Productivity Commission Review of the Economic Regulation of Airports

Australian Airports Investor Group Submission

September 2018

THIS SUBMISSION HAS BEEN PREPARED ON BEHALF OF THE INVESTOR GROUP BY:

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1. INTRODUCTION

This submission is prepared by a group of Australian airport investors, including Australian superannuation funds and private and institutional Australian fund managers (together, the "Investor Group"). Collectively, the Investor Group is invested in 20 airports across Australia and our airport investments represent the interest of millions of Australians either through their superannuation funds or their direct equity investments.[1] We are invested in the four airports monitored by the Australian Competition and Consumer Commission (ACCC) – Sydney Airport, Melbourne Airport, Brisbane Airport and Perth Airport. We are also investors in the self-administered price and quality monitored airports in Adelaide, Canberra, Darwin, Gold Coast and Hobart, as well as regional airports including Townsville Airport and Sunshine Coast Airport.[2]

Many of the Investor Group have been investors in Australian Airports since the Federal Government commenced its airport privatisation program in 1997-98. We are active asset managers and owners and believe the current light-handed regulatory regime operates efficiently and equitably to permit commercial negotiations between airport operators and customers and encourages right timed and sized investments into improving the airports' facilities and services, evidenced by record levels of investment and improved quality of service.

Since the price cap framework was removed in 2002, airlines and airports have consistently been able to reach commercial outcomes despite experiencing some expected negotiation tensions along the way. In our view, any suggestion that there is an absence of countervailing power by airlines is at odds with the practice we observe on a day-to-day basis across the airports in which we have invested. Rather, we have observed negotiations become increasingly robust and transparent over time with significant input from airlines into investment programs, noting airlines have become increasingly sophisticated in their approach over time. The current regime also fosters innovation and permits flexibility for commercial negotiations to extend beyond pricing to include other facilities and services (for example, airline lounges and aircraft hangars) and to achieve non-financial outcomes such as service quality.

In addition to delivering the services and terms as agreed under aeronautical agreements with airlines, airports have invested significant time and resources on additional facilities and arrangements that improve operational efficiency to the benefit of airline customers. A recent example is the successful negotiation of open access for new jet fuel providers at Melbourne Airport and Darwin International Airport, previously restricted only to the Joint User Hydrant Installation (JUHI) joint venture partners.[3] Open access enhances fuel security and provides redundancy, while competition will drive down fuel prices and encourage greater focus on service level expectations to the benefit of airlines.

The light-handed regulatory regime also incentivises airports to deliver innovative projects that have social and environmental customer-centric outcomes that improve the overall passenger travel experience. The Investor Group recognises that airports are community assets ultimately owned by taxpayers, and strongly believe that good stewardship and strong stakeholder relationships are fundamental elements of service delivery. We believe that the current regime strikes an appropriate balance between the short-term commercial interests of airlines and the need to deliver capacity in time to meet increasing demand in the interests of the wider community and Australian economy.

The Investor Group sees no justification for the introduction of a prescriptive and potentially counter-productive arbitration framework. The current regulatory framework already has a range of dispute resolution mechanisms available for both airports and airlines, including the genuine threat of regulation. The fact that these mechanisms have been used relatively infrequently reflects the effectiveness of the current regime, in which

[1] Sydney Airport is listed on the Australian Stock Exchange.
[2] Please refer to Appendix 1 for the full list of members of the Investor Group making this submission and our Australian airport investments.
[3] The JUHI JV comprises of BP, Caltex, Mobil and Shell who own and manage the fuel depot and hydrant infrastructure at the airport.

commercial agreements are ultimately achieved. A 'negotiate-arbitrate' model could potentially foster gaming and result in suboptimal, inefficient and delayed economic outcomes. A fundamental change to the framework for the regulation of airports, including the introduction of a prescribed arbitration regime, could result in a delay to ongoing airport investment or see a subsequent capital reallocation away from airports.

The Investor Group agrees that the annual price and service quality monitoring by the ACCC of aeronautical activity has been for the most part effective and should be retained, notwithstanding that the emphasis of the ACCC is not necessarily placed on the most relevant metrics. While the reporting is factual, we note that the ACCC's public commentary and focus on revenue growth per passenger and profit margins without reference to an appropriate return on capital measure, can be misleading as it places these measures out of context and ignores the significant amount of capital investment made by airports. The Investor Group calls for more balanced commentary that includes the appropriate use of financial metrics that reflect the nature of these investments and we direct the Commission to the Australian Airport Association's (AAA) submission for detailed economic discussion on this topic. We also support the AAA's view that the monitoring of car parking and ground access arrangements suffers from similar methodological challenges so should be amended or phased out.

As an Investor Group, we have sought to comment on relevant investor perspectives and have endeavoured not to cover or duplicate topics that we anticipate will be covered in other submissions by airports and airport industry bodies – particularly those that relate to commercially sensitive information on the status of current negotiations at individual airports, benchmarking of airport charges and financial metrics. We also direct the Commission to the AAA's submission for more detailed discussion and economic research on these related topics. To summarise, our key messages from an investor perspective are:

- **Under the existing light-handed regulatory regime, investors have supported significant capital investment at airports to deliver increased capacity as well as improved and innovative services and facilities.**
- **Airports and airlines face different risks. Unlike their airline customers, airports' assets are large in scale, fixed and immobile, resulting in exposure to a broad range of risks, including demand risk. In comparison, airlines are able to manage their business risks and maximise yield through capacity decisions.**
- **The existing light-handed regulatory model is working – airports and airlines have consistently been able to reach commercial outcomes for the last 16 years, reflecting a balanced negotiation environment. Further, there already exists a range of dispute resolution mechanisms available to airports and airlines. A 'negotiate-arbitrate' model could potentially foster gaming and result in suboptimal, inefficient and delayed economic outcomes.**
- **Airport investors take the threat of regulation very seriously, as demonstrated by the increasingly proactive engagement and collaboration with airlines and passengers to ensure their growth plans and service expectations are met.**
- **Any fundamental shifts away from the stability of the existing regulatory framework will destabilise investor confidence in the Australian airports sector and could result in reduced private capital availability or increased costs of capital.**

We welcome this opportunity to discuss and share our views and experiences as airport investors with the Productivity Commission.

