The Qantas Group Submission

Productivity Commission Inquiry into the Economic Regulation of Airport Services

April 2011

EXECUTIVE SUMMARY

Introduction

The Qantas Group remains committed to a process of constructive engagement between airports and airport users in Australia. Since the introduction of light handed monitoring there has been progress with certain airports towards a more appropriate commercial negotiating approach. However, the Qantas Groups' experience continues to indicate that reasonable commercially negotiated outcomes with airports are the exception rather than the rule. Where such agreements have been reached they are inevitably the result of protracted negotiations often taking years.

Airports are natural monopolies and the current light handed monitoring approach to regulation has been ineffective in preventing the operators of major airports from exerting significant market power in the provision and pricing of airport facilities and services. 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. In particular, excessive lease costs for critical infrastructure such as airline offices, lounges, hangars, maintenance facilities, check in counters, service desks and staff car parking all sit outside any protection provided by the current regime. Airlines, and indeed airports, cannot function without these facilities and yet no protection is afforded to airlines in relation to the provision of these services by airports. Collectively these costs add significantly to the total cost of operations at airports and to the costs airlines and consumers must incur as a result.

Industry performance

The current regulatory framework for airports was designed to provide incentives to the private sector to invest in the delivery of airport infrastructure and services. These incentives were aimed at growing the Australian aviation industry by encouraging the development of commercial relationships between airports and airlines, with the common goal of increasing passenger volume in order to increase revenue and profits for investors

The Australian aviation industry has experienced strong growth over the past decade. Passenger numbers, especially domestic passenger volumes, have grown and airports have achieved high sustained rates of revenue growth, resulting in significant private sector interest in airport investment. However, the success enjoyed by airports is largely the result of the market power they exert and the lack of accountability over service quality. The current regulatory framework does not strike the appropriate balance between providing incentives for airports to invest and ensuring that mechanisms are in place to prevent unreasonable behaviour and excessive pricing of facilities and services.

In the Qantas Group's view, the pendulum has swung too far in favour of airports. The light handed framework is enabling airports to generate excess returns at the expense of consumers and airlines.

Evidence of market distortions and airports' exercise of market power

Market distortions exist within the current regulatory framework. With airports expected to invest almost $6 billion on airport infrastructure over the next ten years, these distortions are likely to be exacerbated unless the current regulatory regime is given the necessary rigour to more effectively monitor the provision of airport services.

This submission will provide evidence of airports' unreasonable behaviour and excessive pricing with particular reference to the Qantas Group's experience in the context of:

- Airport profitability being achieved at the expense of airline profitability
- Monopolistic behaviour in negotiating commercial leases
- Inefficient airport investment decisions
- Inequitable pricing of aeronautical assets
- Excess returns from aeronautical assets
- Uncertainty and inconsistency surrounding use of the regulatory modelling process across airports
- Limited application of 'line in the sand' valuations
- Monopolistic behaviour of regional airports

The submission will also provide evidence invalidating the perception that airports share the risks associated with demand volatility. 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.

Impacts on airlines and consumers

The Qantas Group considers the ACCC's recommendation that the core regulated airports be deemed declared to have merit and believes such a step would assist in rebalancing negotiations between airports and airport users. However, deemed declaration alone will not readily resolve the issues outlined in this submission. This is because:

1. Airports will still be able to present options in a form that suits their requirements and airlines will be required to negotiate both the structure and detail of the arguments on an airport by airport basis. Given the number of airports in Australia this places a significant burden on airlines.
2. Deemed declaration of tier 1 airports will not resolve issues with non price monitored airports or regional airports.
3. Deemed declaration will not resolve issues associated with excessive airport returns in relation to non-aeronautical revenues.

To address the full range of market distortions evident in the Australian aviation market the Qantas Group proposes that this threat is used in combination with a set of 'codes of conduct' for Tier 1 and Tier 2 airports and Regional airports respectively.

These ‘codes of conduct’ would detail principles for access and the framework for commercial negotiations between airports and airlines.

In summary, the Qantas Group’s preferred approach to tightening the current regulatory framework involves:

- Endorsing the ACCC’s deemed declaration of airports (Tier 1);
- Developing a set of binding codes of conduct to facilitate commercial negotiations between Tier 1 and Tier 2 airports and airlines;
- The development and implementation of codes of conduct for Regional airports to facilitate effective commercial negotiations (less onerous than binding codes of conduct for the Tier 1 and Tier 2 airports); and
- Reviewing the current mechanisms for the allocation of aeronautical and non aeronautical revenues.

Contents

1 Introduction

The Qantas Group welcomes the opportunity to make a submission to the Productivity Commission in relation to its inquiry into the effectiveness and efficiency of the current light handed regulatory regime and whether changes or new arrangements are needed.

Since the Productivity Commission's last review of the regulatory arrangements for pricing of airport services, passenger movements have experienced strong growth, particularly in the domestic market. Under the light handed framework the five price monitored airports experienced aeronautical revenue growth ranging from 11 to 17 per cent per annum during the same period. While there is limited transparency of information for secondary and regional airports, those airports that do publish financial information have reported similar levels of revenue growth.

In contrast, the financial performance of the aviation industry during this period has been marked by volatility. During the Global Financial Crisis (GFC), many airlines incurred substantial losses as a result of the significant deterioration of operating conditions and demand.

