

# Productivity Commission – Airport Pricing Review

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Attention: Productivity Commission  
From: Hastings Funds Management Limited (Hastings)

Date: 21 March 2011

## **An owner's perspective on airport regulation**

### **Executive summary**

This submission is in response to the Productivity Commission's (PC) inquiry into the economic regulation of airport services in Australia. As a manager of funds that have over \$2.7 billion of equity invested in Australian airports, Hastings is a key stakeholder in the Australian airport industry. It is in this context that Hastings lodges this submission with the PC on behalf of Hastings' many superannuation, retail and institutional investors.

### ***History of regulation and industry performance***

Direct economic regulation of the airport industry dates back to 1997 with the implementation of a CPI-X price cap regime. This heavy handed regime resulted in airports suffering significant economic losses in the provision of aeronautical services which created a strong disincentive for efficient investment. The shortcomings of heavy handed regulation as applied to airports were recognised at the time by the PC and the government who subsequently in 2002 introduced the current light handed monitoring regime. The industry has grown and performed strongly under the current regime as is demonstrated by the strong investment over the 2005-2010 period, with approximately \$3 billion invested in infrastructure (e.g. new passenger terminals, runway extensions) at the airports in which Hastings' funds are invested. The PC's 2006 review recommended that the light handed regime be continued for a further five years.

### ***Avoiding the costs and unintended impacts of heavy handed regulation***

Hastings supports the current light handed regime on the basis that it contributes to providing an environment that facilitates efficient investment and encourages the negotiation of commercial agreements between airports and airlines. It is debatable whether the regime's monitoring results are actively used or valued by participants in the industry but that is a separate question. The key factor for Hastings as an investment manager is that the regime is light handed in nature which provides for innovation in service provision and the flexibility for counter-parties to reach workable commercial negotiations in a complex environment with many competing price and non-price factors.

The re-introduction of heavy handed regulation would adversely impact on the industry by significantly increasing the degree of regulatory risk associated with infrastructure investments, thereby creating a disincentive for efficient investment. Given the importance of future infrastructure investment to the viability of Australia's major airports, this must be avoided if the services provided by the sector are to be enhanced or maintained. It is estimated that approximately \$4 billion will be dedicated to improving infrastructure at the airports in which Hastings' funds have ownership stakes over the period 2011-2016. The re-introduction of direct price regulation would threaten the viability of a significant proportion of this investment.

Heavy handed regulation would also adversely impact the industry by distorting commercial negotiations between airports and airlines. In the event that a heavy handed regulatory avenue becomes available, the process and nature of commercial negotiation will be significantly distorted – as these negotiations will invariably be conducted against a backdrop of the expected outcomes of regulatory determinations rather than the underlying commercial motivations and needs of the counter-parties. Negotiations for new arrangements will also be delayed by the availability of default regulatory processes. Moreover, regulatory processes and determinations cannot effectively incorporate the wide range of factors that underpin a commercial arrangement (e.g. passenger movements, risk sharing, market volatility, service

levels, etc.), of which pricing is only one. Fixing one of these variables would limit the ability of the negotiating parties to reach an optimal balance across all of these variables, thereby making it difficult to arrive at commercial agreements which are crucial for supporting future investments.

It is also important to recognise the adverse consequences of subjecting specific services to heavy handed regulation, such as the provision of airport car parking. The management of the ground transport system at major airports is a complex task which requires a delicate balancing act to be performed in relation to a wide range of issues (e.g. kerbside availability, traffic management, service offerings, peak service provision, etc.). Subjecting car parking facilities to heavy handed regulation would significantly disturb ground transport operations and constrain the airports' ability to perform this balancing act and provide customers with suitable service offerings. It would also significantly increase the risk associated with investments in car parking capacity and distort decisions relating to the development of land surrounding major airports by altering the relative value of competing uses. This could lead to a shortage in the supply of airport car parking and an inefficient use of land.

### ***Maintaining current regulatory controls***

A key component of the current light handed regime is the constraint that is imposed by the national access regime under Part IIIA of the *Competition and Consumer Act 2010* (CCA), which provides airlines and landside access seekers with the ability to have services declared by the National Competition Council (NCC). This is an effective regulatory control as it provides a strong incentive for airports and access seekers to negotiate terms and conditions on a commercial basis, as declaration means that failure to do so results in arbitration by the ACCC. The effectiveness of this mechanism is evidenced by the previous declaration of several airport services and the successful negotiation of terms and conditions between airports and airlines.

Hastings does not consider that the introduction of a 'show cause' trigger process would strengthen the effectiveness of the regulatory controls under the current regime. Rather, the introduction of this mechanism would result in airports and regulators incurring significant costs in dealing with 'show cause' requests. It would also increase the degree of regulatory uncertainty under the regime, increasing the cost associated with capital financing and subsequently threatening the viability of future investments.

### ***Limiting the scope of the current regime***

Hastings supports limiting the scope of the monitoring regime as much as possible and advises against the inclusion of any additional regional or second tier airports. The expansion of the regime to include additional airports would not be appropriate given the limited market power that is held by regional airports, as is evidenced by the competitive outcomes in these markets despite the absence of regulation. Incorporating these airports would only serve to stifle infrastructure investment without producing any efficiency benefits. It is also considered that given the changing nature of the Australian aviation landscape, and in particular the increased penetration of Low Cost Carriers (LCCs), a review of each of the major city airports may be appropriate, given that some, Perth Airport in particular, are exposed to countervailing airline power to the extent that monitoring may no longer be justifiable from a cost benefit perspective.

### ***Suggested improvements to the regime***

While Hastings is generally supportive of the current light handed framework, there are some areas where it is considered that alterations could further improve the efficiency of the regime:

- Further reviews of the regime and *ad hoc* changes should be avoided as they introduce regulatory uncertainty which impacts the pricing and tenor at which airports can raise debt to fund infrastructure investments. To the extent that such reviews are unavoidable they should be conducted under a very prescriptive framework with time horizons of greater than five years;
- Current arrangements for service quality monitoring, which involves the collation of results from stakeholder surveys, should be replaced by a system that involves a more objective review of service quality as measured independently against Key Performance Indicators for individual airports. The current arrangements fail to take into account the fact that service levels are

- commercially negotiated between airports and airlines and are therefore not directly comparable across airports; and
- It is important that the principle of competitive neutrality is considered when land use and transport planning and funding issues are being considered. Airports should be treated fairly relative to other project and infrastructure developers (such as major sporting venue, shopping centre and commercial and residential property developers).

In conclusion, Hastings is generally supportive of the current light handed regime and views that, with some evolutionary improvements and continued reliance on the effective control mechanisms in place, the regime is a good foundation for continued Australian aviation sector growth. Hastings recommends a continuation of the current regime given its importance to infrastructure investment, the significant costs which would be associated with the re-introduction of any form of heavy handed regulation and the unintended impacts of subjecting specific services, such as the provision of airport car parking or ground transport access, to heavy handed regulation.

## 1. Introduction

The Productivity Commission (PC) has announced that it is to undertake an inquiry into the economic regulation of airport services in Australia. The issues paper for this inquiry was released by the PC in January 2011. This inquiry has arisen as a result of a recommendation made in the Australian Government's 2009 National Aviation Policy White Paper that the PC review the regulatory regime applying to airports in 2012.

The timeframe for this review has been brought forward due to concerns raised in the Australian Competition and Consumer Commission's (ACCC) 2008-09 Airport Monitoring Report regarding the potential monopoly pricing for car parking and also the observation that Sydney Airport had potentially increased profits at the expense of service quality. Hastings is the manager of investment funds that hold assets in the airport sector and these funds, whose ultimate beneficiaries are predominantly Australian superannuants, could be significantly impacted to the extent that the PC's current inquiry leads to changes to the existing regime. It is in this context that Hastings lodges this submission with the PC.

Hastings is manager of a range of listed and unlisted infrastructure vehicles with combined equity investments in the Australian airports sector of over \$2.7 billion. Hastings, a wholly-owned subsidiary of Westpac Banking Corporation, has been operating as a specialist infrastructure funds management firm since 1994 and has a wide range of experience investing in transport assets (including airports, ports and toll-roads), regulated utilities (water and electricity), pipelines and contracted assets such as power generation facilities.

Hastings manages investments in Australian airports on behalf of various Australian superannuation funds and institutional investors through the unlisted funds it manages (The Utilities Trust of Australia ("UTA") and The Infrastructure Fund ("TIF")) as well as on behalf retail and institutional investors via its ASX listed infrastructure fund (The Australian Infrastructure Fund ("AIX")). Since being a founding investor in the 1997 privatisation of Melbourne Airport, Hastings' funds have acquired ownership interests in 11 other airports across Australia over the last 14 years and Hastings has worked with the airports to grow their value and increase the level of service and traffic that they can accommodate.

These infrastructure funds are open-ended funds in nature which means that they have very long-term investment horizons and are designed to potentially hold assets for 40 or 50 years if not longer. As such these funds are natural holders of critical infrastructure assets and they are naturally motivated to invest and promote long term and sustained growth at individual airports and throughout the aviation market.

The figure below provides an overview of the airports in which Hastings manages investments with the percentage indicated being the share of total airport equity managed on behalf of one or more of Hastings' infrastructure funds.



The table below provides a breakdown of Hastings' managed funds' interests in these airports, in terms of ownership stake and total equity value.

Airport	Equity Stake	Hastings' Managed Equity Value	Total Implied Airport Equity Value	Total Approximate Enterprise Value
Perth	UTA: 47.50% TIF: 4.27% AIX: 29.74%	\$473.7m (AIX) \$756.6m (UTA) \$68.0m (TIF)	\$1,593m	\$2,445m
Melbourne & Launceston (APAC)	UTA: 7.62% AIX: 12.39%	\$436.5m (AIX) \$268.5m (UTA)	\$3,522m	\$5,244m
Gold Coast, Mount Isa & Townsville	TIF: 33.67% AIX: 49.07%	\$268.5m (AIX) \$184.2m (TIF)	\$547m	\$994m
Cairns & Mackay	TIF: 20.10%	\$133.9m (TIF)	\$666m	\$1,065m
Darwin, Alice Springs & Tennant Creek	AIX: 28.23%	\$94.2m (AIX)	\$334m	\$530m
Sydney	UTA: 0.65% AIX: 2.60%	undisclosed	\$7,287m (based on MAp)	\$13,000m
<b>Total</b>		<b>Over \$2.7 billion</b>	<b>Approx \$14 billion</b>	<b>Approx \$23.3 billion</b>

\* Equity valuations, debt levels and approximate enterprise values are as at 31 December 2010

Hastings supports the current light-handed regulatory regime which by supporting an unprecedented level of airport investment, facilitating quality and efficiency in service delivery and achievement of commercial agreement between airports and airlines has delivered substantial benefits to the whole Australian community. However, Hastings notes that the current prices and quality of service monitoring regime administered by the ACCC could be improved.

