AUSTRALIAN AIRPORTS ASSOCIATION

AAA SUPPLEMENTARY SUBMISSION

TO THE PRODUCTIVITY COMMISSION

2018 Inquiry into the Economic Regulation of Airports

ABOUT THE
AUSTRALIAN AIRPORTS ASSOCIATION

The Australian Airports Association (AAA) is a non-profit organisation that was founded in 1982 in recognition of the real need for one coherent, cohesive, consistent and vital voice for aerodromes and airports throughout Australia.

The AAA represents the interests of over 380 members. This includes more than 260 airports and aerodromes Australia wide – from the local country community landing strip to major international gateway airports.

The AAA also represents more than 120 aviation stakeholders and organisations that provide goods and services to airports.

The AAA facilitates co-operation among all member airports and their many and varied partners in Australian aviation, whilst contributing to an air transport system that is safe, secure, environmentally responsible and efficient for the benefit of all Australians and visitors.

The AAA is the leading advocate for appropriate national policy relating to airport activities and operates to ensure regular transport passengers, freight, and the community enjoy the full benefits of a progressive and sustainable airport industry.

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1. Introduction

The Australian Airports Association (AAA) is pleased to make this supplementary submission to the Productivity Commission's fourth inquiry into the economic regulation of airports.

In making this submission it is not the intention of the AAA to refute or correct the many erroneous claims that have been made by non-airport inquiry participants in relation to the behaviour of airports. We are confident that the Commission will properly test claims made by all participants to ensure accuracy and to provide an opportunity for both sides of a matter to be properly reflected in cases the Commission chooses to discuss in its Draft Report. That said, the AAA remains ready to assist the Commission in clarifying issues if so desired.

Since the AAA finalised its primary submission to the Commission new information has come to hand regarding the profitability of Australian domestic airlines. On 29 August 2018, Regional Express (Rex) announced a 41% profit increase for the previous financial year[1] - average fares grew by 1.2% whilst load factors grew by four percentage points.[2] On the same day, Virgin Australia reported its highest underlying profit in a decade, EBITDA margin increases of 49.5% and an increase in domestic yield of 3.8%.[3] More recently, Qantas reported record levels of revenue in the first quarter of the current financial year, up 6.3% on the same quarter last year, and an increase in domestic group unit revenue (a measure of average prices per seat kilometre) of 6.8% relative to the same quarter last year[4].

These data indicate that Australian airlines are in robust economic good health. Virgin and Qantas seem to have been able to increase prices in excess of the rate of inflation – something the ACCC suggested in its recent monitoring reports may be evidence of a need to regulate when done by airports. These increases, dating from the second half of 2017, are consistent with those revealed in BITRE data for restricted and discount economy fares.[5]

Moreover, they are further evidence of the benign domestic aviation environment in Australia. Restraining potential future increases in airport charges, which seems to be the driving concern of A4ANZ and its members, is not raised as a risk to future profitability by these companies subject to the continuous disclosure obligations of the *Corporations Act 2001* (Cth). Further, this suggests that the relationship between airfares and airport charges, at least at an industry level, is tenuous as discussed in chapter 2 of the AAA's primary submission.

It is the AAA's view that this benign environment, coupled with strong investment in airport infrastructure, improving passenger experiences and falling aeronautical returns, is evidence that the light handed approach to the regulation of airport aeronautical pricing is working and should not be jeopardised by self-serving, untried and apparently inefficient reforms such as the introduction of final offer arbitration.

In our primary submission we indicated in several places that we might put further material to the Commission for its consideration once we had reviewed what was put to the Commission by other participants. The following five sections, and the two expert reports attached to this submission, set out that material.

1 http://www.rex.com.au/MediaRelease/Files/546_MR20180829-RexReleasesFY1718Results.pdf.
2 http://australianaviation.com.au/2018/08/regional-express-posts-34-per-cent-lift-in-full-year-profit.
3 Virgin Australia (2018a, pp6, 18).
4 https://www.qantasnewsroom.com.au/media-releases/qantas-group-trading-update-first-quarter-fy19.
5 https://bitre.gov.au/statistics/aviation/air_fares.aspx#index.

2. Part IIIA

As indicated in our primary submission, the AAA believes that Part IIIA of the Competition and Consumer Act 2010 (Cth) (CCA) remains a potent and important feature of Australia's airport regulatory framework, as it has since 2002.

The principal concern of airlines in regard to Part IIIA, as expressed in submissions to the Commission, is that it is too hard to get an airport declared. It is not clear why airlines should have an automatic right to arbitration of terms and conditions to airport services, particularly as they have an automatic right to access major airports under the terms of the airport leases, as opposed to other goods and services essential to their businesses that are often provided in concentrated markets. Indeed, the inability to achieve declaration is evidence that competition will not be enhanced by declaration and *may* indicate either the absence of market power or a low likelihood of it being abused.

From a broader policy perspective, why is it that airlines should have an access regime made available to them when users of comparable infrastructure, say shipping lines, need to make out their case for access to a negotiate-arbitrate framework under Part IIIA?

Further, it is not the case that it is now any harder to get an airport declared than it was a decade or so ago. What is clear, however, is that the implementation of past recommendations of the Commission has reduced, and made more certain, the decision making timeframes for declaration.

The AAA has asked its legal advisors DLA Piper to review the legal advice provided by other inquiry participants to the Commission and this is included as Attachment 1 to this submission. This advice sets outs a number of flaws in the advice provided by airlines whilst supporting the views the AAA expressed in its primary submission to the Commission.