This submission has been prepared on behalf of the Investor Group by AMP Capital Investors, AustralianSuper, Colonial First State Group Asset Management, H.R.L Morrison and Co, IFM Investors and QIC Private Capital. Please refer to Appendix 1 for the full list of members of the Investor Group. If we can provide any further assistance or clarify any part of this submission, please do not hesitate to contact Steven Fitzgerald (H.R.L Morrison and Co) or Danny Elia (IFM Investors)

2. THE SUCCESS OF AIRPORT PRIVATISATION IN AUSTRALIA

2.1. BACKGROUND

Privatisation has delivered a very positive result for the Commonwealth Government and Australian taxpayers through the reduction in Government expenditure (net debt) and transfer of risks to the private sector. Ongoing private sector investment in airports has enabled public funding to be available for use in other sectors such as healthcare and education, and the stable regulatory framework has created a sound investment environment for Australian superannuation and institutional funds while delivering improved and expanded facilities for airport users. Australian superannuants and institutions have enjoyed stable financial returns earned through their domestic airport investments, and as travellers, they have enjoyed high quality airport facilities and services that their funds have provided, as demonstrated in customer service surveys such as Skytrax.

Population growth and Australia's increasing attractiveness as a destination for tourism, education and work has resulted in rapid demand for air travel over the last two decades. To meet and support this growth, private capital has invested significantly in airport infrastructure and services and facilities. By ensuring airport capacity is not constrained, airline competition has been fostered which has, in turn, allowed airline capacity growth and maintained downward pressure on airfares to the benefit of the travelling public.

In 2016-17, the Australian airport sector facilitated 119 million domestic passenger movements and almost 40 million international passenger movements. The total number of passengers that travelled through Australian airports during 2016-17 is over 37 percent higher than ten years ago in 2006-07. Annual domestic passenger movements have grown over 28 percent, equivalent to 2.5 percent compound annual growth (CAGR) and annual international passenger movements have grown 74 percent, reflecting a ten year CAGR of 5.7 percent.[4] To support this significant growth, Australian airports, through private capital, have invested over **$11.5 billion** in capital projects over the same ten-year period to provide access, avoid congestion and improve customer service levels.[5]

Since the last Productivity Commission Review (2012) and in the five years to 2016-17, Australian airports have invested **over $6.6 billion** across aeronautical, retail, ground transport and property projects, including:
• **Melbourne Airport:** T2 Development including T2 Luxury Development (2017), Southern Precinct Development including New Terminal 4 and Multi-Level Car Park (2015/16);

[4] BITRE Airport traffic data
[5] Australian Airports Association data

- **Brisbane Airport:** Domestic Hotel Development (2017), Domestic Baggage Handling System (2017), Terminal Car Park LED Lighting Upgrade (2017), International Northern Concourse Expansion (2017), Domestic Retail Development (2016), International Airline Lounges and ePassport Smart Gate (2016), Domestic Southern Apron Expansion (2015)**;**
- **Perth Airport:** Terminal 1 Domestic Pier and Terminal 1 International Departures (2016), International Departures Upgrade and Arrivals Expansion (2015/16), Airport Drive (2015), Terminal 2 Regional Terminal and Associated Infrastructure and Airfield Works (2013);
- **Darwin International:** Catalina Premium International Lounge (2017); 5.5MW Solar Developments (2017), Terminal Expansion (2016).

2 TO 1 RATIO OF CAPITAL REINVESTMENT

Over the last 10 years to 2016-17, shareholders have received total distributions, representing 100 percent equity ownership, of approximately $3.7 billion from Melbourne, Brisbane, Perth, Adelaide, Darwin International, Alice Springs, Launceston, and Parafield Airports. To put this figure into perspective, the same shareholders have collectively approved capital expenditures of over $7.2 billion on these airports in the same period. The ratio of reinvestment is close to 2:1, and demonstrates investors' long-term commitment to maintaining, improving and growing their airport investments.

2.2. THE NATURE OF AIRPORT INVESTORS

Airports are capital intensive and dynamic businesses that require significant investment over the long term to deliver the facilities and services at the necessary consumer and safety standards. Core to the success of Australian airports is the long-term focus of airport investors and their continued investment in infrastructure capacity and improving operations and service quality.

The owners of Australian airports are typically Australian superannuation funds and private and institutional Australian fund managers. In fact, Australian superannuation funds represent around half of total airport ownership across Australia.[6] Benefiting from the accumulative nature of the Australian superannuation regime, airport investors have a growing capital balance that can be drawn upon for continued investment in airport businesses. Additionally, the patient, yield-agnostic nature of superannuation funds allows investment considerations to look through market cycles and make long-term, customer-centric investment decisions.

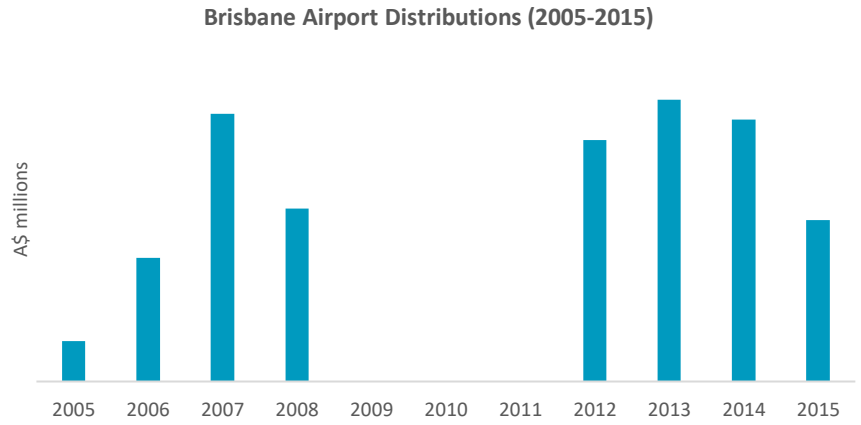
This can be a potential driver of misalignment between most airports and their airline customers when it comes to infrastructure planning, as some airline businesses are listed entities and heavily focused on short-term cash and yield considerations. In addition to the shorter term focus of airlines, airline assets are mobile and airlines are able to withhold or reallocate capacity to match demand and/or maximise yields. An example of this is Qantas Group's recent FY18 results announcement which highlighted the reduction in their domestic capacity during the year.[7] On the contrary, airports face stranded asset risk as they seek to make long-term investments in fixed assets to create capacity that cannot be adjusted if demand changes.

CASE STUDY 1: BRISBANE AIRPORT INVESTORS' SUPPORT DURING ECONOMIC DOWNTURN

- Driven by the long-term nature and investment horizon of Australian airport investors, airport shareholders have remained patient and reliable through periods of economic and market turmoil when access to capital has been severely constrained.
- During the Global Financial Crisis in 2008-09, reduced liquidity in debt and equity capital markets was reflected in availability and pricing of capital. It was critical for airports to manage their business operations and capital structures in an orderly way, thereby ensuring stability, confidence and continuity of service provision.