The purpose of this submission is to highlight the issues and potential consequences that should be taken into consideration by the PC before recommending any changes, in particular:

- The continuation of a light handed framework would be beneficial for the entire airport industry, including the travelling public;
- There is no need for additional airports to be included in the regime or for airports currently subject to the second tier regulatory framework to be incorporated into the price and service quality monitoring regime. Airports outside of the major capital cities do not hold sufficient market power and are subject to substantial countervailing power such that regulatory oversight is not justified. There is also scope for a review of the major city airports to determine whether the continuation of price monitoring is justifiable, given the changing nature of the aviation landscape and the increased countervailing airline power to which airports are subject;
- The continued prospect of future reviews of the regulatory framework, exemplified by this review by the Commission, signals high regulatory risk to investors in airport infrastructure with consequences for investment costs. The removal of both regular and *ad hoc* reviews of the regulatory framework would reduce uncertainty and regulatory risk associated with airport investment, lowering barriers to investment with consequential benefits for airport customers;
- A regime that places less reliance on historical quality of service surveys and more emphasis on negotiated or airport-specific quantitative metrics and objective review procedures would result in a greater level of accuracy and transparency in relation to service quality monitoring, with consequential greater improvements in quality of service for customers;
- That the administration of the current regime could be improved. The methodology and quality of analysis performed by the ACCC could be improved and a less sensational and more responsible reporting policy could be adopted particularly given the importance of the regulatory process, the uncertainty prevalent in the ACCC's recent findings and the potential negative public and policy reactions that inaccurate or sensationalist reporting could encourage; and
- The Part IIIA and Part IVA instruments in the *Competition and Consumer Act 2010* (CCA) provide an effective control mechanism in the current regulatory regime and should be maintained.

Hastings' central objective in this submission, as a manager of long-term investors in the airport industry, is to ensure that regulatory decisions support a reasonable return for investors, continued growth and investment in airports for the direct benefit of airport customers and the continued meeting of desired quality of service standards. Airports require regulatory certainty so that they can invest at lowest cost to deliver these outcomes in the most efficient way.

The structure of this submission is as follows:

- Section 2 outlines the background relevant to the PC's inquiry, looking at the history of economic regulation of the airport sector and the outcomes for the industry;
- Section 3 provides an overview of the current light handed framework and the outcomes that have resulted from the light handed regime with respect to the pricing of aeronautical and car parking services at the monitored airports, the level of investment in airport infrastructure, and the performance of the monitored airports under the light handed framework;
- Section 4 assesses the appropriateness of the current framework, focusing on the need to limit the scope of the regime given the competitiveness of the market for regional airport services and the limited market power that is held by airports in this market;
- Section 5 identifies the future investment required for the ongoing efficiency of the airport industry and highlights the importance of the regulatory environment facilitating efficient investment;

- Section 6 assesses the benefits and costs of the light handed framework, focusing on the avoided costs of heavy handed regulation. This section also assesses the effectiveness of Part IIIA of the *Competition and Consumer Act 2010* as an effective regulatory control under the light handed regime; and
- Section 7 outlines Hastings' recommendations and suggested improvements to the current regime to further increase the extent to which it facilitates efficient outcomes and an environment that encourages efficient investment.

## 2. Background

The airport sector first became subject to formal pricing and service quality regulation in 1997 following the privatisation of the Melbourne, Brisbane and Perth airports.<sup>1</sup> Sydney Airport was not privatised until 2002 due to issues surrounding its future development. The remaining Federal Government-owned airports were privatised around one year later.

Specified aeronautical services provided at privatised airports became subject to a CPI-X price cap. The price cap was set by the Federal Government and administered by the ACCC. The following airports were initially subject to the price cap regime:

- Adelaide;
- Alice Springs;
- Brisbane;
- Canberra;
- Coolangatta;
- Darwin;
- Hobart;
- Launceston;
- Melbourne;
- Perth; and
- Townsville.

Sydney Airport, which was yet to be privatised, was subject to price surveillance and was required to submit proposals for price increases to the ACCC for approval.

The price caps set by government required real price reductions at each regulated airports of around 20 to 27.5% over the initial five year period of regulation. This resulted in many airports suffering significant losses in the provision of regulated services. The price cap regime was designed to promote operating efficiency improvements and to govern how those savings were shared with airport users but in effect it set targets that were unachievable which in turn had negative implications for the sector and its users. Due to the general under-recovery on existing assets there was a strong disincentive or barrier to new investment.

For instance in the case of Perth Airport the price cap was determined using a CPI – 5.5% per annum target which in effect meant that real efficiency increases of 5.5% were required each year for the airport to maintain the same level of real profitability. In practice such operating efficiency gains were not achievable over a sustained period. Airports became fixated on cost cutting in an attempt to meet these targets rather than focusing on more constructive pursuits of driving growth and innovation in service provision.

These shortcomings resulted in the PC recommending that the price cap regime be replaced by a light handed price monitoring regime from 2002. Based on the PC's recommendations, the Federal Government announced that the existing regime was to be replaced by a price and service quality monitoring regime for the seven major capital city airports.

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<sup>1</sup> Previously, airport prices were informally regulated through government ownership and also oversight by the Prices Surveillance Authority.

The investment performance of the airport industry under the light handed regulatory framework has been strong, with significant investments being made in airport infrastructure. Operating profits of major airports increased following the losses sustained under the price cap regime and reflecting the renewed investment in infrastructure. The price and service quality monitoring regime was reviewed by the PC in 2006 with the decision made to continue the regime for a further five years.

As we believe will be evidenced in several of the individual submissions made by airports to this inquiry the real growth in airport aeronautical charges has been very modest since 2002 particularly when new investment and higher quality infrastructure and service levels are taken into account. This is particularly the case when you accept that much of the price increases that occurred in the early years were to reset prices to more sustainable levels from the under-recovery that had been occurring under the CPI-X price cap regime.

Several comparisons have been made in recent years investigating the aeronautical charges at Australian airports relative to other international airports (for instance a detailed study has recently been completed on behalf of Melbourne Airport). These studies demonstrate that under the current regime prices have been kept at very competitive rates by global standards and that efficiency and productivity levels are world class.

### **3. Current regulatory approach**

#### ***Overview of the current regime***

As has been discussed above, a PC review of the price cap regime in 2002 resulted in the Federal Government replacing it with a light handed price and service quality monitoring regime. The central elements of this regime are currently as follows:

- Price monitoring of aeronautical services and car parking;
- Service quality monitoring;
- Price notification for aeronautical services to regional airlines at Sydney Airport; and
- Third party access regulation under the CCA.

The regime initially applied to the seven airports in the major capital cities, however following a PC review in 2006, Canberra and Darwin were subsequently excluded due to their apparent level of market power not being sufficient to justify the compliance costs and potential negative consequences of inclusion in the monitoring regime. In 2008, the Federal Government decided to add car parking to the list of services to be monitored under the regime.

In relation to the price monitoring component of the regime, airports are required to provide annual financial statements including the costs, revenues and profits associated with aeronautical and non-aeronautical services to the ACCC. The ACCC then undertakes an assessment to determine whether the prices charged by airports for the monitored services are appropriate. The information provided to the ACCC by the airports is collected by the PC with a review undertaken every five years to assess the appropriateness of the regulatory framework and whether there is a need to re-introduce explicit price regulation. This review mechanism is intended to discourage airports from the misuse of their market power.

Service quality monitoring is designed to complement price monitoring by providing a commercial incentive for airports to maintain service quality levels. Service quality is monitored for a range of services including those provided by airside facilities, common user service facilities and car parking. Information on service quality levels at airports is provided to the ACCC from several sources including the airports themselves, airlines, passengers, and other organizations and government departments. Passenger surveys are one of the most regularly used sources for obtaining information on service quality levels.

Part IIIA of the CCA provides third parties with an avenue through which to seek access to significant infrastructure services. This includes services provided by airports. This component of the regulatory



framework is intended to act as an incentive for airports and access seekers to negotiate terms and conditions on a commercial basis. However, in the event that this is not possible, access seekers are able to seek access through Part IIIA of the CCA, also referred to as the National Access Regime.

The Australian Government has recently announced the implementation of a second tier monitoring regime for four Federal-leased airports – Canberra, Darwin, the Gold Coast and Hobart. This decision was made based on the increases in passenger volumes observed at some of the larger non-monitored airports. Other airports will also be encouraged to participate in the scheme which is to involve self-administered price and service quality monitoring combined with web-based reporting. Airports are expected to commence reporting under this scheme in this financial year.

### **Outcomes under the current regime**

The price and service quality monitoring regime that has presided over the five major capital city airports since 2002 due to its light handed nature has been extremely effective at encouraging the efficient operation of and investment in airports. The positive outcomes achieved by the regulatory framework were acknowledged by the Australian Government in its National Aviation Policy White Paper:<sup>2</sup>

*“This approach to airport regulation has provided scope for airports to price, invest and operate efficiently while price monitoring allows the Government and the community to scrutinise prices and market outcomes and to provide evidence of unjustifiable price increases were this to occur.”*

### *Pricing*

The monitoring of airport prices is the central component of the current regulatory framework. The removal of the price cap regime and implementation of the price and service quality framework initially resulted in a real increase in airport prices, however this was directly attributable to structural changes in the industry and market-related factors. In its 2006 review of the price regulation of airport services, the PC highlighted the following factors as being the primary drivers of the price increases:

- The unexpected downturn in airport traffic resulting from the collapse of Ansett and the September 11, 2001 New York terrorist attack; and
- The transition from single-till price regulation to dual-till price monitoring, which involved the removal of the previous cross-subsidisation of aeronautical charges from non-aeronautical operations.

The prices that applied under the price cap regime were not sustainable. Even in the event that price cap regulation was maintained beyond 2001-02, a step change would have been required to correct airport charges in order to maintain the sustainability of the industry. Not only were the major airports recording significant economic losses (relative to accepted regulatory benchmarks) under this regime, there is also other evidence to suggest that price increases would have occurred regardless of the nature of the regulatory regime. For example, in 2001 the ACCC had approved a revenue increase of 97% for Sydney Airport and set maximum revenue paths through to 2004-05. This determined the base charges at Sydney Airport over the first price monitoring period. Melbourne Airport has also previously indicated that had price cap regulation continued past 2002, the implementation of the building blocks methodology to determine airport charges would have resulted in price increases of around 65%. Furthermore, it is important to recognise that the PC has previously stated that “starting prices for the price caps were unlikely to be a good basis for efficient pricing”.<sup>3</sup>

Since the initial adjustment, airport charges have increased at a more modest rate. These increases have predominantly been driven by the cost of new investments and also the pass-through of the cost of mandatory security upgrades. In its 2006 review of price regulation of airport services, the PC commented that “price outcomes, and the rates of return earned by the monitored airports, do not appear to have been excessive”.<sup>4</sup>

<sup>2</sup> Australian Government (2009). National Aviation Policy White Paper, p 174.

<sup>3</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 13.

<sup>4</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 11.

