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Airport Regulation Inquiry
Productivity Commission
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Submission by Colonial First State Global Asset Management to the Productivity Commission's Inquiry into the Economic Regulation of Airport Services

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Introduction

As a major investor in the Australian airport sector, Colonial First State Global Asset Management (CFSGAM) is pleased to make this submission to the Productivity Commission's current inquiry into the economic regulation of airport services.

CFSGAM is the consolidated asset management business of the Commonwealth Bank of Australia, one of Australia's oldest and largest financial institutions and a global top 20 bank. CFSGAM and First State Investments (its international funds management business) currently have $152.8 billion in funds under management[1].

CFSGAM is a major investor in Australian airports on behalf of superannuation, insurance and other wholesale clients. We were a foundation investor in the privatisation of both Brisbane Airport and Adelaide Airport, and hold significant (and recently expanded) interests in these airports. For example, we are the largest single investor group at Brisbane Airport, representing owned and managed interests of circa 26.5%. CFSGAM also holds interests in Perth Airport and Bankstown & Camden Airports. Our Australian airport investments currently exceed A$800 million.

With this relevant investment experience, we can offer some insights into the current regulatory environment from an investor's perspective.

Benefits of the Current Regulatory Regime

Airport privatisation, and the subsequent regulatory change to the current price monitoring regime, has been a demonstrable success for all stakeholders. The price monitoring regime has achieved a number of key benefits:

- Encouraging strong investment in airport facilities to meet demand growth;
- Promoting flexible and mutually beneficial pricing outcomes for airports and airlines;
- Providing confidence to capital providers at a time of capital scarcity;
- Ensuring airports maintain service quality; and
- Promoting superannuation investment in infrastructure.

These are considered in turn below:

1) <u>Encouraging investment in airport facilities</u>

Under the current price monitoring regime, airlines and passengers have benefited from significant expansion of airport facilities, funded by a mixture of equity, debt and aeronautical charge recovery. Airport capacity has been maintained ahead of industry demand, while the standard of airport facilities has been improved substantially.

The economic regulatory framework for airports has been a key factor underpinning this success.

[1] As at 31 December 2010
[2] Airport and CFSGAM estimates

In addition to purchase prices totalling approximately $8 billion, Australia's five largest airports have invested approximately $5 billion[2] in new, primarily aeronautical assets.

As one example, in the eight years following the introduction of price monitoring in 2002, Brisbane Airport has made significant capital investments totalling circa $930 million, including carparking, terminal expansion, new roads and ground transport/taxi areas. This compares with investment of circa $116 million in the five years to 2002, the period when charges for major airports were regulated by ACCC under the "CPI-X" pricing regime.

Over the next decade from 2010, Brisbane Airport is proposing to invest $2.6 billion including projects currently underway, of which $1.3 billion is for the proposed new parallel runway – understood to be the world's first major runway to be entirely funded and built by the private sector.

The current price monitoring regime has provided an environment of investment certainty, as the foundation for current and planned capital expenditure. It has allowed a fair return on capital invested, encouraging significant ongoing investment in new and upgraded airport facilities, to meet continued demand growth.

2) Promoting flexibility and mutually beneficial pricing outcomes

The current regulatory regime has facilitated direct and effective commercial discussions between airports and airlines, resulting in flexible and often innovative outcomes.

One example is the Multi-User Integrated Terminal at Adelaide Airport. The terminal was completed in 2006 with capital and operating costs recovered through a new Passenger Facility Charge (PFC). Although the result of commercial negotiations, the PFC is based on the building block principles of a regulated regime. However the PFC reflects a more efficient, flexible and transparent price setting process, negotiated directly between the airport and airlines, compared to formal regulation. It provides a significantly more flexible approach, while protecting the commercial interests of both parties. The PFC was an innovative solution delivering a high standard terminal for the benefit of airlines and passengers.

A current example is Brisbane Airport's planning for the new parallel runway, for which construction will span most of the next decade. The scale, design and long lead time of this project make it one of the most complicated projects in the development of Australian airports. The stability, certainty, yet commercial flexibility offered by the current pricing framework (including the established principle of pricing as investment occurs) will be critical to funding this landmark project.

