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TRANSCRIPT
OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO PRICE REGULATION OF AIRPORT SERVICES

MR G. POTTS, Presiding Commissioner
DR N. BYRON, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT SYDNEY ON MONDAY, 30 OCTOBER 2006, AT 9 AM
Continued from 24/10/06 in Melbourne

MR POTTS: (recording fault) As you would know, that has been a significant development since we released the draft report and that is the Federal Court decision, and as I foreshadowed in Melbourne we will be interested in discussing the implications of that decisions with participants today. But may I thank everyone for their contributions by way of submissions and appearances here at the public hearings.

Our schedule from here is to move to produce a final report, which we will be submitting to the government by 7 January 07. As is customary these proceedings are as informal as possible. We will be producing a transcript of evidence and discussion with interested parties, and also at the end of the hearings today I will provide an opportunity for anyone present to make an unscheduled statement if they wish to do so.

I think those are all the introductory remarks I have to make. Perhaps one additional thing is, could I just ask people to perhaps turn of their mobiles, if they wouldn't mind, to avoid interruptions and as a courtesy to those actually appearing. Thank you very much. So with those brief introductory remarks, could I welcome our first participant Warren Bennett and could I ask participants at the beginning if they could for the record state their name and the organisation that they represent. Thank you.

MR BENNETT: Warren Bennett, executive director, Board of Airline Representatives of Australia. Thank you, Gary. I must admit I wasn't planning on making a detailed initial statement to the public hearing, mainly because most of the things I think that we wanted to say about the PC's draft report were included in our response to that draft document, and so I think that very briefly we might just run through some of the key points that we made in that response and take it from there in terms of whether the commissioners would like to ask me questions.

We saw the draft report as being a very useful document because it made a number of important statements and recommendations about future price setting at Australian airports, and we saw a couple of key ones that we concentrated on in our response, those being that further aeronautical asset revaluations shouldn't be used as a justification for increasing aeronautical charges and anticipated increases in passenger demand should provide a source of downward pressure on airport charges for the use of existing facilities. They were seen by the airlines as being some key statements that the PC had made.

A concern we had about the report, however, was that it appeared that some of the statements and recommendations that the PC were making weren't consistent with their - they weren't internally consistent with other statements and recommendations that were being made. There was a degree that we saw of

ambiguity in the proposals that were being put forward in the draft report, and we had some very serious concerns about the likely results of that ambiguity going forward in pricing negotiations with the airport operators. For that reason we suggested in our response that you should redraft the review principles, and we suggested a possible redraft because we felt that that was our interpretation of what we thought the PC's interpretation of what pricing discussion should be going forward. But regardless of whether or not that is the case we feel that nonetheless there should be a very clear statement by the PC of what its pricing expectations are, because at the present time there is a certain amount of ambiguity in the recommendations coming forward.

There are three potential problem areas that we see in terms of airport pricing going forward. The first one relates to Sydney airport and the view that the PC has taken on the behaviour of Sydney airport in the past, and apparently its view of the behaviour of Sydney airport at the present time is enunciated in the draft report. That's of serious concern to us because we don't believe that Sydney airport has behaved in a way that's consistent with either the principles the PC is espousing or the overarching review principles.

We also have concerns about prices going forward for Brisbane airport and Canberra airport. Our members don't operate at Canberra airport so I'll let my domestic brethren fill you in on any issues that might be associated with that particular airport. But certainly we see the contents of the PC's draft report providing Brisbane airport, for instance, with a further excuse for a very substantial price increase going forward based upon the value of existing assets, and we don't think that is appropriate, it's simply a rent transfer from the airlines and their customers to the airport operator over and above the rent transfer that they achieved, as we see it, when the CPI-X regime was removed in any event.

One of the failings of the report that we saw is that the PC has made little effort to differentiate between airport operators in terms of their price and non-price behaviour, and that means that the worse performing airports tend to get lumped in with the better performing airports, and they can claim that they're doing just fine, thank you very much, no cause for concern. So that I think is highlighted by the PC's view on SACL's behaviour, which we see as being particularly anathema to the sorts of pricing principles coming forward that we would espouse.

In the absence of clear guidelines and unambiguous guidelines going forward on pricing then we see that the airlines will have to continue to rely on Part IIIA of the Trade Practices Act to moderate the pricing behaviour of airports that might be focused on rent transfers. The usefulness of that process is diminished somewhat by the inordinately long time that it takes to achieve an outcome from that process. As you mentioned in your opening statement the recent developments in the Federal

Court determination in relation to a declaration of SACL may change that somewhat, but nonetheless at this point in time it doesn't appear as though there's going to be any change in the amount of time that it might take to get a decision out of that process.

In that regard, therefore, we were somewhat encouraged by the statements of the Australian Competition and Consumer Commission in a submission to the PC on overcharging by monopoly service providers and the impacts on downstream competition. I would like to emphasise that BARA's members operate on very thin profit margins, they compete on a capacity and frequency basis, and increases in cost for those carriers that don't earn high profits will cause them to either reduce capacity or exist the markets, and that thereby does reduce the level of downstream competition. So the statements that were forthcoming from the ACCC in this review were particularly welcomed by BARA.

We also welcomed the PC statement about government-provided airport services. That particular matter relates to aviation rescue and firefighting charge, as I'm sure you're aware, and we saw that the commission's comments in that regard were quite welcome. But it does seem a little bit silly to us that the Productivity Commission and the ACCC seem to be making policy recommendations and pricing decisions regarding larger regional airports, which that other matter related to, on polarised views about the competition those airports face from alternative modes of transport and holiday destinations. The PC and the ACCC seem to have widely differing views on where larger regional airport fit in the competition spectrum.

We firmly believe that because policy decisions and prescriptions relating to larger regional airports can have an affect on the pricing principles established for the airports that our members operate to, that there needs to be a coalescing of the views about what actually is the situation in terms of competition from alternative modes of transport and competition from other holiday destinations that the larger regional airports actually focus upon.

I think in summary we saw the draft report as being a very useful step forward in terms of trying to assess what appropriate principles might be going forward. Some of the statements that the PC made in the report were particularly welcomed by the airlines. We saw it as a real attempt to give some sort of clarity. But, in the end, we see that the ambiguity still surrounding some of the proposals that have been put forward by the PC will give us cause for concern about the credibility of the light-handed regulatory regime going forward.

MR POTTS: Thanks very much, Warren. Perhaps I could begin with a very general question and we might take it from there. Just picking up some of the points you made, in particular that there's a variation in BARA's mind in the conduct of

airports around Australia, and you mentioned one in particular. But also I think when we look at the submissions that we received from stakeholders there does seem to be a fairly clear divide between the views of the airports and the airlines, which I guess raises a few general questions. The first is - and I'd certainly appreciate your comments on this - is if you could elaborate on how the airlines generally view relations with airports in Australia, and whether you think that there is a satisfactory basis for commercial negotiation as a way of arriving at future charging profile, particularly given the position that some of your members have taken in relation to the way in which they think dispute resolution should be handled, for instance, and the degree of prescription which they think is necessary for there to be a genuine commercial negotiation.

MR BENNETT: There are probably a range of emotions that you might care to use to describe the relationships between different airports and airlines around the countryside. They range from extremely strained to developing some frostiness all the way down to being quite amicable and cooperative. We have a situation where we've been - and starting at the particularly strained, we have a situation with Sydney airport where we've been trying to discuss a set of prices and other terms and conditions going forward since September/October 2004. It's now two years later and basically we've gotten nowhere. Since we prepared our response to your draft report the two events that have happened is that the Federal Court has handed down its decision - so that's one influence that we haven't taken account of. The other one is that Sydney airport provided us with their latest pricing model in an attempt to justify the base prices that they see going forward.

What we described in our response as being our anticipated input from Sydney airport and the negotiating process through that model has come to pass, and then some. They've tried to further revalue their assets in order to justify their prices. They're maintaining an increased cost of capital to ensure that the prices that they're seeking to impose as the base price going forward is maintained, and they've come up with a particularly perverse interpretation of the commission's recommendation about sharing productivity benefits between airline and airports. What they've done effectively is said in sharing productivity gains going forward SACL will take 150 per cent of the productivity gains, Airlines can take a hike. We get nothing out of the proposal going forward in terms of productivity benefits. All we're doing is proposing to add a set of non-existent prices over and above their expected operating costs to increase the rate of return that they get on their capital investment. So it's just a blatant attempt to increase the cost of capital going forward in a de facto sense.

So those are the sorts of discussions we're having with SACL. It's particularly galling that the PC keeps saying that there is no evidence of abuse of market power on the part of SACL because from where we sit there certainly is.

The other airport that I particularly mentioned in my opening comment was Brisbane airport. We're entering into discussions with Brisbane airport now about various capital expenditure proposals. We're focusing at the present time on an expansion of the international terminal building. There are debates going forward about the costs of that, the share between aero and non-aero of that development, and whether the timing of it and the scale of it is appropriate. We'll resolve those issues. Those issues can be resolved. But we're particularly concerned about the BAC submission to the productivity commissioner which seeks to justify pricing for existing assets off the revaluations that they've done. The estimation that we make is if they do that then basically the PC will be countenancing about another 40 to 50 per cent increase in aeronautical charges at Brisbane airport just for existing assets. That is a monumental increase over and above the 40 to 50 per cent they got after the removal of the CPI on a set price regime. So to the best of our calculation that's probably what we might end up with if the Brisbane airport proposal is proceeded with.

Other airports are pretty much - Perth airport. We highlighted some problems with Perth airport in our original submission. We didn't harp on that in our second submission largely because I firmly believe that the negotiations that we commenced with Perth airport towards the end of this month on a revised pricing agreement probably will proceed to a satisfactory conclusion. One of the sticking points at Perth airport remains the continued application of a fuel throughput levy which we vehemently opposed. But nonetheless I am reasonably confident that we can, through our discussions with Perth airport, come to a satisfactory conclusion. In the case of Adelaide airport that's bedded down for 15 years, more or less, so there shouldn't be any issues there.

Melbourne airport. We don't see any issues arising a Melbourne airport simply because they've adopted a pricing approach and a consultative approach that we believe is consistent with what the government's intent was with the introduction of light-handed regulation. They will provide us with further pricing models in the near future to justify a new price path going forward for five years to accommodate a fairly substantial capital investment program down there, something of the order of $350-odd million over the next five years. We're fairly confident that we'll reach agreement with them.

Cairns airport is outside this arrangement but nonetheless we've entered into a commercial agreement there and had no problems, really - on the international side. I understand there are a few hiccups on the delivery of the capital program going forward on the domestic side. On the international side there have been no problems.

So generally speaking, for a majority of the airports we're probably reasonably confident that we can develop a sound commercial relationship going forward.

We're not just talking about price here, either. We're talking about other terms and conditions in relation to service level commitments and other non-price conditions contained in the aeronautical services contracts that we negotiate with the airport operators. So I think from BARA's point of view we're reasonably confident we can move forward with most of the airports and agree on a commercial outcome.

MR POTTS: Those comments are interesting. You seem to be saying that it's not a generalised problem, that commercial relations with some airports are quite satisfactory even under the current regime, if you like. I suppose the question is, some of the airlines have sought to have a far more prescriptive system than what we have now, and I think some would indeed argue that it's a move back towards the sort of regulatory system that we had before. I mean, given the sort of difference in the nature and the degree of satisfactoriness, if you like, of commercial relations with airports at the moment, do you think a move in that direction could perhaps be a counterproductive move as far as relations with those airports that are satisfactory at the moment?

MR BENNETT: You need to understand that there is a reason for different airlines having different views about the nature of the commercial agreements that they might have with airport operators. The international foreign carriers that represent most of the membership of BARA arrive at an airport, they discharge their cargo and passengers, they refuel, they take on catering supplies, they get more passengers and cargo and they go away. For the two domestic carriers, though, who operate at airports around Australia the commercial relationship is far more complex; there are far more detailed discussions that need to take place to ensure there's satisfactory access to the necessary services that apply at airports around Australia. So I can understand why an airline such as Qantas and an airline such as Virgin Blue with far more expansive commercial operations at particular airports around Australia could find that there are more ways in which an airport operator might seek to exact rent of the airline operator to the airport.

So there is probably good reason for a range of views, some airlines suggesting a more restrictive and prescriptive basis upon which to negotiate simply because they have far more things to negotiate and far more things to be annoyed about with the behaviour of airports. For the foreign carriers it's not quite as bad as that, and in the discussions that we've had in the past the nature of the discussions that I have had to undertake on behalf of the foreign carriers has been somewhat more truncated than the nature of the discussions that's had to have been undertaken on the part of Qantas and Virgin Blue because of those expanded commercial interests. So whilst the relationship that I'm talking about is probably representative of the foreign carriers, you can find that other airlines may seek to have a far more prescriptive approach. It's understandable.

MR POTTS: Can we move on to the Part IIIA question which was foreshadowed at the beginning and you touched on in your comments, Warren. Could you just address that issue generally for us, what you think the implications are, and I guess in particular if you could focus on, to the extent that you can, any reaction from your international members, if you like. We will of course be taking up the issue directly with, say, Qantas and Virgin, but we'd be interested in the broader view which you can bring.

MR BENNETT: Okay. The Federal Court decision obviously will have an impact on the way Part III operates into the future, I suspect. I mean, I'm not a solicitor so I can't offer any sort of legal comment on the terms and provisions of the decision that the Federal Court made, and, having read the decision, it was particularly convoluted and difficult English to read in any event. But nonetheless it appears that the test as a result of the Federal Court decision, the competition test, is now far simpler than what it was before. So potentially I guess you could say that every airport around Australia could be declared if you were to follow through on that action.

BARA hasn't met yet to fully consider and review the implications of the Federal Court decision, but we've had experience with Part IIIA with the Virgin Blue application, and from memory I think that commenced in October 2002 and that was finalised in October 2006. It was a four-year process. The use of Part IIIA as a tool is really very, very limited because of that length of time that it takes. Airport operators could get up to all sorts of nefarious goings on within a four year time period and you're proposing that they only report every two years. So the spotlight that you can focus on airport operations via Part IIIA and via your monitoring report proposal is very much diminished. So we're a little concerned about that.

I think the initial response of the international carriers would probably be if we can organise to get a consensus view with an airport operator about a commercial agreement going forward, then that's the way we would prefer to attack it. But we're not going to get that unless the PC comes up with a set of pricing principles that clearly define the basis upon which pricing going forward is going to apply. Now, that doesn't necessarily mean that we're saying you have to prescribe a purely mechanical means of setting prices by airport operators; what it means is that we're seeking to ensure that there is a clear message to airport operators about asset revaluations, that there is a clear break on the ability of airport operators going forward to think up new ways of accessing rent transfers from airlines and airport operators.

As I said in our submission, we believe that there has already been a fairly substantial rent transfer as a result of the removal of CPI-X, and we're suggesting that the prices that are in place as at 1 July 2006 represent the appropriate basis for providing an adequate return to all the airport operators on their existing assets. You

need to clarify your statements in relation the effects of passenger growth going forward on prices for existing assets and infrastructure. You need to clarify your position going forward on how the productivity sharing arrangements will apply, because as we've already seen with Sydney airport, it didn't take them long, they've already twisted them around and tried to get more of the productivity benefit for them and nothing for the airlines. So there are various ways that airport operators who might be focused on rent transfers can twist the sort of things and the principles that you're saying to their own advantage, and we're concerned about that.

But nonetheless, as I said, we have only experienced that really to this point in time with one airport operator. The Federal Court decision may make it easier for us to deal with that operator going forward. But as a first point, a starting point, I suspect that the foreign carriers would say to me, "If you can organise to achieve a consensus, commercial agreement that provides us with a known price path, a capital program that meets our needs going forward, service-level commitments that provide us with an assurance of the quality of the airport going forward," then they'd grab it.

DR BYRON: Just to clarify, Warren, it seems to me that our main task is to assess the regime that's been sort of on probation for the last five years and then to recommend to the government either a continuation of that regime with tweaking to improve the way it works or to recommend going back to the sort of CPI-X regulation that we had before, or alternatively a third option of something new yet to be worked out. So can I conclude from what you've just said now that your international members would be reasonably happy with a tweaked and improve version of light-handed monitoring - a light-handed regulatory regime relying mainly on commercial negotiations but with good guidelines in place.

MR BENNETT: So long as there was a circuit-breaker that was far more timely and cost efficient than the current Part III arrangements. It's just not, in the minds of the international airlines, a really effective means of putting in place a process for the government to determine if an airport is behaving badly. It just takes too long. We suggested an arrangement in our initial submission. You guys turfed it out and said it was basically just compulsory arbitration. That's not what we sought, and, as we explained in our response to your draft report, we don't see a great deal of difference between what we suggested and what you suggested; it's just that your proposal is that we make our comments in a monitoring report every two years which, again, is not terribly timely, and again not terribly effective, simply because airports can write glowing reports about their behaviour in the previous two years.

What we suggested is that the circuit-breaker be DOTARS or the government minister. If there is a complaint that airlines have about the behaviour of a particular airport, then we take it to that particular office, in the first instance, and they can make an assessment about whether a pricing review is necessary.

DR BYRON: And could initiate an inquiry under Part VIIA of the Trade Practices Act. That's right, yes.

MR BENNETT: But at the present times, Part IIIA is just too convoluted and too costly to really be effective. Thanks.

MR POTTS: I suppose one question there is - I mean, I certainly agree that the four year process that it's taken to get this latest Part IIIA decision is a very lengthy one, but I guess the question is, with the passage of time, and the establishment of some legal framework precedents, whether the process would become quicker, if you like, and also - I think you touched on this point - that presumably it's going to condition the negotiating framework between the airports and the airlines, and in particular the conduct of the airports, because there are fairly significant transaction costs for both sides in going down the Part IIIA route and presumably the airports would wish to avoid those unless they feel they're absolutely necessary.

MR BENNETT: I would imagine that the airlines would wish to avoid it as well. It is an expensive process and - I have no experience with it; I don't know what it might have cost Virgin Blue and then Qantas to participate in those proceedings, but I imagine it would have been a lot. Certainly, from BARA's point of view, the process that we had to go through with the ACCC back in 2000, 2001, about the pricing decision there, it cost BARA 1 and a half million dollars; and that's just a low-cost model industry organisation trying to represent the interests of its members. But 1 and a half million dollars; it was a lot of money.

I should imagine that we're going to be faced with similar sorts of costs if we have to proceed through this highly legalistic and convoluted process to determine whether an airport is behaving badly. I mean, it should be pretty damn obvious, if you bring to the attention of an appropriate government representative the basis upon which an airport operator is seeking to extract prices over and above competitive levels; that could be determined fairly quickly. That should be a reasonably way to proceed.

It's not as though - I don't believe - that airlines would seek to just go that route in any event. We would have to have in place an argument that explains exactly why we believe an airport operator is behaving badly, but in the first instance I think we should probably pursue the commercial solution to the problem.

MR POTTS: I guess we'd like to think that that assessment should be relatively straightforward and objective, but we ourselves, in our draft report, attempted to assess the performance of airports in the last five years and their price monitoring, and I'd have to say the response we've got from stakeholders who have engaged a

number of consulting firms is to throw more static into the air, if you like, in terms of how you make that judgment, so the question I have for you, I guess, is to what extent do you think some bureaucrats in Canberra, in the Department of Transport, would have the capacity to make the necessary objective assessment to initiate such an inquiry.

MR BENNETT: I can understand why you got a bit of a flack about the way you compare the behaviour of airports because you didn't pick some terribly good parameters to look at. The international comparisons of airport pricing is fraught with danger. You just don't know what the basis of the pricing is at particular airports around the world and, as I highlighted in our response to your draft report, some of the highest-cost airports that you were comparing Australian airports to - we wouldn't want those institutional arrangements to apply in Australia. They were virtually free-for-alls. So that was a crook one.

Then you compared it to the larger regional airports and that was pretty silly too, in my opinion, because there is no relationship between the competitive forces applying to larger regional airports, I don't think, than those that apply to the capital city airports. You've got a different view to the ACCC on what those situations are, anyway, so that is another comparative that's fraught with danger.

The return on assets was basically the only one that you came up with that was probably a reasonable one to proceed with. So I can understand that, but I would have thought that, with a little more thought, and a little more research into the factors influencing airport pricing, then even a bureaucrat in Canberra could make a reasonable assessment about the behaviour of airports in particular commercial circumstances.

MR POTTS: Can we move on to - did you want to follow up anything there now?

DR BYRON: I was just going to comment that the reason that we were interested in the pricing behaviour of Coolangatta, Cairns, Hobart, Townsville was not because we thought that they were close proxies for Sydney, Melbourne, and Brisbane, but because we were looking at places like Darwin and Canberra that have less traffic than some of those that aren't monitored, and we were trying to see whether there was any evidence that being monitored or not monitored had any effect on the pricing behaviour of similarly-sized small airports. We can debate about what the evidence tells us from that comparison, but it wasn't meant to say that, yes, Alice Springs is equivalent to Sydney. Just a comment.

MR POTTS: Could I move on to the cost of capital issue, which you mentioned again and you made some comments in your submission, as a number of others did, and some valid points we'll take into account. But would you agree that the airlines

and the airports face a somewhat similar risk profile vis-à-vis the rest of the market, in broad terms; in other words, to the extent that there's passenger growth, for instance, which is benefiting the airports, that equally benefits the airports and vice versa?

MR BENNETT: That's a difficult one to answer off the top of my head, simply because you've got airlines coming from different markets around the world. The competitive influences and the market outlook for different airlines is quite variable, simply because we have airlines coming from Europe, South America, North America, southern Asia, the Pacific region, northern Asia. Some of those market areas have a particularly strong outlook; others have a fairly wobbly outlook and the future doesn't look perhaps quite so rosy for them. Those sorts of market characteristics would have an influence on the risk profiles of those particular airlines, and therefore the cost of capital would vary between the airlines, and between the airlines and the airport operators of Australia. So it's a difficult question to answer.

You can see the different forces that would affect airlines in different parts of the world just by looking at their profitably reports. Often those in the southern Asian region perform quite well - well, they earn profits. They don't perform quite well but they earn profits, whereas other operators in Europe and North America are still experiencing considerable losses on their operations. Of course, there are a range of factors that influence that - not least of which their cost structures which they have to work their way through, but also the market-risk profile is a factor influencing those outcomes as well.

Then you have the debate about the Middle Eastern airlines and to what extent they might be assisted by governments to improve their performance. There are two diametrically-opposed views on that, of course, but nonetheless they may be factors as well.

So there are all sorts of reasons to say, "Look" - it's difficult to say, but the cost of capital for airlines should be roughly the same as the cost of capital for airports operating in Australia, as airlines come from all around the world and face different circumstances.

MR POTTS: I guess risk is about the variability of profitability rather than the level of profitability.

MR BENNETT: That's right, yes.

MR POTTS: So the question is whether the same sorts of factors are going to be driving any variability that occurs in the profitability.

MR BENNETT: The variability of the losses are quite significant. I mean, North America and Europe - they continue making losses but sometimes they're big and sometimes they're small, but the risk is hard to assess.

MR POTTS: I suppose what we were doing in the draft report was trying to identify some factors that may have affected the cost of capital for airports, and I guess my questioning was whether the same sorts of factors are affecting the airlines, for instance, as would be affecting the airports, and I guess to the extent that there's some relationship to the effect of changes in passenger growth, for instance, and the like on the two industries, and that might be the case.

MR BENNETT: We were particularly disappointed that the PC raised this issue of the cost of capital for airports. We thought that it had been largely resolved in the discussions that we'd had with the airport operators previously. Now you've opened it all up to airport operators possibly going forward, saying, "Our passenger numbers are variable in our opinion; therefore our cost of capital needs to go up." You can also possibly get airport operators saying, "We're pretty productive here. Our productivity is improving; therefore we'll de facto increase our cost of capital to get even greater prices and returns off the airlines."

It was a very unwise thing, from our point of view, for the PC to raise that because what you've done is simply just open up another reason why we may not achieve agreement on prices going forward because we're going to be arguing about cost of capital variations which we don't see as being particularly important for airport operators in Australia at the present time. We think that the risk associated with airport operations is no greater in the next five years than it was in the previous five years. Certainly, there is no indication whatsoever that the sort of domestic shock that affected airports in the past is going to occur in the future. The supply of airline services domestically around Australia seems to have settled down fairly nicely now. The strength of the two domestic carriers is quite robust, so we're unlikely to have that sort of shock..

Whether the variability of international passenger numbers and the risk associated with that exceeds the variability of other risk factors in the Australian economy is a moot point. We don't believe that there is that increased variability.

MR POTTS: We're only trying to draw out the issues, and that's the purpose of the question.

MR BENNETT: We just didn't like to comment.

MR POTTS: I gather that. I can't quite find the page in the submission now, but I

think you've highlighted it here in terms of the principles, that there should be information transparency to assist a negotiating process.

MR BENNETT: Yes.

MR POTTS: Could you elaborate - I'm asking here in relation to the airlines, because you represent the airlines - could you elaborate what that would mean for the airlines in terms of assisting the negotiating process? I mean, clearly the airlines would be expecting greater transparency from the airports.

MR BENNETT: Yes, that's right.

MR POTTS: But, equally, what would the airlines be prepared to do in relation to that to assist the negotiating process?

MR BENNETT: We provide them with all the information that they ask for at the present time in terms of the type of aircraft that's going to be used, the schedules that will be adopted in the coming six months to 12 months, the number of passengers that are actually on board the aircraft. If there are further data requirements that the airport operators would seek to access from the airlines as part of an agreement on a commercial process going further, then we'd be happy to consider that. But I'm not sure what more they would need. They outline in their commercial agreements a fairly extensive list of data requirements that airlines have to provide to them, and to the best of my knowledge airlines do that. I haven't had any complaints from airport operators that airlines are deliberately withholding information that is required. But, certainly, if there are additional data sources that airports might require from BARA's members then we'd be happy to consider whether or not that can be supplied to them.

MR POTTS: Well, I guess to the extent that you think charging - and I think you implied this in some of your earlier comments - the level of charges is essentially a question of rent distribution between the airports and the airlines, and so you're getting down to questions of profitability, if you like. So I'm not sure whether, in relation to the airports, the airlines, or BARA's view, would be that the airlines would expect information from the airports on the impact of changes in charging levels on profitability. But to the extent that you did expect that sort of information, would you regard it as reasonable for the airports to get similar information from the airlines?

MR BENNETT: Similar information on airline profitability is available through IATA, and that's generally publicly available. If that sort of detailed information is likely to be sought then we could probably, through IATA, access that type of information to give to the airport operators.

MR POTTS: So as far as the international operators are concerned, you wouldn't expect there would be problems in providing that sort of information?

MR BENNETT: I wouldn't think so, no.

MR POTTS: Okay. Thank you. Neil?

DR BYRON: Yes. It seems to me that aircraft are about the ultimate form of mobile capital assets, and that airlines are continually redeploying these assets, trying their routes, changing the gauge of aircraft on different services, adding and subtracting services, changing destinations et cetera. I guess one of the things that we have been grappling with is the extent to which airport charges are a major consideration in that continuous sort of testing of the market and redeploying these capital assets. Could you give us any idea of how often or to what extent airports have actually impeded that process when airlines are redeploying assets to maximise their profitability or, conversely, whether there have been instances where airports have actually encouraged new services, new routes, new operators or whatever, and facilitated that process of change.

MR BENNETT: But, certainly, some airport operators - and probably most airport operators, I would suspect - have in place a pricing arrangement to attempt to encourage new services to be operated to their airports. Certainly, Brisbane Airport has one, I know. Sydney Airport, I think. Melbourne Airport does. I presume the others do as well. And that has, in the past, attracted some new services. It's sort of a suck-it-and-see situation, though, for the airlines. As I said, they compete on capacity and frequency, and they're competing on capacity and frequency in an Australian market which is largely a marginal market. There are a few core routes that airlines operate out of Australia. Most of them are fairly marginal, though.

They are low-profitability groups, they operate on thin margins, and so it doesn't take much to tip an airlines view on whether a particular operation is worthwhile in continuing with. You alluded to that, they move aircraft around, and that's simply because the nature of the market in Australia is such that it is marginal. If an airport seeks to increase its charges significantly then that does have an impact on the margin that the airlines earn and, therefore, it can tip them in to moving out of a particular service into something else.

DR BYRON: I was thinking the other day about airlines that I used to fly out of Sydney, like Alitalia, KLM, Lufthansa, Air France which, presumably, would have been BARA members. I was just wondering to myself to what extent their decision to pull out was affected by their view of the airport charging regime; whether they felt that Australian airports were particularly expenses and poor value, and that was one of the reasons, or whether it was - you know, they pulled out for entirely

different reasons, and even if they'd had zero landing charges the still would have gone. Without commenting on any specifics.

MR BENNETT: Yes.

DR BYRON: Now, just, to what extent is this a big ticket issue in terms of those sorts of strategic decisions, or is it a relatively minor one?

MR BENNETT: No, look, it's not a relatively minor one. As I said, there are a number of factors that airlines take into account when they're determining what particular routes they're going to operate. The fact that those airlines have removed their operations from Australia is indicative of a combination of factors, one of which would have been the cost of operating their aircraft to and from Australia, and that's largely fuel, labour and the airport charges. All of those have an impact on the margin that they can achieve on their passengers. It may have been at one point in time that another factor might have been the deciding influence.

