Public Register Version

QANTAS AIRWAYS LIMITED
ABN 16 009 661 901

RESPONSE TO THE PRODUCTIVITY COMMISSION'S DRAFT REPORT

INQUIRY INTO CURRENT ARRANGEMENTS FOR THE PRICE REGULATION OF AIRPORT SERVICES

OCTOBER 2006

Key Points

- Major airports in Australia are monopolies. The PC's draft recommendations do not address the fundamental issue created by airports' market power. Without an effective counter-balance (in this case a binding dispute resolution mechanism) there is no constraint on airport operators' ability to exercise their market power.

- A binding dispute resolution mechanism would facilitate commercial negotiation:

  - ➢ Airport owners would be encouraged to offer reasonable terms and conditions in commercial negotiations with airport users. This will reduce the current imbalance in bargaining power between monopoly airport owners, which tend to adopt a 'take it or leave it' approach, and airport users.

  - ➢ Qantas is not the only advocate of a binding independent dispute mechanism. A diverse range of stakeholders including DOTARS, large and small airlines, other airport users and Melbourne Airport also strongly support the principle. Only airports with a strong degree of monopoly power would be worse off (and therefore resist) a mechanism specifically designed to constrain that monopoly power.

- Suggestions that a dispute resolution mechanism will become a 'default' and hinder the development of commercial agreements is factually wrong and nothing more than scare-mongering by airports:

  - ➢ When airport services were effectively declared at a range of airports between 1998 and 2003, no arbitrations occurred – instead a number of commercial agreements were reached without either party initiating an access dispute.

  - ➢ As a matter of commercial reality, Qantas and (presumably) other airport users and owners will use the binding dispute resolution mechanism only as a last resort. Currently, Qantas attempts to reach agreement with airports by escalating material issues to senior management (including ultimately its CEO). Access to a binding dispute resolution mechanism will not change this – rather, instead of stalemates being reached, more issues will be resolved as both parties will need to consider whether their conduct is reasonable.

- The PC appears to be concerned that 'commercial negotiations' are not possible if an airport can be compelled to supply services on terms it deems inappropriate. This concern ignores the converse current situation – that airport users should not be compelled to acquire services on unreasonable terms and conditions from a monopoly airport.

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

- The PC is concerned that replacing price monitoring with independent binding dispute resolution as a circuit breaker is 'premature'. It would prefer instead to review the situation again in five years. This 'delay' approach means that airport users such as Qantas will either have to accept non-commercial terms and conditions or use Part IIIA of the *Trade Practices Act* to seek declaration of services at airports. The PC itself has recognised the inefficiencies and uncertainties associated with declaration applications under Part IIIA.

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

- A formal response to each of the PC's draft recommendations is provided in Annexure 1.

1. Introduction

Qantas Airways Limited (**Qantas**) is disappointed by the Productivity Commission's (**PC**) draft report on its inquiry into current arrangements for price regulation of airport services (**Draft Report**). A brief formal response to each of the PC's draft recommendations is provided in Annexure 1.

The PC's draft recommendations do not address the fundamental issue created by airports' unfettered monopoly power which was identified by Qantas in its submission of 21 July 2006 (**Qantas Submission**) and which has been demonstrated time and again through prices monitoring by the Australian Competition and Consumer Commission (**ACCC**) as well as the Australian Competition Tribunal's (**ACT**) detailed findings against Sydney Airport in December 2005.

The Qantas Submission identified a Core Principle which must be implemented to advance constructive engagement between airports and airport users in Australia. This Core Principle is that:

> **Airports and airport users must engage in commercial negotiation of terms and conditions of access to services:**
> - **in good faith with full and transparent information exchange;**
> - **supported by binding independent dispute resolution in the event that agreement cannot be reached.**

A binding dispute resolution mechanism consistent with this Core Principle would facilitate commercial negotiation. The possibility of recourse to an independent body would create real incentives for airport owners to offer and airport users to accept reasonable terms and conditions in their commercial negotiations. This will reduce the current imbalance in bargaining power between monopoly airport owners, who tend to adopt a 'take it or leave it' approach, and airport users.

A binding dispute resolution mechanism would eliminate any need for the prices and quality of service monitoring regime. However, in the event that a binding dispute resolution mechanism is not introduced, Qantas supports the PC's draft recommendations to tinker with the existing prices and quality of service monitoring regime, in particular the PC's guidance on aeronautical asset valuations[1] and clarifying the scope of services to be covered by price monitoring[2]. However, in the absence of a binding dispute resolution mechanism those recommendations would have at best a peripheral impact.

