Northern Territory Airports Submission to 2018 Productivity Commission Airport Regulatory Review

1. INTRODUCTION

A short submission is provided by Northern Territory Airports which focuses on the central issue of the relative market power of airlines and airports as experienced by Darwin and Alice Springs Airports. This submission will relate the experience of two airports with a combined airline passenger throughput in 2017-18 of 2.8m passengers.

The unique Northern Territory Airports approach to airport fuel supply will be outlined. The independent Airport Service Quality (ASQ) results over time, which are published by Darwin International Airport (DIA) on a quarterly basis, will highlight what passengers think of quality of service at DIA.

Passenger based airport pricing for airlines comes in 2 parts – an airside charge and a landside charge.

The airside charge covers all costs and return on capital for the aircraft movement area – runways, taxiways and aircraft apron. The standards of the various airside facilities are obviously highly regulated. In terms of long run costs there is little room to move except for items such as additional taxiways or runways. Short run costs can be impacted by timing of runway overlays etc. Apart from expenditure timing the airside 'standard of service' is 'fixed'. Airside charges to airlines for smaller airports often comprise around half of the total passenger based charges.

Landside charges cover items such as passenger terminals and airport infrastructure and systems that support aeronautical operations (eg road system, utility infrastructure). The standard of facilities and quality of service are not regulated and can obviously vary in accordance with airline-airport agreed capex programs in Long Term Pricing Agreements.

A comparison of DIA charges to airlines compared to other Australian airports is at https://www.darwinairport.com.au/corporate/airport-charges#conditions-of-use . Given the low volume of passengers at Darwin this charges comparison provides a sound overview indicator that DIA has efficient long term capital and operating expenditure.

Any airside or landside development must accord with the airport master plan approved by the federal minister under the *Airports Act 1996* following public consultation. Additionally, any major development goes through the public Major Development Plan (development consent) process under the *Airports Act 1996* and must be approved by the federal minister.

Passenger based security charges, where the standard of facilities and staffing is minutely regulated, are essentially money in - money out of the airport business. The only benefit to the airport business is a return on capital invested which is similar to the Weighted Average Cost of Capital (WACC) in the airline-airport Long Term Pricing Agreements. The revenue and expense is periodically reconciled with airlines.

Airlines know that airports are essentially a fixed cost infrastructure business which is why, in Long Term Pricing Agreement negotiations, the major Australian airline groups pay close attention to:

- opening asset base and airport capex programs and ensure there is no 'gold plating';
- the airport Weighted Average Cost of Capital (WACC);
- opex path; and

- passenger projections to ensure the total costs are spread across as many passengers as possible.

These are the 4 fundamental variables which determine passenger based charges in Long Term Pricing Agreements and airlines will not give approval unless the landing point on each is a commercial outcome for them.

2. DARWIN INTERNATIONAL AIRPORT EXPERIENCE

Airport Overview

Darwin is a joint-user civil-military airport and shares the runway and taxiway system with RAAF Base Darwin. It is also a large general aviation airport with some 140 general aviation aircraft.

The dynamics of the Darwin airline market are dictated by the following factors:
- a small population catchment meaning a small outbound market;
- only the regional carrier Air North is based in Darwin so there are no natural constraints on Australian airline groups moving capacity at will;
- Darwin is a true 24 hour airport with 2 overnight peaks and 2 day time peaks. Domestic aircraft are deployed overnight into the Darwin market when south-east Australia is largely shut down by the Sydney and Adelaide airport curfews;
- entry and exit of international carriers is a feature with 1 international carrier (Donghai) entering the Darwin market in the last 12 months and 3 (Malaysia, Philippine and Indonesia Air Asia) exiting in the same period; and
- Qantas Group is the dominant airline group with between 70% and 55% of total domestic and international capacity over the period since the last Productivity Commission Inquiry.

DIA has a common use domestic and international terminal so the airside and landside cost structure faced is the same for all carriers.

Most Recent Airline Long Term Pricing Agreements

Historically, Long Term Pricing Agreements (LTPA's) were settled with Qantas Group as the dominant airline group which, in a common use facilities environment, then sets the broad benchmark for the other 6-9 airline pricing agreements of varying periods.

The most recent LTPA with Qantas Group was from July 2009 to June 2017 (executed August 2010). This took 2½ years to negotiate during a period when the Darwin terminal was over crowded during peak periods. However, DIA could not commence a terminal expansion until the capital expenditure and pricing path had been agreed/approved, initially by the dominant airline group and then other airlines.

