Qantas Group Submission

Productivity Commission Inquiry into Economic Regulation of Airports

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This is a public submission and an evidence-based documentation of Qantas Group's experiences of Australia's airports' monopoly behaviour. It focuses on commercial negotiations, security services, infrastructure and matters of fuel security and access to demonstrate how airports' monopoly behaviour negatively impacts the aviation industry, passenger welfare and productivity growth. It is not an all-inclusive survey of airport regulation and airports' monopoly power.

This submission supplements the investigations of and potential remedies outlined by Airlines for Australia & New Zealand (A4ANZ) and broadly aligns with the submissions made by International Air Transport Association (IATA) and Board of Airline Representatives of Australia (BARA).

September 2018

Table of Contents

1. Foreword

Qantas has been at the forefront of global aviation for almost 100 years. Since its founding in outback Queensland in 1920, it has grown to be Australia's largest domestic and international airline and is widely regarded as one of the world's leading long-distance airlines and one of the strongest brands in Australia.

Millions of passengers

Today, Qantas Group, through its airlines Qantas, Jetstar, QantasLink and Qantas Freight, is a vital, globally competitive aviation business that connects Australians to the world and the world to Australia. Our airline brands operate regional, domestic and international services, and in FY18 carried more than 55 million passengers. Qantas Group flies to 56 airports domestically and operates 3 of its own passenger terminals.

Transformation has been central to our recent success. In 2002, we consolidated regional operations to create QantasLink, which today serves 48 regional communities, transporting 8 million passengers last year. In 2004, we launched Jetstar Australia, a low-cost carrier that made travel affordable for millions of Australians. There are now 4 Jetstar-branded airlines operating across the Asia Pacific, which sold more than 24 million airfares under $100 in FY18.

We have diversified to build an effective portfolio of subsidiary businesses ranging from Qantas Freight to Qantas Frequent Flyer and adjacent Qantas Loyalty businesses. We directly employ more than 29,000 Australians. Our suppliers provide jobs for tens of thousands more.

Whether it is moving people or produce, Qantas Group is at the heart of the modern Australian economy, delivering $11.6 billion in added value, or 0.7% to Gross Domestic Product (GDP) in FY17 according to Deloitte Access Economics.[1]

Anything but a world-leading aviation sector places undue cost on our entire economy.

Driving innovation and simplicity

Being a fit, agile and diverse organisation that drives innovation and simplicity is core to our beliefs. As is the conviction that customers determine our success. Our 3-year Qantas Transformation Program, launched in December 2013, permanently increased our productivity and competitiveness, delivered more choice and cheaper airfares and embedded a commitment to innovate across the Qantas Group.

Through reductions in our domestic cost base, improved productivity of our capital and our people and renegotiations with key suppliers, we achieved over $2 billion worth of benefits. As these benefits and efficiencies grew, we improved passenger service and experience by investing in fleet replacements with 787 Dreamliner aircraft, new cabin infrastructure, technology such as free on-board passenger Wi-Fi and new world first non-stop routes including Perth-London. Five years on, this turnaround led to Qantas Group posting a hard-earned $1.6 billion underlying profit in FY18.

But we cannot rest on past achievements. Our future depends on continued transformation – reducing costs, growing efficiency, lifting productivity, and always innovating to better serve customers with a wider range of more affordable airfares and travel options.

Cost efficiencies thwarted

Fuel costs, expected to rise by $690 million in FY19 and competition in international markets, often from state-owned and monopoly carriers, are beyond Australians' control. But the cost of Australian airports need not be.

As natural monopolies, Australian airports have no effective competition or reason to change or innovate. It is the family visiting the Great Barrier Reef for the first time, the business traveller flying from Melbourne to Sydney for meetings, and the dairy farmer sending fresh milk to the Chinese market that ultimately pay for the high and rising costs of Australian monopoly airports.

There is no effective regulation to contain airport price increases and price gouging, or to encourage operational efficiencies or improved quality of services.

Like other users of airports, we seek cost efficiencies in Australian airport charges. As natural monopolies, Australian airports have the economic advantage of falling costs as output increases. Despite these significant and continual increases in output (passengers and freight), airport charges continue to rise.

As airlines have become more competitive and more efficient, airfares have declined nearly 40% in real terms over the past decade.

Indeed, excluding airport charges and fuel, Qantas Group costs have fallen by 4% in real terms since FY15. At the same time, charges we paid to airports have grown 6.5% above inflation.

Lack of effective regulation has opened the door to blatant profiteering. Australian consumers are paying the price of constantly increasing airport charges.

Airport charges are now our fourth largest cost, after fuel, fleet and people. While we negotiate successfully with other suppliers to reduce costs and ultimately deliver better airfares and travel experiences for passengers, charges by Australian monopoly airports are largely non-negotiable.

Effective light-handed regulation

Current economic regulation of Australian monopoly airports is failing the Australian economy.

Australian monopoly airports collect a toll at every step of a passenger's journey – from extracting high hourly and daily rates for car parking, tolls for taxis and rideshare vehicles and airport concession fees on hire cars to baggage trolley rentals, above-market rents for cafes, newsagents and retailers, throughput levies for jet fuel for aircraft, and finally airport charges on the airfare.

It is costing the economy, consumers and airlines billions of dollars in lost productivity whilst lining the pockets of a few private investors with super profits.

It is not producing the intended constraints on airports' monopoly behaviour, with declaration under the National Access Regime (Part IIIA of the *Consumer and Competition Act 2010*) too uncertain, expensive and time consuming to provide any protection and the recent changes to the regime further inhibiting access to the dispute resolution process.

Australian airports are exploiting their market power to the detriment of the long-term interests of the Australian community.

We are not calling for heavy-handed regulation or government intervention or unnecessary compliance. We seek fair, commercially negotiated outcomes that work in the best interests of the Australian aviation sector and millions of Australian airline passengers.

Current economic regulation of Australian monopoly airports is failing the Australian economy.

Modern, effective light-handed regulation underpinned by access to independent arbitration as a last resort will encourage airports to behave competitively and deliver competitive prices, greater efficiencies and leading innovations for passengers and airport users. It will grow productivity and advance efficient investment decisions.

We need airports to partner with us in reducing costs and making travel more accessible for more Australians. And we need airports to deliver the same efficiency improvements that airlines do to ensure we can keep growing the Australian economy.

Promoting fairness by simplifying the existing light-handed regulation with a clear incentive for good performance will deter Australian monopoly airports from abusing their market power. Fair and reasonable pricing will make airports more efficient and more productive. This will produce better, more sustainable long-term economic wellbeing for all Australians.

ANDREW PARKER
Group Executive
Government, Industry, International and Environment

2. Executive Summary

Exercising market power

All Australian airports implicitly and explicitly possess and exercise market power to varying degrees.

Many airports levy unreasonably high charges, enjoy above-market profits, make inefficient business decisions and engage in poor negotiating conduct.

Airlines and airport users currently have limited, if any, practical countervailing power. The supposition that airlines can withhold capacity or service in markets where they must competitively offer passengers and customers a network of major and regional routes and airports flies in the face of commercial reality.

Australian passengers, producers, communities and the economy are ultimately paying the price of monopoly power through higher airport charges and air freight costs, lower connectivity and fewer opportunities for local and national employment creation.

Australian monopoly airports collect a toll at every step of a passenger's journey – from extracting high hourly and daily rates for car parking, airport tolls for taxis and rideshare vehicles and airport concession fees on hire cars to baggage trolley rentals, above-market rents for cafés, newsagents and retailers, and throughput levies for jet fuel for aircraft – all before the airport charges are included in their airfare.

Qantas Group airlines are members of A4ANZ, IATA and BARA and the Group support the Productivity Commission consideration of approaches identified in these submissions.

Excessive airport and aviation security charges and fees

- Over the past 10 years, Australia's major airports enjoyed a 25% increase in revenue per passenger in real terms while airfares decreased by almost 40%.
- Excluding airport charges and fuel, Qantas Group costs have fallen by 4% in real terms since FY15.
- At the same time, Qantas Group charges paid to airports have grown 6.5% above inflation.
- Australian airports are more expensive than comparable international airports in the United States and New Zealand – Australian monopoly airports receive approximately AU$4.71 more per passenger than those in the United States, and AU$4.21 more than New Zealand airports. A $4 reduction in airport charges paid by each airline passenger would reduce airline costs by over $648 million annually. This could fund millions of airfares, or support daily, non-stop B787 Dreamliner flights to 2 European cities.
- Monopoly airports earn profits from aviation security (e.g. stating a right to collect a "reasonable return on capital investment"). Security charges also fund revenue generating activities, in contrast with existing regulatory understanding that airports deliver only mandated aviation security, and pass-through costs to customers on a not-for-profit basis.

Airports do not bear the risk of passenger and cargo demand

- Australian airports are shielded by airlines from economic instability – passenger volumes and airport margins have increased steadily over the past 10 years while airline margins have been more volatile.
- Markets recognise this through lower rates for airport financing – lenders regard airports as typically being below the weighted BBB/A-rating cost of debt, assumed, for example, by the Australian Energy Regulator (AER).
- Australian airports have not passed on these lower costs through lower passenger charges.

Inefficient airport investments and operations

- Australian airports frequently prioritise investments in retail, car parking and other revenue-raising facilities over aviation infrastructure – and expect passengers to pay for these through higher airport charges.
- Fit-for-purpose aeronautical infrastructure is the exception, not the norm, due to reliance on monopoly returns on that investment from airlines.
- Australian airports lack incentive to collaborate with airlines to deliver innovative technology and facilities for passengers and cargo instead relying on merely increasing capital investment.
- Australian airports currently have little incentive to act efficiently as they recover rising costs from customers.

Quality of airport services variable

- Australian airports suffer a disconnect between performance expected by, and the quality of services delivered to, passengers and airlines.
- Australian airport profits are unrelated to customer satisfaction – the major Australian monopoly airports fall below the top 10 in customer satisfaction, with Sydney Airport ranking 20th, Brisbane Airport ranking 23rd, Melbourne Airport ranking 27th, and Perth Airport ranking 59th.
- ACCC price and quality monitoring data shows service quality levels for passengers at the monitored airports are stagnant or declining while unit revenue and profits at those airports have increased.
- Long, convoluted, resource-intensive negotiations that lack transparency and professional conduct
- Australian airports do not provide meaningful information to assess financial performance and priorities to improve passenger experience – such as pricing methodologies, asset registers, write-offs and depreciation or service levels for passengers.
- Airlines are not able to compel transparency or seek meaningful consultation – for example airlines are generally not consulted by airports where new security services are implemented but are simply notified of increased costs.
- Negotiations are therefore prolonged, convoluted and resource-intensive – some current Qantas Group negotiations have been ongoing since 2011.
- Australian airlines have no effective mechanism or regulatory circuit breaker to promote genuine negotiations with airports.

Effective light-handed regulation required

- The current monitoring regime by the Australian Competition and Consumer Commission (ACCC) and the National Access Regime under Part IIIA of the CCA are expensive, lengthy and ineffective in constraining the market power of airports.
- Qantas Group supports an effective light-handed regulatory framework which includes:
  - Deemed declaration to incentivise commercial discipline and efficient outcomes,
  - Regulatory guidance on WACC, taking account of risk-adjusted costs of capital,
  - Efficient aeronautical pricing and airport leasing principles, and
  - Best practice conduct of negotiations.

3. A Fresh Look at Airport Market Power

Qantas Group welcomes the Productivity Commission's Inquiry into Economic Regulation of Airports.

This chapter seeks to address the question, 'why now?' and covers key recent developments that underline the case for effective light handed regulation to promote competition, stimulate travel and deliver economic benefits to Australia.

Twenty-two years ago, Australian airports began to be privatised. Since then there have been tremendous changes in the aviation sector. The number of travellers and the volume of freight that passes through Australian airports have more than doubled and continue to grow.

Qantas Group agrees the first wave of airport privatisations in the 1990s sparked increases in efficiencies and productivity. But those gains have slipped in recent years. Today Australian monopoly airports present a clear threat to Australia's economic wellbeing and a strain on productivity.

Recent developments

In its previous inquiry report in 2011, the Productivity Commission said, "the regime would benefit from a credible threat" of sanction for airports that abuse their market power.[2]

The ACCC has regularly reported its concerns and advocated for stronger regulation to contain abuses in airport market power.[3] Unfortunately, inaction by successive governments has meant those problems have escalated to unsustainable levels. Key developments include:

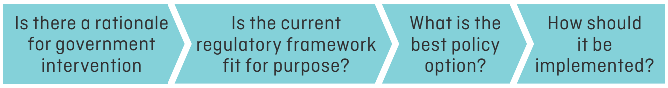
- Airfares have reduced by nearly 40% in real terms over the past decade.[4] In contrast, Australian monopoly airport charges are growing – the 4 monitored airports alone earnt an average 25% more revenue per passenger in real terms.[5]
- Aside from Australian monopoly airports, Australian aviation is far more competitive today. In 2000, more than 1 in 3 international travellers flew into Australia on a red Qantas tail.[6] Today, that number is 1 in 6, with Jetstar responsible for nearly 1 in 10 international arrivals last year. Airlines offer more travel options, routes and airfares than ever before.[7]
- Airlines have been improving efficiency and productivity while airports are not. Excluding airport charges and fuel, Qantas Group costs have fallen by 4% in real terms since FY15. At the same time, Qantas Group's airport charges grew by 6.5% above inflation.
- Airport charges, levies and fees are now Qantas Group's fourth largest cost after fuel, fleet and people.
- Australian airport charges, levies and fees are an anomaly in a competitive economy. Other monopolies such as telecommunications, utilities, transmission networks and rail networks have been far more scrutinised than airports in recent years.
- The current regime provides little oversight of the major airports – and no oversight of smaller airports.
- Aviation now contributes nearly 2.6% to Australia's GDP every year. Despite their growing importance as gateways to capital cities and regional centres, there is no reliable measure of Australian airport productivity.
- Airport negotiations have become overly long and resource-intensive. Some Qantas Group negotiations that commenced in 2011 are still continuing.

Australia is an end of the line destination with a relatively high cost base. It can no longer afford airport monopolies. Lack of innovation, efficiency and productivity gains puts Australia's economic wellbeing at risk.

The remainder of this submission follows the order of the information requests in the Productivity Commission's in order to demonstrate as per the figure below, that there is a sound rationale for effective intervention with a proposal that is better than other alternatives, including the status quo.

Figure 1: Productivity Commission framework to assess regulatory effectiveness

Regulation to promote the efficient operation of airports



Source: Productivity Commission Issue Paper, July 2018

In this submission, relevant data and case studies are considered that show persistent exercise and abuse of market power, through earning monopoly profits, charging above-market high prices, providing variable quality of services and facilities, inefficient operations and capital investments, and lack of transparency and good faith conduct in negotiations.

LACK OF COUNTERVAILING POWER

Australian airports are natural monopolies.

A passenger heading to Sydney, Canberra or Townsville may choose their airline, airfare and class of travel but airlines have no choice of airport.

The monopoly power of airports is amplified by the inelastic demand for airport services and the lack of countervailing power of airlines in negotiating terms and conditions that are fair and reasonable.

Further, the current light-handed regulatory approach does little to 'level the playing field' in commercial negotiations. In the latest Airport Monitoring Report of the 4 largest airports– Sydney, Melbourne, Brisbane and Perth – the ACCC concluded (emphasis added):

> *"It is generally accepted that Australia's four major airports have market power and control access to monopoly infrastructure. As a result, there is a concern that at some airports, airlines do not possess enough bargaining power to ensure appropriate commercial outcomes."* [8]

In Qantas Group's experience, Australian monopoly airports have entrenched their market power further because it is almost impossible for airlines to access independent arbitration under the National Access regime.

Unfortunately, Qantas Group has observed abuses of market power at all Australian major airports and many smaller ones. Suggestions that airlines have the requisite countervailing power or even a capacity to exercise market power through withdrawing services are misguided.

If Australian monopoly airports are genuinely concerned about airlines exercising market power, it begs the question: why are airports so steadfastly and ubiquitously opposed to greater access to independent arbitration to make light-handed regulation more effective?

Airlines today have arguably less power to cease or postpone capacity or flights to monopoly airports than they did during the last Productivity Commission inquiry in 2011. Airlines are mature businesses that must offer customers a network of major and regional airports.

As A4ANZ states in its report of airports' market power,

> *"... a necessary condition for countervailing power is that airlines have a credible option to cease or postpone their purchase, or take up other 'outside alternatives."* [9]

'Take it or leave it' approach by airports

The prospect of countervailing power in this inquiry will be squarely directed at Qantas Group.

Qantas Group resists unreasonable terms of access resulting from opaque negotiations offered by Australian monopoly airports. Qantas Group seeks to mitigate some of the worst excesses of airports and consequently advocate on behalf of its customers and often deliver benefits for all airlines.

With a history of leading developments in global aviation for almost 100 years, coupled with its size, in-house capability and connectivity of its domestic network, Qantas Group works tirelessly to achieve outcomes that are fair and reasonable.

In many instances, Australian monopoly airports have a predetermined profit requisite and will not shift unless this profit condition is met. These airports refuse to move on excessive rate of return assessments and seek to unilaterally impose prices when agreements expire.

Under the current ineffective regulatory regime, the only leverage an airport user has is the possibility of withdrawing services from an airport. In reality, airlines cannot afford to make good on that possibility for reasons including loss of network connectivity, loss of business, claims by passengers with bookings, loss of revenue, redundancy of aircraft assets, redundancy of airport investments such as hangar and lounges, and competition from other entrants.

If airlines' countervailing market power was genuinely effective, Qantas Group would not spend considerable time and resources to undertake protracted and expensive negotiations with airports or to resort to seeking government assistance for reasonable access to Australian monopoly airports' facilities. Indeed Qantas Group would not now be seeking recommendations from the Productivity Commission for effective light-handed regulation.

Qantas Group cannot force an airport to seek independent dispute resolution on prices and contract terms, while airports are not motivated to engage in a process that threatens their high returns. The cost, time and uncertainty associated with the current declaration provisions in the National Access Regime make it ineffective for resolving such disputes.

Impacts on network, service and competition

Qantas Group needs to maintain a wide network of routes and frequencies to serve its customers, maintain a strong competitive position, deliver sustainable returns to shareholders and connect regional communities.

Sydney, for example, is a critical Qantas Group market with dense volumes of business and leisure demand. Reducing capacity at Sydney in response to high airport charges would erode Qantas Group's value proposition to its customers who value its service offering.

Similarly Jetstar is geared towards serving leisure customers, who want to travel to Australia's largest cities and tourism destinations like Cairns and the Gold Coast. Neither Qantas nor Jetstar have the ability to meaningfully reduce their networks without materially impacting competitive relevance.

To argue that the Gold Coast and Cairns Airports, or indeed Adelaide, Darwin and Newcastle airports lack market power is a flawed assumption as it overlooks the fundamentals of aviation networking.

Qantas Group operates in one of the most liberal domestic markets and most competitive international markets in the world. If Qantas Group were to reduce capacity, there is a high likelihood that a competitor would seize the opportunity to fill the void. While Qantas Group has a high share of domestic capacity, this has declined in recent years due to competition.

Australia is one of the only countries in the world which allows foreign entities to establish a domestic airline. For example, in 2007, Singapore-based Tiger Airways Holdings launched Tiger Airways in the Australian domestic market. In the international market, Qantas Group share has also declined as competitors from China, the Middle East, and the Americas continue to increase their capacity.

Unlike some international markets, Australian cities do not have multiple public airports. Substituting modes of transport for travelling between major cities is also unrealistic. Therefore, competition between airports and destination substitution is not relevant in the Australian market. Australia does not enjoy the short distances and modal choices between cities, nor choice of airports in Europe, Asia, China and the United States. Nor do airlines enjoy the density of population that permits the substitution of passengers from one city for those in another. Qantas Group has invested in a fleet to compete for a share of the whole population, not only those who live in a city with a reasonably-priced airport.

To assert Qantas Group could stop flying to Adelaide, Darwin or Newcastle if airports set their charges too high, overlooks the importance of these markets to our passengers, and our obligation to offer a comprehensive national network with seamless connectivity to the Australian community.

Since most of Qantas Group's network has significant strategic imperatives (including connecting trunk routes and international routes that allow greater frequencies and more destinations) its ability to use capacity as leverage in airport negotiations is limited. To suggest Qantas Group cease operations to a whole state or territory of Australia, should a dispute with an airport arise, is nonsensical.

