Australian Government

Department of Transport and Regional Services

SUBMISSION TO THE PRODUCTIVITY COMMISSION REVIEW

OF

PRICE REGULATION OF AIRPORT SERVICES

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Executive Summary

The Australian Government's Pricing Policy Paper[1] released prior to the first airport sales in 1997 stated the objectives of price regulation of airport services as follows.

> *"Pricing oversight arrangements at airports post-leasing have been designed to achieve an appropriate balance between public interest and private commercial objectives.*
>
> *Pricing oversight arrangements are intended to promote operation of the airports in as an efficient and commercial a manner as possible. Pricing is fundamental to the efficient use of airport infrastructure. It is in the interests of airport users in particular, and the national economy in general, that commercially-driven decisions be made about maintaining existing airport infrastructure, and building new infrastructure.*
>
> *The arrangements should also aim to protect airport users from any potential abuse of market power by airport operators. Market power stems from the fact that airports have natural monopoly characteristics.*
>
> *It is the Government's intention to step back from setting prices at individual, privately-leased airports; and to provide a framework in which – over time – airport operators and their customers are encouraged to negotiate directly, and resolve prices rather than involve the Government of the day".*

The Department of Transport and Regional Services (hereinafter referred to as the Department or DOTARS) believes these objectives remain relevant to this inquiry and agrees with the recently expressed views of the major airports and airlines that pricing outcomes reached through their commercial negotiations are preferable to prices being established by a regulator. However, light-handed regulation is not deregulation. Clear pricing principles and guidelines are needed as a basis for commercial negotiations to establish pricing outcomes that are fair to both parties and that achieve the Government's goals in privatising the airports and moving to a light-handed pricing regulatory regime.

The elements of a continued light-handed regulatory model discussed in this submission could further encourage access providers to deliver and price their services efficiently and provide appropriate incentives to maintain existing aeronautical facilities and invest in new facilities to keep pace with increasing demand. The main components discussed (clear pricing principles, a refined definition of aeronautical services, asset valuation principles, enhancing commercial pricing negotiations between airports and airlines through provision for binding commercial arbitration to settle disputes, and revisiting quality of service monitoring) offer suggested aspects that DOTARS believes need to be considered for incorporation into the future light-handed airport pricing regulatory regime. DOTARS' view is that the principles applied in the light-handed model discussed in this submission may be appropriate for use in price negotiations by airports other than the price regulated airports. The price monitoring components (i.e. the financial reporting requirements of the *Airports Act 1996* and the data reporting requirements of *Direction 27* made pursuant to the *Trade Practices Act 1974*) can provide an important control on abuse of market power. DOTARS notes that the findings of this inquiry may lead to modification of the price-monitoring function.

[1] Department of Transport and Regional Development 1996, *Pricing Oversight Guidelines*, Canberra, 1996.

The future regulatory pricing environment should continue to allow parties to interact in their best commercial interests but within constraints similar to those applying in a free and open market. Future information disclosure requirements should facilitate ready determination of pricing behaviour not conforming to the Government's pricing principles.

The Exports and Infrastructure Taskforce[2] in 2005 recommended "That the Council of Australian Governments explore the scope for simplifying and streamlining the regulatory process as it applies to export oriented infrastructure, in particular by:

- providing a presumption that issues to do with export oriented infrastructure will be resolved by commercial negotiation between the infrastructure provider and users;
- providing, in instances where regulation is warranted, a presumption, in the first instance, that light-handed regulation such as price monitoring be applied by the relevant regulator; and
- limiting the use of more intrusive regulatory approaches to instances where light-handed regulation has demonstrably failed."

DOTARS considers that overall the price monitored airports have performed reasonably well under the light-handed pricing regulatory regime, particularly in regard to the level of aeronautical infrastructure development undertaken to keep pace with increasing demand. This development has been facilitated by commercial negotiations between the major airports and their airline customers.

The Australian airports industry today is a vibrant, dynamic industry facilitating the movement of more than 50 million passengers per year. This is made possible by the airports' level of aeronautical investment to date, and will be sustained by the significant future investment already committed by the airports.

The Department considers that the current light-handed airports pricing regulatory regime has been a successful model in most respects and should continue. Following four years experience with light-handed price regulation, DOTARS believes that a number of changes should be considered to enhance the efficiency of the current regime, primarily in the areas of:

- clarifying the Government's aeronautical pricing principles;
- refining the current definition of aeronautical services and facilities;
- clarifying what are acceptable valuation practices with respect to aeronautical assets;
- instigating compulsory, commercial arbitration; and
- revisiting quality of service monitoring (is there a need, and if so in what form?).

The suggested enhancements to the current airport pricing regulatory regime proposed in this submission aim to clarify the regime's objectives and scope, encourage efficient investment in new infrastructure, strengthen the commercial negotiation process and improve the certainty, transparency and efficiency of the regulatory process.

[2] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure – Report to the Prime Minister by the Exports and Infrastructure Taskforce*, Canberra, May.

Introduction

1. The Productivity Commission (the Commission) undertook its first inquiry into airports price regulation in Australia in 2001. Since that time a number of significant events affecting the regulatory environment for leased Federal airports have taken place. This submission draws on and updates the history of airport privatisation presented in the DOTARS submission to the Commission's 2001 inquiry. It examines and draws conclusions from the events that have occurred over the past four years and from DOTARS consultations with airports, airlines, industry bodies and Government agencies concerned with airports pricing regulation.

2. The main goal of this submission is to examine the experience gained with light-handed pricing regulation over the past four years. Therefore, it primarily concentrates on issues that have come to light from the application of light-handed regulation at each of the seven price - monitored airports. Based on the regulatory outcomes at these individual airports, this submission suggests areas where the current regulatory regime could be revised and fine-tuned to continue to develop a world-best-practice pricing regulatory regime for a privatised airports network.

The Historical Context

3. Beginning in the early 1980's, successive Australian (Federal and State) Governments have actively been pursuing microeconomic reform across a number of areas to make the Australian economy more responsive and efficient. The aviation sector in Australia has been a major part of the reform process. The transition of the main airports in Australia from Government owned and operated facilities to private ownership and control through 99 year leases is outlined in ***Attachment 1***.

4. The current regulatory framework for pricing of airport services was implemented as from 1 July 2002 following the Commission's 2002 report on *Price Regulation of Airport Services*[3]. The framework comprises aeronautical pricing principles, a definition of aeronautical services, commercial pricing negotiations between the airports and their airline customers, financial accounts reporting and price and quality of service monitoring at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports.

Experience with the Current Regulatory Framework

5. DOTARS considers that a number of positive outcomes have flowed from the light-handed regulation of airport prices over the last 4 years. These outcomes include record levels of investment in aeronautical infrastructure, and the introduction of innovative management practices at Australia's major airports reflected in new approaches to the provision of aeronautical investment and, indirectly, substantial development of non-aeronautical assets.

6. In addition to the requirements that the airports have to meet under Part 5 of the *Airports Act 1996* and the Airport Leases, at the time that they were privatised the operators of the 10 larger airports (i.e. Melbourne, Brisbane, Perth, Adelaide, Coolangatta, Canberra, Hobart, Darwin, Launceston and Alice Springs) undertook to invest some $700 million over the first 10 years of the leases on aeronautical infrastructure[4]. As at June 2005 (figures for 2005-06 are not available as yet) approximately $568 million of this had been expended, with Adelaide, Darwin, Melbourne, Hobart, Launceston and Perth exceeding their commitments. The four remaining

[3] Productivity Commission 2002, *Price Regulation of Airport Services*, Inquiry Report No. 19, Canberra, January.
[4] No development commitments were sought from the new airport lessee of Sydney Airport as the Airport had recently completed a major facilities upgrade program in preparation for the 2000 Olympic Games.

airports (Alice Springs, Brisbane, Canberra and Coolangatta) all have aeronautical development projects underway or planned which are expected to meet or exceed their commitments within the timeframe under their respective Sale Agreements. Major aeronautical development projects which have been recently completed, or are underway, total over $2.4 billion, including:

- Sydney airport's taxiway, runway and terminal upgrades worth over $100 million to facilitate the new Airbus A380;
- the $500 million development program currently underway at Melbourne airport to accommodate recent and expected future strong growth in international passenger traffic and the new Airbus A380;
- Brisbane airport has embarked on a major aeronautical facilities expansion program (including a new parallel runway, expanded international and domestic passenger terminals, an expanded on-airport road network and surface transport systems) that is estimated to require investment in the order of $1.5 billion over the next 10 years;
- Adelaide's new $260 million integrated passenger terminal; and
- Canberra's $75 million taxiway, terminal redevelopment and runway expansion program.

7. It is clear from these examples, and a range of others that are available for other federal airports, that the airports are investing significantly to anticipate future aeronautical demands. The Department considers that this level of investment is a clear indication that the regulatory regime consisting of the *Airports Act1996* and light-handed pricing regulation has to date provided sufficient incentives for airport operators to invest in aeronautical infrastructure. The Department considers that the pricing outcomes under the light-handed regime show that commercial negotiations are in the main an effective mechanism through which the airlines can participate in these investment decisions and to ensure the investment is efficient and commensurate with aviation demand requirements.