3. Potential application of the Gas Code

The ACCC has suggested that the Commission might recommend the adoption of a set of arrangements similar to those to be found in Part 23 of the Gas Code that relate to unregulated gas pipelines. The principal reason behind the ACCC's suggestion seems to be that the record keeping and information disclosure requirements of this framework would address a perceived, but undemonstrated, asymmetry in information between (unspecified) airports and airlines. It is interesting that the ACCC seems less interested in the asymmetry that airports encounter in relation to gaining airline information such as future fleet plans and traffic forecasts (see section 5.3.4)

As discussed in section 5 of this submission, the AAA believes that whilst airlines generally receive from airports the information they require to negotiate, additional guidance from the government in this regard would help clarify expectations, reduce friction in the negotiating process and reduce transactions costs. A more prescriptive approach, as suggested by the ACCC, would lead to unnecessary compliance costs and a risk of negotiations becoming a "one size fits all" activity.

There is a regime for exemption of unregulated pipelines from the information disclosure requirements of the gas code regime that is intended to limit the imposition of those requirements to circumstances in which the benefits of information disclosure outweigh the regulatory costs. However, the exemption criteria are not readily applicable to airports and, accordingly, it is difficult to predict what scope may exist under an airport-specific regime based on the gas code regime for smaller airports to secure exemptions from the information disclosure requirements.

The gas code regime is essentially a negotiate/arbitrate model which provides for binding commercial arbitration of access disputes, including pricing. It is demonstrably more prescriptive, and therefore less flexible, than the negotiate/arbitrate regime established by Part IIIA of the CCA that would apply if an airport's services satisfied the Part IIIA criteria for declaration.

The gas code regime imposes detailed and onerous requirements on unregulated pipelines to make information publicly available so as to facilitate commercial negotiation. Unregulated pipelines are required to prepare, publish and maintain detailed information on the pipeline, the pipeline services they provide and the standard terms on which they will provide those services. This includes, in particular, monthly service usage information, service availability information (updated monthly) over a 12 and 36 month horizon, certified annual financial reporting information including on the methods, principles and inputs used to calculate the value of the capital base, depreciation allowances and cost allocation, and certified annual average weighted price information. Mandatory guidelines published under the regime by the regulator (for gas pipelines, the AER), in turn, prescribe in detail the approach to preparing financial and weighted average price information including, in particular, the method for capital base valuation.

The gas code regime also establishes a highly prescriptive framework to facilitate the timely commercial negotiation of access. The regime prescribes detailed procedures for the making of access requests by prospective users, access offers by service providers and the initiation of negotiations by prospective users. This includes statutory timeframes, and requires unregulated pipelines to share information with prospective users on request including cost information, information on pricing methods and inputs and third party pricing material such as expert/consultant reports commissioned by the pipeline, data sets, models and so on.

The ACCC submission makes no attempt to identify the nature or extent of the information that airports would be required to provide. As such, it is not possible to evaluate the cost or utility of this proposal relative to the information already provided by airports to airlines.

Finally, the regime confers a right to binding arbitration of an access dispute on prospective users that have followed the procedure for requesting and negotiating access.

Significantly, a party to the arbitration cannot rely on any information not previously provided to the other party before initiation of arbitration, without leave from the arbitrator, and, in determining price, the arbitrator is required to take into account:

1. the principle that prices and other terms and conditions should, so far as practical, reflect the outcomes of a workably competitive market;
2. the price for access to a pipeline service on an unregulated pipeline should reflect the cost of providing that service, including a commercial rate of return that is commensurate with the prevailing conditions in the market for funds and reflects the risks the provider faces in providing the pipeline services;
3. for the purpose of 2, unless inconsistent with 1, the value of any assets used in the provision of any pipeline service must be calculated as the initial capital cost of construction plus capital expenditure since the commissioning, less the return of capital recovered since commissioning and the value of disposals. This approach is variously described as the 'depreciated actual cost', 'depreciated cost of construction' or 'recovered capital method' (**RCM**). Under the RCM, the return of capital in each year is the residual between revenues and costs, and the rate of return for each year and approach to its estimation is a key determinant of the value of the capital base.

Whilst the ACCC has not specifically advocated the RCM method for setting airport prices, Virgin Australia has.[6] As prices set under this method seem to be largely determined by past revenue (or at least EBIT) and capital expenditure outcomes, it should be clear that the RCM does not establish prices that are reflective of long run marginal costs and therefore prices are likely to be inefficient. The potential inefficiencies associated with current pricing approaches discussed in chapter 3 of our primary submission are likely to be magnified under this approach. Further, such an approach significantly blunts the incentive for airports to actively market their services because if they are successful, the revenue will be largely handed back via the accelerated reduction in the asset base. Finally, given the age of many of Australia's airports, the costs associated in interrogating records to establish starting asset bases will be high and unlikely to be justified.