The contradictory response of airports and airlines to the GFC, where the majority of airports continued to increase aviation charges while airlines were significantly discounting airfares to support passenger numbers, is indicative of airports' abuse of market power.

The competition between airlines in Australia has benefited passengers, with best discount fares now around half the level they were in July 2003. Similarly, with competitive pricing of aviation services and other efficiency gains, there would be a positive impact on passenger welfare and airlines.

Airports represent significant capital infrastructure, and will be expected to make further significant investments in new aeronautical infrastructure to meet the demands of a growing aviation industry in future. The Qantas Group estimates that some $5.4 billion investment in major new aeronautical assets will be made over the next decade. It is therefore essential to the sustainability of Australia's aviation industry that the regulatory framework is well balanced to protect the interests of passengers, airlines and airports.

The Qantas Group remains committed to a process of constructive engagement between airports and airport users in Australia. In order to provide the best and most efficient service to consumers, Airports and airlines must negotiate commercially acceptable arrangements for the provision of airport services. However, the Qantas Group's experience is that reasonable commercially negotiated outcomes between airports and airport users have been the exception rather than the rule. It is evident that there has not been sufficient incentive for airports to reach reasonable commercially negotiated outcomes with airlines.

The current light handed regulatory framework and the Government Review Principles have proven inadequate to effectively constrain airports from exerting their monopoly power in relation to the provision and pricing of airport services. The current framework has failed to achieve its intended purpose of guiding the conduct of airports, whether monitored or not, as the issues associated with existing regulatory settings are not confined to the Tier 1 airports.

This submission will provide evidence of airports' pricing and behaviour with particular reference to the Qantas Group's experience in the context of:

- Airport profitability being achieved at the expense of airline profitability
- Monopolistic behaviour in negotiating commercial leases
- Inefficient airport investment decisions
- Inequitable pricing of aeronautical assets
- Excess returns from aeronautical assets
- Inconsistent use of the regulatory modelling process across airports
- Application of the framework across airports
- Confusion around and limited application of 'line in the sand' valuations
- Monopolistic behaviour of regional airports

The deficiencies of the current regime have enabled airports to take advantage of their market power during commercial negotiations with airlines. Key deficiencies in the current system include:

- A lack of clearly defined and sufficiently detailed guiding principles in the light handed monitoring approach;
- No regulatory framework or clear guidelines for Tier 2 and Regional airports; and
- An absence of any binding independent dispute resolution mechanism in the event that commercial agreement cannot be reached between airports and airlines.

2 Background

2.1 History of Airport Regulation

In the mid to late 1990's most major airports in Australia were privatised and subject to price-cap regulation.

The September 11 terrorist event in 2001 caused uncertainty and a sharp drop in air transport demand. In October 2001 the Federal Government suspended price regulation of most airports. It maintained price surveillance of Sydney and regulation of Melbourne, Brisbane and Perth airports although these airports adjusted their price caps upwards by about 6-7 per cent.

In May 2002 the Government adopted the Productivity Commission's recommendations for the removal of direct price regulation and the imposition of price monitoring for the capital city airports (except for Hobart), with pricing to be reviewed in five years. The reintroduction of price regulation was threatened if airports abused their pricing freedom. From June 2002 all price regulations had been removed and these seven airports were subject to price monitoring while the smaller airports were not subject to any controls.

The 2006 Productivity Commission Review recommended that the light handed monitoring regime should continue for Sydney, Melbourne, Brisbane, Perth and Adelaide airports. Canberra and Darwin airports were excised from coverage.

Throughout this document airports are referred to as Tier 1, Tier 2 or Regional as follows:

- Tier 1 Sydney, Melbourne, Brisbane, Adelaide, Perth
- Tier 2 Canberra, Cairns, Darwin, Hobart
- Regional All others

2.2 Rationale and Expected Operation of Current Framework

The rationale for continuation of the light handed regulatory approach was based on the following principles:

1. Airlines had countervailing market power which would mitigate the ability of the airports to extract monopoly profits.
2. Any market power that did exist would cause minimal distortion:
    - At the time, there was a need to encourage airports to invest in providing a better customer experience inside airport terminals. The regime was therefore structured to provide strong commercial incentives and higher profits for airports to invest in non-aeronautical activities. At the same time, pricing for aeronautical activities based on regulatory mechanisms would ensure a reasonable return to airports while keeping aeronautical charges low enough to incentivise airlines to attract more passengers through the airports.
    - There was a reasonable prospect that parties would be able to bargain to a reasonable commercial outcome and as a result the market distortion would not be as large as if there were a regulator involved. This was due to the high risk of regulatory failure distorting production and investment

decisions given the uncertainty in global aviation markets at the time (2001/2).

- Airlines could fall back on Part IIIA of the national access regime if negotiations with airports could not be resolved.

The change from tight price regulation to light handed regulation was intended to reduce the regulatory burden in order to foster new investments and improve commercial dealings with airlines, while still imposing some constraint on airports. The light handed regime was intended to operate through the mutual participation of airports and airlines in commercial dealings, with airports subject to price and quality monitoring by the Australian Competition and Consumer Commission (ACCC), coupled with the threat of re-regulation.