Instead of providing an exhaustive commentary on all the factual and other matters raised by the Draft Report, this response identifies elements of analytical inconsistency and conceptual weakness underpinning the Draft Report. In particular, this response focuses on the analysis which underlies the PC's rejection of the Core Principle. This approach is adopted in the hope that the PC will not allow the opportunity of the current review to pass without rigorously evaluating the robustness of key notions which underpinned its approach in 2001 and apparently still underpin the Draft Report[3].

---

[1] Draft Report, Draft Recommendation 6.1.
[2] Draft Report, Draft Recommendation 5.2.
[3] For example, the PC clings to the notion that non-aeronautical revenue acts as a constraint on the exercise of market power by airports. The PC states that *'[a]irports may limit aeronautical charges to increase passenger throughput and thereby increase earnings from non-aeronautical activities, such as retail concessions'*. This has not been Qantas' experience (see NERA, *Effectiveness of the regulation of airport services: A report for Qantas,* 2006 p25) and is not

2. Binding dispute resolution

Submissions made to the PC establish support for the Core Principle put forward by Qantas from a diverse range of stakeholders including large and small airlines, other airport users, the Department of Transport and Regional Services (**DOTARS**) and Melbourne Airport. Indeed, DOTARS urged the PC to give serious consideration to[4]:

> '… 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'.

Notwithstanding that broad range of support, the PC, at least for now, rejects Qantas' proposal for implementing the Core Principle. Recommendation 7.1 states: *'[a]n airport-specific arbitration regime, or a requirement that agreements between airports and airlines include provision for binding independent dispute resolution, should not be introduced at this time.'*[5] It does this apparently for two basic reasons:

- the potential for dispute resolution to become a 'default' and reduce the incentive for parties to negotiate commercial agreements; and
- a concern that such a change would be premature.

These matters are elaborated in sections 3 and 4 below.

3. Lack of incentive to negotiate

3.1 PC's analysis of incentives to negotiate

The PC appears concerned that airports and airport users would not have incentives to commercially negotiate terms and conditions of access if they had access to a binding dispute resolution mechanism as a *'default option'*[6]. The PC's rationale for rejecting Qantas' Core Principle is *'the most likely outcome of implementing the suggested arbitration mechanisms would be a return to heavy-handed determination of charges, with all of its attendant costs'* [7]*.*

The suggestion that a dispute resolution will become a 'default' and hinder the development of commercial agreements is factually wrong and nothing more than scare-mongering by airports. Only airports with a strong degree of monopoly power would resist the PC supporting a mechanism that is designed to constrain that monopoly power.

---

borne out by the detailed evidence and analysis of the Australian Competition Tribunal (ACT) in the recent *Sydney Airport* matter (see paragraphs 509 to 512 of the ACT decision).

[4] DOTARS, Sub.24, para 41.

[5] It is interesting to note the PC's statement in 2001 in relation to Option B, which the PC ultimately recommended, that *'voluntary commercial agreements between airports and airport users (including non-airline users) would be encouraged by providing guidelines regarding coverage, consultation and dispute settlement mechanisms.'*

[6] Draft Report, p108.

[7] Draft Report, pXXV.

3.2 PC's analysis is contrary to Australian experience

There is no evidence to suggest that binding dispute resolution will become the 'default' position and prevent the development of more constructive negotiations between airports and airport users. Indeed, all the available evidence is to the contrary:

- For the periods between 1998 to 2002 (for Phase I Airports) and 1999 to 2003 (for Phase II airports)[8], during which 'airport services' were effectively declared pursuant to the deeming provision under s192 of the *Airports Act 1996*, there were no arbitrations. Put another way, that is a total of 43 years for which airport services were declared at various Australian airports without arbitration becoming the 'default'.

- During the period for which cargo handling services (from 2000 to 2005) and airside services (since 9 December 2005) at Sydney Airport have been declared there have been no arbitrations – commercial negotiations have continued and there has been no 'race' to the ACCC.

The PC invokes *'[e]xperience in other sectors'* suggesting that *'easy access to a sector-specific arbitration process can fundamentally undermine genuine negotiations'*[9]. No examples are given. There are, of course, many sectors which have mandated negotiation frameworks for previously price regulated businesses featuring a binding arbitration mechanism. Only very recently a draft decision by the Australian Energy Market Commission (**AEMC**), in the context of developing the regulatory framework for transmission revenue regulation by the Australian Energy Regulator, provides for some previously regulated services to be subject to commercial negotiation with a detailed arbitration framework. Whilst explicitly determining that nothing in the regulatory rule compels the transmission provider to provide a service, the AEMC indicated that it[10]:

> 'believes that improvements in cost and performance efficiency can be obtained by requiring TNSPs to negotiate prices, terms and conditions for dedicated service and non-standard use of system services directly with generators and large users. Such bilateral negotiations outside of the revenue cap would subject the costs incurred by TNSPs to commercial testing by informed and self-interested users who, with the support of a right to independent dispute arbitration, would be in a position to apply considerable countervailing negotiation power.'