6 Virgin Australia (2018, p11).

4. Final offer arbitration

A4ANZ and its members have proposed that final offer arbitration (FAO) be put in place to resolve disputes between airports and airport users. The AAA identified a number of concerns with this approach in its primary submission (section 6.3.2), some of which have been echoed by Ms Margaret Arblaster, an academic and former senior ACCC officer who oversaw the prices notification of airports until 2002. Arblaster, in a report attached to the A4ANZ submission to the Commission, writes:

FOA is considered less suitable when the dispute involves a 'package selection' It can be challenging to collapse a set of diverse aspects, such as quality of services, enforceability of terms and conditions and pricing over a period of time, into a single point of comparison where the arbitrator has to choose one of two disparate packages. Where the offer contains not only a price, but also terms and conditions which are nuanced and possibly tailored to the unique needs of one party they are not easily standardised nor summarised in a single number…[7]

It is not clear which airports A4ANZ wants this flawed framework applied to, although it seems to be a set broader than the airports currently monitored or indeed that were monitored when prices notification was removed in 2001-02. Similarly, it is not clear what services it is intended to apply to although it seems to be a broader set than currently set out in the Part 7 Regulations. This proposition seems to be a deliberate and unjustified attempt to impose an economically inefficient single till pricing regime[8] – an approach that is entirely inconsistent with not only the current airport pricing principles but also those set out in the National Access Regime.[9]

Houston Kemp's analysis identifies a range of circumstances in which the application of FOA would be inappropriate:

- there are multiple or complex dimensions that are subject to dispute;
- the scale of the matters in dispute is relatively high, as compared with the total revenue, costs (including opportunity costs) and/or sophistication of the respective parties;
- there is a limited number of similar transactions that may be available for use as market price benchmarks by one or both parties; and
- there is a strong intended relationship between the price that is to be determined and a cost recovery objective.

Accordingly, Houston Kemp suggests FOA is unlikely to be appropriate for airport-airline disputes, since:

- airport charges are set to recover the efficient costs of providing aeronautical services;
- airport-airline negotiations tend to be complex and multi-dimensional;
- airports and airlines are both large and sophisticated parties; and
- the existence of a sector specific arbitration process may represent inherent risks to the commercial negotiation process itself, something the Commission itself has noted on a number of previous occasions.

Clearly, the potential for regulatory error under FOA is substantial and likely to put at risk long run investment outcomes. This likely regulatory error has not been considered, let alone valued, in the analysis undertaken by Frontier Economics and provided to the Commission by A4ANZ that claims the benefits from its proposed reforms, primarily the introduction of FOA, are in excess of $10 billion. The AAA has asked Houston Kemp to review A4ANZ's FOA proposal and Frontier Economics' valuation of it. Houston Kemp's review, which can be found at Attachment 2, demonstrates that the Frontier Economics analysis is both flawed and misleading.

The ability of Houston Kemp to properly review Frontier Economics' analysis has been limited by the refusal of A4ANZ to allow the Commission to release another Frontier Economics report of May 2018 that purports to demonstrate that monitored airports have earned excess returns. The AAA calls for that document to be made available to all participants in this inquiry with redactions reflecting material the Commission appropriately considers confidential to A4ANZ or its members. The AAA also notes that Qantas at various points in its submission (see for example footnote 37) relies on a report prepared by CEPA. Similarly, if that document is in the possession of the Commission it should also be placed in the public domain.

7 Arblaster, (2018, p 43).
8 A4ANZ (2018, p37).
9 Section 44ZZCA of the CCA.

5. Improving negotiating and contractual outcomes

Taking submissions from airports, airlines and their representatives together, and putting aside obvious points of self-interest, it is reasonable to conclude that there is scope to improve the negotiating and contracting processes that underpin the provision of aeronautical services.

However, it is not right to assume that all the behaviours of airports (or indeed airlines) that are objected to are abuses of market power requiring regulatory intervention. It is to be expected that negotiating parties will seek to maximise their own long-term commercial outcomes. We demonstrated in chapter 5 of our primary submission that airlines possess substantial capacity not only to resist price increases but to hold up development, and in some cases developments that have been approved by the Minister under a statutory process.

Council owned airports are likely to also be concerned with the value of aviation services to their communities within the wider suite of services they provide using their limited financial resources.

We would observe that the behaviours and arrangements that led to Melbourne Airport receiving the prestigious IATA Eagle award for its aeronautical services agreement in 2002, at the nomination of Qantas, would be unlikely to be similarly honoured today. The provision of aeronautical services has become more complex, service expectations of airlines more sophisticated, and the information requirements of airlines today are not what they were in 2002.

Perth Airport's submission (section 6.3) outlines the process it has embarked upon to develop a new service framework to underpin future international terminal services. In doing this, it is seeking to meet a set of expectations from international carriers that are very different to those it encountered when it last negotiated with them in 2010-11. That this process takes time is not evidence of heroic airlines resisting the unreasonable demands of a rapacious monopolist but rather that airlines' thinking on these matters tends to develop organically with each new negotiation (in this case, BARA's expectations are clearly conditioned by previous outcomes at Sydney Airport) whilst airports come to these matters less frequently and the outcomes are more critical to their businesses than they are for any given airline.

Context is also important. Perth Airport's engagement with BARA is occurring at the same time it is engaged with Qantas regarding its use of Terminal 4 upon the expiry of the 30 year domestic terminal lease and consolidation into the Airport Central Precinct. In addition to being commercially complex, these discussions present significant airfield, terminal and ground transport option development issues, all of which take time.

Delay does not necessarily represent an abuse of airport market power. Indeed, in some cases it may represent an abuse of market power by an airline as we discussed in our primary submission in relation to the redevelopment of the terminal in Townsville.

Whilst the AAA believes new negotiating and contracting principles will reduce transaction costs and enhance timeliness, it should be clearly understood that negotiations such as those surrounding the new runway in Brisbane, the ones being currently undertaken by Perth Airport mentioned above, and those that will occur at Sydney Airport to facilitate international operations from Terminals 2 and 3, will be drawn out because they are inherently complex. There is a risk that the sorts of arbitration processes favoured by A4ANZ and its members, which seem to place primary store in expediency, will do little more than undermine, in all but the simplest of cases, the efficient development of critical national aviation infrastructure to the detriment of the long-term interests of the travelling public.