Airlines bear volume risk

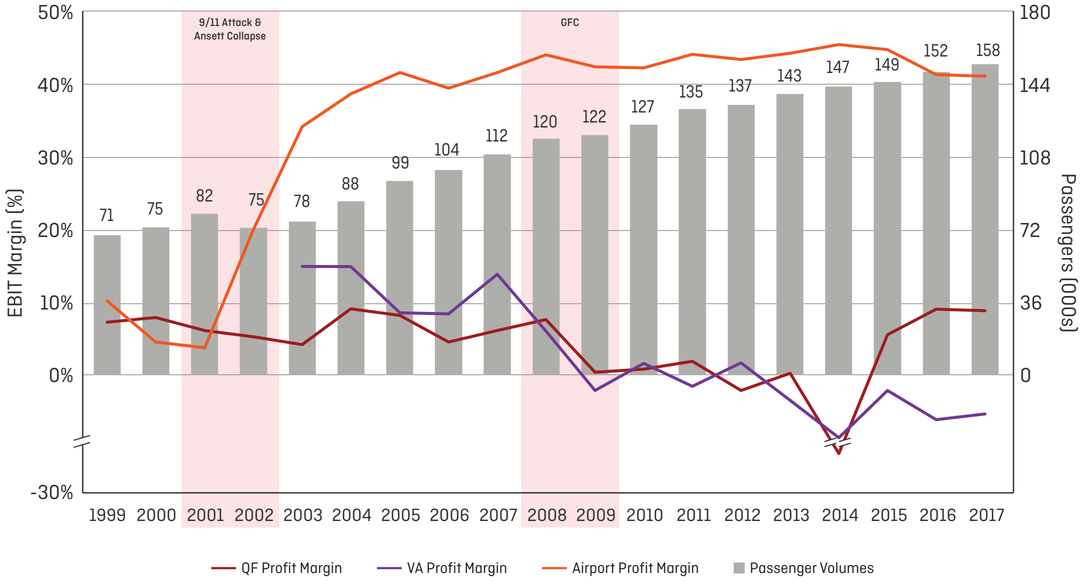
Airlines bear the risk of generating passenger and cargo demand, competition and external market factors. Airports do not share in that risk – they only benefit from airlines' stimulation of passenger demand. The evidence since 2011 demonstrates this systemic volatility and strengthens the case for improvements.

To service such massive, long-term capital commitments airlines must maintain passenger throughput by the use of tactics such as discounted airfares. Airports however, maintain their charges as the airport is insulated from the passenger risk by the tactics of the airlines. Australian monopoly airports have no competition or market pressure to discount aeronautical service charges.

The figure below highlights the volatility in airline margins against a backdrop of Australian monopoly airports' super-profits and a steady increase in passenger volumes despite economic shocks such as the Global Financial Crisis.

Figure 2: Volatility in airline margins

Volatility in the airlines industry has hit airline margins significantly, while airports margins have remained high given increasing passengers.



Source: ABS, ACCC Airport Monitoring Report, BITRE, Annual Reports

Indeed, Melbourne Airport and Sydney Airport affirmed their lower risk to financial institutions:

> *"Our passenger numbers and EBITDA have increased on an annual basis since the privatisation of Sydney Airport in 2002 to 31 December 2017, including in periods of challenging economic and operating conditions, such as the global financial crisis, the European sovereign debt crisis, the SARS outbreak, the Ebola outbreak, ongoing geopolitical conflicts and acts of terrorism."* [10]
>
> –Sydney Airport, 2018

> *"Melbourne Airport's passenger numbers have stayed resilient in the face of strong adverse shocks to both the demand and supply for air travel, and it has typically seen recovery of passenger numbers and a return to passenger number growth within 12 months of the adverse shocks."* [11]
>
> – Melbourne Airport, 2017

> *"Brisbane Airport Corporation (BAC) believes that consistency in passenger number growth rates have supported the stability of BAC's revenues and cash flows, including during the global financial crisis and the European sovereign debt crisis. Between FY12 and FY17, BAC's passenger numbers demonstrated consistent growth despite a severe deterioration in the global economic environment."* [12]
>
> – Brisbane Airport, 2018

Also in a 2013 report for the Civil Aviation Authority (CAA) of the United Kingdom, Cambridge Economic Policy Associates (CEPA) discussed the fact that reducing volume risk would imply lower exposure to systematic risk and produce a lower equity beta.[13] PwC Economics also highlights the lower systematic risks for airports with lower exposure to passenger volume changes to it in their November 2017 report on the WACC range for London Heathrow Airport for the CAA. The New Zealand Commerce Commission has previously made ad hoc adjustments to risk, namely to its sample asset beta for differences between the New Zealand airports and the sample.[14]

The pattern of debt issuance to Australian monopoly airports shows risk-based price adjustments by lenders have also substantially lowered airports' cost of capital. In the next chapter, Qantas Group presents detailed evidence of the lower risks borne by airports which in turn lower the cost of financing airport assets.

However, airports continue to propose and impose pricing models built on the assumption that airports take passenger and cargo volume risk. A more accurate understanding of the lack of volume risk borne by airports, should be taken into account by the Productivity Commission when considering financial benchmarks.

Investors agree airport revenue unrestrained

The significant and ongoing returns generated by Australia's private and council-owned airports through growing revenue streams with higher prices and largely unregulated revenues from non-aeronautical assets have seen them become particularly attractive investment assets.

> *"Sydney Airport has an unregulated revenue stream in a monopoly environment. This is a key reason why it trades at a premium multiple to global peers."*
>
> – UBS, July 2018, Global Airports – Trends and prospects for traffic growth, retail and regulation

Apart from Sydney Airport, none of the other Australian monopoly airports are publicly traded assets on the Australian Stock Exchange. Since privatisation, there has been a growing concentration of ownership of Australian airport assets among a select group of major institutional investors.

For example, the largest and second largest airports in the Northern Territory, Darwin Airport and Alice Springs Airport, are owned by the same investment funds.[15] Appendix 1 further illustrates the high degree of concentration in relation to the 21 federally leased airports and 9 largest airports which are not federally leased.

In the absence of meaningful regulatory change, the trend towards increased consolidation of ownership will continue to erode the already limited leverage airlines hold in commercial negotiations, exacerbate uncompetitive dealings and negatively impact the economy.

The *Airports Act 1996* imposes a 15% restriction on the cross-ownership of any pair of Australia's 4 monitored airports. Qantas Group notes that several institutional investors today own a 15% or higher stake in at least 2 capital city airports.

4. Aeronautical Services and Facilities

This chapter presents detailed evidence of monopolistic behaviour by a range of Australian airports and the negative effects and impacts of this behaviour and in doing so, addresses the Productivity Commission's Information Request 2.

It also discusses why the current regulatory regime is limited in identifying abuses of market power and ineffectual in restraining the monopoly behaviour of the major Australian airports (Productivity Commission's Information Requests 3, 4, 7 and 8).

Finally, it suggests effective light-handed regulation is needed to improve commercial negotiations with and the competitiveness of Australia's monopoly airports, as well as articulating key benefits of change (Productivity Commission's Information Requests 5 and 9).

Qantas Group endorses the submission by A4ANZ which provides an economic- and industry-wide analysis of airports' market power in aviation services and infrastructure, proposes potential remedies to improve outcomes for the economy and community and assesses the costs and benefits of current and new regulatory approaches.

To support this chapter, Qantas Group has undertaken the following:

- commissioned independent economic analysis by CEPA to estimate and compare airports' cost of raising capital, which in turn drives the prices they seek to charge,
- conducted new and original analysis to understand the impact of airport costs at a route and network-wide level, and compare these to relevant international markets, and
- provided evidence on airport negotiations with airports that display monopoly behaviours (such as protracted timelines and excessive rates of return) and outcomes (high cost destinations) consistent with exercise and abuse of market power.

A portion of the evidence has been provided confidentially for contractual and/or commercial reasons.

MONOPOLISTIC BEHAVIOUR

Australia's current light-handed approach to the economic regulation of airports is based, in part, on the assumption that Australian airports do not have significant market power.

The evidence suggests otherwise.

In its Issues Paper, the Productivity Commission similarly notes that examples of how airport operators could exercise market power, include:

- excessive fees or charges for aeronautical services,
- inefficient investment decisions,
- inefficient operation,
- providing services of a low quality or a limited range, and
- the manner in which they conduct commercial negotiations.

Although not an exhaustive list of behaviours, this chapter presents a range of evidence and analysis to demonstrate exercise and impact of market power on passengers, airlines and the economy.

Excessive airport fees, charges and returns

Airfares in Australia fell by 42-52% between 2008 and 2017, reflecting improvements in airlines' efficiency, passenger growth and greater competition.[16]

Airport passenger charges paid on the average airfare to fly from Australia's airports increased by 15-59% over the same period.[17]

The monitored airports are collecting 25% more aeronautical revenue per passenger in real terms compared to a decade ago.[18]

Airport charges per passenger are rising, not moderating in line with passenger volume increases and movements in interest and government bond rates. This is true for Sydney Airport, Melbourne Airport, Brisbane Airport and Perth Airport – and many major and regional airports.

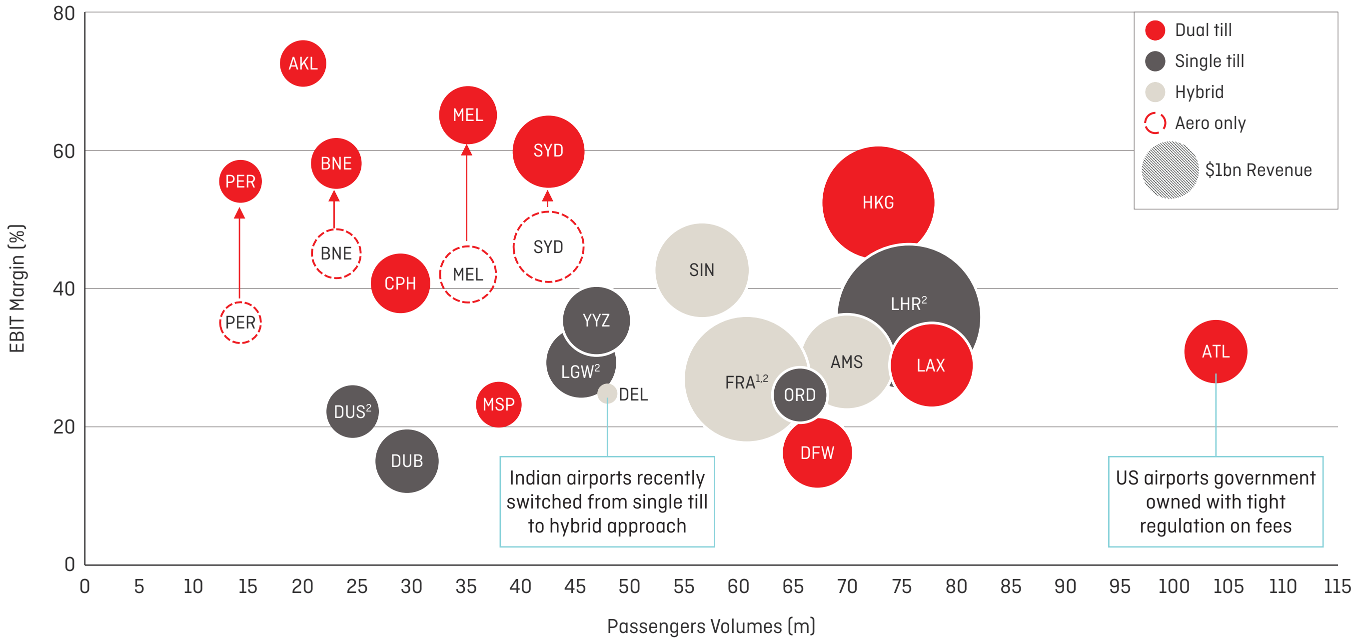
Global comparators

Sydney Airport, Melbourne Airport and Brisbane Airport are in the top 5 most profitable airports in the world.

Against a 2015 global average EBITDA of 55%, Sydney Airport's margin was 83%, Melbourne Airport's margin was 75%, Brisbane Airport's margin was 74% and Perth Airport's margin was 66%.[19]

The figure below demonstrates Sydney, Melbourne, Brisbane and Perth Airports all derive more profit than airports in Singapore, Heathrow, Dubai, Dallas and Los Angeles, all of which have greater economies of scale and have greater substitutes in close proximity.

Figure 3: International airport profitability by size



Healthy, profitable and competitive businesses are essential for a well-functioning economy. However, such above-market profits, combined with high charges, inefficiencies and variable levels of service, indicate unrestrained monopoly power at work.

Lower risk should mean lower rates of return

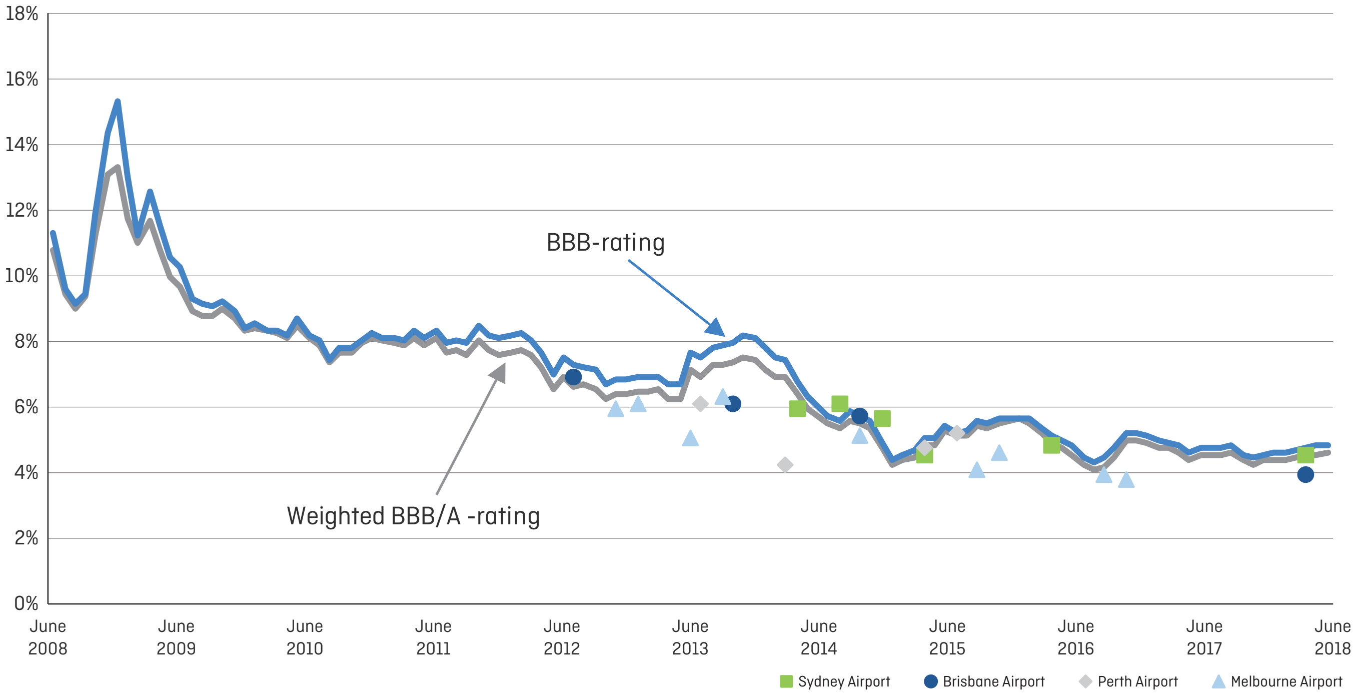
Airlines in Australia have shielded airports from economic and demand volatility, as the previous chapter demonstrates.

A key input in the calculation of airport passenger charges is a passenger forecast for the agreement period. To the extent passenger numbers fluctuate through the period, the airport faces asymmetric risk as it benefits from the upside but is largely shielded from the downside through the airlines adjusting their fares. This is a fundamental flaw in the regime as the evidence below demonstrates. Airports should, therefore, attract lower rates of return as they are lower risk investments. In Qantas Group's experience, airports calculate charges on the incorrect assumption that they bear passenger risk and so set artificially high rates of return. This risk profile is also reflected in the debt issuance costs for Australian airports.

Qantas Group provided CEPA with the 4 monitored airports estimated new debt issuance cost for the last 5 years, which covers around 50% of Sydney Airport's and Brisbane Airport's debt, and over 70% of Melbourne Airport's and Perth Airport's debt.

The figure below plots this against the RBA data on BBB and A-rated non-financial corporate debt that CEPA used for cost of debt estimates. The debt data covers a range of currencies, amounts and tenors (the tenors range from 7 years to 20 years).

Figure 4: Monitored airports' debt issuance compared to RBA non-financial corporate bond yield data (10-year average tenor)



Source: RBA, Qantas Group, Monitored Airports annual reports.

The graph indicates historic debt issuance costs by these airports has typically been below the weighted BBB/A-rating cost of debt (an approximation of the BBB+ investment grade), assumed by the Australian Energy Regulator (AER) for regulated entities.

Although the evidence – including statements made by the airports themselves – confirms strong growth in passengers even under adverse economic conditions, airports are yet to agree to reflect this risk profile in their return expectations and financial pricing model they present to airlines.

To highlight the challenges around WACC discussions, analysis of a sample of 12 airports (mix of majors and smaller), all of them initially targeting rate of returns between 10 and 15% (pre-tax nominal WACC). These inflated return targets indicate widespread monopolistic 'take it or leave it' behaviour by Australian airports which also prolongs airport negotiations.

Impact of super-charged profits

The ACCC has reported the aeronautical asset base of the 4 monitored airports – Sydney Airport, Melbourne Airport, Brisbane Airport and Perth Airport – to be over $8 billion.

Therefore, each single percentage point increase in WACC above reasonable benchmarks is the equivalent of $80 million in higher charges to passengers and airlines every year at these 4 monopoly airports alone.

Qantas Group suggests effective light-handed regulation would promote commercial negotiations that are more conducive to alternative or innovative pricing and risk-sharing models. These, in turn, would discipline excessive charging and promote more efficient investments in passenger facilities.

Excessive charges

Airport monopoly profits are a direct result of excessive charges, levies and fees for every facility or service provided including airport charges, security charges and lounge facility charges.

This section presents data to demonstrate that Australian airport charges contribute a large and growing proportion of domestic airfares and route costs. It also shows that charges at monopoly Australian airports are higher than key international competitor airports.

Airport charges out of step with international comparators

Australian monopoly airports are significantly more expensive than their counterparts in most other regions, and airport-related expenses contribute a greater portion of overall airline costs for Australian carriers than for foreign carriers.

On average, Australia's 5 busiest airports charge airlines and their passengers more for use of aeronautical facilities and services than counterparts in the United States and closer to home, in New Zealand.

Analysis of a sample of the 5 busiest airports across the 3 countries shows that Australian monopoly airports earn approximately AU$4.71 more per passenger than those in the United States, and AU$4.21 more than New Zealand.

Figure 6: Comparison of aeronautical revenue per passenger

Australia		United States		New Zealand	
Airport	$ (AUD)	Airport	$ (USD)	Airport	$ (NZD)
Sydney (SYD)	$18.30	Atlanta (ATL)	$4.51	Auckland (AKL)	$13.43
Melbourne (MEL)	$12.40	Chicago (ORD)	$8.25	Christchurch (CHC)	$13.04
Brisbane (BNE)	$12.60	Los Angeles (LAX)	$10.74	Wellington (WLG)	$11.78
Adelaide (ADL)	$15.80	Dallas (DFW)	$5.90	Queenstown (ZQN)	$12.38
Perth (PER)	$12.60	Denver (DEN)	$6.04	Dunedin (DUD)	$5.34
Average (AUD)	**$14.34**	**Average (AUD)**	**$9.63**	**Average (AUD)**	**$10.13**
Variance from Australia sample:			**-$4.71**		**-$4.21**

Source: Airport Annual Reports 2016/17. FX rates are 1 USD = **1.3582510 AUD**, 1 NZD = **0.905272564 AUD** (23 August 2018)

A $4 reduction in the airport charges paid by each airline passenger would reduce the cost burden by over $648 million annually.[20] As airlines operate in a highly competitive environment, a substantial portion of this benefit would be passed on to passengers and consumers.