In addition, the PC's purely theoretical concern that resort to binding dispute resolution will become the default ignores commercial reality. Qantas and (presumably) other airport users and owners will use the binding dispute resolution mechanism only as a last resort.

Currently, Qantas attempts to reach agreement with airports by escalating material issues to senior management (including ultimately its CEO). Access to a binding dispute resolution mechanism will arguably enhance this current process – instead of stalemates being reached after a series of negotiations between increasingly senior executives in each organisation, more issues will be resolved as both parties will need to assess whether their conduct would be considered reasonable in the event the other party invoked its right to refer the issue to independent binding arbitration.

---

[8] Phase I airports (Melbourne, Brisbane and Perth) were determined to be declared from 23 July 1998 until 1 July 2002. Phase II airports (Adelaide, Gold Coast, Hobart, Launceston, Alice Springs, Canberra and Darwin) were declared from 12 October 1999 until 1 July 2003, and Townsville Airport was declared from 4 August 2000 to 1 July 2003.

[9] Draft Report, p112.

[10] Australian Energy Market Commission, Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Draft Rule Determination, July, p22.

3.3 PC's analysis is inconsistent with the policy of Part IIIA

The PC says that *'[a] key characteristic of commercial negotiations is that parties cannot be compelled to supply goods and services on conditions they deem to be inappropriate'*[11]. In other words, the PC says that 'commercial negotiation' is impossible if a supplier can be compelled to supply goods and services on conditions it deems to be inappropriate. That proposition is the starting point of the PC's analysis rejecting the need for binding dispute resolution.

A proposition may be accepted, as it was by the Hilmer Committee, that 'as a general rule'[12] an owner of property and/or a supplier of services may choose when and with whom to conduct business dealings and on what terms and conditions. That is based on the important notions of private property and freedom to contract. The PC uses similar language but the analysis on which it has relied is very different: it focuses on defining what is '*commercial negotiation*' by identifying an excluding characteristic.

If the PC's proposition is correct then the whole approach to access regulation in Australia is thrown into question. Part IIIA of the TPA establishes a two stage process of declaration and then, failing agreement, arbitration. If negotiation does not produce an agreed outcome then at the arbitration stage it is possible for a party to be compelled to supply goods or services on conditions that it deems inappropriate. The PC, by the proposition it asserts, appears to suggest that negotiations in respect of a declared service cannot therefore be *'commercial negotiations'*.

The PC's proposition contradicts what the Hilmer Committee said when it recommended an access regime as an exception to general rules about freedom to contract. It said[13]:

> 'The proposed access regime relies on negotiation between parties to settle access disputes. Where agreement cannot be reached between the parties, an arbitral process is proposed.'

Previous comments made by the PC itself are also inconsistent. For example, it stated in its *Review of the National Access Regime* :

> 'The regime is not intended to replace commercial negotiations between facility owners and access seekers. Rather, it seeks to enhance the incentives for negotiation and provide a means of access on reasonable terms and conditions if negotiations fail'[14].

It is also contrary to the policy in relation to Part IIIA, as expressed in the explanatory memorandum to the *Competition Policy Reform Act 1995* (Cth)[15]. That policy has been recently endorsed by the Parliament. In the explanatory memorandum to the *Trade Practices Amendment (National Access Regime) Act* 2006 (Cth) it is said that[16]:

---

[11] Draft Report, p112 (emphasis added).
[12] Independent Committee of Inquiry into Competition Policy in Australia, *National Competition Policy,* (Canberra, AGPS, 1993) (**Hilmer Report**), p242.
[13] Hilmer Report, p259.
[14] (2001) Report No. 17, pXV.
[15] Explanatory Memorandum to the *Competition Policy Reform Act 1995*, item 165:*"This regime establishes two mechanisms for the provision of third party access, namely: (a) a process for declaration of services which provides a basis for negotiation of access. This is backed up by compulsory arbitration where the parties cannot agree on an aspect of access; and (b) a procedure whereby service providers can offer undertakings which set out the terms on which a provider will grant access to third parties".*
[16] Explanatory Memorandum to the *Trade Practices Amendment (National Access Regime) Act 2006*, p10.