8. It is DOTARS' view that the light-handed pricing regulatory regime has produced positive outcomes consistent with the Government's policy objectives by-and-large over the past 4 years. However, DOTARS considers that the Government's goals of fostering efficient operations and prices at its major leased airports could be promoted by a number of enhancements to the current regime as discussed below.

Aeronautical Pricing Principles

9. The fundamental regulatory parameters for the current light-handed airport pricing regulatory regime are the Government's pricing principles contained within the Review Principles the Government issued in its response to the Commission's 2002 report on *Price Regulation of Airport Services* (***Attachment 2***). In its response, the Government supported the Commission's *Recommendation 6* that price regulation of airports should be reviewed towards the end of a five-year regulatory period. The Government's view was that "sufficient time needs to be given for the airports and stakeholders to bed down a commercially negotiated operating environment." However, the Government reserved the right to bring forward a review "if there is a strong indication that an airport has unjustifiably increased its prices."

10. The Government's response to the Commission's 2002 report also stated that the Government would only consider re-introducing price controls at an airport if it formed the view that the airport operator had acted in a manner inconsistent with the Government's Review Principles. The pricing principles included in the Review Principles were intended to be non-prescriptive in order to allow the airports and airlines to apply commercial principles in their pricing negotiations. However, it was not the Government's intention to allow an 'open slather' approach to the setting of aeronautical prices. The pricing principles clearly indicate that there is

an upper boundary to allowable aeronautical revenue, based on efficient long-run costs and a commercial rate of return on "appropriately defined and valued" aeronautical assets.

11. A major focus of this inquiry into price regulation of airport services is to determine whether the individual airport operators have acted in a manner consistent with the Government's Review Principles and to report on the effectiveness of the current form of prices regulation of airports (see ***Attachment 3***).

12. It is a matter for the Commission to examine in some detail and judge, under the current regime, whether it considers each of the 7 major Federal airports has behaved in a manner consistent with the Government's pricing principles. This submission does not comment on this issue.

13. Looking to the future, a light-handed regulatory regime, and indeed any pricing regulatory regime, must have a body of principles that govern the pricing outcomes that the regulator seeks to achieve.

14. DOTARS notes that the Council of Australian Governments agreed at its February 2006 meeting to incorporate pricing principles in Part IIIA of the *Trade Practices Act 1974* to guide the Australian Competition and Consumer Commission (ACCC) when it conducts arbitrations of access disputes. Pricing principles have subsequently been included as part of a number of proposed amendments to the Trade Practices Act being progressed via the *Trade Practices Amendment (National Access Regime) Bill 2006*. This Bill is expected to be passed by the Australian Parliament in the spring sittings of 2006. The Revised Explanatory Memorandum[5] for the Amendment Bill states that:

> *"By applying pricing principles across all access routes under the regime, these principles will provide guidance on how the objectives of the regime should be given effect, which will contribute to consistent and transparent regulatory outcomes over time. The pricing principles will also help provide certainty to regulated firms and access seekers, which will improve the operation of a negotiate-arbitrate framework, and provide guidance for pricing approaches in industry specific access regimes."*

15. The Department considers that the Government's proposed pricing principles for incorporation into the *Trade Practices Act 1974* pose a number of questions for the Commission to consider as part of its current inquiry into airport pricing.

Do the current aeronautical pricing principles provide sufficient guidance on the objectives of the light-handed pricing regulatory regime, and if not what further guidelines or principles might be required in a future prices oversight regime?

16. In reconsidering the Australian Government's aeronautical pricing principles, the Commission would need to determine whether there was benefit from a re-statement and clarification of the current principles, particularly with regard to the definition of 'aeronautical services' and 'appropriately defined and valued assets, including land.' DOTARS makes some specific suggestions later in this submission regarding these matters under *Definition of Aeronautical Services and Facilities* and *Aeronautical Asset Valuation Issues*.

[5] Costello, Peter, 2006, *Trade Practices Amendment (National Access Regime) Bill 2006 – Revised Explanatory Memorandum*, Canberra.

Does the current price monitoring process provide the necessary information to determine compliance with the Government's Review Principles and if not what data disclosure requirements (including enforcement measures) are necessary in a future prices oversight regime?

17. Sufficient data disclosure is a pre-requisite for effective pricing negotiations between the airports and their airline customers and for determining adherence to the Government's pricing principles. Comments received from stakeholders suggest that data disclosure has been an issue in commercial pricing negotiations between the airlines and some airports, particularly in the area of costs of individual services and facilities. Whether sufficient unbundled costing data is available during pricing negotiations is a matter that the Commission should examine as part of its assessment of individual airports' performance against the Government's efficiency conditions in its pricing principles. It is DOTARS' view that the regulatory reporting requirements should be sufficient to serve the purposes of the Government's regulatory monitoring process in terms of breadth, accuracy and transparency of the data reported and published. The reporting requirements should also assist the commercial negotiating process between the airports and airlines while acknowledging that some information required in the negotiations is commercially confidential.

What process should be used in future to determine compliance with the Government's pricing principles?

18. The period since July 2002 can be regarded as a necessary bedding-in period to give airports and airlines the opportunity to demonstrate they could negotiate and reach commercial agreements. DOTARS has also been advised by both the major airports and airlines that they consider, subject to some caveats, that commercial negotiations are preferable to the initial regime of price cap regulation in the first five years after privatisation.

19. In determining 'if a further period of price monitoring is warranted', and in what form (having regard to the Commission's threshold question plus commentary on pages 20 through to 22 of its Issues Paper), DOTARS believes that, on balance, the benefits of continuing with a light-handed price monitoring approach, with adjustments as articulated in this submission, outweigh the costs. In addition, DOTARS considers that such a future oversight regime should clearly be performance-based, with appropriate incentives, having careful regard to:

- Whether there have been any changes in the overall degree of market power enjoyed by each of the individual seven monitored airports since July 2002;
- An individual assessment of the maturity of the processes for negotiating access to services and prices at each of these airports since the current regime was put in place;
- Whether any evidence emerges that there has been significant misuse of market power by any of these airports, or that high potential now exists for this to occur for some or all services; and
- If such matters and concerns can be confirmed under the preceding points, what specific measures might be warranted to address these concerns, such as whether a further period of adjustment (incorporating a major review) is required, or whether more specific levels of oversight for individual airports would provide a more credible and timely threat for dealing with abuse of market power?

Definition of aeronautical services and facilities

20. The definition of aeronautical services and facilities is integral to the Government's pricing principles and the overall pricing regulatory regime. For the purposes of the *Airports Act 1996*, the definition of aeronautical services included in the *Airports Regulations 1997* defines:

- those services, facilities and activities to be included in the accounts, reports and financial statements of airport operator companies;
- those services, facilities and activities (and their associated costs and charges) that are within the scope of the Government's aeronautical pricing principles;
- the costs and revenues that are used in determining compliance with the pricing principles; and
- the costs and revenues that are to be taken into consideration in commercial negotiations to determine aeronautical prices.

For the purposes of the *Trade Practices Act 1974*, the definition of aeronautical and aeronautical-related services included in *Direction 27* defines those services, facilities and activities for which the ACCC is to undertake formal monitoring of the prices, costs and profits.

21. Over the period of the light-handed regulatory regime, some confusion has resulted from the separate definitions of aeronautical services in *Direction 27* and the *Airports Regulations 1997* and from the exemption from price monitoring granted under *Direction 27* for 'the provision of a service which, on the date the airport lease was granted, was the subject of a contract, lease, licence, or authority given under the common seal of the Federal Airports Corporation.' *Direction 27* was issued in June 2002 to give effect to the price monitoring aspects of the Government's decision in May 2002 to introduce light-handed price regulation at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports.

22. The Government's pricing principles specify that efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a 'dual-till' basis). The Government's view is that pricing on a dual-till basis provides a pricing framework that allows the airlines to scrutinise the costs of the aeronautical services and facilities provided to them and provides greater incentives for the airports to pursue allocative, productive and dynamic efficiency in their aeronautical operations. The Department considers that the evidence to date supports the view that the Government's policy approach to aeronautical pricing is working, but that the regulatory framework should be strengthened regarding the definition of aeronautical services to ensure, as far as possible, that aeronautical costs and revenues are properly and accurately reported.

23. The Australian Government has announced its intention to align the definitions in Parts 7 and 8 of the *Airports Regulations 1997* and the definition in *Direction 27*[6]. Over the past year, DOTARS has consulted with Treasury with a view to aligning, where appropriate, the definitions to be included in *Direction 27* and the Airports Regulations. DOTARS has also consulted with and received written submissions on the definition from the ACCC, the seven price-monitored airports, Qantas, Virgin Blue, and the Board of Airline Representatives of Australia (BARA). The information provided has led to the conclusion that the current definition included in the airports regulations should be clarified and tightened if it is to fulfil the purposes for which it is intended.