This LTPA feature of airlines assessing and approving airport capital expenditure (i.e. airport airside and landside infrastructure capability and level of service) is one that continues during the life of LTPA's. An example during the 2009 – 2017 LTPA was a 2014 aircraft taxiway upgrading project that expanded in scope with a resulting increase in cost that was more than the amount allocated in the LTPA (note that Darwin is a joint user civil-military airfield and this increase in scope was required by Department of Defence). Airline approval was required for the amended scope and cost with the overall capital expenditure in the LTPA being maintained through substituting capital capacity from other projects which could be deferred.

Another facet of LTPA's is that the airport takes the demand risk associated with the airline agreed passenger growth projections which are a key component in calculating the LTPA pricing path. Demand risk for an airport obviously varies with factors such as passenger throughput, population

catchment, number of carriers, airport slots available, proportion of the passenger traffic carried by airlines which have a base at the airport, diversification of local economy, technology/geography risk (e.g. being bypassed with longer range aircraft, traffic diverted to a competitor airport) and environmental risk (eg Indonesian volcanoes, cyclones).

Airports which have a significant population catchment, large number of carriers, have major airlines with bases at the airport, have few aircraft slots available at peak periods and have low technology/geography risk obviously have a lower demand risk than airports which do not share these characteristics.

Darwin has none of the characteristics which lower demand risk and this is borne out by the fact that Darwin has less overall airline capacity in 2017-18 than it did in 2011-12 (refer Attachment 1). The south-east Australia capital city airports, with the exception of Canberra, have all seen real growth in airline capacity over that period.

Historically, Darwin has enjoyed longer term average annual passenger growth of around 5%. The LTPA's, which included the pricing path to fund a significant terminal and aircraft apron expansion, included airline-airport agreed passenger projections reflecting that historical growth.

A major terminal expansion and additional aircraft apron positions were completed in 2014. The predicted airline-airport agreed 5% pa passenger growth did not occur (refer Attachment 2). This obviously means that the passenger projection/pricing path demand risk, borne solely by the Airport, was realised with a material adverse impact on airside and landside aeronautical revenue.

In Attachment 2 the indicative impact on aeronautical revenue is calculated.

This is an example highlighting the real LTPA demand risk faced by airports in the circumstances of Darwin.

New LTPA Discussions and Airline Paying

Prior to and since the expiry of LTPA's in June 2017 DIA has found it difficult to engage meaningfully with the Qantas Group.

On expiry of LTPA's, and without new ones in place for the 2 main airline groups, DIA applied a 2.5% increase to airline airport charges on 1 July 2017 and a 2.5% increase on 1 July 2018. These pricing increases are slightly less than the pricing path increase in the most recent LTPA and provide for continuation of the ongoing DIA capital program and modest opex growth.

Most airlines, in the absence of an LTPA, are paying the increased charges.

However, Qantas Group has refused to pay the 2.5% increase on the basis that it does not pay charges it does not agree to. DIA does not have a commercially viable response and hence is powerless to counter the Qantas tactic. Qantas Group also has a long standing position that it does not recognise Conditions of Use published by DIA for all airport users.

The debt will continue to accumulate with the options being a negotiated outcome, court ruling or writing the debt off because DIA simply does not have the ability to recoup the debt.

The airport lease under the *Airports Act 1996* requires DIA to continue making the required airside and landside capital and maintenance expenditure to meet aeronautical needs, regardless of the state of play with LTPA's.

In discussions on a new LTPA Qantas Group are open about their insistence that the LTPA Weighted Average Cost of Capital (WACC) should be around 5%. This is strongly at odds with their own Return on Invested Capital (ROIC) objectives and recent performance.

A WACC around 5% is not a basis for future capital investment or returns on the existing asset base.

3. ALICE SPRINGS AIRPORT EXPERIENCE

Airport Overview

Alice Springs is a regional domestic airport in a remote part of Australia. It is important in Central Australia for both its airline services and a resident general aviation fleet of around 50 aircraft.

The dynamics of the Alice Springs airline market are dictated by:

- a very small population catchment meaning a tiny outbound market;
- the passenger traffic is primarily inbound tourism, with intermodal competition from train and self-drive tourism;
- there is competition with Ayers Rock Airport for Central Australian international and domestic tourism passenger traffic travelling by air;
- no airlines have a base in Alice Springs; and
- Qantas Group is the dominant airline group with between 99% and 83% of total capacity over the period since the last Productivity Commission Inquiry (refer Attachment 3).