> 'The objective is to facilitate negotiations where possible between access providers and access seekers after declaration of a service without creating regulatory uncertainty.'

Even if the proposition is accepted that in order for negotiations to be "commercial negotiations" a party cannot be compelled to supply goods or services on conditions it deems inappropriate, it would also presumably follow that nor can a party be compelled to acquire goods and services on conditions it deems inappropriate. Were it not so then the inequality of bargaining power would be obvious and the prospect of commercial negotiation producing efficient outcomes would evaporate. And yet that is precisely what is happening. As the PC says[17]:

> 'The market power enjoyed by the major airports will, of course, condition negotiations and the outcomes they deliver.'

The Core Principle suggested by Qantas cannot properly be dismissed, as it appears to have been, by the adoption of a simple proposition that commercial negotiations are not possible if an airport can be compelled to supply services on terms it deems inappropriate. Such a proposition is not only incorrect but ignores the flipside – namely, the current situation in which airport users are forced to accept unreasonable terms and conditions imposed by a monopoly airport. In this way the PC's approach is inconsistent with the Parliament's approach to access regulation in Australia and fails to recognise the monopoly power of airports.

3.4 Asset valuations and the need for guidance

The PC (as discussed in section 3.3 above) has taken the approach of identifying the characteristics of 'commercial negotiation' and then concluding that binding dispute resolution would be inconsistent with those characteristics. In doing so, the PC has been critical of 'commercial negotiations' to date and noted that *'price outcomes in particular have been heavily influenced by the previous regulatory regime'*[18]. The PC elaborates that observation as follows[19]:

> 'More broadly, expectations and negotiating stances remain heavily conditioned by perceptions of the outcomes that the previous price cap regime might have produced in similar circumstances, and/or by precedents established under that regime or like regimes applying to other infrastructure services. Thus, it is far from clear that all parties have accepted the need for an element of give and take that characterises genuinely commercial negotiations – or that such negotiations can reasonably give rise to a range of outcomes rather than a single answer based on previous regulatory precedent.'

That analysis leads the PC to conclude that *'the transition to a situation where outcomes are dictated primarily by commercial negotiations still has a way to go'*[20].

The above view implies there is a level playing field between airports and airport users to facilitate the 'give and take' of negotiation and ignores the fact that airports are monopoly facilities.

[17] Draft Report, p112.
[18] Draft Report, pXVIII
[19] Draft Report, p108.
[20] Draft Report, p109.

In relation to asset valuation, the PC comments that *'as well as inhibiting negotiations on charges at particular airports, dispute over [asset valuations] is now becoming a major stumbling block to the further development of commercial relationships between the parties more generally. If not resolved, it may therefore threaten the sustainability of the light handed approach'*[21]. Accordingly, the PC's draft recommendation is that the value of aeronautical assets be fixed at a set point in time, namely 30 June 2005.

The inconsistency of the PC's expectations for 'commercial negotiation' and its proposed approach to asset revaluation, each expressed above, is telling. By fixing the asset revaluation issue the PC implicitly accepts that the scope of commercial negotiations must be limited. Asset valuation is important in this context only as a building block; part of a well-established and accepted approach to pricing.

Quite appropriately, since the removal of prices surveillance, airport users such as Qantas have looked at longstanding economic principles to review pricing proposals as well as regulatory precedent. Implicit in the PC's recommendation is an acceptance of the ACCC's decision on Sydney Airport's aeronautical pricing proposal in May 2001. Qantas believes it would be beneficial if the PC could provide guidance of whether that is the correct approach. Without such guidance or a binding dispute resolution mechanism, future pricing disputes are likely to continue to arise.

3.5 The PC fails to consider airport incentives

Some airports expressed views, apparently accepted by the PC, to the effect that binding dispute resolution will become a 'default' and form an impediment to commercial negotiations. The Draft Report cites Westralia Airports and Sydney Airports in support of the proposition that an airport specific arbitration mechanism could be counterproductive to constructive commercial negotiations[22]. Implicit in the PC's conclusion appears to be an acceptance that airlines and other airport users will simply *'go through the motions as a prelude to arbitration'*[23].

Airport operating companies claim to have faced airport users unwilling to enter into binding commercial arrangements in the hope that some regulatory solution might provide a better outcome. For example:

- According to SACL:

  > 'the prevailing nature of the regulatory environment in which these negotiations have been progressing has itself provided an inducement for airlines, quite rationally, not to conclude final agreements. This is because, in so doing, they may deprive themselves of further advantage that they perceive might otherwise arise through either the Virgin Part IIIA proceedings or this scheduled Productivity Commission review'[24].