It is therefore necessary to assess the price increases at airports over the period 2005-06 through to 2009-10, as reported by the ACCC, in order to obtain a better understanding of the pricing outcomes that have been achieved under the current regulatory framework. The reported increases in prices (in the form of aeronautical revenue per passenger) vary across the price monitored airports over this period. The Perth, Melbourne and Sydney airports have recorded modest increases in average aeronautical revenue per passenger of approximately 2.5%, 18% and 22% respectively. The Adelaide and Brisbane airports have reported more significant increases of around 50% over this period.<sup>5</sup> While these increases are significant they have been justified.

Firstly, it is important to recognise that regardless of the airport, airport prices need to be analysed cognizant of inflation and how the type and quality of services provided may have changed or in most cases markedly improved over time. For instance, aeronautical charges may have increased but the services that are now delivered may be significantly different than those historically provided such that a direct price comparison is not directly relevant. Such service type differences could include:

- Increased prevalence of aero bridges;
- Increased automated check-in desks (providing airlines ability to reduce their labour costs);
- Improved baggage system accuracy (reducing airline customer service costs);
- Improved baggage system speed (increasing capacity and convenience); and
- Improved signage and communication systems.

In many cases these new and improved services may have transferred costs from airlines to the airport such that while airport charges may have increased the net real price for these services from the passenger's perspective may have remained flat or actually declined due to efficiency gains and other benefits of scale economics.

The ACCC also monitors car park prices, costs and revenues under the monitoring regime. This function was reinstated by the Federal Government in 2008. The ACCC's airport monitoring reports have included a separate assessment of car park pricing since 2007-08.

In the ACCC's latest monitoring report concern was raised in relation to the potential for monopoly conduct in terms of landside access conditions and the pricing of airport car parking services. Particular and potentially undue attention was given to Melbourne Airport irrespective of the ACCC's own admission that more comprehensive analysis would be required for any definitive findings to be reached on the issue.

In relation to car parking at Sydney, Perth, Brisbane and Adelaide the ACCC commented that it was less clear if car parking prices or landside access levies were excessive.

Hastings recognises that car park pricing and landside access is a complex issue, in fact it is its very complexity that should be focused on when considering the issues raised in this inquiry's terms of reference.

Such complexities include:

- Kerbside availability, allocation and pricing;
  - How to balance the needs of competing groups for kerbside access;
  - Who gets reserved spaces (taxis, limos, public transport, hotel buses, charters, off-airport parking providers);
  - What is a fair price for the premium access and allocation that they are receiving;
  - How can this special access be provided while considering the impact on other users such as the general public who also require access;
- Traffic management;
  - Ingress and egress points from airport access roads;

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<sup>5</sup> Australian Competition and Consumer Commission (2011). Airport monitoring report 2009-10: Price, financial performance and quality of service monitoring.

- Car park entrances and exits (number and position);
- Kerbside access configuration (lanes and ramps);
- Kerbside access restrictions (parking times and locations);
- How to enforce traffic management (fines) to ensure fair access and efficient use;
- Public transport and pedestrian traffic integration;
- Car parking;
  - Product innovation and the provision of range of budget and premium service offerings;
  - Price setting as a method to segment the market and help users choose the most suitable product offering;
  - Peak service provision - Airports provide a vital service to the communities that they serve and they recognise that part of that requires them to provide sufficient airport car parking and access. They therefore work to ensure they have sufficient spaces, shuttle buses, ticketing and customer service capacity to meet peak demand periods (typically the four main Australian school holidays). This is crucial to ensure continued unrestrained passenger growth during these peak periods but it does result in excess on-airport car parking supply during much of the rest of year which must be recovered through average prices. CBD and off-airport car parking providers do not have these same goals of never filling up and is one of main reasons why prices are not directly comparable. Monopoly power exploitation typically involves the constraint of supply and yet our airports strive to do exactly the opposite by seeking to provide excess supply such that no airport user will arrive at an airport and be turned away due to insufficient parking;
  - Fair locational value for scarce land near terminals;
  - Amount of available land for car parking growth;
  - Operational limits on size of multi-story car parks;
  - Alternate uses for land (opportunity cost);
- Safety & security;
  - Pedestrian crossings;
  - Road conditions (lane merging, intersections);
  - Terminal security (restrictions on unattended vehicles and extended parking); and
- Interaction between Airport Master Plans, Ground Transport Plans and Major Development Plans (MDPs);
  - Degree to which current options are limited or driven by historical and future planned decisions regarding location and sizing of runways, apron spaces, gates and terminals.

It is these complexities that make car parking and land access a delicate balancing act for management. Considerable resources and dedicated teams at each airport are required to manage the many competing needs to ensure that effective outcomes are reached.

It should not be underestimated how unlikely it is that all or part of the complex ground transport system could be heavily regulated without significantly disturbing and reducing the efficiency in which each airport provides safe, reliable, modestly priced and convenient access to all users.

#### *Investment*

Investment in airport infrastructure has increased significantly across the monitored airports since the price cap regime was abandoned and replaced by the current light handed monitoring framework. According to the PC, average investment in new aeronautical infrastructure at the monitored airports between 1998 and 2002 was approximately \$90 million per annum. This compared to \$220 million per annum in the three years from 2003 to 2005.<sup>6</sup>

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<sup>6</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 33.

In its 2006 review the PC stated the following:

*“...it seems clear from the evidence before the Commission that the move to a light handed price monitoring regime has made it much easier to undertake new investment and for airports to reach agreement with airlines on charges for that investment.”<sup>7</sup>*

The PC also stated that:

*“Given the pivotal role of capital in enhancing and sustaining airport services, the improved investment environment delivered by the light handed approach is a very important benefit. It will be a source of further gains as a number of the major airports move into a new phase of the investment cycle.”<sup>8</sup>*

In relation to the airports in which Hastings' funds have ownership stakes, infrastructure investments over the period 2005-2010 have totalled approximately \$3 billion. Hastings forecasts that a further \$4 billion will be invested at these airports between 2011 and 2016. Investments in airport infrastructure that have occurred since the implementation of the light handed regulatory framework include the following:

- The construction of a new passenger terminal at Gold Coast Airport;
- The construction of a new passenger terminal at Perth Airport;
- The delivery of the domestic terminal redevelopment project at Cairns Airport;
- The expansion and upgrade of the international terminal at Sydney Airport;
- Terminal upgrades at Melbourne airport to facilitate A380 airplanes
- Expansions to car parking facilities at several airports, including the Gold Coast, Darwin, Melbourne and Perth airports;
- Extension of the runway at the Gold Coast Airport.
- Runway overlay project at Melbourne Airport;
- Main runway overlay projects at the Darwin and Alice Springs airports;
- Additional aircraft parking bays constructed at Darwin Airport;
- Improved baggage handling systems at several airports;
- Increased security and checked baggage screening capabilities at several airports;
- Property development at several airports, relating to logistics, freight, distribution services and retail activities; and

#### *Airport performance*

As has been previously stated, the aeronautical financial performance of the monitored airports under the price cap regime was poor, with several of the major airports suffering significant aeronautical business segment economic losses.<sup>9</sup> Airport performance improved considerably following the implementation of the light handed regime, due to price increases in the years directly following the removal of the price cap regime and average cost reductions predominantly related to growth in passenger traffic. These traffic increases have resulted in efficiency and economy of scale benefits which have been shared with the airlines. The airport profitability that traffic growth has supported has helped delay and reduce the extent that per unit price increases have been required to account for operating expense inflation and new investments.

It is also important to recognise that under the light handed regime, airports have ensured that there is no shortfall in airport capacity. This has been achieved by ensuring that investments in expanding airport capacity are undertaken efficiently from a quantity, timing, cost and quality point of view. The dual-till light handed regime has provided airport operators incentives to:

- Maximize passenger throughput to increase revenues obtained from other sources;
- Increase the level of customer satisfaction with price and service quality to increase the likelihood of future air travel; and
- Promote route development by improving offerings to domestic and international carriers.

<sup>7</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 32.

<sup>8</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 33.

<sup>9</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 43.

#### 4. Appropriateness of the current approach

##### ***Monitored airports***

In relation to the monitored airports, the positive outcomes achieved by the light handed regulatory framework over the past decade demonstrate that it is the appropriate regime to apply to the monitored airports. The positive outcomes achieved under the light handed framework include:

- Mostly modest increases in aeronautical prices, with material price increases being attributable to major infrastructure investments;
- Overall service quality levels remaining at satisfactory to good levels for the monitored airports, with the ACCC reporting service quality improvements for all five of the monitored airports in 2008-09 and 2009-10;
- The significant increase in infrastructure investment at the monitored airports since the price cap regime was abandoned; and
- The transition of the airports from a position where commercial performance was poor and airport owners were failing to attract new investment to a position of commercial sustainability.

Both the PC and the Federal Government have previously noted the important role that the current light handed regulatory framework has played in achieving these beneficial outcomes. For example, in its 2006 review of airport price regulation, the PC commented that:

*“In overall terms and against its objectives, the light handed approach has measured up well. Most importantly, it has created a more favourable investment environment at the airports. Also, while the continuing influence of the previous regulatory regime complicates assessments of price outcomes, so far changes do not appear to have been excessive, suggesting that there has not been systematic misuse of market power in this regard.”<sup>10</sup>*

The Federal Government reaffirmed its support for the current light handed approach in its 2009 National Aviation Policy White Paper:

*“The Government considers that the current ACCC price monitoring scheme remains appropriate to monitoring the pricing activities of Australia’s five largest airports, which are also Australia’s main international gateways.”<sup>11</sup>*

Furthermore, airport operators and shareholders respect that each leased airport is operated with the permission of government and that such licenses to operate cannot be taken for granted. They recognise that to operate and misuse any market power that they may have would be an unsustainable approach and inconsistent with their goals as long term investors.

##### ***Regional airports<sup>12</sup>***

As has been previously stated, the Federal Government has recently announced the commencement of a self-administered second tier monitoring regime with web-based reporting. This regime is to include four Federal-leased airports – Canberra, Darwin, the Gold Coast and Hobart – in addition to any other airports that are willing to participate. While based on the same principles, this framework is less intrusive than the light handed price and service quality monitoring framework that applies to the monitored airports and as such is expected to result in a lower compliance burden for these regional airports and the ACCC.

The appropriateness of this approach to the regulation of regional airports is based on the premise that these airports are operating in what can be considered to be workably competitive markets. The

<sup>10</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 43.

<sup>11</sup> Australian Government (2009). National Aviation Policy White Paper, p 37.

<sup>12</sup> The term ‘regional airports’ is used to refer to airports located in small capital cities (i.e. Canberra, Hobart and Darwin) and locations outside of capital cities (e.g. Gold Coast).

competitive situation in the monitored airports is less clear cut although over time it is also being shown through the success of recent commercial negotiations at those airports that there is a suitable balance of power.

The concept of workably competitive markets and how this applies to the regional airports is considered in the following sections.