Demand Risk

Demand risk for an airport obviously varies with the factors already outlined above.

Alice Springs Airport (ASA) rates highly in most of the demand risk factors and carries real demand risk in any LTPA or similar arrangement.

Refer Attachment 4 for Alice Springs passenger traffic over time. As can be seen, the passenger throughput has varied considerably over time and in 2017 Alice Springs had around 70% of the passenger traffic it enjoyed in 1995. This is unusual among Australian airports. Between 2010 and 2015 Tigerair entered and exited the Alice Springs market twice.

Airport Pricing and Airline Paying

Up until 30 June 2015 there was a Qantas-Airport pricing agreement in place in the form of an exchange of correspondence (no other airline had the need for one).

Since June 2015 there have been discussions with airlines on Long Term Pricing Agreements. As with Darwin, it has been difficult to make progress towards a new LTPA with Qantas Group, particularly their insistence on a WACC around 5%. As noted above, this contrasts with their own Return on Invested Capital (ROIC) objectives and recent performance. A WACC around 5% is not a basis for future capital investment or returns on the existing asset base.

In the absence of an LTPA, Alice Springs Airport (ASA) applied a 3% charges increase from 1 July 2015 and 2.5% increases on 1 July 2016, 1 July 2017 and 1 July 2018. These pricing increases are slightly less than the pricing path increase in the most recent pricing agreement and provide for continuation of the ongoing ASA capital program and modest opex growth.

For the past 3 years Qantas has refused to pay the increases on the basis that it does not pay charges it does not agree to. Qantas continues to pay passenger based charges at the level that applied on 30 June 2015.

Qantas Group also has a long standing position that it does not recognise Conditions of Use published by ASA for all airport users.

ASA has attempted a number of times to engage Qantas Group, in the absence of an LTPA, on payment of the notified increases since 1 July 2015. This has included ASA proposed mediation/arbitration.

There has been no change in the Qantas position. As ASA does not have a commercially viable response it is powerless to counteract the Qantas tactic.

The debt is currently $1.6M and accumulating on a monthly basis. As with Darwin, the debt will continue to accumulate with the options being a negotiated outcome, court ruling or writing the debt off because ASA simply does not have the ability to recoup the debt.

The airport lease under the *Airports Act 1996* requires ASA to continue making the required airside and landside capital and maintenance expenditure to meet aeronautical needs, regardless of the state of play with LTPA's.

After 3 years ASA is seriously contemplating legal action as its only avenue of redress.

4. MARKET POWER

Darwin and Alice Springs Airports present an interesting case study in the debate on airport monopoly power and airline countervailing market power.

Both Darwin and Alice Springs Airports have demonstrated substantial market demand risk and a dominant airline group.

In any Long Term Pricing Agreement (LTPA) reached every parameter of the Agreement is agreed between the airline and airport. The combined agreed parameters (opening asset base, passenger projections, capex and opex projections, WACC, service levels etc) calculate the pricing path. An important, and sometimes overriding, parameter in the pricing path is the passenger projections. The LTPA is a contract, except for the passenger projections where the airport takes the demand risk (note that, if passenger projections are exceeded, airlines normally have a progressive discount regime on passenger charges for any overachievement).

At an airport with lower demand risk the probability the forward looking pricing path will not achieve sufficient revenue to support the capex and opex path is probably minimal. At an airport with significant demand risk, as demonstrated, it is a real issue. The experience of DIA in undertaking a significant expansion of aeronautical facilities on the basis of the passenger projections and related pricing path, and then only achieving minimal growth over a nine year period, is a case in point.

In the circumstance of an airport with real demand risk there appears, because of the airport revenue impact of underachieving passenger projections as opposed to progressive discounts on airline charges for overachievement, to be a material imbalance in favour any airline/airline group which carries a significant component of the airport passenger traffic.

Market power is usually indicated by behaviour. In the case of Darwin and Alice Springs the Qantas Group is ignoring notified price increases on the basis it does not pay any charge it does not agree

to. This short paying can occur indefinitely. In the case of Alice Springs this has occurred for 3 years.

There is no viable commercial response available to either Airport.

This is clear evidence of the exercise of significant market power by an airline group.

5. DARWIN AIRPORT SERVICE QUALITY

Darwin International Airport (DIA) has employed the Airports Council International (ACI) independent Airport Service Quality (ASQ) passenger survey system since 2013 to measure quality of service across 36 parameters. DIA publishes the results on a quarterly basis on its website.