If we allow, however, airport operators in the future to keep extracting rent from the airlines and airline passengers, then that will become a significant factor in determining whether or not airlines operating marginal routes continue to operate to and from Australia. It is one of the factors, and it one that could, in the absence of an effective regime, a light-handed regulatory regime going forward, be a deciding reason for airlines pulling out of Australia.

MR POTTS: Thanks for that.

MR BENNETT: You didn't notice any infrared dots on me while I was talking, did you? He's at close range here.

MR POTTS: This is a friendly place. Thanks very much, Warren, I appreciate it.

MR BENNETT: Okay. Thanks.

MR POTTS: David, are you happy to start a little earlier? Is that okay?

MR CRAWFORD: Yes.

MR POTTS: We're a little ahead of schedule. Welcome to this morning's hearing. As I said at the beginning, if you could just state your names and the organisation you represent, and then perhaps a general statement and we can take it from there.

MR CRAWFORD: Certainly. David Crawford, executive chairman, Westralia Airports Corporation.

MR TICEHURST: Wayne Ticehurst. I've currently got two hats on. Member of the Office of the Chief Executive Officer, pending the replacement or the recruitment of a new CEO at Perth Airport. I'm also the chief financial officer.

MR KATZ: And Isaac Katz. I'm a director of Harding Katz, which is a consulting firm advising the airport today.

MR TICEHURST: Chairman, thank you very much for the opportunity to present today. What we'd like to do is structure this presentation to cover off - initially I'm setting out the key messages that we'd like to leave you with today from these proceedings. As you know we've put in a fairly detailed submission initially, followed by a submission on the draft report. Today what we'd like to do is amplify a number of the key points and messages, and that David will be speaking to those points.

I'd like to, then, cover off on some of the positive outcomes and re-emphasise the positive outcomes that we've seen through this period of light-handed regulation, and some of the key messages there. I know you're very interested to hear about our views on Part IIIA and on dispute resolution, so David is going to speaking in regards to that. I'd also like to then speak about some of the aspects of the draft report we think could be tweaked. On balance, we are very firmly of the view that the draft report has it right but there are certain aspects of it that we'd like to suggest to you that perhaps need some tweaking. Then finally David will be summing up with some concluding comments.

MR CRAWFORD: Let me just go through, I guess, the key messages to start with. I think the first message we have got is that it was fairly clear to us that there was ample evidence available that the previous regime was defective, the CPI-X regime that we worked under. It is also clear that there is no significant evidence that the current system under which we are working has failed. So I think that's one of the very clear messages, that the old system that we went back to was - it had some very, very significantly demonstrated failures, whereas the current regime does not. Therefore, while there is some sense to redefine it there is no justification to throw it out and look for a new system.

The second message is that we do concur with the Productivity Commission, though, that we have still got some way to go under the price monitoring regime. It is not a perfect regime and we have to make sure that we work to achieve a better outcome under price monitoring. We are of the view that that can happen, and we are also of the view that it would be entirely premature to say that it has failed and we should move to a different form of regulatory regime. We should work towards improving the system that we have got, going forward.

We remain firmly committed to setting price and terms of condition to aero services through to commercial negotiations. The outcome that I think the light-handed regime had a very clear intent to was to set the framework where commercial negotiations could prevail. We recognise the tensions that occur in price negotiations. There is not a big price discovery mechanism when there's a negotiation between an airport and an airline, so there will always be some feeling that something has been left between the parties.

So there is not a big price discovery mechanism and there would be tension in the pricing negotiations. But commercial negotiations are much more than price and the relationship between parties are much more than price; and the importance of a successful relationship going forward between the parties depends on being able to keep the price negotiations in context and allow the other matters related to conditions of access to be fully explored during the term of any agreement that might persist. Unfortunately, much of the discussion about what the alternative is is almost exclusively about price, and the purpose, for my mind, of why commercial negotiations are critical is in that it recognises relationships between parties are a whole range of things other than just price.

We do recognise, though, there is a need for an effective circuit breaker to be available when the parties can't agree. I think Part IIIA provides that circuit breaker. The issues with Part IIIA are not peculiar to airports. It is a broad-based regime. There have been changes to Part IIIA, apart from the Federal Court decision, particularly with respect to timing and the disciplines that will have to be imposed around the timing for decisions under Part IIIA. So I think Part IIIA is there as a circuit breaker and I think the Federal Court decision suggests that Part IIIA in the future can be a more effective circuit breaker than it has been in the past.

Finally, I think it's our view, the price monitoring with binding arbitration would rapidly turn into a relatively heavy-handed regime that would undermine the scope for commercial negotiations and would effectively make Part IIIA redundant because you could almost duplicate under a price-monitoring regime what would be attempted under Part IIIA. So our overall view is that given the importance of commercial negotiations, the breadth under which they have to take place, the need to further develop them and strengthen them with, in the background, Part IIIA is still the best way forward for the way in which airports and airlines should negotiate the future arrangements. I guess they're the key things and I'll leave it to my colleagues to now start filling out some of the detail.

MR TICEHURST: Thank you, David. As I said at the outset, I would like to just spend a little bit of time in reinforcing some of the positive aspects of the price monitoring regime and I appreciate we've done this to some length in our

submission, but I really do think it's important to re-emphasise some of the achievements that we've certainly seen at Perth Airport. I don't think there's any doubt at all, certainly not in our mind, the CPI-X regulation resulted in aero charges and levels of investment that were unsustainably low. In Perth's case, we had the highest X-factor of any airport in the country at 5 and a half per cent.

That was built off an FAC network pricing regime based on single till. It was really not an efficient basis of charging from the outset, and it's an important thing I'd like to just re-emphasise, in that there are a number of submissions to this inquiry that seem to be taking the view that somehow or other the starting point prices were correct and therefore that the asset valuations should be based off those starting point prices or an extension of those prices. So from our perspective, certainly we don't see the starting point prices as being anything like being correct and the correction that took place, took place when we reset our charges in 2002, based on an economically justifiable basis.

If I can just look at the investment that's occurred in the five years or four years and five years up to June 2007, under this new light-handed regime. All the spend on capital expenditure - something in the order of six times the amount of capex on aeronautical infrastructure in that time. In fact, we've spent more than what we'd indicated to the airlines that were our pricing terms to the accord that we put in place in 2002. So I think it's very important to recognise that there has been a very positive period under this light-handed regulation for capital investment.

And going forward, it's extremely important to recognise that in the next five years Perth airport will spend something in the order of 120 million, or planning to spend in the order of 120 million on pure aeronautical investment. So that's more than double what we've already spent in this five years. So it's terribly important for us to get it right in terms of creating a frame work for that capital investment to happen. We believe this last four years has done that.

In terms of passenger and airline quality of service; we have a very strong commitment to continuing quality of service monitoring. The results of passenger and airline service surveys that have been conducted to date continue to indicate that there's been an overall high level of satisfaction with the services at Perth airport and as I said, we're continuing to maintain a commitment to that. It was very - I think Warren's comments this morning in regards to commercial terms and conditions having been negotiated with airlines; we've got special mention and we're very appreciative of that, Warren. I think it's an endorsement of the fact that, as far as Perth airport is concerned, there is a mechanism in place and commercial terms and conditions have been negotiated with airlines.

Dispute resolution provisions do exist in the pricing and services accord and in

the license agreement we have with Terminal 3 with Virgin Blue, and they have not been activated in the four years that they've been running. A couple of other practical things that have occurred over the last four years in terms of our focus on minimising costs to airlines to the extent possible. We do take measures to delay aeronautical charges increases where they're necessary. Security charges is a primary example of that. We're all aware of the significant increases in security charges that the industry has worn over the last few years. What we've done is voluntarily put in place mechanisms to delay that increase to airlines.

It's also instructive to highlight that our airfield charges; we've actually kept them flat for the last two years running in recognition of the fact that we have had fairly strong overall passenger growth and therefore we're sharing those productivity benefits with our airline customers. The last four years have also seen, I guess, the encouragement of innovation in terms of delivery of aeronautical services, and we did provide an example of that in a case study in our first submission. It was an international terminal baggage handling project. It also encompassed security - implementation of checked-bag screening. It's about a $25 million project and that case study, I think, highlighted that.

We were able to achieve that innovation, we were able to achieve it through a strong period of consultation, a very successful outcome on a significant capital works project. We were able to have the flexibility to negotiate and agree the project scope and cost and certainly we see that model as a model to be looked at going forward. It's very conducive to development of effective commercial relationships. So I guess in summary, we certainly consider that there's been superior outcomes for all stakeholders in the last four years that have been delivered under this light-handed period of price monitoring and we very much caution about any measures that returned us, either in whole or in part to a heavy-handed form of price regulation.

We strongly believe that we've complied with the government's review principles in regards to this period of light-handed regulation and we've put a fair bit of commentary in our submission in regards to that. I'll now pass back to David who will talk more about Part IIIA and dispute resolution.

MR CRAWFORD: I guess in general terms, our view is that price monitoring and commercial negotiation parties are the objects we're trying to pursue and therefore any form of regulatory intervention has to be used sparingly. I think Part IIIA actually provides that proper regulatory backstop. I don't think it is and should not be designed to be easy to access. It has to be - it is a very significant form of regulatory intervention; the implications are very significant so it should not be too easy to access, but it should be effective when accessed and I think that's what it provides. It is a reasonable regulatory backstop. It is effective. The changes that have been made, as I've said in respect of timing, I think make it more effective in

providing the regulatory backstop.

I don't think it is such a thing where it actually can be accessed very, very quickly and easily, because there is still some - there still has to be a negotiation period beforehand. There is still obviously the need for integrity in the process of considering a Part IIIA declaration application, and in the end there are issues around conduct that have been considered under Part IIIA. So I think it has got the proper balance. It provides the proper balance of being used sparingly but still being effective and I think the most that can be said under the recent Federal Court decision is, it's in a sense likely to enhance the effectiveness of it to the extent that it potentially makes it one part of it; much less conjecture about what's meant by access and what's meant by declaration. It doesn't undermine the rest of it. It clarifies what used to be a fairly significant part of the process without undermining the rest of it.

So I think it effectively - it is another way in which Part IIIA has been improved. To the extent that Part IIIA has been improved, I think it enhances its capacity to be used as the regulatory backstop for the price monitoring regime. The price monitoring regime and commercial negotiations; I said regulatory intervention should be used sparingly and I think the idea of independent binding arbitration is one of those which is of a like mind, that should be used extremely sparingly because given, as I've said, the nature of the negotiations that take place, it's - you have to be very, very careful of using it as the first resort rather than the last resort and trying to pursue the goal of commercial negotiations, it has to be built around the idea that the parties between themselves can find a way to overcome their differences in what are difficult commercial negotiations and will always be difficult commercial negotiations.

But in the end, there is a way in which the parties can achieve those things, because there is sufficient reason to do so. Part of that process, I think is that it does require the parties to have an open and transparent approach to the sharing of information and I think from the airport's part, we propose to do that. I think we do have to recognise though, that no regulatory regime is perfect. There's room for improvement and I think the PC draft report has recognised that there are some areas that can enhance the regulatory regime that's in place now; the price monitoring regime that's in place now.

The package of proposals; the core proposals as we've tended to say, which is in relation to asset valuations and sharing of productivity improvements are ones that we concur with, but as the basis of taking some of that tension out of the price negotiations, future price negotiations, are very, very important. We have recommended that the commission consider the period of the next review, as to whether we should go past the five year time, because if there is a sense that the price monitoring regime hasn't worked, there would be the negotiations that take place in

our case when the five-year review finishes in 2007. There'll be another five year pricing principle, which we'd would obviously build around.

I think it's something that PC considers, is that if they've got a five-year price review, that will, I guess, tend to set the period under which our agreements might take place. If the review were to take place after two renegotiation periods then the PC would actually have a good idea of what's happened through that process of price negotiation between the parties and then be in a much stronger position to make recommendations based on two major negotiations as to those areas which might need further development or indeed, in the airport's case, it would certainly drive the need on our part to reach those commercial negotiations because in the end, we're aware of what the implications potentially are of not being able to reach successful commercial negotiations.

And in terms of regulatory backstop and the need for regulatory improvement, we are always mindful that Part IIIA is there and that will condition our negotiations certainly as we go forward. I'll pass back to Wayne after those.

MR TICEHURST: Thanks, David. As I said at the outset, there are some aspects of the draft report that we would ask the PC to revisit. As a package, as David has just indicated, we accept the draft report. We think it's really on target in terms of the key principles that it's putting forward. One of the comments I do want to make is in regards to asset valuation. We accept the core principle from the draft report about the sensitivity of asset valuation and we do think that that is one of the key elements that, if we can resolve that in the way that the draft report has proposed, it will make the likelihood of further significant disputation very much less than it would be if there was really no principles to develop. So we support the draft report in that regard.

We do, however, have some concern over two aspects of it. The first of those is in relation to a statement that the draft report makes in regards to, and I quote: "New investment should not be added to the asset base" - or "should be added to the asset base at values agreed with customers." We're just a bit concerned about what the meaning and the intent of that is. It seems to us that it could potentially lead us into the sort of problems that we experienced under the NNAI regime.

We would like some further clarification from the Commission as to what it intended by that statement, "at values agreed with customers." We're suggesting to you that perhaps that's a bit too prescriptive. The reality is that we do get agreement from our customers up-front on capital works when we put in place our pricing agreement - we did so in 2002 - in a broad sense, and particularly in regards to major projects. There's an extensive consultation process that we go through. The T1 baggage case study was a great example of that, when we went through and we

scoped it out with customers, and there was quite a lot of feedback that came back from our airlines that enabled us to improve that project.

But we do think that there needs to be flexible approach to the definition of what new investment is and, for example, that we need the flexibility to be able to - having agreed an overall scale of program, that we can substitute or add projects to that without the need for it to be coming down to a very prescriptive and a very detailed reconciliation project. So we would ask the Commission to just clarify what it means by "at values agreed with customers."

The other thing I think we recognise is that the new review principles should allow airports to maintain the real value of their asset base through time, through an appropriate indexation, and that may well be through the use of a nominal cost of capital to a nominal asset base, or a real cost of capital to a real asset base. We're really indifferent as to which one, but we do think there should be some recognition of that principle.

If I can just go through the reporting and monitoring regime; again, the draft report suggests that there - seems to focus more on customer commentaries and what we see to be subjective comments from customers on monitoring. We caution that as being the primary focus of the monitoring regime. We think very much there's a place for quantifiable and more objective measures of quality of service, and we do have some concerns about that it be potential for a qualitative regime based on customer commentary being the most appropriate basis to conduct the quality-of-service assessments.

I'd like to just highlight - we do our own, and I think a lot of the airports do do this as well - we do our own quality-of-service monitoring, in any event, which is over and above the quality-of-service monitoring is really required under the price-monitoring arrangements. We're certainly continuing to do that, at least annually.

In regards to the frequency of the reporting of that, I think the Commission has suggested that perhaps a two-yearly reporting cycle could be beneficial. We're actually quite happy with annual reporting. We don't see that there's been a great cost differential between annual and two-yearly reporting, and because we're doing it annually anyway, we'd be quite happy to maintain that.

If I can just then turn to another area of the draft report which we have some concern with, and that's in regards to monitoring of carpark prices. We understand the Commission is advocating that carpark pricing be continually monitored. We believe that monitoring of carpark pricing is unnecessary. There is already acknowledgment or recognition of carpark prices that - of publishing of carpark

pricing the web pages of a number of airports.

We have added a considerable amount of capacity at Perth airport, in terms of carparking. We have product differentiation between long-term carparking and short-term carparking. Our product called FASTtrack, we introduced for the business traveller, and so forth. We have got more plans - significant plans - to add capacity at Perth airport to meet the demand, including the possibility of a multistorey carpark in the next couple of years, and there's certainly a lot of evidence in terms of off-airport competition for carparking and, of course, other competing modes of transport, including drop-off.

So we are firmly of the view that the role of monitoring for carparking prices is unnecessary. There's a lot of information we've provided in our supplementary submission on that point.

If I can just turn to the definition of aeroservices, we do accept that the current mismatch between Direction 27 and the Act needs to be rectified. It is not a huge difference but there are some administrative issues it creates, so we do think that the definitions do need to be aligned. The key thing that came out of the Commission's draft proposal, however, which we'd again like to clarify, is that it appears that the Commission is suggesting that the current - what we call the carve-out mechanism, in Direction 27 that relate to pre-existing leases and licences - the possible implications of the removal of that may inadvertently redefine revenue from the Qantas Domestic Terminal Leases into the aeronautical category, and we'd just like to get some clarification from the Commission as to whether that's its intention or not, or in fact whether or not it was always recognised that the Qantas DTL would be out of the definition.

We certainly think that if those revenues were included in aero it would be very problematic to determine what they were because that terminal actually has a number of uses of aero and non-aero, so it would be very difficult; but more importantly, I think, we feel that that approach would broaden the scope of commercial negotiations to include revenues and costs that have previously been settled through long-term lease agreements. It would move us more towards the single-till approach.

I'm sure you won't let me leave here until I say something about the fuel throughput fee. On the matter of the fuel throughput fee, we have already foreshadowed in our submission that, in accordance with the review principles, we'll continued to consult with our customers on the charging arrangements at Perth airport, and that includes the future application of the fuel throughput fee. So what I'm saying is that we have acknowledged that there is some issues with it, that there's some sensitivity on behalf of our customers, and they will be picked up and taken on board in terms of our future commercial negotiations with our airline customers.

I'd just like to pass back to David for some concluding comments.

MR CRAWFORD: My concluding comment is relatively simple, that what we've said is we support very, very much the overall thrust of the PC report with some of them - I guess, not the core issues, around which the PC - supporting the core principles around which the PC has developed its recommendations. There are some areas of concern which we think are points of clarification development, but they don't affect the core thrust of what the PC has recommended, that we need a further period of time to develop a price-monitoring regime, and that the Federal Court decision in respect of the SACL case doesn't in fact need to cause any change in the overall recommendation that the PC has made today.

MR POTTS: Thanks very much for a very comprehensive statement.

Perhaps I could begin with this Part IIIA question. I think there's a generally accepted view that the bar has been lowered, if you like, in terms of resort to Part IIIA. The question is how much has it been lowered.

When Melbourne airport appeared last week, the question was put to them, and I think they accepted this line of argument - was that an interpretation, and their view was based on legal advice - an interpretation that can be given to the decision is that application of Part IIIA is no longer a conduct issue. It's now simply a structural issue because this provision of Part IIIA, which the Federal Court gave a different interpretation to, accepted the Virgin argument, if you like - Virgin Airlines argument - essentially means that in future, whether Part IIIA is invoked or not, will turn on those two other key clauses. One is whether the facility can be replicated economically; and the other one is whether it's a significant market or not. On both counts, it would be difficult to argue, I think the view is, that the major airports wouldn't meet those two particular criteria.

So the argument that Melbourne airport was putting was that it's no longer a conduct issue; it's essentially a structural issue. You look at an airport and see whether it meets those two particular tests now.. So I'd be interested in any comments that you could make yourself which I think suggesting that you had a rather different interpretation of what you thought the Federal Court decision meant.

MR CRAWFORD: Can I preface this by saying what I'm saying here is obviously in my role as executive chairman of - - -

MR POTTS: I appreciate that.

MR CRAWFORD: - - - WAC, not in respect of any other roles I might have.

I think there has been some lowering the bar in the sense of the clarification of what the relevant subsection of section 44 means. I don't think, and if my reading of the court decision - did not say that the matters that had been considered - be they the NCC, or the tribunal should not have been considered; it's just that they were not relevant - relevant subsection of - that they were considered under, section 44 for the NCC's case in section 44(h) for the tribunal's case.

So I think that there will still be some way to go, and we probably won't find out until there's the next application for declaration. So I think it has to be seen in that context, of the comments that were made around the meaning of section 44.

I think we also have to recognise that the decision was in the context of the Trade Practices Act that existed at the time - not the changes that have been made subsequently, and the requirements to look at the objects clause.

And the third thing there was, up until now there's been partly, as you've suggested, that it was - you look at the four conditions and say they were necessary and sufficient; and if you satisfy all those conditions, you declared or - I think the judgment, in my mind, says they are necessary but they are not sufficient, that the relevant parties - the NCC and the tribunal - have to make sure that all those conditions are satisfied in respect of declaration; that they are not all the matters that they consider. They must actually tick those boxes before they can - and they all have to be affirmative, and then they have to consider the other matters relevant to a declaration application.

So I don't think - they're, I think, the issues that we will face going forward, but it seemed to me relatively clear in the judgment about those matters, and particularly, as I say, in conjunction with the changes that have been made to Part IIIA. I think there will still be a requirement for the integrity of the process that has to be considered in Part IIIA, and that will mean that matters that previously were considered will still have to be - there will be a range of matters that will have to be considered in addition to what might be a relatively simple ticking of the box, which I think - you're right, if it was simply a matter of just those four divisions that had to be judged by.

MR POTTS: We'll have to wait and see, I guess, but this leads into another questions, and the question relates to whether the airport would consider, in the light of this decision, going down the undertaking route, and I think I know what the answer to that question is. But let me preface the question by saying that, in one of the public submissions we received from Qantas, which is on the web site, I think they made a fairly direct threat that, if the approach that they were recommending was not adopted by the government - and, by implication, they're suggesting that it's

an approach that we ought to recommend to the government, and then it's a matter for the government to decide what approach it adopts; but if that approach were not adopted, they would move to get the airports to declare, in the light of the FC decision.

MR CRAWFORD: In terms of an access undertaking, I think, my view is that it would be entirely premature for us to move to an access undertaking now because we've still got the object of commercial negotiations between the parties . I think the access understanding, as it works, still puts a significant body in between the commercial parties.

In respect of, as we say, the Qantas threat, it seems to me that declaration is not something you apply for. There is a process of declaration where parties have to negotiate in good faith, though there is conduct, in a sense, about declaration. There has to be shown that the parties have tried, in good faith, to reach commercial negotiations and that has failed. Now, if the intention is to say we're not going to negotiate, then it seems to me that it's not that easy to do. There has to be an attempt to negotiate and that would be part of the conduct that would come into considering whether a declaration would apply.

So I think it doesn't automatically mean that you can just jump to Part IIIA. It has to be in respect of a an access regime or an access that has been denied, in which case the airports aren't talking about denying access, they're talking about the conditions of access, and it would have to be clear that those conditions of access have been unable to be agreed between the parties. That requires that there's been before that a genuine attempt on the parties to actually reach that commercial agreement.

Part IIIA is not meant to be, as I said, other than an experiment. I think the drafters of Part IIIA recognise that there's a risk of regulatory failure - a significant risk of regulatory failure - and that the use of Part IIIA should be used sparingly, where there is a very very clear indication that all the other alternatives have been exhausted.

MR KATZ: It's probably worth adding as well that even after declaration, there's a presumption that the parties will negotiate. So there's another reason, really, for Qantas to come to the table to negotiate prior to declaration, rather than waiting for declaration and then coming to negotiate.

MR POTTS: Yes, but declaration has certain implications for the process of arriving at a final decision. It's important in each case, if you can't agree, and it goes to arbitration by the ACCC, which is not part of the commercial framework prior to Part IIIA being applied for. There's a significant difference in terms of the process.

Can I take it then, and this is kind of an important issue for us, that in your mind, in the light of the Federal Court decision, you think that price monitoring is still a viable regulatory framework.

MR CRAWFORD: I think it is, yes. I think very much so, and to the extent that - and I think we shouldn't consider it, as I say, without the other changes that have gone ahead, apart from the SACL decision in respect of Part IIIA. Some of the concerns about the time limits of decisions have been addressed quite separately from what's going on here, and that's really a very important thing. To the extent there's been clarification about what one section of it means, it provides less conjecture around that, but I don't think it limits the effectiveness either of Part IIIA nor of the potential of a price monitoring regime.

MR POTTS: Could I ask you a question about the usefulness of price monitoring, in the longer term framework. You're suggesting that we extend, I think, the next period beyond five years - perhaps seven. I guess the question is to what extent do you see price monitoring as an arrangement which could continue indefinitely - if you like - or do you think it's a transitional arrangement before moving towards just a more commercial one, that's just based on Part IIIA, as the backup, if you like; or perhaps, depending on how things unfold in the next five or seven years, resort to something that's got more regulation to it. Something, perhaps, more akin to the system that operates in the UK, for instance, with the major airports. Could I ask you that question.

I think in your submission you're also making the point that suggests that perhaps it has some more ongoing purpose, and that is it provides some public confidence and exposure to what the airports were doing, by way of their charging policy and conduct.

MR CRAWFORD: The first comment is really in the context of doing five yearly reviews, and I don't know that we have five years of this regime and then we revert to five years of a different regime, then have a look at it in five years and do another one. I don't think that's a good expectation to build up, and I would think one thing you could be mindful of is breaking the circuit of doing that; that we're just going to do this every five years and we might do it. That's one context about five yearly reviews.

The other context of it, though, is having some confidence in the way the eventual outcome will be. I've got confidence that we need to move progressively towards a position where the commercial negotiations can be trusted enough between the parties to deliver the outcomes that are required. I don't think that happens with the backdrop of some pricing principles, and the monitoring of the price in

principles, as distinct from the price - this is really what we're talking about - I think can be an ongoing process because I think it is important for the reasons we mentioned to do that.

The review of the whole regime on a regular basis, I don't think we should move to a position where we don't have to do that, as to whether price monitoring or some other form of regulation should take place. I think Part IIIA, if it gets to the point where the behaviour is seen to be unsatisfactory, will be a constraint on our behaviour and an available course of action for somebody who wants to take an alternative course. So in the longer term I'd see the capacity to have to do away with the idea of reviews of what it would be and the need to break the cycle of five yearly reviews, but also be underpinned by a set of pricing principles that are very very clear about what has to be done in terms of the negotiation framework, I guess, for those commercial negotiations.

MR TICEHURST: Just to add to that, I think the commercial negotiation process is still maturing, but I think we've come a long way in the last four years in terms of that process and we're certainly very strongly committed to that. In terms of the process going forward, I think there's real opportunities for us to develop with the airlines some additional measures; for example, service level agreements and those sorts of things. I know they're very keen on doing that, and we've certainly indicated a preparedness to talk to them about some of those things and this ability to get those things agreed between the parties and going forward. We will continually refine and mature that process, which in my way of thinking should get the government more comfortable going forward, and that parties will really develop something that was always the government's intention, that these commercial agreements would be much more mature.

MR POTTS: I think there's a specific suggestion that the next period be seven years instead of five years. Is that because - and I got this in the introductory comments - you think that would allow two multi-year charging agreements to be negotiated, rather than one. I mean, one disadvantage of it being seven years is that it would then be 12 years in total for price monitoring, which seems quite a long period of time to be making a judgment about the system going forward. But from your point of view, the real advantage of the extra two years is that it would allow two multi-year agreements to be negotiated, and perhaps increase the probability of moving away from the sort of gaming that seems to have been taking place in the last five years, where there doesn't seem to have been a lot of genuine commercial negotiation on charging that hasn't been based on previous ACCC decisions. Could you just elaborate on that for me, to make sure I've got that clear in my own mind.

MR TICEHURST: I think you've actually summarised it extremely well, that you need to have that period of time. Really, when talking about five year regulatory

review we're only talking about four years because the review is activated 12 months out from that time. So it doesn't give you a whole lot of time to cement these relationships, whereas taking it beyond the five years gives you the ability to really have that relationship develop, and a reasonable period of time for the relationship and the monitoring to take place.

MR KATZ: Can I just check. You mentioned the 12 years for price monitoring. I think the suggestion is that you'd conduct a review after seven, so it's there we've got a new enhanced regime this time around, you would conduct a review after seven or maybe eight years, and then you'd make a decision as to whether the new regime is working or not. So in that sense, it's not 12 years, unless you count the part that we've already had.

MR POTTS: That's what I was counting on. We've had price monitoring for five years. You're suggesting that it be tweaked a little bit.

MR KATZ: That's right.

MR POTTS: I think most people would say you're suggesting that it be tweaked and I think, perhaps, those are words that you'd use. So if it went for another seven years, it would mean that we've had 12 years of price monitoring.

MR KATZ: Yes. I guess the concern really is that if you just have five years and only one round of negotiations, you may again conclude that there's insufficient evidence to make a judgment one way or the other.

MR POTTS: I can understand that point of view. I think going from 10 to 12, I don't think, in a policy sense makes a lot of difference, but if it means that you're going to have an extra round of negotiations or charges going forward, then it can make a difference. That's my point.

MR CRAWFORD: I think you've picked upon the key point about this, is that the process we're going on in here is about conditioning behaviour; to achieve an outcome. It's not just about a set of structural things, by which we've managed, about conditioning behaviour, so that people actually behave in order to reach commercial outcomes. That's the context also, I think, of the series of five year ones, of what sort of behaviours does that encourage as distinct from it going to a seven year time frame, and what sort of behaviours does it encourage to try and reach the goal of commercial negotiations.

It's the issue about behaviours, as the issue is about compulsory binding arbitration. It's effectively an issue about behaviours. Is that going to reinforce the behaviours that we want to go forward in respect of achieving commercial

negotiations between the parties.