#### *Economic theory on workably competitive markets*

Workable competition is said to preside in a market in which the level of competition is sufficient to provide satisfactory market outcomes in terms of the product, price and quality characteristics of the service offering (i.e. a state of competition which yields broadly acceptable outcomes) as well as the levels of innovation in the service offering over time.

The nature of the concept of workable competition is that a wide range of market characteristics are able to produce broadly acceptable outcomes to society to the extent that they can be considered to be workably competitive. The implication of this definition is that one workably competitive market need not share the same market structure as another workably competitive market, even if the two markets are for the same good or service. The key issue is that the outcomes of the market reflect those that would be expected from a workably competitive market.

The literature also specifies criteria for workably competitive markets that relate to the conduct and performance of market participants. These criteria include:

- No producer is able to alter its profits by increasing prices and reducing supply (i.e. no producer should possess market power);
- Demand and supply is responsive to price changes;
- Some uncertainty should exist in the minds of rival sellers as to whether price initiatives will be followed;
- There should be no collusion between suppliers;
- There should be no unfair, exclusionary, predatory or coercive tactics (including persistent, harmful price discrimination); and
- There should be independent rivalry between suppliers.<sup>13</sup>

The market for regional airport services satisfies each of these performance criteria. This is largely due to the limited market power of regional airports, which is discussed in the following section. The satisfaction of each of the above criteria with regards to the regional airport market is discussed later in this submission.

#### *Limited market power of regional airports*

The market structure that applies to most regional airports dictates that airport operators possess little or no market power. The absence of market power effectively means that these markets can be considered workably competitive. There are two primary factors that underpin the lack of market power held by regional airports:

- The countervailing power of airlines due to the nature of demand for regional airport services; and
- The competition that exists between regional airports for airline flight paths.

Airlines hold significant countervailing power over operators of regional airports, and in many cases major city airports. The particular source of this countervailing power in respect to regional airports is the lower levels of demand and the smaller number of carriers that service these regional airports relative to the monitored airports.

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<sup>13</sup> Scherer, F. & Ross, D. (1990). Industrial Market Structure and Economic Performance; and Sosnick, S.H. (1958). A critique of concepts of workable competition. *The Quarterly Journal of Economics*, 72(3), pp 380-423.

Airlines servicing these regional airports have the ability to withdraw services from the airport with little notice and to divert these services to other locations. This has been observed in the past. For example, in 2008, Tiger Airways withdrew its domestic and international hubbing services from Darwin Airport with very little notice. Tiger then recommenced services at the airport in June 2010 before again withdrawing in January 2011. Royal Brunei and Garuda airlines have also previously withdrawn their services from Darwin Airport with Virgin Blue having commenced services at Alice Springs Airport in 2003 and withdrawing completely by late 2005.

The growing prevalence of Low Cost Carriers (LCCs) servicing regional and capital city airports has acted to reduce the market power of all Australian airports, not just regional airports. By being flexible in their route configuration and focused on yield, LCCs have made all airports, including major city airport be very conscious of how they set their levels of service, prices and the type and amount of incentives they use to attract and retain airlines.

Essentially, the growth in regional air traffic movements over the last decade has meant that airlines have a range of regional destinations. In this sense, regional airports are competing with one another – failure to meet the price and service levels required by operators will result in them redeploying airline capacity to alternative ports.

For instance, at Darwin Airport the Qantas Group holds considerable bargaining power given its operations provide the airport with historically around 80% of its aeronautical revenues. Qantas used this bargaining power to aggressively push for low airport service pricing during the recent negotiation of Darwin Airport's Aeronautical Pricing Agreement and as such it took over 2 years for a commercial outcome to be reached that both parties were happy with.

The nature of the demand-side of the market for regional airport services means that suppliers are in the position where they are required to respond to the actions of airlines, rather than being able to dictate or influence their decisions. This is less applicable at the monitored airports where, in order to remain competitive, major airlines are required to maintain a certain number of services into each location. Airports that are located in tourist centres are competing against each other for airline flight paths. If an airline is of the view that a regional airport is not offering competitive price and service quality levels it will redirect its services to another regional airport. It is also important to note that regional airports are unable to distinguish between those passengers that are tourist passengers (and therefore form part of the wider, more competitive tourist market) and those passengers that are more non-discretionary (e.g. business travel). As a result of this inability to differentiate between passenger segments, the competitive constraint that is imposed on regional airports by other regional airports in tourism locations extends across the entire passenger base.

In making its recommendation for the Darwin and Canberra airports to be excluded from the price monitoring regime post-2007, the PC stated the following:

*“There is no case for extending the airport coverage of the post-2007 monitoring regime. All of the larger non-monitored airports either face significant competition from other airports or other modes of travel, and/or must negotiate with airlines which have considerably more bargaining power than in their dealings with the major airports.*

*The Commission also considers that monitoring of Darwin and Canberra airports is no longer necessary.*

- *They are relatively small airports dealing with some major airlines that can withdraw services (and have done so), and hence have some countervailing power.*
- *Both face competition from other airports and/or other modes of transport.*
- *And both have less passenger traffic than some of the larger non-monitored airports.”<sup>14</sup>*

The lack of market power held by regional airports is also highlighted by the Federal Government in its Aviation Policy White Paper:

*“Most regional airports handle relatively small volumes of passenger traffic, have lower levels of demand than larger airports and are serviced by a limited number of carriers. These characteristics limit their market power and lessen the case for a form of pricing intervention.”<sup>15</sup>*

The focus when considering potential inclusion in the monitoring regime should be on the level of market power wielded and any indications of abuse rather than any form of passenger threshold. While such a passenger threshold would be simple to implement it could inadvertently draw in growing airports such as Gold Coast Airport which has a relatively weak market power position due to its proximity to Brisbane, its reliance on low cost carriers and its high reliance on leisure passengers. Given the changing nature of the Australian aviation landscape a review of each of the major city airports may also be appropriate given that some, Perth Airport in particular, are much more exposed to countervailing airline power such that monitoring may not be required or justified from a cost benefit perspective.

#### *Workable competition in the regional airport services market*

As has been previously stated, the market for regional airport services is considered to satisfy all of the performance criteria for workable competition. This is largely a result of regional airports possessing very limited market power, as has been discussed above. The paragraphs below assess each of the performance criteria for workable competition and how each applies to the market for regional airport services.

The first performance criterion for a workably competitive market is that no producer possesses sufficient market power to be able to raise its profits by increasing prices and reducing supply. The countervailing power held by airline operators in their dealings with regional airports means that increasing prices for airport services is likely to result in airlines pulling out of the airport and re-directing their flight slots to other airports which offer more competitive terms. This reduced demand and resulting loss of revenues would most likely more than offset any profit impact from increased prices.

The second performance criterion is that demand and supply are responsive to changes in price levels. The level of competition in the regional airport market and the potential for airlines to re-direct their flight slots from one regional airport to another in the event of a change in the relative service offerings indicates that this criterion clearly applies to the market for regional airport services. The level of supply is highly responsive to changes in demand, as regional airport operators are continually competing for available flight slots.

The third performance criterion relates to the presence of uncertainty in relation to whether price initiatives will be followed. While it is only one of the variables across which competition takes place, price is an important determinant of competitive balance in the regional airport services market. Holding all other factors constant (i.e. non-price factors), an increase in the price of the service offering at one regional airport will result in an increase in the relative value (from the perspective of the airlines) of the service offerings of its competitors. This will lead to airlines withdrawing flight slots from the airport with the higher price and redirecting them to those airports with higher value service offerings.

The result of this scenario will be a reduction in the revenue and profit levels for the regional airport with the higher price and a corresponding increase in revenues and profits for its competitors. This situation demonstrates why in a competitive environment such as the regional airport services market, price initiatives implemented by one service provider will not necessarily be followed by other market participants, particularly those that involve an increase in price.

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<sup>15</sup> Australian Government (2009). National Aviation Policy White Paper, p 178.



The fourth performance criterion for workable competition is that there should be no collusion between suppliers. The following four factors are generally required to facilitate effective collusion within an industry:

- Product homogeneity;
- Common sales agencies (i.e. several service providers sell their services through one agency);
- Small number of competing firms; and
- Actions of participants are highly transparent.

None of the above factors are present in the regional airport services industry. This is largely due to the wide range of factors that are negotiated between airports and airlines (both price and non-price) to establish the characteristics of the service offering that is to be provided. This range of factors means that regional airports are not supplying a homogenous product, as there may be significant differences across the industry in terms of the price and service quality characteristics of the services that are provided to airlines. It is also important to note that airports negotiate the characteristics of their service offerings with airlines on an independent basis (rather than collectively).

The competitive nature of the regional airport services industry and the high level of competition that occurs across a significant number of service providers have previously been discussed. This market structure means that the third requirement for effective collusion is also not satisfied. With regards to the fourth and final requirement, the independent nature of the negotiation process between airports and airlines and the high level of competition that takes place across both price and non-price factors means that the actions of regional airports are not considered to be transparent. For example, a regional airport could improve its service offering to airlines without this being made apparent to rival airports.

Just as collusion is not possible in the regional airport services market there is also no potential for unfair, exclusionary, predatory or coercive tactics. These strategies are typically undertaken when a firm is attempting to gain monopoly power in a market. While the general characteristics of the airport industry may indicate that predatory pricing is a potential threat (i.e. high fixed costs and sunk investments), the number of participants competing against each other in the regional airport sector and the competitive pressure that is exerted on market participants precludes this from being a possibility.

The final performance criterion for workable competition is that there should be independent rivalry between suppliers. Independent rivalry basically relates to conduct by service providers in all dimensions of the service offering being provided to customers (price and non-price) in an attempt to gain a sustainable competitive advantage over rivals. Given the level of competition that exists in the regional airport market and the limited scope for price increases and collusive behaviour, it can be concluded that independent rivalry exists in the regional airport services market.

## **5. Future investment requirements in the airport industry**

According to the 2010 infrastructure assessment undertaken by Engineers Australia, the airport sector faces significant challenges if infrastructure capacity is to keep pace with demand in the medium to long term. Although airport infrastructure was considered to be in generally good and improving condition and was attributed a rating of B- (the highest relative sectoral rating), Engineers Australia stated that airports require improvements to cope with future growth. Some of the specific future requirements highlighted in the 2010 report card were:

- A second major airport will be required in or near Sydney in the long term;
- A second new parallel runway is expected to be operational at Brisbane Airport by the end of 2015;
- Melbourne Airport will need a third runway;
- Funding is required for infrastructure expansions at Darwin Airport; and
- Perth Airport will require additional taxiways and an additional runway in the long term.<sup>16</sup>

<sup>16</sup>

Engineers Australia (2010). Infrastructure Report Card 2010 Australia, p 24

It is clear from the assessment undertaken by Engineers Australia that there is still significant investment required in airport infrastructure expansions in the medium to long term in order to ensure that there is not a shortfall in airport capacity to meet the needs of the wider community. The Report Card reinforces the importance of significant capital investment over the next decade to ensure the necessary quality and quantity of infrastructure.