- In a similar vein, Canberra Airport claimed that the proceedings in relation to declaration of airside services at Sydney Airport *'resulted in the airlines not wanting to finalise the Canberra agreement for fear that it may either compromise the more important process of seeking declaration of Sydney Airport or that the NCC process may yield a better outcome that could then be applied at Canberra'*[25].

[21] Draft Report, pXXIII.
[22] Draft Report, p111.
[23] Draft Report, p112
[24] SACL, Sub.26, p25.
[25] Canberra Airport, Sub.30, p12.

Qantas rejects any allegation that it has been 'holding out' agreeing to reasonable terms and conditions to advance its position either in the ACT or through the PC Review.

In relation to Sydney Airport, SACL put the draft Long Term Aeronautical Services Agreement into evidence before the ACT and sought to rely on it, notwithstanding that the draft agreement was provided to Qantas for commercial consideration only a few days before it was put into evidence by SACL. After hearing a significant amount of evidence, the ACT held that the terms and conditions put forward by SACL were at best unreasonable, and at worst, an illustration of it using its monopoly power[26]. Is it surprising in those circumstances that Qantas rejected the draft agreement? Indeed, the very fact that SACL did not comprehend the unreasonable and onerous nature of many of the non-price terms and conditions of access contained within the draft agreement is itself telling.

Similarly, the difficulty in reaching an agreement with Canberra Airport on aeronautical charges was due to the unreasonable terms and conditions provided by the Airport and the Airport's unwillingness to negotiate those terms in any meaningful way.

The logic of airports resisting the availability of binding dispute resolution is dubious when put alongside the claims of airports to be under recovering (or at best fairly and reasonably recovering) on their assets. For example:

- Brisbane Airport Corporation notes that *'the current return on assets is still below what would be considered fair'*[27] and that *'[w]hile there was a significant increase in charges in 2002/03, this increase was insufficient to bring the return on assets to a fair and reasonable level'*[28].

- SACL claims one of the achievements of the light-handed regime at Sydney Airport is *'revenue recovery below levels previously envisaged by [the] ACCC under heavy-handed regulation'*[29] and provides a chart to support a claim that *'revenue has been some $35m less than that which would have provided a satisfactory return on assets using the ACCC's methodology'*[30].

- Adelaide Airport Limited claims that *'Adelaide aeronautical pricing is below any reasonable measure of the shadow regulatory allowable maximum'*[31].

- Canberra Airport notes that increases to airport charges following removal of price caps was *'on a fully justifiable basis'*[32] and that *'Canberra Airport continues to adopt these established pricing principles in its commercial negotiations'*[33].

- Northern Territory Airports claims that *'aeronautical charges at DIA are consistent with the Government's Review Principles for airports that are not capacity constrained. This clearly shows that prices have not increased by more than could be justified on the basis of costs, investment requirements and service quality enhancements. In fact, prices have been well below that required for long run cost recovery'*[34].

[26] The findings of the ACT as to those matters were summarised in the Appendix to the Qantas Submission.
[27] Brisbane Airport Corporation Limited, Sub.35, p13.
[28] Brisbane Airport Corporation Limited, Sub. 35, p27.
[29] SACL, Sub.26, p12.
[30] SACL, Sub.26, p15.
[31] Adelaide Airport Limited, Sub.23, 12; cf Draft Report, p18.
[32] Canberra Airport, Sub.30, p4.
[33] Canberra Airport, Sub.30, p5.
[34] Northern Territory Airports Pty Ltd, Sub.37, p12.

If those claims are correct, then that should lead airport operating companies to embrace, rather than to resist, binding dispute resolution as a circuit breaker to reaching commercial and investment certainty. Recovering only what is fully 'justifiable' or 'reasonable' means airports should have nothing to fear from binding independent dispute resolution and indeed plenty to gain by overcoming claimed 'gaming' by airport users.

Indeed, there are scholars who consider that the need to protect investors in assets such as airports provides a continuing rationale for regulating those assets[35].

DOTARS clearly recognised the logic when it said[36]:

> '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.'

The logic of that position has been recognised by Melbourne Airport which supports the provision of a *'clear mechanism leading to arbitration'*[37] by noting (emphasis added):

> 'In addition to reducing time frames and increasing certainty these proposals also seek to
> - reduce gaming <u>from both sides</u>;
> - encourage commercial rather than regulatory settlement; and
> - minimise costs (including those that arise from the risk of regulatory error) for all parties.'