24. Due to the differing objectives which the definition of aeronautical services must serve under the *Airports Act 1996* and the *Trade Practices Act 1974*, a 100 per cent alignment of the

[6] Truss, Warren 2005, *Media Release – Review Confirms Privatised Airports Regime is Working*, Canberra, 14 November.

definitions may not be possible. For example, it may be considered desirable to monitor the prices, costs and profits of car parking services and facilities on airports while these services may not be considered to be 'aeronautical' for the regulatory purposes of the *Airports Act 1996*. DOTARS' view is that car parking and taxi rank services are not aeronautical services and should not be included in commercial aeronautical pricing negotiations between the airports and airlines. The draft definition at ***Attachment 4*** is included in this submission for consideration by the inquiry primarily for the regulatory purposes of the *Airports Act 1996*.

Fuel Throughput Levies (FTLs)

25. A fuel throughput levy is a charge levied by an airport operator on the fuel provided to aircraft using the airport. FTLs are charged to the oil companies that provide refuelling services under lease or licence agreements with the airport operators. Ultimately, FTLs are passed-on to airlines in the prices paid for fuel and to the travelling public through air ticket prices. In addition to FTLs, DOTARS notes that the airports recover the costs of the fuel facilities on airports through site rental charges.

26. Fuel throughput levies are currently in place at Brisbane and Perth airports. Other airports have indicated that they intend to introduce FTLs in future. Arrangements for FTLs at Federal airports were negotiated and put in place by the Federal Airports Corporation before the Phase 1 airports (Brisbane, Melbourne and Perth) were privatised. While Brisbane and Perth chose to implement FTLs soon after privatisation, Melbourne has stated that it has no intention of introducing a fuel throughput levy.

27. Because the rights to levy FTLs were in place prior to privatisation, even though aircraft refuelling services are defined as aeronautical services in *Direction 27*, FTLs at Brisbane and Perth airports are exempt from price monitoring under the FAC exemption clause. In addition, aircraft refuelling services are not separately specified as aeronautical services in the current *Airports Regulations 1997* definition. Revenue gained from FTLs is therefore considered to be non-aeronautical and is not taken into consideration in the aeronautical pricing negotiations at Brisbane and Perth airports, nor is it reported in the price monitoring reports of the ACCC.

28. FTL's are effectively an economic rent on the land the airport makes available for aircraft refuelling services and facilities. Aircraft refuelling is clearly an aeronautical service which should fall within the scope of the Government's pricing principles. DOTARS' view is that there is no logical reason why aircraft refuelling services should be excluded from the regulatory pricing regime, including aeronautical pricing negotiations, and they have therefore been included in the proposed new definition of aeronautical services and facilities at ***Attachment 4***.

Aeronautical Asset Valuation Issues

29. Over the past year, the Department has obtained advice from the price-regulated airports, Qantas, Virgin Blue and BARA on a number of aeronautical pricing issues. Airports other than Perth advised that they adopted the depreciated optimised replacement cost (DORC) approach[7] to establish their non-land aeronautical asset base (i.e. plant, buildings, equipment and civil improvements such as runways, aprons and roads**)**. Perth airport initially adopted the Federal Airports Corporation book value. A range of valuation methodologies were used by the airports to establish their initial aeronautical land asset base values as shown in ***Attachment 5***. These

[7] An approach to allocating the capital costs of a project under which the asset base is re-valued to be equal to the price of building or buying a modern equivalent asset, depreciated to reflect the shorter remaining life of the existing assets.

starting aeronautical asset base values were reported to the ACCC under provisions of the *Airports Act 1996* and the *Prices Surveillance Act 1983*. The ACCC reports show aeronautical and non-aeronautical asset valuations for the airports over the period 1997-98 to 2004-05, however, land values are not separately reported (see ***Attachment 6***).

30. Since the commencement of the light-handed regulatory regime, Adelaide, Brisbane, Canberra and Perth airports have re-valued their aeronautical assets (including land) for pricing purposes. The extent to which these airports have been able to increase aeronautical prices to reflect re-valued aeronautical assets has been determined through commercial negotiations with the airlines. However, the issue of revaluation of the starting aeronautical asset base (particularly land) as one of the key inputs for establishing aeronautical prices has been a major area of contention in pricing negotiations. In addition, the ACCC notes in its 2004-05 airports price monitoring report that substantial upward revaluations in asset values in recent years at Adelaide, Brisbane, Canberra and Perth have had a downward impact on reported rates of return on these airports' assets.

31. The airlines and BARA contend that once a starting asset value is determined, this value should be 'locked in' for pricing purposes and only updated for actual investment, depreciation and disposal of assets. The Department supports this view as does the International Financial Reporting Standards (IFRS) which are currently being adopted in Australia. The IFRS stipulate that assets under an operating lease (such as the airport leases[8]) are not to be re-valued.

32. As an example of the potential impact of asset re-valuations, in its May 2001 Sydney Airport pricing determination,[9] the ACCC used a building block methodology[10] to calculate allowable revenue. This approach involves estimating total maximum allowable revenue based on projected costs. The maximum allowable revenue is the sum of the return on capital, return of capital (i.e. depreciation allowance) and operating and maintenance expenditure. The return on capital is calculated by multiplying the weighted average cost of capital (WACC) by the written down (depreciated) value of the asset base. In its 2001 determination for Sydney Airport the ACCC used a WACC of 6.8% and an asset base of $1,422 million. In this example, a 10 per cent re-valuation of Sydney's asset base would have increased allowable revenue by approximately $9.6 million per year. The impact of re-valuation is then compounded with subsequent re-valuations.

33. All of the price regulated airports, with the exception of Melbourne, have said that they believe that aeronautical assets (including aeronautical land) should be re-valued periodically and that aeronautical prices should be increased to reflect the increase in asset values. DOTARS' view is that re-valuing assets to derive prices is a circular process that leads to ever increasing prices (so as to maintain rates of return which are depressed by periodic revaluations) irrespective of costs or investment. DOTARS considers that this was clearly not the intent of the Government in moving to a light-handed regulatory regime as indicated in its response to the 2002 Productivity Commission Report on Airport Price Regulation (see ***Attachment 2***). As a consequence, DOTARS considers that the following extract quote from the Government's pricing principles pertaining to "appropriately valued assets" needs to be reviewed and clarified for the reasons stated following the quote:

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[8] Leases are classified as operating leases where ownership of the assets under lease is retained by the lessor.

[9] Australian Competition and Consumer Commission 2001, *Sydney Airports Corporation Ltd. – Aeronautical Pricing Proposal Decision*, Melbourne, May.

[10] All of the price-monitored airports have said that a building block approach is used in their pricing negotiations with the airlines.

"At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a 'dual-till' basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved".

34. Revaluation of aeronautical assets for the purpose of setting prices represents a return on assets for which no outlay was made and for which no regulatory or commercial risk is involved. Aeronautical assets (particularly land) are effectively sunk and any revaluation does not represent a change in either actual or opportunity costs faced by the airport. The Department notes that given the airports are leased on a long-term operating lease basis, any opportunity costs associated with the locations of the airports or other factors are matters for the Australian Government, not the airport lessees. Therefore, any increase in aeronautical charges as a result of revaluation of aeronautical assets would not be based on efficient costs as stipulated in the Government's pricing principles. The Department considers that pricing outcomes achieved through a circular process of asset re-valuation would not be possible in a competitive market situation and are not acceptable in a regulated environment.

Arbitration

35. The Government's position is that the major airports should continue to be subject to the generic provisions of the National Access Regime under Part IIIA of the *Trade Practices Act 1974*. However, experience with the present light-handed pricing regulatory regime has shown that the application of Part IIIA of the *Trade Practices Act 1974* may not be as effective or efficient a circuit-breaker mechanism as one might have hoped for the aviation industry where the Government is looking to see the commercial negotiation process is facilitated as far as possible.

36. Virgin Blue Airlines' application on 1 October 2002 to the National Competition Council for declaration of both the airside service and the domestic passenger terminal service at Sydney Airport[11], in DOTARS view, demonstrates the need for instituting a compulsory commercial arbitration process prior to accessing the National Access Regime. Virgin Blue's application for declaration of the domestic terminal service at Sydney Airport was withdrawn on 6 December 2002 following commercial agreement on terminal access. However, agreement could not be reached on terms of access for the airside service. As a result the application for declaration of the airside service proceeded and almost 4 years later has not as yet been resolved.

37. Virgin Blue argued in its subsequent appeal to the Australian Competition Tribunal (the Tribunal) of the decision by the Parliamentary Secretary to the Treasurer not to declare Sydney's airside service that "where a disparity of bargaining power exists between negotiating parties, the prospect of arbitration if negotiation fails increases the likelihood of the parties reaching a commercial agreement that truly reflects a fair negotiated position." The Tribunal agreed with this position and stated in its *Reasons for Determination*[12] (paragraph. 604):

"We consider that the availability of a binding dispute resolution process provides an incentive for parties to negotiate in a realistic, practical and positive manner in an

[11] Virgin Blue Airlines Pty. Ltd. 2001, *Applications Under Part IIIA of the Trade Practices Act 1974 Requesting Recommendation that Services Provided by Sydney Airports Corporation Ltd. Be Declared*, Brisbane, October.
[12] Australian Competition Tribunal 2005, *Application For Review of the Decision by the Parliamentary Secretary to the Treasurer Dated 29 January 2004 in Relation the Application for Declaration of the Airside Service Provided at Sydney Airport – Reasons for Determination*, Sydney, December 2004.

attempt to resolve differences which affect, and have a real impact on, their daily commercial activities. Indeed, we consider that the availability of a binding dispute resolution process will bring about a more efficient outcome than a situation where no such process is available. More particularly is this so where the arbitrator has to take into account the matters specified in s44X (1) of the Trade Practices Act 1974."

