

**PRODUCTIVITY COMMISSION:
ECONOMIC REGULATION OF AIRPORT SERVICES
DRAFT INQUIRY REPORT AUGUST 2011**

SUBMISSION BY CITY OF GREATER GERALDTON



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The purpose of this document is to offer comments and observations from the perspective of City of Greater Geraldton, as owner/operator of a rural regional Airport, on the **draft** report issued by the Productivity Commission for that purpose, for consideration amongst submissions from other stakeholders as part of Commission deliberations on future policy on the regulation of airport operations in Australia.

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PRODUCTIVITY COMMISSION: ECONOMIC REGULATION OF AIRPORT SERVICES – DRAFT INQUIRY REPORT AUGUST 2011

1. Executive Summary

In this submission, views are offered on a range of matters raised in the draft inquiry report, with primary focus on section 13.1 of the report in which the Commission raises issues related to conduct of rural and regional airports. Before addressing those issues – and related matters covered elsewhere in the report – some background information is provided on Geraldton Airport which is owned and operated by the City of Greater Geraldton, to provide context for this regional perspective.

1.1 Key points in this submission:

The points below are listed in order of their appearance throughout this submission, and retain their original paragraph numbers, for reference:

5.4.1 The descriptor ‘regional and rural airports’ is simply too broad for the purposes of its mention in the draft report. Issues of location, airport capacity, scale of aircraft and passenger movements, whether aviation activity levels can support just GA providers, or regional RPT airlines, or the major airlines, the aircraft types and scheduled seating capacity utilised to service the airports, whether they are dominated by RPT or Charter/FIFO services – these and other factors may assist in classifying or stratifying regional and rural airports in a manner that can enable some focus in examining the issues outlined by the Commission at page 296 of the draft report.

What are the proven misuses of market power by regional and rural airports, as alleged by airlines? What facts have been provided in response by the airports in question, and underlying issues identified by the airports? In which categories of regional and rural airports is there corroborated evidence of a particular malaise warranting examination? Is it a widespread ‘problem’ across the full spectrum of rural and regional airports? Are the problems associated with airports with 10-15,000 passengers per year, or 50-100,000 passengers per year, or 300-500,000+ per year?

The City challenges the assertion that problems alleged by airlines are of sufficient magnitude and scope to warrant consideration of across-the-board application of a pricing principles enforcement regime embracing all rural and regional airports in Australia.

5.4.2 In its final report, the Commission may care to explore the unique arrangements that apply across the various States and Territories in relation to the regulation of Intra-State regular passenger services, including ‘licensed monopoly’ advantages bestowed on particular airlines for services to particular regulated regional and rural airports, rationales for such monopoly services, the levels and distribution of State-subsidised air services, the competitive processes applied by States in setting these arrangements - and the associated constraints such arrangements impose on the regional and rural airport owners in relation to airport planning, entering commercial agreements etc.

6.2.1 Clear distinctions need to be made between the legal entity and ownership models, the commercial business models, and the financing models relevant to major Tier 1 or Tier 2 airports to which the Pricing Principles currently apply, and the very different funding circumstances that characterise smaller regional airports in WA.

6.5.1 The City strongly opposes propositions from airlines and GA operators that airport air-side infrastructure asset valuations utilised in determining airport fees and charges should exclude the capital value of assets at the time airports were transferred under the ALOP from the Commonwealth to Council ownership. The principles of full cost-reflective pricing should apply.

7.2.1 General principle - Security screening charges should be passenger user-pays charges, not subsidised from public funds (Council rates revenues, or Federal or State funds). Unfortunately, security screening charges will inevitably be reflected in airfares, potentially deflating demand and adversely impacting viability of some RPT services at some smaller ports. Where market failure can be demonstrated in regard to commercially viable provision of essential regular transport services to a particular centre, then subsidy may become justifiable as a community service obligation.

8.2.1 The City would strongly object to any broad proposition by any airline that it ought to run Geraldton Airport other than as a commercial trading enterprise delivering a real economic ROI.

8.2.2. No aviation-related revenues from the operations of Geraldton Airport are applied to fund any other City programs, and aviation-related surpluses are devoted exclusively to continuing development of Geraldton Airport.

9.2.1 To the extent that the Productivity Commission, or Airlines, or indeed the ACCC may hold any view that generally accepted accounting principles and practices and/or current Accounting Standards do not appropriately deal with Airport asset valuations generally, or with airport asset valuations by Local Governments that own airports, then the Commission or Airlines or the ACCC perhaps ought to make submissions to the national Accounting Standards body, which has proper jurisdiction over the Standards. Any examination of the issue should logically include consultation with Treasuries and the Auditors-General of the States in which Local Governments own airports, and in respect of which their compliance with Accounting Standards is mandatory under State Local Government legislation.

9.4.1 For a WA Council that owns an airport to put in place a multi-year commercial agreement with airlines, within the limits of the current Local Government Act, such an agreement would be confined to identifying the bases/mechanisms under which pricing may be determined by Council in future – but it cannot specify the actual fees and charges that will apply in future years. This constrains the scope of possible agreements.

9.5.1 In relation to volume-based fee reduction incentives, to encourage airlines to undertake route and destination promotion and development, generating passenger growth, the basic business axiom of risk following the profit should apply. Airlines pursuing their own interests will always argue for fee reduction, assuming never-ending and stable-trend passenger number growth, and will always advocate an associated fixed return model for airport owners reflecting a tightly constrained ROI model. Ultimately the airline position is

self-defeating because if an airport owner cannot renew infrastructure, airlines stop flying; if airports cannot service finance to grow infrastructure capacity, airlines can't grow.

9.6.5 In WA many smaller Council-owned regional airports have never properly factored recovery of capital costs (let alone achievement of a real ROI after capital recovery) into their setting of airport fees and charges. Hence, in many WA regional and rural centres, *under* recovery of capital costs of airports is actually the real problem to be solved.

10.2 There are hundreds of rural regional airports across Australia. In the absence of definition, the draft report appears to adopt a broad-brush position, grouping them all together into a homogeneous class of airports that loosely includes everything other than the major airports to which the pricing principles currently apply. That seems inappropriate.

10.8 For regional airport owners that are obliged by geographic circumstance and population settlement patterns to run airports as essential service assets, incurring real economic loss in operations because of inability to recover full costs, the Pricing Principles do already have a useful guiding purpose. They provide a conservative way to calculate the value of the Community Service Obligation implicit in under-recovery of capital costs through airport fees and charges. Such information might be legitimately included in applications for grant funding from other spheres of Government, as evidence of extent of market failure in air services delivery to remote regional communities.

11.3 Over-regulation impairs markets. That needs to be avoided. Existing ACCC powers already exist and should already be adequate to enable airlines or airport owners to seek redress where one offends the market rights of the other?

1.2 Further Studies of Regional Airports

The City of Greater Geraldton, as owner/operator of Geraldton Airport, wishes to be engaged as a stakeholder in any further examination of the operation of regional airports, by the Productivity Commission.

2. Introduction

2.1 The City of Greater Geraldton has examined the draft report released by the Productivity Commission in August 2011, inviting further public consultation, with a deadline for input by 23 September 2011.

2.2 As owner and operator of the Geraldton Airport, the City offers the following information and views in response to section 13.1 of the draft report which briefly addresses the matter of conduct of rural and regional airports and in which (at page 296 of the draft report) the Commission:

- Seeks information on the potential costs and benefits of extending the Pricing Principles to regional airports; and
- Poses the questions of -
 - How might the principles be applied?
 - Is the problem of sufficient magnitude to warrant any potential enforcement mechanisms?

3. Background: Geraldton Airport

3.1 Geraldton Airport was built as an airfield pre-World War II. The Geraldton Airport was used extensively during WW2 principally for training purposes and as an armament supply base. The Airport was well developed with a network of taxiways, runways, aprons and an extensive number of hangars and barracks. No. 4 Service Flying Training School was formed in 1941, and the Allied Works Council created a range of buildings to accommodate the training school, pilots, trainee pilots, observers, wireless air gunners, and aircraft support personnel. In 1947, unwanted buildings and equipment were auctioned by the Commonwealth, so most WW2 buildings were removed, and the airport reverted to on-going use as a civil airport, owned and operated by the Commonwealth.