That logic is precisely why Part IIIA provides that declaration can be sought by an <u>access provider</u> as well as an access seeker: s44F(1) allows the Designated Minister or *'any other person'* to make an application and s44F(2)(a) expressly contemplates that the applicant for declaration may be the access provider. Once declared, if there is a dispute s44S says that *'either the <u>provider</u> or the third party may notify the PC in writing that an access dispute exists'* (emphasis added).

By failing to properly analyse the incentives of airports, as well as airport users, the PC's analysis of the likelihood of binding dispute resolution becoming a default is necessarily unbalanced.

4. Claim that change is premature

The draft report states that *'even if a way could be found to retain strong incentives for negotiation, in the PC's view, it would still be premature to move in this direction'*[38].

In support of that view, the PC notes that *'[i]mplementation of the PC's proposals to address some of the key sticking points in current negotiations could make it easier for the parties to reach agreement in the future. That is, effectively taking asset valuation*

[35] See, for example, Gomez-Ibanez, Jose A., *Regulating Infrastructure* (Harvard University Press, 2003).
[36] DOTARS, Sub.24, p11.
[37] Melbourne Airport, Sub.13, p69.
[38] Draft Report, p115.

and some particular service coverage issues 'off the table' should reduce the negotiating divide'[39]*.*

In relation to that rationale:

- The PC's view appears to be based, at least in part, on the assumption that some insurmountable issues have prevented the blossoming of commercial negotiations. The PC proposes Government intervention to remove those issues.

- The PC's approach to fix these issues (such as the recommendation that asset values be set as at 30 June 2005) is effectively an acknowledgment that airports have an ability to increase asset values and potentially charges beyond those that would exist in a competitive market. The PC acknowledges that airports are capable of using market power to do that within the existing prices monitoring regime and that has been an impediment to commercial outcomes.
- The PC's reasoning is that because airports have the market power to revalue assets and have done so as the basis for increased charges, removing that problem now will allow commercial negotiation to flourish. That logic is naïve. Uncommercial airport charges are simply a manifestation of an airport's ability to misuse market power. The other ways in which the market power of airports may be exercised is limited only by the imagination of airport operators. Will airport users need to wait until 2011 for the PC to recommend how to overcome the next manifestation of market power to allow commercial negotiation to flourish?
- In addition, the PC is mistaken if it thinks that an assessment of rates of return in the future under the streamlined prices and service quality monitoring will conclusively determine whether airport operators have misused their market power. The ACCC has itself acknowledged the limitations of prices monitoring given its dependence on the quality and transparency of information from an airport. The information that one can gain from an analysis of rates of return is limited. The fact that an airport has a low rate of return does not of itself mean that an airport is not misusing its market power, for example, by charging uncommercial prices. Therefore, time is unlikely to cure the PC's inability to assess whether aeronautical charges are being set at a rate which constitutes a use of market power by airports.

A further matter expressed by the PC to support its view that introduction of binding dispute resolution is premature is that *'the necessity for an airport-specific arbitration regime cannot be properly judged until the consequences of the declaration at Sydney Airport have played out'*[40]. Implicit in that analysis appears to be an unstated assumption that the 'counterfactual' to introduction of a binding dispute resolution mechanism now is simply the current prices and quality of service monitoring regime (with the changes recommended by the PC) going forward together with a 'threat' of Part IIIA[41]. This is wrong. In the absence of airport specific binding dispute resolution it is likely that airport users such as Qantas will have no choice but to accept uncommercial terms and conditions or utilise Part IIIA to seek declaration of services at airports.

Airports, airlines and other airport users have highlighted the inefficiencies of that system and the PC has accepted those inefficiencies[42]. Given that the current regulatory structure is characterised by ongoing unresolved negotiation disputes and there is scope for airlines to seek declaration of airports, both resulting in significant ongoing costs, the

[39] Draft Report, p115.
[40] Draft Report, pXXVI.
[41] Draft Report, p112.
[42] Draft Report, p112.

net benefits from the PC recommending a targeted dispute resolution framework that avoids these costs is likely to be significantly greater than the maintenance of the current framework as recommended in the PC's Draft Report. An industry specific binding dispute resolution process – or at the very least a binding code of practice prescribing dispute resolution processes for reaching initial agreement (which would also be reflected in service contracts) - is consistent with light handed regulation.

Annexure 1: Qantas response to draft recommendations

This annexure summarises Qantas' views on each of the PC's draft recommendations. As noted at the outset, the effectiveness of these recommendations will be at best peripheral if the Government affirms the PC's draft recommendation not to implement a system of binding independent dispute resolution in respect of airports and airport users.

Draft Recommendation 4.1

A modified airport price monitoring regime should apply for five years from July 2007.