3 Evidence of Market Distortion and Airports' Market Power

3.1 Introduction

The current light-handed regulatory framework gives rise to various market distortions and perverse outcomes. These include issues with:

- Market power - airports are natural monopolies and exert their significant market power
- Revenues within the aviation industry appear to be distributed and extracted in an inequitable manner between airlines and airport owners
- Airline yields lagging significantly behind airport yields due to different risk profiles and the impact of competition – a moral hazard problem that has not been corrected
- Abuse of market power in the provision of car parking (both commercial and for airline staff)
- Pricing of commercial leases, in particular relating to:
    - Airports' valuation principles
    - Excessive pricing
    - Monopolistic negotiating behaviour
- Cost and time associated with negotiating commercial agreements
- Inefficient airport investment decisions
- Inefficient and inequitable pricing of aeronautical assets
- Inefficient capital investment forecasting and pricing processes
- Proposals for airlines to pre fund major airport expansions and potential for over recovery
- Forecast errors creating above regulatory returns

These factors combine to increase the cost of aviation services in Australia with consequential negative impacts on the financial performance of airlines and unreasonable costs to airline passengers.

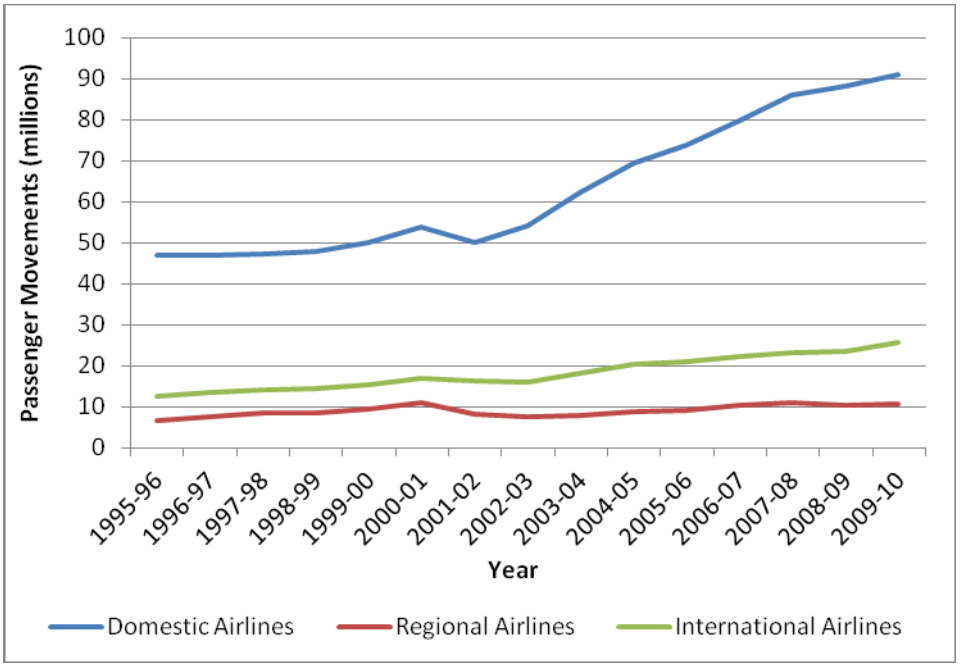
3.2 Industry Growth and Investment

The current airport regulatory framework was designed to provide incentives to the private sector to invest and innovate in the delivery of airport facilities and services. The incentives include the dual till approach, designed to provide airports with an unregulated revenue source, and the ability to negotiate airport charges directly with airlines under the price monitoring framework (rather than through a regulator). These incentives were aimed at growing the Australian aviation industry through encouraging the development of commercial relationships between airports and airlines, which share the common objective of increasing passenger numbers in order to increase revenue and profits for investors.

3.2.1 Growth in Passenger Numbers

Passenger movements have experienced strong growth since 2002. This strong growth has been most pronounced in the domestic market.

Figure 3.1: Historical Passenger Movements[1]



3.2.1.1 Financial Performance of Price Monitored Airports

Aeronautical Revenue

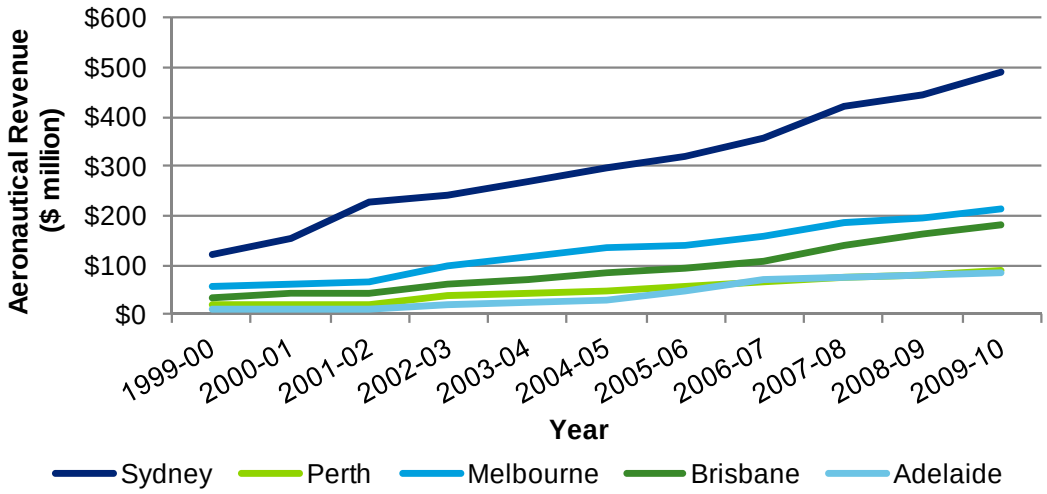
The price monitored airports have experienced strong financial growth over the last decade. Aeronautical revenues at each of the airports have experienced compound annual growth of over 14 per cent over the past decade.

