Airports Submission to the National Access Regime Inquiry

Prepared for the Productivity Commission

Australian Airports Association

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AUSTRALIAN AIRPORTS ASSOCIATION





Introduction

The Australian Airports Association (AAA) is the national industry voice for airports in Australia. The AAA represents the interests of more than 260 airports and aerodromes Australia wide – from local country community landing strips to major international gateway airports. The AAA's members include Adelaide, Brisbane, Cairns, Canberra, Darwin, Gold Coast, Hobart, Perth, Melbourne and Sydney airports. There are a further 100 corporate members who provide goods and services to airports. The Charter of the AAA is to facilitate co-operation among all member airports and their many and varied partners in Australian aviation, whilst maintaining an air transport system that is safe, secure, environmentally responsible and efficient for the benefit of all Australians.

About this submission

The AAA welcomes the opportunity to participate in, and comment on, this important and significant inquiry being undertaken by the Productivity Commission in relation to the National Access Regime (set out in Part IIIA of the *Competition and Consumer Act 2010* ("the Act") and clause 6 of the Competition and Infrastructure Reform Agreement).

All airports who realistically might conceivably fall within the scope of the National Access Regime are members of the AAA.

This submission focuses on those issues raised in the Productivity Commission's November 2012 Issues Paper that are of the greatest relevance to these airports. To a considerable degree, it reflects a consensus view of Australian airports about the National Access Regime insofar as it is capable of application to airports.

However, no two airports are the same, and no two negotiations between airport operator and airline are the same.

Accordingly, some affected airports may also lodge their own individual submissions. At the very least those submissions would be expected to complement this submission by elaborating on the operating environment of the particular airport. However, it may also be that some individual member airports could have a different view on some matters canvassed in this submission. Should that be the case, we would expect that particular airport to raise those issues in their own individual submission, and we ask that those submissions be given full consideration in their own right.

Executive Summary

There is no need for, or justifiable case that can be made in support of, any amendment to the National Access Regime to facilitate or require any enhanced access to any Australian airport to which the Regime is potentially capable of applying.

Airline access to Australian airports is not an issue.

Because airports are not (and under the *Airports Act 1996* no potentially relevant airport can legally be) vertically integrated with an airline, ordinary commercial imperatives dictate that airports negotiate and agree mutually acceptable terms and conditions for airline access. The terms and conditions on which such access are granted are thus properly a matter for commercial negotiation between airports and airlines. As the Productivity Commission itself found in its most recent review of airport regulation, there is already in place a comprehensive, sophisticated and flexible framework of such agreements that have been negotiated between airports and airlines without the need for regulatory intervention. Commonly these agreements extend far beyond merely rights of and cost of access, and deal with the entirety of the airline/airport relationship and advance shared interests such as through joint ongoing marketing activities to promote the relevant destination.

Moreover, for all of Australia's capital cities and for most regional airports, the terms on which they are leased to their current commercial operators or on which ownership of them was transferred to their local government owners require that the airport operator must:

- maintain the airport for use as an airport; and
- provide access to the airport by airline and aircraft operators.

While there is accordingly no problem with airport access that would warrant any change to the National Access Regime, airports have two particular issues of concern with the Regime.

First, it is of fundamental importance that any changes the Commission might recommend to the National Access Regime to address issues that may arise in the context of other industries are carefully crafted to avoid a risk of regulatory overreach or error that might inhibit the capacity of airport operators to raise the funds necessary for continued and essential investment in Australia's future airport infrastructure, or their preparedness to expose themselves to the risks inherent in such expenditure.

Second, it is also important that steps be now taken to minimise the risk that future administrative or judicial interpretations might undermine the policy intent of the current law and water down the necessary threshold pre-conditions for declaration. To this end, the Commission is urged consider the development of clear guidelines, that might be embedded in the Act, as to what would constitute a "material" increase in competition for the purposes of section 44G of the Act. To not do this risks a repetition of the earlier experience of regulatory over-reach.

About Australia's Airports

There are, according to Airservices Australia, over 2000 airports and airfields in Australia.

The AAA recently published a major research paper that identified the most important of these Australian airports. In particular it brought together little known and seldom recognised facts about Australia's regional airports, it sought to dispel various myths that circulate about them, and it catalogued the serious challenges they face in meeting the future needs of the communities they serve. A copy of that paper, *Australia's Regional Airports – Facts, Myths and Challenges*, is being provided to the Commission with this submission, and it is available online at http://airports.asn.au/wp-content/uploads/2012/12/AAA-Regional-Airports-Research-Paper_FA.pdf.pdf.pdf .

The AAA also recently published a study conducted for it by Deloitte Access Economics which showed that, in 2011, Australia's airports generated a total economic contribution of around $17.3 billion – equivalent to around 1.2% of Gross Domestic Product – and estimated that national employment at airports was approximately 115,200 full-time equivalent workers. A copy of that study, *Connecting Australia – the economic and social contribution of Australia's airports*, is also being provided to the Commission with this submission, and is available on line at http://airports.asn.au/wp-content/uploads/2012/06/AAA-DAE-Final-report-19-June-2012.pdf .

These documents together readily demonstrate the importance of all Australian airports – both for the vital contributions they individually make to their local communities, and to the contributions they collectively make to Australia's overall economic and social welfare.

But what they also graphically demonstrate is the vast diversity of Australia's airports. Our largest international gateway airports account for the overwhelming majority of airport traffic, and traffic volumes fall dramatically when compared to other less major airports.

This can be readily seen from the following statistics for traffic just at Australia's ten busiest Regular Public Transport airports:

Passenger Movements 2011-12

	Domestic Airlines	Regional Airlines	Int'l Airlines	Total
Sydney	21,962.732	2,006,762	12,017,305	35,986,799
Melbourne	20,614,457	684,156	6,657,880	27,956,493
Brisbane	14,763,141	1,590,473	4,520,004	20,873,618
Perth	7,963,378	563,658	3,469,758	11,996,794
Adelaide	5,771,730	556,513	618,749	6,946,992
Gold Coast	4,591,303	10,263	725,004	5,326,570
Cairns	3,054,803	383,778	504,200	3,942,781
Canberra	2,640,030	518,655	0	3,158,385
Darwin	1,515,343	172,069	357,210	2,044,622
Hobart	1,813,369	1,268	0	1,814,637

Source: BITRE

By way of contrast, larger regional airports may have RPT passenger numbers of only 1-300,000 per annum, and for smaller regional airports the figure may be well less than 10,000 per annum. Nevertheless, each airport is of vital importance to the community it serves.

The diversity of these statistics is highly pertinent when considering which Australian airports could conceivably fall within the declaration criteria for the National Access Regime.

Section44G of the Act provides that the National Competition Council cannot recommend that a service be declared under the Regime unless it is satisfied of all of a number of matters, including:

- that the facility is of national significance, having regard to the size of the facility, or the importance of the facility to constitutional trade or commerce, or the importance of the facility to the national economy.

Realistically, only the smallest number of Australian airports could conceivably meet this criterion.

Access to Australia's Airports

For the majority of Australian airports, access by airlines is legally guaranteed regardless of the National Access Regime.

This is because all airports to which the *Airports Act 1996* (Cth) applies and the hundreds of airports that were transferred to local government ownership by the Commonwealth are each subject to a leases or transfer deed that include obligations:

- to maintain the airport for use as an airport; and
- to provide access to the airport by airline and aircraft operators.

Moreover, even in those few cases where such legal constraints do not apply, the economic dynamic of operating an airport almost always provides strong incentive to provide rather than deny access:

- Australian airports are not vertically integrated with airlines (and indeed, Airports Act airports cannot be vertically integrated as a matter of law); and
- accordingly providing access wherever this is within the physical capability of airport infrastructure simply makes good business sense.

Viewed in this light, it may be possible to reasonably argue that Australian airports should be legally placed outside the scope of the National Access Regime.

Nevertheless, the AAA does not seek to advance this argument. It recognises that the potential application of the Regime to Australian airports is a legitimate component of the larger airport regulatory regime which includes Parts IV (Restrictive Trade Practices) and Part VIIA (Prices Surveillance) of the Act. The combined operation of these Parts and the National Access Regime together provide a regulatory reinforcement for the otherwise compelling commercial incentive for airport operators to agree mutually acceptable access terms and conditions with their airline customers

Instead, the AAA's greater concern is to ensure that any change to the National Access Regime that the Commission may contemplate in the course of the present inquiry does not carry with it any risk to the current and future growth and operation of airports which is so essential to the Australian economy. As discussed in the following section, experience shows that privatisation of the capital city airports has successfully fostered major investment in Australia's key airports to the benefit of airports, airlines and the Australian community. It is essential that the progress that has been made since those airports were privatised by the Commonwealth in the 1990s and that is fundamentally necessary for the future not be jeopardised.