Airfares have halved over the past decade globally while connectivity has doubled to 21,000 city pairs and passenger numbers have increased.

To illustrate, a $648 million reduction in Australian monopoly airport charges, levies and fees could fund the equivalent of:

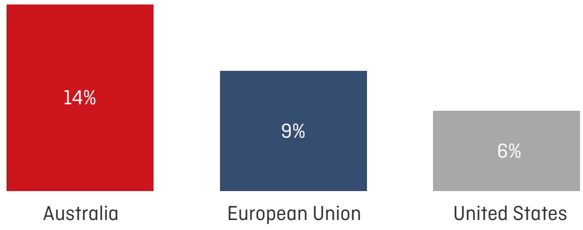
- 6.75 million one-way airfares between Melbourne and the Gold Coast based on average ticket cost of $96,
- 1.8 million one-way airfares between Sydney and Perth based on average ticket cost of $346, or
- 1.6 million one-way airfares between Sydney and Auckland based on average ticket cost of $400.

Savings in airport charges are also highly likely to lead to investment in fleet renewal and growth leading to capacity growth and fuel/operational efficiency.

A $4 reduction would fund additional Boeing 787 Dreamliners, which, would allow daily services to at least 2 new cities in Europe from Perth or open new and exciting destinations in North or South America[21] to provide the Australian community with more travel options.

Qantas Group compared airport costs as a percentage of airline revenues for major Australian (Qantas Airways Limited and Virgin Australia Holdings), United States (Delta Airlines, American Airlines, United Airlines and Southwest Airlines) and European carriers (British Airways, Iberia, Air France/KLM) (see figure below).

Figure 7: Airport Expenses as % of Airline Revenue

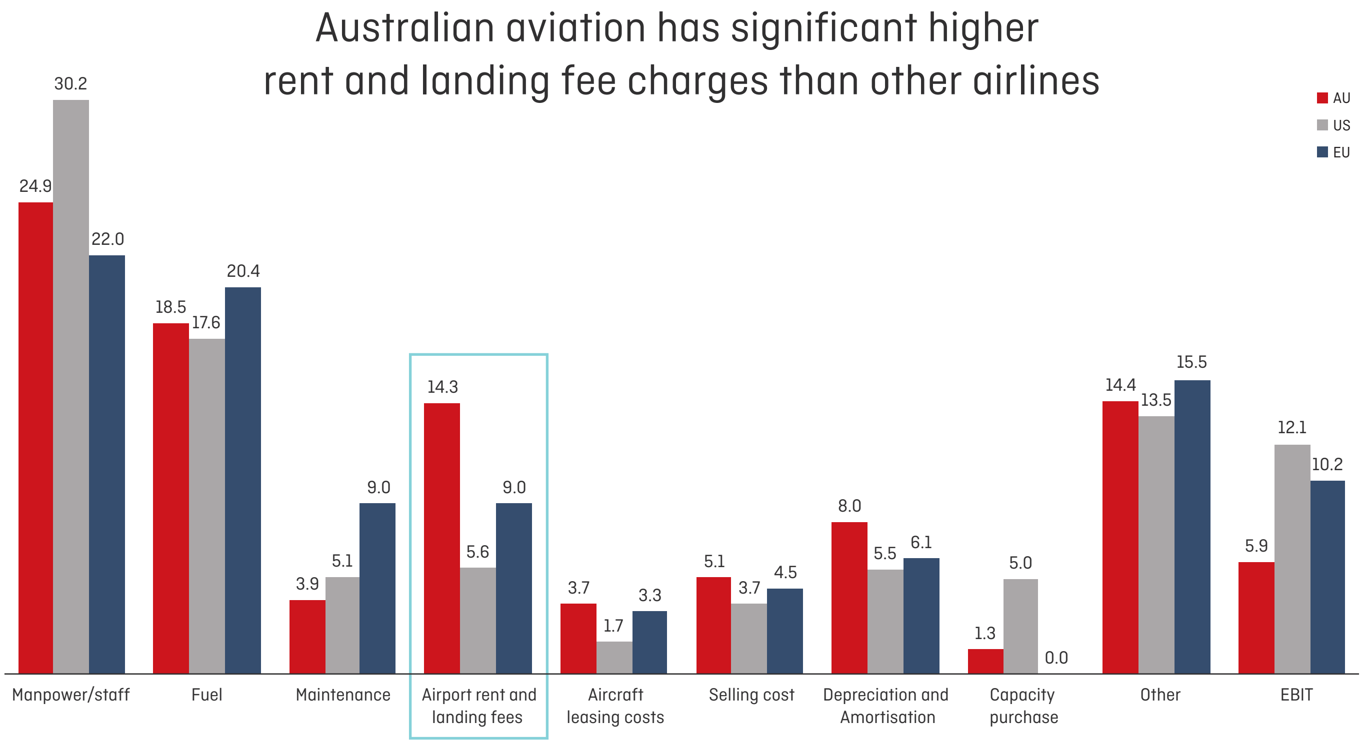


Source: Airline Annual Reports, FY17.
Note: Data estimates % of revenue by cost bucket. Inclusions and exclusions within cost areas may vary by airline.

While these airports vary in size and quality of services, it is clear that Australian airport charges appear to be disproportionally high. The mix of international airports in the comparator set is broad, therefore it is unlikely this disparity is driven by economies of scale/size or by quality differences.

This disparity in airport charges is more stark when compared with the greater consistency of the cost base of the same international airline cohort (see figure below).

Figure 8: % of revenue by cost bucket for major AU (QAG, VAH), US (DL, AA, UA, WN), and EU (BA, IB) airlines



Source: Airline Annual Reports, FY17.
Note: Data estimates % of revenue by cost bucket. Inclusions and exclusions within cost areas may vary by airline.

Inconsistency in airport fee structures

Charges levied by airports bear little relation to passenger volumes, geography, type of traffic or level and quality of services and facilities. The only discernible pattern is a quest for excessive returns by Australian monopoly airports.

Airports charge airlines aviation charges, levies and fees for use of their facilities and associated services (runways, taxiways, aprons, terminal, navigation, and security, etc.). These charges are broken into 3 different components:

- Passenger Service Charge (PSC) – usually paid by arriving and departing passengers,
- Landing Charge (LC) – usually based on maximum take-off weight (MTOW) of aircraft in tonnes, and
- Security Charge (SC) – usually based on departing passengers.

Across the Australian monopoly regional airports that Qantas Group operates, there is a wide variation in all 3 of the above charges with higher airport charges having a significant impact into the price of travel for consumers as well as the commercial viability of air services. It is unclear why there is such a significant variation in the level of airport charges, particularly when comparing Southern and Northern Australia.

When comparing regional airports in Australia with fewer than 500,000 passengers per year, the average cost per passenger (excluding security) is $16 for airports in the southern regions of Australia (NSW, Victoria, South Australia, Tasmania) and $25 for airports in Queensland, Northern Territory and Western Australia - over 50% higher. Moreover, 13 of the top 15 most expensive monopoly airports in Australia that Qantas Group flies to fall within Queensland and Western Australia.

Examples of the impact of these charges, based on a return Dash-8 Q400 service with 60 passengers (pax) and 81% load factor are outlined below: [22]

Southern Airport Example

Inbound: $960

($16 PSC * 60 pax) + ($0 LC * 60 pax) + ($0 SC * 60 pax)

Outbound: $1,035

($16 PSC * 60 pax) + ($0 LC * 60 pax) + ($1.25 SC * 60 pax)

Total Cost: $1,995

Northern Airport Example

Inbound: $2,460

($30 PSC * 60 pax) + ($11 LC * 60 pax) + ($0 SC * 60 pax)

Outbound: $2,640

($30 PSC * 60 pax) + ($0 LC * 60 pax) + ($14 SC * 60 pax)

Total Cost: $5,100

There have been numerous calls for Qantas Group to deploy Jetstar on regional routes to reduce airfares. While Jetstar can and does offer low airfares to consumers, its ability to do so is driven by its lower variable and fixed costs. This operating model is problematic on regional markets in Australia due to high input costs such as monopoly airport charges, fuel levies, inefficient operating patterns, regional maintenance costs, and accessibility.

It is difficult to explain or justify the significant pricing disparity between ports with similar passenger numbers and similar markets. For example, Canberra Airport and Adelaide Airport are often used as comparable airports due to their capital city standing, relatively small international presence and similarity in passenger numbers. But the passenger charge differential between these 2 airports is extraordinary. Canberra Airport currently charges (including security charging) over 200% more than Adelaide Airport.

Similarly, when comparing the major international airports in Australia, there is no evident pattern explaining the significant disparity in airport charges. Fixed costs would be expected to decline as volumes increase but this does not appear to be the case at Australian monopoly airports.

Impact of excessive charges on airfares

Last year, Townsville Airport, ran a poster campaign stating its $80 million redevelopment was possible for 'less than a cup of coffee' for passengers. This inaccurate publicity campaign was designed to publicly pressure Qantas Group airlines.

It fuelled an incorrect perception that airport charges have relatively limited impact as a proportion of airfares.

Across the globe, airlines make an average net profit of $7.76 per passenger. In FY18, Qantas Group posted stronger results with a margin of $10.50 on every $100 it received in revenue.

Sydney Airport earns the highest margin of any airport in the sample shown (more than $50 of every $100 earned contributes to profits), and Brisbane Airport and Melbourne Airport are both in the top 5.[23]

Most increases in airport charges directly affect the sustainability of a route and an airline's ability to maintain frequency and capacity, while offering low airfares. Data released monthly by the Bureau of Infrastructure, Transport and Regional Economics (BITRE), shows domestic sale airfares in Australia are on average 39% lower today in real terms than they were fifteen years ago.[24]

Jetstar sold more than 24 million airfares below $100 last year. The difference between a $9.05 (at Airport A) and a $26.99 (at Airport B) airport passenger charge (including security), dramatically influences the ability of an airline to maintain frequency and capacity, while offering low airfares and stimulating travel. Adding other cost inputs of the operation such as fuel, pilots, cabin and ground crew, maintenance and navigation charges demonstrates the significant and direct impact airport charges have on the commercial viability of airline services.

A Qantas domestic one-way airfare from Sydney to Hobart is now on average 51% cheaper and an international one-way airfare from Sydney to London is now on average 57% lower.[25] Qantas Group's commitment to becoming a leaner business through sustainable transformation in the face of increasing jet fuel prices has enabled it to lower airfares on its regional, domestic and international networks and deliver an enhanced customer experience.

Low-cost airlines experience significant difficulty in entering new markets where airport charges are high. For Jetstar, this makes operating prospects to an expensive airport such as Canberra untenable.

Canberra Airport has publicly implored Jetstar to commence flying to the nation's capital, stating,

> *"It's the largest route that doesn't have a low-cost carrier on it in the Australian market."* [26]

At current rates, however, Canberra Airport's charges could account for up to a third of Jetstar's low prices and would distort the airline's underlying cost base on the route. Jetstar has even implemented a codeshare arrangement with Murrays Coaches on its Canberra-Sydney route. The total bus fare was cheaper than Canberra Airport's charge but customer take-up has been poor. Between January 2016 and August 2018, a total of 74 seats have been sold, which equates to just 2.3 seats a month, highlighting the lack of countervailing power through modal substitution.

Examining route-specific airports costs

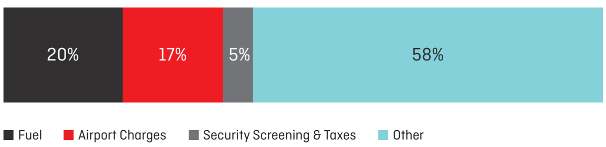
Qantas Group analysis of cost components shows Australian monopoly airports can be the largest contributor to the cost of operating a route.

Box 1: Route Costs –
Jetstar Airways Capital City A to Capital City B

Airport charges including take-off and landing fees and passenger facilities charge, contribute 17% of the estimated cost of flying a passenger on a flight between Capital City A to Capital City B.

These airport charges account for the **second largest cost** incurred by Jetstar on this route.

Jetstar Airways – Capital City A to Capital City B

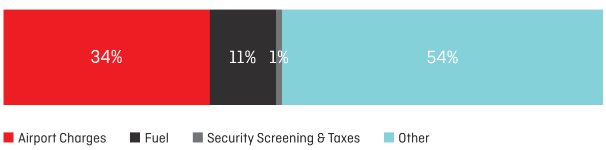


Box 2: Route Costs –
Qantas Airways Capital City C to Capital City D

Airport charges including take-off and landing fees and passenger facilities charges contribute 34% of the estimated cost of flying a passenger between Capital City C to Capital City D

These airport charges account for the **single largest cost** incurred by Qantas on this route.

Qantas Airways – Capital City C to Capital City D



Excessive, above market airport leases

Monopoly airport behaviour extends to high, above-market rental costs for essential facilities, such as hangars, jet bases, terminal leases and staff car parking facilities.

Qantas Group leases 1.3 million square metres at Brisbane Airport, Melbourne Airport, Sydney Airport, Canberra Airport and Perth Airport (including domestic terminal leases).

A thorough market evaluation of the leased facilities, conducted in June 2018 (provided on a confidential basis), estimated that Qantas Group is currently paying significantly more than comparable market rents.

This gap is prior to any anchor tenant or bulk letting discount which would be materially more in a normal competitive market and is commercially reasonable for Qantas to seek at each port or with each airport head lessee.

The valuation report states:

> *"An issue which goes to the prospect of monopoly rent setting (and lease term and condition setting)at airports which has made it difficult to establish on-airport market-based rentals at all ports since the Commonwealth Government's sell-off of the 99 year head (concurrent) leases of the airports in Australia is the fact that a number of subleases, since the sell-off of the airport head leases, have been struck where the rental valuation or rental setting guidelines or directives that existed within the previous Federal Airports Corporation leases have been removed or amended. Lease terms and conditions offered are also often onerous."*

The Federal Airports Corporation lease rental valuation guidelines sought to mitigate the exercise of monopoly power by requiring that market rentals consider off-airport rental evidence. For example, one of Qantas Group's ground leases at Brisbane Airport comprises an older lease, including the Federal Airports Corporation site rental valuation guidelines. It includes statements such as:

> *"the primary source of evidence shall be the rents off airport except where rents on airport are recently derived and sourced off airport."*

The historic rent setting guidelines could have been seen to attempt to avert the logic of monopoly rents in on airport tenancies. Their progressive removal from on-airport leases is further evidence of unrestrained monopoly power.

In light of this evaluation, Qantas Group is considering its options for lease renegotiations with these airports, however past experience suggests a low or limited chance of success.

More effective light-handed regulation would introduce greater commercial discipline into leasing arrangements with the potential to reduce costs for airport users and their customers.

Alternative single/hybrid till options

The current 'dual till' approach used in Australia, where aeronautical assets and costs are defined and only revenues and costs associated with those assets are subject to regulatory oversight, allows overcharging and lack of transparency by Australian monopoly airports.

Furthermore, it entrenches a disproportionate share of risk as airports benefit directly and indirectly from passenger demand while airlines bear all downside volume risks.

Different approaches are used worldwide to understand, regulate and price aeronautical assets and services. Given excess charges and profits are commonplace at Australian monopoly airports, single and hybrid till approaches deserve serious consideration.

Qantas Group asked CEPA to present a comparative analysis of single and dual till approaches worldwide. Their advice draws on their expertise in advising the CAA Singapore on the hybrid till approach used at Changi Airport and preparing reports for CAA UK and other European regulators.

- **Dual till regulation**. Under this approach the regulator declares assets and costs as regulated or non-regulated and only takes account of the revenues for conducting regulated (aeronautical) activities when determining aeronautical charges. Airports retain/ bear net revenues/ losses from non-aeronautical activities. This approach is how the ACCC currently monitors the 4 designated Australian airports and the approach is used by regulators for some airports in Europe.
- **Single till regulation**. Under this approach, revenues from aeronautical and non-aeronautical activities are taken together when setting charges. Assuming the costs of non-aeronautical activities do not exceed the revenues then this approach should lead to lower passenger/ aircraft movement charges. This approach is used by the UK Civil Aviation Authority, the Irish Commission for Aviation Regulation, and in other parts of Europe.
- **Hybrid till regulation**. Under this approach a proportion of non-aeronautical revenues are subtracted from the aeronautical revenue requirements, thereby reducing the aeronautical charges. A number of jurisdictions now use the hybrid till approach, for example the Civil Aviation Authority of Singapore (CAAS), the Airports Economic Regulatory Authority (AERA) of India, Copenhagen Airport and Paris-Orly Airport (where it is referred to as an adjusted till).

A comparative analysis of single till and dual till approaches is below.

Figure 5: Comparing single and dual till approaches

Approach	Advantages	Disadvantages
Dual till	– Incentive to grow non-aeronautical revenues. – Can allow for the isolation of financial risks between aeronautical and non-aeronautical activities.	– Argued to be an inequitable outcome when non-aeronautical services are largely driven by aeronautical services. – Non-aeronautical investments may be preferred over aeronautical.
Single till	– Leads to lower aeronautical charges. – Reduces the complexity of cost and asset allocation between aeronautical and non-aeronautical services. – Argued to be an equitable outcome.	– Under capacity constraints, could lead to welfare loss. – Companies could have less incentive to provide unregulated services as they are obliged to share any revenue benefits with regulated services. – Incentive to misallocate revenues and costs between regulated and non-regulated services. – Carriers are exposed to fluctuations in non-aeronautical revenues.

Source: CEPA, CAA (2000), CAA (2013), CC (2002), Czerny and Zhang (2015), Gillen (2011).

Qantas Group also asked CEPA to provide advice on the potential impact of a hybrid till approach in Australia. By design the hybrid till is seeks to balance between the benefits and downsides of both the single and dual till methods:

- Aeronautical charges will be lower than in a dual till model as non-aeronautical revenue is used to cross-subsidise charges, reducing any inequitable outcome that results from non-aeronautical revenue being excluded,
- Airports will have an incentive to invest in non-aeronautical activities as they benefit from increased revenues. This can lead to further reductions in the aeronautical charges. It does expose carriers to volatility in non-aeronautical revenues, although the ACCC monitoring reports do not indicate that the airports' non-aeronautical revenues are more volatile than aeronautical revenues, and
- Regardless of the allocation rate (or allocation of services with in/out of scope) between aeronautical and non-aeronautical services, a hybrid till approach still involves accounting allocation issues between aeronautical and non-aeronautical services (and/ or in and out of scope).

INEFFICIENT INVESTMENT DECISIONS

Given Qantas Group has operated numerous domestic terminal leases, it is well placed to understand the cost involved in airport infrastructure investments.

Inefficient investment decisions by Australian monopoly airports have increased passenger costs over the past decade. At the same time, Qantas Group commenced a comprehensive transformation program to drive network and operational efficiencies and maximise return on assets.

A number of examples are highlighted below. These are contrasted with Qantas Group's own transformation program (see Box 3).

Aviation security-specific examples are also discussed in the following chapter.

Perth Airport Terminal 3

The landmark nonstop Qantas flight from Perth to London required terminal T3 be retrofitted to allow for seamless international operations of the 787-9 flights by March 2018.

However, there was significant misalignment on expected costs. Perth Airport indicated the works would cost 80% more than Qantas Group estimated and questioned the achievability of the completion date of March 2018. Negotiations for the T3 terminal retrofit took 6 months, threatening the viability of the project as well as the launch date.

A commercial agreement was only reached after pressure from Western Australian Government. Ultimately, this infrastructure project was completed by Qantas Group on time and within its considerably lower budget.

Townsville Airport

Townsville Airport has persistently pushed for significant terminal and apron redevelopment plans totalling approximately $45 million aeronautical capital expenditure without justification. A large amount of the airport's investment plan is driven by increasing its retail footprint by over 200%.

As Qantas Group flies two-thirds of the passenger traffic at Townsville Airport, the Group investigated the proposals and advised the airport that a more fit for purpose and cost-effective design for around $10 million would better meet passenger and capacity needs for many years to come. Townsville Airport can make further investments over and above this to meet its retail desires.

Townsville Airport responded to the proposal with a media campaign to publicly shame Qantas Group. Airport management's questionable tactics included instructing staff to obstruct the entrance to the Qantas Lounge at Townsville.