[6] Australian Airports Association data. Figure excludes Future Fund's airport investments.
[7] Qantas Airways Limited and its Controlled Entities – 2018 Full Year Results, Published 22 August 2018.

- Airport investors provided their support including, where necessary, measures to reduce gearing levels and maintain a strong balance sheet in the face of the uncertainty brought about by the global economic downturn, as well as ensure the airports were well-placed to deliver on their capital expenditure programs.
- As long-term investors, shareholders in Brisbane Airport agreed to forego distributions from Brisbane Airport for the three years to 2010-11, thereby ensuring a strong balance sheet was maintained to enable investment in infrastructure of national significance (for example, the New Parallel Runway).
- This was recognised by credit rating agencies, as Moody's Investors Service stated in a report dated 24 June 2010 report: "Moody's has factored in support from the Airport's shareholder base, which over the last 18 months put distributions on hold to reduce gearing and improve interest cover".



3. PRIVATE CAPITAL INVESTMENT CONSIDERATIONS IN AIRPORT INFRASTRUCTURE

3.1. HIGH OPPORTUNITY COST DUE TO LONG-DATED INVESTMENT HORIZON

Capital is mobile and Australian airports compete for funding with different opportunities across geographies, sub-sectors, asset classes and listed and unlisted products. The capital allocation decision to invest in infrastructure comes at a high opportunity cost due to its size and long-dated payback period:

- Key capacity expansion decisions at airports have **long lead times** and need to be planned and developed ahead of demand to ensure operations are not constrained.
- Airport infrastructure has a **long useful life** and once constructed, the asset is largely **fixed in capacity and location**, resulting in exposure to a broad range of risks as follows:
    - Revenue risks – driven by passenger volume and frequent contract renegotiations with airlines on pricing and capital investment plans;
    - Domestic and global macro-economies driving changes in market demand;
    - Advancements in technology that influence airlines' routes and services decisions, requirements and end-customer travel decisions;
    - Fixed and immobile nature of asset base resulting in limited ability to respond to large swings in market demand;
    - Disruption and delivery risk of new capital projects in live, complex operating environments;
    - Cyber risk, disruptive technologies and shock events;
    - Counterparty, financial and refinancing risks;
    - Geopolitical risks; and importantly,
    - Regulatory risk.

Airports exhibit far more volatile returns than most other infrastructure sub-sectors including regulated utilities, ports and toll roads, due to the high proportion of airport revenues linked to discretionary spend. Annual revenues for regulated utility assets are driven by relatively predictable consumer behaviour (for example,

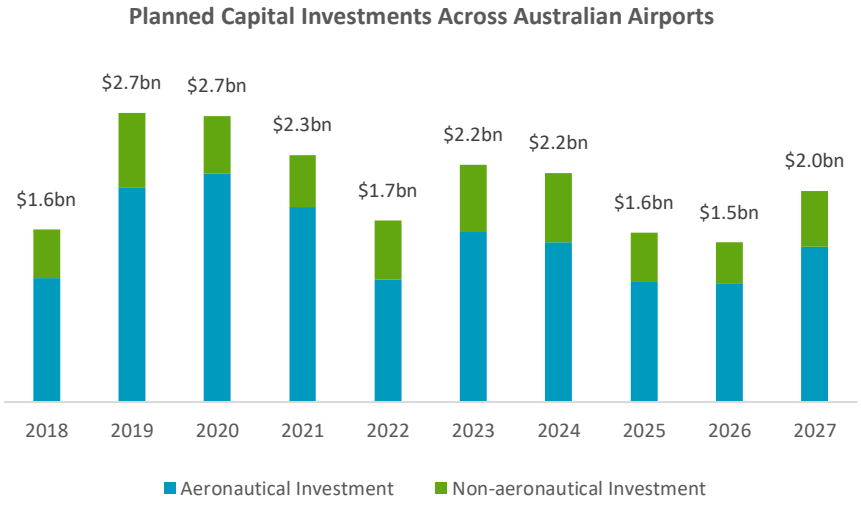
annual power and water consumption) and may be subject to revenue cap regulation and be trued-up for fluctuations, however, demand for air travel and airport retail is sensitive to the state of domestic and global economies and airline capacity and pricing decisions. This was observed during the Global Financial Crisis in 2008-09, where some airports saw significant falls in demand and total passenger movements across Australian airports fell from a 10-year compound annual growth rate of over 6.0 percent per annum to just 0.8 percent.

It is fundamental that the regulatory framework for airport investments is stable and predictable, and provides investors with confidence in their ability to recover operating and capital expenses over the long investment horizon and to earn a return on capital that is reflective of the risk-reward trade-off.

3.2. ONGOING PLANNED INVESTMENTS

Aviation is a strong growing sector, both globally and within Australia. Over the next ten years, the Investor Group's investee airports are forecast to deliver **over $20.6 billion** in capital projects. $15.2 billion is forecast to be spent on aeronautical projects including new runways, apron and terminal expansions, and $5.4 billion in non-aeronautical developments that will expand and enhance ground transport, retail and other facilities to service rapidly growing passenger volumes and provide an efficient and world-class airport experience.

Significant capacity projects and enhancements are underway and in development, including the completion of new runways at Melbourne, Brisbane, Perth and Sunshine Coast Airports and terminal expansions at Perth, Adelaide, Gold Coast and Townsville Airports. It is crucial that the airports regulatory regime does not weaken investors' ongoing confidence that they will be able to earn a fair risk-adjusted return by investing in these long-term, large-scale projects.



Key upcoming planned projects across Australian airports:

- **Brisbane Airport:** New Parallel Runway ($1.3bn), Dryandra Road Underpass, International and Domestic Multi-Level Car Parks;
- **Melbourne Airport:** Third Runway ($1.1bn), T2 Airside Satellite Development ($280m), Forecourt Development including Elevated Road and T4 Express Link, T2 Arrivals Hall and T3-T4 Integration; 6.5MW Solar Development;
- **Perth Airport:** Second Runway ($520m);
- **Adelaide Airport:** T2 Apronway and Taxiway Resurfacing Design, Terminal Expansion and Retail Development, Atura Hotel Development and Hotel Link.

4. THE CURRENT REGULATORY REGIME IS WORKING

The current light-handed regulatory regime for Australian airports is working. Beyond the inherent conflicts of commercial tension between operator and customer, airports and airlines have reached multi-year pricing and capital expenditure agreements since the price cap arrangements were removed in 2002. Negotiation techniques have become increasingly sophisticated and agreements often include innovative aspects that extend outside core aeronautical services.