The Access Experience at Australia's Major Airports

Experience of commercial negotiation of access terms at the privatised airports, starting from a "zero base" at privatisation through to the comprehensive and sophisticated agreements that are now commonplace between airports and airlines, clearly demonstrates that there is no need for any amendment to the National Access Regime insofar as airports are concerned.

This is not to say that there is complete unison between airports and airlines about all aspects of access terms. There are indeed different points of view and either side at times is strongly critical of the other.

Nor is it to say that there is not still room for further improvement in the development and refinement of airport/airline commercial agreement making. Airports accept that they can and should improve in these respects, and hope that airlines share the same perspective of their own performance.

But, in the AAA's submission, this is simply reflective of the ordinary "cut and thrust" of commercial activity. It is certainly not indicative of any regulatory failure, and it provides no cause for regulatory reform.

In particular, there is no justification for deeming any airport services to be declared under the National Access Regime. This proposition was advanced by the Australian Competition and Consumer Commission in the course of the Productivity Commission's most recent review of airport price regulation. Not only was it opposed by the National Competition Council and clearly rejected by the Productivity Commission in its final report, but it was also specifically considered and again rejected by the Commonwealth Government which stated in its response to that report as follows:

> *… the more heavy-handed regulatory approach of deemed declaration and the threat of compulsory arbitration by the ACCC … could reduce the incentive of parties to negotiate in good faith, undermining the government's objective of encouraging the development of commercial relationships. This option also has unpredictable and potentially high costs… Finally, the uncertainty of outcomes … could deter investors who prefer long term certainty about prices in order to justify the large investments at major airports.*

In support of these contentions, the AAA reviews in this section the history of access agreement making at Australia's major airports. In doing so it goes far beyond simply making bald claims by drawing heavily upon both the Commission's own previous findings and the demonstrable history of past moves to seek regulatory access to airport services.

Airport privatisation by the Commonwealth in the 1990s meant that the new airport operators and their airline customers had to develop completely new relationships. Prior to that time, the Federal Airports Corporation had not only the economic but also the legal capacity to dictate the terms on which airlines accessed its airports. And airlines had to deal with only one "landlord".

Post privatisation, access terms became a matter for commercial negotiation, and airlines needed to engage with multiple airport operators, not just one.

The initial airport regulatory regime was quite "heavy-handed", involving ACCC price control at the largest airports to guard against the (theoretical) potential for airport operators to abuse their market position. At the same time, it was the policy position of the Commonwealth from the outset that airport access should eventually be primarily a matter for commercial negotiation between airports and airlines, with regulation forming only a fall-back if and when required.

Since that time, there have been three separate Productivity Commission reviews of airport pricing that have assessed the continually maturing commercial relationship between airport operators and their airline customers, together with a move to and subsequent affirmation of a more "light-handed" form of regulation involving price (and quality of service) monitoring rather than price regulation.

The findings of the most recent Commission report in 2012 relevantly included the following:

> ***Performance of Australian airports***
>
> *FINDING 4.1*
>
> *Australian airports' aeronautical charges, revenues, costs, profits and investment outcomes remain within the performance range of their overseas counterparts. Within this group, Australian airports have achieved:*
>
> - *relatively low aeronautical and non-aeronautical revenue per passenger*
> - *relatively low total costs, operating costs and staff costs*
> - *relatively high profits*
> - *average to above average capital expenditure per passenger and return on capital employed.*
>
> *FINDING 4.2*
>
> *The productivity of Australian airports has improved, while any changes in efficiency or technology have been positive over the post-privatisation period. These indicators suggest that, despite earning below average revenues per passenger, Australian airports are able to profit from cost reductions.*

Market power and regulation

FINDING 5.1

The continued growth of low-cost carriers, overseas national airlines and competition from some secondary airports have reduced the potential for airports to exploit market power. Nevertheless, Brisbane, Melbourne, Perth and Sydney Airports retain sufficient market power to be of policy concern. Given its recent investments, size and position in the national network and long-term customer contracting — as well as evidence from airlines themselves — Adelaide Airport's relatively lower market power is such that the countervailing power of airlines constitutes an effective constraint. Moreover, there is insufficient evidence to suggest the scope of the Tier 1 regulatory regime should be expanded.

FINDING 5.2

In general, the coverage of the current monitoring regime is appropriate, and despite recent technological developments (such as online passenger check-in facilities), the additional benefits of attempting to fine tune the monitored aeronautical facilities and services is unlikely to outweigh the cost.

Investment and capacity

FINDING 6.1

The Australian Government has a number of regulatory and other levers to influence the timing and nature of investment at Australian airports, including lease provisions and requirements under the Airports Act 1996. To date, these levers have not been triggered, as investment has exceeded requirements established at the time airports were sold.

FINDING 6.2

There is evidence of significant investment in aeronautical infrastructure at Australian airports in the period since light-handed monitoring was introduced in 2002, with significant future investment planned. Compared to other Australian infrastructure, airport investment outcomes rate favourably.

FINDING 6.3

Despite instances of delays to aeronautical investment, it does not appear that such delays have been unreasonable. Moreover, airport operators appear to consult with airlines and other airport users about the nature and timing of individual investments at the airports for which they are responsible — although not always to the satisfaction of airlines — and the degree of consultation varies between airports.

FINDING 6.4

The pre-funding of airport investments is a recognised component of the Pricing Principles. There is not a strong case for a prescriptive approach to pre-funding airport investments, and the current arrangement (negotiation between an airport and airlines) appears to have resulted in satisfactory outcomes since privatisation. While this approach appears to have worked well so far, the construction of a new runway at Brisbane Airport (the first in the world by a privatised airport) could be a significant challenge to this approach.

Airside and terminal: monitoring outcomes

FINDING 7.1

Price monitoring data since 2002-03 show substantial total price increases at most of the monitored airports. However, taken in context, these increases do not indicate systemic misuse of market power.

FINDING 7.2

Recent quality of service monitoring for the overall and passenger survey results alone do not indicate any persistent trends that would suggest the misuse of market power.

FINDING 7.3

Quality of service ratings from airline surveys are notably lower than passenger ratings, including ratings of 'poor' for both Sydney and Perth airports. Concerns raised by the ACCC appear to place greater emphasis on the airline surveys.

Commercial negotiation

FINDING 8.1

Commercial agreements are the basis for the relationships between airports and most airlines. Reflecting that commercial negotiation in a light-handed environment only began after 2002 and that commercial agreements typically are for five years or more (and up to 15 to 17 years for some terminal agreements), the opportunity for the parties to iterate to more comprehensive and refined agreements has been limited.

FINDING 8.2

Commercial agreements now incorporate features that airlines considered were absent or deficient in 2006. But despite these advances, airlines assert that commercial negotiations with some airports are one-sided and dysfunctional.

FINDING 8.3

Problems with commercial negotiation are not symptomatic of system-wide failure, but appear to reflect different practices across airports. Sydney airport in particular attracts more criticism than other airports. The variations between airports demonstrate that commercial negotiation can, but may not always, work well.

FINDING 8.4

The divergence in the observations and assertions made by airports, on the one hand, and their airline customers on the other, seems to reflect 'positioning' to either protect or change the distribution of profits between them. Ultimately, the claim and counter claim nature of the evidence means it is not possible to make a definitive call that greater regulatory intrusion is warranted. There is considerable scope to improve commercial negotiation — particularly with regard to contract formation — as it has not yet achieved the level of maturity envisaged with the lifting of price regulation nearly a decade ago.

Options for future airport regulation

FINDING 9.1

Despite complaints from airport users and the public stance on airports taken by the Australian Competition and Consumer Commission (ACCC), existing safeguards have been very little used.

- *The ACCC has not called for, nor has the relevant Minister instigated, a price investigation of any airport.*
- *Since the privatisation of airports, there has only been one application by an airport user to the National Competition Council to have airport services declared. Further, during this time, the relevant Minister has not commenced an application.*
- *No user sought to have the declaration of domestic airside services at Sydney extended beyond the December 2010 expiry date.*

RECOMMENDATION 9.7

An airport-specific arbitration regime activated by deemed declaration of airport services under Part IIIA should not be introduced. Similarly, mandatory codes of conduct and mandatory guidelines to specify matters such as, the allocation of costs to aeronautical and non-aeronautical purposes and building block parameters, should not be introduced.