MR POTTS: Just on the dispute resolution issue, I think I can say fairly that this is probably the area of the inquiry where there's the greatest divergence of views between the airports and the airlines. Despite our invitation for the parties to come forward with what they think would be a workable solution, a concern that we have, if it becomes too prescriptive that essentially turns you back to - even if you want to call it a light-handed regulation, it will turn you back to heavy-handed regulation. So despite that invitation, I don't think anyone actually took it up, which you can interpret it in a number of ways, I suppose. One is that perhaps there isn't a solution to it, that if you are going to put rules around it, that inevitably it will mean that there will be problems and you'll be reverting back to a more prescriptive arrangement.

Your own airport rules clearly won't count and stay in that position, but you might want to comment on the observations that I've made. Also, are there any elements that you think could be looked at which would still allow you to operate within a commercial framework, which you're recommending, but which would perhaps move the current arrangements forward?

MR CRAWFORD: I'll just make some opening comments on it and I'll let my colleagues discuss it. I think we're talking about two different levels of dispute resolution, I guess. Once we've reached agreement with a party for a five year agreement, we have, under our current agreement, dispute resolution procedures within those agreements. We would expect, like any commercial arrangement, that you would have those within the agreement. So that's not the dispute resolution we're talking about. We're talking about the - - -

MR POTTS: New agreements.

MR CRAWFORD: - - - new agreements as a framework to do it. I mean I don't think that there is an easy solution to it because - and I don't think whichever position you put in place it will actually solve the issue because we don't have a deep price discovery mechanism here. We are going to have to negotiate between the parties and reach agreement between the parties about something where it will be the result of a negotiation. There is no real external other market that you can look to to find out whether you've got the right price in it altogether, and that's why I don't think there will be a - all the compulsory arbitration does is actually bring the process to an end. I don't think it actually enforces agreement between the parties and actually gets the parties into any better agreement than might necessarily have been the case.

I think it is entirely premature to move towards putting that thing in place now with some form of arbitration to it because I think it will be because - I think it will be used because they are difficult negotiations. If these negotiations in relation

between these parties are going to mature, that is one of the key things that the parties have to work on is how to actually come to agreement between two parties when we know the negotiations will be difficult. I don't think it's unique to this industry. I think it happens in other industries and they face it without having to resort to somebody else to go to arbitration.

So that's why I guess we haven't added anything to it because I think it is premature to do that, to do it, and as I say I don't think - you would have to make the argument what is unique about this industry compared to other industries where other industries go through much the same difficult processes of negotiation and still have to reach commercial outcome at the end where you walk away and each party thinks they've got something on the table, and you can't really judge that because there's no other way to really discover it through the depth of prices in the market.

MR POTTS: I guess the argument of the airlines is that airports are natural monopolies and that's accepted, I mean that's why these arrangements exist of course. If there wasn't any monopoly power to curtail, then you wouldn't have these arrangements, and the argument is that the countervailing power that's on the other side of the table, if you like, is significantly less so there needs to be some redress in order to achieve satisfactory outcomes.

MR CRAWFORD: I think there are a number of things that push us towards having to reach agreement. It's not just the countervailing power, it's economic interest. I mean there are a couple of problems to why you actually have to reach agreement in the end, and I think they're the two most powerful, there's the countervailing power and the mutual economic interest, and I think it doesn't - to my mind the asymmetry is not significant enough to actually have the level of intervention because I think practically we know what the form of intervention will - I think you've probably identified practically what will happen with that when you've got that intervention if you intervene in the market to get this resolved, and I don't think the asymmetry, if it exists at all, would be sufficient to justify the intervention in terms of - which would in turn be a compulsory binding arbitration, and if we go to a compulsory binding arbitration under price monitoring I'm not too sure then that Part IIIA presumably becomes redundant because you've effectively got what - you'd be defining what the principles of the arbitration would be which I think are defined anyway under Part IIIA.

DR BYRON: I saw a recent article while I was in Perth last week about the rapid expansion in traffic at Perth Airport, particularly because of the mining boom and fly in-fly out and all the rest of it. Could you tell us a little bit about general aviation use of Perth Airport, we've been talking almost exclusively about scheduled RPT, and have there been significant changes in the GA use of Perth Airport over the last few years, and are there factors there that we should be interested in?

MR CRAWFORD: Let me introduce it and then I'll pass it to Wayne to continue. Yes, there has been - we're thinking of changing the name from general aviation because it really doesn't properly describe what's going on and we're tending to call it resource and regional based charter services because they're not small aircraft, they're jets that are operating. In terms of growth - in terms of relative size of the market we've got roughly 5 million domestic passengers, 2 million international passengers, and there are probably about 500,000 passengers that are carried to mine site and back under what we've called general aviation, so that's about the relative size of it.

In terms of growth, the total aircraft movements, I think September - September is up 60 per cent, 50 to 60 per cent, and the nature of the aircraft being used has significantly changed. We have signed up one of the GA carriers to actually start using one of our terminals. It's a nice anecdote I use. What used to be the former Golden Wings Lounge is now a mobilisation and demobilisation area for people flying to mine sites so the Golden Wings Lounge has turned from suits to steel caps. It's a sign of the times of what's going on.

So the issues of - we are facing the issues of the size of aircraft that's being used, the requirements of aircraft being used, whether there's going to be a change in the nature of security requirements that are required where you actually might be able to get some significant cost savings by using a common user terminal compared to what's used now is company-specific hangars, and it creates certain issues for us, mostly in timing because they're very peaky in terms of their time. They fly out from 6.00 till 7.00 in the morning, come back from 3.30 to 5.00 in the afternoon.

So it's a very significant growth area and we are going through a series of negotiations with those parties to see the extent to which they want to use a common user terminal for the larger aircraft, for the fly in-fly out operations, and how we can integrate more fully the GA areas into our other requirements that come with that in terms of parking, a whole range of - and the form of retailing that might be required for people who are coming back from the mine site to do their convenience shopping before they head home; a whole range of issues that are causing us to have to review GA.

DR BYRON: I was reminded by the comment about how your landing charges haven't changed in the last two years, and I was wondering if the significant increase in that sort of regional mine site traffic was giving you far better capacity utilisation of the runways basically, but I hadn't thought of that peakiness that you just referred to, whether that actually creates more of a problem rather than a solution in terms of capacity.

MR TICEHURST: Just to add on to David's comments, certainly there's been a

pretty significant uplift in activity from the regional carriers. They are a very important part of our consultative process. The Skippers, National Jet and Maromba operators, which are the three major ones, are a very key part of those processes. We do keep a constant dialogue with those guys in terms of their plans and their operations.

The growth we've had on the domestic side has really been, I guess, in conjunction with the GA, the catalyst for our decision to keep the airfield charges constant so - we've also had the growth on the domestic capacity, but the comment about the peak charging or the peak period, one of the things we're obviously looking at is how do you influence behaviour in terms of being this peak time we have in the morning, and we're certainly looking at strategies as to how we can do that.

One of the things we're looking at is the opportunity of a discount; rather than a peak period surcharge, which I don't necessarily think works, it's actually doing it the other way and offering the carrot to provide a discount for charter operators, particularly who would operate off that peak, to try and move - not all of it obviously because it would create a different peak but some of it into that shoulder period or another period. So it's certainly something we're turning our minds to.

MR POTTS: You raised a couple of issues. I think you were looking for a response. I'm not sure whether it was now or later, but we'll certainly be picking them up later. I think the first was the meaning of asset values agreed with customers. I don't want to be too precise about this, but the principle behind it was that if you're going to have genuine negotiations about charges going forward that apply to new investment, then there presumably has to be some understanding of what the valuations are of that investment to arrive at the charges. So that was what was implicit in the comment, that there are some detailed aspects that we need to look at, and we can certainly do that.

That was one question. The other one was Qantas leases. Again, I think this has been raised by a few airports, and it's something we'll need to think about, but we would do so against the principle of whether the airport has market power or not, and that's a fairly clear principle we have set out in the report in trying to draw the line between those services that are in and out of the price monitoring arrangements. We're interested in services being in where there's a lack of competition in the provision of the services. So, look, I can't be too specific at the moment particularly in this sort of context here, but that's to give you some idea of the framework against which we would examine those issues.

DR BYRON: Thank you very much, very helpful. We'll take a break now. Can we reconvene at 11.15? Thanks very much.

MR POTTS: Well, we might get under way again, if we could. It's the turn of Brisbane Airport Corporation and I welcome Tim Rothwell. Tim, could you just please for the record state your name and the organisation you represent.

MR ROTHWELL: Tim Rothwell, Chief Financial Officer of Brisbane Airport Corporation. Thank you, Gary. We welcome the Productivity Commission's draft report in view of price regulation of airport services. I think the privatisation of Australia's airports is recognised as one of the most successful processes in the world in terms of the sale proceeds received by the government, the regulatory frame work established and the post-privatisation results, in particular, the quality of service at the airports and more recently the appropriateness - and that's an important word - of the levels of investment and the general improvement of airport airline relations.

A lot of players sent in submissions about the level of investment but I think the important point is that airlines and airports are talking together and they're agreeing appropriate levels of infrastructure, which they certainly didn't used to do. Though airport relationships have been hampered by regulatory uncertainty during the early years - and still, as the commission points out, by lack of clarity or perceived fairness in relation to a number of matters, and they're principally the definition of aeronautical services - and that's only at the margin, really, and the appropriate asset values to be adopted for pricing purposes; and now, perhaps, the issue of rates of return which were to some extent - seemed to be stable previously.

The commission's report attempts to address these matters, encouraging further investment by airports and potential improvements in airport-airline relationships over the next years. The BAC has already announced a ten-year forecast program of investment in terminals, roads and runway infrastructure. Certainly that may go out to 12, 13 years. But over that time period we're looking at around $2 billion of expenditure. Without certainty on these issues, in particular, financial returns, that investment will simply not proceed.

Whilst the BAC may have preferred a couple of different recommendations in some areas, it recognises that the draft report is a balance of the practical and the theoretical to enable the industry to move forward. This submission that we've put in addressed the draft recommendations, and in addition provides additional information to the commission to refute some of BARA's assertions in their recent submission. We've pinched this quote from the Department of Transport submission, page 11, "Clear pricing principles and guidelines are needed as a basis for commercial negotiations to establish pricing outcomes that are fair to both parties." I think that's the critical issue the commission is asked to look at.

We certainly agree that clear guidelines on asset valuations and rates of return are important, and, really, we don't think this is that complicated at the end of the day. I think importantly, if there are threats of arbitration, the Productivity Commission's views and those of government, may well play an important part in that arbitration process.

For the record, BAC historically, and in the future, only ever seeks to achieve fair outcomes in negotiations with airlines.

I won't comment on each of the draft recommendations. I'll just pick up on perhaps two or three that are more important and I'll later go on to talk about BARA's submission, if I can.

On the issue of the definition of aeronautical services, I think we support the change. The main change will actually result in additional services, principally those that were formerly the subject of a Federal Airports Corporation lease, license or authority, prior to privatisation, now being treated as aeronautical, and that's contrary to the government's stated intention at the time the airports were sold. This change represents a potential rent transfer to airlines at the expense of airports, but in the interests of moving forward, BAC supports this proposal. We do however believe that further work needs to be done by the commission and DOTARS to ensure there is no further confusion, which we think there still is.

We detailed a particular issue that concerned us. One is the - I don't know where this came from - the idea of regulating telecommunication infrastructure, which is already regulated by the Telecommunications Act anyway, and the second one, which Perth raised, was the issue of the domestic terminals; as to whether they are in fact intended to now be aeronautical or not. Subject to that though, we're pretty well happy with those changes. On the issue of the suggestion that the government should consider asking the ACCC to monitor charges for carparks, I guess the market power of airports in relation to public carparks is no different to that at hospitals, rail stations or CDB carparks.

There is no reason why airports should be singled out for price monitoring. Airport carparks compete with taxi, limousine, bus and train services and significant off-airport carpark operations. Should the government accept the commission's recommendation, it is appropriate that other carparks be included to ensure that airports are compared to owners of similar assets with similar market power, rather than in isolation.

On the issue of limiting the ACCC's quality of service monitoring to written comments from airports and their customers, I tend to agree with Perth. The quality of service monitoring to date has demonstrated that the airports do have a high

standard. There are always shortcomings in those sort of reports but I think it would be a mistake to discontinue those because I think they provide clear evidence that there is a quality of service at airports that's being maintained; absent those reports, it opens the way for all sorts of allegations about how good or bad service has been.

In relation to the recommendation about future review principles, I think there's little guidance on how the benefits of improved productivity might be shared between airports and airlines. Perhaps some more clarification is needed there and the issue of future asset revaluation is not providing an unfair windfall gain is fair enough, but think that over the period of a 99-year lease, I think the issue of whether it's appropriate to look at nominal returns on nominal assets or real returns on real assets needs to be looked at as you get further out into the 99-year period. Nevertheless, for the purpose of this regime, we'd be happy to see a line in the sand drawn.

In relation to recommendation 6.1, which goes to the issue of how you value aeronautical assets, which as far as we're concerned is the key issue in this debate, it's clearly a compromised proposal that's been put forward, and we're happy to support that compromise, although it will generate issues with airlines where they see that the basis generates different bases at different airports. There are clearly four logical dates for establishing an asset base of price and profit monitoring purposes. The first would be when the airport lease is required, so July 97 for Brisbane, Melbourne and Perth, July 98 for Adelaide and Canberra and July 2002 for Sydney. That makes inter-airport comparison difficult. A second date would be the date that airport charges were deregulated; July 2002. That would enable a fair comparison between different airports. A third date would be the date that international standards effectively came in, which would be July 2004. Another date would be the start of that regulatory period.

Given the different accounting treatments at different airports, BAC proposes that if not already available, there be a clear line in the sand valuation undertaken for each of the price monitored airports and this valuation be undertaken or depreciated up to major replacement cost approach, which is consistent with the ACCC's approach to electricity transmission, regulation, and that company (indistinct) the regulators.

There are two issues again which I've already mentioned, I think, that require a bit of clarification. Whether it's the commission's intention that asset value should be grown by an appropriate inflation measure to reflect the time value of money and the issues of values agreed with customers I think is an important one too. It leaves open the possibility that an airline or airlines that do not have any expansion plans, at a particular airport may seek to block that expansion by refusing to agree the value of or the need for an investment, for no other reason than strategic competitive

behaviour. So we'd prefer something along the lines of "at fair value" supported by independent cost consultants or similar.

Bearing in mind that airports have an obligation and a strong desire to work in good faith with airlines and develop infrastructure - proposed, that are operationally and cost efficient, but ultimately the airport has to decide, is obliged under the airport lease to provide an appropriate level of capacity and quality at the airport to meet market demand. In terms of an airport-specific arbitration regime, I think to some extent the cry for that is simply because there is not clarity on the asset revaluation issue. I suspect if there were greater clarity on the issues that are dividing airports and airlines, then that becomes less important.

For your information, we've included a copy of the dispute resolution procedures in the Brisbane Airport aviation and service and charge agreement. Those terms were agreed to by BARA on behalf of its members and Virgin Blue. I'll come back to Qantas later. Personally, I'm not too concerned about BARA's suggestion that DOTARS should play some sort of role in the event of a dispute, providing genuine negotiations have occurred first. I'd now like to turn to the comments by BARA, and to some extent IATA and others in relation to our post-2007 pricing intention. A number of concerns that we intend to use asset revaluations to justify significant price increases; the facts, as is often the case with BARA submissions, their newsletters are quite different.

It's disappointing to see BARA's attitude change so rapidly. We believe we have a good relationship with BARA, but that appears to count very little as long as BARA can keep prices down. In 2005, BAC was awarded the IATA award for the world's best privatised airport based on its good relationships with airlines. We're a principled organisation that chose in 2002 to negotiate lower charges with its customers - that most airports on the basis that we would over time move towards a fair return on the investment in Brisbane Airport. As compared to some airports, it did so immediately in 2002.

Rather than being commended for this approach, BARA has taken the opportunity to try to ram Brisbane in the eyes of the commissions as an airport that was behaving unreasonably, simply because it expected to continue to move forward towards fair pricing levels over the next few years. It appears that BARA is less interested in the principles of commercial relationships, looking only for any outcome that delivers low airport charges for its members. It's revealing in fact to see that BARA appears to see fairness as inappropriate. Page 17 of their submission, "Indeed Brisbane Airport's main argument is not economic efficiency but fairness." BARA clearly believe it would be unreasonable for prices at Brisbane to be fair, but reasonable for BARA if prices are low.

Whilst all this is not something we would have wanted to waste the commission's time on, I think it's important that the commission is not misled by some of the comments, particularly in BARA's submission. A brief history of our negotiations may assist the commission. In October 2001, we provided BARA and the major customers, with information on what it believed to be fair prices based on the principles and levels of return that the CA deemed appropriate. BAC in fact negotiated a lower price with the airlines, compared to most other airports, with prices increasing by a further 5 per cent each for the next four years, in a step to move towards fairer pricing.

Whilst BARA and Virgin Blue, who were not a member of BARA at that time, reached agreement with BAC, Qantas was not prepared to agree on the same terms and conditions. Instead, they required additional terms, a number of which were perceived by BAC to be anti-competitive. BAC was not prepared to discriminate between airlines and provide special terms, including imposing domestic passenger based runway charges, and a number of others for one airline and disadvantage others. In any event, Qantas has paid charges and were pleased to accept growth rebates, and have acted generally in accordance with the agreement since 2002.

Consistent with its five-year agreement, BAC in 2006 proposed to the airlines that the price be increased by 5 per cent per annum from 2007 for the next five years, and for major new investment adopting ACCC and NNAI principles based on a 10.8 per cent return. BARA and the airlines rejected this proposal, despite the fact that BAC was still not achieving a 10.8 per cent return, on that there was enough licensing or on a cost basis.

Indeed, they certainly indicate they want a five year pricing agreement incorporating all four past projects in a period. It was to deliver a constant rate of return of 10.8 per cent over that period. As BARA indicated in a recent email to the BAC, the apparent adoption by BAC of the notion of a NNAI type price adjustment within such a terminal is not acceptable to airlines. NNAI type adjustments to charges seem an answer, relative with a CPI-X price regime. They do not belong in the current pricing regime.

You would be aware that airlines expect aero charges to be reassessed about every five years of the term of their contractual agreements. The base of that reassessment is the asset value at the commencement of the agreement, determined by privatisation date, asset values, depreciation going forth, plus additional disposals, the value of the capital program over a term, the commercial agreement and efficient operating costs. The aero charge going forward and the costs incurred for the projects should be set on this basis.

This approach advocated by BARA in fact generates higher prices for special

international airlines and those prices proposed by BAC in the first place. Consistent with the government's intentions of airports and achieving a commercially negotiated outcome, BAC have indicated their willingness to adopt the airline's preferred pricing with the methodology.

Whilst we are yet to receive a formal response, the information provided by BARA has again indicated they are now not happy with the proposal either. Their concern is now switched to how we have established this cost of assets in Brisbane Airport. The view may be based on some incorrect information in attachment 6 when we dealt with our submission to the commission, which states that BAC's assets were revalued in 2000. That's only part of the story. Indeed, we'd informed BARA of this fact back on 15 September 2005.

In fact, the situation was similar to Perth Airport, with the 1997 breakdown of the airport purchase price restated in BAC's 2000 annual report, based on independent external evaluations for certain assets. It was not undertaken in detail in 97 and 98. I won't go into the full detail unless it's in the submission. But all evaluations were undertaken by appropriately qualified external valuers; evaluations supported by those evaluation reports. Evaluations were reviewed and signed off by various directors and external auditors, and copies have been provided to BARA.

I'm sorry to dwell on this, but I think it's important in terms of the context of BARA's comments, and Virgin's and Qantas's. BARA also contends that Brisbane Airport's financial returns are excessive, that increased prices are not justified; often quoting Melbourne Airport as one airport with fair return of assets. We provide in the submission a comparison of returns of Melbourne Airport and Brisbane Airport based on the cost of assets, based on the 2 July 97 evaluation. In the case of Melbourne, they're generating currently about a 14 per cent return - this is based on 04/05, which is the last data we have - and in Brisbane's case around 4 per cent. So it's very hard for us to understand why BARA has chosen to single out Brisbane, other than an attempt to try and keep prices below fair levels. It's really hard to understand why they see that our returns are excessive compared to other airports.

Perhaps just a small number of other comments that were made. BARA says it is critical the commission makes clear its expectation of future pricing behaviour by Brisbane and Canberra Airports. Both airports are likely to implement further price increases for existing assets based on their 30 June 2005 asset values. So that's a reference to the commission's proposed compromise date for establishing assets. Now, that doesn't make a significant difference to the reliable revenue.

Page 7, BARA claims that the commission's method mechanically gauges hundreds of millions of dollars in rent when used in conjunction with its Brisbane's 30 June 2005 asset value. It's just plain nonsense. Adopting the proposed

compromise, that is June 2005 asset value as opposed to a 1997 asset value as the base, would have perhaps a difference of around 6 to 7 million dollars of annual rent; hardly gouging hundreds of millions of dollars of rent. Brisbane Airport has clearly given its intentions to significantly increase prices for existing assets in its next pricing agreement. In fact, it is BARA that's requested an increase on the basis that will deliver low prices that we'd already offered them, are a lower price path in the first place.

BARA considers that under the Productivity Commission's proposed rate, the only meaningful numerical measure of pricing is going to be the pre-tax return of assets. We agree with BARA's views on that. So it goes on. I really don't want to keep going because I think you've got the flavour that we're not too happy with BARA's submission in terms of its accuracy or its slant.

A couple of other comments that have come through from either presentation this morning, or indeed in BARA's submission. The issue that the rising passenger numbers should result in lower prices to airlines is clearly a valid one, but I think the point is that the pricing that exists at an airport is based on current forecasts; so if forecasts are actually lower than current forecasts, one would expect prices to rise in the next review. Conversely, if traffic is higher than current forecasts, one would expect prices to fall. So just because there is growth, it's not a reason why prices should increase or decrease.

I repeat, BAC have not proposed increasing prices based on assets that have been revalued beyond 2 July, which BARA has copies of. We'd support the issues that BARA have raised in relation to firefighting services. We're clear that prices there have been set. Some major airports are subsidising smaller regional airports. We have no issue with that, it's government policy, but I don't think privatised airports should be expected to foot the bill for fire services at airports. Our rough calculations are that Maroochydore Airport, for example, which competes for domestic passengers, pays one-tenth of the charge it should for use of firefighting services.

In terms of service level agreements, we gave an undertaking when we reached agreement in 2002 that if there were any issues in the five year light-hand period where service levels were not acceptable to the airlines, we would take immediate action. We have not been notified of any concern under our current agreement about service levels, and we will continue to provide a level service the airlines require at Brisbane Airport.

Service level agreements, if they're meaningful, that's fine. If they're simply penalties against a particular airline they're quite difficult, because I guess the process of processing passengers now through an airport is quite complex, and the

reasons, for example, for delay may be a function of other airlines, of customs, of quarantine or whatever it might be - mechanical problems or whatever, baggage issues and so on. So we don't have a particular problem if the airport is generally responsible for those problems, but it's quite hard to get to the bottom quite often.

We don't want to develop agreements that are based on conflict models. Our preference is to work in partnership with airlines, not to develop agreements that result in constant fights. In terms of countervailing market power, I mean, I think Qantas's threats in terms of the commission perhaps gives an indication of who has market power in this situation. Certainly, the negotiations with those at Qantas, they were very keen to get conditions they wanted; and without those conditions we're not prepared to negotiate, even though the terms seem to be eminently reasonable to BARA and Virgin Blue.

In terms of natural monopolies, I'd just like to dwell on that for a second. There's no doubt at all that a major airport in Australia is at some level a strong natural monopoly, however, at the margin an airport is not a monopoly at all. What will invariably happens with airlines nowadays is they will approach an airport - Emirates would be a good example - to say they have a triple (indistinct) on the production line and they can fly anywhere in the world, so what's the deal. They have all sorts of options open to them, and you certainly see that with the way Virgin negotiates and with the way Jetstar negotiates, where they will do their level best to try and get the best possible deal out of every airport, and they do have considerable market power at the margin. So if airports are to thrive in terms of profitability, it's not just a core level of business, it's actually attracting business at the margin that's very important.

There's also quite a lot of play made of a Allen Consulting report. I think we have in our submission, I think, for all attention, to an earlier submission of theirs which seems to strongly support the idea of using DORC as a basis for setting asset prices of existing assets, I think in an early Electricity Commission matter. Perhaps the commission could check that to see if that seems to be at odds with the current recommendation. I'm sorry I'm rabbiting on a bit, but I guess in essence we welcome the commission's draft report, and we would be happy to clarify any of our comments later if that's helpful. I'm happy to take questions.

MR POTTS: Thanks very much, Tim. It's very helpful those comments, plus the submissions were very detailed as well and addressed the recommendations individually. That was very useful for us. Perhaps I could just begin with the general question of the relationship between the airports and the airlines, which you - I was going to say touched on, but I think you did more than that, I think. You elaborated on it in some detail.

In trying to bring that issue into the nature of the regulatory arrangements that we have going forward, we've had five years of price monitoring now and the draft report suggesting that it be extended for a further five years, do you think that it's going to provide a satisfactory framework, particularly if we address the asset valuation question, which you said you think is the key issue, as I wrote it down, I think, in helping the commercial process. Do you see that if that is done, that price monitoring will be a workable arrangement over the next five years, and that in time it will be possible to dispense with price monitoring and then perhaps just rely on commercial negotiations, backed up by Part IIIA, or do you think that price monitoring will need to continue indefinitely, or do you think that there's a chance of perhaps the system might be tightened even further?

MR ROTHWELL: I think the key issue in our view is having a clear statement of what is seen to be fair in terms of pricing and profitability on aeronautical assets. Clearly, absent to market there has to be some sort of parameter established. I think the commission's last review went a long way to achieving that. I think the only issue is really what is the asset base for pricing purposes. Now, I think the airlines have had a significant win in this review, in that the commission has come down in favour of a historic cost approach to assets. If you look over a 99-year period, to get a 10.8 per cent return on a runway that was perhaps worth $300 million in 1997 is quite different to getting an 8 per cent return - a real return - on a runway that might be worth $2 million in 20 or 30 years' time. So the principle of adopting historic costs, which the commission supports, is a significant win for the airlines.

I think the establishment of the cost base is critical; and once that is dealt with the next issue that would be relevant would be rates of return. The commission has invited the idea that rates of return could rise. I tend to agree with Warren Bennett at BARA that that will create more tension between airports and airlines; and whilst not suggesting that should never be looked at, I think that may be something to be more appropriately looked at in five years' time and take an area of dispute off the table. I don't know whether my fellow airports would agree with that one, but I think it's unnecessary to introduce disputes that don't really exist at the moment.

Although I would agree with the views of the commission - I think the risks have changed over time; increased numbers of low-cost airlines, higher security risks and so forth. So I do think the risk profile has changed, and I agree with the commission's views. I think it's perhaps better though to leave that until later. Having dealt with those two, then I guess the issue that is very important to the airlines is arbitration and what happens, and I suspect if you deal with those two properly in a way that airlines and airports see as fair and reasonable, the reasons for dispute should go away.

There is ample market tension to encourage airports to invest appropriately in

investment - it's not in Brisbane Airport's interest to invest in a Howler runway any earlier than we need it. Indeed, in many ways the later we can push that back, the better the financial returns for Brisbane Airport Corporation. So the airlines and airports are allies in trying to make sure that appropriate investment occurs on these big projects. So there should not really be issues - other than game playing, where a particular airline might not want to expand at a particular airport. Other than that, there should be no issues really between airports and airlines on major investments.

So I think really what is a fair return on the current asset base is perhaps the key issue that divides ourselves and BARA, and if the government will support a particular position. Even if we don't necessarily like that position, I think that will move things forward a whole lot further. I don't have a particular problem, as I said, with the idea of BARA to have the Department of Transport involvement in dispute resolution, providing there have been genuine negotiations on both sides. I suspect however, that if you get the first bit right the dispute resolution issue will go away.

MR POTTS: Those four options that you presented in your submission and again mentioned this morning on the valuation basis; all of those are acceptable to Brisbane. Is that correct? Perhaps to a greater or lesser degree in some cases. What sort of impact also do they have on - I think you mentioned that the agreement you were trying to negotiate going forward provides for a 5 per cent per annum increase, charges relating to existing assets.

MR ROTHWELL: That's what we initially offered, yes.

MR POTTS: Initially offered, yes. Is that influenced by the asset valuation basis that's changing?

MR ROTHWELL: That would be justified almost regardless of the basis, I think. So one could justify higher charges than those based on the value of the assets.

MR POTTS: So the 5 per cent increase - I mean, we've got the airlines saying that in - we made a comment in our draft report about downward pressure if there's traffic growth on charges relating to existing assets. It was picked up by the airlines in particular, and some have suggested that this should be a pricing principle, perhaps written in different ways. Just to finish, can you elaborate on what - given the sort of passenger growth I think you're having at the moment which is pretty much along the long-term trend, which is 5 per cent plus, I think, per annum; can you indicate on what's driving the 5 per cent nominal increase, which is a real increase in relation to existing asset charges?