Whilst airports may theoretically on face-value exhibit some monopolistic characteristics, in practical terms, airports are highly bound by competition and kept in check across multiple fronts including:

- Significant countervailing market power of airlines (discussed below);
- Proximity to other airports, both within and across state and territory borders;
- Fixed nature of airport infrastructure: unlike their airline customers who are able to scale back capital investment (for example, delay the purchase of new aircrafts or redeployment of assets to other routes), the long lead time and long asset life of airport investments mean that airports are unable to respond quickly to changes in market demand. Airports are not incentivised to gold-plate or make hasty investment decisions due to stranded asset risk, noting also that the granular level of negotiation that takes place with airlines on new capital projects acts as a significant mitigant to any risk of gold plating;
- The 'threat of regulation' (discussed below); and
- As stewards of community assets on behalf of millions of Australian investors, airport owners believe in "doing the right thing" by end-customers in order to protect our social licence to operate and global reputations.

4.1. FLEXIBILITY TO NEGOTIATE MORE THAN JUST 'RATE OF RETURN'

Negotiations are complex and robust, with airports sharing substantial amounts of information with their airline customers. More often than not, commercial negotiations involve innovative aspects outside the core aeronautical business including airline lounges, aircraft hangars and other individual airline needs, as well as non-financial outcomes such as service quality. Airports are incentivised under the light-handed framework to reach agreement with airlines for these 'add-on' items in order to reach agreement on a whole-of-dealings basis. These ancillary items over and above base necessary aeronautical infrastructure can be negotiated under a flexible commercial agreement, whereas a heavy-handed or prescriptive arbitration regime would not have the flexibility or scope for innovative solutions to cater for discrete situations.

4.2. ABILITY TO DELIVER INNOVATIVE, ENVIRONMENTAL AND SOCIALLY RESPONSIBLE PROJECTS

In addition to the services agreed with airlines under their pricing arrangements, airports continue to invest in innovative and customer-centric facilities and services. The light-handed regime enables airports to seek out and deliver commercially sensible projects with environmental and social benefits. This includes:

- Innovative solutions to open up access to jet fuel infrastructure and increase fuel security at Melbourne and Darwin International Airport. In addition to fuel security and redundancy, airlines will benefit from competition driven by new entrants into the jet fuel market (refer Case Study 2);
- Globally recognised renewable energy developments at Brisbane, Adelaide, Darwin and Alice Springs Airports. Sunshine Coast Airport was also the first Australian airport to reach carbon neutrality. Reduced carbon footprint and lower utilities costs achieved through renewable developments can be shared with airline customers via reduced operating cost bases;
- Community focussed planning such as Adelaide Airport's purpose-built aeromedical base for the Royal Flying Doctor Service which is co-located with South Australia's emergency State Retrieval Service (MedSTAR) and rotary-wing providers; and

- Brisbane Airport's accessibility focussed operations and facilities.

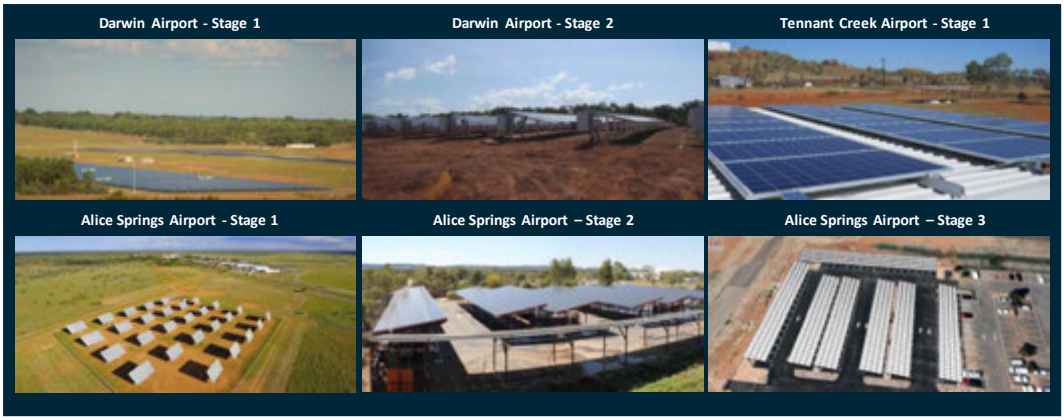
CASE STUDY 2: AIRPORTS PUSH FOR OPEN ACCESS TO JET FUEL INFRASTRUCTURE

The Investor Group is aligned with the views of the AAA, and endorse the approach adopted by Board of Airline Representatives of Australia (BARA) in proposing a reform path to encourage the competitive supply of jet fuel in Australia to airports.[8]

- In 2017-18, Melbourne and Darwin International Airports have each successfully negotiated favourable terms with the incumbent jet fuel supplier, Joint User Hydrant Installation (JUHI), and achieved open access for competing fuel importers to enter these markets.
- In August 2017, Darwin International acquired a 40 percent stake in the on-airport JUHI storage facilities and agreed a timeline to ultimately acquire 100 percent of the facility.
- Over the same period, Melbourne Airport management executed a new 20-year jet fuel lease and operations deed with the JUHI joint venture. The open access lease permits new entrants to use the infrastructure, as well as implements fuel storage capacity and reliability performance indicators that ensure the JUHI joint venture partners deliver timely infrastructure investment aligned with the future growth plans of the airport.
- By introducing fuel supply competition and implementing KPIs in relation to on-airport storage and distribution facilities, airports hope to see some downward pressure on aviation operating costs which will ultimately benefit the airlines as well as passengers via reduced airfares.