As stated previously there are plans currently in place to undertake necessary investment with a further \$4 billion forecast to be invested between 2011 and 2016 by the airports in which funds managed by Hastings are shareholders. Much of this investment is predicated on the current level of sector risk, including regulatory risk, continuation of commercial negotiation track record and the expectation by airports and their shareholders of a fair return on investment.

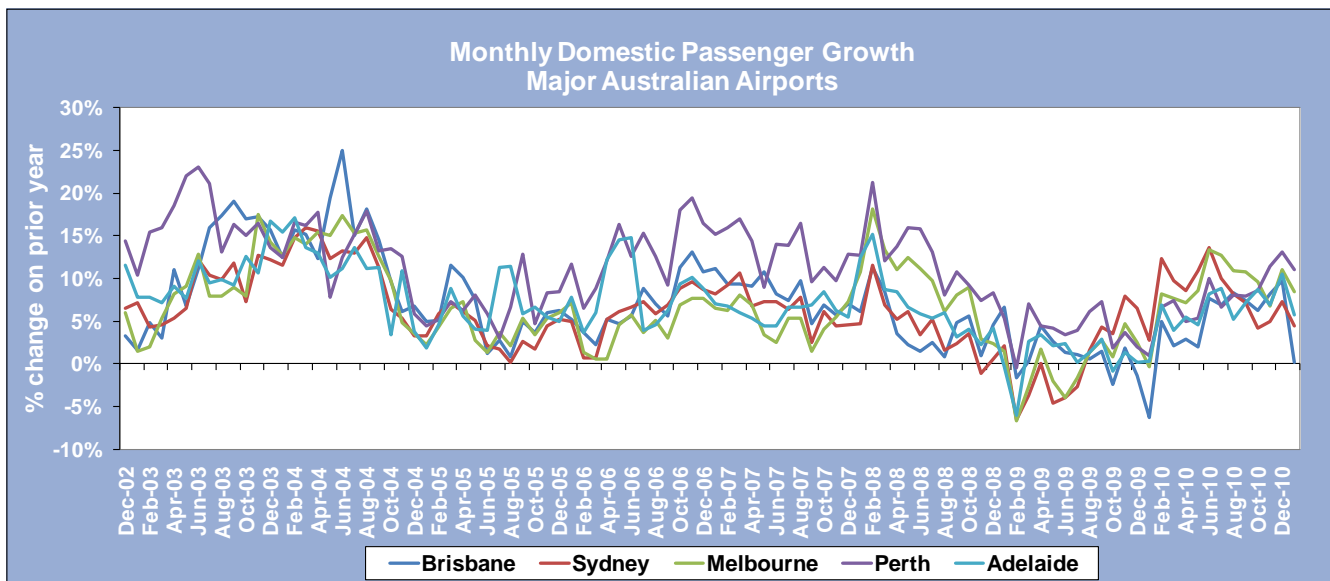
For example, there are significant future investments planned for Perth Airport, with a \$500 million refurbishment program due to be completed by the end of 2014. This program is to include:

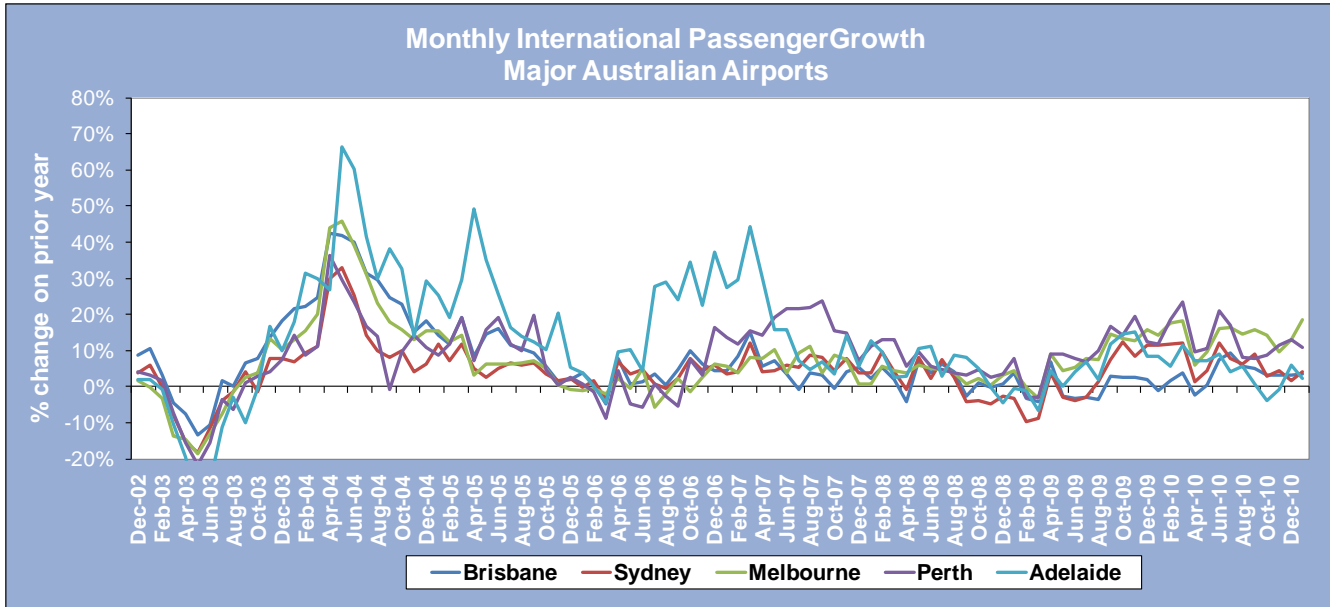
- The \$270 million refurbishment of the international terminal;
- The construction of a \$120 million terminal (Terminal WA);
- \$50 million in expansion works on the aprons and taxiways; and
- Improved retail, road and car parking facilities.

Melbourne Airport has committed to substantial capacity expansions to aeronautical and non-aeronautical facilities over the next 5 years, to the value \$1.0 billion including \$76 million to expand the capacity of car parks over the next 5 years.

At Darwin Airport, \$100 million of investment in aviation facilities is planned over the next 10 years, including \$33.5 million in terminal expansion works. This investment is underpinned by the previously mentioned Aeronautical Pricing Agreement reached with the Qantas Group in October 2010.

As shown in the charts below the Australian Airport sector has seen strong if somewhat volatile month-on-month passenger growth since the adoption of the current light handed regime. In many cases this growth has been unprecedented and well above forecasts included in master planning documents. It has been because of the light handed approach and regulatory certainty and history of reaching commercial agreements with airline customers that Australian airports have been able to grow, invest and adapt quickly enough to provide the capacity to enable this passenger growth and the economic benefits that such growth provides to the wider economy.





Australia's strengthening ties to China and the rest of the Asia Pacific region are forecast to deliver continued robust passenger growth to Australian airports. There is always the risk of demand shocks and changes to passenger traffic growth rates but these risks can be minimised by providing a framework that supports growth. Such growth will necessitate the investments outlined above which emphasizes the importance of a regulatory environment that provides certainty to industry participants and does not provide disincentives for efficient investment. The potential for significant changes to the regulatory regime to threaten investment incentives and economic growth has previously been recognised by the PC:

*“Though the light handed approach has not been without problems, it has delivered some significant benefits – particularly through creating a much better investment environment at the major airports. With several of these airports now entering a new phase of the investment cycle, a return to a more heavy handed and intrusive regime could be costly.”<sup>17</sup>*

In addition to the potential adverse impact on investment levels, it is also important to recognise that the re-introduction of a heavy handed form of price regulation would result in the costs that are currently avoided under the light handed framework potentially being realised. These costs include additional monitoring and compliance costs, costs relating to gaming behaviour by regulated businesses and end-users, and costs resulting from the manipulation of the regulatory process to distort commercial negotiations. The PC has previously recognised the potential for these costs to be realised in the event that heavy handed price regulation was re-introduced:

*“...a reversion to stricter price controls would put at risk the good productivity performance of Australian airports, leading amongst other things to a return to an environment in which considerable managerial resources were employed in dealing with the regulator and seeking ways to 'game the system'.”<sup>18</sup>*

The potential adverse consequences of the re-introduction of a heavy handed regulatory regime are therefore significant, as it would jeopardise the investments in airport infrastructure that are crucial to the industry in terms of meeting future growth. Significantly increasing the costs of regulation and also the degree of regulatory risk associated with investment in the industry by re-introducing heavy handed regulation could result in efficient infrastructure investments being foregone and major airports experiencing significant capacity shortfalls, at great cost to the economy.

<sup>17</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 55.

<sup>18</sup> Productivity Commission (2006), Review of Price Regulation of Airports Services, p 46.

The majority of Hastings' investors are sophisticated institutional investors and superannuation funds who invest across many sectors and asset classes and who have global investment mandates. To them the infrastructure asset class and the Australian airport sector in particular are just a small part of their overall global portfolios. The asset class and sector have been able to attract investment by providing stable investor returns supported by a history of commercial pricing agreements with airlines and an established light handed regulatory regime. Even in this environment it has in some instances been difficult to attract equity and debt capital to fund airport growth and continued operations given the global reduction in liquidity, increased investor risk sensitivity and apparent attractiveness of other sectors at times (such as global equities and distressed debt post the GFC).

For Australian airports to continue to attract capital the sector must retain its competitive advantage which is consistent growth supported by a stable light handed regulatory regime.

## **6. Benefits and costs of light handed regulation**

### ***Benefits***

#### *Avoided costs of heavy handed regulation*

The benefits of the current light handed regulatory framework are the avoided costs associated with heavy handed regulatory measures, such as the price cap regime that was in place prior to 2002 whilst providing a high degree of transparency and accountability around airport pricing. The costs associated with heavy handed regulation, which can be very substantial, are generally separated into two categories – direct and indirect.

The direct costs of regulation relate to those costs that are incurred directly as a result of the regulatory process. These costs include:

- The compliance costs incurred by the regulated business;
- The costs incurred by the regulator in implementing the regime; and
- Costs incurred by stakeholders and end-users in making submissions to the regulator.

In the Commission's 2006 report it was noted that estimates of airport's compliance costs, under the light handed regime in place at the time, varied from up to \$150,000 per airport to in excess of \$300,000 depending on the airport.<sup>19</sup> These costs were potentially understated as they probably did not fully capture the economic value lost through distraction of senior management, boards and shareholders let alone the ACCC, Commission and Government policy makers. Given wage and information system cost inflation since 2006 light handed regime compliance costs would now be substantially higher. The direct costs of compliance under a heavy handed regime would most likely be multiple times the light handed estimates provided above.