The current regime, based on direct commercial negotiations, improves the ability for airports and airlines to bring forward or defer capex projects in response to variations in aviation demand. By contrast, going back to a regulatory pricing regime with independent price determination would be less flexible, more costly and time-consuming, in managing inevitable changes to capex programs, leading to underinvestment or sub-optimal expenditure.

3) Providing confidence to capital providers

Over the past two years, both equity and debt capital providers have continued to support airport investments, notwithstanding the impacts of the Global Financial Crisis. Most airport owners have either waived equity distributions, or injected new equity, to fund capex programmes. Similarly, senior lenders have continued to support airports in debt refinancings and new debt raisings, to fund capex. This is in part due to the stability and balanced investment outcomes offered by the current regulatory regime, which has underpinned the confidence of capital providers during a period when capital remains scarce.

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[2] Airport and CFSGAM estimates

The current regulatory arrangements for Australian airports are viewed favourably by credit rating agencies. This has been instrumental in supporting the strong investment grade credit ratings of the major Australian airports over recent years, in contrast to many of their global airport counterparts who have suffered rating downgrades.

A change in airport regulatory regime could adversely affect investment sentiment and possibly airport credit ratings, thereby restricting airports' ability to access capital.

Airports continue to operate in a volatile aviation and credit environment. Now is not the time to change the current regulatory settings, which have worked well and withstood the challenges of the Global Financial Crisis.

Again referring to Brisbane's new runway, this project will require a significant long term commitment from all stakeholders. A change of regulatory regime, with the associated uncertainty, could severely destabilise the commitment to this nationally significant infrastructure project.

4) <u>Ensuring airports maintain service quality</u>

By promoting continued investment, the current regulatory regime has ensured that airport service quality has been maintained and enhanced. Despite total traffic at the five largest airports growing by 57%[3] between 2002/03 and 2009/10, these airports have continued to make significant investments in upgrading facilities and service capabilities to meet the growing expectations of airlines and passengers.

Notwithstanding significant growth in passenger numbers, ACCC monitoring[4] confirms that the quality of service at major city airports has strengthened between 2002/03[5] and 2009/10, with overall airport ratings increasing slightly from 3.6 to 3.8 during this period. Brisbane Airport warrants particular mention, having been rated by the ACCC for the highest quality of service for seven consecutive years.

5) <u>Promoting superannuation investment in infrastructure</u>

A change to the economic regulation of airports would sit oddly with the Australian Government's stated goal to encourage further investment by superannuation funds in the nation's infrastructure.

The current regulatory regime has facilitated today's airport investment structure, where superannuation funds - the clichéd 'Mum and Dad' investors - represent a substantial shareholder base amongst the key Australian airports. For example, more than 80% of the equity in Brisbane Airport is held by Australian superannuation funds, mostly industry or State Government funds comprising the savings of ordinary Australians.

In a world of mobile capital, superannuation funds are constantly adjusting their investment mix to achieve improved risk-adjusted returns for their members. These funds will redeploy capital to alternative investments, including offshore, if their confidence in the current regulatory arrangements is undermined.

[3] BITRE (total revenue passengers)
[4] ACCC Airport Monitoring Report 2009-10
[5] ACCC (first year with complete published survey data)

Conclusion

The current economic regulatory model is not broken. It continues to provide balanced outcomes for airport customers and investors alike. Meanwhile the broader regulatory and operational framework for airports ensures they continue to operate as responsible corporate citizens and good neighbours.

As nationally significant infrastructure, airports are key contributors to the nation's economic growth. Continued investment in airports by the private sector is critical if the future needs of this growing industry are to continue to be met. In the coming decade, approximately $9 billion[6] will be needed to fund a range of projects at the top five airports, comprising aeronautical infrastructure (terminals, aprons, taxiways and a runway), access roads, car parks and ground transport infrastructure.

This investment will only take place in an environment of stable, predictable regulation, delivering reasonable returns to investors, appropriately balanced with the needs of all stakeholders. We all, including the Commission, must collectively ensure that the current investment model is not destabilised and continues to deliver successful outcomes.

The current regulatory framework strikes the right balance and should continue to underpin airport investment into the future.

[6] Airport & CFSGAM estimates