Beyond this inherent complexity, the AAA believes much of the friction that occurs from time to time in the negotiating process is because there is a misalignment of expectations of negotiating parties. It is the AAA's view that, much in the way that the Pricing Principles have ensured that excess returns have not occurred in relation to monitored airports and have guided price setting at other airports, if the government was to endorse principles for negotiating and contracting this would guide the behaviour of both airports and airlines and lead to a substantial improvement in outcomes through more timely and less expensive negotiating processes.

BARA has suggested a set of *Progressive Commercial Principles* in its submission to the Commission.[10] Whilst not agreeing with every detail of BARA's proposal (such as the approach to cost of capital and the need for a formal dispute resolution mechanism) the AAA believes that BARA's framework provides a sound starting point for developing a framework to guide airports and airlines' expectations of commercial agreements. The AAA would encourage the Commission to consider convening a workshop involving airports and airlines to develop such a set of principles either before or after the publication of its draft report.

Crafted carefully to ensure proportionality, these new principles would provide valuable guidance to smaller airports that negotiate with airlines infrequently and for whom negotiating with major domestic airlines is both a costly and risky process. Further, if acceptable to Government, these principles could be promulgated promptly after the Government receives the Commission's final report in June 2018 thereby avoiding what would be a lengthy, and in the AAA's view, unnecessary legislative process that would be associated with other proposals currently before the Commission.

Clearly, at the time of the next review the Commission would assess airport and airline conduct against these principles, along with the pricing principles, and if it did find significant systemic non-compliance, would need to consider recommending an alternative policy approach.

The remainder of this section canvasses the issues that might be covered in such guidelines, save for the last item that deals with cost of capital issues. In many areas, this should require little more than adapting materials already before the Commission or documenting current practices.

5.1 Quality of service

Section 4.2 of the AAA's primary submission sets out how the experience of passengers using Australia's major airports has improved over the last decade or so. Notwithstanding this, airlines seem to have concerns (generally unsubstantiated with the exception of BARA) about the quality of services they receive despite the material published by ACCC indicating a generally improving set of outcomes for airlines using the monitored airports.

As a basic set of principles, service standards must be objective, measurable, transparent, material and achievable. Ideally, their monitoring should provide a guide to potential investment and other requirements of both airports and airlines.

The AAA suggested in its primary submission that airline quality monitoring should be replaced by contractual arrangements between airports and airlines. BARA has indicated that significant progress has been made in service level framework development at Sydney and Adelaide airports and similar work is underway in Perth and Brisbane. It should not be difficult to apply these learnings to domestic activities.

We acknowledge that a failure of airports to provide services that airlines reasonably expect to have provided to them can be more than an annoyance and can lead to costs to both the airline and its passengers. As such it is appropriate that in certain circumstances where airports fail to provide services to the agreed standard that airlines are compensated.

However, whilst not abrogating their general obligation to deliver efficient operational outcomes, airports should not have to compensate airlines for poor service outcomes that are attributable to the act or neglect of the airline (or its contractors such as ground handing agents or fuel suppliers), other airlines, or third parties such as Airservices Australia or Australian Border Force.

Any guidance promulgated by the Government should also explicitly address what airports can reasonably expect airlines to do to ensure airport efficiency and investment is optimised for the benefits of all airlines, the travelling public and freight owners. In doing so, the guidance should recognise the commercial interests of individual airlines are not necessarily aligned with the interests of the community, the region or the state in which the airport is located, or indeed, on occasion, with the interests of other airlines.

10 BARA (2018, p60).

It will be important to ensure that metrics actually guide behaviours that improve outcomes and signal when new investment is required. The metrics, and the cost of producing them, should be proportionate to the challenges facing individual airports and the Commission may also wish to consider whether such guidance may not be relevant to airports below a certain size.

5.2 Contractual terms

The Commission has reviewed a number of agreements that have been entered into by AAA members and airlines so it is not necessary to revisit the general content of agreements.

In its submission, BARA has set out its "reasonable commercial outcomes" .[11] On face, the AAA considers these would be a good basis for the development of contracting principles. We also support BARA's suggestion to develop common "boiler plate" clauses, bearing in mind the application of the competition law, the passage of time and the need to reflect local airport circumstances. Obviously, work will be required to translate BARA's requirements for major international airports into a set of principles with wider application. However, as indicated above, the AAA and its members would be keen to work with the Commission and airlines to find as much common ground as possible that could form the basis for the Commission's recommendation to the Government.

5.3 Information disclosure

Whilst not providing much by way of specific detail, airlines and the ACCC have proposed reform options that involve increased information provision by airports to airlines. The AAA understands the well-worn arguments regarding information asymmetry in the presence of market power but would observe that the volume of information typically provided by larger airports, plus that provided in response to questions from airlines, would indicate that the current state of play does not warrant policy intervention.

In negotiating new agreements airports have sought to provide information that enables the calculation of prices via an application of the building block model (BBM) described in section 3.2.1 of the AAA's primary submission. The level of detail that can be viewed on Perth Airport's website is indicative of what is typically provided by major airports. Once allowing for matters that are known as a matter of policy in Australia (such as issues around the application of the dual till), it is the AAA's view that the information provided to airlines by major airports in Australia is broadly consistent with the information IATA suggests should be provided in Annex 2 of its submission to the Commission.