- *These new arrangements should clearly signal that a subsequent more detailed scrutiny of an airport's charges, including as appropriate through the Part VIIA inquiry provisions, will occur if the monitoring process reveals strong evidence of significant misuse of market power.*

- *The monitoring process should also make explicit provision for airports and those using monitored services to comment on the reasonableness of charging and related outcomes, and require the Australian Competition and Consumer Commission to include that commentary in its monitoring reports.*

To paraphrase, the PC recommends a clear signal be given that a price inquiry should occur if there is strong evidence of significant misuse of power. This offers nothing by way of credible constraint. In particular, it is unclear what would constitute 'strong evidence'. In the current enquiry, the PC has before it the unequivocal and fresh factual findings of the Australian Competition Tribunal that heard a great deal of evidence. It appears not to accept those findings by concluding there is *'no evidence of systematic misuse of market power'*[43].

Instead, the PC finds that Australian price monitored aeronautical charges are not out of line with non-monitored Australian and international aeronautical charges. It uses this evidence to suggest that there has been no significant and systematic abuse of market power[44]. The use of this evidence to support the claim that misuse of market power has been neither significant nor systematic is flawed, and likely to be highly misleading, for at least three reasons:

- the PC uses a sample size of 38 airports out of a possible 50,000 airports that currently exist in the world, without any analysis of whether that chosen sample is representative of the entire population;

- all or some of the 38 airports sampled by the PC may misuse market power, implying the Australian price-monitored airports are simply in the middle of a 'bad bunch'; and

- as the PC notes[45], there are many reasons why aeronautical charges differ across airports and yet does not seek to 'purge' those influences in reaching its conclusion from the data about use of market power by Australian airports.

[43] Draft Report,p XII.
[44] Draft Report, p25.
[45] Draft Report, p17.

Guidance from the PC about whether the ACCC's decision on Sydney Airport's aeronautical pricing proposal in May 2001 should be adopted would prevent both airports and airport users from relying on analysis that leads to misleading results.

Draft Recommendation 4.2

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

In the absence of implementation of the Core Principle, Qantas does not oppose the further application of the price monitoring regime to Adelaide, Brisbane, Canberra, Melbourne, Perth and Sydney Airports.

The removal of Darwin Airport from the purview of price monitoring is, in the absence of implementation of the Core Principle, highly inappropriate. The stated reasons supporting Darwin Airport's exclusion from price monitoring do not hold:

- The PC believes that Darwin Airport faces considerable competition from Cairns and Broome Airport; particularly for South East Asian traffic, but South East Asian traffic is likely to be less than 10% of total Darwin traffic[46].

- The PC believes that Darwin Airport's aeronautical charges are in line with other airports after taking into account low traffic volumes, but in fact Darwin Airport's aeronautical charges are well above 'benchmark'.

Qantas is also concerned with the PC's comment that *'[i]n the case of Canberra Airport, the equation is finally balanced'*[47]. This ignores Canberra Airport's monopolistic conduct and the fact that the majority of passengers to Canberra (such as Parliamentarians) do not consider other airports such as Sydney to be sufficiently substitutable.

Draft Recommendation 5.1

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

Qantas agrees with the revised definition of services in accordance with the DOTARS proposal for the purposes of price monitoring. However, Qantas views the PC's explicit recommendation for the 'dual till' surprising in circumstances where such a recommendation arguably falls outside the scope of its terms of reference.

[46] According to ACCC data, in 2004/05 international non-transit passenger travel represented 14% of the total number of passengers that passed-through Darwin airport. This percentage is smaller when international passengers from South East Asia only are included. This suggests that Darwin airport faces competition from Broome and Cairns airports for a relatively small set of its total passenger numbers (possibly less than 10%). In addition, it is likely that Darwin and Cairns airports (and to a lesser extent Broome airport) are complements in consumption, with many international and domestic visitors visiting both cities on their holidays.

[47] Draft Report, pXX.

Draft Recommendation 5.2

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

Qantas would not oppose such monitoring but reiterates its comments that to tinker with the existing prices and quality of service monitoring regime, in the absence of a binding dispute resolution mechanism, would have at best a peripheral impact.

Draft Recommendation 5.3

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

In the absence of implementation of the Core Principle, Qantas would welcome an ability to provide such 'commentary' but questions what value it could have in assisting the Government to assess compliance with the Government's review principles.