MR ROTHWELL: I think the point is that in 2002 we did not seek to get a fair return on the value of the assets involved. We at that stage indicated a lower increase

than could be justified with a move towards a fairer pricing over time. So despite the passenger growth, and particularly in a couple of the recent years, we are still not at that sort of level, and that's the basis for justifying the need for further price increases. I think Brisbane Airport will continue to feel hard done by if it is not making a fair return on its aeronautical assets, and I think that's an essential part, I guess whether it's over time or immediately in 2007, I think that's an essential part of moving forward on the basis of an agreement. Now, we felt we had that agreement to gradually move towards a fair pricing level, but BARA has rejected that and has gone further. So I think on that basis our view is that, you know, we need to be able to move towards a fairer turnover time.

MR POTTS: You are saying, I think, that if you fix the asset valuation question in particular, and the cost and capital one, that should then allow you to move to giving satisfactory outcomes under commercial negotiation. But listening to what you're saying then suggests otherwise. Are you saying that's just a matter of the system being gained at the moment while there's this uncertainty about what the regulatory arrangements will be?

MR ROTHWELL: Correct, correct; that providing the pricing proposal we've put forward is consistent with I guess the government's view on what is fair pricing at airports, then it's open to the airlines, if they wish to, to dispute that. But I guess we would be, as we said from the start, only ever seeking to get a fair return on the investment at Brisbane Airport.

MR POTTS: Could we just move on to the Part IIIA question. I think you were here earlier this morning, so you've heard the questions, but just to repeat it very quickly for the record, just what you see as the implication for the Part IIIA decision for the airport. In particular whether you - depending on how it unfolds, but whether you'd entertain the undertaking, were it for instance available under Part IIIA, as a way of dealing with the issue if it emerges in the way that Qantas has suggested, for instance.

MR ROTHWELL: Well, it's a difficult issue. We looked at ACCC's undertakings a while ago and the problem is you can't really develop an ACCC undertaking unless you've got an agreement. So it's a circular discussion. If Qantas or anybody else chooses to try and get assets declared at Brisbane Airport, then I guess that's their option. We can't stop them. In terms of the recent decision, I don't know that it has dramatically changed the situation. Certainly I'm no lawyer, but the advice seems to be that it's perhaps strengthened the airline's positions, made it a little bit easier to have assets declared. But at the end of the day we have nothing to hide in terms of our negotiations.

If we have to go some form of arbitration then we're happy to do that, but I

guess in order to do that it's important that the commission sets down clearly what the government believes is fair in terms of returns on aeronautical assets, because that would form the heart of the dispute, I guess, that somehow we were abusing our position and trying to get unfair returns. So we have no reason to be concerned if Qantas or anybody else chooses to use Part IIIA against Brisbane Airport. Having said that, it's obviously quite a time-consuming and expensive business and it wouldn't be our preference.

MR POTTS: I think you said that as long as the government sets down what is a fair return on assets. Can you just explain what you mean by that?

MR ROTHWELL: I guess there are all sorts of discussions about what is the fair value of the asset base and what is the fair rate of return. I guess for someone - an airline to demonstrate that an airport has abused its monopoly position, then there has to be some implication, I guess, that we're trying to do something that is unfair in that context; and so clarity on this from the commission I think is critical. The legal case may hinge on all sorts of issues, but I think fundamentally, if we get into a Part IIIA issue, then it will be interesting to see whether that is then the basis for deciding what is fair or whether the commission and the government establish that prior to that. Does that make sense, or not really?

MR POTTS: I'm not sure. I mean, I can understand. I thought the answer was going to be tying the asset valuation and cost of capital together to give some implicit return, if you like.

MR ROTHWELL: Correct, yes.

MR POTTS: But you're implying that it was in a Part IIIA context, if some indicator of fair return would be provided, but I think that's unlikely.

MR ROTHWELL: I mean, the issue is that even the Part IIIA, ultimately the airport and the airlines would be sent back to negotiate. So if those negotiations take place in the context of what the government thinks is fair, the whole process becomes futile because we'll end up back where we started after three or four years.

MR POTTS: That may be something for the courts to decide whether the conduct has been acceptable or not and whether the negotiations have taken place in mid-phase or not - can the government set the policy frame work, you know, through legislation. Then it's for others to interpret that in the final analysis, I think.

MR ROTHWELL: I mean, there are very specific facts as well in the Sydney Airport case that have driven the whole decision. So, I mean, as I say, I'm not a lawyer so I don't particularly want to comment in detail, but I think the facts are very

different in terms of the competitive facts in relation to Brisbane, for example, with Coolangatta and Maroochydore, compared to Sydney Airport which has the rights to develop the next Sydney Airport. So competition is prevented in the Sydney basin, whereas in Brisbane somebody is perfectly free to build a new airport at Coomera. So I think the competitive situation in Brisbane is not the same as in Sydney, and if you go through all the facts in the Sydney case I think there are a number of aspects of the case that are different to Brisbane.

MR POTTS: But you are suggesting if these two issues are resolved, that is, the valuation one and the cost of capital, that you believe that there will then be a satisfactory framework for commercial negotiation.

MR ROTHWELL: Absolutely. Absolutely, and I don't think the airlines would want to go through Part IIIA once those things were established.

MR POTTS: If we look at what the reality has been, I think you said with Qantas, you still - you don't have an agreement, I don't think, for the preceding period.

MR ROTHWELL: We don't have a disagreement either.

MR POTTS: You don't have a disagreement, but I thought you said they were seeking - - -

MR ROTHWELL: Qantas sought terms that we didn't believe were reasonable. We had initially proposed going to domestic passenger based charges for runways, for example; and in discussions with Virgin Blue and Qantas, when we understood the implications on one of our major customers compared to another, then we took the view that we should stick as we were and adopt IATA principles for pricing of those services rather than advantaging one airline compared to another. That was probably the key issue that prevented Qantas from signing an agreement with us or reaching an agreement with us.

There were some others that were in there as well, where Qantas wanted specific terms that neither Virgin Blue nor BARA had sought on behalf of their members, and we did not think that was an appropriate basis to move forward. So we were not trying to have a number of different service agreements with different airlines. We were trying to adopt one standard agreement for Brisbane Airport and we weren't prepared to have a different agreement for one airline.

MR POTTS: No, look, I understand that, and that's a purely commercial issue. But it's just whether the changes in the two key issues that you mentioned and you said would rectify the current problems and allow these commercial negotiations to occur properly and to fruition, if you like. Given the experience with Qantas, which is the

major airline of course - it counts for the majority of your business - whether that presumption you're making is a reasonable one going forward.

MR ROTHWELL: I think you have to distinguish between the reality of negotiations and what happens and things that might occur for the sake of inquiries where people can gain to get lower prices. I mean, we have a very good relationship with Qantas. We meet regularly with them. We discuss all sorts of issues. We meet regularly with Virgin as well. We meet regularly with Qantas, BARA and Virgin and we look at the needs of the airport. So the relationships are very good and amicable. The only time it ever becomes an issue is when we start to talk about charges, and as Warren said earlier today, in relation to new investment and the international terminal expansion, that's been a fairly good process.

We've argued about minor things, but that will get resolved. The issue at the heart of it is really what is a fair return on the existing assets of Brisbane Airport, and if we can resolve that I'd be very confident that things will move forward. The other thing is that the market situation is changing. I mean, one of the issues with the whole issue of passenger based domestic charges that seems to get missed out of the debate and that is - and it's highlighted by building a new runway. If you build a runway in Brisbane, you can either allocate costs on a passenger base or a landed tonne base, and in Brisbane's case the impact is quite different. 25 per cent of passengers are international whereas 35 per cent of landed tonnes are international, so international airlines pay around 40 per cent more if you adopt landed tonnes as the basis.

If you adopt landed tonnes as the basis, that is consistent with our principles. Having adopted landed tonnes, there is nothing to stop you then collecting revenue on a per passenger basis, and in fact if you do that in Brisbane, Virgin Blue should be indifferent as to whether we charge - providing the basis is first on landed tonnes, Virgin Blue and Qantas should be indifferent as to whether they have the landed tonne or passenger based charges and produce a similar outcome. So those sort of things are negotiable over time. And I might say just to reinforce an earlier comment, we have dispute resolution procedures and nobody has suggested any dispute between the airlines at Brisbane Airport in the last full year.

MR POTTS: Could I just ask you about those arrangements. There's a process for mediation, I think, by the Australian Commercial Disputes Centre in Brisbane. That's correct?

MR ROTHWELL: Correct.

MR POTTS: Can you just explain the mediation process. When you say "mediated", is that an arbitrated outcome which both parties are required to accept?

MR ROTHWELL: No, the parties are not required to - - -

MR POTTS: They're not required to accept that.

MR ROTHWELL: It's an intent to go to mediation and try and avoid the need for a legal case, but the parties can choose to take legal proceedings if they wish.

MR POTTS: But if it's taken to this dispute centre, whatever decision - well, it's a mediation, I see, it's not an arbitration, that's what you're confirming, and I presume that just applies to matters that arise under existing agreements rather than - - -

MR ROTHWELL: Specifically under the agreement published on our back pages.

MR POTTS: Right, so it's not used, for instance, looking forward to new agreements?

MR ROTHWELL: No, we would not be proposing to change that in the next five-year period unless the airlines want it changed, in which case we talk about it.

MR POTTS: So there's no process within dispute resolution in relation to new agreements going forward that we're not aware of?

MR ROTHWELL: No, but we would adopt similar terms or propose similar terms in the next five-year agreement to the current one. But it may be the airline's view has changed in that five-year period. They were quite happy with those dispute resolution procedures a few years ago. It now sounds like they want to strengthen them somewhat.

MR POTTS: They're trying to differentiate their disputes that occur within an existing agreement and disputes that occur about a new agreement - a new five-year agreement, so that you don't mind the process that would occur, or a dispute that occurred within. That if the problem is about preparing the new contract - the new agreement going forward five years, is there a mechanism for resolving that through third parties or mediation, or is it - - -

MR ROTHWELL: I don't think either party particularly thought about that. No particular reason why not, because I mean, that similar approach could be adopted. It hadn't been requested by the airlines nor had we proposed it.

MR POTTS: Right. You mentioned earlier Maroochydore and the hypothetical - the new airport at Coomera or Beenleigh or Redland Bay or somewhere. To what extent does the fact that you've got Coolangatta to the south and Maroochydore at the

north condition the way Brisbane airport deals with the airlines? I mean, I don't think any of the airlines would unilaterally withdraw all services from Brisbane and put them with the others, but is there an issue that they could reschedule services say from Melbourne to Maroochydore rather than Melbourne to Brisbane? Does that sort of thing play on your mind at all?

MR ROTHWELL: I mean, there are issues, yes. I mean if Freedom Air can choose to operate through Coolangatta rather than Brisbane, it probably doesn't want to operate through two airports there so it could choose either very easily. Jetstar Asia is about to move into new services; it can operate from either airport or in Thai once they've opened their runway. Pacific Blue, Virgin Blue, I mean all of those airlines have options to use other airports and do indeed do so. In fact, the growth at Maroochydore and Coolangatta I think has been quite a bit higher than in Brisbane over the last few years. So there's a natural substitution in the same way that over time, as Sydney airport gets congested and the thickness of routes occurs in Brisbane, more services will move to Brisbane in the same way as routes develop more so services will move from Brisbane to Maroochydore and Coolangatta. So it's a natural process that occurs within Australia.

MR POTTS: I guess I'm just re-exploring the extent to which airlines have some sort of countervailing power in their negotiations with you when it comes to the number, frequency and services or gauge of aircraft or something.

MR ROTHWELL: As I said before, I think at the core of Brisbane Airport or Melbourne Airport or Sydney Airport, there is a core that is clearly very strong market power for the airport. But at the margin there are plenty of opportunities for airlines to choose to use Coolangatta or choose to use Maroochydore at the expense of Brisbane. So they do have alternatives and they do use those alternatives too.

MR POTTS: I think we've covered the ground, Tim, from our point of view. Thanks very much; very helpful. Once again, thank you for your submission and presentation. We'll reconvene at 1 o'clock.

(Luncheon adjournment)

MR POTTS: We might resume the hearings, and I welcome Qantas. Brad, as with the other people who have participated, just state your names to begin with and the organisation you represent; and then presuming there's an opening statement, we'll take it from there with questions.

MR MOORE: Thanks, Gary. Brad Moore, group general manager for Qantas.

MS KADLEC: Jana Kadlec, airport development and concessions for Qantas.

MS HENDERSON: Jill Henderson, deputy general counsel for Qantas.

MS ALBERTON: Jean Alberton, general manager for (indistinct) services.

MR MOORE: Okay, what I'd like to do is go through an opening statement and then onto questions. In terms of introduction, one of the key objectives of the Productivity Commission inquiry is to review the effectiveness of the current regulatory regime to promote commercially negotiated outcomes. In its submission of 21 July 2006, Qantas put forward that (1) airports are natural monopolies, (2) evidence indicates that airports have been using their monopoly power to impose uncommercial price and non-price terms and conditions, (3) airport users have no effective countervailing power, and (4) other than to seek declaration there is no binding dispute resolution process.

The fact that airports are monopolies was recognised by the Australian Competition Tribunal and acknowledged by the Full Federal Court, and I'll quote:

> It is likely that without declaration this issues will either remain the source of protracted dispute, or be resolved by SACL in a manner which is brought about by the exercise of monopoly power, and not brought about by an opportunity for an arbitrated solution. If declaration is made, the environment for the promotion of competition is enhanced in the dependent market because there will be an opportunity for all matters to which we've referred to be resolved by means of independent arbitration more in line with what would be expected in a competitive environment.

In its submission to the Productivity Commission, Qantas has proposed a solution to the imbalance of market power; a core principle supported by an access code. Airports and airport users will engage in constructive commercial negotiation of terms of access to services in good faith with full and transparent information exchange supported by binding independent dispute resolution in the event that agreement cannot be reached.

Access to a binding dispute resolution mechanism will facilitate and encourage both parties to reach commercially negotiated outcomes as each party will need to consider whether their conduct would be considered reasonable in the event the other party invoked its right to refer the issue to independent binding arbitration. The binding third party dispute resolution process would be invoked as a measure of last resort, when all means of coming to commercially negotiated outcomes failed.

Since lodging our submission the Full Federal Court on 18 October 2006 has handed down its decision on Sydney Airport Corporation v Australian Competition

Tribunal. In that decision, the lack of commercial environment and subsequent inability to negotiate with an airport was recognised by the Australian Competition Tribunal and acknowledged by the Full Federal Court. The Australian Competition Tribunal concluded:

> Airport users do not have any effective countervailing power, and in the absence of declaration we are satisfied that any commercial negotiation in future as to price and non-price terms and conditions on which the airport users utilise facilities and related services at Sydney Airport are likely to continue to be protracted, inefficient and may ultimately be resolved by the use of monopoly power, producing outcomes that would be unlikely to arise in a competitive environment.

It followed in the Australian Competition Tribunal's view that declaration of airside service would promote competition in the downstream market by providing independent dispute resolution procedure, ACCC arbitration that would prevent the airport's controller from continuing to misuse its monopoly power. As a result, in addition to Qantas, the Full Federal Court and the Australian Competition Tribunal have concluded that under current arrangements fully commercial negotiations are not possible.

Should the Productivity Commission not recommend adoption of the core principle, Qantas will be in a position of being forced into pursuing declaration under section 3A of the Act, clearly a second-best to be given the unique opportunity available to the Productivity Commission in this process.

What I'd like to do is talk about what we'd like to call the central issue; and the central issue is that major airports in Australia are monopolies. There is no constraint on an airport operator's ability to exercise their market power. In the last five-year period very few agreements have been commercially reached. Airport users are either forced to sign agreements under threat of denied access, or agreements are deemed to be accepted by virtue of flying to the airport.

Some airports have exploited the current regulatory framework by increasing charges, and introducing new charges for existing services that are hidden from monitoring; for example, fuel throughput levy, revaluing aeronautical assets for pricing and price monitoring purpose, and imposing unreasonable non-price terms and conditions which are not scrutinised under the monitoring arrangements or review principles. Without recourse to a binding dispute resolution mechanism, this conduct will continue.

Airports are not equivalent to a Westfield shopping centre. If a store owner cannot agree to commercial terms with a Westfield, they can simply rent space in an

alternative shopping centre or elsewhere. Airport users do not have this option. To put it simply, there is nowhere else in Sydney to land a commercial aircraft other than Kingsford-Smith Airport. Airport users simply have no alternative. Qantas has been negotiating with many airports in an attempt to agree on commercial terms. To date, it has been difficult to achieve. Airport users are either forced to agree to onerous non-price related terms and conditions and to unreasonable increases in aeronautical prices.

There are many examples at each airport where the airport has exhibited monopoly behaviour. It is not Qantas's intention to discuss these at a public hearing, however some of these are highlighted in the submission to the Productivity Commission. The Productivity Commission has already attempted to address some of these issues through its recommendations on matters such as asset revaluation and the impact of passenger volumes and definition of aeronautical assets. However, in Qantas's view, the Productivity Commission has stopped short of fully addressing these issues due to its position on binding dispute resolution.

Without establishing a set of core principles and a binding arbitration process, the Productivity Commission will be supporting an environment where airport users will have no option but to seek declaration. This is clearly not the preferred position of airports or the airport users. It is the intention of Qantas to demonstrate that a binding arbitration process will support and encourage a more balanced playing field, and allow agreements to be reached on a commercial basis. The intent is not to force suppliers to provide facilities and services on commercial terms, but to provide an environment where both buyer and seller are able to come to agreement on commercial terms. It would only be in instances where commercial negotiation and mediation failed that a binding dispute resolution process would be invoked.

Countervailing power does not exist. Airport users do not have effective countervailing power. Qantas does not have the option of a take it or leave it at the major Australian airports. In all of the current and proposed agreements, airports have the right to unilaterally impose charges. Commercial negotiations with the monopoly service provider are therefore not possible.

Qantas has significant investment infrastructure, including terminal, hangars, aircraft, as well as brand and customer loyalty. In addition, there is significant political influences that prevent airport users from withdrawing services from airports. Qantas does not have the option of take it or leave it. Airports and their commercial agreements reserve the right to unilaterally adjust prices and retain the right to make decisions on capital investments.

The only concessions airports have made is that they will consult with airport users. The lack of commercial environment and subsequent inability to negotiate

with an airport was recognised by the Australian Competition Tribunal and acknowledged by the Full Federal Court. The Australian Competition Tribunal concluded airport users do not have any effective countervailing power. It followed in the Australian Competition Tribunal's view that declaration of an airside service would promote competition in the downstream market by providing an independent dispute resolution procedure, ACCC arbitration, that would prevent the airport's controller from continuing to misuse its monopoly power.

The behaviour of Sydney Airport is representative of experiences that airport users have at most major airports. The key differential for Qantas is its negotiation, or is the process consultation. The negotiation process between airport users and airports does not exist. Without constraint and its ability to exercise market power, commercial negotiations with a monopoly supplier, the airport, are not possible. Instead, airports consult with airport users and then impose price and non-price terms and conditions.

The process of entering into an agreement would be better described as a consultation process rather than a commercial negotiation. Where airport users do not agree on key terms and conditions, airport users have no option but to comply or to seek declaration. It is clear that when dealing with a monopoly service provider of essential infrastructure, like an airport, competitive outcomes will not be achieved without the parties having some recourse to binding dispute resolution to constrain an airport's market power.

The negotiation process between airport users and airports does not exist; instead airports consult with airport users and then impose price and non-price terms and conditions. There are several stages to the consultation process, and a standard process would usually work out in this fashion. Firstly, airports would typically engage airport users in a consultation process; a briefing on capital investment and pricing would be undertaken, and agreement would also be presented covering the terms and conditions.

Airport users would then review the information and generally request further information in order to assess the commercial reasonableness. In terms of pricing, airport users have adopted the ACCC building block methodology to assess the reasonableness of the process. Airports are generally reluctant to provide full transparency of the data or the key principles used are not in accordance with the ACCC model. This is the reason for the protracted pricing negotiations.

Airports will then generally send an advice notifying that prices will increase from an effective date and airport users must pay accordingly. There is no scope for further negotiation. Discussions generally take place on non-price related terms and conditions. There is a usually a handful of uncommercial terms and conditions that

remain unresolved. These terms and conditions are generally extremely onerous on airport users. Typically, all risk is transferred to airport users. There is no meaningful service level agreements and no provision for binding dispute resolution process.

In instances where there is no resolution post-escalation, airport users are forced to comply with the conditions by virtue of operating to the airport. I think in some of the early submissions we heard Brisbane Airport take us through an example of a process. I think that's an extremely good example of where airport users were forced to comply with the conditions by virtue of operating to the airport. The Productivity Commission's draft recommendations do not address the fundamental issue created by airports' market power. Without an effective counterbalance, in this case a binding dispute resolution mechanism, there is no constraint on an airport operator's ability to exercise their market power. Airport users have no other option but to concede to uncommercial terms and conditions.

Turning to the solution, Qantas has proposed the core principle. The core principle involves two elements that significantly reduce the possibility of either party acting unreasonably. The core principle is simply this, that airports and airport users will engage in constructive commercial negotiation in terms of access to services in good faith with full and transparent information exchange, supported by binding independent dispute resolution in the event that agreement cannot be reached.

The necessity of price and quality service monitoring would fall away should the core principle be implemented. A binding dispute resolution mechanism, consistent with the core principle and access undertaking, would facilitate commercial negotiation. The possibility of recourse to an independent body would create real incentives for airport owners to offer and airport users to accept reasonable terms and conditions in their commercial negotiations. This will reduce the current imbalance in bargaining power between monopoly airport owners, who tend to adopt a take it or leave it approach for airport users.

Let's turn to binding dispute resolution. A binding dispute resolution mechanism would facilitate and expedite commercial negotiations. Airport owners would be encouraged to offer reasonable terms and conditions in commercial negotiations with airport users. This will reduce the current imbalance in bargaining power between the parties. Airport users would be encouraged to accept the reasonable terms and conditions.

The approach taken by the ACCC in its decision in Sydney Airport's aeronautical pricing proposal in May 2001 should guide the resolution of pricing disputes. The Productivity Commission should confirm this to provide a framework

in relation to future pricing disputes. Invoking the binding dispute resolution process would be a measure of last resort once all avenues of negotiation and mediation have been exhausted. The Australian Competition Tribunal and the Full Federal Court have supported binding dispute resolution and the decision to declare domestic services at Sydney Airport.

A binding dispute resolution would be open to both airport owners and airport users in the event that commercial negotiations fail, thereby encouraging commercial negotiation. The possibility of recourse to an independent body would create real incentives for airport owners to offer and airport users to accept reasonable terms and conditions in the commercial negotiations. This will reduce the current imbalance of bargaining power between the monopoly airport owners, which tend to adopt a take it or leave it approach.

There is support from various independent bodies for binding dispute resolution. Qantas is not the only advocate of a binding independent dispute resolution mechanism. A diverse range of stakeholders, including DOTARS, large and small airport users, other airport users and Melbourne Airport also strongly support the principle. Only airports with a strong degree of monopoly power would be worse off and therefore resist the mechanism specifically designed to constrain that monopoly power. Of key note is the fact that the Australian Competition Tribunal and the Full Federal Court of 18 October have found the declaration of Sydney Airport's domestic airside services was warranted in order to promote competition. This decision allows for binding third party arbitration should the airport users and airports fail to reach agreement.

The Productivity Commission has raised concerns that binding dispute resolution could potentially become the default. Suggestions that a dispute resolution mechanism would become the default and hinder the development of commercial agreements is factually wrong, and is nothing more than scaremongering by airports. No evidence exists to suggest that binding dispute resolution would become the default position and prevent the development of more constructive negotiations between airports and airport users. Indeed, all of the available evidence is to the contrary. When airport services were effectively declared at a range of airports between 98 and 2003 under section 192 of the Airports Act, no arbitration occurred. Rather, a number of commercial agreements were reached without either party initiating an access dispute.

During the period for which cargo handling services from 2000 to 2005 and airside services 9 December 2005 at Sydney Airport have been declared, there have been no arbitrations. Commercial negotiations have continued and there has been no race to the ACCC. As a matter of commercial reality, Qantas, and presumably other airport users and owners will use the binding dispute resolution mechanism only as a

last resort. Qantas attempts to reach agreement with airports by escalating material issues to senior management, potentially including and ultimately the CEO. Access to a binding resolution mechanism will not change this. Rather, instead of stalemates being reached, more issues would be resolved, as both parties would need to consider whether their conduct would be considered reasonable in the event the other party invoked its rights to refer the issue to independent binding arbitration.

Airports claim that airport users have been unwilling to enter into arrangements in the hope that some regulatory solution might provide a better outcome. Qantas rejects any allegation that it has been holding out and not agreeing to reasonable terms and conditions to advance its position either in the Australian Competition Tribunal or through the Productivity Commission review. In fact, the Australian Competition Tribunal decision shows the opposite, and confirms that it was appropriate for Qantas to reject such uncommercial terms.

Indeed, it is noted the positive impact of third party binding arbitration is not lost from the Productivity Commission. In reference to the Sydney issue, the Productivity Commission notes in section 7 of the draft report that if the current appeal is dismissed and declaration stands, it may well lead to a negotiated outcome for the particular dispute and would also condition negotiations at other airports. The Australian Competition Tribunal takes this perspective further. In the factual, SACL will be constrained from misusing its monopoly power in the future because commercial negotiations will be conducted with the knowledge that in default of agreement, independent arbitration is available. Indeed, having had exactly that decision handed down, it has provided all parties and the Productivity Commission with impetus to move forward, except the proposed care principle, and positions airports and airport user negotiations in a more positive and constructive commercial environment.

The escalation process. Access to binding dispute resolution mechanism will not change the escalation process in order to achieve a commercial agreement prior to arbitration. It is envisaged by Qantas that the dispute resolution process practiced today, that is, escalation to senior management and ultimately the CEO, would continue. However, the process would be supported by allowing either party to refer an access dispute to binding dispute resolution should the escalation process fail to reach a commercial outcome.

A binding dispute resolution mechanism consistent with the core principle would facilitate commercial negotiation. The possibility of recourse to an independent body would create real incentives for airport owners to offer and airport users to accept reasonable terms and conditions in their commercial negotiations.

Airports and other airport users have highlighted the inefficiencies of the

current system, and the Productivity Commission has accepted those inefficiencies in its draft report. Given that the current regulatory structure is characterised by ongoing unresolved negotiation disputes and there is scope for airport users to seek declaration of airports, both resulting in significant ongoing costs, then that benefits from the Productivity Commission recommending a targeted dispute resolution framework that avoids these costs. It is likely to be significantly greater than the maintenance of the current framework as recommended in the Productivity Commission's draft report.

The Australian Competition Tribunal and the Full Federal Court have shown support for third party binding dispute resolution in their recent respective judgments. These decisions confirm that Part IIIA should apply to airports, and provide a mechanism for negotiations to take place against a backdrop where either party can refer an access dispute to the ACCC for binding arbitration. This is intended to encourage monopoly service providers, that is, airports, to act reasonably as if they were in a competitive market. An industry specific binding dispute resolution process or at the very least, a binding code of practice prescribing dispute resolution processes for reaching initial agreement, is consistent with light-handed regulation.

To summarise; airports and airport users must engage in commercial negotiation of terms and conditions of access to services in good faith with full and transparent information exchange, supported by binding independent dispute resolution in the event that agreement cannot be reached. This core principle should be supported by an access code to underpin the principles of non-price related negotiations; and the approach taken by the ACCC in its decision on Sydney Airport's aeronautical pricing proposal in May 2001 should guide the resolution of pricing disputes.

The Productivity Commission should confirm this to provide a framework in relation to future pricing disputes. The weight of opinion from Qantas, the Australian Competition Tribunal, the Full Federal Court, DOTARS, airport users and Melbourne Airport firmly support third party binding dispute resolution as a fundamental vehicle to promote commercially negotiated outcomes in airport negotiations. As recently as 18 October, the Full Federal Court pointed out that without a binding third party dispute mechanism, airports' monopoly power would go unchecked and allow a framework where airports will be able to continue to impose their terms and conditions on airport users.

Should the Productivity Commission not recommend adoption of the core principal, Qantas will be in a position of being forced into pursuing declaration under Part IIIA of the Act; clearly a second-best result given the unique opportunity available to the Productivity Commission. The stated objective of the Productivity

Commission was to promote economically efficient airport operations, minimise compliance costs on airport operators and the government and facilitate commercially negotiated outcomes in airport operations. To achieve the objective and move airport negotiations into a constructive commercial environment, we see no alternative but for the Productivity Commission to accept and recommend a binding third party dispute mechanism.

MR POTTS: Thanks. There are a number of questions. Let's begin with the question of the commercial relationship that Qantas has with the airports. Here I'm talking about the airports that are currently price monitored. But I read from your statement that you believe that in the last five years under the price monitoring regime that you just have not had satisfactory commercial relationships with any of the airports.

MR MOORE: Yes, Gary, I think our view is as we described in our description of negotiation versus consultation. We described the process more as a consultation process, and I think there's many examples which we could point to where we've gone through a process where changes have been proposed by the airports. We've sought information, we've had discussion around the information, and we've attempted to negotiate; and at the end of the day the airports have imposed their terms and conditions on us, the airline user. So I think our experience over the five years would be characterised by that.

MR POTTS: So that's true of all airports that are price monitored. Let me take the example of two small airports, Canberra and Darwin, where Qantas has above average amount of business into those airports, and so you could say that those airports in particular depend realistically very much, for their livelihood, for their business profitability, on Qantas's presence, and yet you don't think you've been able to develop satisfactory commercial relationships with them in terms of being able to negotiate satisfactory charges?