RECOMMENDATION 9.8

There should be a further period of price and quality of service monitoring at Australia's major airports when the current arrangements end in June 2013. The new arrangements should

continue to apply to Brisbane, Melbourne, Perth and Sydney airports until June 2020 and be subject to a review in June 2018.

RECOMMENDATION 11.2

Mandatory Part IIIA access undertakings setting out prices, terms and conditions for surface transport operators to access airports should not be introduced.

And, on the specific issue of commercial negotiation, the Commission report included the following more detailed commentary:

Key points

- *Commercial negotiation is rarely conducted among equals, but this is only policy-relevant where one entity's market power derives from an enduring market failure, such as monopoly supply.*
- *Because price regulation ceased in 2002, and commercial agreements run for five or more years, there have been limited opportunities for the parties to iterate them.*
- *Features of commercial agreements, which are now the primary means for terms and conditions for airport services to be set, include:*
  - *price paths subject to variation in agreed circumstances*
  - *consultation on capital investment*
  - *agreed service levels*
  - *dispute resolution.*
- *Airlines consider that commercial negotiation is unnecessarily protracted — often taking years — and that airports' approach to negotiation embodies:*
  - *a 'take it or leave it' approach*
  - *the transfer of risk to airlines*
  - *refusal to provide relevant information and manipulation of building block model parameters.*
- *However, airlines' dissatisfaction is not indicative of systemic failure — some airports are characterised as reasonable, with others said to be difficult.*
- *Neither airports nor their customers support supplanting commercial negotiation with heavy-handed regulation.*

Commercial negotiation is the ubiquitous interaction between entities in market economies. Negotiated contracts attempt to provide certainty about the relationships between suppliers and purchasers of goods and services. Commercial negotiation is rarely conducted among equals — in the automotive industry, for instance, small component manufacturers have been subject to unrelenting cost-down directives from vehicle assemblers in order to secure long-term contracts (PC 2002b). It is not surprising, therefore, that commercial negotiations can range from robust to gruelling, especially where the delivery of complex multi-faceted services is involved.

Commercial agreements, by definition, deliver mutually advantageous outcomes, although each party will try to extract the best outcome for itself at the expense of the other. The more bargaining power a party has, the more likely that it will achieve that aim. Such distributional battles become policy-relevant where an entity's market power derives from an enduring market failure and gives rise to efficiency losses to the detriment of the wider community (chapter 5).

8.1 The slow path from regulation to negotiation

From 1997 to 2002, aeronautical charges at the major privatised airports were determined primarily by the regulator, the Australian Competition and Consumer Commission (ACCC), rather than through commercial negotiations. The ACCC even overruled some agreements between airports and airlines on charges for new infrastructure (DTRS 2001, p. 18).

A Productivity Commission review into price regulation of airport services in 2002 identified that the prevailing regulatory control environment promoted strategic behaviour by all parties and discouraged commercial negotiation. It concluded that:

- *a framework that encouraged negotiation on price and service quality could obviate the need for strong regulatory involvement*
- *to be successful, commercial agreements would need to 'be negotiated voluntarily, without automatic recourse to the regulator and without prescriptive requirements'. (PC 2002a, p. xxxiv)*

The Commission recommended that light-handed price monitoring replace price regulation for a probationary five-year period, and that the situation be reviewed in five years. It noted, however, that even though the parties are better placed than a regulator to work through the details of agreements, decades of government ownership of airports (and airlines) meant that a commercial negotiation culture needed to develop and mature. To this end, the Commission proposed some initial principles to help guide pricing (box 8.1).

1 ***Aeronautical pricing principles***

Pricing principles relate to prices for aeronautical services and facilities (defined in Part 7 of the Airports Regulations 1997). The principles originated with PC (2002a) and include amendments introduced over time, including after PC (2006). The current principles 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[1] 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.

Source: Costello (2007).

2002–2006: commercial negotiation commences and develops

The Productivity Commission's 2006 review into airport services found that light-handed regulation had delivered significant benefits and price outcomes that did not appear excessive. It observed, however, that some non-price outcomes had been less satisfactory and relationships between certain airports and their customers were strained. It is instructive to report some of those airport users' perceptions at that time (box 8.2). These can be drawn on in the context of this inquiry to ascertain if airlines now consider that negotiation dynamics have worsened, remain unchanged or improved.

2 ***Airline views on commercial agreements in 2006***

Qantas said airport users had been required to enter into agreements with terms that:

provided airports with a unilateral right to increase charges

had minimal (if any) service levels and, where included, provided no penalty for the airport operator if it failed to meet the service level obligations

had no binding dispute resolution procedures.

Virgin Blue's major concern was the per passenger basis for charging, which it regarded as disproportionately affecting low cost airlines. It also considered:

airports were over-recovering on aeronautical services

guidance was required on issues such as asset valuation

access to ACCC arbitration was needed to encourage commercial negotiation.

The Board of Airline Representatives of Australia (BARA) said light-handed regulation had resulted in a spectrum of outcomes from airports, ranging from reasonable to intransigent. It identified a number of systemic flaws, including:

the incomplete scope of aeronautical services

disagreement over the valuation of airport assets

the lack of a formal response to ACCC monitoring reports.

Source: PC (2006).

In response to these concerns, the Commission proposed amended pricing principles to 'enhance', but not 'direct', negotiations — for example, principles (c)(i)–(ii) and (f) (box 8.1). Accepting the recommendations, the Government noted:

> *A persistent failure to produce results consistent with these Principles could lead to more detailed scrutiny of an airport(s) … and potentially the imposition of more heavy-handed regulation. The Government also considers that these Pricing Principles should act as a guide for the conduct of all airports … (Costello 2007)*

Adjustments to the pricing principles mirror the evolution of commercial negotiation in a non-price-capped environment. Because commercial agreements typically are for five years or more, the opportunity for regular iterative refinements by the parties from one agreement to the next has been limited. To date, agreement making has been characterised more by 'step' changes than a series of gradual changes. For example, Westralia Airports Corporation observed:

> *Commercial arrangements have progressed from the formal price regulation prior to 2002, through a relatively unsophisticated 'prices and services accord' dialogue commencing in 2002, to far more sophisticated processes from 2007, which are now culminating in comprehensive price and service agreements … (sub. 41, p. 37)*

Similarly, Sydney Airport noted that, after privatisation, it enforced conditions of use developed from (the former) Federal Airports Corporation by-laws. After privatisation, it negotiated non-standard conditions of use with parties for the international terminal and agreements with domestic operators. In 2004, it began negotiations on charges and terms for domestic and international use of the airfield and the international passenger terminal:

> *By the end of calendar year 2007[2], agreements were in place with all international and domestic scheduled passenger airlines … These agreements established a negotiated base level and structure of aeronautical charges for a five year period, with provision for recovery of the cost of new investments over the period, specific discounts, and a range of aeronautical and non-aeronautical terms. (sub. 46, p. 26)*

With airports and airlines entering their second or third round of commercial agreements, their 'learning' to date might be expected to lead to greater maturity and sophistication in future negotiations (and reduce the time taken), unless of course, the framework is inherently dysfunctional.

Commercial agreements are the basis for the relationships between airports and most airlines. Reflecting that commercial negotiation in a light-handed environment only began after 2002 and that commercial agreements typically are for five years or more (and up to 15 to 17 years for some terminal agreements), the opportunity for the parties to iterate to more comprehensive and refined agreements has been limited.