CASE STUDY 3: RENEWABLE ENERGY DEVELOPMENTS AT NORTHERN TERRITORY AIRPORTS

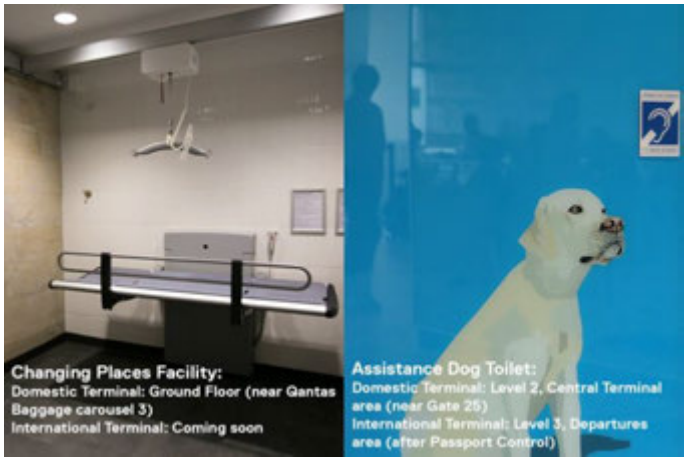
- NT Airports' pioneering investment in solar energy is unparalleled for an airport operator in the southern hemisphere.
- Darwin International Stage 1 (4MW solar array) and Stage 2 (1.5MW) is forecast to meet up to 100 percent of the airport's peak energy demand in the middle of the day, and to generate 25 percent of the airport's overall energy needs. Additionally, the two solar arrays provides a 25 percent reduction in carbon emissions from stationary energy. Combined electricity cost savings is approximately 35 percent or $2.0 million annually.
- Alice Springs Airport (total 0.9MW across three stages) generates 100 percent of daily power usage, with cost savings of $0.35 million annually.
- The reduced electricity costs benefits NT Airports and its airline customers through a reduced operating cost base.
- Significant reduction in carbon emissions – together, the Darwin International and Alice Springs Airport solar developments eliminate more than 8,000 tonnes of carbon emissions annually.



[8] BARA: International Aviation Policy Series, A Competitive Supply of Jet Fuel at Australia's Major International Airports, December 2014

CASE STUDY 4: BRISBANE AIRPORT'S FOCUS ON ACCESSIBILITY AND CUSTOMER-CENTRIC SERVICE

- Brisbane Airport is focused on accessibility for all workers and travellers and welcomes assistance animals. Tailored disability training programs are provided to all Brisbane Airport staff, including front-line airline staff, volunteers, and security staff to ensure a consistent customer experience across the board.
- In the last five years alone, Brisbane Airport has invested in excess of $3 million on accessibility and other customer-centric initiatives. This includes the completion of number of accessibility remediation projects, such as upgrading of public stairs, added Tactile Ground Surface Indicators to escalators and travelators, lift upgrades and way-finding.
- In addition to creating a welcoming and improved customer travel experience for all passengers, Brisbane Airport's accessibility initiatives will improve airline operational efficiency and enhance safety across the airport precinct.
- In 2014, Brisbane Airport opened Australia's first airside assistance animals' facility, removing the need for travellers with assistance animals to repeatedly leave the building and re-navigate security, customs and immigration processes.
- In 2017, Brisbane Airport opened Australia's first dedicated 'changing places' bathroom facility for passengers with special needs. Changing Places bathrooms provide additional space for people with profound disabilities and their carers to use the amenities more comfortably.
- Brisbane Airport was the first airport in Australia to be recognised by Alzheimer's Australia as an approved Dementia Friendly organisation.



5. THE COUNTERVAILING POWER OF AIRLINES IN COMMERCIAL NEGOTIATIONS

Airports are strongly incentivised to reach commercial agreement with airline customers and they lack appetite for the uncertainty of seeking to enforce outcomes through the courts. Airports do not have the legal capacity to unilaterally set airport charges. Airports have different levels of negotiating power in relation to the major airlines, driven by the market share of the major airlines and available capacity for the introduction of new carriers into a particular airport. This enables a countervailing market power which leads to effective negotiation processes for setting aeronautical charges, including airlines having a significant degree of power and input as to where, how and when the aeronautical dollar is spent on facility maintenance, improvement and expansions.

This is demonstrated by the current stalemates experienced at Melbourne, Perth, Adelaide, Darwin and Alice Springs and Townsville Airports, where pricing and capital expenditure agreements have been executed with all but one remaining airline group. Several airports are now recording significant underpayment from this airline group, while the airline group continues to use the same airport services and refuses to support capital expenditure projects. While disputes on pricing, capital projects or terms can result in delayed contract renewals under the current regime, it reiterates the complexity of aeronautical negotiations and that airports cannot force outcomes. If a mutually acceptable outcome is not achievable, airports and airlines have a range of dispute resolution avenues available for dispute resolution, including litigation. (Refer Section 7.1)

Airports are, however, service providers not only to airlines but to passengers and the decision to progress legal proceedings is a serious one. Airports are focussed on improving customer experience and will avoid or minimise

disruption to passengers where possible. For example, while there are commercial levers that airports can lean on when airlines fail to comply with their contractual obligations (for example, eviction from lounges and terminals and removal of branding), airports are aware that these actions would ultimately hurt the end-customer. Airports operate under a social licence and have a strong community service obligation to provide an efficient and positive journey experience.

Airports can be at a disadvantage to airlines in terms of utilising media and public influence as they typically do not hold the primary relationship with the end-customer. Passengers book travel arrangements through airlines' websites and as a result, airlines have access to passenger details and information and are able to communicate and develop relationships with passengers before and after their travel arrangements. On the other hand, with the exception of social media and online advance car park bookings, passengers often do not interact with airports until they arrive at the airport precinct. Major domestic airlines also have a larger base of stakeholders compared to airports, and are often listed entities with prominent public profiles enabling airlines to have greater reach and support from the travelling public.

5.1. DIVERGENT INTERESTS BETWEEN DIFFERENT AIRLINES – POWER OF INCUMBENT AIRLINES

Foreign carriers have been and are looking for more airport capacity in order to increase services to Australia. Airport investors have supported this growth through infrastructure investment and improvement in service quality. The ultimate beneficiaries are end-customer passengers who benefit from increased choice and increased competition between airlines, driving down the cost of passenger airfares.

Airport operators are continually trying to reconcile between the expectations and plans of individual airlines and groups. Negotiations are complex and often contentious, particularly when it comes to the topic of capacity growth and changes in airport infrastructure for the benefit of the broader aviation community (passengers and businesses alike), which may be contrary to the interests of established airlines seeking to protect their market share. This has become increasingly contested in more recent times as airport capacity becomes constrained and these complex discussions will continue to intensify with significant capital expenditure investments planned.

Incumbency has led to the high barriers of entry for new airlines, particularly in the Australian domestic market. Australia's domestic aviation duopoly is evidence of the strong market power and difficulty for new airlines to penetrate into the market. The two-speed aviation market in Australia further supports this – international passenger growth of 5.7 percent annually over the last decade was made possible through continued investment in airport infrastructure agreed with airlines. This compares to total domestic passenger movements of only 2.5 percent growth per annum over the same period.