Attachment 5 compares the results of 2013 (when the major terminal expansion was underway) to the most up to date 2018 results. There is a clear improvement in passenger views of quality of service across the board.

6. AIRPORT FUEL SUPPLY

Jet fuel at Australia's main airports is supplied by joint venture Joint User Hydrant Installations (JUHI's).

JUHI's were established at the 10 largest airports in Australia by fuel volume. All are unincorporated joint ventures with between 2 to 4 oil company members except for Sydney where Qantas is one of the JUHI participants.

The JUHI model has been in use for almost 50 years in Australia and was introduced to minimize the capital required for fuel infrastructure at airports (and therefore the price of jet fuel). Membership is via equity purchase whereby each joint venture member has an equal share.

However in the almost 50 years of JUHI experience in Australia, there has been only one new member (Qantas) join at one airport via equity participation.

The Board of Airline Representatives of Australia (BARA) has consistently lobbied for some time for competitive supply of jet fuel at Australia's international airports. "All jet fuel, whether locally produced or imported, is stored at each airport before being distributed to aircraft. Open and effective access to these facilities is therefore critical in supporting the achievement of BARA's vision for a competitive and reliable supply of jet fuel." P12 *A Competitive Supply of Jet Fuel at Australia's Major International Airports,* Board of Airline Representatives of Australia, December 2014.

Darwin took the opportunity of the JUHI bulk fuel storage lease expiring in December 2016 to open the Darwin jet fuel market to competition. This was achieved by DIA purchasing 40% of the joint venture bulk storage and aircraft apron hydrant installations in 2017 with the remainder being acquired over 12 years. Prior to 100% DIA acquisition, any capital expenditure on the bulk storage facility and aircraft apron hydrant network will be 100% funded by DIA.

This has created an open access market for jet fuel supply in Darwin with companies outside the former joint venture members now bidding on fuel supply contracts. There are indications that on a like for like basis the Darwin jet fuel cost has reduced because the market is now contestable.

Alice Springs is in a different situation but the medium term objective is to have an open access market.

Attachment 1

Darwin International Airport Airline Seat Capacity FY 2011-12 to 2017-18							
Airlines	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**
Air North	342,608	350,808	351,725	416,380	422,940	407,249	382,046
Indo AirAsia	109,800	-	72,720	74,880	74,160	75,240	41,760
Malaysia	-	-	42,240	63,040	50,240	48,320	3,840
Philippine	-	18,096	124,246	100,580	109,176	140,316	105,632
Qantas Group	2,267,596	2,031,903	2,078,115	1,831,739	1,745,020	1,784,240	1,699,048
SilkAir	13,824	54,450	56,720	67,910	88,092	73,224	81,012
Virgin Group	423,637	516,617	521,402	592,275	650,262	655,800	644,120
Others	68,685	115,130	86,911	32,942	58,605	56,622	67,018
Total	3,226,150	3,087,004	3,334,079	3,179,746	3,198,495	3,241,011	3,024,476
Qantas Group Capacity Share	70.3%	65.8%	62.3%	57.6%	54.6%	55.1%	56.2%
Virgin Group Capacity Share	13.1%	16.7%	15.6%	18.6%	20.3%	20.2%	21.3%
Air North Capacity Share	10.6%	11.4%	10.5%	13.1%	13.2%	12.6%	12.6%

Source: Darwin International Airport capacity data

Attachment 2

DIA Calendar Year Passengers 2007 to 2017 and Demand Risk Revenue Impact 2015 to 2017								
Calendar Year	**Domestic Passengers**	**International Passengers**	**Total Passengers**	**Growth on Previous Year**	**5% Growth pa in LTPA's**	**Published Aero Charges per Passenger**	**Approx. Aero Rev. Impact Each Year**	**Approx. % Actual Aero Revenue**
2007	1,311,984	151,319	1,463,303					
2008	1,409,316	187,837	1,597,153	9.1%				
2009	1,324,799	195,742	1,520,541	-5.0%	1,667,010			
2010	1,405,968	217,005	1,622,973	6.7%	1,760,861			
2011	1,559,770	326,935	1,886,705	16.2%	1,848,904			
2012	1,612,078	328,714	1,940,792	2.9%	1,941,349			
2013	1,643,931	333,217	1,977,148	1.9%	2,038,416			
2014	1,760,539	318,670	2,079,209	5.1%	2,140,337			
2015	1,768,761	262,787	2,031,548	-2.3%	2,247,354	$17.65	-$3.8M	9%
2016	1,803,129	272,069	2,075,198	2.1%	2,359,722	$18.18	-$5.2M	12%
2017	1,801,998	274,857	2,076,855	0.1%	2,477,708	$18.73	-$7.5M	16%