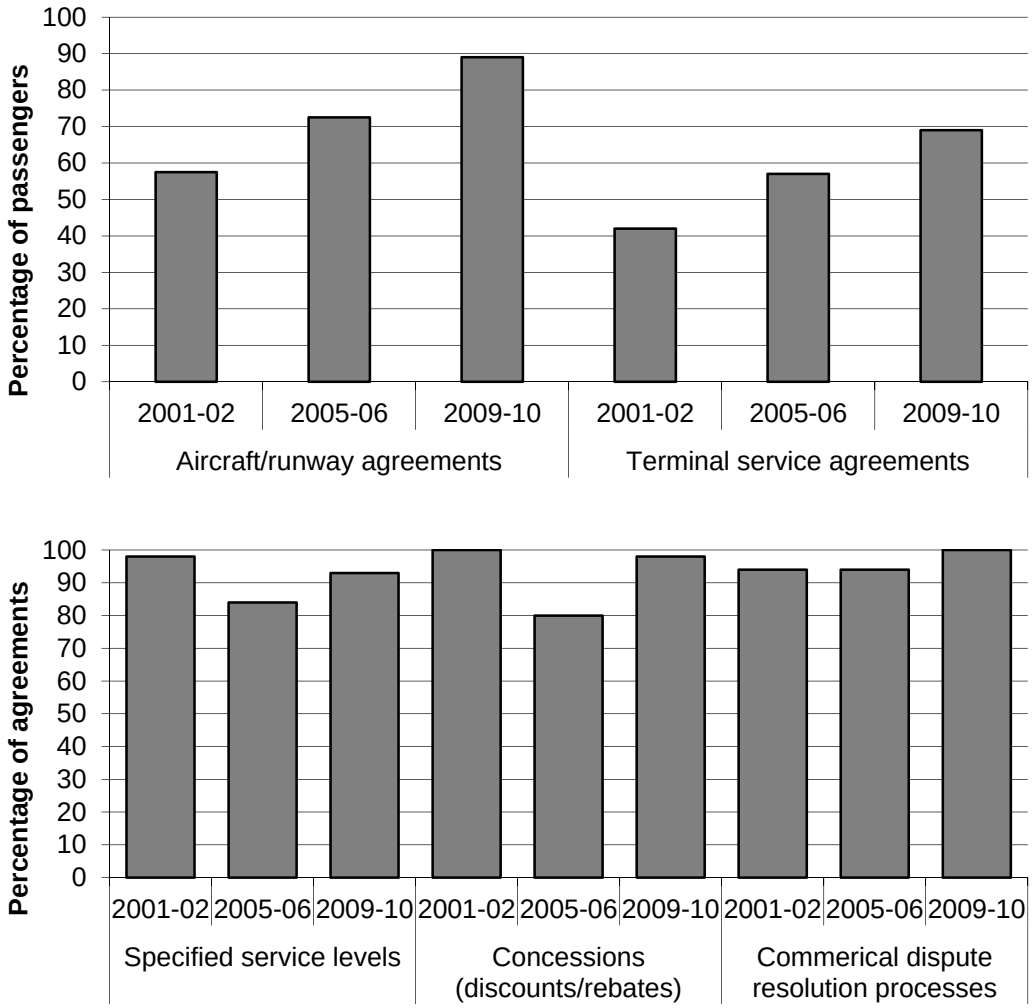
Commercial negotiation becomes more sophisticated

Forming a definitive view on the state of negotiations between airports and their customers is problematic. Submissions are replete with claims, contradictions, counter claims and refutations — as was the case with the inquiries undertaken in 2002 and 2006. Allegations are often made in confidence and therefore difficult to verify.

It is clear that commercial agreements are now the primary means by which terms and conditions for airport services are set. Drawing on its constituent base, the Australian Airports Association (AAA) submitted that, at June 2010:

- *89 per cent of airports' passengers flew on airlines that had aircraft/runway related agreements*
- *69 per cent of airports' passengers flew on airlines that had terminal services agreements*
- *93 per cent of agreements specified service levels for at least one service*
- *98 per cent offered discounts, rebates or enticements and all specified commercial dispute resolution processes (figure 8.1).*

Figure 8.1 ***Coverage and content of commercial agreements[a]***



a *Data on coverage (excluding domestic terminal leases), service levels and dispute resolution relate to all Tier 1 airports and two (of four) Tier 2 airports. Data on agreements offering discounts relate to four Tier 1 airports and two Tier 2 airports.*

Source: Australian Airports Association (sub. 18, pp. 14–15).

Since 2001-02, the proportion of passengers covered by agreements has increased significantly. However, the proportion of agreements that specify service levels or offer discounts has fallen slightly (figure 8.1). According to the AAA, this fall is due to the expansion in the number of agreements since 2001-02, including with airlines that have little interest in multi-faceted agreements. This explanation is plausible given the entry of low-cost and international carriers with relatively low-scale operations. For these airlines, the transactions costs involved in negotiating specific term agreements may lead them to instead use an airport's generic 'conditions of use' and 'schedule of charges'.

On the substance of the agreements, the AAA claims 'a consistently high percentage of agreements' involve service obligations, discounts and dispute resolution mechanisms. Airports' submissions echo this view (box 8.3).

However, some regional (for example, Newcastle) and smaller capital city airports (for example, Hobart and Darwin) reported that low-cost carriers (LCCs) have changed the way they do business. Newcastle Airport stated that, given the footloose nature of LCCs and their aggressive stance on airport charges, there is pressure to find other sources of revenue (such as car parks and retail) to make up for lower aeronautical revenues:

> *… the market dominance of an airline, particularly on domestic routes, should not be underestimated. This can affect pricing and contract negotiations leading to a greater dependency on ancillary revenue for an airport to thrive and expand … (sub. 14, p. 2)*

For the larger airports, commercial agreements form the basis for their relationships with the majority of airlines. While there is no 'template' for commercial agreements, based on the information provided by airports, it appears that some increasingly common elements are:

- *longer duration — 5–7 years for aeronautical and up to 15 years for terminals*
- *price paths subject to variation in agreed circumstances*
- *prohibitions on unilateral introduction of charges for some aeronautical services*
- *consultation processes on capital investment with exchange of information*
- *rebates for airlines where airports fail to meet agreed service levels*
- *airports to bear construction risk and traffic risk associated with new investment*
- *discounts for new services, including new destinations*
- *dispute resolution processes ranging from mediation to arbitration.*

Some agreements provide novel features. For example, Adelaide Airport reported it:

> *… offers a choice of charges based on passenger (pax) or tonnes, to give airlines added flexibility depending on their business model. Airlines are allowed to elect from year to year which method of charging will apply ... This facility enables airlines to elect whether they or AAL bear traffic risk. (sub. 12, p. 5)*

Box 8.3 ***Airports' views on commercial agreements***

Sydney Airport Corporation Limited: *'Sydney Airport has in place a number of separate commercial agreements with various international airlines in addition to the standard agreement taken up by other international airlines and has agreements with all scheduled domestic airlines. These agreements differ according to the needs of the airlines and the facilities and services used. The agreements … are for five years, although some are of 17 years duration. They all include dispute resolution clauses negotiated with the airlines.' (sub. 46, p. 10)*

Melbourne Airport: *' … commercial agreement can be reached over the capacity, quality and price of aeronautical services and facilities. The agreements provide a commercial dispute resolution process, which as a fall-back, provides for binding arbitration for the life of the agreement.' (sub. 29, p. 64)*

Brisbane Airport Corporation: *'Airlines … have supported the use of five-year pricing agreements which have given them certainty as to investment in capacity and to pricing … Risks have been shared between the parties and there has been regular consultation on progress of the investment program.' (sub. 40, pp. ii–iii)*

Westralia Airports Corporation: *'During the second half of 2011, WAC expects to conclude comprehensive seven-year agreements with airlines on a wide range of price and non-price terms, covering at least 85% of passenger movements … WAC provided all airlines a comprehensive proposal, including:*

- *a comprehensive indicative 10 year capital expenditure plan …*
- *10 year passenger forecasts with supporting explanation;*
- *detailed breakdown of all assumptions;*
- *the proposed pricing model; and*
- *a pro forma prices and service agreement.' (sub. 41, pp. 8, 38–9)*

… We've now executed comprehensive agreements with airlines representing around 83 per cent of … annual passenger movements and the one major airline that we are yet to reach agreement with has … advised that it wishes to undertake a period of more intensive negotiations next week with a stated objective of, by the end of next week, concluding an agreement with us. If this transpires, we will have reached seven-year agreements with airlines representing over 95 per cent of our passenger movements.' (trans., p. 266)

Adelaide Airport Limited: *'AAL has in place formal pricing agreements for aircraft services which have been negotiated with and agreed to by all of its major airline customers. The agreements are for a period of 5 years, the second such arrangement was negotiated in 2007 … Prices are negotiated based on a cost based price calculated using the ACCC approved building block model. Prices are only escalated during the period of the agreement by CPI adjustments each year. The pricing agreements are underpinned by AAL's Conditions of Use which include Performance Principles and Dispute Resolution clauses.' (sub. 12, p. 5)*

Darwin International Airport: *'The current LTPA [long-term pricing agreement] has an 8 year term and an agreed investment profile of around $100M. The fact that each item of aeronautical investment is approved by airlines means that terminal and associated infrastructure quality of service is dictated by what airlines are willing to pay for.' (sub. 7, p. 3)*

Canberra Airport: *'… these agreements took time and effort by both parties to negotiate … They are all long term agreements for the use of services at Canberra Airport — indeed some are for up to 15 years.' (sub. 50, p. 8)*

Hobart International Airport Pty Ltd: *'Hobart Airport has sought (successfully) to reach long-term growth partnerships with airlines that are beneficial to all parties, agreements which are reached through a process of commercial negotiation.' (sub. 56, p. 8)*

Based on airlines' comments reported in box 8.2, the focus of disagreement and/or concerns has shifted since 2006. For example:

- *agreements now contain clauses to constrain unilateral increases in charges and most have service level obligations, involving rebates for service failure*
- *the scope for asset re-valuations to trigger unwarranted increases in charges has largely been resolved by the 'line in the sand' approach*
- *agreements now commonly contain dispute resolution procedures*
- *disputes about the per passenger basis for charges have diminished.*

Despite these apparent improvements, airlines contend that negotiation with airports remains manifestly unsatisfactory (box 8.4). Regional Express, for example, noted that 'the process of reaching satisfactory and workable commercial agreements has a long way to go' (sub. DR93, p. 10), while Qantas stated that 'reasonable and commercial outcomes that are negotiated are the exception' (trans., p. 143).