38. A disparity of bargaining power can exist not only on the part of the airlines but in some situations on the part of airports, particularly those airports which may be regarded as "price takers" (eg due to location, level of competition between airlines, etc.) and also on the part of third parties, such as fuel providers, involved in negotiating 'terms of access' with the airports. Although the National Access Regime incorporates a negotiation/arbitration process, this process can not be implemented until the legal processes leading to declaration of the service which is subject to dispute have been exhausted. If the service is not declared the parties in dispute have no access to arbitration unless both parties agree to submit the dispute to an independent arbitrator. Over the past 4 years of light-handed regulation, DOTARS is aware of only one pricing dispute between an airport operator and the airlines which has been resolved through voluntary arbitration.

39. Advice received from stakeholders is that intractable disputes are frequently 'resolved' in favour of the party with the greatest market power rather than to the mutual satisfaction of both parties. In terms of providing access to arbitration, it could be argued that the National Access Regime may also be seen to be biased against the airports as an airport would have to apply for its services to be declared before it could gain access to the National Access Regime arbitration process.

40. The Competition Principles Agreement[13] in 1994 between the Commonwealth and State and Territory Governments states in clause (4) (g) that "Where the owner of a facility that is used to provide a service, and a person seeking access cannot agree on terms and conditions for access to the service, they should be required to appoint and fund an independent body to resolve the dispute, if they have not already done so." On the basis of this principle the National Competition Council found in November 2003, in considering Virgin Blue's application for declaration of Sydney's airside service, that a legally binding dispute resolution mechanism is a necessary condition for an effective access regime under criterion (e) of sub-section 44G(2) of the *Trade Practices Act 1974*.

41. In competitive market situations binding arbitration provisions are commonly written into commercial agreements. In a light-handed regulatory environment which seeks to emulate competitive market conditions, a more efficient commercial arbitration process for aeronautical pricing matters could reinforce the commercial negotiating process by negating a 'take it or leave it' position by either party. DOTARS believes that serious consideration needs to be given to implementing a commercial arbitration model where the parties are required to proceed to an independent commercial negotiator/arbitrator (agreed between the parties) for a binding decision when they can't agree on terms and conditions (including non-price terms and conditions) in their commercial negotiations. DOTARS considers that the arbitration procedure should be based on the documents provided to the arbitrator by the parties in dispute. Such an arbitration process should also incorporate processes to discourage vexatious or without merit arbitration applications, such as awarding costs according to the merits of the case put forward.

[13] Council of Australian Governments 1994, *Competition Principles Agreement*, Canberra, 1994.

42. Incorporating the Government's pricing principles and guidelines in such a commercial arbitration process would provide clear guidance to the preceding commercial negotiations without unnecessarily interfering with those negotiations. A transparent arbitration process, such as is detailed in the ACCC's Statement of Regulatory Approach to Assessing Price Notifications[14], enables the parties in dispute to anticipate the probable outcome of an arbitration, which would in many cases obviate proceeding to arbitration with its associated costs.

43. If a commercial arbitration process is incorporated in a future pricing regulatory regime, the question arises as to whether and under what conditions the airports, airlines and third parties should be able to access the National Access Regime. At its meeting of 10 February 2006, the Council of Australian Governments accepted the recommendation of the Exports and Infrastructure Taskforce[15] (the Fisher Report) that time limits should be placed on all regulators and parties to the regulatory process. However, allowing for appeals and merits review of regulatory decisions will mean that access to Part IIIA will remain a lengthy process. In addition, a number of changes contained in the *Trade Practices Amendment (National Access Regime) Bill 2006*[16] are likely to limit airports and airlines access to the National Access Regime because, for example, the Bill amends Part IIIA so that declaration of a service cannot be recommended unless access to the particular service would promote a material increase in at least one market other than the market for the service. As the conditions determining whether airport services can be declared are similar for all major airports, a decision that one airport's service cannot be declared could be expected to set a precedent for all of the major airports. This could effectively exclude the large federal airports from the National Access Regime.

44. In the event that access to the major airports is not subject to the provisions of Part IIIA of the *Trade Practices Act 1974* in future, the conclusion reached by the Tribunal in paragraph 19 of its *Reasons for Determination*[17] in Virgin Blue's appeal of the Parliamentary Secretary to the Treasurer's decision not to declare Sydney Airport's airside service is of particular relevance:

> "*We are satisfied that the environment for competition in the market for the carriage of domestic air passengers into and out of Sydney would be enhanced if the Airside Service was declared, in particular, because of the opportunity that declaration would create for airlines to have any access dispute with SACL resolved by the independent arbitration of the ACCC, there being no other effective dispute resolution procedure available to domestic airlines using Sydney Airport.*"

45. Given the above comments on the need for improved arbitration processes, per Item 3 of the Commission's Terms of Reference for its inquiry into airport pricing (see ***Attachment 3***), DOTARS believes the Commission's careful examination of the issue of arbitration in price negotiations will provide valuable input on a key aspect of the Government's deliberations on a future pricing regulatory regime.

[14] Australian Competition and Consumer Commission 2005, *Statement of Regulatory Approach to Assessing Price Notifications*, Melbourne, July 2005.
[15] Ibid. footnote 2
[16] House of Representatives - Commonwealth of Australia 2006, *Trade Practices Amendment (National Access Regime) Bill 2006*, Canberra, February.
[17] Ibid. footnote 12.

Quality of Service (QoS) Monitoring

46. This issue is specifically referred for review at Item 4a of the Commission's Terms of Reference for its inquiry into the pricing of airport services. In theory QoS monitoring helps to ensure that airport operators are not obtaining improved productivity through running down assets or reducing their standards of service below the levels reasonably expected by users. QoS monitoring may also identify whether airports are investing appropriately, for example, by upgrading infrastructure or investing in new facilities to improve levels of service or facilitate increased demand.

47. In December 1997 Regulations were made under Part 8 of the *Airports Act 1996* to put in place a QoS monitoring regime for Melbourne, Brisbane and Perth Airports. Subsequently those Regulations were amended to include Sydney Airport and the eight larger regular public transport airports sold in Phase 2 of the airports sales (Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, and Townsville[18]). The *Airport Regulations 1997* presently specify fifty separate performance indicators for Brisbane, Melbourne, Perth and Sydney airports and forty-seven indicators for Adelaide, Canberra and Darwin airports. The ACCC's latest *Quality of Service – Price-monitored Airports Report for 2004-05*[19] indicates that over the past three years, overall quality of service levels at the seven price-regulated airports have ranged from satisfactory to good.

48. In future though, given the strong investment performance achieved under the current light-handed regime, the Department questions the need for continuing QoS monitoring. Our view is reinforced by a number of stakeholders expressing the opinion that the current QoS monitoring is unnecessarily burdensome. In addition to ACCC's QoS monitoring, a number of the airports undertake their own QoS surveys for administrative and management purposes. Further, the Airports Council International sponsors a customer satisfaction measurement and benchmarking program called Airport Service Quality. As at April 2006, there were 76 airports participating in the program worldwide including Adelaide, Coolangatta, Melbourne, and Sydney airports.

49. In this context, DOTARS would value the Commission's view on whether, and if so in what form, QoS monitoring should be retained.