MR MOORE: Yes, Gary, in response to your question, what I will do is I'll ask my team if it's okay just to support with some of the detail and experiences they've had. So I'll just ask Jana, if you want to talk specifically about those airports.

MS KADLEC: Sure. Canberra Airport, I think in particular, there's quite a long history with Canberra Airport, and we're in the process of negotiating at the moment for a new terminal; and I think in fairness, those negotiations at the moment are going quite well, you know. What we've seen with Canberra and with other airports is that where we do actually - straight after negotiations or we do come to an impasse, conditions are actually imposed on us. So it's difficult to take that further in the absence of the support of a third party binding dispute resolution process. So for example, with Canberra Airport we had what we considered were alternative

measures that we could take in terms of addressing the customer service and the demand that we have for that airport.

Unfortunately, through our negotiations with Canberra Airport at that time we weren't able to pursue those options for various reasons. We didn't accept those reasons, but unfortunately we had to. We were forced to accept those reasons, which has led to the position that we're in today where we are negotiating with Canberra airport on a new terminal. Those negotiations are happening at the moment and we don't know where they'll end up, but you know, obviously we're working with Canberra Airport quite closely to make sure that we try and get to a commercial outcome there. The issue at hand is that we were actually forced to take the specific route in terms of where we end up with our product at the airport.

MR POTTS: And Darwin Airport?

MS KADLEC: Darwin Airport; I haven't been too involved in Darwin Airport so I'm going to defer to my colleague in terms of pricing, but I think Darwin Airport - we came to an agreement with Darwin Airport in terms of where we finished up.

MS MORITZ: Yes, that's correct. It has been quite a long, protracted process with Darwin Airport. However, we did come to an agreement at the end. The relationship is not as complex as what we have with other airports because you will likely assess - so that Qantas is the majority of the traffic, and so I would probably say Darwin is probably the good guy of the bunch, in our relationship.

MR POTTS: I know there have been problems with Sydney Airport, and that's been mentioned this morning by other participants, but Melbourne Airport is often mentioned as one where commercial relations seem to be on a better footing; but that's not Qantas's experience?

MR MOORE: Jana, do you want to?

MS KADLEC: I think Melbourne Airport is probably one where we do have a better footing in terms of commercial negotiations. We actually have a signed agreement with Melbourne Airport. It's one of the only airports, other than Cairns I believe, where we have an actual signed document. At other airports we've been forced to accept the conditions of use by virtue of operating to that airport. So we have no scope for negotiation at the other airports without going to the Part IIIA provisions. So Melbourne Airport we've negotiated. We don't necessarily think all of the terms and conditions are, you know, fantastic, but it was a negotiated outcome that we've been comfortable with over the past five years; and we're about to enter into new agreements with Melbourne Airport.

MR POTTS: So does that suggest if you take the case of Melbourne, and perhaps Darwin to a lesser extent, it is still feasible to reach satisfactory commercial outcomes under the current regime without the added regulatory arrangements you're suggesting?

MR MOORE: I think what it suggests is that we're at the behest of the preference of the local airport. So in some cases where the airport leadership and the airport itself adopts a reasonable position during commercial negotiations it is entirely possible to get an outcome. I think the issue for us is that we're entirely at the behest of the position of the airport leadership, and if that airport leadership chooses to adopt an unreasonable position we have no recourse and the airport has the capacity to impose their terms and conditions on us.

MR POTTS: Looking at the issue of investment, in the last investment plans in the last five years, much of the feedback we've had about price monitoring is that one of the advantages of the system has been a far more responsive arrangement as far as new investment is concerned from the point of view of users. Would you endorse that view, or do you believe that that's an exaggeration?

MS KADLEC: I think that it has been positive in terms of investment. It addresses the key issues that we have at airports. However, I need to add that basically we've been reminded by many of the airports that we are just an airport operator. They will consult with us, but at the end of the day the decision is the airport's decision to invest in whatever they choose to invest in and the airlines and the airport users will pay accordingly. So I think it goes back to the point that Brad made that that's a negotiation versus consultation process, and what we would be seeking is a stronger negotiation process so that we can actually influence the outcome rather than purely be consulted and then have to adopt the pricing and non-pricing conditions that result from that.

MS MORITZ: Could I just add to that. Earlier this year there was a fuel throughput levy being introduced at Canberra Airport, and when we inquired with oil companies who was passing on the charge they said they had just collected it for the airport because the airport has decided unilaterally to build a brand new fuel depot facility. So I think I just want to support my colleague in the sense that the investment decision is often - sometimes not probably for the best economic outcome for the users.

MR BYRON: Just to follow up on that, Brad, I think you said that you know, it's a take it or leave it offer. Has there been any case where, when presented with a new pricing or service agreement that Qantas has been able to go back and say - with a counter-offer and have that discussed, or have you never been able to get a counter-offer back onto the table?

MS KADLEC: We've been negotiating, Qantas in conjunction with the other airlines and BARA on particularly price. Generally, the price is pretty much fixed. Airports are inflexible in terms of the base price, and this is where the issue about increasing passenger numbers comes in. We would be looking at the base price actually reducing and then any new investment coming in on top of that. We're actually not seeing that and this is what we're trying to put on the table in our negotiations to say that the base price, whatever it might be - let's say for argument's sake it's $20, and that was fixed on forecast for a period five years behind us. We need to adjust that base price because the airport is getting $20 per passenger, but now the passenger numbers might have increased by 10 per cent.

So they're the sorts of arguments that we're coming back with on the table, but what we've found with the airports is that they're unwilling to consider that in terms of passenger numbers; and most of the time it's a base price plus a CPI or a base price plus NNAI, and it's not always the NNAI component of it that we're in dispute with. In most cases we actually agree with the increases based on new capital spend. It's the base price which we're really struggling with in terms of negotiation with airports.

MR MOORE: Just to add there, I think the issue is that it would be fair to say that we have the opportunity to put our representations across the table and put our position across the table. The central issue though, is that it's entirely at the discretion of the airport of whether they consider them or not; and if they choose not to then they have the ability to impose and do impose their terms and conditions on us.

MR BYRON: And you have to pay them?

MR MOORE: We have to pay them, yes. We have no alternative but to pay them. There's a number of examples which the team here could talk through, but a number of examples where, you know, by virtue of continuing to operate at the airport, we have to pay them. For us as an airline, I mean, particularly Qantas, and all that goes with being Qantas in Australia, our capacity to move out of some of these airports such as Brisbane and Sydney is just not possible.

MR BYRON: Of course.

MS MORITZ: And Canberra.

MR POTTS: Can you explain how important these charges are in terms of ticket prices? I mean, are we talking here about initiative related to the distribution of rents between airports and airlines, or do you think that it's a broader issue and that it

affects the final air ticket price, if you like, and responsiveness of the travelling public to using airlines? Do you have any information on that?

MS KADLEC: We do have information. I don't have that obviously handy at the moment, but certainly we can come back to that with the information. But I think what we're seeing is really that the responsiveness is dependent on the elasticity of demand of the market. So the issue for the airline is that in many instances we can't pass on the full price increase to the passenger in terms of the passenger charge, and we've got to wear that in terms of our bottom line. So it does actually affect - we'll hold the ticket price constant so that the yields that we're receiving back are adversely affected. So basically what we're seeing is that the airport is able to increase its prices so it has no risk and that the impact of those increases are being shared by either the passenger or the airline depending on the elasticity of demand.

MR POTTS: So if we take the fuel levy, for instance, that's been in place for the last three or four years, which - what, in Qantas's case, roughly, on domestic travel, what is it on average per ticket?

MS HENDERSON: Are you talking about the fuel throughput levy?

MR POTTS: No, the fuel surcharge.

MS HENDERSON: You're talking about the fuel surcharge. I think it's varied. I think about $25 on a one-way ticket. I could stand to be corrected.

MR POTTS: So $25 on a one-way ticket. If I believe what you're saying about the significance of airport charges, can you give me some idea of what the effect on demand has been of the $25 per ticket?

MS HENDERSON: We put some evidence on in the Competition Tribunal on exactly this point back in the hearing in 2004, and certainly the business person who gave that evidence indicated that passengers do have a different perception and demand characteristics for a surcharge than they do for straight charges. I think the important thing is, Qantas isn't pointing out that airport charges at certain airports are too high and therefore that is what's creating the problem. Qantas has always been very strong on the fact that the behaviour of dealing with airports on both price and non-price terms and the fact that we are in a situation dealing with a monopoly service provider, that creates uncertainty, and when we have nowhere to go, that affects our business overall. So I think it would be wrong to say that we're focusing specifically on price aspects alone.

MR POTTS: No, I'm just trying to garner some information on some of these issues, and I find it hard to believe - let me try and get some more information from

you. The $25 per ticket, has that had any affect on the demand for domestic travel in Australia?

MS KADLEC: I don't think we're prepared with that information, but we can certainly come back with that. But I think that the issue that we're making is that that surcharge, the passengers actually have a choice. There is competition in the provision of airline services, so if they choose not to fly Qantas because we have a surcharge they have a choice between other airlines that operate here. The point that I think that we're trying to make is that we don't have that choice in terms of the provision of airport services.

MR POTTS: No, I'm just trying to inform the issue of what impact airport charges have, whether we're really talking about a distributional issue between the profitability of airports and airlines, or whether airport charging is affecting the price of air tickets and how much people travel. But I mean, bear in mind that I think landing charges at Sydney are something like $3.50 - someone from Sydney Airport can correct me if I'm wrong - compared with $25 for the fuel surcharge. So I'm just interested in the question, in Qantas's judgment, as the major airline in Australia, what the relative impact of those different charges are on the travelling public, or whether really the question we're really looking at is the profitability between the airports and the airlines.

MS KADLEC: I think you need to go beyond the prices as well. I think you need to have a look at the conditions of use of those airports as well, and where the risk is transferred. So you know, while we're unable to give you a direct answer on the impact that it has had on demand because we don't have that information with us, we can certainly provide that back to you.

MR POTTS: Sure. That would be useful if you could.

MR MOORE: I think the other key point that I'd like to make - and we'll certainly go away and then we'll provide that data. But I think, just to highlight the difference between our market relationship with our customers and the relationship we have with airports, is that airports have the ability to pass on any cost increases that they deem appropriate, and we have no ability to change that. They can do that unilaterally and impose those increases on us; whereas in our position we're forced to absorb those cost increases and may or may not be able to pass them on to the customer, depending on the market environment.

MR POTTS: Okay. Can I move on to the issue you raised about the relationship between light-handed regulation and binding dispute resolution. You said you feel that they are consistent. I guess when reading the draft report you'd probably conclude that we're not sure that they are consistent, that the government introduced

light-handed regulation five years ago with a view to encourage the commercial negotiation and moving the parties in that direction. As we've set out in the draft report, we have a question about whether the sort of arrangement that you're proposing - however you like to describe it, the various terms - that fundamentally in the end, because it allows for binding arbitration, presumably by a party agreed to by both parties, which would probably mean the ACCC, that that essentially would be moving you back to the sort of arrangement we had before.

That seemed to be implied by some of your comments, Brad. I thought that you were talking about the ACCC model that existed, that is, the basis on which the airport should be thinking of negotiating with Qantas. So in a way it's not moving the game forward very far from where we were five years ago. It may be that that's where it comes out in the end. All we are doing is producing a report for government. But that is our concern if you go down the route that you're talking about, because one party, if it views the ACCC as its friend - just to use shorthand language here - in other words, it will give the decisions it believes is better from its point of view, going back to the point that I was making before; which is you've got a pie and you're talking about dividing it up between the airports and the airlines, that whichever party thinks the arbitrator is going to favour their position, will they have an incentive to negotiate?

MR MOORE: I think there's - and I'm going to invite my colleagues to comment on this. But I think there's a number of issues in there. I guess the first one is that we're not suggesting in any definitive manner exactly binding third party arbitration will exactly be. But the view we would put forward is that we're currently in a situation where airports have the ability to unilaterally impose their terms and conditions on airport users, ie, airlines. We're proposing an alternative where a binding third party arbitration mechanism would encourage all the parties, including airports, to enter into a reasonable commercial negotiation process.

We'd do that for two reasons. One is that the alternative binding third party arbitration would instil in both parties during the negotiation process incentive to reach an outcome which is under their control. So we'd much rather have an outcome that they reach directly with the alternative party than send it to a third party which is outside of our control. Secondly is that they would know that their behaviour and their reasonableness or otherwise during the negotiation process would be something that would be taken into account during any arbitration or subsequent arbitration process that took place.

Taking all that into account, it's our view that if you had a third party arbitration process put in place, it's going to encourage and promote the parties to reach commercially negotiated outcomes. That's in direct contrast to where we're at today, where the outcomes are not commercially negotiated. There is a process of

consultation where the airports impose terms and conditions on the airport users unilaterally. Do you want to comment?

MS HENDERSON: At the time when the government decided to go with the light-handed regulation, it was expressly contemplated that in conjunction with prices monitoring options under Part IIIA would continue, so I just question, as a result of that, how a mechanism which mirrors Part IIIA, which allows for negotiation and if that negotiation fails, recourse to binding arbitration. I just question if that's designed to facilitate commercial negotiation, how that's inconsistent with light-handed regulation.

Certainly one of the themes that I've sort of observed today is people not drawing a distinction between what could be seen as compulsory arbitration versus commercial negotiation with recourse to binding arbitration; and certainly Qantas's position is that, contrary to the sort of statements made by other people, we are not desperate to go and have a third party be the umpire. We're desperate to have the option so that the party, when negotiating with the airport, knows that there will be someone looking at the reasonableness both of their and our behaviour, to encourage both of us to reach commercial negotiations and agreed outcome. So I guess that's why I question how it could be seen as a return to heavy-handed regulation.

MR POTTS: So are you suggesting that if you thought you could get a better outcome from the regulator by going down the binding arbitration route that you wouldn't pursue that? It does seem to me the implication of what you're saying, you want to be a good citizen regardless of the financial implications for Qantas.

MS HENDERSON: I'm not a pricing expert myself, but I wouldn't say that there is a huge degree of certainty about exactly what price would come as a result of a third party looking at it. Certainly if the facts were very similar to the last pricing decision, then you could be looking at that for sort of precedent value, but at the end of the day you're always going to be measuring up options. You won't be considering are you better invoking a third party to be the arbitrator, or because of the cost and the time involved are you better accepting a different term and condition. The point is, you're both going to be in the same position. The airline and the airport are going to be asking themselves the same questions about their decisions, and we think that's healthy.

MR MOORE: The other point I'd just like to add to that is that I think the fundamental issue for us is that the system is currently designed to have airports impose their position unilaterally on airport users. What we're suggesting is a reverse of that, is that where you redesign the system to encourage both parties to enter on a reasonable and good faith basis in commercial negotiations to genuinely get outcomes that are agreed to between both parties, rather than have one party

impose their outcome on the other. We believe that if you have a third party binding arbitration option at the end of the process that encourages both parties during the negotiation process to be reasonable and to come to a mutually agreed solution, and that is in direct contrast to where we are at currently.

MR BYRON: There's one other aspect to this binding third party dispute resolution that a few people have put to us, is that in many cases the dispute is not just bilateral. I think, Brad, that in everything you've said here this afternoon, you've been talking in the context of one on one. Now, does it make a difference if in fact there are multiple parties involved? I'm quite persuaded by what you're saying in the sense of one on one, but does it really matter if it's multilateral?

MR MOORE: I think it adds another layer of complexity to it, but I still don't think - it fundamentally doesn't change the issue - is that all it means that with other parties involved it adds another layer of complexity to the negotiation process. The fundamental issue remains the same, that currently the system is that airports have the ability to unilaterally impose their solution, their terms and conditions on airport users, whether we're one or whether we're many. What we're proposing is let's redesign the system so that it encourages the airports and airport users to get into the room and come to a mutually agreeable outcome, and whether it's one or whether it's many, or multi parties to the negotiation, the issue remains fundamentally the same.

MS HENDERSON: As you know, with declaration, it's not just the party that was the applicant for the declaration that gets the benefit of the process, and so in some ways the binding dispute resolution model could mimic that.

MR BYRON: So it doesn't really matter whether we've got two 800-pound gorillas in the room or an 800-pound gorilla and two 400-pound gorillas or a 600 and a 200-pound gorilla versus one gorilla? I'm not wanting to pursue the gorilla thing.

MR MOORE: I think at the end of the day the answer is no, it doesn't.

MR BYRON: Having multiple parties on one side doesn't necessarily add or detract from the difficulties.

MR MOORE: No, I mean, it does add a layer of complexity that's not there when you have two parties in the room. But I think the fundamental principle and the fundamental objective that we're trying to achieve doesn't change, and I think the solution we're proposing is equally applicable as if there's two parties in the room or 10.

MS MORITZ: Could I just add to that; Qantas, when we negotiate, it's not only the access to the airport. As part-owner of Sydney Fuel Depot, we also are involved in

the depot negotiation. The experience that Qantas alone experienced is also experienced from oil companies, transporters. So there are many layers of negotiations that we go through. However, you know, for instance with the depot, three years down the track, it's a long circle. We're all walking around on that and it still hasn't come to the end.

MR BYRON: I'm glad you mentioned that, because you know, discussion tends to focus on the relationship between airports and airlines with regard to landing fees and terminal charges; and as you've reminded us there are many other dimensions of the market power of airports.

MS HENDERSON: One of the limitations of the Part IIIA declaration proceeding is it comes down the definition of the service that has actually been declared and so because of the history of the existing Sydney Airport declaration, that only applies to certain, I guess, conduct on the airport. So you may have a duplication of declaration proceedings to the extent that there's any other conduct that we feel that we've got no other option but to seek declaration.

MR POTTS: On the core principle that you mention, I think that full and transparent information exchange is an important element of it, in your view. I presume that you're saying that in supposing that the mutual exchange of information, would that be right, between the airports and the airlines?

MR MOORE: Yes, that's correct. Jana, do you want to comment on this?

MS KADLEC: Yes. I think certainly where we have information that's relevant to the airport in terms of the impact that we have, potentially on the capital infrastructure and what plans they're making. But I think the important thing to note here is that we are actually the buyer of the service, so we need far more information than the airport would need of us because they're not purchasing anything from us. So the airport is the party that is actually providing the service and providing the price, so we need that information to be able to assess that that is reasonable in the absence of competition. So we can't go somewhere else and say, "Well, we can get it cheaper down the road," or is it reasonable in terms of the price for the service.

MR POTTS: Right. So you'd be expecting the airports to give you more information than you give them.

MS KADLEC: We would be happy to give the input information that they need in terms of planning for their airport which drives price, in terms of NNAI.

MR POTTS: But I guess if - and to the extent that charging is a distribution issue between the profitability of airports and airlines, and there's probably an interest on

both sides, if you like, and what impact the charges have on the profitability of both enterprises.

MR MOORE: Yes, I think that - I mean, it's obviously - I mean, we would be committed to a principle of open and transparent exchange of information as it is related to the commercial negotiation, and as it is relevant. That's always caveated by commercial confidentiality and exposing potentially some sensitive, private information. But I think the governing principle for us is and would be that it be full and transparent exchange of information.

MR POTTS: Brad, you repeated a point that was in your submission that if the government, after it receives our report, doesn't proceed along the lines you're suggesting - and I'll hasten to add here that our role is purely advisory (indistinct) decisions that happen within the hands of government, of course - you'd feel you had no option but to seek declaration in relation to other airports. I just want to have that confirmed, that that's what is Qantas's corporate position on this, because that's the submission as from the general counsel, I think.

MR MOORE: I think that I would look at this in terms of a process, in that I think what's happened here is that we have, as it currently stands, an option of another step being inserted in the process. So if I just step through it, currently, as we go through we'd like to call a consultation process. We have a process where we exchange information. The airports place their request in front of us and we request information as provided. We may go back with an alternative position. If we can't reach agreement then it's escalated through senior levels of our organisation, and potentially to a mediation process.

If that fails, and fails to achieve an outcome between us, we now have an option of declaration, and Qantas's position is that we would consider, and are considering whether that's appropriate on each of the individual circumstances as we approach them. But I think the bottom-line answer to the question is that, yes, that is an option available to us now, and yes, we could consider it as an option going forward, depending on the circumstances that were in any negotiation with a particular airport.

MR POTTS: So what you're saying is, before considering the declaration route you would first of all wish to pursue commercial negotiations - - -

MR MOORE: Absolutely.

MR POTTS: (indistinct) to get a satisfactory outcome. So you wouldn't be moving, for instance, to seek a blanket declaration of airports that you would think would be caught by Part IIIA.

MS HENDERSON: I think we're still in the - the note from the general counsel was putting forward, in our case, the worst-case position, that if there is no movement from government in relation to a compulsory binding arbitration model, then we would feel that we were left with no position but to seriously consider declaration.

One of your questions is, would we now draw a line in the sand and say, "Right, we're going to have X months of negotiation before we seek declaration"? I think our view is haven't we already had that, to some extent, in the last few months and years, dealing with an airport. The option of declaration has always existed, and you'll see in Qantas's first submission dated July that that was one of the options we put forward as implementing the core principle. So I don't think that this is a new position that we would consider declaration, and really we see this as an important step in a continuum of our dealings with airports.

MR POTTS: Because I think you made the point before, and quite rightly so, that this Part IIIA decision may well have strengthened the hands of the airlines in commercial negotiations; I mean, to the extent that it's shifted the balance between the airports and the airlines and lowered the bar. Qantas's negotiating position, as weak as you may think it is because of lack of countervailing power, presumably has been strengthened. So it may be that through the process of commercial negotiation now that you can get outcomes that are more favourable from your point of view.

MR MOORE: We think it definitely is a step forward, but I think we all need to note that in the process of declaration there's substantial resource time and cost that gets invested in going down that path. Our proposal would be that that's not to the benefit of any party and that if we could design the system to be more efficient to get outcomes for all parties on an efficient and timely basis, that encourages all of us to get to a point where we get mutually acceptable agreements, that that would be a better outcome at the end of the day.

MR POTTS: Okay.

MS HENDERSON: Because one view - my personal view is that the Full Federal Court decision has really just confirmed that there is a real problem in the negotiating, I guess - natural negotiating positions between airports and airlines and airport users. So really, all it's doing is confirming that because of the monopoly nature of an airport there needs to be some type of, I guess, enhanced ability to negotiate with the right of seeking independent arbitration if those negotiations break down. So it's not like - we really welcome the full Federal Court decision, but there's still a problem in the actual market structure between the two parties.

MR MOORE: Whilst we see that as a step forward, I think fundamentally what we're saying is that we have an opportunity, and potentially the recommendations are put forward by the Productivity Commission to redesign this system so it encourages the outcomes we all want, which is mutually-agreeable commercial agreements rather than the current status.

MR POTTS: Anything further?

DR BYRON: I don't know if you were here this morning when I asked - I think it was BARA - about the aircraft being the extreme example of a mobile capital asset which can be readily deployed to anywhere whenever it generates the greatest return. My question then to BARA, and the same question to you, is to what extent is there evidence of airports through their behaviour actually hindering airlines in wanting to re-deploy aircraft onto which routes are most favourable almost - offer the best and most efficient use of those capital assets, as opposed - do they impede or do they facilitate when airlines want to explore new routes, flying from Narrabri to Mangalore or somewhere that nobody has done before? Hypothetical. Does their behaviour inhibit that sort of flexibility that I imagine airlines need in continually testing the market - where to deploy your assets - or have they helped it?

MS KADLEC: I think it's probably a mixed bag, from an airport's point of view. They will probably encourage more activity to the airport to increase their profitability, but we have also seen airports where they have, through what they've tried to implement between various use of terminals on that airport, an inefficiency of the use of our aircraft. So we were forced as one stage to tow aircraft from one terminal to the other purely for the sake of paying passenger facility charges rather than being able to process passengers through one terminal and then busing them to another terminal. So it meant that an aircraft, for example, that flew in from Wagga and then was departing to Canberra had to be towed from one terminal to another terminal just to facilitate a passenger flow, because of the structure that that particular airport actually put in the terms and conditions.

So it is quite a mixed bag in terms of the utilisation; but I think the most important thing - and Brad mentioned it in his notes - is that as a domestic carrier - and the other large airline will probably be in the same position - we have significant infrastructure invested in various airports. So our ability to move our moveable assets or our capital investment there is limited because we have a maintenance base at certain airports and we have crew bases, and we have a whole lot of supporting operational and infrastructure works that support the operation in the Australian airports. So it's a little bit more difficult for the home based carriers to be able to flexible in terms of responding to what the airports actually enforce on us in terms of price and non-price conditions.

DR BYRON: I guess I was wondering that, to the extent that you could now schedule more services from Avalon to Maroochydore or Coolangatta, and therefore bypass both Brisbane airport and Melbourne airport; does that give you any clout at all? I mean, not that you would do it for every flight, but a few times a week, does that, at the margin - - -

MS KADLEC: There is a little bit of benefit to us, but I think the thing that we need to remember is that the base infrastructure at those airports - the Avalons and the Coolangattas and Maroochydores or wherever else - is limited. So the capacity of those airports - you can only fly a certain amount of aircraft and certain type of aircraft into those ports, so they aren't true competition to the larger Australian ports where we do actually have (1) the infrastructure, and also the capacity of those airports to operation into.

DR BYRON: Thanks very much.

MR POTTS: I think that's it. Thanks very much, Brad.

MR MOORE: Thank you.

MR POTTS: Thanks for your time.

DR BYRON: Thank you very much, and thanks for your very helpful written submissions.

MR POTTS: Welcome. Thank you very much for coming to the hearings. We're just asking if you could state your names to begin with and the organisation you represent, for the record; and perhaps an opening statement. We can take questions from there.

MR HANLON: David Hanlon, acting general manager ground operations, Virgin Blue.

MR DAVID: Andrew David, chief operations officer, Virgin Blue.

MR SNOW: Simon Snow, Gilbert and Tobin; advising Virgin Blue.

MR BALCHIN: Jeff Balchin, the Allen Consulting Group, here with Virgin Blue.

MR DAVID: I'm going to start with an open statement.

MR POTTS: Thank you.

MR DAVID: I'd like to begin by thanking the Productivity Commission for the opportunity to appear and speak to you at today's public hearing. As the Commission will be aware, Virgin Blue has lodged a number of lengthy written submissions setting out in detail its view on the issues raised in the commission's issues paper, and the draft report. I will endeavour today to provide the commission with a summary of Virgin Blue's position in relation to the price regulation of airport services.

Jeff will provide an overview of the reports that he has prepared for Virgin Blue and which have been provided to the commission. These reports address specific issues including major airports' compliance with the government's review principles, and appropriate values for the airports' assets. Simon Snow will provide a summary of Virgin Blue's view of the effect of the recent decision of the Full Federal Court. We're happy to take questions at the end of the brief introduction and address. David Hanlon has detailed knowledge of Virgin Blue's negotiations with airports as well as the results of these negotiations.

Virgin Blue's position in relation to the price regulation of airport services is quite simple. Major airports in Australia are natural monopolies. There are no effective substitutes for their services. Unless constrained, monopolists will act to increase prices above efficient levels or reduce the quality of the services they offer, or both. Virgin Blue does not see any reason why major airports would act any differently from other monopolists. This is especially the case where managers of privatised airports have duties to maximise returns to their shareholders.

Under the current regime, Virgin Blue does not consider that there are any effective constraints on the monopoly powers of major airports. The regime has failed in this regard. None of the supposed constraints on monopoly power, such as the threat of re-regulation, the countervailing power of airlines, or non-aeronautical revenue, stands up to any detailed scrutiny. The Australia Competition Tribunal confirmed this in its decision to declare the domestic airside service at Sydney Airport.

We believe that in the absence of an effective constraint on their monopoly power, major airports will continue to increase their charges above efficient levels and set terms and conditions for use of their facilities that would not prevail in a competition market. The harm from this conduct extends beyond the impact that it has on airlines and other users of airport services. Increased airport charges result in higher fares, and since most passengers are very price-sensitive, these increases result in reduced demand for air travel and a welfare loss to a society as a whole.

In its draft report, the commission emphasised that one of the key goals of the price-monitoring regime is for airlines and airports to negotiate access terms and

conditions commercially. While Virgin Blue considers that commercial negotiations have many advantages when compared to a price-control environment, they should not be seen as an end in themselves. In relation to negotiations with monopoly airports, Virgin Blue's experience is that increasingly the airport simply imposes prices significantly above efficient costs. This is not in the interests of the airline, its passengers, or society as a whole.

Virgin Blue believes that in prioritising commercial negotiations, the commission is looking for airlines and airports to negotiate in the same way that they would in a competitive market. However, without an effective constraint on airports' market power, this simply will not happen. Therefore, Virgin Blue submits that the commission should recommend the introduction of a negotiate/arbitrate model for the provision of aeronautical services at major airports in Australia.

Such a model offers the best of both worlds: the opportunity to have true commercial negotiation as the primary method for determination of access terms and conditions for airports, while also allowing for parties to seek independent arbitration in the rare event that there is an intractable dispute. Such a model should also retain and improve the current price-monitoring mechanisms. I will now address some of these points in more detail; however, given the wide range of issues that have been raised during the course of the commission's inquiry, my remarks today will not be exhaustive.