FINDING 8.2

Commercial agreements now incorporate features that airlines considered were absent or deficient in 2006. But despite these advances, airlines assert that commercial negotiations with some airports are one-sided and dysfunctional.

8.2 Airport users' views on commercial negotiation

Participants raised concerns about their dealings with airports over prices and/or conditions — see International Air Transport Association (subs. 9, DR100), Overnight Airfreight Operators Association (sub. 13), Board of Airline Representatives of Australia (BARA, subs. 19, 59, DR83), Regional Aviation Association of Australia (RAAA, sub. 49, 61), Qantas (subs. 52, DR128, trans., p. 143), Virgin Blue (subs. 54, DR126, trans., pp. 119–20), Qantas, Virgin Blue, RAAA and BARA (sub. 55), Regional Express (sub. 65) and Toll Group (sub. 48). Matters raised by airport users in relation to surface transport are canvassed in chapter 11.[3]

Views vary by airport

The dissatisfaction expressed by airlines is not necessarily indicative of widespread systemic failure of commercial negotiation.

Box 8.4 ***Airline views on commercial negotiation in 2011***

BARA was especially critical of Sydney:

> *BARA believes that SACL [Sydney airport] has probably progressed to a point where only the imposition of stricter economic regulation is likely to be able to correct its long-term commercial conduct. (sub. 19. p. 3)*
>
> *For [Adelaide, Brisbane, Melbourne and Perth airports] BARA is concerned that some may have chosen to forget the basis on which they are now obtaining very high rates of return and are becoming increasingly aggressive in their demands in seeking to maintain such levels. (sub. 19, p. 6)*

The RAAA contended that commercial negotiation:

> *… has been characterised by inappropriate use of airports' market power … massive price increases, lack of adequate consideration of operational needs including safety issues, the loss of security of tenure, amenity and the ability to negotiate. (sub. 49, p. 4)*

Qantas raised concerns about regional and capital city airports:

> *Whilst the Government's Aeronautical Pricing Principles were intended to serve as a guide for the pricing of aeronautical services at the non-monitored capital city and larger regional airports, many of these airports also exert significant market power and exhibit behaviours that are not consistent with those of service providers operating in a competitive environment. The current regulatory regime provides no disincentive at all for the major airports in charging demonstrably excessive rates for any core aviation facilities that sit outside the current light handed regime. (sub. 52, p. 2)*

Virgin Blue considered that:

- *airlines cannot effectively commercially negotiate with major Australian airports except in cases where the airports have a special commercial incentive to do so;*
- *airports have been able to increase airport aeronautical charges above efficient levels and increases in charges have significantly exceeded increases in costs; and*
- *at the same time, services at airports have not generally improved or, worse, have deteriorated. (sub. 54, p. 7)*

Regional Express, which also focused on Sydney airport, stated that:

> *… it is nonsensical to point to the existence of long term commercial contracts as being proof that there is no abuse of market power or efficiency impact downstream. Major carriers, not being able to simply stop using Sydney Airport, could be signing such contracts under duress or as the 'least worst option' with consequent efficiency impacts. (sub. 65, p. 4)*

BARA's 'report card' summarises the commercial conduct of airports as:

Adelaide: Approach to aeronautical pricing is principally formula driven.

Brisbane: Continues to reap the largest windfall gains while continuing to revalue its assets and claim low returns.

Melbourne: Has traditionally been the most reasonable, but commercial conduct has deteriorated in recent times with a marked reduction over the transparency of capital investment programs.

Perth: Traditionally very poor, but has improved substantially recently.

Sydney: Continues its poor conduct seemingly unconcerned with the existence of the prices monitoring regime …

Cairns: Has sought to set prices based on unrealistic asset valuations, unrelated to current passenger throughput levels. (sub. 19, p. 21)

In a similar vein, the domestic airlines also tended to shy away from generalisations about airports as a whole. Virgin Blue, for example, stated:

- *… some airports can be unwilling to share with Virgin Blue information regarding the basis for price increases which are often the subject of negotiations …*
- *airports will on occasion adopt an inflexible approach to negotiations. This includes the refusal … to agree to certain provisions … such as effective dispute resolution clauses. (sub. 54, p. 17, emphasis added)*

The combined airline industry submission noted that 'Since the introduction of light-handed monitoring there has been progress with certain airports towards a more appropriate commercial negotiating approach' (sub. 55, p. 1).

The RAAA likewise submitted that its members' 'experience of airports since privatisation has been largely negative, with the possible exception of a small number of regional airports' (sub. 49, p. 4).

Toll Group, a provider of logistics services, complained of some airports, in particular Sydney, adopting an intransigent attitude to access and pricing decisions. It noted, however, that where it has been in dispute over pricing and access:

… the response by airports has varied considerably from a high standard of commercial conduct to a 'take it or leave it' attitude. For example, Brisbane and Adelaide airports have demonstrated on occasion a willingness to consider independent arbitration and negotiation. In other instances, we have been forced to accept an unreasonable outcome because the airport has refused to negotiate. (sub. 48, p. 8)

Regional Express singled out Sydney Airport for criticism and made a general observation that negotiation benefited large airlines:

Some aeronautical service charges are subject to 'commercial arrangements' with individual operators which is Sydney Airport's preferred method of negotiating charges … This allows larger operators to negotiate a better deal than their smaller competitors. (sub. 65, p. 12)

And BARA alleged that it 'has been involved in lengthy and generally pointless "negotiations" for many years … with Sydney Airport Corporation Limited (SACL) simply making demands for higher

profits and prices' (sub. 59, p. 2).[4] *It stated that this problem stems from a failure 'to hold SACL accountable for its poor commercial conduct' (sub. 19, p. 3).*

BARA concluded that successive governments' refusal to act on Sydney airport meant that light-handed regulation lacks credibility.

FINDING 8.3

Problems with commercial negotiation are not symptomatic of system-wide failure, but appear to reflect different practices across airports. Sydney airport in particular attracts more criticism than other airports. The variations between airports demonstrate that commercial negotiation can, but may not always, work well.

What are the main problems?

Airlines provided a litany of complaints about airports' attitudes to, and behaviour in, commercial negotiations. Essentially, there are some common criticisms of negotiation processes that, to the extent they are correct, could contravene the spirit of 'good faith' negotiation and contract formation. Complaints included allegations that airports:

- *adopt a 'take it or leave it' approach and dictate rather than negotiate*
- *refuse to provide information that is necessary for airlines to understand the basis for increased charges*
- *unfairly transfer risk to airlines*
- *are not amenable to resolving disputes*
- *are prepared to spend years negotiating.*

In addition to these concerns, airlines also considered that more revenue streams should be classified as aeronautical in order to reduce aeronautical charges (Qantas, sub. 52, p. 21; Virgin, sub. 54, p. 37).

Airlines also considered that building block parameters — asset betas, market risk premiums and the weighted average cost of capital — should be subject to regulatory specification (see annex to chapter 6).

