rental cars. In 2010, the ACCC recognised, in a document bearing the name of the current Chairman of A4ANZ, that such practices at Perth Airport:

> offer a more efficient mechanism for allocating scarce terminal space than a collective bargaining arrangement. In addition the outcome of the competitive tender is likely to be that the facilities, including premium counter and car park space, will be allocated to the car rental companies that value them most.\(^\text{111}\)
The evidence collected by HoustonKemp suggests that the opportunity cost of the land used to provide car parking services by the airports is likely to be significant and has recently increased, namely:

» the airports would be able to rent out the car parking land for other purposes for substantial sums;

» airports are becoming more like small cities with a wide range of services being offered, giving rise to many alternative uses for the premium land used to provide car parking services next to the terminals;

» the land used for car parks has increased substantially in value over the last five years; and

» the value of locational rents are very high in the CBDs near each of the airports – for example, the price of car parks can more than double over a distance of just one kilometre, even though the same service is being provided.

Given that the land used for car parking is usually in the most premium location next to each airport terminal, the EBITA margins earned by the airports for car parking are likely to be explained to a significant extent by locational rents and convenience premiums.

Finally, airports have a strong incentive to maximise total passenger throughput, regardless of how the passengers arrive and leave the airport, given the small proportion of total airport revenue that parking represents and the vast majority of the airports’ revenues that is reliant on passengers throughput. Airports can therefore be expected to seek to maximise patronage of the airport (and the range of commercial opportunities such visitors present), rather than car parking revenue.

7.2.2 No evidence of using market power through non-price terms

The evidence and analysis set out in the reports prepared by HoustonKemp also show airports are not exercising substantial market power in the supply of car parking services by non-price means such as by reducing the quality or quantity of car parking services.

First, the airports have each invested very substantial sums in improving their car parking services and increasing their capacity. All of the car parks almost always have a substantial number of car parking bays available. In other words, the airports have not used any market power to restrict the availability of car parks.

Second, the investment in car parks has improved the quality of the service provided. The airports’ car parking facilities have consistently rated as either ‘good’ or ‘excellent’ in almost all measures tracked by the ACCC over the last five years. This is inconsistent with the airports having used any market power to provide a low quality of service.

7.2.3 Market outcomes have not deteriorated in the last five years

Market outcomes have not deteriorated since the Commission’s last review:

» car parking prices have generally remained stable in real terms. Small adjustments have been made to reflect changing patterns of demand and congestion but there have also been some major shifts, such as Melbourne Airport’s 20% price reduction in early 2018;

» with a couple of exceptions, car parking prices at the airports have increased by less over the last five years than the proportional increase in the value of the land in proximity to the car parks, that is, the change in the opportunity cost of the land;

» each airport is likely to have earned a lower return on land used for car parks in 2016-17, as compared to 2012-13;

» the number of car parking spaces across all the airports has increased substantially over the last five years; and

» all but one of the survey ratings of car parking quality improved, or stayed the same over the last five years.

None of these factors are consistent with airports seeking to exercise market power by charging excessive prices, reducing quality or hindering access. This is unsurprising given that the airports are unlikely to possess any substantial market power.
7.3 Airports have not exercised any market power in landside access

The ACCC has often claimed that airports may increase the prices or reduce the quality of ground access services to encourage customers to use the airport’s own car parking services. For example, the ACCC has said that:

Because airports earn a significant proportion of revenue from their own car parks, they are unlikely to have a strong incentive to provide favourable terms and conditions for the alternative transport modes to access the landside areas controlled by airports.112

Further, Mr Sims has said:

Airports set the terms and prices to landside areas. This means that they are in a position to impede competition to on-airport car parking by increasing access costs for alternatives such as off-airport car park operators.113

The AAA notes that these issues have been a concern for the ACCC for at least a decade. In its press release discussing the release of the 2007-08 Monitoring report, the ACCC said:

The report discusses factors that may affect the price of car parking at airports. They include airports being in a position to set higher car parking prices because they are able to influence the costs of alternatives to on-airport car parking (including off-airport parking, cars, taxis, and bus and train services). Although not conclusive, the ACCC considers that some results are consistent with airports having a monopoly position.114

The AAA accepts that airports have an ability, and indeed an obligation, to manage access to the airport and particularly the terminal kerb for entirely legitimate safety, security and operational efficiency reasons and this confers on them a degree of market power. However, it is also the case that if an airport were to act in the way the ACCC seems concerned about it would almost certainly be in contravention of section 46 of the CCA.