To date, airports have responded proactively by bringing the aviation community together to make capital planning and investment decisions. For example, Adelaide Airport has significantly de-scoped its terminal expansion plans to a smaller, short-term expansion focused on providing interim international capacity, given the lack of support from a major domestic airline for the original, larger, integrated international/domestic expansion project that would have also provided additional domestic capacity. As discussed in Case Study 5, the de-scoped project results in the need for a multi-staged series of terminal expansion projects as the current expansion will only provide capacity to 2029. While this is not optimal from a disruption and cost perspective, management has worked collaboratively with airlines to develop an outcome that meets airline expectations whilst satisfying the pressing need for international capacity in the short to medium term and a full retail transformation that benefits all airport users.

CASE STUDY 5: ADELAIDE AIRPORT'S TERMINAL EXPANSION PROJECT – BALANCING THE CONFLICTING OBJECTIVES OF VARIOUS AIRLINES AND THE LONG-TERM NEEDS OF THE BROADER COMMUNITY

- Adelaide's rapid growth as an international and domestic destination has prompted a $165 million Adelaide Airport terminal expansion that will significantly improve the travel experience for passengers, meet and greeters and employees in the precinct.
- The three-year construction project will significantly upgrade international arrivals and departures as well as dining and retail facilities both landside and airside. In addition to expanded border control and security space, international upgrades include a second, longer baggage belt in arrivals, a bigger Duty Free precinct for arrivals and departures and a complete refurbishment of retail areas for domestic and international passengers.
- The terminal expansion project was designed in collaboration with the airlines and has undergone significant redesign from its original scope at the request of a large domestic airline group. The ultimate design was rationalised from an integrated international/domestic capacity expansion project to an international-only expansion that provides capacity through to FY29 and results in the need for a multi-staged series of smaller terminal expansion projects to meet future demand.
- Management are focussed on balancing the conflicting objectives and expectations of various airlines and the longer-term needs of the broader community.

CASE STUDY 6: AIRLINE CONSULTATION IN DESIGNING MELBOURNE AIRPORT'S NEW TERMINAL 4

- The New Terminal 4 (T4) development was delivered to ensure that Melbourne Airport was able to meet increasing demand in the domestic aviation market, and particularly the growing low cost carrier (LCC) market.
- T4 hosts over 30 new retail concessions including Boost Juice, Brunetti and Country Road, providing a wide range of retail and food and beverage options for passengers, meeter and greeters and precinct employees. Concessions were hand-picked through extensive market research of T4 users' preferences.
- T4 was designed to meet the needs of the LCC airlines by delivering substantially upgraded but streamlined 'no frills' facilities that allows airlines to service their customers at the lowest possible cost.
- T4 was the first terminal in the Asia Pacific region to feature fully self-service check-in facilities, with no conventional check-in desks.
- Twelve new aircraft gates were provided in the new Pier G and designed as ground level, walk-out operations (i.e. no aerobridges) in direct response to airline requirements to simplify operations and reduce cost.

6. CONCERNS AND SUGGESTIONS REGARDING THE ACCC'S MONITORING REPORTING

The Investor Group acknowledges that the ACCC's annual Airport Monitoring Report collects a breadth of data for different information users and generally assists in maintaining transparency of airports' operational and financial performance. Whilst the reporting is detailed, we believe there are more effective and representative reporting measures available on service quality and passenger experience which we encourage the Productivity Commission and ACCC to consider adopting.

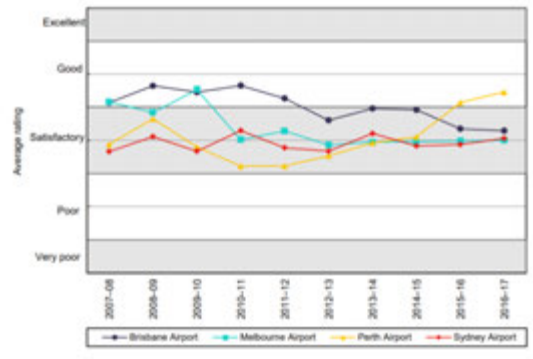
Further, we strongly encourage the ACCC to adopt headline metrics that reflect the significant capital (scale and long-term payback period) invested into airport assets and drives financial performance. Financial measures used to assess airport performance should consider the high opportunity cost of infrastructure investment, risk to delivery and long lead-time and risks associated with recovering a return on capital as discussed Section 3.1. We also note that while the reporting is factual, comments and headline profit metrics can be misleading absent of context. In particular, the Investor Group is conscious of the adverse impact that selective use of financial performance measures can have on the end-consumer, threatening the efforts and ability of airports and airport owners to improve airport infrastructure facilities for airline customers and passengers.

6.1. AIRPORT SERVICE AND QUALITY MONITORING

The complex relationship between airports and airlines creates a natural response for airlines to rate airports' quality of services more sceptically than end-customers/passengers. The ACCC's 2016-17 Airports' Monitoring Report shows airlines' ratings of airports' service quality to be between the lower bound of Satisfactory to middle bound of Good, whereas the ratings observed from passenger surveys shows all four monitored airports to be, on average, far more favourable, from the lower bound of Good to lower bound of Excellent. The passenger survey results have made small increments or stayed relatively consistent over the last ten years across the monitored airports (despite volumes increasing substantially from 116 to 150 million total passenger movements over the last ten years), and reflect a much higher level of satisfaction compared to the airlines.

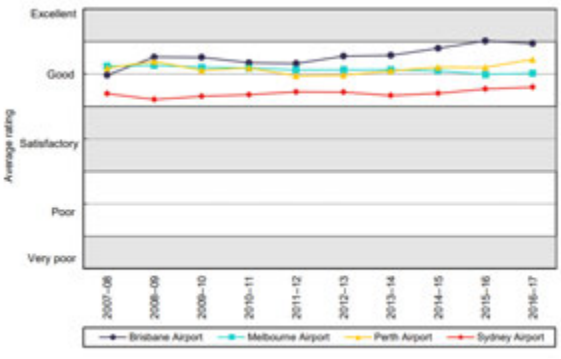
We note that the large increase at Perth Airport occurs during the period immediately after the completion of the dedicated regional terminal (Terminal 2) and the opening of the Terminal 1 domestic pier used by Virgin Australia, and coincides with the commodities crash that caused the withdrawal of Perth's high volume of Fly-In Fly-Out regional mining services. During this period, on-time performance exceeded expectations due to the reduced number of services and the incumbent regional airlines were able to grow in what was effectively an unconstrained environment. While services and amenities improved for passengers travelling through Perth Airport, passenger survey ratings over the same period barely changed in comparison to airline satisfaction.

AVERAGE AIRLINE RATINGS OF QUALITY OF SERVICE



Source: Airline surveys.