The fact that airlines seek further information from airports should not be seen as the result of an abuse of market power or incompetence on the part of airports. The production of information is not costless, the information needs of different airlines vary and change over time. Airports therefore produce information on the basis of what they assume will address most of the needs of most airlines in full knowledge that questions will be asked for further detail on some, but by no means all, matters.

That said, AAA members do encounter behaviour from airlines where information requests are designed to "game the system" either in order to extract unreasonable benefits, financial or otherwise, for themselves or delay the major developments that may benefit their competitors. The AAA stresses that the majority of airlines in the majority of circumstances do not indulge in this behaviour but when it occurs it can be particularly disruptive. The AAA would expect that any information sharing guidance the Government provides should clearly set out not only what information airlines can reasonably expect, but also what is unreasonable.

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11 BARA (2018, pp37-39).

5.3.1 Capital expenditure

When negotiating new pricing agreements, airports will provide detailed capital expenditure programs covering projects to provide new services, improve quality, increase capacity and maintain or replace existing assets and services essential for safety and security. In a program of hundreds of millions of dollars, one would expect to see details provided on projects that might involve expenditure of as little as $30,000. Along with the identification of the project, a justification of the project is provided. For small replacement projects, this might be limited to "asset has reached the end of its useful life". New aprons might be justified by increased parking demand. New runway lighting projects may be justified by a desire on the part of the airport and airlines to facilitate operations in poorer visibility conditions than permitted by current equipment.

The AAA would be interested in working with airlines and the Commission to develop guidelines on the extent of information and justification required for projects relative to their value. Such guidelines would be particularly helpful to regional airports.

5.3.2 Operating expenditure

Major airports will typically provide operating cost estimates for each pricing category (for example airfield and different terminals) with a level of detail greater than that contained in the regulatory accounts for the monitored airports.

These costs will vary over the forecast period according to a range of factors including:

» expected increases in unit costs – wages typically will grow at margin over CPI whilst in some cases there may be market based growth estimates for utilities prices (especially energy);

» changes in activity – if an increase in the size of a terminal is expected, then cleaning and utilities costs typically will increase reflecting the larger floor area; and

» airport cost reduction programs.

Airlines have on occasion sought information on the remuneration of a wider range of corporate and operational positions that for privacy reasons airports have rejected. It is not clear what, if any, additional operating cost information in these regards airlines feel they need, but the AAA remains open minded about the development of guidelines on the level of detail on operating costs that can be reasonably required.

5.3.3 Allocation methodologies

Since privatisation, to support the publication of accounts under Part 7 of the *Airports Act 1996* (Cth) (the AA), the ACCC has published guidelines for the allocation of revenue, costs and assets between aeronautical and non-aeronautical activities (as defined under regulations made under Part 7 of the AA). The application of these guidelines to airports subject to monitoring has been subject to audit sign-off. The AAA is not aware of any instance where auditors or the ACCC have questioned the application of the guidelines.

The AAA understands that monitored airports apply these allocations in their aeronautical pricing negotiations. Further, it is difficult to see how the same guidelines would not be suitable for pricing aeronautical services at other airport accounts providing some common sense was applied to the materiality of the allocations relative to the size of the airport business.

5.3.4 Activity forecasts

Major airports will typically provide airlines with independent third-party forecasts of passenger numbers by market segment (international, interstate, regional) for periods of at least 10 years and often longer. These are typically based on expected activity levels in the near few years that are then grown at rates determined by macro-econometric models. These forecasts are often supplemented by "busy hour" utilisation rates for various assets such as parking positions, runway usage and baggage systems to support the identification of growing points of congestion and potential future investments. Low, medium and high forecasts are often produced.

Airlines will often challenge passenger forecasts – the higher the forecast the lower the agreed price. However, the consequence of an artificially inflated forecast is that it might bring forward investment. Similarly, forecasts that are too low may fail to recognise the need for investment to ensure congestion is avoided and service standards are maintained. The AAA understands that when asked to produce forecasting of the same level of detail as provided by airports, airlines typically decline to do so.

Information symmetry in this regard is low. Airports and airlines have access to the same publicly available information that external forecasters use. Whilst airports *may* have private information relating to a number of airlines, this will necessarily be less than what the airlines know about their own plans, those of their subsidiaries and their alliance partners. It is almost certainly the case with respect to domestic markets that the participants in the domestic duopoly possess more relevant demand information than any of the AAA's members.

Whilst it is difficult to see what other information airports could provide to airlines on activity forecasts, it might be helpful for the Commission to explore what activity information airports could reasonable expect to receive from airlines.

5.4 Additions to the Pricing Principles - cost of capital

Section 3.4.2 of the AAA's primary submission demonstrates that since the removal of prices notification in 2002, the currently monitored airports have not earned excessive returns from their provision of aeronautical services. The assessment of a "reasonable return" has been established by Houston Kemp by reference to methods and market parameters well established by Australian regulators and industry based parameters consistent with those estimated by the New Zealand Commerce Commission and by the ACCC during the period of prices notification. The prices underpinning these outcomes have generally been agreed to by airlines on an *ex ante* basis using costs of capital consistent with Houston Kemp's analysis.

As there is no evidence of excess returns, there is no need to impose some form of *ex ante* regulatory device such as a rate of return guideline developed by the ACCC as suggested by BARA.[12] Rather, the current *ex post* review undertaken by the Commission in the periodic inquiries, the continuation of which we support, is an appropriate regulatory approach to dealing with any future abuse of market power associated with excess prices.

Indeed, the development of such guidelines is not without risk. Whilst New Zealand structurally has a light handed monitoring framework, the Commerce Commission's role in developing the information disclosure requirements (including in relation to cost of capital) has effectively put it in the role of establishing allowable rates for return. This has significantly undermined the "light handedness" of the regime.