The AAA understands from its members that other than a few inquiries of a very minor nature, the ACCC has shown absolutely no interest in this area of law enforcement – its only interest seems to be in making unsubstantiated claims when it releases its annual monitoring report rather than law enforcement, presumably because since 1997 the ACCC has had no evidence of an airport breaking the law.

It therefore should come as no surprise that HoustonKemp found there is no evidence that the airports have exercised market power in relation to providing airport access to ground transport providers and specifically in a way to assist their own car parking services. In particular:

» there is no evidence of any ground access provider being denied access to an airport without good reason;
» there has been little change to ground access charges in real terms over the last five years;
» prices are cost reflective in that they are higher for vehicles that stay longer and/or are larger;
» off-airport car parking operators, the closest competitor to the airports’ own car parking facilities, do not pay more than other users of ground access services that have similar sized vehicles – airports do not impede competition in the way described by the ACCC;
» the airports locate facilities for a variety of no to low yielding access modes – such as private vehicle pick-up and drop-off, and taxi ranks and supporting holding areas – on high value land located proximate to terminals, thereby prioritising the efficient movement of passengers and vehicles over higher commercial returns that could otherwise be generated from this land, and over locating their own car parking facilities closest to terminals;
» to manage peak demand and alleviate congestion for access modes like private vehicle pick-up and drop-off, the airports provide free parking options, prioritising quality for customers and the efficient movement of passengers and vehicles over the potential commercial returns from these assets;

112 ACCC (2017, p 38).
facilitating the entry of ride-share operators often despite obstructive actions from incumbent taxi interests; and

the airports have continued to invest substantial sums in providing high quality landside access services, and this is reflected in the ratings of quality for landside access as reported by the ACCC – indeed, in 2016-17, all services were rated as excellent, good or satisfactory, with good being the most common.

7.4 Conclusion

The evidence and analysis set out above, and in more detail in the reports prepared by HoustonKemp demonstrate that, over the last five years:

» the monitored airports do not hold substantial market power in car parking services;
» the monitored airports have not used substantial market power in the provision of car parking services; and
» the monitored airports have not exercised substantial market power in relation to landside access charges.

These findings demonstrate that there is no systematic evidence of abuse of market power by monitored airports in the provision of car parking or landside access services. The Commission will find the same applies to other Australian airports.

This evidence is entirely consistent with every credible analysis that has been undertaken since 1997. Further, the trend is that airport car parks are experiencing increasing competition from other modes of access, which they actively facilitate, which is being seen in reductions in market share for airport car parking services despite improvements in the quality and increasing diversity of service offerings.

Further, consumers have an increasing range of options to understand ground access offerings and, other than hearing the misleading observations once a year from the ACCC chairman, are blissfully unaware of the ACCC’s activities in this regard – there is no benefit for consumers from airport car park monitoring. There is no basis for further monitoring of car park services at the monitored airports, it represents and unnecessary regulatory burden and the Commission should recommend its abolition.

Given the potential for enforcement action under section 46 of the CCA and the operation, safety and security imperatives associated with ground access management, the monitoring of ground access arrangements if anything constitutes an even more unnecessary burden and similarly should be abolished.
Other Issues relevant to the Inquiry

The previous chapters addressed issues related to the presence of market power, its use and what if anything should be done about it. The Terms of Reference and the Issues Paper raise some issues that go beyond these, namely the provision of jet fuel supply and ground transport planning. Whilst not wishing to downplay the importance of these issues, they are best dealt with by the AAA’s members as concerns vary from airport to airport and involve a wide variety of interactions with fuel suppliers and state and local governments that the AAA is not involved with.

Beyond these matters, there are a couple of issues the AAA would like to raise that go to the efficient and competitive provision of airport services in Australia, and in particular regional Australia.