Take it or leave it

Airports stated that they cannot embark on new investment without the approval of airlines. Airlines claimed the opposite — that, in any practical sense, negotiation with airports is a take it or leave it proposition. This notion of 'gun at the head' negotiation is often asserted as a fait accompli. The RAAA, for instance, stated that the major airports:

… are all monopoly businesses with the power to impose 'take it or leave it' conditions in the certain knowledge that operators, particularly regional operators, must either 'take it' or severely damage their businesses (or worse). (sub. 49, p. 12)

While the presumption is that market power must inexorably lead to an abuse of process, actual outcomes are likely more nuanced. For instance, BARA stated that airports' initial offers usually seek maximum prices and subsequent negotiations often result in poor outcomes for airlines. The point is, however, that despite the 'outrageousness' of an ambit position, typically there is a negotiated outcome. Qantas provided an example whereby:

Jetstar recently approached all Australian airports to install Self-Service equipment in Domestic terminals to facilitate the implementation of SMS technology … the Self-Service technology is in place in all Domestic ports Jetstar operates to in Australia. Negotiations with Sydney Airport around the installation of this Self-Service equipment in T2 have been extremely difficult … The airport has identified a number of trivial issues … exemplified by the citation of the potential fading of carpet at a different rate due to equipment blocking sunlight on the carpet.

… Jetstar has now created a draft formal agreement … The airport has 'in good faith' agreed to allow Jetstar to install Self-Service technology at Terminal 2 in the short term while the airline continues to formalise an agreement with the airport. (sub. 52, pp. 20–1)

Few would dispute that a major hub airport will have a stronger bargaining position than an airport in a more competitive environment. Nevertheless, it is also unreasonable to treat airlines as powerless. Chapter 5 canvasses the constraints on airport market power including the complementarity of non-aeronautical revenues and airline countervailing power. In short, the presence of market power does not automatically mean an airport will exercise and misuse it.

Indeed, a notable juxtaposition of views relates to the non-capital city airports. Smaller airports, particularly those that might be attractive to low-cost carriers or that are tourism 'end destinations' complain of 'take it or leave it' negotiation stances — this time by airlines.

Moreover, several airports reported that where airlines do not agree to increased charges, it is not uncommon for airlines to refuse to pay the increased charges and to continue to pay the 'old' rates. As legislation prohibits airports from denying services (chapter 3), the non-payment of additional charges can go on for some time (box 8.5).

Box 8.5 ***Airlines can and do refuse to pay***

Airlines do not always accept increased charges. Rex cited its refusal to pay an increased levy at Sydney airport:

> *… the lease agreement had expired and Rex was forced to simply refuse to pay the increase and risk eviction. After Rex's refusal to pay the initial 30% increase the lease was never renewed and Rex has not had tenure for its hangar site for some years as a result. Because of the lack of tenure, Rex has found it difficult to make certain investment decisions … (sub. 65, p. 8)*

Rex adopted a similar tactic at Melbourne airport, which had worked with Virgin Australia to improve that airline's security screening processing in the common user facility. Rex considered that this would degrade the service offered to it and decided that it 'will be holding back 70% of the security screening fees as compensation for the degradation of service provided' (sub. 65, appendix 3).

Hobart International Airport submitted that negotiating on a 'take it or leave it' basis would:

> *… result in airlines flexing their countervailing market power by reducing capacity and subsequent passenger traffic … due to the discretionary nature of passenger traffic at Hobart Airport, we cannot afford to negotiate in a non-commercial manner; with no market power the cost to our business … of not reaching a commercial outcome is far too high. (sub. 56, pp. 8–9)*

Similarly, Adelaide Airport Limited reported that:

> *One domestic airline did not engage in the price negotiations for 12 months which was after agreement had been reached with all other domestic airlines … the airline continued to access Adelaide Airport during that time and only paid the pre-increase charges until agreement was reached. No action was taken by AAL to recover the underpayment during the course of the year, nor was any attempt made to refuse access on the grounds of the substantial 'arrears' accumulating in AAL's books. (sub. 12, p. 4)*

Furthermore, it also could be risky for an airport to undertake major investments without airlines' agreement. As Westralia Airports Corporation noted:

> *While theoretically WAC could proceed to commit to major capital investment without having first reached agreements with airlines, or by seeking to unilaterally impose increased prices, in a practical sense WAC is most unlikely to be able to achieve funding support from equity or debt*

providers with the resulting risks of disputation, non-payment and regulatory intervention. (sub. 41, p. 59)

The AAA also highlighted that an airport might be considered culpable if it only provided services at a level for which airlines were prepared to pay:

> *It is not unknown for an airport to want to upgrade its terminal services in the near future and yet face resistance from airlines who wish to see upgrades deferred to a future date because they are not prepared to contribute to the inherent cost in the short term. Clearly there would be legitimate grounds for concern if airports could enforce a 'take-it-or-leave-it' position and unilaterally impose upgrades and higher costs on airlines — which is simply not the case. Equally it should be a legitimate ground for concern if an airport is criticised for providing airport services at only the level for which airlines are prepared to pay. (sub. 18, p. 36)*

Indeed, airports need to deal with the conflicting needs of airlines. For example:

- *airport investments that increase capacity may be opposed by incumbent airlines that see no upside from providing greater access to competing airlines*
- *low cost and infrequent carriers may have little interest in contributing to improving passengers' experiences at common user facilities.*

Melbourne Airport noted:

> *There will be times where some airlines agree and some do not about issues involving the provisions and pricing of common use services and facilities. There will be times where an airport for its own legitimate business reasons pursues a course of action (within the bounds of the Principles) which will have differential impacts on its customers and possibly detrimental impacts on some. (sub. 29, p. 66)*

These commercial conflicts are compounded by the fact that airports are volume businesses with long-term horizons (a reflection of the cost and life of assets) whereas airlines are focused on yield and shorter horizons. While the City of Greater Geraldton agreed with this point:

> *Airlines have short/medium term commercial imperatives; airports have to make longterm infrastructure investments — and there are natural tensions between the two models. (sub. DR111. p. 30)*

The RAAA claimed the opposite is true:

> *… airlines invest more money in capital and infrastructure and have longer lead times and investment horizons than airports … (sub. DR115, p. 4)*

Given these characteristics, it would be remarkable if commercial negotiation was conducted smoothly.

Protracted negotiations and unwillingness to provide information

Virgin Blue talked of negotiations with airports on price and non-price matters that, in some cases, extended over 12 months or more (sub. 54, p. 17). Similarly, Qantas submitted that:

> *In many cases the period of negotiation nears the duration of the contract, and commonly takes many years. When negotiations extend for several years the outcome cannot be considered a truly commercial agreement. (sub. 52, p. 19)*

BARA stated that it 'has found that negotiating the provision and pricing of international aeronautical services and facilities with SACL has been protracted with less than satisfactory outcomes' (sub. 19, p. 4).

While unduly protracted negotiations are undesirable, commercial negotiation is still maturing. As noted, there have been few rounds of negotiated contracts to date. The matters under negotiation for multi-product entities, such as airports, are inherently complex (chapter 6). As MAp noted in relation to the regulated privatised airports at Heathrow and Gatwick:

> *The CAA determinations for these airports now occupy more than two years out of every five, and contain extensive detail on many areas — despite the intention of the regulator to broker commercial negotiations evidenced in the requirement for 'constructive engagement' introduced in 2005. (sub. 22, p. 12)*

Thus, complexity and protracted negotiation can be a feature of any regulatory regime, whether light-handed or involving price controls. It is important, however, that airports provide sufficient, high quality and detailed information to airlines if negotiations are to be expedited. From an airport's perspective also, protracted negotiation can mean delayed investment.

Notwithstanding the problems with the former regulatory arrangements, parties in the industry have a general understanding of the building blocks approach to setting prices. Indeed, one airport contended that 'a necessary evil' of the former regulatory regime was that it established a well understood pricing methodology (particularly in the context of 'necessary new investment'). Similarly, Brisbane Airport Corporation noted:

> *The significant improvements in airport/airline relationships that have developed and matured is in the large part, due to the stable pricing framework (aeronautical/non-aeronautical definition, valuation of assets, building block pricing model, pricing as investment occurs etc.) that has evolved as 'shadow regulation' through the earlier ACCC and Productivity Commission involvement. (sub. 40, p. ii)*

BARA (sub. 19) and Virgin Blue (sub. 54) noted that agreements with most airports revolve around aeronautical charges derived using the building block formula. An important established parameter of the building block approach is that pricing is now based on established 'line in the sand' asset

values plus capital investment.[5] This has reduced the scope for disagreements in a critical area of negotiation.

As the Commission found from its discussions with airlines and privatised airports in New Zealand, Australia's 'rule of thumb' resolution of this matter stands in contrast to the New Zealand experience where asset revaluations are the prime area of contention (and the subject of legal challenges) in pricing consultations. Outside that contentious issue, in New Zealand it seems that the parties agree on many matters. (See consultations in appendix A.)