3.2 The Commonwealth transferred the airport to the Shire of Greenough under the Aerodrome Local Ownership Plan (ALOP), under which the Commonwealth continued to contribute part capital and maintenance funding for its continued operation.

3.3 In 1990 the Commonwealth Government announced plans to discontinue operation of the ALOP. With cessation of ALOP arrangements effective as at 30 June 1991 freehold ownership of the airport land passed to the Shire, and the Commonwealth ceased having ownership, or having any fixed responsibility for funding contributions or for sharing of net operating surpluses from airport operations.

3.4 As part of the ALOP windup, the Greenough Shire Council was provided a grant of \$180,000 to upgrade its airport facilities. Much of this was expended on resealing the main runway. From 1991, Greenough Council became solely responsible for the operation of the Geraldton Airport. As a result of amalgamation of the City of Geraldton and the Shire of Greenough, airport ownership passed to the newly created City of Geraldton-Greenough. Following amalgamation of the adjacent Shire of Mullewa with the City, the new City of Greater Geraldton was created on 1 July 2011 and now owns the Geraldton Airport.

3.5 The City has full freehold title over and has no residual obligations under the ALOP, except for the requirement to provide land areas as appropriate for use by Air Services Australia and the Bureau of Meteorology.

3.6 Since acquiring ownership of Geraldton Airport, the Council has made significant investments to upgrade infrastructure and facilities:

- In February 1999 Council expended \$2.04m on a variable thickness asphalt overlay of the main 1980 metre runway 03/21, taxiway and aprons. This raised the runway pavement rating PCN from 14 to 34 to allow unrestricted operations of B717-200, F100 and similar 100 seat jets. In aviation terms, the main runway is developed to Code 3C standard, but because the runway is 45 metres wide it is able to handle aircraft to Code 4C (e.g. B737/A320) under particular conditions.
- During the late 1990's planning commenced on a new terminal building, as the capacity of the existing Brearley Terminal built during Federal ownership was inadequate. The new Greenough Terminal Building was completed in July 2001. The old Brearley Terminal continues in use for GA and freight operations.
- Secondary runway 14/32 was reconstructed and asphalted in April 2006.
- Apron expansion comprising approximately 8,500m² of new work was undertaken in 2007.



Geraldton Airport – Runways and Apron Configuration 2011

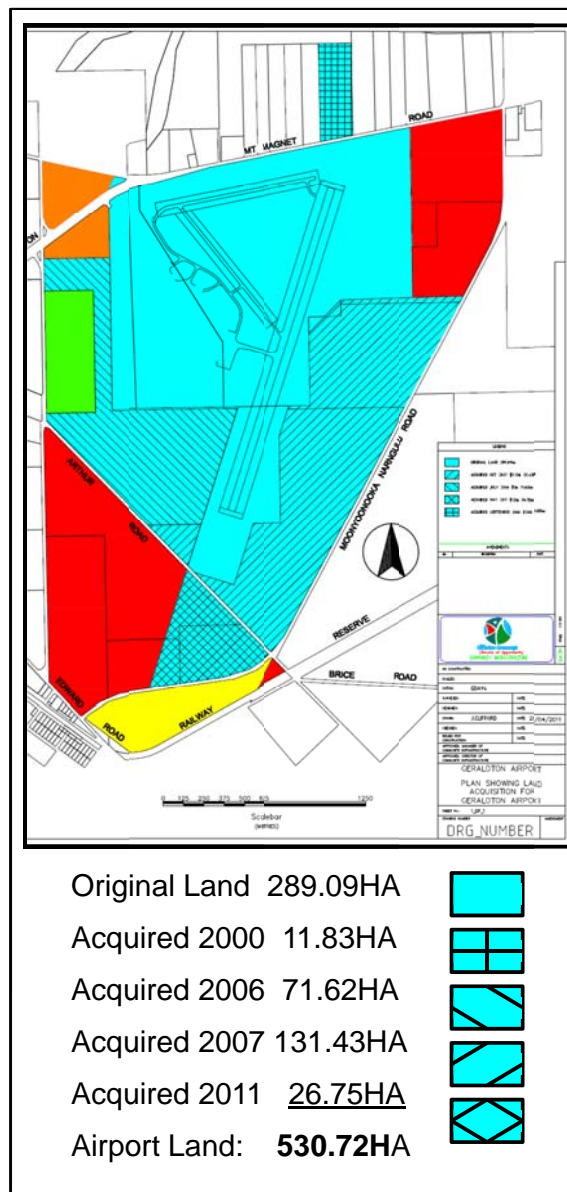


Geraldton Airport – passenger and baggage security screening facilities and terminal building extension for new secure departures lounge opened 2011

3.7 With funding assistance from State and Federal governments, the Greenough terminal building was expanded to enable construction of a new secure passenger departures lounge, and installation of passenger and checked bag security screening facilities during 2011 in readiness for deregulation of the Geraldton air service route, anticipated introduction of RPT jet aircraft, and to meet new Commonwealth standards for security screening under the Air Transport Security Regulations and Air Transport Security Act, to come into force in 2012 for aircraft under MTOW 20,000kg.

4. City Acquisition of Additional Land for Airport Needs

4.1 Since acquiring the Geraldton Airport from the Commonwealth, the Shire of Greenough and its successor airport owners, the City of Geraldton-Greenough and now the City of Greater Geraldton, have progressively acquired additional land to ensure availability of adequate land areas to meet the needs of future air-side and land-side airport development.



4.2 Most recently, the Council has acquired additional land to the south of the airport, to accommodate a planned new 2600 metre runway designed to meet future aviation needs. Since 2000, from a land area of 289 hectares as originally acquired from the Commonwealth, through additional land acquisitions the dedicated freehold area of the Airport has grown by an additional 241 hectares to now total about 531 hectares. These additional freehold land acquisitions have been funded by City Ratepayers.

5. The WA Intra-State Air Services Context & Geraldton

5.1 Geraldton Change from Regulated to De-regulated RPT Airport

5.1.1 The Commission will be aware that while the Commonwealth administers inter-State air services, in Western Australia the State Government regulates intra-State air passenger services. As of 1 July 2011, following a long review of passenger services and a related competitive process under which airlines were invited to submit bids for provision of RPT services, the State Government implemented new arrangements which effectively determine which RPT airlines may provide services through which regional airports in WA.

5.1.2 In effect, regional airports in WA are classified as either 'regulated' or 'de-regulated' and, in respect of airports that are deemed regulated the State Government determines which airlines will service the airports and – where appropriate – which services the State will subsidise to ensure provision of regular passenger services. For provision of regular air passenger services to some remote regional locations, in WA the subsidy arrangements remain essential for (amongst other) social policy reasons. In addition to regulation of RPT services, the State Government imposes particular regulations on the extent of Charter operations allowed through regulated airports, to ensure that economic viability of RPT services is not undermined.

5.1.3 Before July 2011, Geraldton Airport was 'regulated' with provision of RPT services confined to a single airline - Skywest. That airline thus had a State-bestowed RPT services monopoly in relation to Geraldton – but that licensed monopoly came with explicit obligations attached - to provide scheduled RPT services through other regulated regional airports including Kalbarri, Carnarvon and Exmouth on the coast and some inland centres which, on passenger demand numbers, would otherwise have required State subsidy to sustain viable scheduled RPT services. Skywest was also able to provide RPT services to unregulated airports further north, including Karratha and Port Hedland.

5.1.4 In essence, this model provided Skywest with the ability (through ticket pricing for different destination services) to leverage the Geraldton RPT monopoly, and route development to northern regional ports, to cross-subsidise provision of RPT services to lesser ports such as Exmouth, Carnarvon and Kalbarri in a small ports network, serviced utilising F50 aircraft. Effectively, in lieu of subsidies payable by the State to ensure regular scheduled services to these lesser ports, airfares on the monopoly Perth-Geraldton RPT service and on services to northern ports, tended to cross-subsidise to an extent the airfares for Exmouth, Carnarvon and Kalbarri passengers. Relatively high Perth-Geraldton airfares resulted.