8.1 Jet fuel supply arrangements

As outlined in chapter 2, the supply of jet fuel and oil was estimated to make up 26.8% of global airline costs in 2017. Qantas Airlines estimate that fuel costs were 21% of their total expenditure for FY2017\(^{115}\). In addition, BARA has estimated that the cost of jet fuel often represents over 40% of operating expenses for international airlines operating to and from Australia.\(^{116}\)

It is interesting to note that recent annual profit announcements by both Virgin Australia and Qantas have placed significant emphasis on managing fuel costs yet made no mention of airport charges – a stark comparison to the emphasis in advocacy efforts they appear to be making on the same issues.

Airlines typically adopt a number of strategies to contain the cost of fuel, including hedging, investment in new, more fuel-efficient aircraft and yield and price management. Other strategies involve airlines, airports and Air Services Australia working together to plan improved air traffic management and improved approaches to air navigation. Each of these strategies will have an impact on the overall cost of jet fuel, albeit limited.

The concentration of the jet fuel market in Australia is the greatest impediment to containing the impact of the cost of fuel on airfares. The jet fuel markets in Sydney, Melbourne and Perth are controlled by at most two suppliers. Although it is estimated that around 50% of the jet fuel used in Australia is imported, there is capacity to source an even greater amount of jet fuel from a larger number of international suppliers at lower prices if significant reform to the Australian jet fuel supply chain is undertaken.

The interests of airports, airlines and the travelling public are unusually aligned in seeking to break up any restrictive supply arrangements currently in place. The current situation at most major airports is that the off-airport storage facilities are owned by a single supplier, which usually also owns the lease of the fuel hydrant pipeline and on-airport storage facility.

In its policy document published in December 2014, BARA proposed that one potential mechanism for opening up competition in this market would be for airport operators to provide access to off-airport storage facilities and provide use of them on a fair and open basis to any jet fuel suppliers servicing airlines.\(^{117}\)

If reform of the jet fuel market in Australia is to be undertaken, which the AAA would strongly support, different solutions will need to be arrived at for each of the major airports. Many will face capacity constraints or have limited ability to develop the necessary extra storage facilities. Additionally, reform will only be achieved with government support and intervention, especially if new arrangements involve storage at, and transport from, ports.

\(^{115}\) Qantas (2017, p20).
\(^{116}\) BARA (2014, p4).
\(^{117}\) Ibid, p8.
The lack of competition in the jet fuel market in Australia was also an issue highlighted as needing further consideration and work by government in the final report of the Competition Policy Review in March 2015:

*Competition in jet fuel supply... should be a focus of further reform efforts in the sector.*

With increased production of jet fuel in the Asia-Pacific region, and the barriers currently faced by globally recognised jet fuel providers seeking to enter the Australian market, the time for reform is right even if the pathway towards achieving that reform may not be obvious or easily reached.

Although not directly addressing the policy solution proposed by BARA in its policy document, a number of AAA members are planning changes to the jet fuel storage and supply arrangements at their airports. The AAA is aware of work currently being undertaken by Perth, Darwin and Melbourne airports to address jet fuel supply chain capacity and reliability and the security of its supply – a matter that is currently being reviewed by the Federal Government. This review will be concluded by the end of 2018.

### 8.2 Ground transport planning and access

Airports are increasingly investing in their own ground transport networks to ensure an efficient flow of vehicles to, from and around the airport, however this needs to be complimented by appropriate road and rail networks beyond the airport. It is essential that all levels of government recognise the importance of investing in ground transport infrastructure that ensures efficient connectivity. This connectivity must be maintained in order to minimise constraints in the efficiency of passenger transportation and the freight supply chain.

As a result of the National Aviation White Paper, airports leased from the Commonwealth were required to include surface access plans in their airport Master Plans and also put in place consultative arrangements with state and local government authorities to improve the planning and development of ground transport linkages to airports. The AAA understands that these reforms have led to better information exchange, improved planning outcomes and more efficient project delivery.

The benefits of these reforms can be seen from the delivery of the Gateway WA project at Perth Airport and the T4 Transport Hub at Melbourne Airport, as well as current projects underway at a range of airports, including around the domestic terminal precinct at Sydney Airport and the development of the Perth-Forrestfield rail link. All of these projects require complimentary investment by airport lessees on their sites, funded by a mix of aeronautical and non-aeronautical revenues. The flexibility afforded by the current regulatory regime strongly supports these outcomes.