While the direct costs can be material, they are normally outweighed by the indirect costs incurred as a result of heavy handed regulation. These costs are attributable to unintended consequences from economic regulation and arise as a result of information asymmetry and industry complexities. The most significant indirect costs associated with heavy handed regulation are as follows:

- Socially desirable transactions being foregone due to heavy handed regulation potentially preventing parties from voluntarily entering into commercial arrangements that are mutually beneficial.
- Opportunity cost of regulation in relation to foregone innovation and efficiency improvements resulting from the regulated business concentrating on managing its relationship with the regulator rather than on improving its service offering to better meet its customers' needs;
- Market participants (including the regulated business and end-users) attempting to 'game' the regulator to obtain favourable regulatory outcomes as opposed to operating in the interests of economic efficiency; and

<sup>19</sup>

Productivity Commission (2006), Review of Price Regulation of Airports Services, p 36.

- Manipulation of the regulatory process, whereby the regulator can be prematurely drawn into commercial negotiations by a party to exert pressure on another party that results in a distortion in the outcomes that would have prevailed in the absence of heavy handed regulation.

The distortionary impact on investment decisions and the potential to prevent socially beneficial investments from being undertaken is the most significant of these unintended consequences of heavy handed regulation. These costs are greater in industries where the nature of the industry and the demand profile dictate that investments manifest in lumpy and indivisible capacity expansions (i.e. a significant investment is required to meet a capacity shortfall and can result in significant, but not inefficient, spare capacity). This is the case in the airport industry, as infrastructure expansions (e.g. new runways or taxiways) need to be added in discrete units rather than being progressively expanded in order to meet demand. This can result in significant spare capacity being created by infrastructure expansions which can be problematic in terms of determining a regulated price.

One of the key concerns with investment in regulatory processes involves the delay that can be caused by the heavy handed regulatory intervention. Delays in the expansion of capacity at the Dalrymple Bay Coal Terminal (DBCT) in Queensland provide an example of the potential for heavy handed regulation to cause costly delays in the provision of infrastructure capacity. The imposition of heavy handed price regulation at DBCT resulted in a two year delay to the expansion of terminal capacity. This meant that at the time that coal terminal capacity was most valuable (2004/05) it had not been created. This resulted in all participants in the Queensland coal industry experiencing significant losses.

The investment in airport infrastructure that has taken place in recent years under the light handed framework has previously been discussed (see section 3). Many of these investments would not have been possible without the light handed regime providing participants the flexibility to reach innovative commercial outcomes.

The pricing and other terms and conditions governing access to and investment in airport infrastructure are established through extensive commercial negotiations between airports and major customers (i.e. airlines). A large number of issues are taken into consideration by the negotiating parties in determining the pricing arrangements and terms and conditions that are to apply to these agreements. These issues include:

- Forecast passenger movements;
- Risk sharing levels;
- Potential airline and airport operating volatility;
- Economic and financial market volatility;
- Capital availability and pricing;
- Regulatory environment;
- Legal environmental (particularly in relation to environmental law)
- Desired amenities and service levels (and any required variations between low cost airlines and full service carriers);
- Employee and passenger safety and security; and
- The long term development plans of customers (airlines, retail, Australian Quarantine and Inspection Service (AQIS), etc) and the airport.

These complexities emphasise the importance of commercial negotiations being the means by which agreements, which support future investments, are reached between parties. The fixing of a single variable such as the price to be charged (as is the case under price cap regulation) is highly problematic as it limits the ability of the negotiating parties to reach an optimal balance in relation to the other variables, such as service quality levels and risk sharing arrangements. The characteristics of the agreement are interrelated and therefore need to be negotiated between the participants, rather than being partially determined by a regulator.

This also highlights the problems that would arise in the event that a heavy handed regulatory avenue was made readily accessible to the negotiating parties. This would result in the process and nature of commercial negotiations becoming significantly distorted, as these negotiations would be conducted

against the backdrop of the expected outcomes of regulatory determinations rather than the underlying commercial needs and incentives of the negotiating parties. This would cause significant delays in the establishment of new commercial arrangements. Furthermore, regulators are not appropriately positioned to take into account the wide range of factors (as discussed above) that underpin commercial agreements between major airports and airlines.

This is a key difference between the airport industry and industries that are subject to heavy handed price regulation such as electricity distribution. In electricity distribution, consumers are provided with a homogenous service. The price can therefore be set without any adverse impacts on the service offering. This is not the case in the airport industry where price and non-price factors are interrelated.

In addition to the airport sector specific issues mentioned above it should also be noted that all manner of non-sector specific regulatory issues would arise were the airport sector to be placed under a heavier handed regime. Issues such as the debate regarding what is an appropriate rate of return on investment, is CAPM an accurate or well based theoretical model to calculate such rates of return, and what asset bases should be used when applying such rates of return. Each of these issues is complex and would require considerable airport and regulatory resources to debate let alone solve.

The PC has previously recognised the adverse impacts of heavy-handed regulation on investment in the airport industry, stating the following in its 2006 review of airport price regulation:

*"...price cap regime that was widely acknowledged to have put various hurdles in the way of new investment, diverted management resources to dealing with the regulator and impeded the development of commercial relationships between airports and airlines."<sup>20</sup>*

#### *Avoidance of unintended consequences of heavy handed regulation*

It is also important to highlight the adverse impact of unintended consequences likely to arise in the event that particular services, such as the provision of airport car parking, are singled out for heavy handed regulation. The expansion of airport car parking facilities requires lumpy investments with high fixed costs. The risks associated with regulation in the sector producing adverse unintended outcomes are magnified by the complexity of the tradeoffs inherent in car parking operations and investment at airports.

As mentioned previously there are also significant issues associated with the relative poor load factors associated with the use of airport car parking facilities, meaning that demand is highly variable and that at times usage rates can be very low. This has implications for the pricing of the use of these facilities as, in order for the airport operator to recover the full costs associated with car parking facilities, it is necessary to charge prices that are reflective of average load factors. It also highlights the dangers with simply comparing airport car parking charges with those elsewhere (which benefit from considerably higher year round utilization factors).

The implementation of a heavy handed regulatory regime to determine the prices to be charged for airport car parking would significantly increase the risk associated with investing in expanding car parking facilities. With car parking prices being determined by the regulator, airport investors would be burdened with significant cost recovery risk.

Subjecting car parking to heavy handed price regulation will also distort decisions relating to the development of land around regulated airports by altering the relative value of the land for alternative uses. For example, consider a scenario where, in the absence of heavy handed regulation, the most efficient use of a particular parcel of land near a major airport may be the construction of additional car parking capacity. The imposition of heavy handed regulation on airport car parking may result in the value of this investment being reduced due to the increased risk (and reduced expected returns) associated with the investment. This could change the relative values of other potential uses of the parcel of land (e.g. development of a large freight handling facility) due to the fact that the construction of

<sup>20</sup>

Productivity Commission (2006), Review of Price Regulation of Airports Services, p 42.

car parking facilities is no longer the highest value option. Under this scenario, the imposition of heavy handed regulation has distorted investment incentives so that land surrounding a major airport is not used for its most efficient purpose. The result is an inefficient allocation of capital resources resulting from regulation.

The outcome of this increase in risk could manifest in a shortfall in investment in airport car parking facilities over time. This would have adverse consequences for airport customers - when existing car parking facilities become severely capacity constrained. This will not only result in a depleted direct service offering to airport customers, it could also lead to increased congestion costs and traffic management issues at airports and their surrounding transportation networks.

Heavy handed regulation of on-site car parking would also likely significantly impact off-airport car parking providers. To the extent that on-airport car parking prices are set too high by a regulator, off-airport providers would likely increase their rates magnifying the economic damage caused by regulation. If such prices were set too low by the regulator under a heavy handed regime then this would likely drive off-airport parking providers out of the market, which could magnify any under-investment and capacity issues caused by a heavy handed approach.

The social costs of potential investment distortion and any resulting congestion issues would likely significantly outweigh the questionable benefits arising from temporarily reducing airport car parking charges.

These costs are avoided under the current light handed regime which still manages to achieve economically efficient outcomes that are consistent with outcomes in a workably competitive market.

#### *Avoided costs of regulatory uncertainty*

Investments in airport infrastructure involve large, up-front capital contributions which create fixed assets with a high risk of expropriation and long period before revenues payback initial investment. In this environment, confidence in the continuity of a particular environment is fundamental to facilitating efficient and timely investment. This need for confidence extends especially to the regulatory environment as it is at a particular risk of financially significant change. The relatively high operational risk associated with airport operations (where profit is very sensitive to changes in throughput and prices struck with airlines via commercial negotiations – which are themselves uncertain) make investment particularly sensitive to perceived regulatory risk.

A sound regulatory environment that provides stability and certainty is essential to providing the confidence that underpins private investment in significant infrastructure. Past studies have found a positive relationship between private investment levels and the independence and credibility of a regulator, particularly in relation to the regulator's ability to make commitments.<sup>21</sup>

The importance of providing certainty to facilitate airport investment is evidenced by a key objective of the Federal Government's 2009 National Aviation White Policy Paper which was to provide the aviation industry with the certainty and incentive to plan and invest for the long term. The paper also included the following statement:

*"The Government recognises that regulatory stability is important for airports as they make long term investment decisions. It will continue with price monitoring – including in relation to car parking – at the five major airports, as the basis for economic regulation."<sup>22</sup>*

A lack of regulatory certainty increases the magnitude of risk that is associated with investments in sunk infrastructure. Such increased risk would effectively increase the cost to investors of undertaking these investments (through the sourcing of the initial capital) and could result in socially beneficial investments

<sup>21</sup> Pargal, S. (2003). Regulation and Private Sector Investment in Infrastructure: Evidence from Latin America. Policy Research Working Paper 3037.

<sup>22</sup> Australian Government (2009). National Aviation Policy White Paper, p 184.

being foregone. The provision of regulatory certainty enables airports to source capital at a competitive cost and thus undertake efficient investment projects.

Even the perception of potential regulatory uncertainty or volatility can have adverse impacts on the availability and cost of capital for airport infrastructure investments. Market sensitivity to all types of uncertainty has been heightened by the recent Global Financial Crisis. As such, any uncertainty that is created by periodic reviews or unexpected changes to the regulatory regime is only likely to further increase the cost, jeopardise the availability or delay the sourcing of debt and equity funding for airport development. Such avoidable regulatory costs will ultimately be shared by airports, airlines and end users to the detriment of all.

The airport industry currently has a uniquely high regulatory risk as it is the only industry with a regulatory regime which institutes a review of the entire regulatory framework every five years, as distinct from the regulatory parameters being subject to review as is the case in most regulated industries.

Maintenance of the current regulatory framework provides a certain environment for investors. By restricting the regulatory intervention to the monitoring of price and service quality levels, the current framework provides airports and investors in airport infrastructure with a reasonable level of certainty that the costs relating to efficient infrastructure investment will be recovered in the future. Under a price cap or heavier handed regime, this certainty does not exist and investors have greater concerns in relation to the recovery of their initial capital expenditure. The impact of this uncertainty on airport investment is evidenced by the limited amount of investment that occurred under the price cap regime period.