The Australian Energy Regulator (AER), a body closely associated with the ACCC, sets (without access to merit review) a binding rate of return guideline that applies to energy distribution and transmission businesses subject to price control under the National Gas Law and the National Electricity Law. The AER's recent behaviour is best described as a relentless drive to reduce retail prices, and therefore infrastructure prices and returns, in total disregard of credible arguments put to it on the long-term impacts on consumers.

Given the ACCC's general hostility to airports, as mentioned in the AAA's primary submission,[13] having the ACCC involved even in the provision of "guidance", which will be seen by many as simply determinative, is likely to create investor uncertainty and risk the setting of inefficiently low prices that could lead to less investment in capacity and service equality.

It is generally the practice of major airports when engaging with airlines over long term pricing agreements to provide expert reports regarding the cost of capital for their aeronautical businesses. The AAA understands those reports have consistently supported the levels of returns being earned. By contrast, very little third party evidence is provided to airports by airlines and, as discussed above, there is no public material available to participants in this Inquiry that calls into question the analysis and conclusions of Houston Kemp regarding the absence of excess returns.

12 BARA (2018, p60).
13 AAA (2018, p88).

6 Security

6.1 Engagement with airlines on security measures

One of the central claims put forward by Qantas in relation to security is that airlines are not consulted on the security measures implemented by airports and there is little to no opportunity to provide input and discuss these processes.[14] This is simply not true. For many years Qantas, Virgin Australia and BARA have been involved in both individual and collective industry discussions with airports and the Aviation and Maritime Security Division of the Department of Home Affairs (and its predecessors) on the requirements and measures associated with Australia's evolving aviation security regulatory framework. In addition to the Government's recent changes to security screening equipment requirements, there has also been close and cooperative collaboration for several years on the Government's other major reform to the industry, the introduction of airside screening requirements.

Both major and regional airports have established airport security committees, which include representatives from airlines and Government intelligence, regulatory and law enforcement agencies. These committees meet regularly to discuss emerging risks, changes and pending changes in security regulation. Through these fora, changes in screening and other security arrangements are discussed and finalised in context with the risk profile for the aviation sector, including emerging risks and vulnerabilities as well as local initiatives such as innovative technology. In addition, subsequent changes affect security costs and hence forecast fees and charges are provided to airlines in written form for consideration.

The following case study provides a recent example of the consultation arrangements that one airport put in place with airlines in relation to the new airside security screening regime that was mandated by the Department of Home Affairs. The consultation process undertaken by this airport is not unique for the airside security changes, with several other airports indicating they undertook similar processes.

In this example the major airport undertook to develop the most efficient and sustainable long-term solution possible to meet the Government's new airside screening requirements. This major airport began socialising its conceptual solution for the Government's requirements as early as 2016.

Subsequently, several detailed discussions took place between the airport and Qantas and Virgin Australia, including a presentation and joint site inspection in July 2017 involving airline security and finance/commercial team representatives. A copy of the presentation was also provided to BARA for endorsement in July 2017. Throughout the development and design process the solution was also presented at local forums such as the Airport Security Committee, Airport Security Consultative Group and the Airline Operators Committee.

6.2 Airport security charges to airlines

In general terms, the direct capital and operational costs associated with implementing security measures at airports (as mandated by the Government) are passed through to the airlines that are required to have their passengers and baggage screened. Depending on the airport and the security requirements and processes in place, this pass-through of costs is typically developed in contractual negotiations with airlines on a per passenger (or per departing passenger) basis and recovered through a direct security charge and/or terminal services charge.

As the Commission would appreciate, the infrastructure and operations at airports across the country varies significantly. It is therefore not surprising that there are differences between airports in the way security related costs are recovered. However, it is widely accepted by airports and airlines that the labour costs associated with Government mandated passenger and baggage screening are largely treated in a cost pass-through approach, where the costs are distributed across the airlines' passenger base. In some cases, capital equipment costs are treated like another part of the terminal's infrastructure. Given the airlines are the entities with the direct commercial relationship with passengers (the primary source of funding), the most efficient manner of cost recovery is for airports to recover costs from airlines and for these costs to become part of the airlines' cost bases. We discuss in chapter 2 of our primary submission how changes in these costs may or may not be reflected in airfares.

14 Qantas (2018, p30).

The calculation of these charges is outlined and summarised for airlines in a transparent cost pass-through model, which at most airports is managed through an 'overs and unders' approach. This approach was developed by the ACCC during the prices notification period from privatisation until 2001-02. Airports provide key assumptions for the year ahead in relation to security costs, including passenger forecasts and forecast capital and operational costs to meet the Government's security requirements. Each year this model is updated with actual passenger numbers and actual costs, and future costs are re-forecast. Any under or over recovery from the prior year, results in reconciliation of costs to be incorporated into the future year charges. This ensures that both the airport and airlines can either be reimbursed or charged for security related costs depending on the variance between actual and forecast costs.

Some issues have been raised, particularly by Qantas,[15] on the pass through of costs in regards to security measures such as screening of goods/retail staff, airside access controls, some landside measures (CCTV and landside security patrols).

6.2.1 Goods screening

It has been alleged that the costs of screening of goods and staff for retail outlets in the sterile area of airport terminals should not be passed onto airlines, as it "goes beyond those security services necessary to safeguard against unlawful interference with aviation".[16] Depending on the configuration of individual terminals, a significant proportion of these goods may be consumables for airport lounges. In any event, this is not a big issue - the AAA estimates that retail and lounge consumable screening makes up three per cent or less of the total costs associated with passenger screening.