### 8.3 Future aviation security arrangements

As part of the Budget released on 8 May 2018, the Australian Government announced changes to airport security requirements at both major and regional airports across the country. These changes were developed by the Government following a review of airport security arrangements (conducted by the Inspector of Transport Security) in 2017. This review was instigated following the foiled terror attack at Sydney Airport in July 2017.

The challenge in establishing the appropriate level of security at airports is that the global threat environment is constantly evolving. Threat actors are continuing to innovate and experiment with new techniques, technologies and concealment methods in an attempt to defeat security measures.

While some of the detail regarding the specific nature of the changes has not been made publicly available (so as not to undermine the enhancements being made to the aviation security framework), it is important to recognise that the changes require significant equipment and infrastructure upgrades at both major and regional airports across the country. Further, this equipment will significantly increase the maintenance and other operational costs of airports and potentially be beyond the funding capacity of some smaller airports.

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Under the current Government’s arrangements, the Aviation and Maritime Security division of the Department of Home Affairs has responsibility for establishing the necessary security requirements at airports. Whilst the AAA and its members have enjoyed a largely cooperative and strong working relationship with government agencies in recent years, we remain concerned that from time to time the determination of the requirements is made in isolation, or at least abstracted from, a proper understanding of the challenges of delivering outcomes and in particular the long-term costs that airports and their airline customers may face.

Costs vary widely between airports not only because of size but locational issues reflecting previous terminal design decisions and the current state of buildings and services. Based on a survey conducted by the AAA of the ten busiest airports in Australia, it was estimated that the total combined capital and operating expenditure for costs related to meeting security requirements was approximately $295 million for the financial year end 30 June 2017. Of these costs, approximately $255 million were operational expenses and approximately $40 million capital expenditure.

The Government has allocated $50.1 million dollars in funding for those regional airports required to procure new security screening equipment as a result of the new requirements imposed by the Government. Whilst this funding is welcomed it is limited to the procurement of equipment and does not extend to any terminal infrastructure upgrades required to support the new equipment (with a very limited number of exceptions) or ongoing maintenance and other operating costs.

For many of the airports impacted by these changes (particularly the major airports where no funding assistance has been provided), the costs of complying with the new requirements are significant. Due to the size, weight, vibration, heat and noise characteristics of some of the new equipment being introduced many airports will need to make significant infrastructure investments. In some cases, this may include reinforcement of mezzanine floors, terminal reconfigurations to accommodate a larger security screening point footprint, as well as reconfiguration and/or duplication of complex checked baggage screening systems to ensure the airport remains operational.

The costs associated with screening passengers and bags are subject to commercial negotiations between airports and the airlines that require passengers and baggage to be screened. As they ultimately fund them, airlines closely scrutinise the costs incurred by the airport to ensure no unnecessary over investment. It is for this reason that capital investment in security screening equipment is directly linked to the type of equipment mandated by the Government. Given that operational expenditure is the largest ongoing cost, there is continued focus from industry on improving efficiency in operations while still maintaining the necessary security outcome.

8.4 Revised approach to providing border services at new and redeveloping airports

On 4 June 2018, the Department of Infrastructure, Regional Development and Cities, the Department of Home Affairs, and the Department of Agriculture and Water Resourcing jointly wrote to the AAA and impacted airports to advise of the Government’s revised approach to providing border services at new and redeveloping airports (and ports).

In summary, the correspondence noted the Government has:

... established a new clear, transparent and consistent process to help ensure that border services are available at airports/ports when they are required’ ... costs incurred by Home Affairs and Agriculture to establish border services at a port (to procure and install specialist equipment and recruit staff, amongst other things) are to be recovered from the port operator. Port operators are also responsible for costs associated with any relevant infrastructure and facilities required to support international services.
The AAA acknowledges the Government’s efforts to establish a more straightforward, transparent and consistent process for the establishment of border services at new international airports. Unfortunately under the Government’s revised approach, airports will now be required to absorb the cost incurred by the Department of Home Affairs and Department of Agriculture associated with establishing border services.

Airlines already pass on a Government mandated $60 charge to each international departing passenger, known as the Passenger Movement Charge (PMC). The PMC was originally introduced in 1995 to assist in offsetting the costs incurred by Government for the provision of border services at airports and ports, some of which are the very costs the Government is now proposing industry absorb directly (in addition to the PMC) under this revised policy.