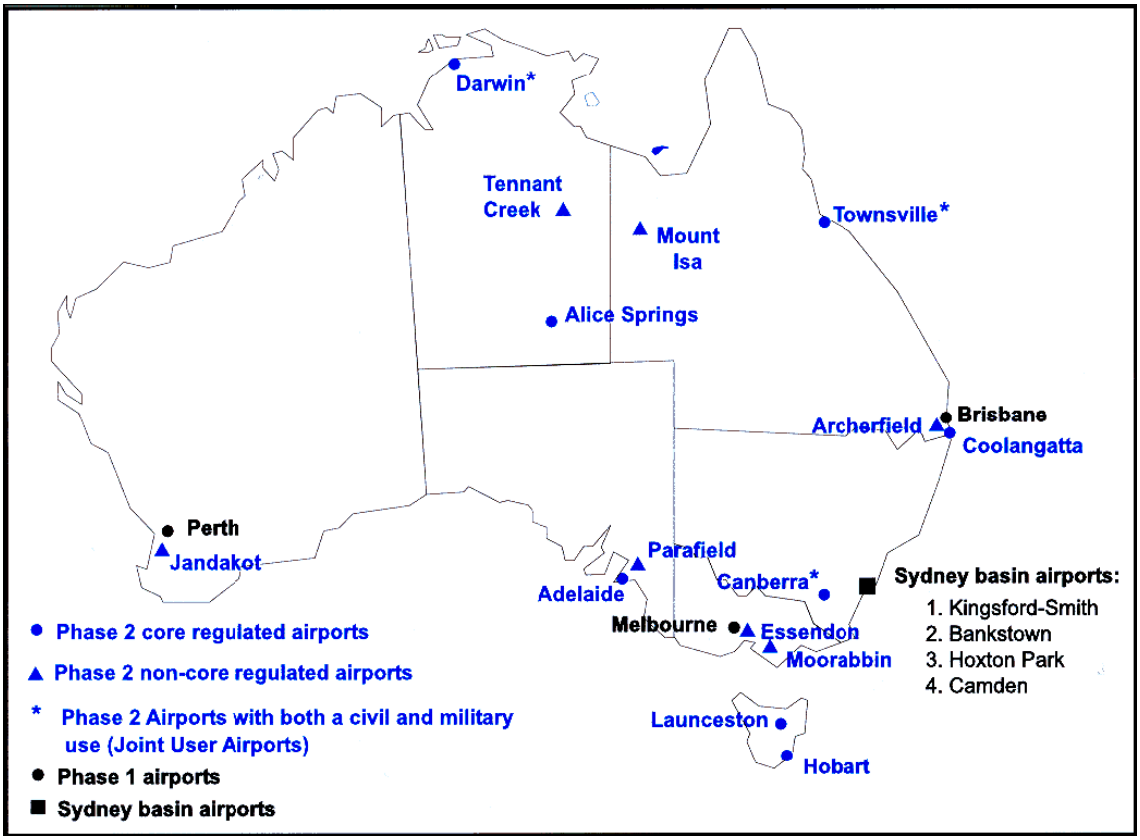
Department of Transport and Regional Services
July 2006

[18] A decision was taken jointly by ACCC and DOTARS not to apply the Part 8 requirements to Alice Springs, Coolangatta, Hobart, Launceston and Townsville airports.
[19] Australian Competition and Consumer Commission 2005, *Quality of Service – Price Monitored Airports 2004-05*, Melbourne, November.

The Privatisation Process

A Government-owned statutory authority, the Federal Airports Corporation (FAC), was established in 1988 to manage the operation and development of Federal airports on behalf of the Commonwealth. It started with 17 airports (including the major capital city airports), to which a further 6 were added in 1989 with one later being sold by the FAC.

Former Federal Airports Corporation Airports



Following a scoping study in 1995 into the possible sale of the 22 airports operated by the FAC, the Australian Government announced its intention to privatise the FAC airports via the sale of long-term leases. The sale of the Sydney Basin airports (including Sydney, Bankstown, Camden and Hoxton Park airports), however, was deferred pending the outcome of an environmental impact study into a possible second major airport for Sydney.

The decision to privatise reflected a number of factors, including:

- The need to improve efficiency and flexibility in the way airports are managed and operated, by introducing new technology and working practices and fostering a commercial culture;
- Airport privatisation was a further step towards enhancing contestability and competition in Australia's domestic and international aviation markets which earlier Government initiatives had sought to create;
- Privatisation released the value of sunk investments by taxpayers, enabling the proceeds to be applied to alternative priorities such as reducing debt;

- The growing maturity of private financial markets capable of funding major transport infrastructure investments; and
- From a public policy standpoint it was important that commercial and regulatory activities that were previously undertaken by the FAC were separated to avoid real and potential conflicts of interest.

During 1997 and 1998, long-term leases (50 years with an option to renew for a further 49 years) were sold over seventeen of the FAC operated airports in two phases. The first phase sold leases to Melbourne, Brisbane and Perth airports and the second phase sold leases to a further fourteen airports, comprising:

- 10 regular public transport airports – Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, Townsville, Mt Isa and Tennant Creek; and
- 4 general aviation aerodromes – Archerfield, Jandakot, Moorabbin, and Parafield.

In July 1998 two wholly Australian Government-owned companies were formed to acquire leases over the four Sydney basin airports (Sydney, Bankstown, Camden, and Hoxton Park) and Essendon airport. The sale of the Essendon Airport lease began in early 2001 and all of the shares in Essendon Airport Limited were sold to a private sector company in September 2001.

On 13 December 2000 the Government announced its conclusion that Sydney Airport was able to handle air passenger demand over the next ten years and that it would therefore be premature to build a second major Sydney airport. Bankstown Airport Limited, Camden Airport Limited and Hoxton Park Airport Limited, previously subsidiaries of Sydney Airport Corporation Limited (SACL), were separated from SACL on 29 June 2001. The shares in Sydney airport were sold in June 2002 and the shares in Bankstown, Camden and Hoxton Park airports were sold in December 2003. This completed the airport privatisation process, yielding total proceeds of approximately $8.5 billion.

Only companies that meet strict ownership criteria can own / operate a Federal airport lease. These criteria are that:

- Australians hold a majority (at least 51%) of the paid-up capital, voting power, and rights to distributions of profits and capital of each company holding an airport lease; and
- an individual airline together with its associates does not hold more than 5% of any interest in an airport company (this maintains competition policy principles by separating ownership of an airport operator from ownership of airlines); and
- an airport company's head office is located in Australia and a majority of its directors are Australian citizens.

The sale of leases to the 18 major airports resulted in 12 different consortia, with a spectrum extending from major Australian (eg AMP, Commonwealth Bank and Macquarie Bank) and international firms (eg BAA, Schipol, Manchester, Serco and AGI) operating the larger airports, to smaller, locally owned businesses, operating the smaller regular public transport airports.

Permitting a level of foreign ownership and participation in the operation of Australia's major airports not only facilitated access to international capital and expertise but also permitted new and innovative management practices to be brought to bear in the Australian market place. This diversity of experience and managerial practices is today presenting itself in innovative approaches to attracting airline business and hence competition between airports desiring to grow their aeronautical business.

The Initial Pricing Regulatory Framework

In the lead-up to privatisation, the Commonwealth Government recognised that a period of adjustment to prices oversight might be necessary in the new regulatory environment. Twelve of the FAC's 22 airports were designated as 'core-regulated' airports under the *Airports Act 1996* and were subject to price regulation under the Prices Surveillance Act 1983. The core-regulated airports were those airports with significant 'regular public transport' (RPT) activity and comprised Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra, Darwin, Hobart, Launceston, Coolangatta, Townsville, and Alice Springs.

From 1 July 1997, the Government implemented a prices oversight regime for the Phase I privatised airports (Brisbane, Melbourne and Perth), consisting of:

- prices notification for aeronautical services;
- a Consumer Price Index (CPI) minus X price cap on aeronautical services;
- prices monitoring of certain aeronautical related services; and
- cost pass-through provisions for necessary new investment and government-mandated security services.

The value of 'X' in each airport's CPI-X price cap was set to reflect productivity improvements that the Government considered could be made in the provision of aeronautical services. Hence an important feature in the sales process was a requirement that the efficiency gains potentially available at the major RPT airports be shared with airport users.

For the purpose of administering the CPI-X price-cap and for prices monitoring, aeronautical and aeronautical-related services were broadly defined in a series of Declarations and Directions. Aeronautical-related services were separately declared for prices monitoring by the Australian Competition and Consumer Commission (ACCC) for those airport services where the airport operator was considered to have scope to exercise market power, but where coverage of the services under the more formal price cap arrangements was not considered warranted. The CPI-X prices oversight regime was extended to cover Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville airports with effect form 1 July 1998.

As Sydney Airport was not privatised until 2002, price regulation differed in some respects from the other core-regulated airports. From July 1998 (when Sydney Airport was corporatised) aeronautical-related services at Sydney were subject to prices monitoring similar to the other core-regulated airports, however, prices of aeronautical services at Sydney Airport were regulated by means of a prices notification regime whereby proposed price increases had to be approved by the ACCC under specified criteria.

As a result of reduced global demand for aviation services following the terrorist attacks in the United States on 11 September 2001, and the collapse of Ansett Airlines (also in September 2001), the Government changed prices oversight arrangements at the core-regulated airports. The changes included allowing a once-only price increase, as a pass-through in the price cap, for some airports. Price regulation was removed entirely from Coolangatta, Alice Springs, Hobart, Launceston and Townsville airports in October 2001.

Light-handed Price Regulation

In December 2000 the Government instructed the Commission to undertake an inquiry into *Price Regulation of Airport Services*. The purpose of the inquiry was to examine whether new regulatory arrangements, targeted at those charges for airport services or products where the

airport operator had been identified as having most potential to abuse market power, were needed to ensure that the exercise of any such power could be appropriately counteracted. The outcomes of the Commission's inquiry were released in January 2002 and the Government's response was announced in May 2002 (Attachment 2).