AVERAGE PASSENGER RATINGS OF QUALITY OF SERVICE[9]



Source: Passenger surveys.

[9] ACCC Airport Monitoring Report 2016-17.

SUGGESTIONS: ALTERNATE SERVICE AND QUALITY MONITORING

Australian airports and their shareholders understand the importance of monitoring and improving passenger service. The large majority of major Australian airports (including airports not subject to ACCC monitoring) voluntarily undertake frequent and ongoing self-monitoring of passenger satisfaction through the Airports Council International ("ACI") Airport Service Quality (ASQ) surveys which are conducted regularly with results reported on a quarterly basis to the boards and shareholders of the airports. Service level targets such as those measured by ASQ results are typically part of the annual remuneration incentive schemes for airport senior management teams.

Since its creation in 2006, the ASQ Survey has become the world's leading airport passenger satisfaction benchmark with over 340 airports participating, across 85 countries. ASQ is the only global airport survey based on measuring passengers' satisfaction taken while they are at the airport. Some 600,000 passengers per year are interviewed prior to boarding their flight and asked to rate their satisfaction with the airport's services across 34 key performance indicators. In 2017, over half of the world's 7.7 billion travellers passed through an ASQ airport.

With a global, world-leading measure for passenger satisfaction already in existence and being closely monitored and benchmarked by airports, the ACCC service quality surveys could be considered unnecessary duplication. A more effective, timely and efficient way forward would be for the monitored airports to report ASQ survey results to the ACCC.

6.2. CONCERNS REGARDING CURRENT FINANCIAL METRICS REPORTING

We note that the ACCC's annual monitoring report is factual in its presentation of airports' financial performance. However, the Executive Summary and related media commentary tends to emphasise and focus on revenue per passenger metrics, operating profits and profit margins, with little attention given to the return on assets measure embedded in its report. Where a return measure has been used in the ACCC's 2016-17 monitoring report shows that return on assets for each of the monitored airport's aeronautical assets has been in decline for the past several years. The range of returns (between 7 to 11 percent) is also commensurable to the risk profile of such investment, and shows no evidence of monopoly premium or abuse of market power.[10]

As discussed above, airports are capital intensive businesses and require significant ongoing investment. Therefore, discussion of operating profit margins (which excludes capital expenditure) can be misleading. Profit margins and revenue per unit metrics are better suited for fast moving consumer goods and retail businesses with minimal capital requirements.

We refer to the AAA's submission for further detail on why benchmarking revenue per passenger and profit margins is an oversimplification and not an appropriate measure of airports' true returns, as it does not reflect the significant amount of capital investment made by airports.

SUGGESTIONS: FINANCIAL METRICS REPORTING

There exists an opportunity for the Productivity Commission to review and revisit the information collected and financial metrics reported by the ACCC. The Investor Group welcomes the opportunity to engage collaboratively with the Productivity Commission and the ACCC to determine the most relevant financial metrics and benchmarks.

[10] ACCC Airport Monitoring Report 2016-17.

Importantly, information presented publicly in media releases should be balanced and reflect both operating results as well as capital investment and the returns on investment.

6.3. GROUND TRANSPORT AND CAR PARK PRICING MONITORING

Often, the public debate around car parking is centred on at-terminal car park prices, ignoring the various parking options and pricing levels available at airports. At-terminal under cover car park prices are indeed higher than the long-term, off terminal car park, reflecting a premium for product standard and convenience, which is a fundamental principle underpinning car park businesses more generally.

The Investor Group's view is aligned with the ACCC's findings that there is a sufficient range of parking options available on and off-airport (with airport shuttle connection) and online discounted pre-booking options to drive substantial competition to avert any leverage of airports' theoretical monopolistic positions. While Melbourne Airport has continued to attract negative attention for its car parking prices, the ACCC's 2016-17 Airport Monitoring Report notes that motorists in Melbourne have extensive options and "can choose from 15 different car parks operating near the airport". The Investor Group also notes that in 2016-17, Melbourne Airport significantly lowered its drive-up car park prices in response to the increasing off-airport car parking competition and customer feedback in an attempt to win back market share, further supporting that sufficient competition exists.

Airports have cost-free ground transport options, including transfers to and from long-term car parks and kerbside public pick-up and drop-offs. In addition, rideshare and taxi access charges in the airport precinct are well-known and published on airports' websites in line with recommendations from the 2011 Productivity Commission report. Further, many airports have public transport options including heavy rail and bus services, and/or support the development of new mass transit linkages (for example, Melbourne Airport's support for a rail link).

The Investor Group believes that airports have made significant efforts to increase competition in ground access markets, which have significantly increased choice for consumers and reduced the market shares of their own car parks. We understand that a number of airports have commissioned independent studies on market power issues relating to ground access and have all found there is no evidence of abuse of market power, reiterating the Commission's findings in the past. **On this basis, the Investor Group supports the AAA's view that the monitoring of car parking and ground access arrangements should be amended or phased out.**

7. DISPUTE RESOLUTION

Since the removal of the price cap regulation in 2002, airport operators and airlines have demonstrated an ability to achieve commercially negotiated pricing outcomes. The Productivity Commission's 2011 inquiry found "neither airports nor their customers support supplanting commercial negotiation with heavy-handed regulation" and the Investor Group concurs with the Commission's view that "having moved to commercially focused negotiations with at least some form of constructive engagement, it would seem retrograde to allow a reintroduction of heavy-handed regulation that could displace commercial negotiations and encourage gaming".

The commercial negotiation process and acumen between airports and airlines has grown in sophistication over time. The current experience across airports and airlines' aeronautical services negotiations and the outcomes achieved for the benefit of all users are testament to the balance of bargaining powers of each party. The Investor Group believes the current stalemate with one airline group presents a distorted view of a functional regulatory regime due to potential gaming by the airline group in response to the timing of the Productivity Commission's review.

7.1. THE CURRENT REGIME HAS A RANGE OF DISPUTE RESOLUTION MECHANISMS

The current regulatory regime includes a range of mechanisms available to both airports and airlines to resolve disputes, and the agreements in place between airports and airlines contain extensive dispute resolution frameworks. Airlines have demonstrable and significant countervailing power in negotiation and airports lack the legal capacity to unilaterally enforce commercial outcomes. In order for airports to assert their position in the face of determined airline resistance, they must bring costly and risky legal proceedings.

Dispute resolution in the courts is a well-developed and functional process utilised for business negotiations across industries. This should not differ for airport and airlines.