5.1.5 Declaring interest - the City participates in the Coral Coast tourism development group of Councils, covering the tourist destination strip from Exmouth south to Dongara on the WA Coast. Kalbarri and the Murchison Gorge are within daytrip driving distance of Geraldton, and some years ago the City entered into an arrangement with the Shire of Northampton to jointly develop the small Kalbarri Airport. The City is a 50% owner of the Kalbarri Airport.

5.1.6 Through the State Air Services Review process, the City argued strongly that the cross-subsidy model was inappropriate, and that any regional location requiring subsidy to ensure provision of scheduled RPT services (for Federal or State social policy reasons) should have that subsidy paid by the Federal and/or State Governments to an RPT services provider selected via a transparent competitive process as a visible community service obligation – and should not be achieved via cross-subsidies hidden in the fares structure of RPT passengers flying to other destinations.

5.1.7 The City argued strongly for:

- deregulation of Geraldton Airport, allowing competition by multiple RPT carriers, to drive setting of air fares through open market competition; and
- introduction of new regulated RPT arrangements, with direct State subsidy paid to a competitively appointed carrier or carriers, to ensure continued provision of scheduled services to smaller airports, particularly to Kalbarri and Carnarvon.

5.1.8 In the event, after receiving public and stakeholder submissions, reaching an initial view on proposed new WA RPT services arrangements, then inviting and considering final submissions from airlines, the State Government introduced new RPT services arrangements for regional airports effective from 1 July 2011. Relevant to Geraldton, these include:

- deregulation of the City-owned Geraldton Airport, allowing open competition between airlines for RPT services;
- partial deregulation of Commonwealth-owned Exmouth airport for RPT services, with Qantas (or one of its subsets, most likely QantasLink) now licensed to compete with Skywest; and
- introduction of new RPT service arrangements for near-north coastal centres, including Kalbarri, by a single carrier – Skippers Aviation.

5.1.9 Until 30 June 2011, Skywest Airlines had a monopoly license to provide RPT services to/through Geraldton. From 1 July 2011, that license expired. Skywest has continued to provide its scheduled RPT services, enhancing its F50 turbo-prop services with F100 Jet services – including a weekly service to Bali via Port Hedland – so Mid-West residents can now fly to South East Asia, without having to go via Perth. Skippers Aviation has established presence in the terminal, and commenced services through

Geraldton. QantasLink will commence 12 weekly services through Geraldton utilising new 75 seat Q400 aircraft in November 2011 adding capacity of 900 seats per week to the Perth-Geraldton route.

5.2 How is this relevant to the Commission's work?

5.2.1 It is important that the Commission understands and takes into account the imposition of another tier of regulation on regional airports by State Governments, via their responsibilities to regulate intra-state air services. The City cannot offer observations in regard to how this impacts regional airports in other States but, in the case of WA, as illustrated above, the State regulatory framework acts to constrain the freedoms of both Airport Owners, and Airlines. Capital City and other major airports operate primarily under the Commonwealth regulatory framework. In WA, regional airports also operate under State regulation, and it is assumed similar arrangements apply in other States.

5.2.2 In WA, air services reviews are generally conducted on a 5 year cycle, although the most recent review period was protracted. Designation of an airport in WA as 'regulated' or 'deregulated' can significantly alter the planning parameters of an airport. Unless a regional airport in WA is designated under such an air services review by the State Government as being 'deregulated' *and can confidently forecast that it will remain 'deregulated'* it cannot plan, for example, for the operational presence of multiple RPT airlines –and that obviously impacts how it plans for future apron space, terminal facilities, infrastructure for likely future aircraft types of multiple competing airlines, and so on. Given long planning and delivery lead times and the long operational lives of essential aviation infrastructure, the need to operate within a 5 year intra-state air services review cycle can present challenges, and the more so, the smaller the population centre and its airport.

5.2.3 This should *not be taken as criticism* by the City of the WA regulatory framework for intra-state air services. The City is conscious of the social and economic policy imperatives confronting the WA State Government, recognising both the unique size and geography of the State relative to other States, and the emerging trends of State economic development and population settlement patterns. On the basis of its own comprehensive economic development and population forecast modelling, and real data showing a consistent 5+% growth in passenger numbers over the past 5 years, the City is confident that Geraldton Airport will remain a 'deregulated' airport into the future, in WA State Government terms, and can now plan accordingly across longer time horizons.

5.3 What did being a State-Regulated Airport Mean?

5.3.1 Being a State-regulated airport, with a single licensed-monopoly RPT services provider that demonstrated perhaps less than maximum possible effort to promote and grow the Geraldton route or near-region network, effectively left Geraldton airport in limbo. Absence of RPT services competition, and cross subsidy of small passenger load ports in the near region meant high air fares. Within a four hour drive of metro Perth, enabling substitution between transport modes, high air fares dampened growth of air services demand. From the City perspective, Airlines seemed more interested in capturing mid-west and north-west FIFO charter market share, to maximise utility of their aircraft, than necessarily giving first priority to building the Mid West regional WA RPT

market. Their commercial imperatives are understood, so that observation is not necessarily meant as a criticism.

5.3.2 Being a regulated port had a serious negative influence on the way that both the City and the Airlines viewed the airport. In 2007, a Geraldton Airport Master Plan update gave development priority to a new 800m runway parallel to the main runway, for relatively static levels of <5000Kg GA operations, plus a new short runway for potential new pilot training operations – despite the obvious small aircraft training circuit noise impacts on nearby urban areas. It was a plan that reflected a degree of frustration with the absence of RPT services diversity or growth and it failed to adequately reflect strong strategic economic growth and population trends emerging since 2005. By default, regional GA users dominated the consultation processes of the master plan review, in the absence of overt RPT Airline interest and active participation in planning for longer term strategic development of the airport. There was little interest from Airlines other than the then licensed monopoly provider, other Airlines ignoring the potential for their own future operations through the airport. That highlights an inherent flaw in allowing licensed monopoly arrangements for RPT services at growing regional airports to operate over long time periods.

5.3.3 Fortunately, the City did not commit funding for the GA-only developments foreshadowed in the 2007 master plan, realising that strategic development needed to focus on longer term future RPT and large aircraft charter services for the rapidly expanding regional economy. By 2008-9, the City had commenced an aggressive campaign to achieve State deregulation of Geraldton Airport. Had deregulation not occurred, it is possible that Geraldton Airport planning focus would have remained (by default) on regional GA activities – with Airlines consequently stuck with an aged Code 3C runway (despite consistent 5+% annual RPT passenger growth) incapable of supporting significant growth and the related introduction of more economic larger modern aircraft on the route. The City would have been unable to fund a Code 4C enhancement of the existing main runway, let alone develop a new and longer 2600m Code 4E strip - on top of the capital costs of new GA-specific runways that would *never* have delivered a positive return on investment.

5.3.4 The lesson from this is that while some Airlines claim they are not sufficiently informed and consulted on master planning of major city airports, *for smaller regional RPT airports such as Geraldton the opposite problem applies* – in past years they have declined the opportunity to become actively engaged in the process. Disinterest perhaps best characterises their posture, unless they have a short-term commercial imperative associated with a particular airport.

5.3.5 Now that Geraldton is deregulated, with competition between RPT airlines for provision of services through the port with QantasLink entering the Geraldton market in November 2011, the City anticipates a change in level of interest of Airlines in master planning of Geraldton airport. The City also anticipates greater interest from domestic airlines because international airlines out of South East Asia and the Middle East are now exploring use of Geraldton as their first alternate to Perth airport – to achieve operational economy benefits by not having to carry fuel loads (up to 10 tonnes extra in some cases) to enable them to reach the current designated bad weather or emergency Perth alternates of Kalgoorlie or Adelaide. Geraldton has the particular advantage of

having an established international seaport, with Customs and other gateway agencies already established in the city. That some of the interested airlines are international LCCs will perhaps excite the interest of Australian airlines in due course.