Based on the findings of the Commission's inquiry, the Government considered that lighter-handed regulation of airports was appropriate in place of price-caps and prices surveillance of aeronautical related services. A regime comprising aeronautical pricing principles, commercial pricing negotiations between the airports and their airline customers, and price monitoring of both aeronautical and aeronautical related services was implemented at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports. Quality of service monitoring was also implemented from 1 July 2002. The adoption of a light-handed approach recognised the inefficiencies arising for the industry in the setting of aeronautical prices by a regulator. For example, the price-cap arrangements acted as a strong incentive for stakeholders to dispute new pricing proposals and to employ regulatory gaming tactics rather than negotiating in good faith.

Under the current light-handed regime, the seven designated airports are required to provide annual financial statements in relation to the provision of aeronautical services and non-aeronautical services separately to the ACCC. The airports must also report costs, revenues and profits relating to the supply of aeronautical and aeronautical-related services to the ACCC. Price monitoring reports for the 2002-03, 2003-04 and 2004-05 financial years have been published by the ACCC to date.

A lighter-handed approach to airports regulation was intended to provide greater scope for the airports to price, invest and operate efficiently. The purpose of price monitoring was to assist the competitive process by allowing the community to scrutinise prices and market outcomes and to provide evidence of unjustifiable price increases were this to occur. It was also considered that price monitoring would act to curb any abuse of market power by the airports.

ATTACHMENT 2

JOINT PRESS RELEASE NO. 024

MINISTER FOR TRANSPORT & REGIONAL SERVICES
TREASURER

PRODUCTIVITY COMMISSION REPORT ON AIRPORT PRICE REGULATION

The Treasurer and the Minister for Transport and Regional Services today released the Productivity Commission's final report on Price Regulation of Airport Services, and also announced the Government's response to the report.

The Government has accepted the Commission's recommendation that Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin airports be subject to price monitoring for five years. These arrangements will take effect from 1 July 2002. An independent review will be carried out towards the end of the five-year period to ascertain the need for future airport price regulation.

"The Government's response has taken into account the interests of airports, airport users and the travelling public," Mr Costello and Mr Anderson said. "The price monitoring arrangements will provide airports with greater scope to undertake efficient aeronautical investments and more flexibility to respond to a changing aviation environment."

"The major airports have a strong commercial incentive to encourage passenger growth and maximise non-aeronautical revenue. Nevertheless, the Government will initiate a review if there is evidence of unjustifiable price increases. This would be in addition to the statutory protection given to stakeholders under the Trade Practices Act 1974."

The Ministers noted that the Government reserved the right to re-impose price controls if it were found that airport operators were abusing their market power by unjustifiably raising prices.

Mr Anderson noted that these new arrangements would not impact on regional airline operations into and out of Sydney. "They will continue to be guaranteed reasonable access to Sydney airport under the slot management system and with a prohibition on any increases in aeronautical charges that exceed the Consumer Price Index. We would like to thank the Productivity Commission and all those who provided submissions and assistance to the review," the Ministers said.

The Government's response to the report is available at http://www.treasurer.gov.au and http://www.dotrs.gov.au.

Background

The Commission was asked in December 2000 to examine whether there is an ongoing need for price regulation of airports. The Commission's final report was provided to the Government on 25 January 2002.

Melbourne, Brisbane and Perth airports are currently subject to a CPI-X price cap. Sydney airport is subject to prices notification (where it is required to notify the ACCC of any proposed price increases). These arrangements will expire on 30 June 2002. Adelaide, Canberra and Darwin airports have been subject to price monitoring since October 2001. This arrangement will continue, with some minor modifications.

CANBERRA
13 May 2002

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GOVERNMENT RESPONSE TO THE PRODUCTIVITY COMMISSION REPORT ON PRICE REGULATION OF AIRPORT SERVICES

<u>Recommendation 1:</u> For Sydney, Melbourne, Brisbane and Perth airports, price caps and prices notification arrangements should be replaced by mandatory price monitoring arrangements for a probationary five-year period, as outlined in Option B.

- **Airports-specific prices monitoring arrangements could be incorporated either in the Airports Act 1996 (Airports Act) or the Trade Practices Act 1974 (TP Act), but should be consistent with any generic price-monitoring provisions that may be introduced into the TP Act following the Commission's separate review of the Prices Surveillance Act 1983 (PS Act).**

In the event that the Government opted for a stricter form of price regulation at these four airports, Option A should apply such that:

- **annual price caps of the form CPI-X continue for five years at Melbourne, Brisbane and Perth airports. Price caps should be set to reflect the efficient costs of providing aeronautical services in the long run, on a dual-till basis. Price caps should be complemented by price monitoring of some 'aeronautical-related' services; and**
- **for a capacity-constrained Sydney Airport, prices should not be required to fall in real terms. Regulation should comprise either prices notification or a price cap of the form CPI-X, with X set at zero. Price increases should be allowed to reflect peak-period demand and to accommodate necessary investment.**

<u>Response:</u> The Government supports the introduction of price monitoring for Sydney, Melbourne, Brisbane and Perth airports, as outlined in Option B.

The current airport pricing arrangements were intended to be transitional, with a review to be held before the end of five years to determine what form of prices oversight should apply in the future. The Commission's review concluded that Sydney, Melbourne, Brisbane and Perth airports have considerable market power in some aeronautical services. However, due to commercial constraints, the potential for abusing that power does not warrant a heavy-handed regulatory regime.

The Government considers that lighter-handed regulation of airports is now appropriate. In particular, it appears that airport operators have strong commercial incentives to increase passenger throughput, and have facilitated the entry of new airlines to the market. As a safeguard, the Commission proposes that the price monitoring arrangements in Option B would only apply for a probationary period of five years. A review would be conducted towards the end of this period to determine whether there have been unjustifiable price increases that warrant reimposition of price controls. The threat of possible re-regulation will

encourage negotiated pricing outcomes based on efficient costs and an adequate return on capital.

However, the Government will also maintain a reserve right to bring forward the review, or conduct a separate review, if it appears that there have been unjustifiable price increases. Where a review indicates that there is evidence of unjustifiable price increases, the Government could decide to re-introduce price controls. (Further detail on the review process is set out in the response to Recommendation 6.)

A lighter-handed approach provides greater scope for airports to price, invest and operate efficiently. Price monitoring enhances market transparency by allowing the community to scrutinise prices and market outcomes, and can also assist the competitive process, without resort to heavy-handed price controls.

The Commission also recommends that airports-specific price monitoring be consistent with any generic price monitoring provisions. The Government considers that prices monitoring for airports should draw on generic prices surveillance provisions, rather than requiring airport-specific measures.

Recommendation 2: For Adelaide, Canberra and Darwin airports, mandatory price monitoring of aeronautical services and some 'aeronautical-related' services (as outlined under Option B) should continue for five years. (Airport-specific price-monitoring arrangements could be incorporated either in the Airports Act or the TP Act, but should be consistent with any generic price-monitoring provisions that may be introduced into the TP Act following the Commission's separate review of the PS Act.)

Response: The Government supports this recommendation.

The Commission found that Adelaide, Canberra and Darwin airports are likely to have a moderate degree of market power in some airport services that warrants ongoing price monitoring, at least as a transitional measure. The Government supports this approach. This would continue the arrangements applying since the 5 October 2001 amendments to the prices oversight framework that removed these airports from price cap regulation.

Recommendation 3: Quality monitoring of regulated services (as outlined under Option B) should continue at all airports subject to price regulation; that is, at Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin airports.

Response: The Government supports this recommendation.

The Government agrees that quality of service monitoring is a useful adjunct to price monitoring, as it helps to ensure that airport operators are not obtaining improved productivity through running down assets or reducing their standards of service below levels reasonably expected by stakeholders. Quality monitoring of regulated services may also identify whether

airports are investing appropriately, for example, by upgrading infrastructure or investing in new facilities to improve levels of service or facilitate increased demand.

The Commission has also suggested that quality of service indicators be reviewed, to ensure that the monitored services remain within the control of airport operators. The Government supports this approach but notes that benchmark comparisons between airports is facilitated by an overall view of service quality. The Commission also proposes that quality of service outcomes be published on an annual basis as part of the broader reporting requirements under price monitoring. The Government agrees that these outcomes should also be taken into account in the review of airport price regulation, which is to be completed towards the end of the five year regulatory period (see Recommendation 6).

Recommendation 4: Neither price monitoring nor price caps should be reintroduced for Alice Springs, Coolangatta, Hobart, Launceston and Townsville airports. The Airports Act should be amended so that these airports are no longer designated as 'core-regulated' airports.

Response: The Government agrees that neither price caps nor price monitoring should be re-introduced to Alice Springs, Coolangatta, Hobart, Launceston and Townsville airports, but wishes to reserve its position in regard to removing the financial and quality of service reporting obligations applying to them.

As the Commission found that Alice Springs, Coolangatta, Hobart, Launceston and Townsville airports all have low market power, the Government considers that price monitoring or price caps for these airports is no longer required.

As 'core regulated' airports, they are subject to a number of general regulatory provisions in the Airports Act that concern the management and operation of the leased Federal airports. It is appropriate that those provisions should continue to apply. The Government understands, however, that the intention of the Commission's recommendation is to eliminate the obligation on these airports to report financial and quality of service information under Parts 7 and 8 of the Act. In that regard, the Government proposes that this requirement be reviewed against its policy objectives and, as part of a broader review of the Act, to consider further whether this information should continue to be provided.