Source of calendar year passenger statistics: Department of Infrastructure, Regional Development and Cities (DIRDC), Airport Traffic Statistics
Notes:

1. Dominant airline group 2009/10 to 2016/17 Long Term Pricing Agreement (LTPA) executed August 2010.
2. DIA internal FY passenger data varies from the DIRDC calendar year data (latest DIRDC data available) due to the collection methodology and timing, but paint exactly the same picture. It is thought preferable to use publically available passenger data collected from airlines to avoid doubt about the veracity of numbers.
3. 5% Growth pa Projection in LTPA's column uses the 2008 calendar year DIRDC figure as the base because of the 2009/10 FY to 2016/17 FY LTPA's.
4. Demand Risk Revenue Impact calculation 2015 to 2017 illustrates the quantum of post-terminal expansion aero revenue impact when airline-airport agreed passenger projections were not achieved. Aero revenue does not include passenger security charges where the revenue and expenses are periodically reconciled.

Alice Springs Airport Seat Capacity FY 2011-12 to 2017-18							
Airlines	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**
Alliance	6,000	16,940	24,960	21,750	21,280	20,968	20,960
Air North	-	-	-	-	6,335	9,090	9,968
Qantas Group	826,335	823,772	842,815	831,753	830,368	843,082	835,103
Virgin Group	360	34,560	146,340	37,036	110,472	109,532	116,076
Other	-	-	-	-	-	360	-
Total	832,695	875,272	1,014,115	890,539	968,455	983,032	982,107
Qantas Group Capacity Share	99.2%	94.1%	83.1%	93.4%	85.7%	85.8%	85.0%
Virgin Group Capacity Share	0.0%	3.9%	14.4%	4.2%	11.4%	11.1%	11.8%

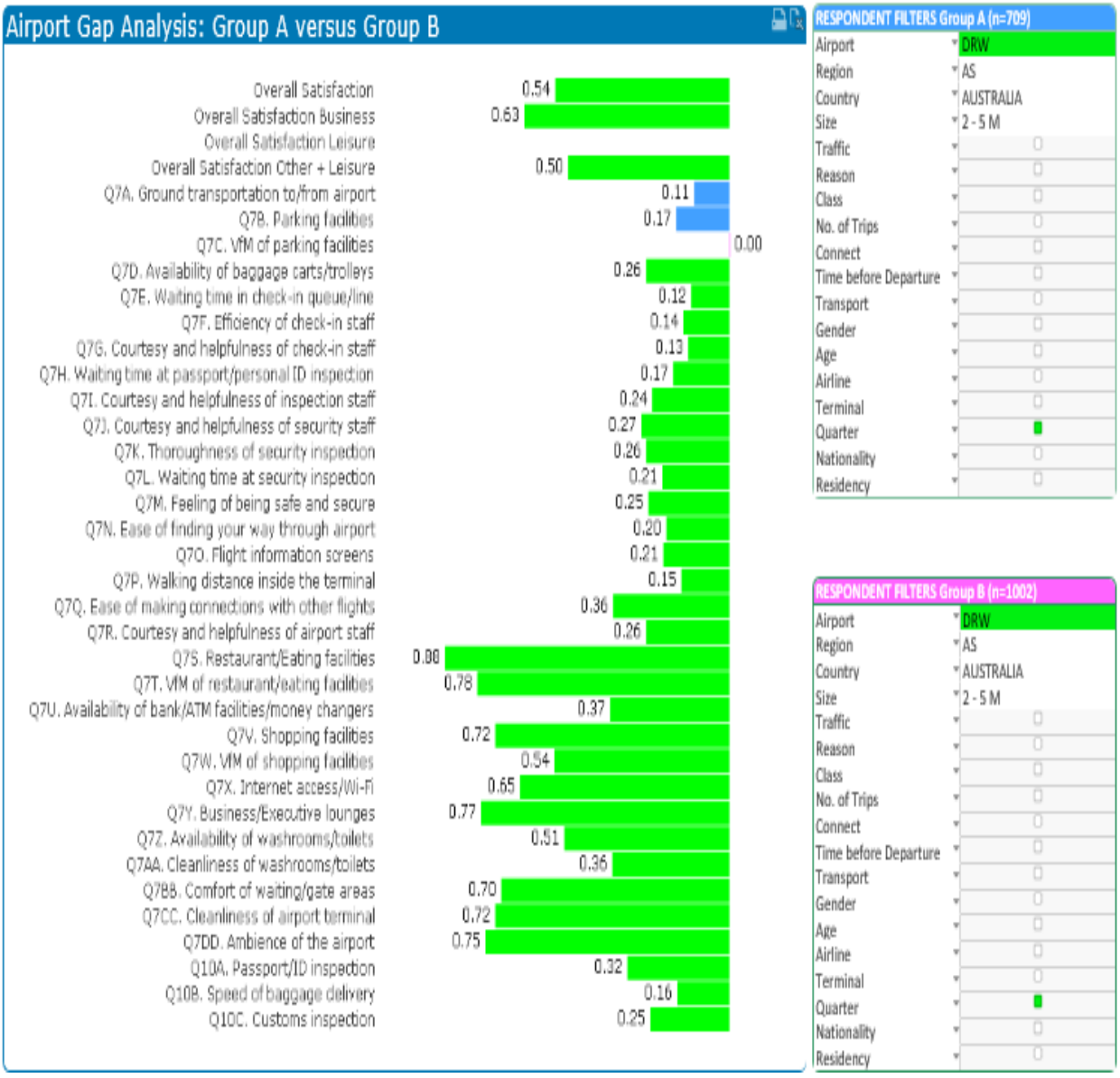
Source: Alice Springs Airport capacity data