- Airports remain exposed to declaration under Part IIIA and reforms relating to process make it a more efficient process than before;
- Airports can give an access undertaking under Part IIIA;
- Airports and airlines can agree to private mediation and/or arbitration; and
- Both sides can elect to use media and political influence to publicly and/or privately influence the position of the other party.

The fact that these mechanisms have been used relatively infrequently is just one measure of the effectiveness of the current regime, in which commercial agreements are ultimately achieved.

7.2. AN ARBITRATION MODEL MAY RESULT IN PERVERSE OUTCOMES AND GAMING

A fundamental shift towards a 'negotiate-arbitrate' model is likely to drive perverse incentives where negotiating parties prematurely use the mechanism rather than seeking a genuine negotiation in good faith. Disputes that emerge between airports and airlines are multifaceted and usually cover more than fair pricing and can involve a range of interdependent factors. Further, it is often the case that the interests of multiple airport users can be involved. A 'one size fits all' approach is therefore not appropriate for the aviation industry.

Furthermore, adoption of the 'Final-Offer' Arbitration framework, as proposed by the A4ANZ, is a fundamental change to the current regulatory regime that may introduce dysfunctional gaming of the process and will increase uncertainty for equity investors and debt providers, which would be acknowledged by ratings agencies. While the effects are not certain, a major shift away from the existing regime will destabilise investor confidence and could result in reduced private capital availability, or the costs of capital to increase.

As outlined above, there are already a range of avenues in the current regime which are accessible for both airports and airlines to resolve disputes. **The Investor Group fails to see the justification for the introduction of a formal arbitration regime when mutually acceptable commercial outcomes are demonstrably being achieved across the industry through a robust negotiation framework.**

7.3. THE 'THREAT OF REGULATION' IS GENUINE

The threat of regulation is a significant deterrent to any abuse of market power. Since airports' price and service quality monitoring commenced in 2002, the ACCC has not recommended to the Government that it (the ACCC) should undertake a pricing investigation. Further, in both 2007 and 2012, the Productivity Commission similarly found no misuse of market power in the prices and returns in monitored aeronautical businesses.

As infrastructure investors, the Investor Group are also invested in other infrastructure sub-sectors and are familiar with the prescriptive and inflexible heavily regulated regimes in, for example, the water and power utilities sectors. As discussed above, a major attraction to investing in airports relates to the dual-till, light-handed regulatory regime which encourages commercial outcomes, incentivises innovation and allows investors to earn appropriate risk-adjusted returns that reflect volatility of the sector. The threat of regulation is genuine

and heavy-handed regulation or arbitration would destabilise the investment rationale in airports and subsequently drive investors to reconsider their capital allocation.

Since privatisation and particularly in the intervening years since the Productivity Commission review in 2012, airports have continued to become increasingly proactive and responsive to customer and stakeholder feedback, reflecting that airports and airport owners take the threat of regulation seriously. This is a function of commercial necessity, due to the proliferation of growth projects that have required airports to respond to airline customer needs, as well as a community obligation to ensure increasingly higher security standards as required by law, and to meet passengers' increasingly higher quality expectations.

The Investor Group supports BARA's push to include service levels, outcome measurement and linkages into investment decisions and capital allocation. Airports have attempted to adopt this approach by incorporating service and performance measures into major airport consultation processes including capital development plans. For example, Sydney Airport and Melbourne Airport have commenced the inclusion of Key Performance Indicators in their service level agreements with airlines and bear the financial consequences of any service underperformance. Melbourne Airport has also created a functional advisory group, the Capital Consultation Group, to facilitate collaboration and communication with airline customers. This involves all major carriers with the exception of one large Australian airline which has elected not to participate. Airlines with executed aeronautical services agreements are invited to participate and meet with the airport's project planning and delivery teams on a regular basis to evaluate and endorse the scope and timing of aeronautical-related projects prior to construction commencement.

---------- **End of Submission** ----------

8. APPENDIX 1 – INVESTOR GROUP MEMBERS

Investor Name	Australian Airport Investments
AMP CAPITAL	**AMP Capital Investors** Melbourne Airport, Launceston Airport, Port Hedland Airport
AustralianSuper	**AustralianSuper** Melbourne Airport, Brisbane Airport, Adelaide Airport, Perth Airport, Hobart Airport, Darwin International Airport, Launceston Airport, Parafield Airport, Alice Springs Airport, Tennant Creek Airport, Sydney Airport
CANBERRA AIRPORT	**Capital Airport Group Pty Limited** Canberra Airport
Colonial First State Global Asset Management	**Colonial First State Global Asset Management** Brisbane Airport, Adelaide Airport, Parafield Airport
MORRISON&CO	**H.R.L Morrison & Co Limited** Perth Airport, Melbourne Airport, Launceston Airport, Gold Coast Airport, Townsville Airport, Mt Isa Airport, Longreach Airport
ifm investors	**IFM Investors Pty Ltd** Melbourne Airport, Brisbane Airport, Adelaide Airport, Perth Airport, Darwin International Airport, Launceston Airport, Parafield Airport, Alice Springs Airport, Tennant Creek Airport, Sydney Airport
MACQUARIE	**Macquarie Infrastructure and Real Assets** Hobart Airport

New South Wales Treasury Corporation

Melbourne Airport, Launceston Airport, Perth Airport, Brisbane Airport, Adelaide Airport, Parafield Airport, Darwin International Airport, Alice Springs Airport, Tennant Creek Airport, Sydney Airport

Palisade Investment Partners Limited

Darwin International Airport, Alice Springs Airport, Tennant Creek Airport, Sunshine Coast Airport

Perron Group of Companies

Gold Coast Airport, Townsville Airport, Mt Isa Airport, Longreach Airport, Cairns Airport, Mackay Airport, Adelaide Airport, Parafield Airport, Melbourne Airport, Brisbane Airport, Perth Airport

QIC Private Capital Pty Limited

Brisbane Airport

State Super (SAS Trustee Corporation)

Melbourne Airport, Launceston Airport, Gold Coast Airport, Townsville Airport, Mt Isa Airport, Longreach Airport, Brisbane Airport, Adelaide Airport, Parafield Airport

StepStone

Melbourne Airport, Launceston Airport

Sunsuper

Melbourne Airport, Brisbane Airport, Adelaide Airport, Perth Airport, Darwin International Airport, Launceston Airport, Parafield Airport, Alice Springs Airport, Tennant Creek Airport, Sydney Airport, Gold Coast Airport, Townsville Airport, Mt Isa Airport, Longreach Airport, Cairns Airport, Mackay Airport, Sunshine Coast Airport

UniSuper

Sydney Airport, Adelaide Airport, Parafield Airport, Brisbane Airport