At an airline roundtable conducted by the Commission (appendix A), Australian airlines expressed a general view that consultation and provision of information by airports sometimes involves them receiving a 'fat' book specifying various rationales for, and a building blocks approach to underpin, new investment proposals. Airlines suggested that often there was insufficient evidence that demand management and/or productivity-enhancing practices had been fully explored, which might otherwise have reduced the need for, or allowed deferral of, an investment.

Airlines contended that an imbalance of market power meant that they might have to pay for new investments that airports had introduced too early. Virgin, for example, expressed concerns that market power can lead to airlines having to pay for the 'gold plating' or excessive investment at some airports or for the added cost from the inefficient management of infrastructure projects (sub. DR126, p. 10). Such claims:

- *involve conjectures about the relative state of knowledge of participants to these transactions — for example, do airlines have the means to verify demand projections and other assumptions?*
- *presuppose that airports have the capacity and desire to raise capital for projects that might be unnecessary or that could be deferred.*

As was the case in the Commission's 2006 review, what does seem clear is that negotiations over non-price outcomes appear to be unsatisfactory in some circumstances and commercial relationships remain strained. For example, while airports provide substantial information under the building block framework — some more so than others — airlines have expressed their dissatisfaction with the degree of transparency and want more information on the extent to which existing assets are being used efficiently.

Fairness and asymmetric risk profiles

Airlines claimed that the pricing behaviour of airports during the global financial crisis (GFC) was a litmus test of the existence of market power (box 8.6). During the crisis, as demand fell, airlines had little choice but to cut airfares heavily to maintain their load factors, but airports made no corresponding price reductions.

Box 8.6 ***Asymmetric risk profiles and 'fairness'***

A source of irritation for the airlines was the manner in which they were forced to respond to the GFC relative to airports. Virgin Blue said:

> *When demand for air travel drops, as it did during the GFC, airlines discount fares in order to stimulate demand and keep load factors steady. Airports do not alter their charges in response to demand shocks … as airfares drop, airport charges remain the same and become a higher proportion of airfares. In this way, the risk of sharp falls in demand is borne almost entirely by airlines. (sub. 54, p. 6)*

Similarly, Qantas reported that:

> *Recent experience during the Global Financial Crisis (GFC) demonstrated that airports and airlines have asymmetric risk profiles and that airports exercised significant market power in transferring risk to airlines during a particularly turbulent global economic period. Australian airports derived significant benefit when airlines discounted airfares, as passenger volumes increased driving an increase in airport yield. This demonstrates the market distortion whereby airports do not share downside risk and enjoy upside benefits given no mechanism exists for airlines to share these upside benefits. (sub. 52, p. 3)*

And, the joint airline industry submission said the GFC experience provided:

> *… evidence of the market distortion whereby airports do not share downside risk and enjoy upside benefits in their entirety, given no mechanism exists for airlines to share these upside benefits. A comparison of airline earnings to airport earnings during the GFC clearly illustrates this point. (sub. 55, p. 2)*

Airports contested the airlines' claims. For instance:

- *Sydney Airport said that:*

  During the economic downturn in 2009 that resulted in falling passenger demand, a number of airlines approached Sydney Airport to renegotiate and amend the terms and conditions in those agreements. Despite the known commercial risks that eventuated and contracted terms in place, Sydney Airport positively responded by renegotiating several key contractual terms including the need for lower investment due to lower traffic volumes … Sydney Airport deferred a number of capital projects by extending the life of existing assets and/or deferring projects

due to slower passenger demand. The net effect will be slower increase in airport charges in the years between 2009 and 2012 than previously advised. (sub. 46, pp. 27–8)

- *Adelaide Airport submitted that during the GFC 'the annual CPI increase agreed in the pricing agreement was foregone … in recognition of the adverse circumstances facing the industry at that time' (sub. 12, p. 5).*

Exemplifying further the problem of claim and counter claim, in relation to Sydney Airport's claim about deferring projects during the GFC, Qantas submitted that:

> *In late 2008, Sydney Airport Corporation Limited (Sydney Airport) approached airlines around proposed amendments to the capital works program. As a result of the GFC, and slower than expected passenger growth, the airport was seeking to align the delivery of capital investments in an efficient manner that met with passenger demand requirements. One of the projects proposed for delay was investment in new aprons.*
>
> *In February 2009, the Qantas Group advised the airport that it did not support the proposed deferral of the investment in new aprons. BARA also did not support the delay in the aprons … Regardless of the airlines objections to the delay … Sydney Airport deferred the investment. Now, almost two years later, and well after Australia has recovered from the effects of the GFC, the investment in aprons at Sydney airport still has not occurred to the level required. (sub. 52, p. 32)*

The Commission considers that the behaviours cited in box 8.6 do not constitute 'significant market power in transferring risk to airlines'. Airlines had to protect their load factors and this helped insulate airports' revenues. The airlines' response would similarly have benefited fuel companies, catering services and the travelling public.

Nonetheless, the Pricing Principles (box 8.1) encourage sharing of risks and returns 'as agreed between airports and their customers'. This might include cases where passenger numbers exceed projections, leading to over-recovery of charges levied on airlines for a new investment. In these instances, some form of rebate might be negotiated. Where demand is less than projected in commercial agreements, airports generally carry that risk.

Airlines have, however, suggested that airports pass on all costs incurred, including project over runs, regardless of their efficiency or reasonableness. If such practices were permitted, then airlines would bear the risk of changes to the scope or cost of investment. The corollary to this would be that airports would have little incentive to manage project risks. Ultimately, these are matters for negotiation, unless manifest misuse of market power is evident.

Beyond those directly affected, few participants commented on commercial negotiation and dispute resolution. The Department of Infrastructure and Transport concluded that:

> *While prices for aeronautical services have increased since privatisation, the Department notes that these have been negotiated with the airlines and reflect significant investment in aviation*

infrastructure … These agreements fix prices and services between airports and participating airlines for periods that typically range from three to five years and in some cases as long as 15 years.

… these commercial agreements have evolved to become increasingly sophisticated, for example often including clauses to deal with risk sharing and other matters of contention. This is a positive outcome, although … some airlines remain concerned about their ability to overcome the market power of the larger airports, and believe there is room for greater transparency about the underlying assumptions of the building block pricing models. (sub. 43, p. 10)

In response, BARA accused the department of making 'unsubstantiated claims over the quality of commercial negotiations with airport operators' (sub. 59, p. 1). The RAAA similarly challenged the department's conclusion, and commented that 'it is simply not the experience of RAAA members … that the current regulatory regime is working effectively' (sub. 61, p. 2).

Dispute resolution

Virtually all commercial agreements between airports and airline customers have dispute resolution processes (figure 8.1). Melbourne Airport reported (sub. 29, p. 66) that those contracts that are not subject to dispute resolution are those that:

- *relate to decisions taken by the airport about operational or regulatory issues, or*
- *may affect the amount of capital shareholders are required to commit.*

It is unlikely that any airline would now enter into an agreement unless it contained dispute resolution clauses. Typically, they involve disputes being escalated up the line, ultimately to CEOs. Some go further, with recourse to an arbitrator selected by a disinterested person in a neutral jurisdiction. And, the courts always remain an option. The 'escalation' mechanisms have been used, but the Commission understands that arbitration mechanisms have not been invoked at any airport.

These dispute resolution mechanisms are confined to issues within existing contracts. As acknowledged by Melbourne Airport:

… it is not the settling of disputes within agreements that is of policy concern. Rather, it is those situations where the differences between the parties are so intractable that no agreement can be reached or that airlines, whilst continuing to pay for services believe the conduct of the airport concerned is outside the Principles laid down by the Government. (sub. 29, p. 66)

The arguments for dispute resolution, including arbitration at the contract formation stage, are central to the ACCC's proposal for airports to be deemed declared under Part IIIA of the Competition and Consumer Act 2010 (Cwlth). This issue is discussed further in chapter 9.

8.3 Where to now?

There is a divergence in the perceptions between how airports and airport users view commercial negotiation under the light-handed framework. The Department of Infrastructure and Transport has taken the view that 'disagreements on access to airport services and facilities are eventually resolved through commercial negotiations, despite sometimes difficult negotiations' (sub. 43, p. 10). And, indeed there does appear to be some commonality of view about retaining negotiation. Almost all participants agree that commercial outcomes are preferable to the regulatory intervention model of the past. For example, Qantas submitted that 'to provide the best and most efficient service to consumers, Airports and airlines must negotiate commercial acceptable arrangements' (sub. 52, p. 7). Virgin, similarly noted that 'Commercial negotiation is the most efficient and flexible method of setting the terms and conditions for which airports supply, and airlines acquire, airport services' (sub. 54, p. 46). Both, though, maintain that airlines lack countervailing power in negotiations with airports (Virgin, sub. DR126, pp. 7–8 and trans., p. 119; Qantas, trans., pp. 143–44).