Draft Recommendation 5.4

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

In the absence of implementation of the Core Principle, Qantas would not oppose price and service quality monitoring outcomes being combined in a single report. However, the PC's recommendation that such a report be published every two years is misguided. Assuming the next PC inquiry into the price regulation of airport services begins April 2011 (five years from the start of the present inquiry), that inquiry will be based on only one completed price and service quality monitoring report from 2009. The 2011 price and service quality monitoring report would come into existence once the PC inquiry was largely underway. There would be an argument that, again, there was insufficient information on which the PC could base any meaningful recommendations.

Draft Recommendation 5.5

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

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

Qantas would welcome augmentation of the overarching review principles. However, it must be acknowledged that, without some kind of binding dispute resolution process,

'enforcement' or even monitoring of compliance with those principles (even those recommended above) is virtually impossible. In particular, measurement of 'productivity gains' and determination of a mechanism for equitably sharing those gains would seem to be practically problematic.

By suggesting that there be another review in 2011 the PC implicitly acknowledges that the problem of airport market power is unlikely to go away. One may ask whether it would be simpler to resolve the problem now by removing (rather than further tinkering with) price monitoring and implementing binding dispute resolution against the backdrop of pricing principles consistent with the ACCC's approach to pricing as recorded in its decision on Sydney Airport's aeronautical pricing proposal in May 2001; letting stakeholders sort things out for themselves.

Draft Recommendation 6.1

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

- *the value of tangible (non-current) aeronautical assets reported to the Australian Competition and Consumer Commission as at 30 June 2005, adjusted as necessary to reflect the proposed service coverage of the new regime (see draft recommendation 5.1);*

- *plus new investment (at values agreed with customers);*

- *less depreciation and disposals.*

Qantas welcomes the recommendation to set aeronautical asset valuation at a fixed point in time but believes that the more appropriate and equitable date for this purpose is the date of the grant of leases in respect of 'privatised' airports. That is because the purchase price for the long term lease of each privatised airport was obtained through a competitive sale process reflecting the value of the airport's assets in their current use. Those privatisation sales values are relatively recent and readily available[48], as well as capable of being 'rolled forward' to today.

The Commission's proposal to draw a line in the sand on asset revaluation and accept 'booked' revaluations as at 30 June 2005 creates the opportunity for a significant windfall gain for the operators of Brisbane and Canberra Airports. Both airports have revalued their asset bases but did not fully incorporate these revaluations into prices. Instead these airports reduced their reported rates of return in the ACCC's Monitoring Reports. The risk Qantas faces from this draft recommendation is that these operators will seek significant price increases to lift their reported rates of return (on revalued non-current assets) to a level they will claim is 'reasonable'. Unless the PC clarifies its recommendation, airlines risk price increases in the order of 46% at Brisbane Airport and 62% at Canberra Airport – for no added value.

By this recommendation the PC:

- acknowledges that airports have the market power to revalue assets (and have done so) as the basis for increased charges; and

- accepts the ongoing relevance of asset values as a building block for airport service pricing thereby demonstrating that its rejection of binding dispute resolution is based on an unrealistic ideal of 'commercial negotiation'.

[48] See NERA, *Effectiveness of the Regulation of Airport Services: A report for Qantas*, 2006, pp42-43.

Qantas also questions how, in practice, future compliance with this draft recommendation would be enforced.

Draft Recommendation 6.2

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

Some elaboration of what is meant by 'customer agreement' would be appropriate. For example, if the 'agreement' is to be deemed by use of the airport then would that be sufficient?

The PC also noted that[49]:

> 'Given past price increases, there may be little reason for further rises, other than to pay for specific new investments and any additional security upgrades. In fact, the projected continuation of steady growth in passenger demand, and thus greater capacity for airports to spread fixed costs, should put downward pressure on prices.'

The rationale for that principle is simple: higher passenger numbers spread over the same fixed costs will lead to lower average fixed costs and therefore lower average total costs. Qantas would, however, welcome some enunciation of that principle in the PC's recommendations because the same rationale has applied for the last five years with no 'downward pressure' on prices yet evident. Indeed, Qantas notes that aeronautical charges have grown post price monitoring (between 1997/98 and 2004/05) by a rate well above the 2.1% growth rate in the Australian CPI over the same time period. In particular, landing fees paid by Qantas to domestic airports have risen in compound annual growth rate terms by 10.3% per annum between July 2003 and July 2006.

Draft Recommendation 7.1

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

Qantas proposed that the Core Principle be implemented to encourage constructive engagement between airports and airport users. This draft recommendation dismisses the Core Principle. Qantas' rejection of this draft recommendation is elaborated in sections 3 and 4 of this document.

[49] Draft Report, pXVI; see also Draft Report, pp8, 13 and 25.