5.4 Key Points – Need to Categorise Regional Airports?

5.4.1 The descriptor ‘regional and rural airports’ is simply too broad for the purposes of its mention in the draft report. Issues of location, airport capacity, scale of aircraft and passenger movements, whether aviation activity levels can support just GA providers, or regional RPT airlines, or the major airlines, the aircraft types and scheduled seating capacity utilised to service the airports, whether they are dominated by RPT or Charter/FIFO services – these and other factors may assist in classifying or stratifying regional and rural airports in a manner that can enable some focus in examining the issues outlined by the Commission at page 296 of the draft report.

5.4.2 What are the proven misuses of market power by ALL regional and rural airports, as alleged by airlines? What facts have been provided in response by the airports in question, and underlying issues identified by the airports? In which categories of regional and rural airports is there corroborated evidence of a particular malaise warranting examination? Is it a widespread ‘problem’ across the full spectrum of rural and regional airports? Are the problems associated with airports with 10-15,000 passengers per year, or 50-100,000 passengers per year, or 300-500,000+ per year? The City challenges the assertion that problems alleged by airlines are of sufficient magnitude and scope to warrant consideration of across-the-board application of any pricing principles enforcement regime embracing all rural and regional airports in Australia.

5.4.3 In its final report, the Commission may care to explore the unique arrangements that apply across the various States and Territories in relation to the regulation of Intra-State regular passenger services, including ‘licensed monopoly’ advantages bestowed on particular airlines for services to particular regulated regional and rural airports, rationales for such monopoly services, the levels and distribution of State-subsidised air services, the competitive processes applied by States in setting these arrangements - and the associated constraints such arrangements impose on the regional and rural airport owners in relation to airport planning, entering commercial agreements etc.

6. Regional Airports and Different Funding Models

6.1 Council-Owned Airports & Different Funding Models

6.1.1 The Commission might note that, different from privately leased/owned major city airports, which are dependent on either private equity or commercial loan funding for infrastructure development and, different from privately held regional airports (such as those built and owned by mining companies for FIFO traffic for their own mine sites), many airports owned by WA Local Governments utilise very different funding models, with different sources and costs of capital.

6.1.2 States such as Victoria have Local Government legislation that makes provision for establishment by Councils of independent legal entities, wholly owned by Council, or

allowing equity partnerships, but created as separate corporations for the purposes of operation of commercial trading enterprises, such as airports. That offers some very distinct advantages as, amongst other things, it:

- offers potential to separate significant risk from the Local Government and its ratepayers;
- enables access to (and imposes the constraints associated with) funding streams other than ratepayer-provided funds or rates-guaranteed loan funds, making airport investment decisions more dependent on bankable feasibility studies applying full commercial disciplines;
- allows appointment of Boards of Directors at arms-length from elected Councillors and the Council, with Corporations Law obligations;
- enables a majority of Board members to be selected on the explicit bases of aviation industry expertise and relevant commercial skills and business acumen;
- prevents undesirable local political interference in management of airport operations;
- requires transparent funding to the airport entity by Council of costs to the airport of any community service obligations associated with Council-determined social, economic or environmental objectives that would not otherwise be pursued as core business by a commercial airport entity and/or its service airlines (thus removing hidden subsidy/cross-subsidy effects and distortions in resource allocation or pricing decisions).

6.1.3 Unfortunately, unlike other States, the WA Local Government Act does not (yet) make provision for Councils to create separate legal entities for conduct of commercial trading enterprises. (The WA Nationals are currently endeavouring to address this constraint on Councils via a private member's Bill recently introduced in the State Legislative Council, but despite strong advocacy by the WA Local Government Association and by Cities, it is unclear how the major Parties will respond to this Bill).

6.1.4 In addition to the points above, there are tensions between several aspects of this statutory constraint worthy of deliberation:

- It tends to *confine* access by Councils (for airport purposes) to capital loan funding sources permitted to Local Governments by the State Government – and in the case of WA that means within the 'guidelines' of maximum permitted loan obligations defined in a ratio relationship with the Rates Base purported to represent capacity of a Council to meet debt servicing obligations as a going concern – but obviously unrelated to the discrete commercial capacity of a particular airport as an entity to service capital (whether it be equity or debt). The City currently negotiates and obtains its loan facilities via State Treasury, rather than in the capital market.
- It *enables* access to debt capital for airport development with costs of capital reflecting the credit ratings of the State and the Local Government, 'guaranteed' by the Rates base in the first instance – with an inherent potential distortion effect on cost of capital (relative to credit rating of an airport as a discrete commercial entity).
- Within a Council, it creates competition for application of State-constrained available loan funds between airport purposes, and other essential hard and soft infrastructures that are the traditional *core business* of Local Governments – for example roads, drainage, parks and sporting facilities, waste management facilities etc. – and this has a significant

influence on the timing of airport infrastructure investments, regardless of aviation trends and needs.

- It exacerbates tensions between capital programming priorities at a Regional versus City level for Regional services hubs, such as Geraldton, because its airport is an essential regional infrastructure asset, not merely a City asset.
- For major investments like new runways, it effectively *obliges* medium sized regional Councils such as Geraldton in WA which owns an airport with only 105,000 passenger movements per year (in contrast with other regional Councils with higher throughput volume airports such as Kalgoorlie or Karratha, which have significant annual aircraft and RPT + FIFO passenger movement numbers) with constrained access to loan capital, *to rely almost exclusively on support from Federal and/or State Government capital funding Grant programs*, for any significant investment in aviation infrastructure – else the investment simply does not happen. In turn (given the annual grant process timing cycles, and fierce competition across Councils for shares of the limited capital grants cake) that severely limits the ability of any WA Council-owned airport as an entity to plan the timing of development of aviation infrastructure in alignment with aviation demand trends, or integrating the planning needs/desires of airlines.

6.2 Key Point – Different Funding Capacities and Models

6.2.1 Clear distinctions need to be made between the legal entity and ownership models, the commercial business models, and the financing models relevant to major Tier 1 and Tier 2 airports to which the Pricing Principles currently apply, and the very different circumstances that characterise smaller regional airports in WA.

6.3 State and Federal Funding for Regional Airports

6.3.1 The WA State Government provides regional centres with significant funding support through grants from its Regional Airports Development Scheme (RADS) and – if identified as a high priority flagship initiative by one of the regional Development Commissions – through capital grants that may be available under the State Government Royalties for Regions program.

6.3.2 For example, under its recently released Mid West Investment Plan, the Mid West Development Commission has designated important Geraldton Airport developments including a new 2600m runway amongst its flagship programs across the coming 5 years. The new runway project, to create a new Code 4E runway for B787/A330 class aircraft to replace the existing Code 3C-developed current runway, has a raw strip-only cost estimate around \$50M and, with associated taxiway and apron developments, is likely to cost \$60+M.

6.3.3 This presents real financing challenges for a regional City with:

- a current population of 40,000 but forecast to reach 80-100,000 by 2030,
- a current Rates base of only \$25M, and aggregate current annual City budget (including Federal and State general purpose grants, roads grants etc.) turnover of around \$70M, and

- annual airport passenger movements forecast on a conservative actual-movements trend to grow from 105,000 in 2010-11 to around 220,000 by 2030 – an estimate that does not reflect high-case economic and population growth forecasts.

6.3.4 The City will depend in significant part on funding assistance from Federal and State programs to deliver this new airport capacity, seen as being an essential regional infrastructure investment to meet anticipated Mid West regional growth needs.