Airport C

Airport C, a major aviation hub, put forward a capital expenditure plan for a terminal expansion to spend $277 million ($212 million or 76% aeronautical). Qantas Group considered the cost unjustified against market demand (with both parties misaligned on forecasts), and indicated, in principle, support of a lesser development to support fit for purpose works. Negotiations and many of the necessary upgrades effectively stalled over the next 18 months whilst the airline invested significant amounts of time and resource to attempt to support the airport with a co-created outcome.

Airport C presented an updated capital expenditure cost of $435 million ($385 million or 88% of which was labelled aeronautical facilities) Airport C's proposed pricing for aeronautical services would significantly increase. Challenges exist with the scale of actual spend, airports building ahead of demand and the ability for negotiation of fair and reasonable returns with no regulatory oversight.

These examples demonstrate that Australian airports can simply recover costs from airlines. Instead of supporting infrastructure that is fit-for-purpose and efficient, the current regulatory framework incentivises gold plating of airport infrastructure.

INEFFICIENT AIRPORT OPERATIONS

Airports have not generated operational efficiencies and productivity gains despite rising passenger volumes and improving technology. Quantifying inefficiencies at airports is difficult as comparable and publicly available data is limited. Confidential evidence is included in a number of case studies.

Inefficiencies in security operations are more readily comparable and relevant data is presented in the next chapter.

Box 3: Qantas Group Transformation Program

After reporting a $2.8 billion loss in FY13, Qantas Group embarked on an aggressive transformation program. In 2014, in response to changing market conditions, increased competition, record fuel costs and economic volatility, Qantas Group undertook a 3-year, $2 billion cost reduction, in order to remain competitive in the Australian aviation market. This was achieved through maximising return on assets, improving productivity and ensuring that the Group had the right aircraft on the right route, reducing unnecessary expenditure and investing where it aligned with our strategic priorities.

Transformation efforts focused almost entirely on operating a more efficient business, while also improving services and product offerings to customers.

The transformation program enabled Qantas Group earnings to grow from a loss of $2.1 billion in FY13 to a record profit of $1.6 billion in FY18. Transformation initiatives included:

- Capital expenditure reduction initiatives, increased aircraft utilisation and fleet simplification,
- Non-essential headcount reduction and improved labour productivity, and
- Procurement/supplier renegotiations

Over the same period, Qantas championed innovation and enhanced customer experience:

- Introduced the B787-9 Dreamliner aircraft to gradually retire the aging B747 fleet,
- Launched Perth-London, the first ever nonstop Australia to Europe service,
- Announced Project Sunrise, including intentions to operate nonstop from the East Coast of Australia to London and New York,
- Introduced free high-speed inflight Wi-Fi in the domestic market,
- Reconfigured its fleet of Airbus A330s and announced plans to reconfigure its A380 fleet with lie-flat Business Suites, and
- Renovated London, Hong Kong, Singapore, and Melbourne Qantas Lounges to world-leading standard.

Internationally, several carriers have recognised the challenging nature of the aviation industry and embarked on a transformation process, summarised in the figure below. Transformation allowed nearly all of the carriers below to renew their fleet, reduce their capital expenditure, improve efficiencies and increase labour productivity and utilisation.

Figure 9: Comparison international airline transformation initiatives

Carrier	Capacity Reduction	Capex Reduction	Fleet Renewal	Labour Productivity/ Reductions	Increased Utilisation/Reconfig	New Operating Model	Network restructure/ reduction	Procurement/ supplier renegotiations
Continental	✓			✓				
UNITED	✓	✓	✓	✓	✓		✓	✓
DELTA		✓	✓	✓	✓			
American Airlines			✓	✓				✓
AIR CANADA			✓	✓	✓	✓		✓
BRITISH AIRWAYS	✓		✓	✓	✓			
IBERIA	✓		✓	✓	✓		✓	✓
AIRFRANCE KLM	✓			✓	✓		✓	
airberlin	✓		✓	✓	✓			✓
Lufthansa			✓			✓	✓	✓
JAPAN AIRLINES			✓	✓	✓		✓	✓
malaysia airlines			✓	✓	✓		✓	✓

Without the introduction of a regulatory incentive to improve the competitiveness of their offerings, airports are far less likely to seek improved productivity, efficiency and customer satisfaction that innovative and transformational change has brought to the aviation industry more broadly.

PROVIDING SERVICES OF VARIABLE QUALITY

As mentioned previously, Sydney, Melbourne and Brisbane Airports are in the top 5 most profitable airports in the world (based on EBITDA).[27] Unlike competitive industries, this profitability does not appear to be linked to excellence in customer service.

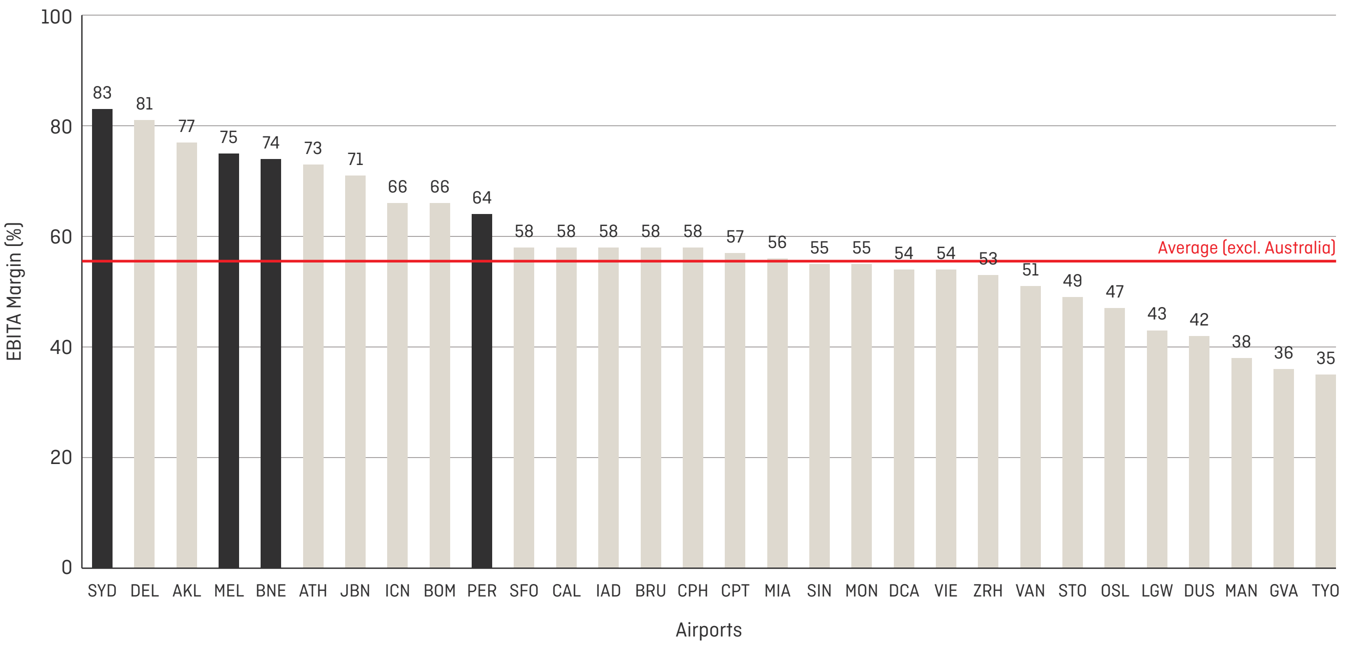
Skytrax World Airport Awards are voted for by air travellers in the largest, annual global airport customer satisfaction survey. The survey is operated as an independent study, with no entry fees or charges to any airport. The 2018 customer satisfaction awards were based on 13.73 million airport survey questionnaires completed by over 100 different nationalities of airline customers during the survey period.[28] The survey operated from August 2017 to February 2018, covering airports worldwide and evaluating traveller experiences across different airport service and product key performance indicators from check-in, arrivals, transfers, shopping, security and immigration through to departure at the gate.[29]

According to Skytrax Awards for 2018, the top 5 rated airports in the world are Singapore Changi (EBITDA of 55%, Seoul Incheon (EBITDA of 66%), Tokyo Haneda (EBITDA of 35%), Hong Kong and Doha, both of which are outside the top 20 airports by EBITDA.[30]

The major Australian monopoly airports fall below the top 10 in customer satisfaction. Sydney Airport is ranked 20, Brisbane Airport is ranked 23, Melbourne Airport is ranked 27, and Perth Airport is ranked 59.[31]

Other international airports deliver excellent customer satisfaction levels without exorbitant earnings.

Figure 10: Average EBITDA Margins (2015) for Australia airports higher than average



Source: Leigh Fisher 2017 report

Closer to home, the Journal of Air Transport Management published a peer-reviewed paper in July 2016 on the passenger experience at Melbourne Airport. It found:

> *"There are significant discrepancies between passengers' expectations of service quality and their perceptions of service quality at the airport. Measured values for passenger satisfaction are found to be consistently lower than those for passenger expectations, which imply that there is room for Melbourne airport to improve its service quality. Airport parking, immigration, internet/Wi-Fi access, and baggage delivery are areas that may have caused concerns for passengers and should be urgently addressed by airport management."* [32]

The ACCC and Productivity Commission have highlighted the need for an effective quality of service monitoring for Australian monopoly airports. This acknowledges that in the absence of competition for services, consumer interests need to be protected to ensure airport operators do not allow services to fall below acceptable levels.

However, monitoring of airport services and facilities by the ACCC and the subsequent reporting are not sufficient to ensure the standards of service expected by consumers. Similarly, there is little ability for airport users to seek price discounts or rebates where services or facilities are not performing to acceptable standards.[33]

Qantas Group endorses BARA's submission to this inquiry that Australia's monopoly airport operators have not delivered on the intended benefits of light-handed regulation and the industry is particularly concerned with the significant disconnection between the performance assumed by airport management and the actual quality of services delivered to passengers and airlines for prices paid.

CONDUCT IN COMMERCIAL NEGOTIATIONS

Commercial negotiations between airlines and Australian airports are typically one-sided with airports withholding information critical to understanding the financial and economic value of proposed infrastructure and service developments. They are also regularly delayed, protracted and overly complicated, requiring significant Qantas Group and external resources. In some instances, airports have displayed unsafe and unprofessional conduct during negotiations.

Current regulatory frameworks fail to incentivise commercial negotiations between airlines and airports. They do not encourage efficient pricing principles or disciplined negotiating conduct.

Lack of transparency or engagement

Australia's monopoly airports predominantly have not and do not provide reasonable cost transparency to the aviation industry to support pricing proposals.

Their negotiating approach is based on an entitlement to earn high rates of return through charges, levies and fees they deem appropriate. Australian airports do not shy away from pointing to the apparent flaws in the current regulatory arrangement as justification for their behaviour. The lack of transparency creates significant information asymmetry between airport operators and airlines.

Given the asset-intensive nature of the aviation industry, the limited transparency from airports places airlines in a weak bargaining position, as demonstrated by a sample of statements by airports below.

> *"…we will not be disclosing the information (Qantas) has sought as there is no statutory requirement for us to do so."*
>
> – Airport D

> *"…we are not prepared to provide full copy of the building block model but rather seek to negotiate a commercially agreed position which is consistent with the intent of the Productivity Commission reviews."*
>
> – Airport E

More commonly an airport will simply remain silent rather than offering information that is obviously relevant to a reasonable assessment of its commercial offer. The most common example is the allocation of costs between aeronautical and non-aeronautical facilities or services.

Airports almost never provide business cases or cost-benefit analyses for their capital projects, or outline impacts on the overall passenger experience. In the absence of meaningful information that allows airlines to assess the reasonableness of proposed increases to airport charges, the validity of potential increases becomes questionable.

Similarly, airlines have little ability to negotiate with local council-owned airports regarding the terms of access. Under local government legislation, councils have discretion to set the charges they wish. While Qantas Group spends considerable time and effort trying to negotiate with councils, the outcome is often the same as other airport negotiations: little information on proposed capital plans or how charges have been determined, and few if any incentives or rebates on terms of access.

Existing regulatory arrangements present airports with neither incentive nor obligation to apply airport charges in a consistent and transparent manner.

As discussed, earlier, airports are aware that a threat to withdraw services is not credible or viable particularly if airlines need to compete for contract business within the port. In effect, airlines have very little if any countervailing market power despite claims made by airports.

Modelling airport charges and prices opaque

Improving the consistency and transparency of relevant inputs into the pricing methodologies adopted by airports has the potential to remove significant bottlenecks to commercial negotiations.

Qantas Group uses the building block model as the main reference point to assess the reasonableness of charges. Building block methodology seeks to set an allowable revenue target and is consistent with many Australian regulatory frameworks.

Most major Australian airports and many smaller ones claim to apply a building block methodology but there is little consistency with key inputs often arbitrarily assigned.

Other examples of inconsistency of input methodology include:

- **Forecast horizons**: Some airports attempt to capture the full life of new assets, while others only forecast over the pricing period being negotiated (usually 5 years), and
- **Accounting treatments of assets**: These can vary from one airport agreement period to the next. For example, one model will use opening asset balance as a cash outflow and ending asset balance as a cash inflow.

Given the monopoly status of Australian airports, there is a major imbalance of power during negotiations. A significant factor to this poor outcome is attributable to the vast information disparity that exists between the parties. This is particularly concerning given the symbiotic relationship between airlines and airports. In more competitive markets, commercial negotiations are assisted by transparency and openness.

These poor negotiating behaviours from Australian monopoly airports then lead to considerably protracted negotiations which result in inefficient negotiating processes, and costly inputs of time and resources by airlines and airports alike. Unfortunately, this also leads to opportunity costs because of delayed investment in airport infrastructure.

Unnecessarily protracted negotiations

Negotiations between airlines and Australia's monopoly airports typically last between 18 and 36 months, and frequently run over key deadlines. This leads to significant uncertainty in business planning for both parties with airlines continuing to pay previously agreed charges and airports backdating increased costs.

Prolonged and hostile negotiations also lead to a deterioration in the relationship between airlines and airports. This further results in escalation over key commercial terms which threaten the customer experience. It also prevents meaningful collaboration on technology, environmental and security improvements or tourism and export market development.

Penalties to prevent airlines seeking declaration

In several instances, airports successfully negotiated clauses that penalise or withdraw incentives if Qantas Group sought or became involved in a declaration. At least 4 of Qantas Group's current pricing agreements and incentive contracts with 2 major airports include these contract clauses.

Hostile and/or unsafe behaviour

Ongoing disputes with Canberra Airport including holding a Qantas aircraft to ransom encapsulates unacceptable and unsafe negotiating behaviour. Following an unexpected landing due to bad weather, Qantas Group was forced by Canberra Airport to pay a nonstandard $18,000 diversion fee, equivalent to $100 per passenger. The unprecedented charge is 9 times greater than Melbourne Airport and Adelaide Airport, and more than 20 times greater than Sydney Airport. Canberra Airport parked a ground vehicle behind the aircraft and refused to allow the aircraft to leave until payment was made by credit card. Such poor behaviour poses significant risks to the safety of aircraft, passengers and the community at large.

Similarly, following a negotiation dispute with Airport F, Qantas Group's invitation to attend Quality Control meetings where service standards at the terminal were to be agreed, was unilaterally rescinded. Qantas is the largest user of this facility and lack of input threatens the customer proposition at Airport F. Poor negotiating behaviour was also demonstrated when Airport F warned Qantas Group that if their Aeronautical Services Agreement terms were not agreed, Qantas Group ran the risk of "being left behind" on terminal redevelopments.

Airport behaviour hampers productivity

Inconsistencies and obfuscations in airports' modelling impact efficiency across Qantas Group and lead to:

- Limited ability to compare the methodologies and prices of airports across Qantas Group's domestic network. This makes it very difficult to determine value through comparisons between charges and quality of assets and services,
- Higher costs and longer delays in finalising negotiations due to senior management and staff time, consultant fees, travel and other costs.

Improving the consistency and transparency of the price modelling methodology adopted by airports has the potential to remove significant bottlenecks to commercial negotiations and streamline outcomes.

CURRENT REGULATORY FRAMEWORK LIMITED

Monitoring of prices and quality at airports

The current price and quality of aeronautical services monitoring regime is not fit for purpose.

As set out below, Qantas considers that the current monitoring regime is not effective and does not deter monopolistic behaviour for the following reasons:

- The limited information collected adds little to transparency,
- The regime is not supported by any powers of the regulator to intervene, and
- There is no credible threat posed by the availability of declaration under Part IIIA of the *Competition and Consumer Act 2010* to influence negotiations.

A more modern and robust set of tools, within a light-handed regulatory framework, is required to detect and prevent abuses of Australian monopoly airports' market power.

The Productivity Commission's Issues Paper notes that a core function of the monitoring regime is:

> *"...to identify cases of airport operators exercising market power in ways that cause harm to the community, and to deter such abuses."* [34]

As ACCC Chairman, Rod Sims, acknowledged:

> *"Experience has shown that, in circumstances of natural or legislated monopoly, price monitoring will have little or no longer term impact on the conduct of the monopoly infrastructure owner."* [35]

The methodology of the current price monitoring regime prevents the identification of monopoly power for several reasons.

Although the ACCC collects some data on prices, profits, assets and quality, it is currently not possible to assess these against the efficient long-run costs for providing services. Additional guidance on the regulatory asset base is needed. This submission also highlights instances of airports arbitrarily classifying infrastructure as aeronautical or non-aeronautical.

Profits are necessarily backward-looking. A forward looking regulatory benchmark WACC would be far better in assessing Australian monopoly airports' target WACCs.

While the ACCC sets out guidelines for how the returns and assets should be allocated, each airport in Australia has its own accounting practices. These practices affect how the assets are revalued, how returns are recorded, and how returns and assets are allocated between aeronautical and non-aeronautical.

The ACCC notes this may also mean its approach to monitoring the airports' returns and profitability prevents consistent comparisons between the airports due to variable operating and financial arrangements.

In addition, and perhaps more importantly, monitoring of airport prices does nothing to deter monopoly behaviour.

As evidence in this submission and others such as A4ANZ has shown, monitoring has not prevented the largest 4 monopoly airports in Australia from increasing prices, building unnecessary infrastructure or providing poor and inefficient services. Monitoring does not give the ACCC power to intervene in the largest 4 airports' setting of terms and conditions of access to the airports' infrastructure.

More than 40 million domestic passengers – or 1 in 3 – travelled outside the 4 largest airports last year. The ACCC lacks powers to monitor price and quality at these other major airports or indeed any other federally leased airports in Australia.

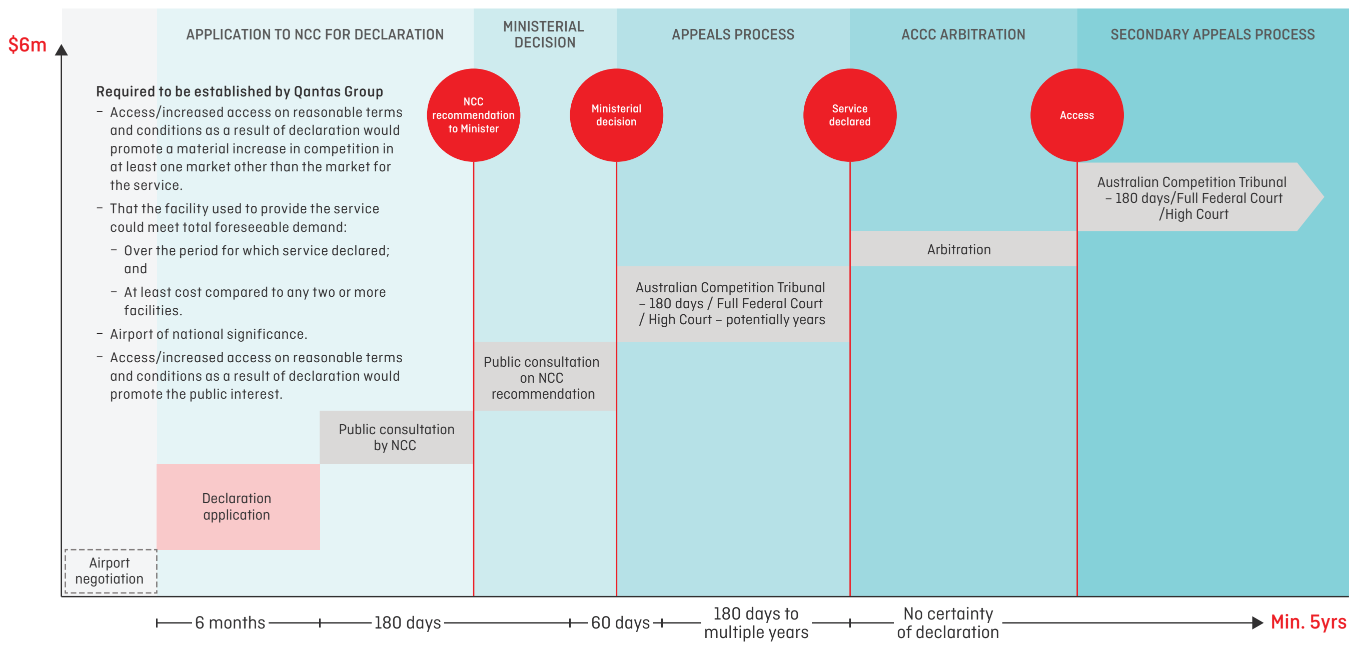
The Productivity Commission's own analysis of second tier airports shows that not all of them publicly disclose aeronautical charges or service quality or complaints-handling procedures and outcomes.[36]

The potential to apply for and obtain declaration under Part IIIA of the *Competition and Consumer Act 2010* does not positively influence commercially negotiated outcomes with airports (as further explained below).