While it is true some airports do not separately charge retailers for the screening of goods and staff, there are a number of factors to take into consideration. At many airports goods are screened outside of peak travel times, have little to no impact upon facilitation rates and utilise staff and equipment that would otherwise be underutilised at those times. In other words, the incremental cost associated with the screening of these items is very low, if not zero, and as such, allocating cost to the activity would not enhance efficiency.

The introduction of the Government's strengthened security measures will very likely reduce facilitation rates and therefore encourage passengers to present at screening points earlier to account for potential delays. Goods and retail screening is not only integral to the customer service experience but more importantly to the security outcomes for airlines and passengers, and therefore there is a strong rationale for airports to pass through these costs to airlines where it is deemed necessary.

However, there are instances where airports have made arrangement to charge retailers directly for the costs associated with screening their staff and goods. This is done in situations where the infrastructure and operations in place at airports lend themselves to this arrangement and there are identifiable incremental costs, such as a dedicated screening point.

6.2.3 Airside access controls

The requirements for airside access control have been imposed by the Government to ensure that individuals are not able to unlawfully interfere with aircraft. This involves ensuring:

- unauthorised persons are not able to access areas where aircraft are operating; and
- authorised persons intent on doing harm cannot bring inappropriate items and materials into proximity with operating aircraft.

As far as authorised persons are concerned, they are almost exclusively airline employees, outsourced labour of airlines or people involved in providing services to aircraft. It seems that if costs were allocated to contractors it would pass back to airlines as would the additional expense airports would incur in establishing such an unnecessary arrangement.

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15 Qantas (2018, p29).

16 ibid.

6.2.4 Landside measures

As with goods screening and airside access control, it has been alleged that landside or front-of-house security measures are not a justifiable cost to be passed through to airlines. While the Government has not yet mandated landside security measures, there has been specific landside security guidance material issued to airports to assist in mitigating the threat to crowded places in the landside areas of designated airports. The Department of Home Affairs has also indicated that it will continually review this guidance material in light of the threat environment and it is likely that it will form the basis of future regulatory requirements.

CCTV technology at airports has not been deployed to maximise revenue from car parking fines through number plate recognition, as suggested by Qantas. Number plate recognition systems have been implemented at several major airports in consultation with Australian Federal Police and Australian Border Force and airlines to assist in the early identification of persons of interest who may pose a threat to aviation or the passengers at the airport. The CCTV systems are also being used at some airports for live behavioural monitoring by trained professionals to assist in recognising suspicious behaviour (both landside and airside).

Regardless of whether security measures are being deployed landside or airside, airports implement these measures in consultation with airlines and other stakeholders with the primary objective of preventing an attack on aviation. In this current threat environment implementing measures to assist in preventing front of house attacks are entirely appropriate and are in line with Government-issued guidance. One only needs to reflect on the major front of house terrorist attacks at airports in Turkey and Brussels within the last two years to understand the devastating effect these attacks can have on aviation and the travelling public.

On that basis, it is entirely appropriate for airports to consult with airlines and share costs associated with landside security measures that are designed to protect aviation and the traveling public.

6.2.5 Airport staff costs

The administration of compliance with aviation security requirements is not a costless exercise. Beyond contracted labour, a significant overhead is incurred. Most airports generally recover this through general charges, although when passenger and checked bag screening were introduced the ACCC allowed the recovery of additional overhead costs. There should be no issue in this regard providing there is no “double dipping” which proper cost allocation methodologies should prevent.

6.3 Case studies

The following three case studies are based on information provided by AAA. The first case study provides a counter-point example to the claims of airlines that airports are inherently inefficient at providing security and make no attempt to reduce costs. The second and third case studies provide examples of the sort of conduct airports endure when dealing with airlines.

6.3.1 Security cost savings passed onto airlines

Many airports are continually looking to improve efficiencies throughout their businesses, which can often result in reduced costs. Airport security processes are no exception. Below are examples of efficiencies one major airport identified, resulting in direct cost saving for airlines.

» The airport identified an activity performed by labour in the international baggage handling system that could be performed automatically with a minor technology solution and as a result saved the airlines approximately $400,000 per annum.

» Perimeter patrol vehicles were traditionally staffed by up to two security personnel for WHS and security reasons. The airport undertook research on a technology solution to reduce the manpower associated with this function to one security person, while continuing to meet WHS and security obligations. This resulted in another saving to airlines of approximately $400,000 per annum.

Rather than indicate airports are inefficient, these examples show that despite little contribution to airport profitability, the light-handed framework is delivering dynamically efficient airport behaviour.

6.3.2 Airline short-paying on security charges

Following the foiled terror plot at Sydney Airport in July 2017, the Department of Home Affairs issued a special directive to all major airports to increase the rates of random explosive threat detection (ETD) to 35% of passengers. As a result, the increased costs caused one major airport to review its security recharge model. Following this review, the airport provided formal notification of a revised security charge to Qantas for their consideration on 30 April 2018. A meeting to discuss the revised charge was subsequently held with Qantas on 4 May 2018, during which a detailed breakdown of all elements included within the recharge model were provided, including a copy of the current Aviation Security Services contract. The revised security charges took effect from 1 July 2018, noting the cost associated with the increased ETD rate had been absorbed by the airport up to this point.