However, over the period 2005/06 to 2009/10, aeronautical revenue growth has slowed to around 11 per cent at Sydney, Melbourne and Perth, whilst Brisbane and Adelaide have continued to grow at around 16 per cent to 17 per cent per annum.

Aeronautical revenues have provided the airports with a stable source of income. The GFC, which saw many businesses suffer financially, had only a minimal impact on the aeronautical part of an airport's business. As will be discussed in section 3.3, this was in large part due to significant price discounting by airlines, which supported continued high passenger numbers.

[1] Source: Bureau of Infrastructure, Transport and Regional Economics

Figure 3.2: Airport Aeronautical Revenue

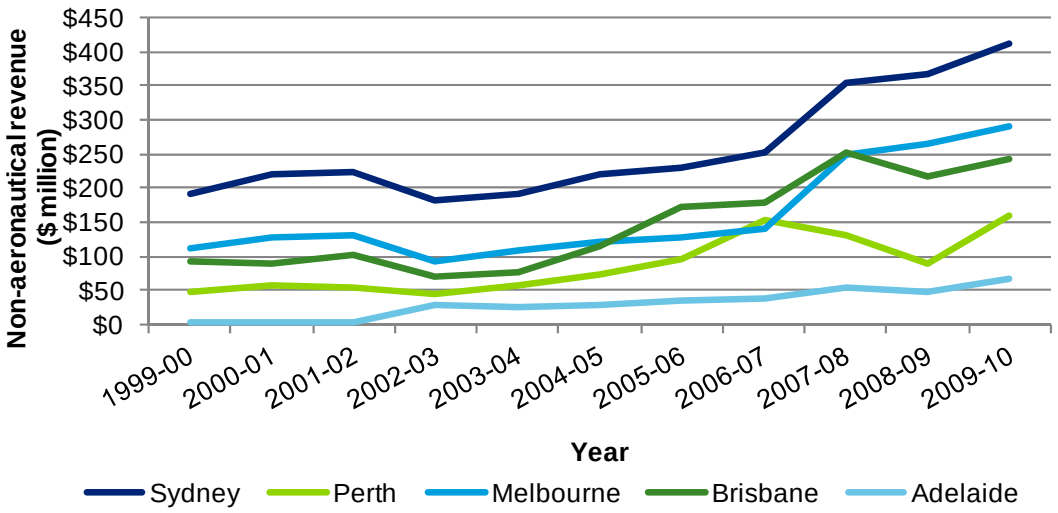


Non-aeronautical Revenue

Non-aeronautical revenue comprises a significant proportion of total revenues for each of the five Tier 1 airports (as shown in Figure 3.3). However, there is a greater degree of volatility in non-aeronautical revenues than in aeronautical revenue (as shown in Figure 3.2). This is particularly important as the original rationale for a dual till system of airport pricing was designed to assist airports in off-setting the supposed volatility in aeronautical pricing.

The terrorist attacks of September 11 2001 and the GFC in 2007-08 had a noticeable negative impact on the revenue from non-aeronautical assets. The two figures demonstrate that, whilst airlines provide protection for aeronautical revenues through their price discounting, this is not the case for non-aeronautical revenues.

Figure 3.3: Airport Non-Aeronautical Revenue[2]

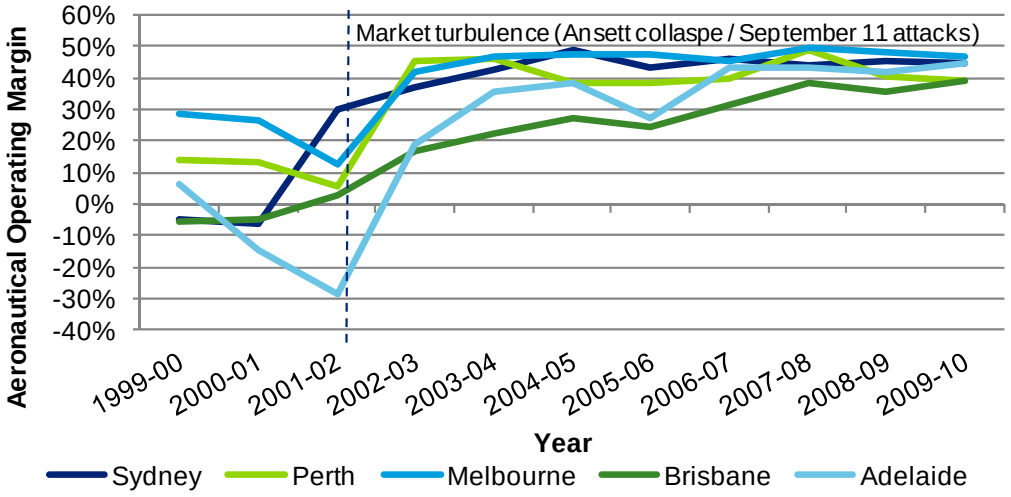


[2] Source: ACCC price monitoring reports

Aeronautical Operating Margin

Airport operating margins on aeronautical assets improved dramatically following the privatisation process and the removal of the price cap measures. There has been a high degree of convergence in airport operating margins on aeronautical assets based upon financial statements reported to the ACCC (generally in the range 40 to 50 per cent). This convergence suggests that there has been a stabilisation in operating margins and that a level of maturity has emerged in the aeronautical side of airport operations.