Declaration regime difficult, expensive and unlikely to succeed

Qantas Group experience shows that seeking to declare an airport under the National Access Regime can take 5 years and cost upwards of $6 million, excluding the length and cost of the negotiation itself. The process and timelines are set out in the figure below.

Figure 11: Declaration process and timelines



After recent changes to the access regime in Part IIIA of the CCA, airlines have an almost negligible chance of succeeding in declaring one of the 4 largest airports, as legal advice provided to A4ANZ shows.

Legal advice by Johnson, Winter & Slattery provided to A4ANZ and included in its submission to the Productivity Commission suggests that recent changes to Part IIIA of the CCA are likely to increase the legal threshold that must be met, particularly in relation to non-vertically integrated infrastructure such as airports. The combined effect of these amendments, together with the existing significant cost, time and uncertainty associated with the declaration process, is that there is no legitimate threat of proceeding to arbitration as a means to resolve disputes.

Under the current regime, the "Appeals process" step shown in the figure above could involve a Tribunal "reconsideration" of a declaration decision by the Minister (on recommendation from the NCC) followed by appeals to the Australian Competition Tribunal, Federal Court, Full Federal Court and High Court, as occurred in the declaration of the domestic airside services at Sydney Airport. This results in further protraction of the declaration taking many years from the date on which an application is lodged.

Declaring smaller monopoly airports was and remains impossible as the national significance test cannot be met. This further limits the value of the national access regime as a deterrent to monopoly behaviour.

EFFECTIVE LIGHT-HANDED REGULATION NEEDED

This section addresses the Productivity Commission's Information Request 9 and contains evidence that changes to the current light-handed approach to airport regulation are necessary.

Deemed declaration of the major airports would encourage transparency, align negotiating priorities, release resources and improve economic efficiencies.

Credible threat of regulatory intervention

Qantas Group supports A4ANZ's work on effective light-handed regulatory solutions and welcome discussion with the Productivity Commission, aviation industry and government on how credible, workable solutions can be achieved to improve economic wellbeing.

Solutions should align to these key principles:

- Light-handed approach that prioritises commercial outcomes,
- Establish regulatory benchmarks for measuring the value and productivity of airport assets,
- Mandate pricing principles for aeronautical services,
- Require information disclosure and transparency of aeronautical/non-aeronautical assets, costs, revenue and security charges,
- Consider single and hybrid till approaches,
- Make security charging more consistent, transparent and cost effective,
- Expect reasonable negotiating conduct and behaviour, and
- Enable access to independent arbitration where negotiations fail.

Accordingly, Qantas Group supports an effective light-handed regulatory framework underpinned by the principles outlined above with the following key components:

- Deemed declaration to incentivise commercial discipline and efficient outcomes with access to arbitration if agreement is not reached for major Australian airports. The various aspects of a negotiate and arbitrate model are explored further in the A4ANZ submission.
- Regulatory guidance on WACC, including taking account of risk-adjusted cost of capital, as discussed in this chapter.
- Require efficient aeronautical pricing principles. A draft set of principles were first proposed by the Productivity Commission in its 2006 Inquiry report and subsequently included in the Australian Government's Aviation Policy Green Paper in 2009 (refer Appendix 2 for details). These offer a constructive basis for consideration.
- Establishing pricing and valuation principles for commercial leasing arrangements.
- Benchmarks for best practice negotiating conduct.

Application in other sectors

A useful and successful analogue for the approach proposed by Qantas Group is found in the broadcasting sphere.

The National Transmission Network (NTN) comprises many hundreds of sites upon which are located buildings, towers and other infrastructure required to transmit radio and television services, in particular for national broadcasters, ABC and SBS. It was originally owned by the Australian Government, which subsequently transferred ownership of the network to the National Transmission Company Pty Limited in February 1999. That corporation was then privatised in April 1999 and today is known as BAI Communications (see https://www.baicommunications.com/). It continues to supply services to ABC and SBS, among many others.

The sale originally occurred under the *National Transmission Network Sale Act 1998* (NTN Act). The *NTN Act* established an access regime. The access regime operates very simply, in essence as a deemed declaration of certain 'nominated services' (identified in s13) provided by means of the NTN for the protection of identified 'nominated customers' (identified in s15). The *NTN Act* thereby allows engagement of the arbitration based telecommunications access regime in the event of a dispute about nominated services without the need to go through any complicated declaration process.

The *NTN Act* successfully dealt with the situation where a few customers needed services from a large supplier by piggybacking on the then new telecommunications access regime.

That arbitration-based telco access regime applied for more than a decade post-privatisation of the NTN during which time processes were established by the ACCC to deal with access disputes generally in the telecommunications industry. There were no known access disputes under the NTN Act. Indeed, the NTN access regime continues to apply today in that frozen form, even though the legislation upon which it piggybacked has now changed considerably in its principal application to telecommunications access.

Now there is nearly another decade in which there are no known access disputes. There has been no opening of a floodgate to arbitration. Rather the service provider and the national broadcasters have negotiated commercially and entered several long-term service contracts and renewals and there has been capital spent on the NTN, but all with the conditioning safety net of ACCC arbitration based on defined principles having been available if negotiation failed.

Differences in telecommunications access regime

Qantas Group notes the Productivity Commission Report in 2012 referred to the frequency of ACCC arbitrations under the telecommunications access regime (Box 4, page XL) as a factor counting against deemed declaration for airport services. As the Productivity Commission recognised elsewhere in its 2012 Report (see page 181), telecommunications are an integrated network infrastructure industry which is quite dissimilar to multi-product, standalone entities like airports.

In particular, the experience of frequent ACCC arbitrations in telecommunications was a consequence of the introduction of competition in the 1990s in that integrated infrastructure context and the failure at the time to vertically disaggregate Telstra into separate wholesale and retail businesses. Introducing competition where the incumbent upon whom competitors relied for key inputs was also their largest competitor unsurprisingly gave rise to numerous disputes.

Airports and airlines are different. Unlike Telstra and telcos, they do not compete with one another. Airports and airlines are the same as the NTN Access Regime where the services provider is not a competitor of its customers. Telstra as an access provider and the many access seekers were always downstream competitors. That created a wholly different negotiating dynamic and is not a suitable guide to what will likely happen if the safety net of third party arbitration under Part IIIA operates to condition the negotiations between airports and airlines.

In addition to the deemed declaration models and arbitration options put forward by A4ANZ, a number of other measures should be adopted to assist with information sharing and transparency. Qantas Group considers this to be the most critical piece in resolving disputes between the parties, and will significantly reduce the likelihood of either party needing to access arbitration.

EU analogue on pricing and information disclosure expectations

The European Union Directive 2009/12/EC is discussed in detail in IATA's submission to the Productivity Commission inquiry.

It provides a certain degree of assurance for airlines regarding airport charges. The objective of Directive 2009/12/EC is to establish a common framework regulating the essential features of airport charges and the way they are set, also ensuring airport managing bodies increase transparency in their justification of charges and consult with airport users. Its key components are:

- Ensuring charges are set in agreement with airport users,
- Airport users to have the adequate level of transparency in order to properly assess the justification of the existing or new charges proposals, and
- Requirements for information flow to and from airport users.

For the Australian context, additional minimum transparency requirements are worthy of consideration:

- Facility and services clearly described in order to understand the charges proposals,
- Disclosure of the till applied by the airport for setting charges,
- Disclosure of the calculation method used by the airport,
- If the airport managing body operates more than 1 airport what are the effects on the level of charges?
- Disclosure of annual reports, audited accounts and notes to understand the airport's charges approach and consistency between displayed costs during consultation and the company's financial data,
- Full disclosure of operating costs, including staff costs, changing in staffing levels, maintenance costs, IT costs, utilities, consulting/outsourcing costs, and any other additional costs that airlines are expected to pay for,
- Dual and hybrid till airports to separate aeronautical from commercial costs appropriately,
- Investments discussed, planned and agreed with airlines with transparency including timelines, costs benefits, business cases, capacity, demand and usage,
- Transparency of investment; depreciating assets, including changes in asset life cycles or evaluation methods, and
- Disclosure of traffic forecasting methodology.

Setting benchmarks for best practice conduct

Voluntary codes of conduct or best practice benchmarks may further assist in facilitating commercial negotiations, reducing the likelihood of parties proceeding to arbitration and providing guidance to arbitrators, should they be required. IATA's submission outlines additional benefits of 'Best Practice Consultation'.

Potential costs and benefits of changes to the regulatory regime

Effective light-handed regulation will deliver net benefits to the economy, community and consumers.

Qantas Group asked CEPA to identify some of the potential benefits of changing the regulatory regime. These include:

- Increased opportunities to travel because of higher frequencies or additional routes implemented by airlines in response to lower charges. Given the contribution of airport charges to their cost structure, lower charges can be expected to positively impact the airlines' route development. Lower charges may prompt a re-evaluation of airline offerings and improve the viability of new or more frequent routes,
- Increased competition between airlines as lower charges allow competing airlines to expand their offer (or enter new markets) and increase the substitutability of their services to passengers. Airlines can be expected to evaluate the commercial viability of potential new markets and routes on an ongoing basis. Reductions in airport charges could increase the attractiveness of market entry (notwithstanding the presence of other barriers), and therefore the level of competition among airlines, and

- Increased quality of service to passengers. Quality of service improvements are most likely to occur as a side-effect of increased competition between airlines. To the extent that reduced charges impact the profitability of airlines, their ability to invest in capacity and service quality (for example, purchases of more or larger aircraft) may also be improved.

CEPA notes:

> *"Interests of airlines and passengers should be relatively aligned in a well-functioning aviation market. Moderating growth in airport charges should, over the long-run, result in pass-through to passengers via lower airfares and/or more and improved services."* [37]

Airlines adjust airfares in response to market conditions. For example, the ACCC has previously noted that in the face of economic shocks, airlines may reduce airfares during an economic downturn to maintain passenger volumes.[38] In contrast, airports may not be required to reduce their charges, and are insulated from lower demand by the airlines, as discussed earlier.

Frontier Economics quantified the potential benefits of the more specific amendments proposed by A4ANZ to deliver effective light-handed regulation. By facilitating commercial negotiations between airports and those seeking access, the proposed changes would unlock significant benefits to the Australian economy and the long term interest of the Australian community, including:

- Additional investment by airlines in improving the consumer experience, including building fleet capacity, preserving essential regional air services, collaborating with airports to progress innovations in customer experiences, improving domestic and international service levels and technological innovation, and other new and important initiatives such as pilot academies,
- Demand increase generating a consumer surplus of approximately $5.9 billion on a net present value (NPV) basis, $650 million per annum,
- Connectivity improvements creating travel time savings valued at $820 million on an NPV basis, almost $90 million per annum,
- GDP benefits of $10.9 billion on an NPV basis with an estimated $1.2 billion annual increase in GDP, due to improved global connectivity, and
- Other wider domestic economic benefits from improvements in air connectivity and creation of more competitive markets.

Effective regulatory approaches are also expected to reduce administration and compliance costs for all parties by up to $22.7 million on an NPV basis, when compared to the current regime.

Reducing costs and improving efficiencies would allow Qantas Group to explore more innovative travel options – as the Group did during our recent transformation program (Case Study below).

New routes such as Perth-London nonstop may become more plausible more quickly. Successful cost discipline could accelerate Qantas Group's ability to execute initiatives like Project Sunrise, which challenges manufacturers to build an aircraft with the capability of operating nonstop flights from Sydney to London and New York. These innovations create new routes and significantly increase passenger and freight volumes passing through airports.

5. Aviation Security

Qantas Group is proud of its safety and security record and partners with Governments and airports to protect its passengers, people and operations.

Qantas Group supports a "threat- and risk-based" approach to security regulations and requirements. The Productivity Commission Inquiry is timely for examining the regulatory and commercial framework under which airport security charges are currently calculated and recovered by airports in Australia.

This section highlights challenges to the cost-effective delivery of security services at Australian monopoly airports and suggests efficiency improvements.

Recent aviation security screening and policy changes announced in the 2018 Budget are necessary for responding to emerging threats. These will introduce CT scanners for all checked baggage, require body scanners at major domestic airports and increase them at international airports as well as upgrade security at regional airports. They will necessitate significant increase capital and operational expenditure.

The Federal Budget provided $51 million for new capital investment. Industry-wide capital expenditure is expected to be $750 million-$1 billion for the security upgrades. There is no allowance for operating expenditure.

The calculation and recovery of security costs is a serious issue that is becoming ever more critical. A review of global aviation security costs, undertaken in 2015, found:

> *"Unless significant changes are made, the monetary and economic costs of the current aviation security system are likely to reach unsustainable levels over the next 15-20 years as the number of air travellers and air cargo continue to grow."* [39]

Unintended gaps in the regulatory framework have enabled airports to avoid scrutiny and exercise market power on security services. Airports currently have virtually unlimited discretion as to the types and costs of security services they will procure This has contributed to excessive costs, operating inefficiencies and a systemic lack of transparency.

Qantas Group supports an effective light-handed regulatory approach to airport regulation. Qantas Group seek outcomes-based legislation to deliver aviation security efficiently, while minimising cost and maintaining the passenger experience at airports.

REGULATORY OVERSIGHT

Qantas Group requested specialist legal firm Norton White to provide a memorandum addressing current regulatory and commercial challenges posed by the current regime and proposing options for addressing those issues. A full copy of the memorandum is included in Appendix 3.

Aviation security in Australia is regulated under the *Aviation Transport Security Act 2004* and *Aviation Transport Security Regulations 2005* (the regulations) (collectively, the legislation).

In general terms, the security regulations mandate minimum outcomes or standards. They do not prescribe a comprehensive standard or precisely how it is to be satisfied. The operator of a security controlled airport is left with discretion on how to meet the security standards. There is no mechanism currently in place that gives airlines any real control or influence over how those requirements are met, or whether security measures are reasonable, necessary or proportionate.

While the legislation imposes minimum security standards on airport operators and screening authorities, it does not address, or attempt to allocate, the costs of meeting those standards. In practice, security costs are generally incurred by airports and passed on to airlines through various charges and levies, some of which are ultimately paid by passengers through airfares or surcharges.

The current way in which aviation security-related costs are calculated, articulated to the airline industry and recovered by airports poses several significant issues for airlines that could be addressed by the Productivity Commission and security regulators.

These problems are outlined below.

EXPANDING WHAT CONSTITUTES AVIATION SECURITY

During and immediately after the privatisation of airports, government and regulators expected that airports could "pass through" unavoidable, direct costs related to "passenger screening, baggage, screening and counterterrorist security" (refer Norton White advice for details).

The current legislation imposes several outcomes (such as ensuring sufficient controls to delineate airside areas from landside areas) but does not mandate how those outcomes must be achieved.

The types and scope of costs charged to airlines and their passengers under the umbrella of Government-mandated airport security requirements has grown significantly since the concept was first introduced. Costs which were not originally contemplated by Governments as being recoverable by airports are now being passed on to passengers and airlines. Some examples are set out below.

Earning profits from security

Airports across Australia today charge passengers and airlines for return on security-related capital investments, administration fees and ordinary business expenses.

As an example, Northern Territory Airports (Darwin Airport, Alice Springs Airport and Tennant Creek Airport) asserts its right to levy administration fees and extract a return on security assets in its Condition of Use (emphasis added):

> ***"8. Government Mandated Charges***
>
> ***8.1 Payment of Government Mandated Charges***
> *You must pay Us Government Mandated Charges applicable, for Us providing the Government Mandated Services to You.*
>
> ***8.2. Government Mandated Services***
> *We administer the Government Mandated Services for the provision of safety and security at Our Airport, which include (but are not limited to) the following Services:*
>
> *(a) Terminal Passenger screening;*
>
> *(b) Terminal Passenger checked bag screening;*
>
> *(c) Policing;*
>
> *(d) Other Services required by the Commonwealth Government or other lawful authority (including the DOIRD) and any additional security measures We are required to take or which We undertake through third parties and which may include the incurrence of capital expenditure (allowing a reasonable return on capital investment) to provide such Services and which are provided by Us to You at Our Airports from time to time;*
>
> *(e) Any hiring of equipment required for providing the Government Mandated Services; and*
>
> *(f) Any operational and administrational costs incurred by the Airports to provide the Government Mandated Services either directly, or on a contract management basis…"*

Return on capital investment is commonly accepted by finance and accounting experts as a measure of the profitability and value-creating potential of companies.

Northern Territory Airport's own terms and conditions acknowledge it is entitled to make a profit on security.

Several other airports have suggested that the "pass-through" principle for security costs do not apply to them, hence they apply a margin through WACC, and administration and corporate fees.

Redefining aviation security

Airports have also expanded the types of security services for which they recover costs from airlines. While the nature of the security threat necessarily changes over time, some of the costs passed on by airports go beyond those security services necessary to safeguard against unlawful interference with aviation (which is the primary purpose of the legislation). They now include services required by the airport as part of its business model.

Examples of services Qantas and Jetstar have routinely had to pay for include:

- Car licence plate readers in car parks, taxi and hire car areas, and arrivals and departures areas to help airport maximise car parking fines, revenue and use,
- Screening of retail and non-aeronautical goods and staff. This includes but is not limited to champagne, wine, spirits, cosmetics and cigarettes sold in duty free stores; clothing, shoes, and bags at premium and designer stores; and souvenirs, food, beverages, and magazines in retail outlets within the sterile area,
- Airside access and airfield security charged only to commercial airline operators rather than all airport customers, such as freight, general aviation, and ground handling companies. Adelaide Airport, Perth Airport and Brisbane Airport engage in this practice, and
- Airport employee costs and overheads.

LACK OF TRANSPARENCY

International Civil Aviation Organization (ICAO) guidance in its Policies on Charges for Airports and Air Navigation Services states:

> *"…Consultations should take place before any security costs are assumed by airports, aircraft operators or other entities…"* [40]

Unfortunately, airlines are generally not consulted by airports where new security services are implemented but are simply notified of the increased cost. Examples of this include the introduction of contract security 'Landside Security Officers'. These airports have cited guidance from the Aviation and Maritime Security (AMS) agency which refers to front of house vulnerabilities. AMS does not direct airports to apply these measures and it is tenable that such measures are State Government or private policing functions, therefore outside the scope of federal 'Government mandated security requirements'.

In addition, most airports' terms and conditions generally give them broad leeway to introduce new charges for security services deemed necessary by the airport at any time. For example, Airport H's Aviation Services and Charges Agreement provides that Government Mandated Services include (emphasis added):

> *"other services required by the Commonwealth Government or other lawful authority and any additional security measures we are required to take and which are provided by us to you at Airport H from time to time".* [41]

ENCOURAGING INEFFICIENCY

Under the current regime, airports procure the services but ultimately do not have to pay for them. They have no incentive to obtain value for money in the same manner they would be if they were ultimately responsible for the costs. The current system is inherently inefficient, encourages inefficiency and reduces productivity.

Unfortunately, airlines which have a direct interest in ensuring services are provided in the most economically efficient manner, largely are not able to influence the scope or manner of procurement of aviation security services.

Qantas Group currently operates domestic terminals at Sydney Airport, Melbourne Airport, Brisbane Airport and Perth Airport under domestic terminal leases and is responsible for screening and other security services at these terminals. Jetstar also has a significant presence at these airports, operating from common user terminals where airports are responsible for security provision.