Recommendation 5: Commercial agreements should be encouraged and assisted (for example, by providing guidelines regarding coverage) under price-monitoring arrangements, or price caps, if they were retained at some airports.

Response: The Government supports this recommendation in principle and it was always the Government's intention that airports and stakeholders should commercially negotiate pricing outcomes on aeronautical and aeronautical-related services.
The Government agrees that there is merit in supporting the development of commercial agreements. However, it is not clear that the Government needs to, or should, play a role in preparing guidelines for the conduct of those negotiations or the content of particular

agreements that may take various forms and cover any variety of matters. The Government is conscious of the costs that would arise from a highly prescriptive regulatory process and considers that it is the parties affected that are best placed to determine these matters in a manner that suits their particular operational needs.

In the event that commercial agreement cannot be concluded in relation to access terms and conditions, the access provisions in Part IIIA of the TP Act provide recourse to arbitration for determining those conditions for 'declared' services.
The Government is, however, prepared to assist airports and airport users develop industry guidelines for commercial agreements should that be required.

Recommendation 6: Price regulation of airports should be reviewed towards the end of the five-year regulatory period. The review should be independent and public. Its objective should be to ascertain the need for any future price regulation of airports (including price monitoring or more stringent price regulation). In making its assessment, the review should be guided by principles of efficient pricing plus several other criteria set out under Option B. Agreed review criteria should be spelt out at the beginning of the regulatory period.

Other airports should be included in the review only where there was prima facie evidence of persistent misuse of market power (namely, evidence of inefficient prices, poor quality etc).

Response: The Government supports this recommendation, but reserves the right to bring forward a review if there is a strong indication that an airport has unjustifiably increased its prices.

The Government supports the Commission's recommendation that there be an independent review towards the end of the five year regulatory period to assess the need for continued price regulation. Sufficient time needs to be given for the airports and stakeholders to bed down a commercially negotiated operating environment. In that regard there is an expectation that airport operators will implement transitional arrangements that are mindful of the impacts on the industry from adopting efficient pricing principles, and will negotiate with stakeholders a path by which they may be achieved over time.

As indicated in the response to Recommendation 1, however, the Government considers that it should reserve the right to bring forward the review, or conduct a separate review, if it appears that an airport operator has unjustifiably increased prices. The Government would only consider re-introducing price controls on an airport if it formed the view that the airport had operated in a manner inconsistent with the following principles.

Review Principles

At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing

aeronautical services (on a 'dual-till' basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.

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

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

Quality of service outcomes should be consistent with user's reasonable expectations, and consultation mechanisms should be established with stakeholders to facilitate the two way provision of information on airport operations and requirements.
It is expected that airlines and airports will primarily operate under commercial agreements and in a commercial manner, and that airport operators and users will negotiate arrangements for access to airport services.

The Government considers that the principles outlined above will also form the basis of the future five year review, taking into account intervening industry developments.

The Government agrees with the Commission's recommendation that the five year review only cover those airports that will be subject to price monitoring, unless there are compelling reasons to include additional airports in the review.

Recommendation 7: All airports should be subject to the generic provisions of the National Access Regime in Part IIIA of the TP Act. An airport-specific access regime should be considered only if procedural improvements, such as scope for multilateral arbitrations, are not made to the National Access Regime.

Response: The Government supports the application of the generic provisions of Part IIIA to airports.

The existing airport-specific access regime, as set out in s.192 of the Airports Act, was introduced as a transitional measure to streamline the access processes under the TP Act as they apply to the newly privatised airports. The intention was that the arrangements under s.192 would ultimately expire, and that airports would be subject to the generic access provisions of the TP Act. Little use has been made of the declaration provisions and, in view of this, Sydney airport will be sold into the Part IIIA generic regime.

There is no compelling case made for the airports-specific access provisions to be continued and the Government agrees that all airports should be subject to the generic access provisions of Part IIIA of the TP Act. Part IIIA contains mechanisms for 'declaring' access to a service, and includes arbitration and enforcement mechanisms in the event that the access provider and seeker cannot agree on terms and conditions of access. Part IIIA also includes provision for access providers to submit undertakings to the ACCC that specify the terms on which access will be made available to third parties. Combined with the Part IV provisions of the Act, Part IIIA provides protection for access seekers that have been unreasonably denied access to services eligible under the legislation.

Some parties have raised concerns as to the operation of the Part IIIA provisions. The Government has under consideration the Commission's recommendations to improve the operation of Part IIIA.

Recommendation 8: Prior to implementation of the chosen regulatory approach, airports and airlines should be consulted on the practicalities of the proposed regulation and made aware of its various requirements, in order to reduce uncertainty and the potential for disputation. In particular, bidders for Sydney Airport should have a clear picture of the regulatory framework for that facility so that expected future airport charges can be factored adequately into the sale price.

Response: The Government supports the intentions of this recommendation.

As a matter of course the Government consults with industry stakeholders when considering changes to the operation of the regulatory environment. The Government will be consulting with interested parties on the details for implementing the regulatory measures and, in particular, on proposed information-reporting requirements for the purposes of price monitoring. On the matter of the future regulatory approach, the Government has taken into account the views of industry players who have contributed to the deliberations of the Commission in the making of its recommendations.

The Government is mindful of the fact that bidders for Sydney Airport should have a clear position on the proposed economic regulatory framework. Accordingly, the Government's response has been announced so that the prices oversight arrangements to apply are understood by bidders and can be taken into consideration in formulating final bids for Sydney Airport.

ATTACHMENT 3

Terms of Reference

Inquiry Into Current Arrangements For The Price Regulation of Airport Services

Productivity Commission Act 1998

I, PETER COSTELLO, Treasurer, pursuant to Parts 2 and 3 of the Productivity Commission Act 1998, hereby refer current price regulation arrangements for airport services to the Commission for inquiry and report within nine months of receipt of this reference. The Commission is to hold hearings for the purpose of the inquiry.

Background

In 2002, the Government introduced a light-handed approach to price regulation of airport services with market power in line with recommendations made by the Commission in its 2002 Report on Airport Price Regulation. Under the Government's policy, price notification and price caps under the Prices Surveillance Act were discontinued for all airports (with the exception of regional air services at Sydney airport), and price monitoring for Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth, and Sydney airports was introduced for a five year period and with a review of the arrangements to be conducted at the end of this period. The Government reserved the right to bring forward the review if there was evidence of unjustifiable price increases.

The purpose of this inquiry is to examine the effectiveness of the current light-handed regulatory regime for airport pricing and to advise on any changes to the regime.

Scope of Inquiry

1. The Commission is to report on whether airport operators have acted in a manner consistent with the Government's Review Principles and on effectiveness of the current form of prices regulation of airports having regard to the objectives that the regulatory regime should:
    a. promote the economically efficient operation of airports;
    b. minimise compliance costs on airport operators and the Government; and
    c. facilitate commercially negotiated outcomes in airport operations, benchmarking comparisons between airports and competition in the provision of services within airports (especially protecting against discrimination in relation to small users and new entrants).

2. In undertaking its assessment, the Commission is to have regard to the Government's Review Principles which are:
    a. At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a 'dual-till' basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.
    b. Price discrimination and multi-part pricing that promotes efficient use of the airport is permitted. This may mean that some users pay a price above the

long-run average costs of providing aeronautical services, whereas more price-sensitive users pay a price closer to marginal cost.

c. At airports with significant capacity constraints, efficient peak/off-peak prices may generate revenues that exceed the production costs incurred by the airport. Such demand management pricing practices should be directed toward efficient use of airport infrastructure and, when not broadly revenue neutral, any additional funding that is generated should be applied to the creation of additional capacity or undertaking necessary infrastructure improvements.
d. Quality of service outcomes should be consistent with user's reasonable expectations, and consultation mechanisms should be established with stakeholders to facilitate the two way provision of information on airport operations and requirements.
e. It is expected that airlines and airports will primarily operate under commercial agreements and in a commercial manner, and that airport operators and users will negotiate arrangements for access to airport services.

3. The Commission is to review aeronautical asset revaluation practices and dispute resolution mechanisms at each of the price monitored airports and advise on improvements that would be consistent with the Government's Review Principles.

4. In making its recommendations on future price regulation arrangements for airport services, the Commission is to:
    a. have regard to its findings on the behaviour of airport operators and airlines and the effectiveness of the existing prices and quality of service monitoring of airports;
    b. identify relevant alternatives to the current arrangements and the extent to which these alternatives would better achieve the Government's objectives in privatising the airports and moving to a light-handed pricing regulatory regime;
    c. analyse and, as far as practical, quantify the benefits, costs (including compliance costs) and economic and distributional impacts of the current arrangements and the alternatives identified in b).

5. To the extent applicable the Commission is to have regard to:
    a. the Australian Competition Tribunal's decision of 9 December 2005 to declare the airside services at Sydney Airport and subsequent consideration of this matter by the Federal Court; and
    b. the outcomes of the Council of Australian Government's (COAG) 2005 review of National Competition Policy.