Figure 3.4: Airport Aeronautical Operating Margins[3]



3.2.1.2 Financial Performance of Tier 2 and Regional Airports

The ongoing profitability of Tier 2 and Regional airports can be demonstrated by the performance of Queensland Airports Limited (QAL) and Northern Territory Airports (NT Airports). Hastings Funds Management and its Australian Infrastructure Fund (AIX) have equity holdings in both of these companies. Some of their funds are listed on the Australian Stock Exchange, and disclosure of information around the performance of their assets is required. However, information relating to other Tier 2 and Regional airports is not readily available, as they are largely held by private companies. The financial performance of QAL and NT Airports has been very strong:

- QAL, which owns Gold Coast, Townsville and Mt. Isa airports, reported compound annual growth in revenue of 15.5 per cent per annum over the period 2005/06 to 2009/10. Its Earnings before interest, taxes, depreciation and amortisation (EBITDA) grew at 12.2 per cent per annum over the same period, whilst passenger numbers grew at 9.3 per cent per annum[4]
- NT Airports, which owns Darwin, Alice Springs and Tennant Creek airports, reported compound annual growth in revenues of 15.5 per cent per annum over

[3] Source: ACCC price monitoring reports, Operating profit margin calculated as operating profit divided by total revenue

[4] Hastings Funds Management, *Queensland Airports Limited (QAL)*, available at www.hfm.com.au/assets/airports/qal/, accessed 31 March 2011

the period 2005/06 to 2009/10. Its EBITDA grew at 17.1 per cent per annum over the same period, whilst passenger numbers grew at 8.5 per cent per annum.[5]

As discussed above, publicly available information on the asset values of other regional airports over time is very limited. This lack of transparency is the result of many of these airports being held privately in unlisted investment vehicles, forming part of a portfolio which limits the detail provided on the financial performance of individual airports or owned by local councils which do not publish specific airport accounts. This creates an information asymmetry in relation to financial statements and asset revaluations for airports that are not subject to ACCC price monitoring and is a major concern for the Qantas Group. This information asymmetry means that it is difficult for airlines to assess whether airport charges are reasonable or not, and for the Government or a regulator to establish whether such airports are exercising market power in setting prices above competitive levels.

3.2.2 Increasing Private Sector Investment in Airports

The impressively high returns generated by Australia's airports have made them attractive assets for private investors. The combination of a stable regulated revenue stream, with the ability to generate significant unregulated revenues from non-aeronautical assets, is a key feature in their attractiveness. Given the current unregulated environment within which Tier 2 and Regional airports operate, private sector interest in these airports is increasing, as evidenced by a number of recent transactions.

- In January 2010, Auckland International Airport Limited announced its purchase of a 24.6 per cent interest in North Queensland Airports, the owners of Cairns and Mackay airports. The transaction was valued at approximately $167 million[6].
- Hobart Airport was sold by the Tasmanian Government to the Tasmanian Gateway Consortium for approximately $350 million in 2007 (a tenfold increase from its original sale price of $35 million in 1997). The Tasmanian Gateway Consortium comprises Macquarie Global Infrastructure Fund III with 50.1 per cent interest and Retirement Benefits Fund Board with a 49.9 per cent interest[7].
- Queensland Airports Limited (QAL) acquired Gold Coast airport in 1998. In 2005, QAL acquired 100 per cent of the equity interests in Australian Airports (Mount Isa) Pty Limited and Australian Airports (Townsville) Pty Limited Airports[8].

The ownership structure of airports typically involves a specific operating company for each airport, a parent company which may own several airport operating companies and shareholders of the parent company. A table at Appendix 7.1 sets

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[5] Hastings Funds Management, *Airport Development Group (NT Airports)*, available at www.hfm.com.au/assets/airports/adgnt/, accessed 31 March 2011

[6] http://www.cairnsairport.com.au/Corporate/News-Updates.aspx

[7] http://tasmaniantimes.com/index.php?/article/hobart-airport/

[8] http://www.mountisaairport.com.au/about_mountisa.php

out the ownership structure of the 21 federally leased airports, as well as the nine largest airports which are not federally leased. The data shows increasing concentration of direct ownership and cross ownership of assets.