CONTRACTS INEFFECTUAL

The current system is predicated on the assumption that airlines will be able to negotiate acceptable contractual terms and conditions governing the pass-through of security charges with airports.

Airports are a monopoly supplier and airlines do not have countervailing power to negotiate terms and conditions that address the issues noted above, and are often presented with terms and conditions on aviation security on an "as is" basis with little room for negotiation.

In addition, the kinds of practices described here (which grant airports broad power to determine and change security costs with little consultation or transparency) have become market standard for Australian airports, which also serves to limit the power of airlines to negotiate and amend those clauses. Qantas Group considers that unfortunately airlines have no choice but to largely accept the standard terms and conditions governing the recovery of government mandated services.

Some airport agreements contain clauses which require the airport to take steps to manage mandated services in an economically efficient and cost-effective manner. But these clauses are largely ineffective in addressing the issues noted in this report as there are no repercussions for the airport for failing to meet these requirements.

For example, Brisbane Airport's Aviation Services and Charges Agreement only obliges it to use 'best endeavours' and take reasonable steps 'where possible'. It would be difficult in practice for an airline to rely on this kind of clause if it believed the airport was in breach.

IMPROVEMENTS NEEDED

Some options for addressing these issues are set out below. These are complementary and may be considered together.

Obligations on AMS to ensure efficiency

Qantas Group believe there is merit in considering amendments to section 19 of the *Aviation Transport Security Act 2004* to require transparency through cost, efficiency and service level disclosures when AMS approves airport Transport Security Plans and to allow that information to be passed onto airlines.

Appropriate boundaries on the concept of recoverable security costs

This could be effected by amendments to the Legislation to provide that airports are only entitled to recover security costs which fall within defined limits to be set out in the Legislation. The definition should be consistent with the meaning originally envisaged by the Commonwealth when airports were privatised as set out in Direction No 13 – that is, the direct and unavoidable costs of complying with the Legislation.

Qantas Group suggests that these principles also cover a 'user-pays' approach where non-airline users such as retail outlets are expected to pay for the cost of screening and other core security services associated with operating in sterile areas. Arguably, the airport should bear some of these costs as a cost of doing business.

Price monitoring of government-mandated security charges

Qantas Group considers that the current price monitoring methodology is flawed but, if it is to be retained at all, could be improved to more effectively identify misuse of market power in relation to security charges as follows:

- **ACCC to require disclosure of profits and indirect costs**. The ACCC could be required to obtain and publish additional information in relation to airports' breakdown of security charges to ensure compliance with their obligations under amended regulations and TSPs as referred to above,
- **Single till monitoring**. ACCC assessments relate to aeronautical services and so are done on a 'dual till' basis meaning that they do not cover non-aeronautical activities (with the exception of car parking) and so do not assess the level of prices and profits on a single till basis. Qantas Group considers this to be problematic as an airport services many complementary markets and its charges for aeronautical and non-aeronautical services, including security are interdependent, and
- **Benchmarks**. Current monitoring has no clearly articulated benchmarks against which to assess an airport's performance. Options for benchmarking include against the airport's weighted-average cost of capital or efficient comparators to that airport.

Implement pricing principles for security charges

Another potentially complementary option is for the Government to implement a set of mandatory aeronautical pricing principles which include security costs. The principles should detail:

- appropriate boundaries on what constitutes a recoverable security charge, including requirements to prevent airports from profiteering from security services,
- requirements for transparency in how costs are calculated,
- a mechanism for airlines to be engaged into the security services obtained and how they are procured, and
- access to independent arbitration where the parties cannot reach agreement on how government mandated security charges are to be calculated and passed through.

The principles could be mandated in a number of ways, such as introduction of guidelines by the ACCC, legislative amendments or introduction of a code of conduct.

6. Car Parking and Landside Access

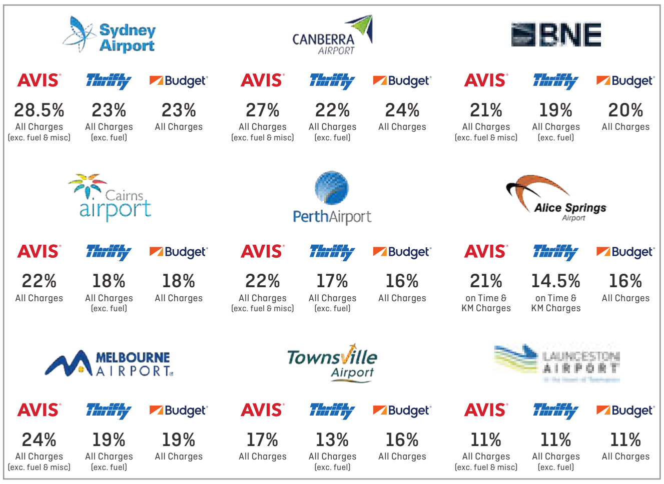
This chapter addresses the Productivity Commission's Information Request 10 and highlights examples of abuses of market power that affect the ability of Qantas Group passengers to access their flights at reasonable prices and terms.

Australian airport monopoly power abuse is not restricted to airlines. Unfortunately, a number of other airport users, including taxis and ride-sharing businesses, retail businesses, bus companies and car rental companies similarly experience unfettered charges, inefficient investment, lack of transparency and consultation, and unilateral decision making.

EXCESS FEES FOR CAR RENTALS

In Western Australia, the State Government has advised public servants that "Airport Concession Recovery Fees" are payable on all rentals vehicle at Australian airports.[42] They advise staff that they will pay the following contract rates when a rental vehicle is collected from an airport and suggest staff consider hiring their vehicle from non-airport premises to save on costs.[43]

Figure 12: Airport Concession Recovery Fees payable by Western Australia Government employees at key airports



Source: Government of Western Australia, 'Airport Concession Recovery Fees' (CUA MVR2014), https://www.contractswa.finance.wa.gov.au/resources/MVR2014_Airport_Concession_Recovery_Fee.pdf

EXCESS PROFITS IN CAR PARKING

Aside from airport charges, the next largest cost for an airport customer is the cost associated with travelling to and from the airport.

The ACCC found that for the reporting period of 2016-17 profit margins for airport car parking ranged from 52.4% for Perth Airport to 71.9% for Sydney Airport.[44] In that single year, Sydney Airport made an operating profit of $97.0 million from its car parking operations, Melbourne Airport made $86.7 million and Brisbane Airport made $63.7 million.[45]

These recent results demonstrate that the current regulatory regime is not an effective constraint on airports' market power in the supply of car parking services. There is no effective constraint on airports' market power as it relates to car parking and allows airports to set monopoly prices.

CAR PARKING COSTS RECOVERED FROM AIRLINES

Qantas Group has experienced further issues with charging models adopted by Australia's monopoly airports in regards to car parking. For example, Sydney Airport constructed a new express car park in 2015 and allocated the cost for the drop-off and pick-up area as 100% aeronautical while it also collects non-aero car parking revenue from this site for cars parked longer than 15 minutes. Sydney Airport would not respond to reconsider the aeronautical funding allocation, despite clear evidence that non-aeronautical revenue was being derived.

7. Land Transport Linkages

This chapter addresses the Productivity Commission's Information Request 12 and highlights existing arrangements for the planning and operation of land transport linkages.

Qantas Group supports intermodal connectivity in the aviation market. Seamless customer connection is vital to a thriving transport and aviation industry, provided this connectivity does not add additional charges to airport users, as part of an airfare.

Seamless connections have a fundamental role, connecting different modes of transport to ensure that users, whether passengers or goods, can move through the entire journey to and from the airport without interruption. The intention should be to eliminate inefficiencies and minimise transfer times between modes.

Genuine seamlessness is vital for the smooth transport of people, raw materials and products and is central for economic growth. Minimising transfer times for customers by providing high-quality mobility improves the quality of the customer experience.

Qantas Group considers there are at least 3 major land transport projects at present in Australia that are important to ongoing success and growth at airports. These include:

- WestConnex project (Sydney),
- Melbourne Airport rail link, and
- Western Sydney Airport (WSA) rail link.

It is critical the WestConnex project ensures seamless connection for customers to and from Sydney Kingsford Smith Airport. Easing traffic congestion to the gateway of the airport and reducing travel times for airport users and customers are essential to maximising the public benefits of the publicly-funded WestConnex project.

Melbourne Airport rail linkages it is about ensuring the most direct routes possible are utilised, connecting customers, users and passengers from the city to and from the airport.

WSA rail link needs to ensure any proposed rail line meets customer needs, creates seamless inter-modality between transport modes. It is critical the project is fit-for-purpose, not gold plated and not included as an additional cost to any airport charging model.

All land transport linkages must ensure efficient and seamless connection for customers and freight alike, but balanced with a sustainable charging model that is fair and reasonable.

8. Air Services to Access Regional New South Wales

This chapter addresses the Productivity Commission's Information Request 13 and discusses regional ring fencing arrangements under the *Sydney Airport Slot Management Scheme 2013* (part of *Sydney Airport Demand Management Act* 1997).

Qantas Group supports the preservation of the current state in regards to the regional ring fencing regime.

Regional ring fencing – or permanent regional service series (PRSS) – applies between Sydney Airport and regional airports in New South Wales. PRSS slots cannot be used by international or domestic services except in exceptional circumstances to ensure regional NSW communities have access to the state's capital.

An operator may only apply for a slot to offer a regional service if the slot:

- is part of a PRSS,
- is not during a peak period, or
- is used to meet a special need and is not part of an existing slot series or slot group.

Current peak regional services cannot be moved out of PRSS hours in favour of international or interstate services.

A regional services operator may only swap a PRSS with a non-regional operator if the time of the other slot is within 30 minutes of the original time of the permanent regional service slot.

Qantas Group recognises the importance of preserving access to regional markets at the right time. Fleet and operations established to support Qantas Group customer needs require certainty. This enables customers to travel for critical appointments in Sydney and regional cities and fly home again the same day. It also facilitates inbound connectivity to regional tourism destinations and outbound connectivity for business and leisure travel by Australians.

9. Aviation Fuel Security and Supply

This chapter addresses the Productivity Commission's Information Request 14 and highlights the state of competition in the jet fuel market in Australia.

Assurance and reliability of supply are critical.

STATE OF COMPETITION FOR JET FUEL SUPPLY

Australia currently imports approximately 60-65% jet fuel. This has increased over time from 25% in 2011 due to the progressive closure of 4 refineries. Increased import reliance heightens the supply risk under exceptional circumstances (e.g. political unrest, war, extreme natural disaster). Imported jet fuel is currently sourced from South Korea, Singapore, China and Japan, which makes up greater than 85% of total jet fuel imports.

In Australia, monopoly airport operators provide leases and licences over airport land to facilitate fuelling of aircraft. The on-airport component of the fuel supply chain usually includes part of the pipelines from the supplying refinery or terminal, the hydrant, airport fuel storage and facilities to deliver fuel to planes, such as hydrant dispensers and tanker vehicles.

Every major Australian airport and most regional airports have a single on-airport storage facility. These facilities are wholly- or majority-owned by oil companies. All facilities are operated by or under Technical Service Agreement with oil companies.

Both airports and oil companies exercise power over the state of competition for jet fuel supply in Australia.

AIRPORTS

Airports have the capability to exert influence on fuel supply and costs. Some examples of airports' behaviour are detailed below.

Licence fees and rent

Oil companies are often required to pay airport owners rent for the land the fuel facilities are located on and/or a licence fee for selling fuel to airlines. Oil companies then pass through these costs as part of the fuel price. Responsible pricing by airport operators can ensure these pass-through costs are kept to a minimum. Revenue from these aeronautical facilities is not offset against the airport's aeronautical charges. Being a third party to the charge, airlines have no ability to consult or negotiate these fees.

Fuel Throughput Levy (FTL)

Some airports in Australia charge a Fuel Throughput Levy (FTL). The FTL is often not commensurate to the provision of any additional products or services. Airport revenue from the FTL represents a windfall gain, worth millions of dollars to Australian monopoly airports annually. Additionally, revenue derived from the FTL is not offset against the allowable revenue calculated as part of the other aeronautical charges paid by airlines. This has a direct impact on airline fuel prices as the fuel providers pass through the cost directly to airlines and their passengers as a higher fuel price. Airlines have no ability to consult or negotiate this fee.

Long term lease tenure and adequacy of on-airport facilities

A major barrier to investment in on-airport storage by fuel infrastructure owners is long-term lease tenure. Lease tenure provides the fuel infrastructure owners with certainty and enables appropriate investments to be made to support market growth and ensure jet fuel supply reliability.

An airport cannot operate without adequate fuel supply. By ensuring there is adequate storage to meet projected growth and peak demand, an airport can prevent supply disruptions. This can be managed through regular meetings with on-airport storage operators to ensure suitable facilities and lease security exists.

Fuel facility relocations

Costs associated with relocating fuel facilities are ultimately borne by airlines and passengers. Airports, rarely engage and consult airlines prior to relocating these facilities, often without any operational imperative to do so.

OIL COMPANIES

There are several problems faced by airlines in relation to oil companies which restrict competition in the jet fuel market and lead to higher pricing.

Access to on-airport fuel facilities

At most airports in Australia new suppliers can only access on-airport fuel facilities via equity ownership. The process for equity access at a major airport JUHI is complex and time-consuming with little transparency. An increase in the number of suppliers able to provide fuel to the airport will encourage competition, lift productivity, improve efficiencies and decrease fuel prices.

Australian airports JUHIs that do allow non-equity access do not typically have a published access fee. Melbourne Airport and Canberra Airport are examples of this. This lack of transparency is in contrast to airports internationally.

Reliability of supply and adequacy of off-airport facilities

Having adequate tankage and distribution on-airport is important but if off-airport supply is unable to meet airport demand, this will result in a tighter market, increased pricing and potential supply disruptions. Additionally, there are heightened supply risks associated with imported jet fuel due to the lack of refining capability to correct quality problems.

All storage capacity in Australia is held commercially within the supply chain, with limited capacity for emergency reserves.

Access to monopoly upstream infrastructure

Access to monopoly upstream supply chain is very difficult and this further restricts access to new suppliers prevents competition at airports.

IMPROVEMENTS NEEDED

To overcome challenges in jet fuel supply and improve competition in the jet fuel supply market, Qantas Group supports consideration of the following:

- Greater transparency of information, particularly in respect of the FTL. Additionally, easier access to arbitration on commercial terms (e.g. rental and FTL) would assist to resolve the above issues with Australian airports and jet fuel supply. While Qantas Group opposes the principles of a FTL, where one is charged, Qantas Group believes revenue derived from the FTL should partially offset the allowable revenue calculated as part of the building block model to determine more suitable passenger charges.
- To overcome the problems experienced with the fuel companies in the Australian market, Qantas Group recommends consideration of regulatory models similar to those used in the EU. The EU Ground Handling Directive 96-67-EC mandates non-equity access at EU airports and provide a published fee for non-equity access. This could also be extended to upstream monopoly infrastructure. The EU legislation has enabled many new suppliers to enter the market at European airports and compete with existing suppliers, which has produced a positive impact on jet fuel competition and lowering of jet fuel prices at these airports.

For contractual and commercial reasons, additional details of Qantas Group evidence have been provided on a confidential basis.

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10. Appendices

Appendix 1

Airport Ownership Key Developments

Airport Ownership Key Developments

The ownership structure of airports typically involves an operating company, a parent company which may own several airport operating companies and shareholders of the parent company.

To illustrate the high degree of concentration occurring in relation to Australian Airports, Qantas group prepared analysis based on available data (as at 20 July 2018). Notable ownership stakes are highlighted below.

- Industry Funds Management has large ownership stakes in eight airports across eastern and central Australia. It owns over two-thirds of Darwin, Alice Springs and Tennant Creek airports' operating company, more than one-quarter of Melbourne and Launceston Airports, and over one-eighth of Brisbane, Adelaide and Parafield airports,[46]
- Perron Investments Pty Ltd also partially owns 8 airports – 6 in Queensland, including Gold Coast, Townsville, Mount Isa, Longreach, Cairns and Mackay, as well as Adelaide and Parafield airports.
- Colonial First State has significant stakes in 2 capital city airports, owning over 15% of Brisbane Airport, Adelaide Airport and Parafield nearby,[47] and
- UniSuper also has large ownership stakes in 2 capital city airports, owning nearly half of Adelaide and Parafield airports and over 16% of Sydney Airport.

The concentration of direct and cross-ownership of Australian airport assets by the private sector is evident through several transactions since the last Productivity Commission inquiry in 2011.

- In January 2018, Perron Investments and The Infrastructure Fund increased their shareholding of North Queensland Airport when Auckland International Airport sold its 24.6% stake for $370m.[48]
- In March 2015, UniSuper purchased an additional 40 million Sydney Airport shares for $212 million, increasing its ownership from 12.6% to over 14%, in addition to its 49% ownership of Adelaide and Parafield airport.[49]
- In March 2013, Industry Funds Management (IFM) increased its ownership of Airport Development Group, the owners of Darwin, Alice Springs, Tenant Creek Airports and Longreach airports from 55.6% to 77.4%, adding to its already existing and extensive ownership of Melbourne, Launceston, Brisbane, Adelaide and Parafield Airports.[50]
- In August 2012, Future Fund announced it would acquire all of the Australian Infrastructure Fund's portfolio assets, including taking control of its 12.4% ownership stake in Australian Pacific Airports Corporation (owners of Melbourne and Launceston Airports), 49.1% of Queensland Airports Limited (owners of Gold Coast, Townsville, Mount Isa and Longreach Airports), 29.7% of Perth Airport Group (owner of Perth Airport) and 28.2% of Airport Development Group (owners of Darwin, Alice Springs; and Tennant Creek Airports).[51]

Table A.1: Analysis of ownership consolidation (as at 20 July 2018)

Shareholder	Airport Ownership Stake	Related Parent Companies
Industry Funds Management	25.17% – Melbourne 25.17% – Launceston	– Australian Pacific Airports Corporation
	12.8% – Adelaide 12.8% – Parafield	– Adelaide Airports Ltd
	77.4% – Darwin 77.4% – Alice Springs 77.4% – Tennant Creek	– Airport Development Group
	13.8% – Brisbane	– Brisbane Airport Corporation
Future Fund	20.34% – Melbourne 20.34% – Launceston 30.01% – Perth	– Australian Pacific Airports Corporation – Perth Airport Development Group
Sunsuper Superannuation Fund	Unavailable (UA)% – Gold Coast UA% – Townsville UA% – Mount Isa UA% – Longreach 1.50% – Brisbane 1.95% – Perth	– Queensland Airports Ltd – Brisbane Airport Corporation – Perth Airport Development Group
UniSuper Ltd	49% – Adelaide 49% – Parafield 16.09% – Sydney	– Adelaide Airport Ltd – Sydney Airports
First State Super	100% – Bankstown 100% – Camden	– BAC Airports

Shareholder	Airport Ownership Stake	Related Parent Companies
Gardior Pty Ltd ATF The Infrastructure Fund	UA% – Gold Coast UA% – Townsville UA% – Mount Isa UA% – Longreach 7.19% – Perth 27% – Cairns 27% – Mackay	– Queensland Airports Ltd – Perth Airport Development Group – North Queensland Airports
Colonial First State	15.3% – Adelaide 15.3% – Parafield 17.% – Brisbane	– Adelaide Airport Ltd – Brisbane Airport Corporation
Perron Investments Pty Ltd	UA% – Gold Coast UA% – Townsville UA% – Mount Isa UA% – Longreach 3.4% – Adelaide 3.4% – Parafield 7.0% – Cairns 7.0% – Mackay	– Queensland Airports Ltd – Adelaide Airports Ltd – North Queensland Airports
AMP	27.32% – Melbourne 27.32% – Launceston	– Australia Pacific Airports Corporation
SAS Trustee Corporation	18.47% – Melbourne 18.47% – Launceston	– Australia Pacific Airports Corporation
Palisade Investment Partners	22.6% – Darwin 22.6% – Alice Springs 22.6% Tenant Creek	– Airport Development Group
Statewide	19.5% – Adelaide 19.5% – Parafield	– Adelaide Airport Ltd
Lipno Holdings	UA%- Gold Coast UA% – Townsville UA% – Mount Isa UA% – Longreach	– Queensland Airports Ltd
Alan Moss	UA% – Gold Coast UA% – Townsville UA% – Mount Isa UA% – Longreach	– Queensland Airports Ltd
QAL Investments Trust	UA% – Gold Coast UA% – Townsville UA% – Mount Isa UA% – Longreach	– Queensland Airports Ltd
Project Cricket State Super Unit Trust	UA% – Gold Coast UA% – Townsville UA% – Mount Isa UA% – Longreach	– Queensland Airports Ltd

Appendix 2

Australian Government Draft Aeronautical Pricing Principles

Draft Aeronautical Pricing Principles

The pricing principles relating to prices for aeronautical services and facilities (as defined in Part 7 of the Airports Regulations 1997) provided by airports are:

a) that prices should:

i. be set so as to generate expected revenue for a service or services that is at least sufficient to meet the efficient costs of providing the service or services; and*

ii. include a return on investment in tangible (non-current) aeronautical assets, commensurate with the regulatory and commercial risks involved and in accordance with these Pricing Principles;

b) that pricing regimes should provide incentives to reduce costs or otherwise improve productivity;

c) that prices (including service level specifications and any associated terms and conditions of access to aeronautical services) should:

i. be established through commercial negotiations undertaken in good faith, with open and transparent information exchange between the airports and their customers and utilising processes for resolving disputes in a commercial manner (for example, independent commercial mediation/binding arbitration); and

ii. reflect a reasonable sharing of risks and returns, as agreed between airports and their customers (including risks and returns relating to changes in passenger traffic or productivity improvements resulting in over or under recovery of agreed allowable aeronautical revenue);

d) that price structures should:

i. allow multi-part pricing and price discrimination when it aids efficiency (including the efficient development of aeronautical services); and

ii. notwithstanding the cross-ownership restrictions in the Airports Act 1996, not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher;

e) that service-level outcomes for aeronautical services provided by the airport operators should be consistent with users' reasonable expectations;

f) that aeronautical asset revaluations by airports should not generally provide a basis for higher aeronautical prices, unless customers agree; and

g) that at airports with significant capacity constraints, peak period pricing is allowed where necessary to efficiently manage demand and promote efficient investment in and use of airport infrastructure, consistent with all of the above Principles.