6.3.5 Page 290 of the draft report identifies some of the Federal funding programs relevant to regional airports, and particularly remote area airports. It is worth highlighting that there is *a very large number of Local Governments across Australia*. Councils are genuinely grateful for every dollar they receive from the Federal Government. However, in the context of the large number of Councils with rural and regional airports across the nation, mention (at report page 291) of \$2B in untied funding to Councils and “..some of the separate \$1B of local community infrastructure funding to airport-related projects..” gives a misleading impression that the Commonwealth is a major funds provider to rural and regional airports on an ongoing basis. Untied funding, and community infrastructure funding from the Commonwealth, tends to be applied by the hundreds of rural and regional Councils across Australia for provision of core-business local government infrastructure – roads, drainage, waste management, parks and community amenities – with very few if any Councils able to regularly apply these funds to their airports.

6.3.6 Apart from function-specific programs (such as those managed by the Office of Transport Security, providing grants for the costs of security screening equipment for regional airports), Councils can seek infrastructure development grants through RDA. Through any program cycle however, the Federal Government determines areas of focus and relative priorities for RDA and other infrastructure grants, and rural and regional airports tend *not* to rank highly in grants awarded.

6.3.7 RDA grant patterns reflect a unique Canberra view of the ‘regions’ where the Perth metro area is apparently seen as being a ‘regional centre’, attracting a very high proportion of RDA grants awarded to WA – with only a very small proportion of the most recent RDA grants in both number and dollar terms getting to non-metro regional centres in WA. That is a continuing source of frustration to WA non-metro regional Councils.

6.3.8 The reality is that the Commonwealth largely opted out of funding regional and rural airports over twenty years ago in 1990-93 when it ended the transitional ALOP scheme to divest its regional airports to Council freehold ownership. A proportion of them have subsequently been sold to private owners, and (per report page 291) the number of regional airports with RPT services has about halved in the intervening years.

6.3.9 Of the remainder, a small minority have inter-state RPT services, the overwhelming majority providing only intra-state services and the trend continues for decline in intra-region services, with consolidation to State capital connection routes. Local GA operators fill the gaps where RPT carriers no longer care to fly.

6.3.9 While the Commonwealth may have an overarching responsibility for airspace and aviation operations, safety and security regulation, and regulation of international and inter-state RPT operations, they do not regulate intra-state air services or determine which airlines may or may not service regional airports, those matters being the province of the States.

6.4 The 'Commonwealth-Paid Sunk Costs' Proposition

6.4.1 Some elements of the aviation industry live in the past, still lamenting passing of the good old days when airports were Commonwealth managed and airport fees were modest, based on partial recovery of cash-based recurrent costs, with capital investment in infrastructure like runways regarded as a sunk cost, a public good. In recent informal dialogue with some airline and GA representatives they suggested that since the City gained the original runway and taxiway infrastructure "free" from the Commonwealth via the ALOP, and thus did not fund the construction of these structures, with the City only funding subsequent pavement reinforcement and wearing surface works, then the City ought to regard the value of the runway for depreciation expense and cost recovery purposes as *just the cost of the subsequent works funded by the City*. Paraphrased, it was earnestly suggested that the City should:

- exclude any residual asset value at the time of airport ownership transfer from the Commonwealth, that value being deemed a non-recoverable 'sunk cost';
- ignore for the purposes of runway asset valuation the significant extension of the working life of *the original structure* as a consequence of the major pavement enhancement undertaken by the City; and
- ignore the significant *changed capacity* of the original asset, from increasing runway PCN rating from 14 to 34.

6.4.2 This is mentioned to illustrate the thinking of some airline and GA representatives. The City rejects such propositions as inappropriate 1950s thinking. The City applies full lifecycle costing to infrastructure assets, and advocates support of cost-reflective pricing principles associated with infrastructure services.

6.5 Key Point – Past Commonwealth Sunk Costs

6.5.1 The City strongly opposes propositions from airlines and GA operators that airport air-side infrastructure asset valuations utilised in determining airport fees and charges should exclude the capital value of assets at the time airports were transferred under the ALOP from the Commonwealth to Council ownership. The principles of full cost-reflective pricing should apply.

7. Security Screening at Regional Airports

7.1 Security Screening - General

7.1.1 The number of regional airports likely to continue with RPT services, once Federal requirements to apply security screening obligations to aircraft other than RPT jet aircraft, extending security screening requirements to aircraft under the current bottom MTOW limit of 20 tonnes, may fall further without Federal funding of security facilities, and extension of State (or new Federal) subsidies to continue RPT services.

7.1.2 Capital cost of screening equipment is not the only issue for smaller airports. The recurrent operating costs are also significant, with costs of maintaining the sophisticated

equipment in remote locations, and labour costs of providing the security screening services, particularly given onerous OTS requirements for mandatory minimum numbers of trained and certified security screening personnel. In the context of small volumes of passengers at many regional/rural airports the operating costs alone drive relatively high per-passenger security fees required to recover those costs.

7.2 Key Point- Security Screening Charges

7.2.1 General principle - Security screening charges should be passenger user-pays charges, not subsidised from public funds (Council rates revenues, or Federal or State funds). Unfortunately, security screening charges will inevitably be reflected in airfares, potentially deflating demand and adversely impacting viability of some RPT services at some smaller ports. Where market failure can be demonstrated in regard to commercially viable provision of essential regular transport services to a particular centre, then subsidy may become justifiable as a community service obligation.

7.3 Security Screening at Geraldton

7.3.1 In the specific case of Geraldton Airport, in 2010-11 the City received:

- Grant funding from the State RADS program, as a contribution towards the capital costs of extending the main terminal to accommodate the checked baggage screening equipment, and to create a new secure departures lounge; and
- Grant funding from programs administered through the Office of Transport Security, to cover the capital acquisition costs of the security screening equipment.

7.3.2 Hence the City did not have to provide all of the funds necessary upfront for the essential building extension and screening equipment investments, to be ready for RPT Jet aircraft under current Federal screening regulations, and the extension of screening obligations to RPT aircraft under 20 tonnes MTOW in 2012. Without the grants, security compliance with 2012 requirements would have been very difficult.

7.3.3 While they generously contributed to assist the City meet capital costs of initial implementation of the new passenger and baggage security screening requirements, the City cannot realistically expect the Federal or State Governments to provide maintenance, upgrade and asset renewal funding for the technologically complex screening equipment, or funding for maintenance costs for the extended terminal building. Hence depreciation costs of the new assets will need to be included in determination of general passenger fees and charges, to establish asset renewal/ replacement capacity, and will be reflected in determination of the annual operating result for the airport.

7.3.4 RPT Airlines cannot operate without compliant security screening equipment and operations at Airports. It is interesting to note that, in some airports in WA, Qantas is the designated Security Authority, rather than the Airport owner/manager. Separate from the Airport, Qantas (or their security service operations contractors) negotiate security fees with other airlines, to recover security services costs. Hence the security fees are not determined or levied as an Airport owner's fee. Because of advice to Geraldton from certain other Airports that the arrangement of having an Airline as the designated security authority creates difficulties for Airport managers, particularly with instances of failure to advise Airport management on a timely basis of security incidents occurring within their airport, a different approach was taken at Geraldton Airport. The Airport is the designated security authority,

not an airline. Rather than the airport employing additional staff to operate the screening services, public tenders were called for provision of qualified personnel and day-to-day operation of the baggage and passenger security screening services.

7.3.5 In the event, for Geraldton Airport, Skywest won the tender process and, in relation to the provision of security screening services to other airlines, Skywest recovers the fees (to cover their security screening operating costs) directly from other airlines. Much the same way as this occurs at airports where Qantas is the provider, and Skywest pays security fees to them. But Skywest is accountable as a contracted service provider to the Airport Manager for effective operation of the security screening services.

7.3.6 There are bound to be variations on Screening Authority models across the national spectrum of large City airports through large-to-small regional airports with RPT services, each with its own costs/benefits profile, and its own price-setting approach. A useful study might embrace comparison of how security screening charges are set and subsequently reflected in airfares, when negotiated airline-to-airline, or airport owner/operator to airline.

8. Councils Generating Airport Profits to Fund Other Council Programs?

8.1 Legitimate Business of Councils to Operate Trading Enterprises

8.1.1 As a basic proposition, the City argues that it is perfectly legitimate for a Council to operate a commercial enterprise to generate a surplus that can provide a source of funding for other Council programs. Doing so relieves some of the funding burden on ratepayers for general programs or new initiatives.