There is a degree of concentration occurring at the Parent Company level in some geographic areas (noting that the Government packaged some assets for the privatisation process), including:

- In Queensland: Queensland Airports Limited ownership of Gold Coast, Townsville and Mt. Isa airports
- In Northern Territory: Airport Development Group's ownership of Darwin, Alice Springs and Tennant Creek airports
- In South Australia: Adelaide Airport Limited's ownership of Adelaide and Parafield airports; and
- Australia Pacific Airports Corporation owns both Melbourne and Launceston airports

A number of large investment funds have equity stakes in multiple airports across the country:

- Hastings Funds Management and it's Australian Infrastructure Fund (AIX) has a sizeable ownership stake in ten federally leased airports and two non-federally leased airports, comprising Melbourne, Perth, Sydney, Launceston, Darwin, Alice Springs, Tennant Creek, Gold Coast, Townsville, Mount Isa, Cairns and Mackay.
- Perron Investments has an ownership stake in three federally leased airports (through Queensland Airports Limited), and two other airports (through North Queensland Airports) comprising Gold Coast, Townsville, Mount Isa, Cairns and Mackay.
- Palisade Investment Partners has an interest in three federally leased airports (through Airport Development Group) comprising Darwin, Alice Springs and Tennant Creek.
- Macquarie Group, through associated investment vehicles, has ownership in two capital city airports, Sydney and Hobart.

Hastings Funds Management appears to be developing significant geographically based market power through its ownership interests in a number of key Queensland airports. The fund has an ownership interest in at least fifteen airports, including twelve Australian airports, five of which are based in Queensland. Although Hastings does not have an ownership interest in Brisbane, the largest Queensland airport, it has interests in many of the Tier 2 and larger Regional airports in Queensland, namely Gold Coast, Townsville, Mt. Isa, Cairns and Mackay and this concentration in ownership could present a risk to competition in the North Queensland market.

Whilst it is acknowledged that the privatisation of airports has delivered increased investment in Australia's airports, the trend towards consolidation and cross-ownership amongst Tier 2 and Regional airports is of significant concern to the Qantas Group. Airports are natural monopolies to begin with and this trend represents a further reduction in what is already minimal potential competition between airports as concentration of ownership effectively increases airport market

power. It is very difficult for an airline to take a commercial position in a negotiation with an airport on, for example, the appropriate level of Weighted Average Cost of Capital (WACC), if members of the Board of the airport corporation have access to data about what each airline is paying in other airports. No 'Chinese wall' can prevent this having an influence if the very same individuals sit on multiple airport boards.

Airlines lack countervailing power when negotiating airport charges with individual airports including those in regional locations, as will be illustrated in Section 3.5. With many regional airports under local council ownership, there is a high risk of concentration of airport ownership should the private sector acquire these assets.

An example of the influence of concentrated ownership on negotiations between airports and airlines can be observed in the almost parallel clauses and wording in the original draft pricing and services agreements prepared by two airports with common significant shareholders. While airlines are supportive of consistency, the Qantas Group is concerned that information sharing between airports further exacerbates the asymmetry of information during commercial negotiations.

This trend towards consolidation and cross-ownership of airports is likely to increase uncompetitive behaviour by airports and reduce the limited leverage airlines have in negotiations with individual airports. There is also significant risk of uncapped asset revaluation triggered by change of ownership unless the 'line in the sand' principle is applied to all *Airports Act* airports, not merely those subject to light handed monitoring.

3.2.3 Anticipated Airport Expansion

Continued growth in passenger demand is underpinning the development of the next wave of airport expansions. Based upon these expansion plans, the Qantas Group has developed an estimate of major capital projects expected over the next decade. The forecast capital expenditure at Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin airports between 2011 and 2021 is estimated at $5.4 billion (in real 2011 terms)[9]. In addition, Hobart Airport is forecasting capital expenditure of $492 million between 2009 and 2029. Added to this will be other smaller capital investments, replacement capital expenditure and security enhancements.

This level of new investment will impact on future airport charges and the current regulatory framework will not ensure that these investments are efficient (in terms of timing, scope and cost) or that only efficient costs will be passed on to airlines (as set out in more detail in Sections 3.3, 3.4 and 3.5). The current framework does not ensure that prices are set equitably so that existing passengers are not subsidising future passengers and that airports do not exploit their monopoly power in the delivery of these assets. Based upon experience with the existing regulatory framework to date, the Qantas Group believes that there is a significant risk that existing market distortions will be amplified through inefficient and inequitable pricing of future airport investment.

[9] Excluding 2nd Sydney airport

3.2.4 Conclusion on Industry Growth and Investment

Australia's aviation industry has experienced strong growth over the past decade. Tier 1, Tier 2 and Regional airports have experienced high sustained rates of growth in revenues, which in turn has resulted in significant private sector interest in airports as investments. This, on face value, suggests that the light handed regulatory regime has established an environment attractive to private airports, and has provided them the incentive to grow and invest in the aviation industry.

The Productivity Commission must assess whether the source of the success of airports is as a result of innovations and efficiencies, or as a result of the market power that airports have and trading off the back of airline innovation. It must also assess whether the current regulatory framework has struck the right balance between providing incentives for airports to grow and invest and ensuring that airports are not abusing their market power through setting prices significantly above the level that would be expected in a competitive market.

In the Qantas Group's view, the pendulum has swung too far in favour of airports. The light handed framework is enabling airports to generate excess returns to the detriment of airlines, consumers and the broader economy. This is also the trend at non-price monitored airports as they lack any regulatory oversight on price and behave accordingly. In supporting this view, the Qantas Group will outline the market distortions that it observes, and the inefficient, inequitable and monopolistic behaviours of Tier 1, Tier 2 and Regional airports. It is critical to ensuring that the regulatory framework is well balanced to protect the interests of the public and all other stakeholders given the bow wave of major new investment in Australian airports expected over the next decade.