*For the purpose of determining aeronautical prices through commercial negotiations, these should be long-run costs unless another basis is acceptable to the airports and their customers.

Appendix 3

Norton White Lawyers: Memorandum of Advice on Aviation Security

MEMORANDUM OF ADVICE
Economic Regulation of Airports

QANTAS AIRWAYS PTY LTD

5 SEPTEMBER 2018

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LAWYERS

TABLE OF CONTENTS

1. BACKGROUND

We have been asked to prepare a report outlining:

(a) the regulatory and commercial regime under which airport security charges are currently calculated and recovered by airports in Australia;

(b) issues faced by airlines regarding the cost of airport security posed by the current regime; and

(c) proposed options for addressing those issues.

2. OVERVIEW OF AVIATION SECURITY REGULATION

Aviation security in Australia is regulated under the *Aviation Transport Security Act 2004* (Cth) and *Aviation Transport Security Regulations 2005* (Cth) (the **Regulations**) (collectively, the **Legislation**).

Based on an airport categorisation model (which is presently assessed against factors including aircraft operations, maximum take-off weights and the number of passengers transiting through an airport), the Legislation prescribes a set of minimum standards to be met by aviation industry participants for the purposes of safeguarding against unlawful interference with aviation and maintaining aviation security, including:

(a) maintaining an approved Transport Security Program (**TSP**);

(b) designating secure areas within airports;

(c) establishing physical controls over access to landside areas and zones; and

(d) screening of persons, baggage and goods entering a Sterile Area.

Attachment A to this report outlines the basic structure of the relevant security requirements affecting airports.

2.1 Mandated Minimum Outcomes

In general terms, the security regime mandated by the Regulations specifies minimum outcomes or standards. It does not prescribe a comprehensive standard or precisely how a requirement is to be satisfied. The operator of a security controlled airport is left with a discretion on how to meet the security standards. For example, Regulation 3.20 provides that the security requirements for a sterile area in a landside security zone should include at least 1 screening point. There is not a recommended number of screening points. Likewise, precise operational requirements for screening points are not prescribed. It is left to the screening authority to determine how many personnel are required for each screening point and how many screening points are required for a particular location.

This approach is applied to almost every security requirement specified in the Regulations. A sterile zone must have a barrier *"sufficient"* to delineate the airside area, it must have *"effective"* access control points and patrolling, electronic surveillance *"or any other suitable measures"* to inspect the barriers for damage and to deter and detect unauthorised access to the airside area. How this is to be achieved is left to the security operator.

There is no mechanism currently in place that gives airlines any real control or influence over how those requirements are met, or whether particular security measures are reasonable, necessary or proportionate.

2.2 Costs

While the Legislation imposes minimum security standards on airport operators and screening authorities, who obviously must incur costs in complying, it does not address, or attempt to allocate, the costs of meeting those standards. In practice, security costs are generally incurred by airports and passed on to airlines through various charges and levies, some of which are ultimately paid by passengers through fares or surcharges.

3. ISSUES WITH CURRENT SYSTEM

The current way in which aviation security-related costs are calculated, articulated to the airline industry and recovered by airports poses a number of significant issues for airlines that could be addressed by the Productivity Commission and Commonwealth Government.

3.1 Expansion of types of security-related costs recovered by airports

A key issue is that the types and scope of security costs recovered by airports under the umbrella of 'government-mandated charges' has expanded since the concept was first introduced, so that costs which were not originally contemplated by Government as being recoverable by airports are now being passed on to airlines.

When Commonwealth airports were first privatised, the Treasurer issued Direction No 13[1] which set five-year price caps for each of the relevant airports. However, it also allowed airports to pass through to airlines "*…100 per cent…of those <u>direct costs</u>*

[1] Pursuant to section 20 of the *Prices Surveillance Act 1983* (Cth).

related to Government mandated airport security requirements" without affecting the airport's compliance with its price cap.

Although no formal definition was provided in Direction No 13 on what constituted 'government mandated airport security requirements', the ACCC made the following remarks in its Regulatory Report of Brisbane Airport for 1997-1998:

> *"…The price cap regime allows airport operators to "pass-through" to users 100 per cent of the costs related to Government mandated airport security requirements, without those increases affecting compliance with the price cap. The Department of Transport has advised the Commission that such costs comprise amounts charged to the airport by the Australian Protective Service ("APS"). In future, Government mandated security requirements met by the airport operators and other service providers would also qualify for the cost "pass-through" arrangements."*

The Australian Protective Service (**APS**) charge, which was often levied by airports, covered the costs of passenger screening, baggage screening and counter terrorist security at designated ports.

Further guidance on what constituted government mandated security requirements was provided in the ACCC's Annual Report 1999 – 2000 (at p72) which stated that only 'direct costs' should be passed through and favoured the 'avoidable cost' model[2]:

> *"…The price cap instruments include a pass through provision for <u>direct costs</u> of providing government-mandated airport security requirements. <u>These requirements cover passenger screening, baggage screening and counter terrorist security.</u>*
>
> *Over the year the Commission provided guidance on the costs that can be passed through the price cap. In March 2000 it released a position paper Government-mandated security requirements: the meaning of 'direct cost' as it relates to the price cap pass-through provisions. <u>The paper concluded that the avoidable cost approach to determining the cost of complying with government-mandated airport security requirements accords most closely with the Commission's understanding of the prices oversight arrangements.</u>*
>
> *Over 1999–2000 the Commission assessed 17 security pass through notifications from price-capped airports, seven of which were checked baggage screening, eight passenger screening and two APS notifications. The Commission also assessed one checked baggage and two passenger screening notifications from Sydney airport. All the decisions were made in accordance*

[2] An avoidable cost generally refers to an expense that will not be incurred if a particular activity is not performed. Avoidable costs generally refer to variable costs that can be removed from a business operation, and would exclude, for example, fixed overheads such as terminal rental.

with the approach adopted in the Commission's position paper." (emphasis added)

However, since that time, airports have significantly widened the scope of the costs they now pass through to airlines under the banner of 'Government-mandated security costs' to include costs that would not fall within the guidance noted above. Some examples are set out below.

(a) ***Indirect costs and profit***

Over time, airports have expanded the recovery of government mandated services from direct costs (i.e. unavoidable, direct ordinary costs of providing passenger and baggage screening and counter terrorist security) to include indirect costs such as administration fees, return on capital investment and overheads.

As an example, Northern Territory Airports (Darwin, Alice Springs and Tennant Creek Airports) provides the following in its Condition of Use (emphasis added):

"8. Government Mandated Charges

8.1 Payment of Government Mandated Charges

You must pay Us Government Mandated Charges applicable, for Us providing the Government Mandated Services to You.

8.2. Government Mandated Services

We administer the Government Mandated Services for the provision of safety and security at Our Airport, which include <u>(but are not limited to) the following Services</u>:

(a) Terminal Passenger screening;

(b) Terminal Passenger checked bag screening;

(c) <u>Policing</u>;

(d) Other Services required by the Commonwealth Government <u>or other lawful authority</u> (including the DOIRD) and <u>any additional security measures We are required to take</u> or which We undertake through third parties and which may include the incurrence of capital expenditure <u>(allowing a reasonable return on capital investment)</u> to provide such Services and which are provided by Us to You at Our Airports from time to time;

(e) Any hiring of equipment required for providing the Government Mandated Services; and

(f) Any operational <u>and administrational costs incurred by the Airports to provide the Government Mandated Services either directly, or on a contract management basis…</u>"

By including a "*reasonable return on capital investment"*, Northern Territory Airports' terms and conditions suggest that it is not only recovering its costs of providing security services - it may also be making a profit.

In addition, policing is ordinarily a government responsibility which would not usually be provided by an airport or paid for by airlines. As noted by the International Civil Aviation Organization (**ICAO**) in its 'Policies on Charges for Airports and Air Navigation Services': "…*Civil aviation should not be charged for any costs that would be incurred for more general security functions performed by States such as general policing…"*

(b) ***Security costs not directly relevant to preventing unlawful interference with aviation***

Airports have also expanded the types of security services for which they recover costs from airlines. While the nature of the security threat necessarily changes over time and airports may be required to introduce new security services to address those threats, we understand that some of the costs passed on by airports go beyond those security services necessary to safeguard against unlawful interference with aviation (which is the primary purpose of the Legislation) and may include a limited number of general security services required by the airport as part of its business.

Some examples are set out below:

(i) **Licence plate readers** – Licence plate readers are understood to have been introduced, or are being considered, by airports for landside areas such as car parks, taxi/hire car areas and arrivals and departures areas, and that the costs of which are passed on to airlines by way of a security charge. We understand that these licence plate readers are located on landside areas, may not be linked to any law enforcement database and are primarily for the purpose of managing carpark usage. It appears to us that measures implemented by an airport to ensure that it obtains the maximum possible revenue from its carparking facilities should be categorised as a business expense of the airport, and not an aviation security cost that should be borne by airlines or the travelling public. Similar concerns arise for other applications of licence plate readers in other locations such as taxi/hire car areas where we are instructed that airports may derive revenue in the form of a surcharge on the vehicle operator but pass the security cost on to airlines.

(ii) **Non-aeronautical staff and goods screening –** it is understood that the security charges imposed by most airports include the costs of screening non-aeronautical goods and staff, such as those in retail outlets within the sterile area. Arguably the cost of such screening should be excluded from the aeronautical security charge, as is the case with non-aeronautical goods at Sydney Airport (not non-aeronautical staff). The current disparity in the way different airports allocate goods screening costs further demonstrates the confusion/ambiguity on how security charges are calculated overall.

(iii) **Staff security clearances / ASICs -** Australia Pacific Airports (Melbourne) Pty Ltd recovers staff costs relating to obtaining security clearances and ASIC cards under its terms and conditions for use of its terminals at Melbourne Tullamarine Airport (emphasis added):

> *"**4 Fees and Charges***
>
> ***4.1 Operator to pay APAM***
>
> *The Operator must pay APAM the Licence Fees and all other fees and charges properly calculated and invoiced in accordance with these Terms and Conditions*
>
> ***Schedule A – Definitions***
>
> *"Security Rules" means those requirements established for the time being by APAM, acting reasonably, as being essential to the security and safety of the Airport, including, without limitation, in relation to:*
>
> *(a) emergency procedures;*
>
> *(b) <u>staff security clearances;</u>*
>
> *(c) security screening (personnel and goods);*
>
> *(d) <u>aviation security identification cards</u>; and*
>
> *(e) fees reasonably set by APAM from time to time to recover security costs on a pass through basis <u>including a reasonable allocation of overheads."</u>*

Again, it is arguable that the cost of obtaining security clearances and ASIC cards for airport staff is a business expense that is simply part of doing business as an airport and should not be passed-on to airlines as an 'aviation security' cost.

This ability of airports to pass on a wide range of security-related costs is facilitated by the Legislation which imposes a number of outcomes (such as ensuring sufficient controls to delineate airside areas from landside areas) but does not mandate the means by which those outcomes must be achieved. We understand that airlines are generally supportive of outcomes-based security legislation and do not seek to move to a more prescriptive system; however, we note that the structure of the Legislation provides airports with broad discretion as to the kinds of security services they will procure.

In addition, most airport terms and conditions generally provide airports with broad leeway to introduce new charges for security services deemed necessary by the airport at any time. For example, Brisbane Airport's Aviation Services and Charges Agreement provides that Government Mandated Services include:

> "*other services required by the Commonwealth Government or other lawful authority <u>and any additional security measures we are required to take and which are provided by us to you at Brisbane Airport from time to time</u>*".

It must be remembered that Direction No 13 only allowed airport operators to pass through direct costs related to Government mandated airport security requirements which, as clarified by the ACCC, required an 'avoidable cost' test. The imposition of some of the charges noted above may not meet this test.

(c) ***Security costs which are not reasonable or proportionate***

We are instructed that some airport operators have implemented security services which are not considered to be:

(a) reasonable or necessary to comply with the Legislation; or

(b) a proportionate response to the regulatory requirement or threat.

Under the current regime, we understand that certain airlines are not ordinarily consulted in a meaningful way on the introduction of security services and that once security services have been included in an airport operator's approved TSP, those airlines have limited ability to dispute the appropriateness or reasonableness of the services or prevent the cost being passed through.

To give an example, a major Australian airport previously advised Qantas that, as the airport operator, if their TSP was approved by the Department, then everything included in that TSP becomes a "mandated security charge" that can be passed on without consultation with or agreement by Qantas.

In this context, the airport included a requirement in its TSP that all aircraft must be guarded to prevent unauthorised access. Qantas strongly disagreed at the time that this security measure was necessary, reasonable or proportionate to prevent unlawful interference with the aircraft given the significant security measures already in place in secure areas where aircraft are parked. In addition, this requirement was (and continues) not to be mandated by other airports or prescribed by the Legislation.

When Qantas disputed the requirement, the airport advised that if Qantas failed to perform the guarding, the airport would do so on Qantas' behalf and pass the costs through. The airport's position was not supported by the Department who advised that a TSP holder cannot compel another TSP holder to take particular action by including it in their approved TSP without prior consultation or agreement with that other TSP holder. However, section 15 of the Act makes it an offence to fail to comply with another aviation industry participant's TSP.

3.2 Current system is not transparent

We understand that under the current system, certain airlines have limited awareness of the way in which government mandated security charges are calculated by an airport. In general, airports often specify the quantum of the charges payable and require airlines to pay the stated amount with little meaningful consultation or transparency as to:

- what services are provided;
- how they have been procured (and how this obtained value for money);
- the basis of the airport's calculations; or
- why the airport considers a particular service to be 'mandated' under the Legislation.

For example, Brisbane Airport's Aviation Services and Charges Agreement provides:

> ***"9 Government Mandated Costs and Government Mandated Charges***
>
> *You agree to pay the Government Mandated Charges relating to your use of the Government Mandated Services. <u>The Government Mandated Charges are set out in Schedule 6</u> and are payable by you in accordance with clause 10.*
>
> ***9.1 What are Government Mandated Costs?***
>
> *Government Mandated Costs are the costs that we incur in providing to you the Government Mandated Services. To recover Government Mandated Costs we will impose on you the Government Mandated Charges. <u>Government Mandated Charges (set out in Schedule 6) will be determined by us in accordance with the Commonwealth Government's directions or as determined by the relevant authority from time to time</u>."*

This is inconsistent with ICAO's Policies on Charges for Airports and Air Navigation Services which recommends that: "*…Consultations should take place before any security costs are assumed by airports, aircraft operators or other entities…"*

Where consultation occurs, it is not always sufficient to provide real input or transparency to airlines. We are instructed that there have been instances where particular airports have invited certain airlines to attend working groups where new security measures are announced and, following the working group, the airport takes that airline's attendance as tacit approval of the measures that were proposed.

Given this lack of transparency, airlines have no easy way to verify that:

(a) the security costs charged by an airport accurately represent the security costs actually incurred;

(b) each cost passed on as a security cost is in fact mandated by the Legislation; or

(c) security costs are not being double-recovered by airports in one of the other charges payable by airlines (particularly where overheads and return on capital investment are included).

The International Air Transport Association (**IATA**) recognised this issue in in its position paper on security charges:

> *"Many governments expect aviation to pay for its own security, while the cost of security for other modes of transport and public areas is fully subsidized and paid for by governments (e.g. train stations, stadiums, public buildings). Expanding aviation security measures has resulted in significant increases in security costs that airports or third party security providers have passed on to airlines and their passengers through higher security charges. Nonetheless, there is often a lack of clear information on responsibility for costs, revenue and efficiency in the provision of airport security services. Security providers in most airports are not a part of the regular consultation process and airlines are often not involved in determining the requirements and costs of security services that they assume…"*[3]

3.3 Current system is inefficient and encourages inefficiency

Under the current regime, airports procure the services but ultimately do not have to pay for them. They therefore have no significant incentive to obtain value for money in the same manner they would be if they were ultimately responsible for the costs. In this way, it can be argued that the current system is inherently inefficient and encourages inefficiency.

In addition, airlines, which have a direct interest in ensuring that the services are provided in the most economically efficient manner, largely do not have the ability to have any significant impact on the scope or manner of procurement of the services.

Qantas currently operates domestic terminals at Sydney, Melbourne, Brisbane and Perth airports under domestic terminal leases and is responsible for screening and other security services at these terminals. Jetstar also has a significant presence at these airports, operating from common user terminals where airports are responsible for security provision. Qantas therefore has firsthand knowledge that the recovery of security charges by airport operators at common user terminals are higher than the costs incurred by Qantas in directly providing substantially the same services at selected domestic terminals. This supports the proposition that airports may agree to or accept prices or levy charges above required or acceptable levels.

[3] IATA Policy on Security Charges - https://www.iata.org/policy/Documents/security-charges.pdf

3.4 Current system out of step with international best practice

The current system, as outlined above, is inconsistent with international best practice. ICAO's Policies on Charges for Airports and Air Navigation Services outlines the following in relation to Security charges (emphasis added):

> ***"Security charges***
>
> *7. States are responsible for ensuring the implementation of adequate security measures at airports pursuant to the provisions of Annex 17 — Security to the Convention on International Civil Aviation. They may delegate the task of providing individual security functions to such agencies as airport entities, aircraft operators and local police. It is up to States to determine in which circumstances and the extent to which the costs involved in providing security facilities and services should be borne by the State, the airport entities or other responsible agencies. With reference to the recovery of security costs from the users, the following general principles should be applied:*
>
> *(i) <u>Consultations should take place before any security costs are assumed by airports, aircraft operators or other entities</u>.*
>
> *(ii) The entities concerned may recover the costs of security measures at airports from the users <u>in a fair and equitable manner, subject to consultation</u>.*
>
> *(iii) Any charges for, or transfers of, security costs to providers, aircraft operators and/or end-users should be <u>directly related to the costs of providing the security services concerned and should be designed to recover no more than the relevant costs involved</u>.*
>
> *(iv) <u>Civil aviation should not be charged for any costs that would be incurred for more general security functions performed by States such as general policing, intelligence gathering and national security</u>.*
>
> *(v) No discrimination should be exercised between the various categories of users when charging for the level of security provided. Additional costs incurred for extra levels of security provided regularly on request to certain users may also be charged to these users.*
>
> *(vi) When the costs of security at airports are recovered through charges, the method used should be discretionary, but such charges should be based on either the number of passengers or aircraft weight, or a combination of both factors. Security costs allocable to airport tenants may be recovered through rentals or other charges.*
>
> *(vii) Security charges may be levied either as additions to other existing charges or in the form of separate charges but should be <u>subject to separate identification of costs and appropriate explanation</u>."*

We are instructed that examples of costs levied by some airports which may be inconsistent with ICAO's principles include:

- costs not directly relevant to preventing unlawful interference with aviation – paragraphs 7(ii) and (iv);
- return on capital investment, overheads or administrative fees – paragraph 7(iii);
- costs related to general policing functions, motorcycle patrols, blast-proof doors and glass, counter-terrorism treatments such as bollards and traffic wardens – which, depending on the circumstances, may be inconsistent with paragraph 7(iv); and
- additional charges for 'enhanced security' measures, where limited consultation or explanation of the cost, justification or benefits are provided - paragraph 7(vii).