Debt refinancing in the airport sector is common and substantial. Over \$10 billion of Australian airport debt will need to be refinanced at some point during the next 10 years. Such refinancing and the pricing at which it occurs is reliant on stability of cash flow and certainty of the regulatory environment. Regulatory stability and certainty, free from undue threat of change, results in cheaper debt which benefits the public by promoting growth and delivering high quality and better priced facilities and service for airport users. Currently the majority of airport debt is short term reflecting the rate of regulatory reviews which have been occurring and the similar tenor of the airport pricing agreements signed with airlines.

It is important to note that if the period of the regulatory contract could be set to the same period as the life of an investment, the regulatory uncertainty and therefore regulatory risk associated with that investment would be eliminated. Regulatory uncertainty and risk increases when the arrangements for the recovery of the costs associated with an investment can be revised subject to regulatory reviews or determinations that take place over the investment life cycle. Therefore, regulatory risk increases as the period of time over which the regulatory regime can be altered is shortened. This means that the current reviews of the regulatory framework every five years are serving to increase the level of regulatory uncertainty and risk under the regime, thereby creating a disincentive for efficient investment to be undertaken.

#### *Regulatory creep*

Regulatory creep refers to the scenario whereby additional services and/or facilities are progressively included within a regulatory regime as a result of the criteria for inclusion being relaxed over time. There is a risk that if a pattern is established of expanding the current price and service quality monitoring regime to include additional airports, more and more airports may be incorporated into the regime at future reviews, eventually resulting in a significant number of airports being unnecessarily subject to the regulatory framework. As has been previously established, airports in minor capital cities (Canberra,



Hobart and Darwin) and airports in regional locations do not possess sufficient market power to necessitate an extension of the current regulatory regime.

Regulatory creep has previously been raised as an issue of concern by participants in other regulated industries. For example, concerns were raised by infrastructure owners in 2006 during consultation with the Ministerial Council on Energy over the new regulatory framework for energy market pricing. The specific concern was that excessive regulator discretion under the regime had the potential to leave businesses open to the risk of regulatory creep, particularly in relation to reporting requirements becoming excessive and imposing an unnecessary and costly burden on regulated businesses.

Concerns were also raised during the 2004 review of the Gas Access Regime. These concerns related to the potential for regulated gas assets (i.e. pipelines) to be shifted through the different levels of coverage and types of regulation under the regime (i.e. between price monitoring and the setting of reference tariffs). Regulatory creep was also one of the issues addressed by IPART in its 2006 review of the burden of regulation in New South Wales. Stakeholders considered that the significant external pressures on and incentives for government to regulate were resulting in more and more regulation, some of which was unnecessary.<sup>23</sup>

#### *Effectiveness of current regulatory controls*

It is important for any light handed regulatory regime to have effective controls which discipline the behaviour of market participants. This is important to ensure that market participants do not abuse any market power or countervailing power that they may possess in commercial negotiations and as a result of such discipline or constraint the market does not become subject to the equivalent of costly heavy handed regulation.

The current framework contains two regulatory control mechanisms:

- The threat of the re-introduction of heavy handed price cap regulation; and
- The access regime outlined in Part IIIA of the CCA.

Airport industry participants are well aware of the potential for heavy handed regulation to be introduced, meaning that the threat of its re-introduction acts as an effective control on the actions of industry participants (i.e. airports understand that if they do not act in accordance with the current light handed framework so that it results in efficient outcomes, there is the potential for airport services to once again become subject to a high cost price cap regime).

The second control under the current regulatory framework is the access regime that is administered through Part IIIA of the CCA. Under Part IIIA, access seekers can lodge an application with the National Competition Council (NCC) for access to a particular service that is provided by a facility to be 'declared', on the basis that it will result in a material increase in competition in one or more related markets. If the NCC rules that an airport service is appropriate for declaration, the airport owner is required to negotiate mutually acceptable terms and conditions of access with airlines. If these negotiations fail, the parties are permitted to appoint an independent arbitrator to rule on the terms and conditions. If this avenue fails, the dispute can be referred to the ACCC for determination. The ACCC essentially approaches such a determination as it would for a service subject to a heavy handed regulatory regime.

Part IIIA of the CCA has proven an effective mechanism for resolving serious and protracted disputes between airports and airlines. The following airport services have been declared by the NCC:

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<sup>23</sup> Independent Pricing and Regulatory Tribunal (2006). Investigation into the burden of regulation in NSW and improving regulatory efficiency. Final Report.

- Provision of landside roads and associated vehicle facilities for dropping off and picking up passengers at Melbourne Airport – declared in May 1999 by the ACCC under now repealed Section 192 of the Airports Act 1996;
- Freight handling services at Sydney and Melbourne airports – declared from March 2000 until March 2005; and
- Domestic airside services at Sydney Airport – declared in December 2005.

Part IIIA of the CCA exerts a discipline on airports and their customers to negotiate prices and other terms and conditions relating to the use of airport facilities in good faith. Failure to do so on the part of the airport will result in the customer (i.e. the airline) lodging an application with the NCC to have the service in question declared. Once a service is declared, the access seekers have the ability to involve the ACCC in the dispute resolution process, with the ACCC determining the terms and conditions of the agreement in accordance with the pricing determinations undertaken for other regulated entities (i.e. effectively a heavy handed regime).

Amendments to the CCA (previously referred to as the *Trade Practices Act 1974*) came into effect on 14 July 2010. These amendments included the imposition of time limits on the declaration process which was designed to improve the timeliness of the declaration process. Section 44GA under Part IIIA of the CCA states that the NCC is required to make a recommendation within the 'consideration period', which is defined as a period of 180 days (6 months), starting on the day the declaration application is received.

In the event that the NCC is unable to make a recommendation within the consideration period, it must provide written notice to the designated Minister, specifying when the NCC must now make a recommendation and explaining why the NCC had been unable to make a decision within the consideration period. It is also important to note that the designated Minister has 60 days from the receipt of the NCC's final recommendation to decide whether or not to declare the service.

While the NCC has not been required to reach a determination on a declaration matter since the introduction of this time limit, it is worthy to note the timeframe within which the most recent declaration process was completed. On 22 March 2010, the NCC received an application for the declaration of the service provided by the Herbert River tramway network in North Queensland. The NCC handed down its draft recommendation on 1 June 2010 and its final recommendation on 16 July 2010, well within the 180 day consideration period.

Part IVA of the CCA also constitutes a regulatory control under the current regime. The provisions of Part IVA impose a general duty to trade fairly in relation to consumers, and also in respect of certain business transactions. While the conduct of airports can be brought under scrutiny under these provisions, they are considered less applicable to major airports than those in Part IIIA.

For regulatory controls under a light handed regime to be economically efficient, it is necessary that the mechanism represent a 'last resort' for both service providers and access seekers. This means that airports and airlines will be provided with the necessary incentives to negotiate on commercial terms, with dispute resolution and arbitration (and the declaration of services) being a last resort after negotiations are unsuccessful.

Evidence from the industry suggests that the current regulatory controls (and particularly the access regime under Part IIIA of the CCA) are effective in achieving this objective, with commercial agreements regularly being established between airports and airlines. Once agreed these commercial agreements also typically include dispute resolution procedures which are instigated in the event of a dispute such that issues which arise during each agreements term are unlikely to lead to NCC or ACCC involvement.

It is important that the need for regulatory control mechanisms to constitute a 'last resort' is taken into consideration by the PC when assessing new control mechanisms. Failure to do this will result in commercial negotiations becoming distorted and the costs associated with the regulation of the airport sector increasing significantly.

Australian Airports are not a homogenous group; they serve different markets, have varying degrees of market power and operate with different management teams, shareholders and strategic goals. Hastings, as the manager for funds who are significant shareholders in many airports, expects each to operate in a fair, honest and transparent way with its airline customers and other stakeholders. This includes full compliance with standards, industry codes of conduct and relevant laws (including the CCA).

One of the benefits of using the mechanisms in the CCA to enforce the current regime is the power they give the ACCC to single out individual airports for inquiry and investigation without triggering a regime review and negative consequences for other airports.

### **Costs of light handed regulation**

The costs associated with the current light handed regime are relatively minor, and relate predominantly to the costs imposed on airports in having to comply with regulatory obligations. The most important consideration to an assessment of the costs of the current arrangements is the limited evidence that they have led to any delay or distortion in investment incentives for the airport owners.

The compliance and reporting costs incurred by the five airports included in the current regime are not considered significant given their size and do not constitute a constraint on efficient investment. As has previously been discussed, the compliance costs incurred by the monitored airports under the light handed regime have previously been estimated at between \$150,000 and approximately \$300,000 per airport, acknowledging that these estimates are likely to understate the costs relating to the management effort associated with complying with the regime. Furthermore, the costs incurred by the major airports in complying with the provisions of the current regime are unlikely to be materially different to the costs that would be incurred by a prudent airport operator in relation to maintaining management and financial accounts and assessing service quality levels. This would not necessarily be the case if the current regime was expanded to regional airports with fewer resources and financial capacity.

The most important point to note in relation to the compliance and reporting costs incurred by the monitored airports under the current regime is that these costs are significantly less than the benefits associated with the current light handed regime, predominantly relating to the provision of an environment that facilitates efficient investment.

## **7. Improvements and recommendations**

While Hastings is generally supportive of the current light handed regulatory framework, there are some areas where it is considered that improvements to the regime could further improve the efficiency of the sector in terms of the level of regulatory certainty that is provided to industry participants and also the environment for efficient investment. This section also contains Hastings' recommendations that relate to specific components of the regulatory regime.

### ***Changes to the review arrangements***

The first suggested improvement relates to the mechanisms by which the regulatory framework is to be reviewed by the PC. Under the current framework, the regulatory regime that applies to the airport industry is reviewed by the Commission every five years (or earlier, as in this case). Compared to other regulated industries throughout the economy, this is a short timeframe for a review of the regulatory framework to apply to an industry. The regular reviews of the regulatory regime by the PC are doing more harm than good as they are fostering uncertainty over the regulatory regime that is to apply to the industry over the medium term. This is significant given the long-term nature of investments in airport infrastructure and the need for long-term certainty for efficient investment to be undertaken.

The Government has previously stated that it understands the need for regulatory certainty in the airport industry:

*“The Government recognises that regulatory stability is important for airports as they make long term investment decisions. It will continue with price monitoring – including in relation to car parking – at the five major airports, as the basis for economic regulation. A full review of Australia’s airport economic regulatory regime will be undertaken by the Productivity Commission in 2012.”<sup>24</sup>*

However, this understanding is not evidenced by the fact that the Government has brought forward the scheduled review to 2011 (rather than 2012 as scheduled). Regardless of whether the rescheduling of the PC review was appropriate, *ad hoc* changes to the regulatory regime such as this serve to increase regulatory uncertainty and the associated risks and costs to investment. This needs to be avoided if investment in airport infrastructure is to keep pace with future growth. A stated policy of more targeted airport specific inquiries would reduce the need for regime wide reviews and lessen the negative consequences resulting from perceived regulatory risk.