Airport charges are important to Virgin Blue. At the outset, it is important to recognise that airport charges matter to Virgin Blue; they are a significant part of Virgin Blue's cost base. Over the past six years a key part of Virgin Blue's business model has been growing demand for air travel by offering low fares. Virgin Blue's approach has not been to simply compete head-on with Qantas, the domestic full-service airline. As detailed in Virgin Blue's original submission to the commission, the results of Virgin Blue's entry are clear. There has been a substantial reduction in discount and restricted economy airfares, and there has been very strong growth in domestic and regional passenger traffic. These gains have been made despite the exit of two domestic carriers in the last five years.

Virgin Blue's business model depends in large part on its ability to keep airfares low. It does this through adopting a number of practices used by low-cost carriers throughout the world to keep their cost bases down. For example, Virgin Blue operates just one type of aircraft, the Boeing 737, and has more seats on its aircraft than a full-service carrier such as Qantas. Virgin Blue also takes a number of steps to reduce the turnaround times of its aircraft, such as using embarking and disembarking from both the front and rear exits.

Airport aeronautical charges make up a very significant proportion of Virgin

Blue's lead-in fares and average promotional fares, as set out in the confidential written material provided to the commission. Therefore, increases in airport charges have a significant impact on Virgin Blue's cost base. Virgin Blue has no option but to pass on at least some of any increase to passengers, and this can have a significant impact on airfares and on passenger numbers, given the price sensitivity of many of Virgin Blue's passengers.

Increased airport charges cannot therefore be dismissed as merely rent transfers between large corporations. There are significant efficiency and welfare effects. The report from The Allen Consulting Group in response to the commission's draft report demonstrates that even a 25 per cent increase in the airport aeronautical charges at Sydney airport would result in hundreds of thousands of fewer passengers flying to or from Sydney every year.

Major airports are unconstrained. It is because airport charges are a significant part of Virgin Blue's cost base that Virgin Blue is so concerned by the fact that major airports face no constraint in the exercise of their market power. The commission's earlier recommendation that price controls for airports be replaced by price monitoring alone was based largely on the premise that major airports' market power would be constrained by the non-aeronautical revenue they earn. However, this constraint has been the subject of detailed economic examination and found not to be effective. In the tribunal's Sydney Airport decision, the evidence of Sydney Airport's own expert was that this constraint would not prevent Sydney Airport from increasing its take-off and landing charges substantially above efficient levels. No airport has seriously argued to the contrary.

The other potential constraints that have been discussed in submissions to the commission and the commission's draft report are equally ineffective. Airlines do not have sufficient countervailing power to be able to keep airport charges to efficient levels; and experience shows that where one large airline does have a measure of bargaining power it is likely to be used to the joint benefit of the airport and the larger airline and to the detriment of other airlines.

In relation to the threat of re-regulation, the current price-monitoring regime meets none of the accepted criteria to be an effective constraint. The criteria for triggering sanctions are very unclear. It is not clear how the relevant regulator, whoever that is, would identify when the criteria has been breached, and the penalty for breach is also unlikely to be a sufficient deterrent. Nor is Part IIIA of the Trade Practices Act an effective constraint on airports' market power. While the recent full Federal Court decision confirmed that the declaration test should be a simpler test than the one that the tribunal had adopted in the past, the declaration process still suffers from the significant disadvantages of being very time-consuming and costly.

It is worth remembering that the Full Federal Court's decision that was handed down this month related to an application for declaration that Virgin Blue lodged with the NCC four yeas ago. Simon will provide a short summary of Virgin Blue's view of this decision and would be happy to answer any questions.

The tribunal agreed with Virgin Blue that Sydney Airport was not subjected to an effective constraint, and this reasoning has now been quoted with approval by the Full Federal Court. There is no reason to believe that any other major airport in Australia is in any different position. Virgin Blue is very troubled that the commission is continuing to recommend that its light-handed regime should continue, even though the basis for relying solely on price monitoring has been shown to be flawed and has not been able to identify any other effective constraint on the market power of airports.

In relation to the price regulation of airport services, Australia is out of step with international practice. With the exception of New Zealand, no other country has privatised its major airports and not sought to place some effective constraint on their monopoly power. Current airport charges are inefficient. Virgin Blue considers that in the period since price controls were removed, airports have generated revenues well in excess of efficient costs. This is not surprising, given that they are unconstrained monopolists. Even the report prepared by the consultants retained by Melbourne Airport commented that Australian airports were the most profitable in the world. Although the review principles require that revenues not be significantly above the efficient costs of providing aeronautical services, in its draft report the commission has not conducted any analysis of the major airports' revenues against their efficient cost of providing these services.

The Allen Consulting Group did conduct such an analysis, and while Jeff will provide a more detailed summary of his reports, this analysis demonstrated that airports' aeronautical revenue was significantly above the long-run costs of efficiently providing the services. Virgin Blue was surprised that the commission did not address or respond to these findings in its draft report. Instead of comparing revenues with efficient costs, the draft report considers whether there is any strong evidence of any systematic misuse of market power by airports.

Principally, on the basis of two comparisons, the commission found that there was no evidence. Virgin Blue has two comments to make in response. First, it is not clear to Virgin Blue how the commission devised the test that applied in the draft report, since it does not appear from the review principles. Secondly, for the reasons set out in detail in Virgin Blue's written submissions, the comparisons relied on by the commission suffer from a number of significant limitations.

In addition to generating revenues significantly above efficient costs, since the

removal of price control, airports have introduced inefficient methods for charging for aeronautical services, including charging on a per passenger basis for take-off and landing. In addition to being inefficient, such charges also damage competition in the airline industry and are inconsistent with world's best practice. With the exception of New Zealand, no other country in the world has airports that charge on a per passenger basis for take-off and landing. New Zealand is of course the only other country that has privatised and deregulated its airports.

Given the detailed reasoning of the tribunal on the issue of per passenger charging for take-off and landing, and the other evidence Virgin Blue presented to the commission, Virgin Blue was disappointed by the commission's treatment of this issue. Full details of our view on these matters are set out at length in our submission to the commission. Virgin Blue's views on the commission's draft report; it will come as no surprise to the commission to learn that Virgin Blue does not agree with the central recommendation of the commission's draft report that the current regime, relying as it does on price monitoring alone, be extended for a further five years.

The commission also states in the draft report that it expects the recent growth in passenger numbers, which is forecast to continue into the future, will place downward pressure on aeronautical prices. Virgin Blue does not share the commission's confidence that increasing passenger numbers will result in lower prices. Instead, unless there is some additional constraint on airports' market power, this increased revenue and increased margin will simply add to airports' profitability. Indeed, I understand that Melbourne Airport has already sought to explain to the commission why prices will not in fact decrease, even though its costs are largely fixed and its passenger numbers are growing strongly.

The commission has recommended that airports be allowed to share the benefits of increased productivity with their airline customers; however, the commission has not defined what will amount to acceptable sharing nor what productivity benefits airports will be allowed to keep. In taking this approach, Virgin Blue is concerned that the commission may have given airports an excuse not to decrease aeronautical charges.

Airports are likely to assert that increased revenue from passenger growth is productivity growth, and that the commission's recommendations allow them to keep the vast majority of this benefit. To prevent this from happening, the commission should state clearly in its final report that the only productivity gains that should be retained by airports are those gains that are properly attributable to the efforts of the particular airport. Further, the commission should clarify that sharing does not mean that an airport is entitled to keep the majority of such benefits itself.

In relation to the price-monitoring process, Virgin Blue strongly agrees with the commission's recommendations to standardise the definition of aeronautical services in line with the submission made from DOTARS. However, Virgin Blue strongly disagrees with the commission's recommendation that the frequency of the report be significantly reduced. This recommendation appears to be based on the assumption that airport charges are likely to be fixed for larger periods of time.

As discussed in Virgin Blue's submissions, many major airports are not prevented from unilaterally increasing their charges on very short notice. In these circumstances, reducing the frequency of the monitoring reports to only one every two years would mean that an increase implemented in July 2008 would not be reported until early 2011.

Further, the price-monitoring regime should apply to all major airports, and certainly Darwin Airport shouldn't remain subject to price monitoring. The commission advances two reasons why Darwin Airport should be excluded from price monitoring. The first is that Darwin Airport faces competition from other airports such as Broome for international flights. If there is any constraint from this competition, then it will only have an impact on international charges.

The second reason given is that Qantas will have an increased bargaining power. The fact that Qantas might have increased bargaining power due to the fact that it accounts for the majority of flights to Darwin Airport is cold comfort to Virgin Blue. As Virgin Blue discovered at Sydney Airport, to the extent that a large airline has any bargaining power, this power is likely to be used to the benefit of the airport and the larger airline and to the direct detriment of Virgin Blue. I would also note that Darwin Airport does not have a good track recording of providing Virgin Blue with pricing or costing information on a voluntary basis.

In relation to asset values, Virgin Blue welcomes the commission's opposition to asset revaluations. While Jeff will discuss these issues in more detail, Virgin Blue does not consider June 2005 to be the appropriate cut-off date for revaluations. Instead, the commission should recommend that the starting asset value for airports be those values implied from the prices allowed under the previous price cap regime. As for asset betas, Virgin Blue strongly disagrees with the commission's statement the asset beta of airports has risen and is surprised by the absence of any detailed analysis to support this conclusion. Jeff will address this very important issue in more detail.

Virgin Blue's solution. It is clear that the current price-monitoring regime has not been effective in preventing major airports from earning aeronautical revenues significantly above efficient costs or from levying charges in inefficient and anti-competitive ways. The impact of this goes beyond a mere wealth transfer from

airline shareholders to airport shareholders. Charges above efficient levels result in reduced passenger numbers and welfare losses to society as a whole. Going forward, Virgin Blue believes that the commission must recommend a regulatory regime that will prevent airports from raising charges significantly above efficient levels, while also retaining maximum flexibility to allow airports and airlines to negotiate and agree on efficient and competitive terms and conditions for the use of airports' facilities.

Virgin Blue considers that a negotiate/arbitrate model of the sort detailed in its submissions would meet these criteria. Such a model should allow parties to have disputes resolved by an independent expert arbitrator. Given the issues involved, Virgin Blue considers that the ACCC is best positioned to perform this role. There is no-one else that Virgin Blue is aware of who would have the necessary expertise and who would be seen as an independent by both airports and airlines. In order to facilitate commercial negotiations the ACCC should issue guidelines on key pricing principles, as detailed in our submissions.

Further, parties will be most likely to negotiate commercially where there is transparency of information. For this reason, the price monitoring regime should be retained and improved, as set out in Virgin Blue's original submission. Given clear guidelines on key pricing principles and transparent cost information, there is no reason to fear that airports and airlines will automatically resort to arbitration in preference to commercial negotiation. Arbitration is costly and there is little to be gained from the process if there is reasonable certainty as to the outcome.

It is worth remembering that a number of airport services have been declared to date without any party yet resorting to arbitration and other industries have had similar experiences with a negotiate, arbitrate model. Nevertheless, there will of course be the occasional dispute which will not be resolved through negotiation where arbitration may be necessary. However, Virgin Blue does not expect there to be many such disputes. If the commission is still concerned by the possibility of this happening, then Virgin Blue would recommend the commission revisit the operation of the model after a probationary period to determine whether additional incentives are warranted.

A negotiate/arbitrate model also offers the best outcome for the investment. Airports will be free to engage in an efficient investment without the need to go through any formal NNI process, and the availability of arbitration will act as a constraint on inefficient and wasteful investment. Finally, the model recommended by Virgin Blue offers significant benefits over a future involving a multiplicity of declaration applications for airport services. This future may be more likely following the Full Federal Court's decision. Virgin Blue's model would provide welcome certainty while avoiding the significant costs and delays that would be

associated with multiple declarations. I now propose to hand over to Jeff to provide an overview of the reports that have been provided to the commission from the Allen Consulting Group. Thank you.

MR BALCHIN: Thank you, Andrew. As just mentioned, the purpose of my presentation is just to provide an overview of the work that we undertook for Virgin Blue. I'll first turn to the work we did assessing whether the airport pricing practice had complied with the government's pricing principles and the related issue to that of asset valuation, and then I'll finish with a few observations on asset betas.

Now, economic principles do not provide an unambiguous answer as to what price should be charged for some infrastructure and, relatedly, what should be assigned as the cost. Sunk assets, if you don't have an alternative use, they'll remain in the use irrespective, but there needs to be some certainty about the past so you can provide some certainty for new expenditure, new investment as well as new operating obligations.

The method we concluded was most appropriate for defining and estimating long-run cost was to start with a cost that was being recovered under the previous price control and to ask under what circumstances that cost would be justifiable for a change in the cost price to flow through to airport users. We concluded that if there's an increase in the ongoing cost of providing aeronautical services then the airport should be permitted to raise prices, if necessary, to provide that cost. Where new capital projects are undertaken, again it's the situation where efficiency demands that the airport should expect a return of those funds that are invested.

Similarly, if there's a shock to demand such as what happened immediately after the exit of Ansett, an airport should be free to adjust prices to prevent the revenue shortfall. But further price rises from those that existed under the previous price control regime - for example, to align prices with a new asset valuation which in reality is just a change to a book entry - serves no useful purpose in economic efficiency and therefore should not be considered justifiable.

Now, the method that we applied to derive long-run cost according to this method was quite straight forward, used familiar tools from utility regulation, and it was explained in quite detail in our first report, including the information sources we use. So I describe that in detail. The results that we obtained from that analysis was that the revenue to all of the airports which has increased substantially since the cessation of formal price controls has increased by a far greater amount than can be explained by an increase in operating or capital costs and prices have increased by far more than can be explained by any permanent shock to demand. In some cases that increase has been not just by an amount but by a far greater amount.

Moreover, given that the cost of providing aeronautical services is largely fixed and the pricing basis around most of the airports is based on passenger numbers which continue to grow, the gap between revenue and cost for all airports will continue to expand over time if the current price levels are maintained. So from this we concluded that the airports have not complied with the government's review principle number 1 and number 3 that revenue track the long-run cost of providing aeronautical services over time.

I will now turn to the related issue of asset valuation. Now, first on this matter let me acknowledge the commission's finding that there is no strong argument in economic principles for revaluing aeronautical assets to reflect their opportunity cost or otherwise. As we put it in our first report, it's difficult to argue that revaluing land assets, that their opportunity cost will have tangible consequences for economic efficiency. But even if it did, then the same theory would imply that all assets should be valued at opportunity cost. The far greater share of the assets for the airports are irreversible investments in terms of runways, terminals, aprons, the like.

Our method for determining the long-run costs, as I described above, implies a specific method for setting an initial regulatory value for aeronautical assets; namely, the effect is that the regulatory value is the value that was implied by the former price control regime. The fact that a value can be implied by a level of prices shouldn't be really taken as radical. Indeed, in competitive markets that's actually the way it works. This is also a method that has been widely used by regulators in situations where there was a desire to make a pragmatic decision about where a value should be locked in going forward such that there wasn't a great adverse effect on efficiency but so that there was certainty about the recovery of new costs going forward.

Now, we consider this method is reasonable and it's most consistent with economic efficiency. We pose the trade-off as being that on the one hand the lower value - as else constant - would improve economic efficiency. The reason is that we're dealing with a declining cost industry where the marginal cost is generally very low, and so by minimising the value, you're minimising the mark-up over marginal cost that creates allocative efficiency losses. But we also recognise that it's in the interests of dynamic efficiency that investors are treated in a manner that's considered to be fair and reasonable with respect to their sunk assets. Even though assets may be sunk, investors can interpret decisions about past investments as indicative of how future investments might be treated; and that's well accepted.

But our view is that that trade-off is best achieved by setting a value that is consistent with the level of price control as it previously applied. That's nothing more than saying that it would have been quite reasonable for a purchaser of an asset that's subject to price regulation to recover a value that's consistent with the value it

had under that price regulation. From our experience in working for a lot of regulators as well as regulated companies and having been around lots of privatisations, we would see it as being quite an unreasonable assumption for purchasers to believe that in the future they could increase revenue in the future for reasons that weren't tied to new expenditure obligations or new investments being made, but rather just through changing accounting entries. Accordingly, we disagree with the commission's valuation proposal, and our conclusion is it will sanction rises in prices since the cessation of price controls that don't reflect changes in cost or demand but only adjustments to book values.

Now, on this matter, the commission stated that it considers the setting of the initial regulatory value as being one of a distributional issue only, ie, not having consequences for economic efficiency. Respectfully, on this matter I would have to disagree. For there to be no efficiency implication then it either has to be assumed that the airlines won't pass on changes in aeronautical charges or that passengers demand for tickets for flights is perfectly pricing elastic so that if there is a change in ticket prices there is no demand response. Neither of these assumptions is valid.

We've just shown in the material we've provided that even a pure monopolist under our simplifying conditions would be predicted to pass on half of the change in its notional cost in the final prices. For a Cournot duopolist this rises to about two-thirds and in competition it's about 100 per cent. So it has to be expected that at least some and a significant part of any change in motion of cost would be passed through in the final prices.

Turning to the question about whether passengers will actually respond to change in ticket prices, there are a plethora of imperial estimates of the own price elasticity of demand for air travel. In fact, this seems to be one of the most studied areas in price elasticity that I've ever seen. The evidence shows overwhelmingly that it's not perfectly pricing elastic, and indeed for leisure travel it's something you would categorise as having a very high price elasticity of demand in absolute terms. A recent Canadian study has summarised, I think, probably the world of elasticity studies that existed at the time and came up with a median price elasticity of demand for short or leisure traffic at one and a half, which is a very high price elasticity of demand.

To illustrate what this means for efficiency, we've set out the results of some economic material that was provided by a leading expert in this area in the context of the tribunals hearing into the declaration of SACL. This material, as we've pointed out, predicts a material effect on a number of flying passengers from reasonably modest increases in aeronautical charges for just one airport, and that will be multiplied across them all.

I will now turn to the matter of asset betas. The commission has made several observations about asset betas, and in particular it has concluded that there are reasons to believe that the asset betas associated with providing aeronautical services may have risen since the ACCC administered the previous price control regime. Just for the uninitiated, the asset beta is a measure of the relative risk of an asset and therefore of the return that the asset requires. Now, the estimation of asset betas is a complex area and so I'll keep my comments reasonably brief.

First, in my view, the commission's qualitative analysis is considered only a subset of the possible changes that may have occurred to the environment within which aeronautical services are provided. One factor I think that may be significant which is qualified by the remarks I'll soon make, is the effect of the increased competition between airlines on the countervailing power, on the market power of the airports, in particular, increased competition by users of the service we'd normally predict a decrease in any countervailing power that existed, which would normally be associated with a reduction in the asset beta.

But more importantly, though, intuition is of quite limited use when estimating asset betas, even if the full range of factors that may affect betas was actually known. We really have no idea about knowing what effect they have on asset betas in quantitative terms. At best we can come up with a direction, but in terms of coming up with an effect on a beta and the effect of a number of factors, it's really nothing more than guesswork. Asset betas are an area where the only - betas is, as in all cost of capital parameters, is an area where the only robust point of reference is empirical information.

Turning to that, estimating asset betas though is a substantial empirical exercise, and I'd be the first to admit it's one that's far from a precise science. In fact, you wouldn't call it a science. It's far more towards the spectrum of art than science. To just illustrate some of the problems, betas can only be estimated for share market listed entities, so that immediately reduces the sample size considerable. For those comparable type entities that can be found, very few of them - I don't think there are any that provide only aeronautical services. So you're dealing with mixed entities, a few number of mixed entities to start with.

Then there are numerous plausible methodological choices that are open to the researcher when you estimate betas, such as the choice of a length of the sample period, how frequently you should sample observations; is it daily, monthly, weekly or longer periods; how should returns be measured, discrete or continuously compound them; and whether and how betas should be adjusted or combined to improve their precision, and how you should adjust them for differences in leverage. All of these matters are areas where there is no single way of doing things. What you need at the end of the day is judgement to interpret the totality of the empirical

evidence.

Having set out those caveats though, we have provided some preliminary estimates in our latest reports, certainly on behalf of Virgin Blue. On the basis of that our conclusion is that it didn't support the finding that the betas the ACCC had used for airports and under its previous role were too low. Indeed if you tried to draw strong conclusions from what we've called a preliminary analysis, you'd have to say that the reverse inference is more supportable. But what we would conclude on the basis of that and on the basis of our concerns about the use of qualitative evidence is that much more analysis is required before any firm robust conclusion on the level of asset betas for aeronautical services can be made. I'll leave my remarks there and I'll now hand over to Simon Snow to discuss implications of the recent Federal Court decision.

MR SNOW: Thanks, Jeff. I'll be short to allow time for questions obviously. In short, Virgin Blue welcomes the recent decision of the Full Federal Court SACL v ACT. Virgin Blue has written to the commission setting out in pretty full detail its view of the impact of the decision, so I'll just give a brief summary and overview of Virgin Blue's position and take any questions at the end of that or other questions if people have them.

The first point that Virgin Blue would like to make is the correct test is simple. The decision confirms Virgin Blue's consistent view that the test under declaration criteria in (a) in Part IIIA was always intended to be a simple test; therefore the decision cannot be seen as surprising. Essentially, this simple test asks whether access to the service is necessary in order to permit effective competition in a dependent market and that language reflects Competition Principles Agreement clause 6 as well.

Secondly, the old test was unnecessarily complex. The test applied by the tribunal in previous cases and also in the original Sydney Airport decision asked whether declaration as opposed to access would promote competition in the relevant market compared with the existing position. Such a test often involved a complex inquiry into the likely state of competition following declaration, and the Full Federal Court has confirmed Virgin Blue's view that such a complex inquiry is not required under criterion (a).

It's also clear that the simple test is what parliament intended. It could not be said that the simple test or its consequences for airports is inconsistent with the intention of parliament or of government. The simple test confirmed by the Full Federal Court is the test intended by parliament, and as the decision shows by its careful analysis of the parliamentary materials and the source documents, including the Hillmer Report, the COAG explanatory material and clause 6 of the Competition

Principles Agreement. It's also worth noting that the source material referred to by the court also includes a number of references to airports as examples of natural monopolies when discussing the essential facilities problem.

It's also clear that government intended Part IIIA to apply to airports. As others have said today the application of Part IIIA to airports is entirely in keeping with the government's policy on access to airports. The government's response to recommendation 7 from the commission's last inquiry into airport services stated, and I quote, "The government supports the application of the generic provisions of Part IIIA to airports."

Next, I'd like just to note that declaration itself doesn't result in price regulation. While the Full Federal Court decision has confirmed the declaration test should be a more easily satisfied one, it should be remembered that declaration does not of itself result in any price regulation. Parties remain free to negotiate commercially, and if a declared airport acts reasonably in the interests of efficiency and competition, arbitration would never be required.

However, we'd like to note that even with the decision, Part IIIA is still not an effective constraint on airport market power. Part IIIA is not an effective constraint for the reasons that Andrew gave before, which is that it takes a very long time to have a service declared and the costs involved in seeking declaration can be quite high. It's also worthwhile noting that the operation is not retrospective; to the extent that there was an overcharge in the period prior to a declaration date, that overcharge can't be recovered through the declaration process. Therefore Virgin Blue continues to press for the commission to recommend a negotiate/arbitrate model for aeronautical services at major airports.

Finally, Virgin Blue believes that other solutions must not require amendment to Part IIIA to reduce its scope. The commission would no doubt be aware that declaration under Part IIIA can be avoided if an effective access regime is introduced. Virgin Blue's proposed negotiate/arbitrate model would indeed be such an effective access regime. But Virgin Blue is also prepared to consider other effective access regimes that have been proposed by other parties, including the one proposed by Qantas. However, Virgin Blue would strongly object to the introduction of an ineffective access regime coupled with an amendment to Part IIIA to exclude airports from its operation. Virgin Blue believes that such a proposal would significantly reduce the rights that parliament and the government clearly intended that airport users should have. That's the short summary, thank you.

MR HANLON: No, I'm not - - -

MR SNOW: There's a few minutes left.

MR POTTS: Let me say at the beginning, we found your submissions very useful, particularly a lot of the technical analysis in it, and I don't really want to go into those issues here because we don't have enough time. But I did want to say that it was very helpful from our point of view. Although I suppose I make the obvious point that if you put two economists in a room they probably won't agree on anything and it's probably symptomatic of what we've seen with some of the technical issues that you have addressed in your report. There have been other consultancy firms engaged by other stakeholders and they've come up with quite different reasoning and conclusions. So I just make that point.

Perhaps can I start with the Part IIIA issue, because you're as close to this as anyone, I think, Virgin Airlines. Can I put this question to you. There's been a difference of view, I think it's fair to say, among the airports in particular that we have exchanged views with, both here in Sydney and in Melbourne, about the import of the Federal Court's interpretation. One airport said to us that they believe the interpretation they've put on it by the Federal Court means that it's no longer a question of a conduct of an airport, essentially it just becomes a structural issue that I think as you were implying in your comments, almost by definition as far as airports are concerned, access is required to enable competition.

So that particular leg of Part IIIA on the interpretation that you're giving it is sort of almost knocked away, if you like, which leaves you with two other key tests that have to be met. One is, can the service be economically replicated, and I don't think anyone would suggest that as far as a major airport is concerned that that test could be met; and the second one is, is it a nationally significant market? Again, they're likely to meet that particular test. So on one reading it becomes a structural issue and not related to the conduct of the airport itself. Others have said, particularly today, that no, they don't think that is the case, it's still partly dependent on the conduct or behaviour of the airport. Could I get your interpretation on what you think this decision means in terms of how relations between airports and airlines will unfold?

MR SNOW: I think there's two questions there: what impact it will have on how airports and airlines will interact - and I defer to others to sort of talk about that. But in terms of what it means, I think it's important to remember that the decision really revolves around largely criterion (a). There are other declaration criteria as well, including criterion (f). There's also the potential for a residual discretion; however, we would say that the position in relation to criterion (a) is never quite simple and it shouldn't be about a conduct test, but is more about a test of whether or not access is required in order to compete in independent market for effective competition in a downstream or upstream market, and that's not a question that really revolves so much in relation to criterion (a) around the particular conduct of an access provider.

But in relation to the other question, is there anything you would like to add?

MR HANLON: We would see negotiation as always the first step in any process. We're not going to lean on this. We always have said that we don't want heavy-handed regulation and that's still our stance. This hasn't changed that much for us. We still want to sit down and negotiate with airports, and we see that as the first step in any commercially agreed position between the parties.

MR POTTS: So you're saying that you believe that negotiation would be the first thing that you'd prefer to do - - -

MR HANLON: Absolutely.

MR POTTS: - - - in terms of conducting your business?

MR HANLON: It has been - - -

MR POTTS: But equally, if you chose not to do that, you believe that under the interpretation given to Part IIIA you could seek declaration; and presumably, if you wished, you could seek a blanket declaration.

MR HANLON: We would always seek negotiation when it's - - -

MR POTTS: If you accept the argument that it's a purely structural thing, not to do with the conduct of an airport.

MR SNOW: Sure, and I think the Full Federal Court's decision speaks for itself. But I would just remind everyone that there are other criteria there as well as criterion (a), but I think the decision says quite clearly that the criterion (a) test is much simpler and straightforward test than has been considered by the tribunal in the past.

MR DAVID: We have had no internal discussions about any blanket declaration.

MR HANLON: Our current position is that we're not declaring any other airports.

MR POTTS: Right. You're not expecting declaration.

MR HANLON: At this stage, correct.

MR POTTS: The reason for that is you believe - is it because this process is unfolding, or is it that you believe that Part IIIA has increased your negotiating position vis-a-vis the airport, or is it because you believe that your commercial

relations with other airports is satisfactory?

MR HANLON: I think it's probably something else after four years. We're all just a bit tired and I don't want to do it again. I know I've made some lawyers and some consultants very wealthy, but you know, we don't want to do that. It is costly, it is time-consuming. Four years and we still don't have a resolution. You know, if we start doing this, it just turns into a real joke. We're in the business of business. We've got far too many things on the drawing board at the moment to be worried about declaration lawyers and sitting in courts. That's the last thing that we'd want to do.

MR POTTS: Do you expect though that this will shake the conduct or approach of the airports? To the extent the bars have been lowered, which I think you were saying it has been, you would think that the airports would, if you believe that Part IIIA has got significance to it, in terms of a backstop if you like, you would see the airport as having greater interest in entering into commercial negotiations.

MR DAVID: We wouldn't have gone down this path if we didn't think that was going to be an outcome, but our fundamental approach is we would still prefer and negotiate, then the ability to fall back to arbitration if we have to. But we operate with airports at many, many levels, through the day, through the week, through the month, through the year, and we need those to be healthy relationships. We need to work together.

MR POTTS: Can I take it from that comment, Andrew, that by and large - I mean, leaving aside Sydney Airport obviously where you had an issue, I don't know whether you have an ongoing issue. But as far as the other airports are concerned, by and large the commercial relationship is on a good footing. Is that a reasonable categorisation of it?

MR HANLON: It's a bit of a mixed bag really. Some are good, some are bad. Some turn on weeks, get better, you know, it's business. We can be friends today, enemies tomorrow, friends the day after. It's just business. So to say they're all good or they're all bad - and even leaving Sydney to one side - it kind of is a bit of a generalisation. It's probably a mixed bag more than anything.

MR POTTS: It's just that we heard from Qantas that by and large it's not a satisfactory relationship.