3.5 Current contractual system is ineffective in overcoming issues

The current system is predicated on the assumption that airlines will be able to negotiate acceptable contractual terms and conditions governing the pass-through of security charges with airports. However, airports are often a monopoly supplier and we are advised that airlines do not generally have the countervailing market power to negotiate terms and conditions that address the issues noted above, and are often presented with terms and conditions on security on an "as is" basis with little room for negotiation.

In addition, the kinds of clauses extracted above (which grant airports broad power to determine and change security costs with little consultation or transparency) appear in our experience and having regard to the standard terms and conditions published by major Australian airports to have become market standard for Australian airports, which also serves to limit the power of airlines to negotiate and amend those clauses. As a result, we understand that airlines have little choice but to largely accept the standard terms and conditions governing the recovery of government mandated services. As indicated by ICAO and IATA, the situation is not isolated to Australia.

The Productivity Commission, in its issues paper, states that "*An airline may have countervailing market power in the situation – it could withdraw (or threaten to withdraw) from the route if it is unsatisfied with the airport's terms of service…"* However, we note that network airlines, such as Qantas or Virgin Australia, are generally not in a position to withdraw from particular routes.

While a number of airport agreements do contain clauses which require the airport to take steps to manage Government Mandated Services in an economically efficient and cost-effective manner, we are instructed that these clauses are largely ineffective in addressing the issues noted in this report as there are no repercussions for the airport for failing to meet these requirements. For example, Brisbane Airport's Aviation Services and Charges Agreement provides (emphasis added):

> ***"9.5 Our management of Government Mandated Charges and Government Mandated Services***
>
> *We will use our best endeavours to manage the Government Mandated Charges and to provide the Government Mandated Services in the most economically efficient and cost effective manner having regard to best practice in the industry and the service levels mandated by the Commonwealth Government.*
>
> *We will take reasonable steps, where possible, to manage any third party costs and any third party contractors in order to efficiently manage the Government Mandated Costs and provide the Government Mandated Services as much as reasonably possible. We agree to consult with Major Users in relation to the ways in which we can manage any third party costs and any third party contractors to efficiently manage Government Mandated Costs and provide the Government Mandated Services."*

An obligation to use 'best endeavours' and take reasonable steps 'where possible' does not impose any clear, measurable obligation on an airport, and from a legal perspective it would be difficult in practice for an airline to rely on this kind of clause if it believed the airport was in breach.

4. OPTIONS

The calculation and recovery of security costs is a serious issue that is becoming ever more critical. The quantum of security costs payable by airlines are significant and in real terms have generally increased year on year. A review of global aviation security costs undertaken in 2015 found that "*Unless significant changes are made, the monetary and economic costs of the current aviation security system are likely to reach unsustainable levels over the next 15-20 years as the number of air travellers and air cargo continue to grow."*[4]

In our view, issues posed to airlines related to the calculation and recovery of security charges set out in this report can be addressed by the Commonwealth. Whilst we understand that airlines are generally supportive of a light-handed regulatory approach to airport pricing, the current lack of any regulation, government oversight or guidance on security charges has likely contributed to the excessive costs, inefficiencies and lack of transparency outlined above.

Some options for addressing these issues are set out below.

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[4] Gillen, D. and Morrison, W, '*Aviation security: Costing, pricing, finance and performance"* Journal of Air Transport Management (2015), volume 48, pages 2-3

4.1 Impose obligations on AMS to ensure efficiency

One option would be to impose obligations on the AMS (or another appropriate government body) to ensure that aviation industry participants providing mandated airport security requirements and recovering costs do so in an efficient and cost-effective manner. This could be achieved by inserting a section in the Act similar to section 9A of the *Civil Aviation Act 1988* (Cth) that would require AMS to perform its functions in a manner that ensures, as far as is practicable, security measures are implemented in an efficient and cost-effective manner. A less prescriptive option would be to amend section 19 of the *Aviation Transport Security Act 2004* (Cth) to require transparency through cost, efficiency and service level disclosures when AMS approves airport TSPs and to allow that information to be passed onto airlines.

4.2 Impose appropriate boundaries on the concept of recoverable security costs

Another option would be to impose appropriate limitations and boundaries on what costs are recoverable by airports as security costs / government mandated charges. This could be effected by amendments to the Legislation to provide that airports are only entitled to recover security costs which fall within defined limits to be set out in the Legislation. The definition should be consistent with the meaning originally envisaged by the Commonwealth when airports were privatised as set out in Direction No 13 – i.e. the direct and unavoidable costs of complying with the Legislation.

Under this arrangement, other indirect or unrelated costs - such as overheads, administration fees and return on capital investment - would be expressly excluded.

This may help to prevent airports from passing on costs that are not reasonably necessary or proportionate to the prevention of unlawful interference with aviation and may bring the Australian system more clearly into line with international recommendations.

4.3 Amend current price monitoring of government-mandated security charges

The ACCC currently collects some data on government mandated security costs at Sydney, Melbourne, Brisbane and Perth airports as well as limited quality of service data in relation to screening. The current methodology is considered by some airlines to be flawed and could be improved to increase its effectiveness in identifying misuse of market power:

(a) **ACCC to consider indirect costs / profit –** In its most recent report, the ACCC noted that: "*Aeronautical profit excluding security costs is not discussed in this report because <u>government mandated security revenue is set to recover the costs associated with security services and does not affect the overall profitability of the airports</u>*". As outlined in this report, this is not always the case and 'government mandated security revenue' can include return on capital investment, indirect costs and costs which airlines consider are not necessary for the prevention of unlawful interference with aviation. The ACCC could be required to obtain and publish additional information in relation to airports' breakdown of security charges to ensure compliance with their obligations under amended regulations and TSPs as referred to above.

(b) **'Hybrid till' approach** – we are instructed that ACCC assessments relate to aeronautical services and so are done on a 'dual till' basis meaning that they do not cover non-aeronautical activities (with the exception of car parking) and so do not assess the level of prices and profits on a single till basis. This is considered to be problematic as an airport services many complementary markets and its charges for aeronautical and non-aeronautical services are interdependent. Monitoring on this basis would not necessarily replicate how a competitive airport sets its prices and requires cost allocation between aeronautical and non-aeronautical activities that hampers the effectiveness of the ACCC monitoring regime. An option for addressing this issue would be to monitor with respect to airports' total 'passenger related' operations (sometimes referred to as a hybrid till approach).

(c) **Benchmarks** – we are instructed that the current monitoring has no clearly articulated benchmarks against which to assess an airport's performance. Options for benchmarking include against the airport's weighted-average cost of capital or efficient comparators to that airport.

4.4 Implement pricing principles for security charges

Another option is to implement a set of pricing principles for security costs similar to the Aeronautical Pricing Principles which govern monitored capital city airports and were intended to serve as a guide for the pricing of services at non-monitored capital city and larger regional airports.

Ideally, the principles would detail:

(a) appropriate boundaries on what constitutes a recoverable security charge, as noted in paragraph 4.2;

(b) requirements for transparency in how costs are calculated;

(c) a mechanism for airlines to have input into the security services obtained and how they are procured; and

(d) an acceptable dispute resolution procedure where the parties cannot reach agreement on how government mandated security charges are to be calculated and passed through.

This could be done in a number of ways, including by introduction of guidelines by the ACCC or introduction of a voluntary code of conduct.

5. SCOPE OF REPORT

This report has been prepared for Qantas for the purpose of responding to the Productivity Commission's Issues Paper – Economic Regulation of Airports. You should not refer to or use the report for any other purpose. We accept no duty of care to any person other than Qantas.

In preparing this report we have relied upon:

(a) facts and evidence supplied by Qantas and have not investigated or verified all of those facts or evidence; and

(b) publicly available versions of airport standard terms and conditions. We note that individual contracts entered into between airports and airlines (even where based on those standard terms and conditions) may vary from those extracted in this report.

We note that the regulatory and commercial issues and options for addressing those issues that are identified in this report are only those considered to be material and are not intended to be a comprehensive or exhaustive list.

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ATTACHMENT A

Overview of Aviation Transport Security Regulatory Regime

Transport Security Program

Part 2 of the *Aviation Transport Security Act 2004* (Cth) (the 'Act') requires operators of security controlled airports to have and comply with a Transport Security Program (TSP). Almost all commercial airports are security controlled airports, although they fall into different categories. Division 2.2 of the Regulations sets out what a TSP for a security controlled airport must contain, which comprise of:

- procedures for managing security at the airport, including organisational structures and security management arrangements, roles and responsibilities of security contact officers, employees and contractors, and other staff;[5]
- quality control procedures;[6]
- a detailed description of the airport;[7]
- maps of airside and landside areas and security zones;[8]
- physical security and access control;[9]
- measures and procedures to carry out screening and clearing of persons and baggage;[10]
- access control and screening for security restricted areas at designated airports;[11]
- details of cargo facilities with direct access to airside;[12]
- measures to deal with the control of firearms, other weapons and prohibited items;[13]
- measures and procedures in the event of a heightened security alert;[14] and
- details of personnel with particular security roles.[15]

Airport Areas and Zones

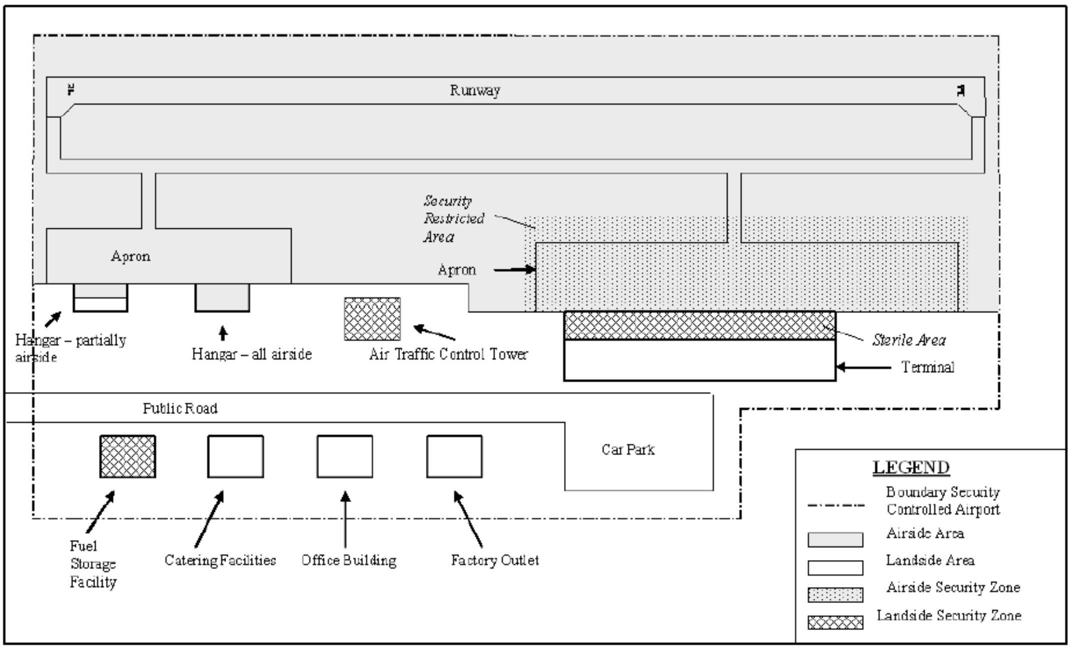
Under Part 3 of the Act, the Secretary for the Department of Home Affairs may designate an airport as a security controlled airport and assign a category to that airport.[16] A security controlled airport has an airside area and a landside area. An airside area is to control access

[5] Regulation 2.11 of the *Aviation Transport Security Regulations 2005* (Cth).
[6] Regulation 2.12 of the *Aviation Transport Security Regulations 2005* (Cth).
[7] Regulation 2.13 of the *Aviation Transport Security Regulations 2005* (Cth).
[8] Regulation 2.15 of the *Aviation Transport Security Regulations 2005* (Cth).
[9] Regulation 2.16 of the *Aviation Transport Security Regulations 2005* (Cth).
[10] Regulations 2.17 and 2.18 of the *Aviation Transport Security Regulations 2005* (Cth).
[11] Regulation 2.18A of the *Aviation Transport Security Regulations 2005* (Cth).
[12] Regulation 2.19 of the *Aviation Transport Security Regulations 2005* (Cth).
[13] Regulation 2.20 of the *Aviation Transport Security Regulations 2005* (Cth).
[14] Regulation 2.21 of the *Aviation Transport Security Regulations 2005* (Cth).
[15] Regulation 2.22 of the *Aviation Transport Security Regulations 2005* (Cth).
[16] Sections 28(2) and 28A of the *Aviation Transport Security Act 2004* (Cth).

to operational areas of a security controlled airport while the landside area is any other area within the boundaries of the security controlled airport.[17]

Within these areas are airside security zones, landside security zones, airside event zones and landside event zones which are subject to stricter controls, such as the restriction of access, preventing interference with aircraft and ensuring the security of air traffic control facilities, fuel storage areas, general aviation areas, cargo and baggage handling facilities, navigational aids, fire stations and other emergency service facilities, critical facilities and critical structures.[18] The Act provides that the Regulations may prescribe the relevant requirements for these zones.[19]

Division 3.1 of the Regulations provides the following diagram of a typical security controlled airport:



Controls and Access

For airside areas and zones, Regulation 3.15 outlines the following minimum requirements:

- a barrier sufficient to delineate the airside area;
- effective access control points to permit authorised access to the airside area;
- patrolling, electronic surveillance or any other suitable measures to inspect the barriers for damage and to deter and detect unauthorised access to the airside area;
- if possible, illumination of the aircraft parking area while a prescribed aircraft is parked there at night; and
- prescribed signs placed at the barrier in such a way that anyone entering the

[17] Section 29 of the *Aviation Transport Security Act 2004* (Cth).
[18] Sections 31, 31B, 33 and 33B of the *Aviation Transport Security Act 2004* (Cth).
[19] Sections 35, 36, 36A, 37, 38, 38A of the *Aviation Transport Security Act 2004* (Cth).

area knows that it is an airside area and either at every entrance to the airside area or at the barrier in a way that anyone entering the area knows that it is an airside area.

Subdivisions 3.3.2 and 3.3.3 of the Regulations outline additional requirements for security restricted areas (which are airside security zones[20]) at non-designated and designated airports and the relevant offences for the failure to comply with these requirements.

Regulation 3.20 provides that the security requirements for a sterile area in landside security zone should comprise the following:

- at least 1 screening point is established and maintained;
- the sterile area is enclosed in a barrier sufficient to prevent cleared persons in the sterile area coming into contact with persons who have not been cleared, and to prevent cleared persons getting access to anything from outside the sterile area that has not been cleared;
- appropriate measures are taken to deter and detect unauthorised access to the sterile area;
- a person who enters the sterile area through a screening point is screened and cleared unless the person is permitted to pass through without being screened;
- a person can enter the sterile area other than through a screening point if he or she is of a class of persons permitted to do so;
- vehicles and goods that enter the sterile area are screened and cleared;
- a cleared vehicle is able to enter the sterile area only if it is authorised and is driven by an authorised person with a valid ASIC, or a valid VIC or TAC and is supervised by somebody who properly displays a valid ASIC;[21] and
- erection of prescribed signs so that anyone entering the area knows that it is a sterile area.[22]

For other landside security zones, precautions need to be made to ensure that only authorised persons and vehicles can enter the zone.[23]

For both airside and landside areas, the responsibility of these security requirements is with the 'responsible aviation industry participant' whose Transport Security Program has been approved. This is the operator of a security controlled airport.[24]

Screening and Clearing

Part 4, Division 2 of the Act provides that the regulations may, for the purpose of safeguarding against unlawful interference with aviation, prescribe requirements in relation

[20] Regulation 3.01 of the *Aviation Transport Security Regulations 2005* (Cth).
[21] The operator of a security controlled airport issues the relevant ASIC (Aviation Security Identification Card) and VIC (Visitor Identification Card). A TAC (Temporary Aircrew Card) is normally issued when an ASIC holder does not have it on their person or is yet to receive an ASIC after an application has been made.
[22] Regulation 3.20 of the *Aviation Transport Security Regulations 2005* (Cth).
[23] Regulation 3.21 of the *Aviation Transport Security Regulations 2005* (Cth).
[24] Section 12 of the *Aviation Transport Security Act 2004* (Cth).

to screening. These requirements are prescribed in Division 4.1 of the *Aviation Transport Security Regulations 2005* (Cth).

Under Regulation 4.02(1), an aircraft must be a cleared aircraft before departure if it is operating a regular public transport operation or an open charter operation with a maximum weight of at least 20,000 kg. An aircraft must also be a cleared aircraft if it departs from a category 1 security controlled airport, from the same airport apron as an aircraft operating a regular public transport operation or an open charter operation with a maximum weight of at least 20,000 kg, and within the operational period of that aircraft.[25] This is described as a screened air service.

Under Regulation 4.04, the things that are to be detected by screening, to the extent that it is technically possible to do so, are any weapons or prohibited items on persons or their belongings, and any explosives in checked baggage. Carry-on baggage (including carry-on baggage belonging to an aircraft's flight crew) must also be cleared.[26]

This raises the relevant question of who can carry out the relevant screening. Under regulation 4.03, the Secretary may specify a person, or persons jointly, who are authorised or required to carry out screening at a security controlled airport or part of a security controlled airport. The Secretary must specify sufficient persons to ensure that the sterile area of the airport is covered by at least one screening authority.

In respect of liquid, aerosol and gel products (LAG), the screening authority for a security controlled airport will commit an offence if, in relation to an international air service:

- it does not establish a LAGs screening point;[27]
- does not put in place reasonable measures to ensure that persons who pass through the LAGs screening point, to enter a LAGs cleared area, are screened at the screening point;[28]
- does not put in place reasonable measures to ensure that a person does not enter a LAGs cleared area without being cleared unless exempt;[29]
- does not put in place appropriate procedures to ensure that a person does not carry a LAG product through the LAGs screening point unless exempt or the LAG product is in a LAGs container and sealed LAGs bag;[30]
- does not put in place appropriate procedures to ensure that a person does not carry more than 1 sealed LAGs bag through the LAGs screening point;[31] or
- does not display a prescribed LAGs screening point sign.[32]

In terms of checked baggage screening, an aircraft operator commits an offence if it conducts a screened air service and the operator loads an item of checked baggage knowing

[25] Regulation 4.02(2) of the *Aviation Transport Security Regulations 2005* (Cth).
[26] Regulation 4.15 of the *Aviation Transport Security Regulations 2005* (Cth).
[27] Regulation 4.22D of the *Aviation Transport Security Regulations 2005* (Cth).
[28] Regulation 4.22L of the *Aviation Transport Security Regulations 2005* (Cth).
[29] Regulation 4.22M of the *Aviation Transport Security Regulations 2005* (Cth).
[30] Regulation 4.22N of the *Aviation Transport Security Regulations 2005* (Cth).
[31] Regulation 4.22O of the *Aviation Transport Security Regulations 2005* (Cth).
[32] Regulation 4.22P of the *Aviation Transport Security Regulations 2005* (Cth).

it has not been cleared.[33] The screening authority at a security controlled airport commits an offence if it carries out screening and cleaning of baggage for a screened air service and does not have appropriate procedures in place to ensure that an item cannot be placed in or on any cleared baggage during the period when baggage is cleared and when baggage is checked in in circumstances where baggage must be cleared before it is checked in.[34]

[33] Regulation 4.23 of the *Aviation Transport Security Regulations 2005* (Cth).
[34] Regulation 4.24 of the *Aviation Transport Security Regulations 2005* (Cth).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