3.3 Evidence of Market Distortions

Market distortions exist within the current regulatory framework. These distortions are likely to be exacerbated in future years as airports make significant investments in new infrastructure unless the current light handed monitoring regime is adjusted to become a more effective regulatory approach. This section sets out the key market distortions which prevail and which impact materially on airlines' ability to negotiate with airports on reasonable terms for the provision of facilities and services.

3.3.1 Exercise of Market Power by Airports

Airports in Australia display characteristics of natural monopolies, regardless of size. Given the size and geographic distribution of the Australian population there is little or no real competition between domestic airports.

The ACCC considers that 'the price monitored airports have significant market power, and in addition, a number of characteristics provide airports with the incentives and ability to exercise their market power at the expense of users and earn monopoly rents from aeronautical services. In particular:

- There are significant barriers to entry given the natural monopoly characteristics of the major airports in Australia
- The availability of alternative airports is generally limited and there is inelastic demand for aeronautical services

- Airlines generally have a low level of countervailing power in negotiating terms and conditions of access to the major airports
- There is considerable uncertainty as to both the triggers for further regulation and the outcome of any dispute resolution process (such as declaration and arbitration under Part IIIA)[10]

The ACCC's comments support the widely accepted view that airports have significant market power. A key issue when considering the adequacy of the existing regulatory framework is whether airports exercise their market power or not. The evidence presented in this section demonstrates that airports are exercising their market power in a number of ways.

3.3.1.1 Commercial Negotiations

Given the prevailing market power of airports, it is not surprising that commercial negotiations between airports and airlines typically involve significant information disparity. This contrasts with the dynamics of negotiations undertaken in more competitive markets. Typically, commercial negotiations in infrastructure industries between companies that have comparable bargaining power are marked by transparency and openness. Indeed, it is common for commercial transactions to be negotiated on an 'open book' basis, and for the price of services to be determined having regard to costs of supply. In such industries efficiency gains are frequently shared between service provider and acquirer.

A clear demonstration of the extent to which airports exert their market power is the protracted nature of the negotiation process the Qantas Group and other airlines endure when attempting to reach a commercially acceptable agreement with an airport. 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. Set out below are several examples of inefficient negotiations which have taken place with Tier 1 and Tier 2 airports. These inefficient negotiation processes involve the commitment of significant time and resources by both airports and airlines. There are also opportunity costs as a result of delayed new investment in airport infrastructure. In the Qantas Group's view the length of time associated with these negotiations is indicative of a system that is not working adequately and highlights the need for viable dispute resolution when negotiation fails.

Table 3.1: Airport Contract Negotiations

Airport	Negotiated Agreement	Negotiation Process	Contract Duration / Negotiation Period
Sydney	2007 ASA	[CONFIDENTIAL]	[CONFIDENTIAL]
Melbourne	2007 ASA	[CONFIDENTIAL]	[CONFIDENTIAL]
Brisbane	2007 ASA	[CONFIDENTIAL]	[CONFIDENTIAL]

[10] ACCC 0910 Airport Monitoring Report

Airport	Negotiated Agreement	Negotiation Process	Contract Duration / Negotiation Period
Adelaide	2011 Price negotiation	[CONFIDENTIAL]	[CONFIDENTIAL]
Perth	Long term infrastructure and pricing agreement. Last agreement expired June 2007. WAC proposed holding charges flat for 2 yrs whilst negotiations continued. In June 2010 WAC proposed a CPI increase whilst negotiations continued.	[CONFIDENTIAL]	[CONFIDENTIAL]
Canberra	Long term infrastructure and pricing agreement	[CONFIDENTIAL]	[CONFIDENTIAL]
Darwin	Long term infrastructure and pricing agreement	[CONFIDENTIAL]	[CONFIDENTIAL]
Cairns	Long term infrastructure and pricing agreement	[CONFIDENTIAL]	[CONFIDENTIAL]
Hobart	Long term infrastructure and pricing agreement	[CONFIDENTIAL]	[CONFIDENTIAL]

3.3.1.2 Negotiations Around Airlines' Introduction of New Technology

New technology is an essential component of airlines' efforts to enhance the customer experience by delivering new and improved product in a cost effective manner.

The difficulties airlines face when attempting to introduce new technology in airports is well illustrated by recent negotiations between Jetstar and Sydney Airport.

Example 3.1 Negotiating for New Technology at Sydney Airport

Jetstar recently approached all Australian airports to install Self-Service equipment in Domestic terminals to facilitate the implementation of SMS technology. The airline has worked closely with all airports to address any concerns raised and 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 and at one stage the airport

threatened not to allow Jetstar to install the equipment. The airport has identified a number of trivial issues (not identified by any other airport) which have been raised to Executive Management for resolution. The triviality of issues raised is exemplified by the citation of the potential fading of carpet at a different rate due to equipment blocking sunlight on the carpet.

In an effort to resolve these issues and provide Sydney Airport some comfort around the operating protocols, Jetstar has now created a draft formal agreement which its Legal resources have spent many hours developing.

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. If both parties cannot reach agreement, Jetstar will have to manage an inconsistent offering as SMS product will be in place at all airports except Sydney.

This is a clear example of an airport unnecessarily complicating and delaying the process during negotiations with an airline. Qantas Airlines has had similar experience with other airports (with common user terminals) during negotiations concerning the introduction of its new check-in technology, Next Generation Check-in. These airports generated many specific requirements and design changes. In the case of one airport, additional costs of $250k were incurred as a result of last minute substantial design changes.