6. In undertaking the review, the Commission is to advertise nationally, consult with key interest groups and affected parties, and produce a report.

7. The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report.

PETER COSTELLO
6 April 2006

ATTACHMENT 4

Proposed Definition of Aeronautical Services and Facilities

Preamble[1]

Aeronautical services and facilities are services and facilities provided at airports for the purposes of operating and/or maintaining civil aviation services at the airport including, but not limited to, the items listed below. As the nature of services change, it may be necessary to amend the list of specified items.

Aeronautical costs and revenues are costs and revenues associated with the provision and use of aeronautical services and facilities and which are recovered either directly or indirectly (eg. access charges for ground handling operations, and fuel throughput levies) from airlines.

Sub-heading (a) Aircraft-related services and facilities, including the provision, maintenance and repair of:		**Sub-heading (b)** Passenger-related services and facilities, including the provision, maintenance and repair of:
(a)(i) runways, taxiways, aprons, airside roads and airside grounds		(b)(i)) public areas in terminals, public amenities, lifts, escalators and moving walkways
(a)(ii) airfield and airside lighting		(b)(ii) departure and holding lounges, and related facilities (excluding club/business lounges)
(a)(iii) aircraft parking sites and facilities		(b)(iii) aerobridges (including nose-in guidance systems) and airside buses
(a)(iv) ground handling services and facilities (including equipment storage and refuelling)		(b)(iv) flight information and public-address systems
(a)(v) aircraft refuelling services and facilities (including pipelines to and from the JUHI)		(b)(v) facilities to enable the processing of passengers through customs, immigration and quarantine
(a)(vi) airside freight handling and long/short term staging areas essential for aircraft loading and unloading		(b)(vi) check-in counters and related facilities (including associated queuing areas)
(a)(vii) airfield navigation services and facilities (including visual navigation aids)		(b)(vii) landside terminal access roads and facilities (including lighting and covered walkways)
(a)(viii) airside safety and security services and facilities (including rescue and fire-fighting services and perimeter fencing)		(b)(viii) security systems and services (including closed circuit surveillance systems)
(a)(ix) environmental hazard control services and facilities		(b)(ix) baggage make-up, handling and reclaim facilities
(a)(x) services and facilities to ensure compliance with environmental laws		(b)(x) telecommunications infrastructure
(a)(xi) aircraft light and emergency maintenance sites and buildings		(b)(xi) office space and facilities in terminals or airside for airline staff who are essential to the airline's operations at the airport

1. The Definition of Aeronautical Services and Facilities is intended to include all services and facilities at airports that are necessary for efficient civil aviation operations at the airport. Commercial arrangements for the purpose of providing a 'premium' service to a particular sub-set of airline customers, and commercial aeronautical property transactions where the airport does not have a high degree of market power are excluded.

ATTACHMENT 5

Table: Summary of Airport's Practices on Asset Valuation and Setting of Aeronautical Charges

Airport	Initial Asset Base Valuation		Non-land Asset Revaluation	Land Revaluation		Basis for Aero Charges
	Buildings	Land		For Accounting Purposes	For Pricing Purposes[1]	Building Block Approach?
Melbourne	DORC[2]	Market value (based on a mixture of rural and light industrial)	DORC	Yes	No	Yes
Perth	FAC book	FAC book (re-valued using DORC in 2001-02 and booked into accounts in 2003-04)	DORC	Yes	Yes	Yes
Brisbane	DORC	Market value (light industrial)	DORC	Yes	Yes	Yes
Sydney	DORC	Value determined by ACCC (indexed historic cost)	Market value	Yes	No	Yes
Canberra	DORC	Market value (mixed use sub-division)	Market value (external valuer)	Yes	Yes	Yes
Adelaide	DORC	Initial cost and engineering values (indexed historic cost)	Independent valuation (DORC)	Yes	Yes	Yes
Darwin	DORC	Market value (unimproved industrial land)	DORC	Yes	No	Yes

1. All airports, except Melbourne, have indicated they believe the asset base should be re-valued periodically for pricing purposes.
2. Depreciated Optimised Replacement Cost. An approach to allocating the capital costs of a project under which the asset base is re-valued to be equal to the price of building or buying a modern equivalent asset, depreciated to reflect the shorter remaining life of the existing assets.

ATTACHMENT 6

Table: Airport Physical Assets Summary

	Asset Class	Sydney ($'000)	Melbourne ($'000)	Brisbane[1] ($'000)	Perth ($'000)	Adelaide ($'000)	Canberra ($'000)	Darwin ($'000)
Year 1997/98	Aero		*463,058*	*258,638*	*79,709*			
	Non-Aero		228,813	135,788	102,203			
	Total assets		**692,871**[2]	**394,426**[3]	**181,912**[4]			
Year 1998/99	Aero	*1,174,452*	*444,512*	*248,188*	*96,540*	*99,046*	*57,560*	*54,213*
	Non-Aero	1,398,820	242,949	137,186	104,719	59,830	12,185	11,299
	Total assets	**2,573,272**[5]	**687,461**	**385,374**	**201,259**[6]	**158,876**[7]	**69,745**[8]	**65,512**[9]
Year 1999/2000	Aero	*1,574,081*	*429,009*	*493,511*	*92,217*	*130,897*	*56,434*	*52,202*
	Non-	1,487,422	294,478	171,739	104,858	81,366	27,485	11,282
	Total assets	**3,061,503**	**723,487**	**665,250**[10]	**197,075**	**212,263**[11]	**83,919**	**63,485**
Year 2000/01	Aero	*1,625,504*	*415,215*	*522,287*	*88,906*	*132,943*	*95,136*	*49,153*
	Non-Aero	1,535,156	303,493	163,243	120,554	*82,236*	84,952	11,317
	Total assets	**3,160,660**	**718,618**	**685,530**	**209,460**	**215,179**	**180,088**[12]	**60,471**
Year 2001/02	Aero	*1,568,198*	*426,707*	*533,704*	*84,463*	*129,364*	*223,192*	*46,064*
	Non-Aero	1,516,875	298,068	162,182	121,920	83,072	112,434	14,518
	Total assets	**3,085,073**	**724,775**	**695,886**	**206,383**	**212,436**	**335,088**[13]	**60,582**
Year 2002/03	Aero	*1,646,683*	*425,231*	*571,127*	*84,392*	*131,134*	*154,107*[14]	*43,985*
	Non-Aero	1,565,734	313,477	216,110	129,918	80,331	352,877	14,247
	Total assets	**3,212,417**	**738,708**	**787,237**[15]	**214,310**	**211,465**	**506,984**[16]	**58,232**
Year 2003/04	Aero	*1,620,371*	*420,539*	*562,186*	*175,626*	*175,607*	*148,563*	*43,492*
	Non-Aero	1,558,417	317,766	200,698	208,083	87,833	480,122[17]	14,649
	Total assets	**3,178,788**	**738,305**	**762,884**	**387,719**[18]	**263,440**	**628,685**	**58,140**
Year 2004/05	Aero	*1,587,409*	*473,549*	*563,578*	*196,193*	*305,788*	*163,592*	*53,866*
	Non-Aero	1,564,606	345,340	215,409	217,154	107,088	531,051	17,133
	Total assets	**3,152,015**	**818,889**	**778,987**	**413,347**	**412,876**	**694,644**	**70,999**
Sale price		**5,600,000**	**1,310,000**	**1,387,000**	**643,000**	**363,500**[19]	**65,890**	**110,150**[20]

Source: ACCC's Annual Regulatory Reports for Airports

Notes: Attachment 6

1. From 1997/98 to 2001/02 leasehold land is not included.

2. Land leased as part of airport acquisition has been valued at acquisition at fair value.

3. Leasehold land and buildings are independently valued every three years.

4. The basis of valuation of operational land is replacement cost on an existing use basis. Investment property is valued at fair market value.

5. The cost of non-current assets constructed by SACL includes all direct costs incurred. These costs include materials, labour, borrowing costs, and other directly related expenditure. Items of property, plant and equipment comprising a class of non-current assets are re-valued at the same date on a consistent basis. Re-valuations will be conducted at least every three years.

6. Revaluation based on fair value.

7. Land held under lease and leasehold improvements are carried at cost or directors' valuation.

8. Property, plant and equipment are included at cost or independent valuation.

9. The cost base was assigned to the assets.

10. Re-valuation.

11. Revaluations are made in accordance with a regular policy whereby independent valuations are obtained every three years and carrying amounts adjusted.

12. Other assets and commercial buildings were re-valued by the directors as at 30 June 2001.

13. Land, Buildings and other improvements were re-valued as at 30 June 2002.

14. Reclassification of assets from aeronautical to non-aeronautical.

15. On 1 July 2002 the company established a new class of non-current assets, titled investment property.

16. Leasehold land, buildings, building improvements and other property assets were re-valued on 30 June 2003 at fair market value by the directors based on advice from a registered valuer.

17. Certain land, buildings and improvements have been subject to re-valuation.

18. Re-valuation based on fair value.

19. Including Parafield airport.

20. Including Alice Springs and Tennant Creek airports.