It is suggested that further reviews of the regime and *ad hoc* changes be avoided on the basis that they introduce regulatory uncertainty and therefore adversely impact the ability of airports to raise debt to fund infrastructure investments. However, to the extent that such reviews are unavoidable, a more prescriptive mechanism should be introduced, with a time horizon of greater than five years. As previously stated, this will increase the degree of regulatory stability in the industry and provide a more conducive environment for efficient infrastructure investment. It is considered that in between reviews, if such reviews continue, the existing control mechanism provided by Part IIIA of the CCA provides an effective mechanism for dealing with disputes under the current regime. This mechanism enables the ACCC to investigate disputes at individual airports without the need for an industry-wide review of the regulatory framework and the associated uncertainty and instability that such a review causes.

#### ***Reform of service quality monitoring and performance measurement***

One of the main areas of potential improvement under the current regulatory framework relates to the service quality monitoring arrangements. While the monitoring of service quality levels is an essential element of a light handed price monitoring regime, in order to ensure that service levels are not sacrificed for short-term profit, the current mechanisms for monitoring and reporting service quality performance could be improved.

Under the current framework, the service quality levels at airports are monitored using results obtained from surveys of airport stakeholders including passengers, airlines and other stakeholders that use the facilities and services provided by the airports. The results from these surveys are collated and used by the ACCC to determine an overall level for the quality of service at each monitored airport.

The ACCC’s current approach to service quality monitoring is not providing the most accurate indication of relative service quality levels across the monitored airports. The most significant issue with the current approach is that service quality levels are not comparable across the monitored airports. This is predominantly a result of service levels being agreed upon between airlines and airports with the actual service levels depending on a range of other factors. For example, an airport servicing low cost airlines may have a less luxurious terminal or no aerobridges as a result of the airlines not wanting to incur additional costs. This should not result in the airport receiving a lower service quality rating, as it is part of the commercial negotiations that take place between airport operators and airlines, something which the current regulatory framework is designed to encourage.

The fact that service quality is one of the parameters that are commercially agreed upon between airport operators and airlines is a factor that is not always made apparent to passengers and other airport stakeholders such as customs, police and quarantine officials. This means that stakeholder service quality surveys are not necessarily the most accurate tools for assessing service quality levels at airports. Furthermore, such surveys are exposed to subject bias for commercial positioning and public relations reasons.

<sup>24</sup> Australian Government (2009). National Aviation Policy White Paper, p 183.

Based on the above factors, Hastings considers that the current public quality survey approach could be an area of improvement for the current regulatory framework. It is recommended that the current process be replaced by a system that involves a more objective review of service quality as measured independently against individual airport's specific contractual Key Performance Indicators (KPIs). This would represent a more balanced and fair methodology that would ensure conformance in airport service quality monitoring. Such a methodology would alleviate the current situation whereby potentially inaccurate and misleading service quality rankings are developed which receives unwarranted coverage in media and also in government reports.

### ***Maintenance of the current regulatory controls***

As has been previously discussed, the control mechanisms under the current regulatory framework, in particular Part IIIA of the CCA, are effective at providing a 'last resort' to airport industry participants and also at providing an incentive for the commercial negotiation of the terms and conditions of access to airport services between airports and airlines.

There has recently been some discussion around the implementation of a 'show cause' trigger and process under the regime. In its 2006 review of airport price regulation, the PC recommended that the Government be required to make an explicit judgement on whether the conduct of any of the monitored airports requires further scrutiny. Under this mechanism, the responsible Minister would be required to indicate that either no further investigation is warranted or alternatively that one or more airports be required to 'show cause' why further investigation should not take place. In the event that the airport/s failed to show sufficient cause, their conduct would be subject to an inquiry from the ACCC. The PC considered that this would strengthen the threat of re-regulation under the regime.

However, as a result of concerns raised by both airports and airlines in relation to the impact of the proposed 'show cause' mechanism on the ability of airports to finance capital investments, its impact on commercial negotiations and also the time and cost pressures associated with the proposal resulted in the Government opting not to introduce the 'show cause' mechanism into the regulatory framework. In the National Aviation Policy White Paper, the Government stated the following with respect to the 'show cause' mechanism:

*"In light of the concerns expressed by stakeholders regarding the draft guideline, the Government is not proposing to introduce the annual 'show cause' assessment at this time. The Government is sensitive to any potential impact a show cause assessment could have on airports' ability to attract capital, particularly because of the impact of the global financial crisis on investor confidence and access to finance, now is not the time to introduce this. However, should the ACCC monitoring report or other evidence indicate that an airport warrants further investigation for its pricing behaviour, the Minister retains the discretion to recommend a formal inquiry under the Trade Practices Act."<sup>25</sup>*

The 'show cause' mechanism does not constitute a more appropriate control on the behaviour of airports and airlines than is the case under the current control mechanisms, however it would come at far greater cost. This cost would be borne in the time and resources required to respond to 'show cause' requests on a regular basis and, more importantly, an increase in the cost associated with the financing of capital investments. As has been previously discussed, the importance of infrastructure investment for the future viability of the airport industry means that the latter of these costs could be particularly significant.

On this basis, it is considered that the current mechanisms are providing an effective control on the behaviour of participants in the airport industry and that the implementation of a 'show cause' mechanism would not strengthen the existing controls and would impose significant cost on the airport sector, including threatening important future investments in airport infrastructure capacity.

<sup>25</sup> Australian Government (2009). National Aviation Policy White Paper, p 180.

### ***Maintain the limited scope of the monitoring regime***

Hastings supports limiting the scope of the monitoring regime. The expansion of the monitoring regime to include airports in minor capital cities and regional locations is not appropriate given the different environments in which these airports operate and subsequently the low level of market power that is held by these airports relative to the airports located in major capital cities.

The inclusion of additional airports in the monitoring regime would be likely to stifle investment that is required to ensure that the capacity of these airports maintains pace with future growth. As there is considered to be little benefit in the ACCC monitoring price and service quality levels at these airports, their incorporation into the framework would not be beneficial for the airport industry as a whole. The recently introduced second-tier self-administered regime for the larger non-monitored airports is considered to be more appropriate. It is also considered that there is potential scope for reviews of major airports to be undertaken to determine whether the continuation of the monitoring regime is justifiable, given the changing nature of the industry, in particular the increased penetration of LCCs and the corresponding impact on the countervailing power of airlines.

### ***Land Use and Transport Planning***

Hastings is comfortable with evolutionary changes to planning and infrastructure funding policies but expects competitive neutrality in regard to these matters. Specifically, airports should not be placed at a competitive disadvantage to other entities (such as non-airport property developers and commercial real estate investors).

Currently airports have to submit major development plans to the Minister for federal planning approval. They also work to engage with local council and state government agencies regarding their plans. To the extent that they require formal local and state approval, this would put them at a competitive disadvantage with regards to cost and timing to the extent that their federal approval requirements are not removed or others are not also placed under federal planning jurisdiction.

Furthermore, in some states airports are also required to pay council rates and yet in many cases they do not receive the council services (roads, stormwater, etc) that are typically funded using such rates. Airports in these instances therefore need to fund their own infrastructure services in addition to paying rates which puts them at a commercial disadvantage to other operators who only pay rates. There is also a growing debate regarding the appropriate level at which airports should contribute to major road works which support access to and from their terminals. There have been some great examples (such as recently in Perth in advance of the Gateway WA project) where airports have assisted in the planning and funding of off-airport road developments to facilitate access and growth in airport usage. Again, it is requested that airports be treated with competitive neutrality in this respect. They can be requested to contribute to road improvements but only to the extent that is common and expected of other entities (such as shopping centres, schools, sporting grounds, hospitals & residential property developers). This contribution and involvement is generally limited to intersections and short access roads not highways and major roads which are primarily a state and local responsibility and funded from general taxes.

## 8. Conclusion

Hastings is generally supportive of the current light handed price and service quality framework for the regulation of major airports. The light handed nature of the regime provides market participants with the necessary flexibility to reach commercial agreements in a complex environment. Since its implementation, the industry has observed a period of significant investment in infrastructure and strong performance of the industry following a period of poor aeronautical financial performance under the heavy handed CPI-X price cap regime.

The most important benefits associated with the light handed regime are the avoidance of the costs and unintended impacts of heavy handed regulation, which include:

- Socially desirable investments and transactions being foregone due to the distortionary impact of heavy handed regulation on investment decisions, which is attributable to the high level of regulatory risk associated with heavy handed regulatory regimes;
- Distortion of commercial negotiations between airports and airlines by fixing one of several elements that are negotiated between the parties. This jeopardises the establishment of these agreements which are vital to the viability of long-term infrastructure investments;
- The unintended consequences associated with subjecting specific services to heavy handed regulation, such as airport car parking. This is likely to result in an increase in regulatory risk associated with investments in car parking capacity, the distortion of the relative value of alternative land uses, which could result in the a future shortage of supply of on-airport car parking, and also the complication of airports' task of managing the complex ground transport system; and
- Other direct and indirect costs associated with heavy handed regulation, including:
  - The significant compliance and reporting costs incurred by regulated businesses;
  - The potential for regulatory creep;
  - The adverse consequences associated with the 'gaming' of the regulator by market participants to achieve certain outcomes;
  - The costs associated with the manipulation of the regulatory process by market participants; and
  - The opportunity costs in the form of foregone innovation and efficiency improvements relating to the resources dedicated by regulated businesses to managing their relationship with the regulator.

Hastings supports the continued reliance on Part IIIA of the CCA as the primary regulatory control instrument under the current regime. The effectiveness of this mechanism is evidenced by the willingness of airports and airlines to enter into commercial agreements and also the past declaration of various airport services by the NCC.

It is considered that introducing a 'show cause' trigger process in the regime would fail to improve the effectiveness of the current regulatory controls while significantly increasing the costs incurred by airports and regulators.

Hastings supports limiting the scope of the monitoring regime as much as possible and advises against the inclusion of any additional regional or second tier airports. Many Australian airports possess limited market power and are operating in markets that are achieving outcomes consistent with the principles of workable competition.

Given the changing nature of the Australian aviation landscape, it may be appropriate to review the market power that is held by the major city airports, as some, Perth Airport in particular, may be exposed to countervailing airline power to the extent that price and service quality monitoring is no longer necessary or justifiable.

While generally supportive of the current framework, Hastings does consider that the regime could be improved in some areas which would provide further benefits to the airport industry. These include:

- The avoidance of further reviews and *ad hoc* changes to the regime to avoid the introduction of regulatory uncertainty which threatens the viability of infrastructure investments. In the event that regime reviews do need to be undertaken, it is recommended that a more prescriptive review mechanism be introduced with time horizons of greater than five years;
- Reform of the service quality monitoring arrangements, with the current process of collating the results of stakeholder surveys to be replaced by a system that involves a more objective review of service quality as measured independently against KPIs specific to individual airports. It is considered that the current system is inappropriate as it does not take into consideration that service levels are agreed upon commercially between airports and airlines and are therefore not directly comparable across the monitored airports; and
- While not opposed to changes to land use and transport planning policies, Hastings notes the importance of maintaining competitive neutrality between airports and other project and infrastructure developers.