MR DAVID: At the end of the day you're still dealing with monopolies and you're dealing with privatised monopolies with no price caps in place. So what we're suggesting is give us some guidelines and we can work more effectively, and that's the fundamental problem we have with dealing with monopolies. We can't take our

aircraft somewhere else.

MR POTTS: In some cases the airports in the last five years have done nothing more than work off the ACCC model, indeed that was one of the reasons why we thought we needed another five-year period of price monitoring, because it hadn't really been tested. The full commercial relationship hadn't developed yet for whatever reason and the airports partly were just running off the ACCC models. Now, if they're running off the ACCC models, which might sort of ask some questions about your own analysis, I suppose, where you believe the pricing has been, what, inappropriate in terms of the long-run costs - but I don't want to get into that issue because it's a technical issue.

But nonetheless, I mean, if the ACCC is going to be the arbitrator as you see it under the regime that you're proposing, they were the ones who put in place this sort of model that's being used in many cases in the last five years, and you know, some of the airlines - Qantas and perhaps Virgin to a lesser extent still haven't found that satisfactory.

MR SNOW: I think it's worth also reminding ourselves that the ACCC when asked to consider not just the level of charging, but the manner of charging as well, objected to per passenger charging, yet that hasn't stopped all of the airports or a large number of them considering or moving to per passenger charges. Jeff, did you want to respond on that?

MR BALCHIN: Yes. Just on that, on the ACCC model, I don't think it can actually be sort of demonstrated there is compliance with an ACCC model, because the single biggest, I suppose, variable in the whole thing is what value is assigned to the existing assets that were in place some time in the past; and Sydney Airport is the only airport for whom the ACCC expressed an opinion on that. For the remainder of the airports there was a price cap there and its only role is to tick off any (indistinct) so it I mean it really comes down to - I mean, an airport - five different people could have five different views about what the regulatory asset base is and give five different answers, and I expect the ones the airports have used in their models are higher than the ones that I've used and the ones that are generated by themselves. The work we've done though is to infer the asset value from what was - from what prices were allowed under previous price caps. I don't know what they've actually done in their models.

MR POTTS: On this negotiated/arbitrated model, which I think really is the key difference to what we're proposing, if you look at the submissions we've received as a whole, and particularly as far as the airlines are concerned, that is the major point of differentiation in the draft report. As we set out in the draft report the concern we have is, you know, whether you can design a negotiated/arbitrated model which

doesn't in time just become a de facto form of regulation; because the parties will - if the ACCC is the arbitrator then the parties will come to know where the ACCC will draw the line in terms of what's a reasonable outcome, and there may well be commercial negotiations but the commercial negotiations inevitably will be around that line because the parties know - one party will know if it can't get an outcome that is at least as satisfactory as where the ACCC will come out. After you allow for transaction costs, why not go to the ACCC and get an arbitration, because their model will become very well known, and it was very well known when we had the old regime.

So I mean, the question in my mind to put to you is how can you convince us that the sort of models that you're talking about which is a fallback ACCC arbitration with detailed pricing guidelines produced by the ACCC to guide the commercial negotiation, it won't be a de facto form of regulation? Now, that's the fundamental issue we have. I mean, if we can think of a system that will avoid that problem and result in genuine commercial negotiations, because that's what light-handed regulation is about, that will be great. But we baulk at the idea that you can sort of create this system without really having a system which is a de facto form of regulation.

MR HANLON: A couple of things on that and one is the system we're coming up with isn't like the old NNAI regime where it was a default back to the ACCC. We're not saying this is a default to the ACCC. We're saying this is a negotiation and, we're saying as long as everyone is reasonable - you're right, people will work out where the ACCC is going to lie and that's at the reasonableness line. So as long as the airport when they're offering us the pricing is around that, why would we spend four years and millions of dollars to go and get what we've been given? It just doesn't make sense. But if we know that the reasonableness line is about here and the airports are playing games up here, of course we're going to go, because it's worth it. But it's not a default. We're not defaulting to that. It's not like the old NNAI, and I want to make that clear.

Our system is built on negotiation, and we're trying to do that with a lot of airports over the last five years; some successful, some not so successful; some were on a basically take it or leave it basis. So from our point of view it's not a default, it's a circuit-breaker if it's necessary. There's clear guidelines as we said before from the ACCC, so we're all going to know what's pretty much what we're going to get if we go there, and that's basically that it's a reasonable price, an efficient price for, you know, proper and efficient investment; and that's all we've asked for.

MR POTTS: But doesn't that mean it's effectively been set by the ACCC, because you just said that, "We'll negotiate but we'll know what we get if we go to the ACCC."

MR HANLON: No, you're going to know roughly what you're going to - you know, you're roughly going to deal with the 2001 kind of building-block model. There'll be a rough guideline on some betas and some rates of return et cetera. But you know, the passenger inputs, the OPEX inputs, the other inputs, the ACCC isn't going to know them and they're negotiated to build up the model and to build up a price; and as long as that's reasonable and efficient along the way then we've got what we wanted, an efficient price for proper investment.

MR SNOW: I think it's also worth noting that there's a larger focus on sort of aeronautical prices, if you like. Obviously there are great benefits in terms of arbitration for non-price terms and conditions that we should remember as well. The other thing is to remember that the ACCC is largely going to be concerned about ensuring that there's an efficient level of revenue recovered. There is still a great deal of flexibility that can be retained through commercial negotiations that's available under this system that wouldn't be available under a sort of formal price control system.

The parties can still engage in all sort of negotiations around the structure of charges, how charges are implemented, timing, a range of other factors. It's just that, I guess, in the back of everyone's mind there will be the knowledge of what the ACCC is likely to regard as the efficient - or any other arbitrator if you like - what is the efficient level of revenue that the airport should be recovering. If an airport tries to recover significantly in advance of that amount of revenue, then that's where I guess there's - an arbitration option is always seen that it can restrain that overall revenue, but in terms of how it's sliced up, how it's charged - so long as agreement can be reached flexibly between airlines and airports they're free to do that.

MR POTTS: That's an interesting question. I'd like to discuss this question which you emphasised in your comments and that's appreciated. It's this question of to what extent is it rent sharing that we're talking about and to what extent is efficient pricing important, and particularly the impact of Virgin Airlines as a low-cost carrier on airport landing charges. You will have heard this already because I've asked it a few times before, but I'm wanting to know what the impact on airlines has been of the fuel surcharge that's been put in place in the last few years as a result of the increase in world oil prices, which I think Qantas mentioned it averages about $25 per ticket. I think in Virgin's case it's probably less, but nonetheless it's significantly higher than say the landing charge at Sydney Airport.

A couple of questions to begin with. One is what impact has that surcharge has on passenger demand for Virgin seats; and secondly, to what extent does Virgin Airlines apply that charge differentially among passengers according to the part of the market? So if you like, you apply Ramsay pricing, so where the market is more

elastic then you don't apply the full surcharge, whereas where it's more inelastic you apply perhaps a surcharge to a greater extent. Flowing on from that, to what extent does Virgin see scope to do the same thing with airport charges? In other words, even if you're being charged a certain amount per aircraft or per passenger, I presume it's within your powers of flexibility to apply that differentially across customers, or not?

MR SNOW: Not if it's charged per passenger. I think that - - -

MR POTTS: It's only an average, though, isn't it?

MR SNOW: - - - significantly reduces the flexibility.

MR HANLON: Can we just start with - Virgin Blue is a low-cost carrier which essentially - the model is built on keeping costs as low as they can, keeping the fares down that we charge to our passengers - as low as we can to stimulate demand. That's every cost: airport charges, fuel, labour, everything. We really try and squeeze them as much as we can. When things like fuel come to us, yes, we do have to review that, because any cost increases have to be recovered from your guests. What we've done is, we've got an all-encompassing price, an all-inclusive price, so we don't say, "It's 20 bucks plus 10 for the fuel." We say, "It's 120 bucks for the flight." So from our perspective we don't recover all of the fuel on all of the paying passengers.

What we've found is that a lot of the people on the higher-priced tickets go to the lower-priced tickets to try and keep the savings in their pockets; so we have a diminished demand on the higher-priced tickets and we have a greater demand on that. So ultimately the revenue to us falls. But we've seen how that can affect - it does affect demand. I know Jeff can talk probably for years about the elasticity of price and tickets, but it does have a significant effect - but it's all prices, but we do try to keep them as low as we can. As far as differentiating - you asked about differentiating - - -

MR POTTS: Well, before we leave that, the passenger numbers, what's happened to passenger numbers for Virgin since you've seen the increase in oil prices which - you know, rather than applying a levy you just put it into the price of the ticket. Has that had an - - -

MR DAVID: In some cases we absorbed the cost but we couldn't pass it on.

MR POTTS: But there's some things you've had to pass on.

MR HANLON: Correct. There has been reduced demand on those tickets.

Correct.

MR POTTS: Passenger numbers overall for Virgin have been affected by this rather significant cost increase?

MR HANLON: It's hard to explain, because at the same time we've had quite a significant growth phase. So we've had the growth and the lowering of passengers, so that maybe our growth hasn't been as high as what it should have been. As far as total passengers goes, I'm unsure, but I can get back to you on that. But there has been a decreased demand in our higher-priced tickets.

MR POTTS: But to the extent that you can't identify easily a change in trend from an increase in charge of $20 per ticket, is it going to be possible to say that for a $3 landing charge that goes up by 50 cents, for argument's sake, that that is having an impact on passenger numbers?

MR DAVID: I think we've outlined in our submission though how those charges relate to both the profit on individual sectors and how they relate as an average compared to both the medium fares and the lowest fares as well.

MR HANLON: I think the numbers need to be sort of carefully considered. I think the overall sort of total airport and aeronautical charges are much more than $3. They're in the vicinity of 10 and more for the different airports; of course, you have to take off and land.

MR SNOW: On top of that I think it's also worthwhile remembering - and this issue was discussed at quite some length in the tribunal decision in relation to fuel levies and surcharge and what the impact was. Just because you introduce a certain fuel surcharge, if you like, on all different fares it doesn't mean that your average fare actually increases by that same amount. In most circumstances, as David said, it will increase by in fact a lot less than that.

MR POTTS: Can you apply the surcharges differentially, and do you?

MR HANLON: Yes, in the same way we manage our revenue on a series of buckets depending on the capacity - - -

MR POTTS: So that figure you mentioned of hundreds of thousands - I think in the confidential submission you're actually quoting a figure - - -

MR HANLON: Correct.

MR POTTS: Was that calculation based on an assumption that the full cost was

passed on to each and every passenger regardless of the segment of the market?

MR SNOW: That would have been out of Tae's work.

MR HANLON: No.

MR SNOW: There's assumptions as to - - -

MR BALCHIN: No, there were differential - the modelling that it was based on was a conjectural variation of a oligopoly model, and there were different assumptions made about the conjectural variation that varied from full monopolies or part of - prefer Qantas's business class where there was only 50 per cent of the cost margin - cost change passed on, to an assumption in the case of the leisure passengers, the fare-sensitive passengers, that that was almost (indistinct) competition, which was I think 80 or 90 per cent or so of the cost change passed on. So it depended on the amount of rivalry, I would assume, in that particular market. So - - -

MR POTTS: Wouldn't it be the other way around? Wouldn't you pass it on in the elastic part of the market?

MR BALCHIN: No, the amount you pass on depends on the amount of market value you have. That's a general principle. In perfectly competitive markets, a dollar increase in marginal costs tends to increase prices by a dollar, but monopolies at least with a linear demand curve passes on only half. The reason for that is that the marginal revenue curve is twice the size of the average revenue curve that you only get half passed on. The impact on demand, though - there's added impact on demand, and the impact on demand then depends on the price elasticity of demand that's assumed. Those price elasticity and demand figures were based on published empirical evidence on price elasticity of demand.

I think what we probably have seen in Australia over the last five years is probably a reasonably rich data set that's been created that will make for some reasonably good estimates of price elasticity of demand, because it's quite useful to have prices and things happening to get nice robust estimates. But I'm not aware of anyone who has actually seriously properly analysed the passenger and price information over the last five years in Australia to come up with a robust estimate of price elasticity of demand; in which case I would always recommend deferring to published international studies in answer to that.

DR BYRON: From my recollection, with the introduction of the light-handed regulation regime by the Australian government, one of the things that was relied upon to "keep the airports honest" was a credible threat of re-regulation, or at least an

inquiry if there was clear evidence of abuse of market power. Now, the thought occurs to me is, is the problem that you've described one of design of the system or is it one of how the system has been implemented in that even when there was some abuse of market power, nothing was done and therefore there is no credible threat.

That raises the question of, you know, who blows the whistle? You know, at what point does the red flag go up? Another metaphor is at what point does the constable burst out of the cupboard with the big stick in his hand? Now, is the problem that light-handed regulation is inherently flawed because of the system design or is it just we wouldn't be in the position we're in today if at some point in the last five years the whistle had blown, the red flag had gone up?

MR HANLON: I think there's a couple of things in that. One is when you're dealing with a monopoly, to have really, truly meaningful negotiations you need some constraint. I think that's quite obvious. Without that constraint, you'll never have really meaningful negotiations. So I think there's that. Whether that's in the design or what, I'm unsure, but maybe it probably is, it's a fundamental flaw in it. As far as the cop coming out with the baton, yes, we never did see that. Would that have helped? It could have. I'm unsure. But without that constraint I just can't see why a monopoly who has to increase its value to its shareholders would want to stop playing with the power that it's been given. We need to have a constraint.

DR BYRON: Yes. The other part of this conundrum - and I don't have the answer to this puzzle - is that we're speculating about the sort of outcomes and prices that would be achieved in a competitive market model, and yet I can't think of too many places in the world where you would actually get that competitive, you know, free-market model in terms of provision of international airport services. There aren't too many places where they're side by side and competing head to throat, you know, like two commodity sellers in a bazaar. So we're trying to compare what we actually see with some hypothetical and unobservable ideal of what the prices would be under perfect competition. Is that a problem with - - -

MR HANLON: I see the ideal being that a monopoly who has significant market power is not going to behave like it has in the previous X years and not forced prices on us on a take it or leave it basis. I just can't see that happening. Sure, we are speculating how they're going to act in the future but it's odd that we've only had a few airports come to us with a pricing proposal going forward for the next five years. You know, they're all waiting to see what comes out of this. The games will go on unless there's some constraint there. I just can't see how it can't.

For five years I've been doing this and banging my head up against that wall. I just keep doing that. I don't know why sometimes, but I do. But it just doesn't go away by giving them a greater light-handedness, if there's such a think. You know,

the constraint needs to be there. Without the constraint, you will have this, 30 June I'll get the letter and on 1 July my price will go up by anything. I will get that. We need a constraint. Whether it's the model we came up with, Qantas's, Melbourne Airport's, the Department of Transport, we're all mature enough to kind of think, yes, we kind of need it, both sides of the fence.

Remember if airports behave as they've said they have all this morning - and we've got a couple this afternoon - and all last Monday - I don't know if you saw them in Melbourne - then what have they got to fear? Because they are behaving properly, or they're telling us that, so what is their problem if they've got this arbitrator in the background? How does it hurt them? I just don't understand that. They're telling us how they're behaving properly, they're pricing efficiently. You know, how does that - you take that - if we believe them the arbitrator really won't make any difference if they're behaving as they say. Did that answer your question? I - - -

DR BYRON: Yes. Thanks.

MR POTTS: That might be a good point to finish.

MR POTTS: Let's recommence and welcome Sydney Airport. Russell, as I've said to others, if you could first just state names and organisation you represent and then an opening statement and we'll take questions from that.

MR BALDING: Thank you very much. Russell Balding, chief executive officer, Sydney Airport. I'll ask my colleagues also to introduce themselves.

MS MASTERS: Nicole Masters, general manager, aviation business development.

MR SCHUSTER: And Dominic Schuster, manager, airport pricing and economics.

MR LEACH: And Wayne Leach, senior corporate lawyer, Sydney Airport.

MR BALDING: Thank you. Sydney Airport welcomes the opportunity to appear before the commission today. There are a number of matters that I would like to raise by way of opening comments, and I'll obviously then be happy to take any questions that you may put to us. But first let me say that from a general policy point of view we believe the commission has got it right in respect of its support for the continuation of light-handed regulation and in recognising that it would not be desirable to return to price regulation or a heavy-handed regulatory approach. However, we believe there are some matters within the draft recommendations that

need some clarification and minor modification.

Therefore, as part of this opening statement, I would like to address three main areas: those being asset valuation, obviously the outcome of the recent Federal Court decision in respect of Part IIIA, and dispute resolution. But before I respond to those areas, it bears repeating that while the commercial airport industry has been around for some 70 to 80 years, the current regulatory framework is still fairly new and airlines and airports are in the process of developing fully formed, mature commercial relationships; and by virtue of that will necessarily take some time to bed down the shift - which is a major shift - from government ownership and heavy-handed regulation to a more commercial environment involving diverse ownership under a light-handed regime.

It goes without saying that airlines are important businesses and they play an important role in our economy, in our society and our everyday lives. But so too do airports. Airports are not only major businesses in their own right, but they are also significant contributors to the economy more generally. They represent key infrastructure for airlines as well as for millions of passengers and for the broader economy that rely on their services. For this reason, it is essential that the regulatory framework strikes the right balance to ensure that the interests of the users are protected, but also that airports have the confidence - and that's an important issue - the confidence to continue with the significant investment that has characterised the past five years of the regime that we are currently in. We believe that the commission has recognised these issues in its draft report and that the final recommendations, if consistent with the draft recommendations, we believe will establish an enhanced basis on which to pursue commercial outcomes and fully transition to a new, more dynamic industry.

So I now move to the specific areas. Firstly, in respect of asset valuation, I think it's been recognised the key issue in resolving and avoiding disputes about pricing is clearly the divergence of views that has prevailed between airports and airlines in relation to asset valuation, and more particularly land valuation. The commission's proposal of adopting a pragmatic line in the sand approach to resolving this issue by essentially recognising previously booked revaluations in aeronautical asset base submitted by airports to the ACCC as part of their 2005 financial accounts we believe has its merits and we generally support it. However, we do qualify that support on two key points. Firstly, while accepting that there will be no revaluations under the pragmatic approach, we do believe that asset values should be indexed for inflation consistent with regulatory practice. This ensures that the return on investment is not eroded by inflation.

Secondly, we also believe that any errors in those accounts when the line in the sand is drawn - errors of accounts that have been identified and corrected in subsequent accounting periods and signed off by the auditors as a proper correction must be able to be remedied for pricing purposes. Having said that, as we argued in

our initial submission, we still consider that using an opportunity cost value of land is the more appropriate and economically efficient approach in respect to pricing. However, as I said, we do support a pragmatic line in the sand approach for the time being. We suggest that reconsideration of the issue of asset valuation be undertaken as part of the proposed 2011 review to see whether at that time a less arbitrary and more economic approach to asset valuation can then be adopted.

In respect to Part IIIA, while we note the Full Federal Court's decision in the Virgin Blue matter, our concern is not necessarily with the possibility of declaration and ACCC arbitration in the event of true denial of access, but with ensuring that Part IIIA is an avenue of last resort and does not effectively become a de facto price regulation tool that encourages regulatory gaming. The Federal Court's decision suggests that the national access regime provides significantly easier recourse to declaration and arbitration than was considered to be the case when light-handed regime was introduced, effectively lowering the bar for declaration.

It also results in uncertainty for infrastructure providers and will enable airlines to use and continue to use Part IIIA of the TPA not as a method of obtaining access or increased access to airport services - as such, access is already provided - but rather as a method of first resort to seek regulated pricing outcomes and regulated determination of airport operational and commercial issues. We believe that the Full Federal Court has placed an interpretation on Part IIIA, which results in greater uncertainty and is inconsistent with the government's underlying policy objective in formulating Part IIIA as a national access regime of general application. Significantly, we also consider that it is incompatible with a policy of light-handed regulation. We believe that the government needs to give consideration to legislative amendments to restore Part IIIA to its proper position of a last resort for true access disputes.

Which leads me to dispute resolution. Fundamental to the preparedness of any infrastructure owner to commit to major new investment is the degree of competence they will have about receiving a fair commercial return over the prolonged period of their investment's life. That competence inherently springs from a stable and certain regulatory environment and the infrastructure owner's ability to influence the price, the terms and the conditions on which services are provided. Influence over terms and conditions relates to both the formulation of new supply agreements and the ability to resolve disputes that may arise within the bounds of a concluded agreement.

Sydney Airport agrees with the initial position that the commission has reached in its draft report that it would be premature and potentially counterproductive to mandate any form of industry dispute resolution thereby risking the light-handed nature of the regime, particularly given that we are still in the relatively early stages

of the regime's application. We believe that the various proposals for binding dispute resolution put to the commission would in practice operate as a substantial disincentive to commercial negotiations and impose a heavy regulated framework over prices and other terms. We have, as you asked, given serious consideration to the commission's request for views on whether there is any scope for a form of intervention in this area that wouldn't necessarily constitute a return to heavy-handed regulation or as you were saying earlier to distort the dynamics of commercial negotiations. As this stage we do not believe there is one.

As such we believe that third party binding arbitration is inconsistent with light-handed regulation and indeed current government policy. Put simply, any proposal which requires binding dispute resolution will give rise to an incentive for parties who perceive that they may get a better outcome from third party dispute resolution to simply go through the motions as a prelude to arbitration and not engage in genuine, commercial negotiations. We therefore support the commission's view that no airport's specific arbitration regime or mandatory requirement for binding independent dispute resolution should be introduced at this time.

This is not to say that Sydney Airport is necessarily opposed to third party dispute resolutions. Indeed, its existing agreements make provision for third party medication, and in negotiating its proposed new long-term commercial agreements SACL will continue to offer this form of third party intervention within any new agreement. With good faith on both sides and with the benefits of the guidance that will flow from the commission's final report, airports and airlines will be much more able to achieve mutually acceptable commercial agreements that enhance the provision of airport facilities and at the same time underpin investor confidence.

Putting it simply, we believe that the framework for resolving disputes arising under an agreement is a matter for commercial negotiation between the parties and should be determined at the time that the agreement is put in place. So in concluding these opening remarks, I'd just like to add that light-handed regulation has worked, and against the backdrop of your draft report it will continue to work. Considerable progress has been made in moving to a mature, commercial environment, and the commission's recommendations as currently drafted with some minor modifications in respect of land valuation will provide sufficient clarity to contentious issues to further expedite the transition to a mature commercial environment. Thank you.

MR POTTS: Thanks, Russell. Look, I might begin with your concluding comments there, if I could; that you think that light-handed regulation has worked and that is the way forward in the future. But the airlines have said to us just in the last couple of hours since lunch essentially that they don't believe that an effective, satisfactory, commercial relationship with the airports can be developed over time without satisfactory dispute resolution mechanism, which when you go into some of

the details of it looks as if it involves a fair amount of prescription from a regulator or an arbitrator of one kind or another; which is contrary to what you were saying yourselves in terms of what you think is the right structure going forward.

So I guess the question is, as you're representing Sydney Airport is do you believe that you can over time develop a satisfactory commercial relationship with the airlines within the structure that you're supporting?

MR BALDING: We definitely do believe that, and as I said in my opening comments, I think a lot of the contentious issues or debate and discussion around contentious issues I think will be addressed through your report, if that report is consistent with the draft recommendations and your draft findings, particularly in respect of the issues in respect of asset valuation and the way going forward for asset valuation. As I said, the pragmatic approach of drawing the line in the sand makes it very clear where things are in respect of those assets valuations. Issues in respect of the third party binding arbitration, I believe that, you know, people put the question to you, "How do you have a commercial outcome if there's no third party binding arbitration?" And that has been put to this commission by Qantas and to a lesser extent by Virgin.

In my view, not having a mandated third party arbitration is an advantage to a commercial outcome, because you haven't go that regime sitting in the background. You rely on proper commercial negotiations; you rely on good faith negotiations to sit down at the table and to negotiate in genuine terms, rather than having the opportunity, as I said, to go through the motions and go to arbitration. So at the end of the day by not having mandatory third party arbitration it creates or is one of the contributing factors of having an effective regime to sit down and have genuine commercial negotiations.

MR POTTS: The argument of the airlines is that the table is tiled, if you like, fairly - - -

MR BALDING: Which way?

MR POTTS: Fairly significantly in the airports' favour, and that a lot of that is because of the lack of countervailing power that the airlines believe that they have. In some categories it's almost as a take it or leave it situation in terms of what the airports say to the airlines. Can you comment on that, to what extent you believe that it's an equal negotiation and to what extent that it might not be an equal situation.

MR BALDING: I'm still a relative newcomer to the industry, but in respect of countervailing power I've got to say I think it is equal. You know, when you sit down and have discussions with major airlines - and I'm talking major airlines as

opposed to minor airlines - although the minor airlines are represented by BARA. Where those parties sit down with a genuine will to have a commercial outcome, then it is equal power. You know, there has been assertions that we impose conditions and prices upon airlines and you just said it's a take it or leave it situation. It's definitely not a take it or leave it situation.

We come to the table, and I'm sure sometimes in good faith airlines come to the table with the basis of negotiating a commercial outcome that is to the benefit of each party. That is what commercial outcomes are all about. You may not get that outcome on day one. It takes a long time to get that outcome. These are complex issues that we're addressing and we're addressing from different sides; but at the end of the day if you come to the table with that good will to achieve that commercial outcome then it will prevail.

MR POTTS: But in some cases the effort to negotiate a new agreement has taken many years and still hasn't been concluded.

MR BALDING: Yes, that's correct.

MR POTTS: Do you think that's not unreasonable in terms of a normal commercial - - -

MR BALDING: No, as I said, these are very complex - - -

MR POTTS: - - - relationship?

MR BALDING: These are very complex issues, but as I said earlier, I think, you know, a number of matters that you have raised in your draft submission and part of your draft recommendations will facilitate the conclusion of those agreements much sooner than what they would have otherwise have been. You know, where you create an environment, a regime, that provides the necessary incentives to sit down and have a genuine commercial negotiation then it will conclude much earlier than it otherwise would have been. As I'm saying, the recommendations that you've put forward I think will definitely address that. But at the end of the day, it has been some two years, I think, since SACL has been in negotiations to have a long-term commercial agreement, but I've got to stress that's lapsed time; that's not time in total sitting at a table.

Also too, I think in clearing the way, the way you have proposed in your draft submission it will also facilitate, as I said, genuine commercial negotiations where there will be counter-offers and not just pure rejections. Proper commercial negotiations is both ways; it's not just one party putting an offer on the table or a proposition on the table and the other parity rejecting it. You need proper

counterproposals. So the negotiations to date, although they've been some two years, as I stress it's not lapsed time; but at the end of the day it's looking to engage partners to get those counterproposals.

MR SCHUSTER: If I can add to that the negotiations have been undertaken entirely against the backdrop of the Part IIIA applications, which I think has conditioned the way they've been undertaken; and I think it's also important to note that we're not in a sort of a limbo in terms of agreement, that we have negotiated and executed agreements with all our airlines customers. So the question is whether we can agree on enhanced terms or not, rather than whether agreements can be reached in the first instance.

MS MASTERS: A considerable amount of progress has actually been made in those discussions. So there has been, you know, starting points sort of at a distance and moving much closer together on some very complex issues that have been developed for the first time, including service level agreements and indemnity sort of issues. I mean, they're really quite wide-ranging and quite complex where the different parties have different points of view, and we have moved a long way to come to a point where a number of those issues have been dealt with - and there are still some that need to be dealt with. But basically, I think we feel that there really is with the additional clarity that can come out possibly of the Productive Commission's findings great opportunity to take further steps forward and conclude those arrangements.

MR POTTS: I think the airports are saying to us that they believe the better prescription of the guidelines as proposed in the draft report will help the process, but I don't think the airlines are endorsing that. They still believe that this imbalance in negotiating power, if you like - I don't want to get back onto that precisely, but I'd like to get into the question of the implications of the Part IIIA decision where I think in your comments, Russell, you're clearly indicating SACL's views that the bar has been lowered and that it's something the government ought to address.

But to the extent that you believe the bar has been lowered, is that likely to affect SACL's approach to commercial negotiations? I mean, you're not in the position where domestic air services are declared and there's a certain process that comes out of that. So it' rather specific to Sydney Airport at the moment. Do you see that as an issue in terms of going forward and trying to see whether the commercial framework is going to be better for negotiations?

MR BALDING: First of all, I'd just like to make the point that we're still considering our position, and based on the legal advice we've been getting that will obviously inform the decisions we take. But having said that, I think you just mentioned, and it's right to point out, that basically nothing has changed. We were

declared before the appeal and we remain declared. So we're going about business in the normal manner. We will continue to negotiate with airlines in good faith in the way we've been negotiating up until now. So from that point of view the actual result of the appeal is not impacting on the way that we are sitting down to negotiate with airlines in good faith to achieve a commercial outcome.

MR POTTS: But do you think - I mean, the likelihood of being declared now - I think the one avenue of appeal you have now is to the High Court, I think. I'm not a lawyer, but I presume that's the case. So there's still a legal process to go through if you wish. But putting that to one side, you're presumably nearer to the point where you have to negotiate within a certain time frame or it becomes arbitrated by the ACCC. But does that - - -

MR BALDING: I think there needs to be - - -

MR POTTS: - - - sort of in some way condition your approach to - the risk of actually being arbitrated by the ACCC - does that in some way influence the way you negotiate?

MR BALDING: No, not really.

MR POTTS: No?