8.1.2 It is not clear from the draft report whether Airlines have complained about the fundamental right of Councils as airport owners to run them as profit-making trading enterprises, or whether the concern of Airlines is legitimately confined to the potential for a Council to abuse a monopoly power to achieve excessive profits, to fund other Council programs. The City would strongly object to any proposition by any airline that it ought to run Geraldton Airport other than as a commercial profit-generating trading enterprise delivering a real economic ROI.

8.1.3 Current City of Greater Geraldton Council policies do not require a 'dividend' to the City from the aviation operations of the airport. At this stage in its development, confronted with need to fund significant new infrastructure, the whole annual operating surplus from aviation operations is transferred to an Airport Reserve, for the purposes of funding ongoing development of airport aviation infrastructure and facilities. No aviation-related revenues from the operations of Geraldton Airport are applied to fund any other City programs. However, noting the substantial investments by the City in acquisition of additional land to future-proof the airport, the Council legitimately reserves the right to deploy funds as it sees fit, from surpluses derived from any ancillary non-aviation activities within its airport precinct, for example, the leasing out of land-side areas to commercial non-aviation businesses.

8.2 Key Points – Airports are Legitimate Trading Enterprises

8.2.1 The City would strongly object to any proposition by any airline that it ought to run Geraldton Airport other than as a commercial trading enterprise delivering a real economic ROI.

8.2.2. No aviation-related revenues from the operations of Geraldton Airport are applied to fund any other City programs, and aviation-related surpluses are devoted exclusively to continuing development of Geraldton Airport.

9. Airline Concerns about Regional Airports

9.0.1 The draft report makes reference to complaints by several Airlines about the conduct of some regional Airports in allegedly misusing market power, and it notes the aspiration of some airlines to impose similar solutions as are currently imposed on major city airports. The following observations address particular issues raised in section 13.1, but also cover some of the issues complained about by Airlines in relation to major City airports which (by inference) it appears the airlines suggest also apply to some rural and regional airports.

9.1 Asset Valuations

9.1.1 The issue of relating pricing to asset valuations, and the question of asset revaluations giving rise to allegedly unjustified increases in prices of airport services and over-recovery of investment, is challenging, in the context of the unique ‘line in the sand’ approach currently applied under the pricing principles protocol to major city airports which – Sydney excepted – are Commonwealth-owned leased airports. The protocol currently prevents upward asset revaluations flowing through into higher service pricing assessments. In relation to the major price monitored airports, this is significant in the context of 5+ year negotiated commercial agreements on services and pricing between airports and airlines.

9.1.2 The line-in-the-sand approach raises the fundamental question of jurisdiction over Accounting Standards with which corporations (and Local Governments) must comply. It ought to be legitimate for an entity to undertake periodic valuation of assets in accordance with generally accepted accounting principles and practices, and in compliance with international and national Accounting Standards, and to then utilise the resulting asset values (which may include *reduced* not just increased asset dollar values, and may also include increases or decreases to assessed residual economic working lives of assets) in the accounting determination of amortisation or depreciation expenses as appropriate, and in the determination of prices for goods and services.

9.1.3 To the extent that any ‘line in the sand’ protocol constrains the ability of a corporation to price its goods and services to generate sufficient revenue to maintain the economic productive capacity of its production assets, and generate a reasonable return on investment (which by definition should mean pricing short of abuse of monopoly power), then it is arguable that that protocol should be open to challenge.

9.1.4 In the case of airports owned by Local Governments, the Commission might note the mandatory compliance obligations under Local Government legislation in the various States as to application of Accounting Standards, including those relating to valuation of assets and depreciation.

9.2 Key Point – Asset Valuations

9.2.1 To the extent that the Productivity Commission, or Airlines, or indeed the ACCC may hold any view that generally accepted accounting principles and practices and/or current Accounting Standards do not appropriately deal with Airport asset valuations generally, or with airport asset valuations by Local Governments that own airports, then the Commission or Airlines or the ACCC perhaps ought to make submissions to the national Accounting Standards body, which has proper jurisdiction over the Standards. Any examination of the issue must include consultation with Treasuries and the Auditors-General of the States in which Local Governments own airports, and in respect of which their compliance with Accounting Standards is mandatory under State Local Government legislation.

9.2.2 The City of Greater Geraldton has a simple position on this matter. It will undertake periodic technical assessments of the residual economic working lives of its assets, and will commission independent reviews of the fair accounting value of its assets by independent licenced valuation professionals, in accordance with the Accounting Standards, and in compliance with its mandatory statutory compliance obligations as a Local Government in WA. *Non-compliance is not an option.* Airport infrastructure asset valuations so assessed will be utilised as the basis for business planning, including setting of fees and charges for the Airport by the City. Importantly in this context – see the next section that addresses the matter of constraints – under WA Local Government legislation – on ability of Councils to enter long term commercial agreements.

9.3 Constraints on Commercial Agreements: WA Council-Owned Airports.

9.3.1 The Commission might note that Local Governments have particular constraints in relation to setting of fees and charges across multiple years. In particular this is relevant in WA, where the Local Government Act currently makes no provision for creation by Councils of separate legal corporations to undertake commercial enterprises and, as part of the business of such enterprises, to set prices (fees and charges) separate from the statutory powers of the Council.

9.3.2 In the absence of such a provision in WA, fees and charges for Council owned airports must be determined *each year* through the annual Council Budget process. There is no other statutory head of power under which Local Government fees and charges may be determined in WA. Further, Local Government legislation in WA does not allow a Council in one year to make a determination that imposes a budget decision such as a rate or fee or charge on the Budget of a future year, or pre-commits such a budget determination by a future Council. Councils in WA under new arrangements have to plan finances out 10 years, and most large Councils already run detailed forward estimates out at least five years – but the process of striking Rates and setting fees and charges is an annual legislated process.

9.4 Key Point – WA Councils & Commercial Agreements

9.4.1 For a WA Council that owns an airport to put in place a multi-year commercial agreement with airlines, within the limits of the current Local Government Act, such an agreement would be confined to identifying the bases/mechanisms under which future pricing may be determined by Council in future – but it cannot specify the actual fees and charges that will apply in future years. This constrains the scope of possible agreements.

9.4.2 At this stage, no RPT airline has approached the City seeking to negotiate a multi-year commercial agreement however the City anticipates that QantasLink may do so in the near term. In principle, this City has no objection to the approach of having negotiated commercial agreements with airlines, covering a sensible forward estimates period, but (in the absence in WA of a statutory power to create a separate legal entity with power to determine fees and charges for an airport, separate from the powers of Council) the airlines need to understand the statutory limits relevant to airports owned by Local Governments in WA.

9.5 Flexible Fee Setting.

9.5.1 In relation to volume-based fee reduction incentives, to encourage airlines to undertake route and destination promotion and development, generating passenger growth, the basic business axiom of risk following the profit should apply. Airlines pursuing their own interests will always argue for fee reduction, assuming never-ending and stable-trend passenger number growth, and will always advocate an associated fixed return model for airport owners reflecting a tightly constrained ROI model. Ultimately the airline position is self-defeating because if an airport owner cannot renew infrastructure, airlines stop flying; if airports cannot service finance to grow infrastructure capacity, airlines can't grow.

9.5.2 In simplistic model terms, the airlines argue that from a (100PAX@\$10Fees=\$1000) base, growing to (200@\$5=\$1000) still gives the airport owner the \$1000 to deliver necessary ROI, and getting to 200 passengers should deliver the airline the whole \$5 extra margin per passenger, with nothing of the \$5 for the airport. They see no justification for any share of the \$5 going to the airport, ignoring doubling of wear and tear costs on the on-airport roads, car parks, terminal and related passenger facilities, common-use areas etc. Their arguments are self-serving and ignore airport cost drivers associated with passenger throughput.