Attachment 4

Alice Springs Airport Calendar Year Passenger Traffic Over Time			
Year	**Passengers**	**Year**	**Passengers**
1995	908,772	2007	623,525
1996	823,697	2008	650,880
1997	782,529	2009	674,901
1998	796,021	2010	668,844
1999	790,625	2011	598,749
2000	759,274	2012	579,752
2001	635,715	2013	655,245
2002	554,234	2014	621,069
2003	586,417	2015	593,510
2004	609,908	2016	612,174
2005	599,080	2017	618,493
2006	618,889		

Source: Department of Infrastructure, Regional Development and Cities (DIRDC), Airport Traffic Statistics

ASQ results Year to date 2018 compared to first year results 2013



ASQ Parameter	2018 YTD	2013 Results	Variance
Overall Satisfaction	4.03	3.49	.54
Overall Satisfaction Business	3.91	3.28	.63
Overall Satisfaction Leisure	4.13	3.63	.50
Ground Transport to/from airport	3.83	3.72	.11
Parking Facilities	3.76	3.59	.17
Vfm of parking facilities	2.98	2.98	.00
Availability of baggage carts	4.00	3.74	.26
Waiting time in check-in queue / line	4.09	3.97	.12
Efficiency of check-in staff	4.29	4.15	.14
Courtesy and helpfulness of check-in staff	4.28	4.15	.13
Waiting time at passport/personal ID inspection	4.14	3.97	.17
Courtesy and helpfulness of inspection staff	4.19	3.95	.24
Courtesy and helpfulness of security staff	4.07	3.80	.27
Thoroughness of security inspection	4.11	3.85	.26
Waiting time at security inspection	4.06	3.85	.21
Feeling of being safe and secure	4.24	3.99	.25
Ease of finding your way through airport	4.27	4.07	.20
Flight information screens	4.13	3.92	.21
Walking distance inside the terminal	4.29	4.14	.15
Ease of making connections with other flights	4.20	3.86	.36
Courtesy and helpfulness of airport staff	4.14	3.88	.26
Restaurant / Eating facilities	3.59	2.71	.88
Vfm of restaurant / eating facilities	3.15	2.37	.78
Availability of bank/ATM/ money changers	3.52	3.15	.37
Shopping facilities	3.30	2.58	.72
Vfm Shopping facilities	2.93	2.39	.54

ASQ Parameter	2018 YTD	2013 Results	Variance
Internet access / Wifi	3.72	3.07	.65
Business / Executive lounges	3.58	2.81	.77
Availability of washrooms / toilets	3.95	3.44	.51
Cleanliness of washrooms / toilets	3.87	3.51	.36
Comfort of waiting gates / areas	3.71	3.01	.70
Cleanliness of airport terminal	3.87	3.15	.72
Ambience of the Airport	3.71	2.96	.75
Passport / ID Inspection	4.04	3.72	.32
Speed of baggage delivery	3.79	3.63	.16
Customs Inspection	3.97	3.72	.25