MR BALDING: The risk is always there. Whether it's easier to get access to the ACCC for arbitration purposes, that's another matter. The risk is always there. I think it's more about, as I said, sitting down with a genuine bona fides to seek a commercial outcome. But at the end of the day, you know, we can't predict what the airlines want to do, and I don't think you should be, you know, shooting at shadows in respect of how you sit down and actually negotiate and negotiate in good faith. The thing that I want to stress is that, you know, irrespective of the outcome of the appeal, Sydney Airport is continuing in good faith to sit down and negotiate, and negotiate what we see as good commercial outcomes. We're not sitting on our hands. That would be, you know, not the right thing to do.

MR POTTS: Does the undertaking route that's available under Part IIIA, in the light of these developments - and I understand your comments that you just continue negotiating in good faith, but does this decision in some way perhaps change your perception of that operation?

MR BALDING: To my knowledge we haven't given that full consideration yet, and you need to give it some consideration, because there are some concerns in going down an undertaking route, and you end up in a situation where you're negotiating with the ACCC as opposed to negotiating with your partners that you want to have a

long-term commercial arrangement with; and feedback from the ACCC is merely comments coming back from the other parties. As I said, we'd need to consider it, but I don't see that as an ideal environment to conduct negotiations to go forward in what we're all trying to do.

I think you mentioned a bit earlier when someone else was here about looking to go forward in respect of this light-handed regime as opposed to going backward. If we're going to get to a point where we actually are going forward and we're moving to a more mature commercial environment, that is about creating a regime, an environment, that has the proper incentives to sit down and have proper commercial negotiations, and to do that you have got to negotiate with the people who you ultimately have that relationship with. I don't want to have a relationship with the ACCC.

MR POTTS: You need a relationship of trust too, don't you?

MR BALDING: You need respect and trust; you do in any negotiation, particularly in respect of business outcomes, because at the end of the day these are ongoing relationships. This is not just a once-off contract that you might do, you know, between a supplier and a procurer of services. This is ongoing. So at the end of the day, when you sit down with the airlines you are looking to build that ongoing strategic relationship. It comes to a situation where you don't just want a one-off event. Major infrastructure assets such as airports are there for the long haul; this is not a short proposition we're talking about here.

Since I've come to Sydney Airport I've endeavoured to get out there and engage with the various airlines with my colleagues, and there is genuine goodwill on our part, as I said, to engage and to seek a commercial outcome, but my view is - and getting back to your question in respect of the undertaking part - I would rather engage with the people that I have to do business with rather than the third party arbitrator.

DR BYRON: While I appreciate your endorsement of the light-handed regulation approach and the role price monitoring might play in that, I think in view of all the feedback that we've had from all sources, there seems to be a fairly clear consensus that the current price monitoring regime needs at least some tweaking, or perhaps some real teeth; or if not teeth, then strong gums. As you've said, we've suggested some things about asset values. We've expressed our reservations about the risk of binding third party dispute resolution becoming de facto regulation. What else is there that we might recommend that would increase the prospects of a mutually acceptable workable regime based around mature commercial negotiations? Is there anything else that we might recommend?

MR BALDING: I think it is about further certainty and particular clarity about the third party binding arbitration. I've heard both sides of the arguments, and you've rightfully allowed both sides of the argument to be aired, but from where we're coming from it's difficult to see how you can progress proper commercial negotiations and ultimately move to a more mature commercial environment when you've got, you know, a perceived threat - at the very least a perceived threat of third party binding arbitration or intervention by a third party. Now, whether that intervention be by a Minister of the Crown or, heaven forbid, bureaucrats in Canberra, you know, the fact that it is still there, and it is a perception that it does allow gaming, which we've made very clear and you've made clear in your submission we're looking to avoid gaming and eliminate such. But at the end of the day clarity is what it's about.

DR BYRON: You might have heard I asked before about was the previous regime unrealistic in expecting that the monitoring regime would produce evidence of abuse of market power, were it to occur, and that action would be taken on the basis of that evidence; because from the airlines' point of view what they see as a clear abuse of market power and no action was taken, to use the metaphor, the constable didn't leap out of the closet. Was it unrealistic to expect that someone perhaps in DOTARS would look at an annual monitoring report and say, you know, "That airport has just gone too far this time," because it's probably only, you know, 0.1 per cent more than some other airport last time.

So the idea that someone would recognise abuse of market power when they saw it without it ever being explicitly defined and thresholds and benchmarks and parameters set up in advance for good reason, does that explain why, you know, the system just hasn't generated any red flags? Is it possible that red flags would ever go up, in which case if they're not, then what the hell is this price monitoring about?

MR SCHUSTER: I can add a comment. There seems to be two things here. One is a reasonably generic notion that market power has been materially abused and someone should have stopped it. So there's a question mark certainly about whether that is in fact the case, whether the constable should have stepped out of the closet. The other issue is one of indeed how should the constable make himself known to everybody, that there's this fairly binary notion that an airport would be stopped and dealt with in a heavy-handed fashion in response to any perceived abuse of market power.

As far as I'm aware, the Department of Transport has liaised with individual airports from time to time over things that raised their concern. So it certainly appears to me that the Department of Transport was aware of issues that were emerging at airports and had taken action, albeit in a more low-key way, to make the airports aware of their concerns. So it's not necessarily that the airport should be

immediately subject to a more heavy-handed form of regulation. The regime can work in a more measured and balanced way based on the nature of the issue arising.

DR BYRON: Thank you very much.

MR POTTS: Information transparency; thinking about this question of dispute resolution mechanisms, the airlines have said that information transparency is an important part of the process, and I presume you would also see it as an important part of a process just in commercial negotiations. Can you give us some feel for how you approach the issue of information transparency with the airlines?

MR BALDING: I can, and I'll ask Nicole to go into a bit more detail, but we are currently sitting down with airlines at the moment through part of the negotiation process, and in respect of transparency we've provided a comprehensive package of data and information in detail in respect of our charges, what makes up those charges and the arguments in support of those charges. So we're engaging with airlines on a comprehensive basis. So there's a whole lot of detailed information that has been provided to them for feedback and comment, and Nicole might give detail.

MS MASTERS: It's not the first time that we have provided that sort of information. Over quite some time we have been engaged with the airlines on discussing price and other things, and we have provided detailed information, I think back in September 2004 which was updated earlier this year. We have subsequently now provided a very comprehensive package of information in support of our base charges, which is the thing that the airlines have been indicating is of most concern to them. That, as Russell has said, includes a whole lot of information about assets and traffic forecasts and the way that we've approached our land valuation.

We've endeavoured to incorporate the sort of thinking that has been indicated in your draft report, to try and take that on board and build that into the model. We've provided the airlines with the model so that they can go away and get it up on their screen and work with the model and understand it, and we have indicated a consultation process that we've put in place. Some airlines I think may need a little bit of extra time to respond to us in that process. But at the moment, you know, we've had a couple of meetings.

We've indicated that we would like them to write to us by a certain date so that they can tell us what they're thinking and then we'll respond to them, and we've, you know, indicated sort of time frames for this consultation process to occur. So I mean, it's about as detailed as you can get. I'm not sure what more we could provide in the sort of base case environment to sort of indicate the way that we've put our model together and the assumptions that we've used and why.

MR POTTS: Are there any areas of information that the airlines are seeking which they think is important for conducting negotiations fairly, if you like, that the airport is not willing to provide?

MS MASTERS: I don't think so.

MR SCHUSTER: Not they've made aware to us.

MS MASTERS: No, I don't think so. I mean, we think that the information that we're providing on the base case and the engagement that we have ongoing with them about that is hopefully the information that they have been seeking and will, you know, sort of indicate to them clearly what we're thinking.

MR BALDING: We'll be in a position to respond if they're seeking further information, but to be frank, there was concern from the airlines in respect of the time it was taking to provide this information, and I may have inadvertently caused that problem, because when I first gave a commitment to provide this updated information I gave the commitment - I think this is unreasonable in respect of the time it was going to take to put together from SACL's point of view, only being new into the organisation, I gave a commitment that couldn't be achieved.

So there was an expectation by airlines that this information would be delivered a lot sooner that it was to be possible to be delivered, and I'll take responsibility for that, but management now has provided that information and engaging with the airlines and we'd welcome any feedback from the airlines in respect of any further information that they'd require.

MR POTTS: So you think the airlines have enough information to judge whether the proposed charges are reasonable or not?

MS MASTERS: We do believe that, yes.

MR POTTS: So do you show impact on profitability and that sort of thing or not?

MR SCHUSTER: No, we've - - -

MR POTTS: I mean, their argument is that it's about monopoly power and that the airports will take monopoly profits out of the system, so if that information is not available it may be difficult to form that judgement. Don't get me wrong in my question, I'm not saying it's something you should do. I'm just seeking your comments on whether you think that is something that is appropriate or not.

MR SCHUSTER: The airlines have indicated to us that they think the ACCC's

approach to modelling prices is a reasonable starting point for indicating what are reasonable charges and we've adopted that model in providing it to them. Now, that doesn't provide an indication of overall airport profitability as such, but it indicates a level of revenue and level of charges which is commensurate with appropriate return on your asset base. So I think they have all the information that they need to evaluate the charges or revenue levels that we're putting forward.

MR POTTS: So you're falling back onto the ACCC model. Does it then become a matter of how you interpret some of the assumptions that are built into the ACCC model that can form a difference between what's acceptable to the airlines and where, for instance, the ACCC might come out on this issue if given the task?

MR SCHUSTER: The approach we've taken up to date over the last couple of years, we've been very mindful of what we perceive to be a range of reasonable pricing outcomes; because under what we see is a commercial relationship there needs to be recognised - be some give and take. To our minds this is not about pinning down the lowest price that a regulator may approve and then matching that with a set of terms and conditions that the airlines would most like. We've put forward a set of terms and conditions which we think materially enhances the way airports use our services, and we've put forward a pricing proposal which we think falls well within the range of prices that would be considered satisfactory if viewed against a regulatory background. What we're asking now is some commercial give and take to the extent to which we need to enhance the terms and conditions, to the extent to which we need to consider our prices as part of coming up with what is a reasonable package of measures.

MR POTTS: Any time frame for how this is going to move forward?

MR BALDING: There has been a time frame developed. Nicole?

MS MASTERS: Although the consultation process I described earlier has a sort of meetings process and then a correspondence process, at the moment with a conclusion just before Christmas I think some airlines have indicated they may wish to have some - a bit longer in order to properly evaluate the material. So it may be that we go beyond that, but we would be hoping that we can conclude these consultations certainly sort of by the end of December or in early January.

MR POTTS: These are the ones that have been going on for two years. Is that correct?

MS MASTERS: The discussions that have been going for two years have been quite multi-dimensional. They've covered a new agreement with a whole series of provisions within that agreement including service level agreement and there has

been quite a lot of movement on that. We're currently engaged with one particular airline on looking at the service level agreement very closely. They've raised some issues with us, and we're now talking to them about that and trying to come up with something that falls between where we were and where they wanted to be so that we can all sort of move to something that we can all accept. There has been a fair bit of discussion about ground handling conditions of use which was potentially another set of arrangements that could form part of the agreement itself. Then there has been the pricing issue as well, which has sort of been through a number of iterations. So it's quite multi-dimensional, and the discussions from I think late 2004 have developed over time.

MR BALDING: To be fair, those discussions were also quite fluid, because in true commercial negotiations as you sit down and discuss these matters it's not just only price because it's a whole comprehensive agreement to pick up a number of conditions. You know, the airlines might say, "Well, look, you know, how about negotiating this. We want something" - you know, whether it be premium passenger processing (indistinct) transfer, whatever the case may be - so you'll sit down and start negotiating it. So you're looking at it in its holistic package and not just individual elements of the package.

DR BYRON: Just from Nicole's description then of the complexity of the multi-dimensional nature of the agreement, I was thinking that with all the potential for trade-off and give and take between different elements of that package, if it was me I wouldn't like to see a third party negotiating or fixing that.

MS MASTERS: Well, that is one of our concerns. I mean, that is - - -

MR BALDING: That's our point.

MS MASTERS: - - - quite honestly one of our concerns that having a third party arbitration, whether it's commercial or whether it's a regulatory agency does create some difficulty in terms of the breadth of the sort of discussions that are ongoing and the fact that, you know, you may not be quite so enthusiastic about moving and sort of giving and taking on either side if in the end some regulatory or commercial arbitration body is going to sort of make a decision without due regard to the ability to fully comprehend the sort of give and take that's already arisen. I mean, if you distil it down to one question, "What's the price?" that's one thing, but these discussions are far more, you know, sort of multi-dimensional than that, and in our view it's very difficult for such a process to literally go to an arbitration outcome.

MR BALDING: As we said, that's one of the major problems we have with it in having a third party arbitrator who fully understands the complexities and the comprehensiveness and the history that has gone into reaching the point where we

are and ultimately it will come down to one or two items to be finally negotiated or arbitrated and it's very difficult to arbitrate those one or two items at the very end of a long process if they're not fully across the amount of trade-offs that's taken - on both sides, all the way through to get to where we are. So that's one of the difficulties that we have in finding an arbitrator that could do that, have sufficient necessary expertise, be of sufficient independence to be able to come forward and to deliver that outcome.

DR BYRON: I asked Qantas earlier today whether having multiple parties to an agreement made it - obviously makes it more complex, but is there a fundamental difference between a multi-party negotiation and a bilateral one?

MR BALDING: There is.

MS MASTERS: I think so. I mean, obviously probably most of the airlines have similar views on certain things, but then they will diverge on other things; and that's one of the challenges for us as a multi-user facility is trying to accommodate different airline requirements and work with them in long-term planning and trying to develop outcomes that they're looking for, which may be sort of different to what another airline might be looking for. So one of the challenges that we face is working on a multi-dimensional level to try and achieve good outcomes for everybody.

MR POTTS: You've spoken negatively about a mandated dispute resolution, and I understand the reasons for that. If we were to be looking through particular elements that might be conducive to making the commercial process work better, are there any suggestions you could make? I mean, we have been talking about this issue of providing adequate information to the airlines and you're providing me with a spreadsheet and the figures that go with it, et cetera. But are there any suggestions that you would make there that you think might be worthwhile to consider including in principles or whatever to make the process work better without going the distance of having a mandated mechanism?

MR BALDING: I think it's more about articulating or creating the necessary environment to conduct the commercial negotiations in good faith, and a prerequisite of commercial negotiations, as I said a bit earlier, is in respect of being able to enter into counter-offers, offers and counter-offers. At the moment, negotiations have been an offer and pretty well a rejection. You were talking a bit earlier to the airlines about them providing the information, because transparency does go both ways as well, and you know, again I think once this issue of clarity is resolved in respect of the environment we're operating within and the constraints that would be there, transparency will work a lot better in respect of both parties. So it is about transparency and the whole environment of commercial negotiations.

MR SCHUSTER: I would suggest that an explicit recognition that the prices charged for services shouldn't be viewed in isolation from the terms on which they're provided and would be of benefit to the terms of the regime.

MR POTTS: Can you elaborate?

MR SCHUSTER: Only to say that the commission's draft report recognises a need of commercial give and take and it also recognises that there will be a range of price outcomes that would be considered acceptable. In a sense it doesn't bring those two together to say that the price outcome for the service should have regard to the terms of access that had been agreed commercially as well.

MR POTTS: And the quality of the service - - -

MR SCHUSTER: And the quality of service.

MR POTTS: We tried to link those two together at least. There is some relationship between price and quality, of course.

MS MASTERS: It is our view that the clarity that you've already indicated that you may offer in your final report on things like land value and asset data or the weight of average cost of capital - that sort of thing - we feel would be helpful, although we are aware that some of the airlines are not accepting of those views, but I guess we would hope that if the commission comes to a final view and reaffirms those sort of thoughts then we would hope that all parties will in the interests of coming to the table to resolve their negotiations and conclude final arrangements, that we would all sort of move to accept those views. I mean, we still do have a clear view that opportunity, cost of land, is in our view the better approach. So we don't necessarily think that the line in the sand is the best outcome, but we are prepared in the circumstances to move forward on that basis and that's what we have incorporated into our base charge model.

MR BALDING: It's in all our interests to move forward and, you know, to create the right environment through the Productivity Commission report to be able to move forward, to provide the necessary incentives for both parties to sit down and have proper outcome negotiations. It's not in our interests as managers of infrastructure and it's not in my shareholders' interest to under invest in the infrastructure. So there needs to be a degree of certainty and a degree of confidence in going forward. I think once these elements come into play there will be better facilitation for these negotiated outcomes because it's in everyone's interests to have a properly negotiated commercial outcome, for the infrastructure owners to continue to invest in the infrastructure and it has been noted quite significantly in respect of a

number of independent reports since privatisation, the degree of capital investment into the infrastructure and, you know, we want to go forward with that.

MR POTTS: I think we can understand all of that. I think the issue, having spoken with the airlines and airports at some length through this process, is the degree of guidance that's required to achieve that outcome. I think by and large the airlines are saying that, "Yes, we're happy to have commercial negotiations as long as they're within this corridor defined by an independent arbitrator." The airports are saying, "No, we'd prefer to have something much wider than that and we believe that we're mature enough and everything else not to require that sort of guidance."

MS MASTERS: Well, we genuinely - - -

MR POTTS: I mean, I'm just encapsulating, that's all, the way it's coming through.

MS MASTERS: Yes. I think we're genuinely attempting to operate under the light-handed regime that is intended to facilitate commercial outcomes and that has been our first goal, to develop commercial outcomes and to work with our airline customers who are very important to our business to achieve those.

MR POTTS: So you see relations improving with the airlines? I mean, Sydney Airport is rather specific as far as this is concerned, because you've been in the news more of course with the Part IIIA, and certainly some of the airline representatives have singled out Sydney in their public comments here at the hearings. So you've observed the way this is unfolding, and going forward you think there is an improvement in the relationship, that it is only to be expected that you go forward in the price-monitoring process.

MR BALDING: There will always be, you know, a degree of tension between airlines and airports. I think it's the nature of the beast, but it is having the maturity to sit down and improve those relationships both from a strategic point of view and from an operational point of view. The last thing I want to be doing is having a blue with my customers, and I'm quite sure the airlines are the same way. In actual fact, those sentiments have been expressed today, most recently when you were talking to Virgin. But at the end of the day it is about maturity and it is about sitting down with your customers and having both a strategic and operational relationship with them and it's in everyone's interests to improve that relationship and go forwards. That's not saying there won't come a point in time when we'll all agree to disagree, but at the end of the day these things don't happen overnight.

They are not the simple issues we're dealing with here. They are long-term issues. They're major infrastructure issues, and so at the end of the day it is about - just keep plugging away at it. There is no magical solution to this. As I said earlier,

I think you've got it right. It would be premature to impose, you know, third party binding arbitration, but there's no magical solution and you look at both sides of it. But at the end of the day, I think what you've come up - and what you're proposing I think is the best for the current environment.

DR BYRON: Just one more - and I'd like to change the subject a bit. I said earlier this morning that this inquiry is focussed very much on the relationships between the major capital city airports and the RPT operators, the major airlines and within that, you know, landing charges and passenger terminal fees, et cetera. But my concerns is to check whether there are other issues that we should also have been looking for that are a bit broader than that; perhaps other airport users and the airport operator, whether that's corporate jets and non-scheduled public transport flights, whether it's the refuellers or the maintenance providers or catering services or who knows.

It seems to me that the nature of the market power that airports have extends to more than just the two or three - the two major domestics and the international airlines. I'm probably asking the wrong person - but would you agree that first of all the airport's clients is a much broader set than just, you know, Qantas, Virgin and BARA, and should we not follow up with some of that broader set of stakeholders to ensure that they also are moderately satisfied or not totally dissatisfied with the current regulatory regime?

MR BALDING: Give me an example of some more of the broader stakeholders, other than passengers.

DR BYRON: Fuel supplies. We haven't talked today about the regionals. We've talked about the domestics and the internationals, for example. Now, regionals are probably more important to some of the other capital cities than to your airport, but I'm just sort of, as we get to the final session of today's play and it occurs to me that there's people who have been left out of this discussion today who may have a serious interest in how the regime operates with regard to the behaviour of the major capital city airports.

MS MASTERS: I don't know that we would suggest that you should necessarily scope out other people that may not have put themselves forward for a public discussion. I mean, the process has been fairly public. So I guess our view would be that those who felt they wanted to come forward had the opportunity to do so and to make their own submissions. Obviously they've done that. I don't know that we'd have any other comment about whether you should be - - -

DR BYRON: But you're not aware of outstanding issues with any of those other - shall I call them minor stakeholders - - -

MR BALDING: No.

DR BYRON: - - - rather than major stakeholders.

MS MASTERS: No, they're all stakeholders.

MR BALDING: They're all important stakeholders. You know, you mentioned fuel. We are in current negotiations with the JUHI in respect of the fuel supply, in respect of an extension renewal of that contract and those negotiations are continuing. As mentioned here today Qantas is a shareholder of that entity. You mentioned regionals, you spoke to the CEO of Regional Express Airlines on Tuesday in Melbourne. You've made some specific comments in respect of your draft submission which was slightly, you know, a bit broader in the terms of reference and there's comments you've made in respect of the regional airlines.

We actually think they've got merit and actually support them, particularly in respect of the aircraft size, because when you're looking at an airport like Sydney and the constraints that Sydney has on it, it's important that we look at a whole range of options to improve the utilisation of that asset, and I further note that, you know, when you were talking to Jeff Breust he suggested last week that, you know, he mentioned the idea of having regional airlines, or particularly turbo-prop aircraft excluded from the 80 movement cap per hour and, you know, a suggestion like that, I think that suggestion has merits.

DR BYRON: That was very creative, I thought.

MR BALDING: Yes, because it's two things: (1) it's recognising that, you know, a turbo-prop aircraft is not a noisy aircraft, and the 80 cap for movement was about noise. So therefore it's a recognition that it is not a noise issue, but also would provide the regional airlines the opportunity in respect of peak hour slots without being expensive international carriers coming into Sydney. So I think that's a comment or a proposal from Jeff Bruce which I think has merits, and I'd encourage the Productivity Commission to pick that one up.

MR POTTS: Just on that, can I ask you though, from a technical point of view if they are exempted from, I think it's the 80 per hour - - -

MR BALDING: It's 80, yes.

MR POTTS: - - - then the limitation becomes one of how many aircraft you can actually move within an hour if it's unrestricted to turbo props, and you've got to have certain space in between aircraft, it's got to be longer between jet and turbo props, so what would be the effect of actually taking them out of the 80 per hour,

given this other limitation?

MR BALDING: I'm told - and if my colleagues can help me - I'm told in conversation I've had with the slot manager that Sydney Airport has capacity for more than 80 movements per hour. So it wouldn't be a technical issue to fit them within that hour.

MR POTTS: Are we talking about four extra per hour, or 10 per hour or 20 per hour? I think it's about four per hour.

MR BALDING: It's about my recollection, I think, yes.

MR POTTS: I'm just trying to put the suggestion in context, that's all.

MR BALDING: Yes. As I'm told, it wouldn't impact Sydney Airport. They would still be able to achieve the 80 movements per hour plus the turbo engine aircraft.

MR POTTS: Is that right, is it? So you'd be able to get more than 84 per hour then.

MR BALDING: Yes.

MR POTTS: Would you be able to provide us with some information on that?

MR BALDING: Yes, I can follow that up.

MR POTTS: I guess if you had any comments on the other suggestions he had that would be useful as well.

MR BALDING: We'll follow it through.

MR POTTS: Thank you very much. Do you have any more questions? I think that's it for us, Russell, thank you very much. Just before you leave, I did mention at the beginning of proceedings today I'd give people in the audience an opportunity to make a statement if they wished to. Would anyone like to take that up?

MR BROWN: Can I make a couple of quick comments?

MR POTTS: Okay. Would you like to wait until SACL - - -

MR BROWN: Yes, sure.

MR POTTS: Would you like to come across here? Just for the record, that's all I

meant and the microphones. Thanks, Russell.

MR BALDING: Thanks.

MR POTTS: Could you just mention your name and organisation just for the record.

MR BROWN: Matthew Brown, manager aviation for Canberra Airport. Canberra Airport hadn't planned on presenting to the commission today. Unfortunately, my managing director is out of the country and we weren't able to present either last week or this week. Having said that, I thought I'd offer Canberra Airport's position in relation to three matters that have been raised in today's proceedings that are relevant to Canberra Airport.

Firstly, the role of price monitoring going forward. Following the Brisbane Airport's presentation there was some discussion about the role of price monitoring. From our point of view in Canberra we saw price monitoring as being a transitionary measure and that it would effectively set the rules going forward in much the same way as the former price cap regime set the rules for new investment. Those rules have been followed to the letter in Canberra Airport's experience during this current period of prices monitoring. We saw that the prices monitoring regime would develop those rules for the balance of the asset base, so the existing assets as it were.

To the extent that the commission has sought to address the outstanding issue of asset values, we believe that that has set the ground rules going forward and that to the extent that they would be built into the review principles, airport behaviour in future could be assessed and actions taken by government or users under Part IIIA to address any perceived shortcomings in airport behaviour.

Secondly, in terms of rates of return, to some extent Canberra Airport agrees with Brisbane Airport. At this stage we don't see any merit in revisiting rates of return. Arguably we could have theoretical arguments about an increased rate of return at Canberra Airport, but we're interested in moving forward, getting on with doing business rather than putting new issues on the table that are of contention between airports and airlines.

Thirdly, in relation to Qantas's comments, both in today's proceedings and earlier in their submissions, might I say that Canberra Airport is dumbfounded at the comments made by Qantas. I don't want to get drawn into a "he said she said" exercise here, but while I thank Jana for her recognition of the positive negotiations that Canberra Airport has had with Qantas on the new terminal development, the balance of Qantas's comments today would be characterised by selective disclosure and misrepresentation of fact.

In terms of selective disclosure, Qantas spoke about consultation instead of negotiation. This is certainly not the case in Canberra. Qantas conveniently failed to mention that in the case of its discussions with Canberra Airport on the new terminal the airline has actually drafted four out of the five documents that will give effect to the agreement on the new terminal. That certainly goes beyond consultation to the extent that the documents are their own, and if they're not happy with them, well, they should tear them up and we'll start again.

In terms of misrepresentation of fact, Qantas again refers to a fuel throughput levy. Again they mentioned it today on top of their submission to the commission. A fuel throughput levy in contrast to, I guess, an investment based recovery charge is an access fee and Canberra Airport certainly does not have an access fee for the provision of fuel in Canberra. What we have is a fee that recovers the cost of new investment and that's an important point to make in the context of our fuel throughput fee.

Qantas seem to suggest that the fuel fee in Canberra Airport was a somewhat surprising eventuality for Qantas and that it had been unilaterally imposed. In fact, Canberra Airport spoke to Qantas at length about the need for replacing the aged fuel facilities in Canberra Airport and had discussed a number of recovery mechanisms with Qantas for the recovery of that investment cost. In that regard I note that the adopted throughput based fee was the approach preferred by Qantas for the recovery of this new investment, as opposed to a passenger based fee as had typically been the case for all other new investments at the airport. They're the only formal points that I wanted to respond on, but if the commission had questions that related to Canberra Airport I'd be happy to take those as well.

MR POTTS: No. We appreciate your submission. It sort of set out some issues that we're very interested in looking at carefully. I appreciate the address comments that you've made today. We can understand that. Thanks, Matthew.

MR BROWN: Okay, thank you.

MR POTTS: Sorry, one more, my apologies.

MR CARSON: Stephen Carson from Brisbane Airport Corporation, I'm the financial services manager there. I just had just two quick comments. One to just pick up a point that was missed in Tim's earlier presentation, but the other was just to clarify some comments made in Qantas's presentation today. There is just an implication when Qantas were talking about the agreements that were in place with airports around Australia. Qantas specifically mentioned a couple of airports that they did have agreements with. Tim had mentioned earlier that we didn't have a

formal agreement with Qantas, that we had an agreement with BARA and with Virgin, and there was an inference in Qantas's presentation that the reason that they didn't formally agree to our aviation service and charges being that terms were considered unreasonable.

That wasn't actually the case. The reason that we didn't reach agreement with Qantas was because of additional terms that they wanted to include beyond what BARA and Virgin had agreed to. So it wasn't the fact that terms in our agreement were unreasonable, it was that they weren't as comprehensive as what Qantas required. So I just wanted to clarify that.

The second point I wanted to make was something that Tim missed. It was in relation to the Allen's report which was commissioned by Virgin and discussed today. Allen's recommended starting point asset values for pricing purposes based on starting point pricing that airports had in July 1997. Basically they extrapolated those prices to develop an asset base. Just two comments on that: that's a flawed method of developing a starting point asset base because firstly FAC was a single-till operation as opposed to the dual-till philosophy that the airports were sold under, and secondly FAC had network based charging, so the charges didn't represent the assets that they're associated with at each airport.

The second point to make in that regard is that that methodology conflicts with previous consulting work that Allens has done on behalf of the ACCC in terms of pricing asset base for pricing for regulated assets. I refer the commission to our reports written by Allens in 2003 and 2004 for pricing electricity industries and we can provide copies of those if that's required. That's all I have to add.

MR POTTS: Thanks, Stephen. Anyone else? I think I can say that's it. Thank you all very much for your participation; very helpful.

AT 3.44 PM THE INQUIRY WAS ADJOURNED ACCORDINGLY

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