The revised policy is particularly detrimental to emerging international airports in regional areas as it raises genuine concerns of inequity, particularly when these small to medium sized airports are least able to justify the increased costs. No existing international airport has ever been required to incur these types of establishment costs for border services as this is a Government function – indeed the Commonwealth met the cost of Qantas’ exclusive border control in Terminal 3 at Perth Airport despite services being available at Terminal 1. This new policy emerged very quickly after Qantas commenced these operations.

These costs are the result of Government mandated services designed to protect Australia’s borders. This role is a critical Government function and must be fully funded by Government. In the AAA’s view it is unacceptable for new entrants (both airports and airlines) to absorb costs associated with procuring Government owned and operated equipment, as well as the costs associated with recruiting Government staff to carry out border protection functions when incumbents enjoy tax payer funded facilities.

Airports already provide border agencies with the infrastructure and facilities required to carry out their functions at the airport. Airports currently incur these costs, as well as any costs associated with the relocation of border services in the event of a terminal redevelopment. It is difficult to understand the justification for requiring airports to now incur direct Government costs associated with establishing border services, particularly given these services will only be considered after a rigorous application process and meeting the requirements of a newly strengthened national interest test. If the airport is able to demonstrate there is a genuine business case to establish international services and the Government has agreed it is in the national interest to do so, it is difficult to understand why the airport should then absorb these additional Government set up costs.

The AAA also notes that this policy is intended to apply to existing international airports, as well those seeking to establish international services. For existing international airports, the policy advises that this new process could be triggered by a change to the existing business model for international services. One of the examples given in the Government’s advice as to what could constitute such a change is an increase in the number of international carriers or services. In preliminary discussions with the Department of Home Affairs shortly after receiving this advice, it was indicated that the increase in services/carriers would need to be in excess of the Department’s forecast growth and resourcing for that airport for the new process to be triggered. The AAA believes it would be beneficial for existing international airports to be provided with more clarification on the Government’s projections for ‘natural growth’ at each international airport in order to determine if or when this process could potentially be triggered.

The new policy is also problematic for existing international airports that are undertaking terminal redevelopments and infrastructure changes in order to increase the airport’s capacity and improve the passenger experience. This revised policy would seem to impose an additional Government approval process, in addition to Major Development Plan (MDP) approval processes already in place at Australia’s major airports. The timeframes set out in the new policy, as well as the approval process involving the national interest test and the requirement of seeking airline endorsement, are not conducive to efficient investment and appear to create an unnecessary and problematic regulatory barrier. It is unclear how this new policy and existing MDP approval processes are linked (if at all) and what additional costs may be incurred by the airport as a result. The AAA believes that additional guidance and clarification on this issue needs to be provided to industry, or perhaps these considerations could be incorporated into the MDP process.
The AAA believes that imposing any additional costs for the provision of Government border services onto industry (and therefore onto passengers) is in direct contrast to the Government’s stated objective of continuing to grow Australia’s $50 billion tourism industry. Without any changes to the Passenger Movement Charge arrangements, the proposed funding arrangements will act as a disincentive for airports to grow or introduce international services, the introduction of which increases competition and thus lowers airfares.

This proposal is aimed at delivering outcomes that are contrary to the interests of the travelling public and the policies being pursued by airports and state governments. For example, at a time when the Commonwealth is signalling potential cost increases, virtually every state and territory government is providing resources to develop new markets, particularly into north Asia and the sub-continent.

The AAA has urged the Government to consider an alternative solution for the cost recovery of establishing new border services and increasing capacity of existing ones. If the Government maintains that these additional costs are to be absorbed by industry, it will create significant barriers to entry in allowing smaller airports to attract international services and in doing so, disproportionately impact tourism opportunities for regional Australia. The potential impacts on existing international airports are also concerning as this new process appears to create additional regulatory burden and additional costs, particularly if there is not agreement between border agencies and airports on forecast resourcing requirements.

At the time of writing, the AAA has yet to receive a formal response from any of the agencies in relation to this issue. The AAA urges the Commission to consider these issues in its draft report.
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