9.5.3 While always advocating the fee reduction model in their self-interest, Airlines never willingly entertain an airport owner argument that a down-shift in passenger numbers requires a per-seat *increase* in fees (e.g. 50@\$20=\$1000 using the illustrative model), the airlines effectively wishing to pass all risks of air travel market volatility, including all risk of consequent under-recovery of aviation infrastructure costs, onto the airport owner.

9.5.4 If airlines want all the profit in up-times, and want airports to invest in the airport infrastructure necessary to create capacity to enable airlines to benefit from the up-times, then they must also be prepared to accept a share of the fiscal risk in the down-times. Yes, it is difficult, but an airline can nearly always pay out of an aircraft lease, or pay to defer delivery of an additional aircraft. Such practices are a standard part of the aviation industry and are factored into their industry risk models – and they prudently hedge those risks. In sharp contrast, an airport owner cannot pay its way out of the commitment of a new runway or new aprons, *once they have been built* (with investment justification based on the forward estimate/promise of airline passenger growth).

9.5.5 It may be prudent business practise in that context – and perhaps more so in the light of the hard stance of Airlines opposed to accepting any share of the risks to airport owners of passenger movement downturns – for Airport owners to adopt Low-case movement estimates in feasibility studies for major new airport infrastructure, and in their longer range view of per-passenger fees required to recover capital and generate ROI. Low-case future

passenger number estimates help mitigate the risks of future aviation activity downturns, at investment commitment/timing decision stages.

9.5.6 The behaviour of airlines in the way that they endeavour to exert their market power inevitably influences the behaviour of Airport owners and managers. The larger the airline, and the smaller the airport, the more potential there is for overbearing negotiation tactics to be brought to bear by the airline, as if to intimidate the airport owner into submission. Some airline representatives are not particularly interested in negotiation. Confronted with an adversarial approach from some airline representatives, it's little wonder that the resolve of some small airport owners hardens against agreeing to growth thresholds at which they might consider changes in fee structures, and instead adopting non-flexible pricing levels that do not allow lower charges when significant passenger growth occurs.

9.5.7 Regional airport owners understand there is mutual benefit from growing and maintaining higher passenger numbers, but the attempted projection of market power by some airlines towards smaller regional ports in relation to fees has real potential to result in airport owners becoming exasperated by the lack of respect and courtesy from airline negotiators – and adopting a hard line take-it-or-leave-it posture, *in self-defence*. Is this exercise of market power by the Airport owner? Hardly – with few other options, it's a legitimate response of small airports to the attempted assertion of vastly superior market power by some large airlines. Genuine negotiation might deliver different outcomes.

9.5.8 In the extreme, the tactics of some airline representatives with regional airport owners include attempted bluff on the matter of “allowed ROI”, or “prescribed ROI limit” - actually asserting a view that rural regional airports are *obliged* to apply the pricing principles model obligatory on price-monitored large City airports, regardless of operational realities. At best, the approach of such airline representatives towards regional airport owners might be described as disingenuous. At worst, based on the apparent presumption by some airlines that all airports deliberately over-recover capital and contrive pricing to achieve excessive commercial ROI, it reveals a sad ignorance (or perhaps sadder, a cynical manipulation) of the fiscal realities of operation of many regional and rural airports.

9.6 The Real Regional Problem: Over Recovery or Under Recovery?

9.6.1 Many regional and rural airport owners would like to set their fees and charges using the ‘pricing principles’ model applied by the major City airports, *but they dare not*, because the full recovery of capital and consequent passing on of full cost-reflective regional airport fees by RPT airlines would in too many cases make airfares unaffordable, damaging passenger demand – and potentially rendering an essential regional service unviable. Many regional Councils have little choice than to ***under-recover*** infrastructure capital costs of their regional and rural airports, to prevent their residents losing essential air transport services. In the non-metro rural regions, the affordability of airfares for local populations is a significant local economic and political issue, keenly understood by airport owners - and some airlines.

9.6.2 A fundamental reality is that runways, taxiways and aprons are costly capital investments, and they have similar structural working lives regardless of location. There are cost penalties in construction in many non-metro regions, making airport infrastructure more expensive to deliver. A regional airport owner with just 50-100,000 RPT passenger

movements a year has very different cost recovery and strategic risk management parameters than a City airport with 5,000,000 passenger movements a year, but with similar primary air-side infrastructure investments such as runways. Some airlines appear to have profound difficulty grasping the differences, even suggesting that regional fees-per-passenger should be benchmarked against Capital City airport fees. Little wonder that some regional airport owners simply walk away when airlines throw such propositions onto the negotiation table as their ambit claim.

9.6.3 For many smaller regional RPT airports owned by Councils, closer study might reveal that the real problem to be solved is not *over* recovery of capital on aviation infrastructure investments, through pricing of airport services. Rather, it is *under* recovery, and that inevitably leads to inability of owning Councils to fund even major refurbishment, let alone renewal/replacement of essential aviation infrastructure – and it effectively creates hidden subsidies for the airlines. Those in particular with aged WW2 airstrips that have not yet had major refurbishment have limited time remaining to address this emerging issue.

9.6.4 The realities of the nature of this problem were starkly demonstrated in past years with failure of Local and State Governments (pre AAS27/29 reforms) to properly include depreciation of infrastructure assets as an expense in determining rates, fees and charges – with inevitable need for substantial Federal Government funding assistance to renew essential urban infrastructures (like sewerage) in some older major Cities. The same themes still echo today in relation to utilities infrastructure, for instance electricity generation and transmission, with great residual difficulty in shifting communities towards full cost-reflective pricing. State Governments are confronted with potentially election-losing pressures over that non-trivial issue.

9.6.5 In WA many smaller Council-owned regional airports have never properly factored recovery of capital costs (let alone achievement of a real ROI after capital recovery) into their setting of airport fees and charges. Rather, in many cases airport charges are determined based on recurrent operating costs only and, over periods of years, these have only been adjusted annually by CPI. Many owning Councils have been keen to minimise the impact of airport charges on the level of airfares. For those Councils, any obligation to apply the Pricing Principles in setting airport charges therefore might be rejected. The only useful value for them would be to apply the pricing principles to determine the upper limit of potential charges, for comparison against charges determined under local political considerations, to enable calculation of the hidden subsidy – and the effective value of the unfunded asset renewal capacity. In many WA regional and rural centres, *under* recovery of capital costs of airports is the real problem to be solved.

9.7 Council Expertise

9.7.1 In observations by the Commission, there was reference to perceived lack of airport/airline expertise on the part of ‘generalist’ Local Government officers responsible for airports owned by rural and regional Councils. For some smaller, remote rural centres that observation might be valid, but as a generalisation across all rural and regional centres it is a patronising observation and an inaccurate assessment.

9.7.2 In respect of expertise, the Commission might note that many larger regional Councils that operate RPT airports – including Geraldton - employ experienced, professional airport managers, and utilise the services of specialist aviation industry consultants (including consultancy services provided by the operators of some major City airports) to undertake or assist in airport master plan development and business planning, and to advise on airline relationships and service pricing models. There is also an accelerating trend for larger regional Councils to employ executive staff with other than traditional Local Government backgrounds, emphasising commercial business management capabilities, and valuing the injection of major City business experience into their management teams.

9.8 Scale and Passenger Forecasts

The trend with major airports to which the Pricing Principles formally apply is to put in place commercial agreements (in effect, contracts) that are based on forecasts of passenger movement numbers, to lock in the bases for price movements over the period of the agreement. Related to this, Airlines utilising price-monitored airports expect to be consulted on Master Planning, and assert a right to express disagreement with the extent and nature and proposed timing of new infrastructure and facilities investment proposals by Airports. The extent of the relative market power of Airlines at particular airports determines the extent to which a particular Airport will take such Airline disagreement into account in their capital investment decision making. The matters need to be viewed together, not in isolation.

Some Airlines argue that some major Airports deliberately under-estimate likely future passenger numbers to enable them to over-estimate necessary per head fees and charges necessary to recover capital costs and generate reasonable return on investment, across the period of commercial agreements – to the detriment of Airline margins. However, the alleged benefit to airports is illusory because of adverse fee impacts on airfares, and propensity for some market sectors (like leisure) to be price-sensitive, potentially retarding passenger growth, or even reducing passenger throughput.