At no stage during the consultation process did Qantas indicate they had concerns with the revised security charge, however this became apparent in late August 2018 when both Qantas and its subsidiary Jetstar short paid the passenger security charge. Formal notification was received from Qantas on 19 September 2018 confirming they were to undertake a full review of the airport's security screening charges and requested a detailed breakdown of all elements included within the recharge model, information that was originally provided by the airport on 4 May 2018. At the time of writing, this dispute has yet to be resolved.

6.3.3 Airline behaviour degrades passenger experience

An airline operating out of a regional airport unilaterally elected to terminate its role in coordinating security screening services. The airport then stepped in to coordinate security services, including the replacement of redundant and non-compliant equipment.

This coincided with significant changes to the operating schedule of airlines, causing bunching of flights and consequent severe peaks in the departing passenger volumes. Despite engagement with the respective airlines, there was no appetite to move schedules to smooth presentation rates at the screening point.

The airport recognised that an additional x-ray screening machine was required to maintain acceptable wait times for passengers departing during peaks. The airport approached airlines to fund the cost of the additional x-ray machine through an increase in security recoveries in a transparent and straight pass-through arrangement. The airport proposed that the additional resourcing and capital investment be funded through a very small (a matter of cents) increase in the price paid per departing passenger.

It took more than 12 months to secure an agreement on these arrangements with one airline group. During that period it was the travelling public on all airlines who suffered a severe deterioration in service standards, due to the protracted negotiations of one airline group. Airline customers endured queues that on occasions extended out of the terminal and onto the pavement, with security processing times in excess of 30-35 minutes and consequent late aircraft departures.

Eventually agreement was reached and the second x-ray machine was installed. The number of security delays reported by the airline has since significantly reduced from 50 to just seven over a comparable six-month period. The airline also reported a reduction in fail-to-board delays from 34 to zero over the same period, as a result of the expedited screening process permitting early boarding reconciliation.

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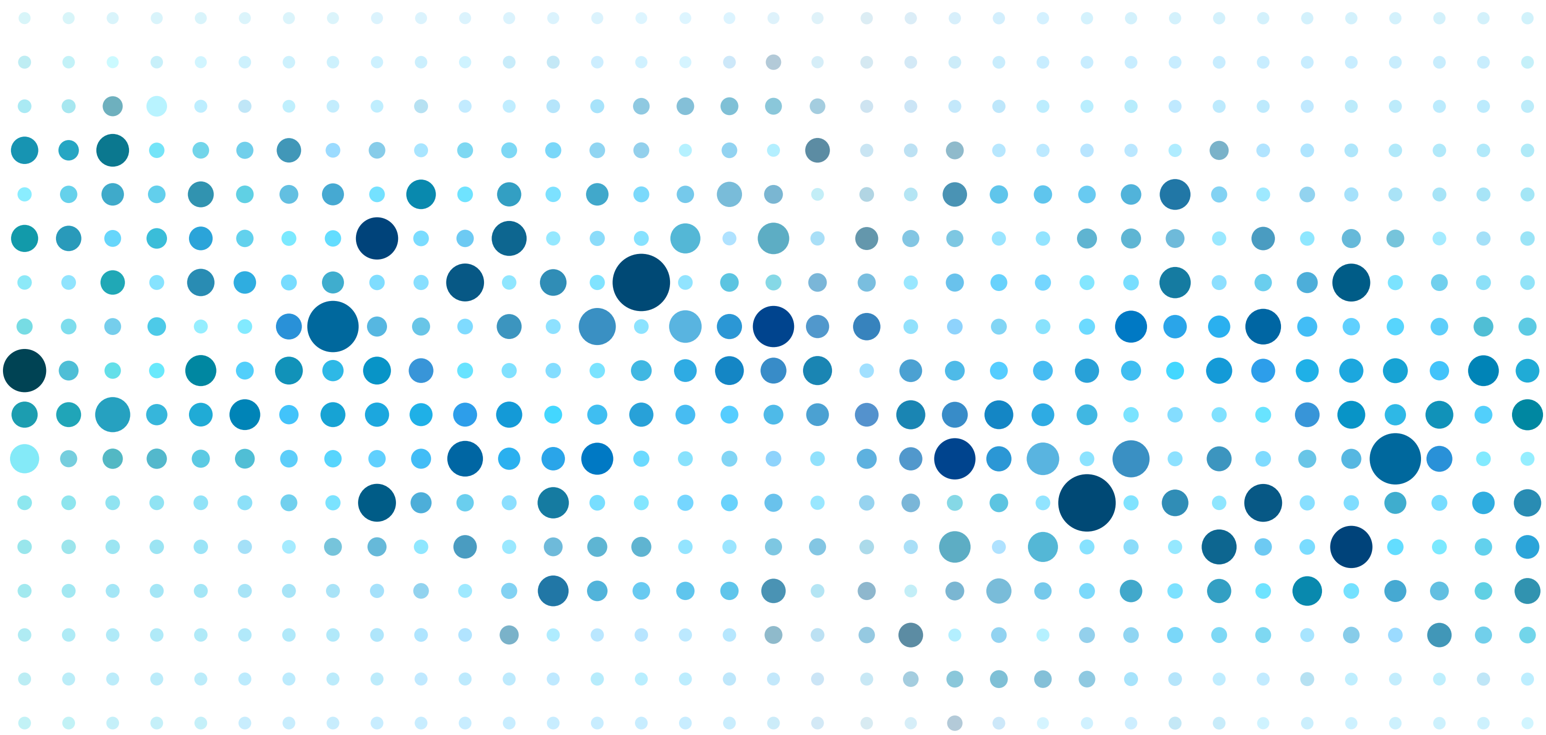

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