The conundrum is that while airlines are emphatic that prices and terms be set by commercial negotiation, their suggested reforms get very close to a return to heavy-handed regulation. Most notably, airlines support the application of ACCC arbitration as an adjunct to quasi-regulation, such as mandatory codes. This type of framework could detract from commercial negotiations. This issue is discussed further in chapter 9.

FINDING 8.4

The divergence in the observations and assertions made by airports, on the one hand, and their airline customers on the other, seems to reflect 'positioning' to either protect or change the distribution of profits between them. Ultimately, the claim and counter claim nature of the evidence means it is not possible to make a definitive call that greater regulatory intrusion is warranted. There is considerable scope to improve commercial negotiation — particularly with regard to contract formation — as it has not yet achieved the level of maturity envisaged with the lifting of price regulation nearly a decade ago.

These extracts from the Commission's most recent report reinforce the AAA's submission that there is no need for any change to the National Access Regime insofar as it supports commercial agreement making between airports and airlines.

So too does the history of moves by airlines to seek regulatory access to airport facilities. The following table shows all such moves and is drawn from the website of the National Competition Council.

Number	Date of application	Applicant	Service	NCC recommendation	Decision	Outcome and subsequent events
D0003	Nov-96	Australian Cargo Terminal Operators	Qantas ramp and cargo terminal services at Melbourne and Sydney international airports (two services)			Withdrawn.
D0004	Nov-96	Australian Cargo Terminal Operators	Ansett ramp and cargo terminal services at Melbourne and Sydney international airports (two services)			Withdrawn.
D0005	Nov-96	Australian Cargo Terminal Operators	Particular airport services at Sydney International Airport	To declare 2 services, not to declare 1 service (May 1997)	To declare (July 1997)	The Federal Airports Corporation applied to the Australian Competition Tribunal for a review of the Minister's decision to declare the 2 services. The Tribunal determined to declare the services for five years from 1 March 2000.

D0006	Nov-96	Australian Cargo Terminal Operators	Particular airport services at Melbourne International Airport (three services)	To declare 2 services, not to declare 1 service (May 1997)	To declare for 12 months (July 1997)	The 2 services were declared from August 1997 until 9 June 1998, and since have been subject to access provisions of the *Airports Act 1996*.
D0016	Oct-02	Virgin Blue Airlines Pty Ltd	The use of runways, taxiways, parking aprons and other associated facilities necessary to allow aircraft carrying domestic passengers to: (1) take off and land using the runways at Sydney Airport; and (2) move between the runways and the passenger terminals at Sydney Airport (airside service)	Not to declare (November 2003)	Not to declare (January 2004)	On 18 January 2004 Virgin Blue applied to the Australian Competition Tribunal for a review of the Minister's decision. On 12 December 2005 the Tribunal overturned the Minister's decision and determined that the airside service be declared for five years expiring on 8 December 2010. On 6 January 2006 the service provider (Sydney Airport Corporation Limited (SACL)) lodged proceedings in the Federal Court to challenge the Tribunal's determination. The Federal Court upheld the Tribunal's determination. SACL subsequently sought leave to appeal to the High Court. Leave was refused.

D0025	27-Sep-2011	The Board of Airline Representatives of Australia Inc.	Jet fuel supply infrastructure at Sydney airport#	Not to declare (March 2012)	Not to declare (May 2012)	

note that the infrastructure in question in this application was not operated by the airport operator, but by third parties unrelated to the airport operator.

The bottom line of this history is that on only one occasion has an airline sought declaration of airport services provided by a current airport operator, and that occasion is notable for two particular features:

- first, while services were declared (contrary to the National Competition Council's recommendation), Virgin and Sydney Airport resolved the underlying matter through commercial negotiation without the need for arbitration or other intervention by the Australian Competition and Consumer Commission; and

- second, while the declaration decision was held on judicial review to be legally made under the law as it then stood, it was a widely held view that the law was deficient and should not have permitted declaration in the factual circumstances as they then prevailed. Section 44G of the Act was subsequently amended in an endeavour to deal with this situation, by requiring that henceforth a service can only be declared where access (or increased access) to the service would promote a material increase in competition, and not just some increase, no matter how inconsequential.

Safeguarding Investment in Australia's Airport Infrastructure

As noted above, a major concern of the AAA in the present inquiry is not to wind back the potential for application of the National Access Regime to Australian airports but, rather, to ensure that any change to the Regime that the Commission may contemplate in the course of the present inquiry does not carry with it any risk to the current and future growth and operation of airports which is so essential to the Australian economy.

Privatisation of the capital city airports has successfully fostered major investment in Australia's key airports to the benefit of airports, airlines and the Australian community. But major future investment is still required and it is essential that the regulatory settings not jeopardise the capacity of airport operators to raise the necessary funds or the preparedness to undertake the risks inherent in expending such funds.

Airports are capital intensive businesses. Large investments must be made in assets that have no alternative purposes, exhibit decreasing costs over their useful lives and may be in service for up to one hundred years. Recognising and minimising inefficiencies in relation to these long-term investments is crucial to ensuring the long-term dynamic efficiency of the industry. In particular, airports must have confidence that they will have the opportunity to earn a reasonable return on their capital so that they can invest the right amount, at the right time.

The potential costs of getting this wrong in an industry of national importance can be enormous. The long vessel queues that formed off the Port of Newcastle in 2003/04 – due largely to a chronic shortage of port and transport infrastructure – is an obvious illustration of the potential costs of under-investment. The negative impacts upon the Australian economy if similar bottlenecks emerged in the aviation sector would be equally, if not more wide-reaching. Fortunately, the experience at airports has been altogether different and positive.

Since 2002, airports have continued to invest to cater for growing passenger numbers, to improve the quality of the services offered to customers – passengers and airlines alike – and to enhance the efficiency of their operations. In total, airports have invested more than $3.5 billion in aeronautical services over the last nine years, growth of almost 50 per cent per annum on average.

In addition, many of the investments that have been undertaken have been of an 'airport changing' nature, and have improved markedly the quality of service offered to customers. Some of the more notable examples include:

(a) the opening of the new airport multi-user terminal at Adelaide Airport, with substantially improved facilities, services and business opportunities;

(b) the expansion of the international terminal at Brisbane Airport, which also offered significant improvements, and the commencement of new runway works;

(c) the ongoing investment taking place at Canberra Airport completely redeveloping the Canberra Airport terminal building;

(d) the extension of the main runway at Gold Coast Airport which allowed the direct introduction of long haul international flights which was originally not possible; the surrender of the Qantas Domestic Terminal Lease and the complete redevelopment and expansion of the main terminal building to accommodate a common user international and domestic terminal;
(e) the terminal expansion programme and expansion of aero-bridge gate capacity at Melbourne Airport; and
(f) the redevelopment and upgrade of the international terminal at Sydney Airport; and
(g) the $200M T2 (Domestic Terminal) Redevelopment followed by $15M + upgrade works for T1 (International Terminal) at Cairns Airport.

It is also obvious that substantially more investment is going to be needed over the next ten to twenty years to meet the projected growth in passenger numbers. Indeed, by 2029-30, annual passenger numbers are forecast to exceed 230 million – a 250 per cent increase on current levels.

The AAA has no doubt that the best way for that investment to occur is through airports and airlines continuing to reach mutually beneficial commercial agreements. A continuing emphasis on commercial agreements without resort to regulatory intervention will enable greater cooperation between airports, airlines and other stakeholders and allow efficient outcomes to be achieved without the risk of regulatory overreach or error.

The second major concern of the AAA is that future administrative or judicial interpretations might undermine the policy intent of the current law. In particular, there is a risk that, unless adequate guidance is provided, the threshold precondition that declaration must lead to a "material" increase in competition may be watered down. This would lead to inappropriate declarations and unwarranted regulatory intrusion into what should be the ordinary working of the market-place. It is important that steps be now taken to minimise the risk. To this end, the AAA recommends that the Commission consider the development of clear guidelines, that might be embedded in the Act, as to what would constitute a "material" increase in competition for the purposes of section 44G of the Act.