The obvious opposite problem is that *over*-estimation of passenger numbers across the tenure of a commercial agreement leads to under-estimation of necessary per head fees and charges, and consequent failure to generate adequate capital recovery and return to the Airport owner – to the benefit of Airline margins, and the detriment of Airports. However, the benefit to airlines is also illusory and the preference of airlines for such beneficial arrangements is myopic, because under-maintained and under-capitalised airports eventually result, constraining airline growth on that route, or within that network.

Regardless, such considerations are irrelevant in circumstances where, while passenger forecasts may be utilised for airport infrastructure planning, they are not utilised at all, or only partially factored into airport service price setting, with user-pays capital cost recovery ideals made subordinate to local economic and social policy imperatives, requiring CSO support and effectively subsidising airline operations in real economic terms. The smaller the airport and the more remote the location, the more likely such circumstances will prevail, with fees and charges largely set to cover recurrent operating costs only. At this end of the spectrum it would be nonsense for airlines or GA operators to allege abuse of market power through excessive airport fee setting, or to demand application of the pricing principles relevant (perhaps) to major City airports. Maintaining an appropriate perspective requires consideration of scale and cost/fare sensitivity.

10. Rural and Regional Airports - Observations

10.1 Section 13.1 of the draft report briefly addressed matters of conduct of rural and regional airports and (at page 296 of the draft report) the Commission:

- Seeks information on the potential costs and benefits of extending the Pricing Principles to regional airports; and
- Poses the questions of -
 - How might the principles be applied?
 - Is the problem of sufficient magnitude to warrant any potential enforcement mechanisms?

10.2 There are hundreds of rural regional airports across Australia. In the absence of definition, the draft report appears to adopt a broad-brush position, grouping them all together into a homogeneous class of airports that loosely includes everything other than the major airports to which the pricing principles currently apply. That seems inappropriate. In which types of rural regional airports is the Commission actually interested? Is it just those with Inter-State RPT services? Or does it include those airports with at least Intra-State scheduled RPT services and subject to State regulation in addition to Commonwealth aviation regulation? Does it include those with significant non-RPT charter passenger (e.g. FIFO) throughput, including Miner-owned strips? Alternatively, perhaps the Commission has in mind classifying airports by scale of passenger operations, regardless of passenger or service provider type? Any further exploration of this subject requires setting of some boundaries and definitions.

10.3 That several major RPT airlines, or an association of regional airline operators express their concerns about an alleged problem, with a particular rural/regional airport or airports - from their self-interest perspective - does not (at least on the basis of the very limited information provided in the draft report) constitute a case that a systemic problem actually exists requiring Productivity Commission or ACCC or other policy or regulatory agency attention. Airline commercial motivations are clear, and a cynical view – in relation to their attacks on “rural and regional airports” - might be that the airlines are merely trying to make their problem somebody else’s problem, because they can’t get their own way through genuine collaborative negotiation with regional airport owners. Airline market power relative to small and medium sized regional airport owners *is vastly superior*, they know it, and they rarely miss an opportunity to leverage it, to further their interests, regardless of impact on smaller regional airports. With major capital city airports, major airlines have a countervailing market power; with rural regional airports they have a dominating market power.

10.4 Geraldton Airport has just been freed from State regulation of RPT services. The City fought for deregulation of the port, intent on overcoming licensed monopoly airfares, and getting competition into RPT services delivery, to drive airfares down, to make airline flying more affordable for Mid West region residents. With a single licensed carrier and only 105,000 passenger movements (inbound + outbound) through the terminal in 2010-11, in order to protect the continuation of RPT services, the City has not to date factored full recovery of all capital costs into its setting of fees and charges for the airport. A modest annual operating surplus (revenues less recurrent operating costs) is targeted for transfer into an airport reserve, to enable funding of smaller enhancement projects. However, in the

absence of full recovery of capital, the Geraldton Airport is obliged to rely heavily on Grants from other spheres of Government, or capital budget allocations from ratepayer funds, for any major infrastructure renewal or expansion project. Many regional airports are in the same position.

10.5 Having been deregulated, allowing any interested RPT airline to fly through Geraldton, the City has subsequently been confronted with the behaviours of several airlines other than its long-standing resident RPT provider. The process in recent months has been enlightening, confronted with demands for incentives as-of-right, demands for no-fee honeymoon periods, permanent reduction of landing fees and passenger service charges, and thinly veiled threats of 'formal proceedings' unless aggregate revenues fall within the "allowable" ROI limit for airports – as if Geraldton was a major city airport, subject to major airport competition and pricing control regimes, and guilty of deliberate over-recovery and excessive fees. In sharp contrast, some airline representatives, understanding the fiscal difficulties confronting small/medium airport owners, negotiate appropriately and have been welcomed.

10.6 The notion of having Major City Airport pricing principles imposed to protect airlines from misuse of market power by Geraldton Airport is a silly proposition, having regard to real life, and under-recovery of capital. From a small/medium airport owner perspective, the far more interesting question is whether or not the intimidating use of market power by major airlines in relations with rural regional airports is systemic across Australia and is of sufficient magnitude to warrant imposition of enforcement mechanisms on airlines to protect the legitimate interests of rural regional Airport owners.

10.7 As noted elsewhere, a significant proportion of regional airport owners are constrained in moving towards real cost reflective airport fees and charges, because of relatively small scale of passenger operations, the recognition of regular passenger services as essential regional services, and the adversely large impact on airfares if fees included full capital costs recovery plus ROI.

10.8 The problem for many (and possibly a significant majority of) regional airport owners is **under-recovery** (not over recovery) of capital through airport fee revenues. Maintaining air services and minimising impacts of airport fees on airfares is the overriding imperative for a large proportion of Council-owned rural and regional ports across Australia. There would be little point in mandating the application of the major city airport pricing principles to these regional airports, because they either don't factor in capital costs recovery **at all** in setting their airports fees and charges, or they add a little capital recovery to their recurrent cash operating costs to create very modest airport cash surpluses, to cover or service small airport enhancements. These airport owners are simply not doing what the airlines perpetually assert the major city airports attempt to do. Hence applying the pricing principles to these regional airports would deliver NO benefits to either the airport or the airlines – and would simply add a mandatory process cost to airport owners that serves no useful purpose.

10.9 For regional airport owners that are obliged by geographic circumstance and population settlement patterns to run airports as essential service assets, incurring real economic loss in operations because of inability to recover full costs, the Pricing Principles might have an alternative useful guiding purpose. They provide a conservative way to calculate the value of the Community Service Obligation implicit in under-recovery of capital

costs through airport fees and charges. Such information might be legitimately included in applications for grant funding from other spheres of Government, as evidence of extent of market failure in air services delivery to remote regional communities.

11. Does the Alleged Problem Warrant an Enforcement Mechanism?

11.1 Is the problem of alleged misuse of market power by rural regional airports of sufficient magnitude to warrant any potential enforcement mechanisms? There is simply insufficient information in the Commission draft report, or in publicly available information, to offer an informed view. How many complaints of alleged misuse of rural regional airport market power have been referred to the ACCC by airlines or GA operators? That would seem to be the acid test.

11.2 Airlines today want least-risk, most-profit utilisation of airport infrastructure and facilities, and want flow of profits from aviation activity biased in their direction, away from airports. Airports would prefer to shed risk towards airlines, and bias profit flows towards the ports. Airlines have short/medium term commercial imperatives; Airports have to make long-term infrastructure investments – and there are natural tensions between the two models. Striking a reasonable balance will inevitably resolve to negotiation, within a sensibly limited regulatory framework that doesn't impair the market, while protecting all players against abuse of market power.

11.3 Over-regulation impairs markets. That needs to be avoided. Existing ACCC powers already exist and surely should already be adequate to enable airlines or airport owners to seek redress where one offends the market rights of the other?