3.3.1.3 Lease Negotiations

In order to use areas in airport precincts that give exclusive tenure to a particular airline customer, airlines are required to enter a commercial leasing arrangement with airports. These areas include airline lounges, office administration space, staff car parks, hangars, ramp and hard stands which are often constructed on aeronautical land and are essential for aeronautical operations. The Qantas Group's experience in negotiating commercial leases with airports demonstrates very clearly the extent to which airports exercise their market power and the inaccuracy of the view that current regulatory arrangements are satisfactory because airlines bring countervailing power to these negotiations.

As these leased facilities are currently defined as non-aeronautical, revenues derived from and costs attributed to these facilities are unregulated. As a consequence, airports typically have little interest in negotiating a fair and reasonable commercial arrangement with airlines and the outcome is inevitably that airports charge excessive rents.

In recent years there have been numerous examples of monopolistic behaviour by airports, in the form of excessive pricing and unreasonable negotiating tactics. Several of these are evidenced below.

Airport Valuation Principles

The Qantas Group believes that the valuation approach adopted by airports is unacceptable. The majority of airport authorities assert that they are their own market. This response serves to highlight the approach airports are prone to adopt in the absence of any regulatory impediment. Such comments also undermine the theory that airlines possess countervailing power when negotiating commercial leases with airports.

The premise adopted by airports is that specialist use of an airport should be reflected in the rents charged. The limited amount of space available creates a high demand for facilities, further increasing rents. The lack of alternative creates a situation whereby an airline has an operational need for an area or facility but cannot create competitive tension in negotiating. All airports use own achieved rents as the starting point for comparables regardless of the size of space leased. A premium is then added to reflect the 'specialist use' theory.

In a non airport environment, a standard lease with a commercial landlord would typically contain dispute resolution clauses with regard to valuations. Each party generally retains its own valuers to conduct assessments. If no agreement can be reached then a binding determination from another, independent valuer, is sought. This is not the process adopted by airport authorities in negotiations. Airports effectively 'cherry pick' the context for benchmarking, adopting off-airport valuations if it suits or non-airport if not.

Another widespread issue in commercial leases on airports is the inclusion of ratchet clauses. These clauses essentially safeguard a landlord from ever having to suffer a decrease in rent, even if it can be proved beyond reasonable doubt that the market rate has decreased. Despite being uncommon in normal commercial leasing such clauses are prevalent in airport leases and are often presented as 'not negotiable' by airports.

Airports' approach to the valuation of space occupied by the Qantas Group lounges is also of significant concern. All airports classify lounges as premium space and charge accordingly. However, lounges are typically located in low traffic, discreet areas of an airport. Further, restrictions are also usually placed on permitted use within a lounge. For example, no retail offerings are permitted. The Qantas Group believes lounges are an essential requirement for a full service airline and should not be viewed as premium space by airports.

Excessive Pricing of Leased Facilities

In negotiating leases with airports, the Qantas Group has numerous examples which evidence excessive airport pricing behaviours. The following examples illustrate some of the Qantas Group's experiences.

Example 3.2: Excessive Pricing

Brisbane Airport - Qantas Staff Car Parking

During 2007 Qantas staff car parking was moved from the domestic terminal precinct to a site in the international terminal precinct. The move was a Brisbane Airport requirement and was opposed by the Qantas Group. The airport constructed a new site for use by the Qantas Group and other users of the airport.

The cost to use the facility was increased by 25 per cent in 2009] and a further 10 per cent in 2010. The airport's justification was that a capital recovery for the cost of construction was required, despite the fact that the Qantas Group had no desire to move from the previous facility. The new site was further for staff to travel and increased the Qantas Group's labour costs accordingly.

The charging mechanism was also unreasonable as Brisbane Airport insisted

on charging for each member of staff. Given its large number of shift workers the Qantas Group is effectively charged multiple times per day for using the same car park space. The Qantas Group proposed that a per bay per month charging arrangement was fairer and reflected the way most commercial operators would charge. It would also reduce administration time and cost, a stated aim of the airport. Despite repeated attempts to find a solution the proposal was not accepted and the current charging arrangement persists.

Example 3.3: Inflexibility on Lease Terms

Brisbane Airport - Grossing up Leases

In 2010 Brisbane Airport informed the Qantas Group that it would only offer Gross leases from the start of 2011. The Qantas Group objected to this demand on the basis that:

- Gross leases provide the landlord with a guaranteed increase in outgoings as well as rent as each review falls due.
- Any reduction in actual outgoings becomes a benefit to the landlord rather than the tenant.
- Grossing up leases blurs the distinction between the rent and outgoings elements of the lease and makes comparables harder to calculate.

the airport stated that all other tenants had gross leases and that they would not accept any representation from the Qantas Group to continue with nett leasing.

Example 3.4: Definition of Aeronautical and Non-Aeronautical Facilities

Sydney Airport - Qantas Sales Desk

The Qantas Group operates a sales desk at Sydney International Terminal departures level. The sales desk is an essential offering to Qantas Group customers requiring additional ticketing and related services.

Sydney Airport insist this area should be classified as retail and levies rents similar to the concessions in the surrounding area. As the check-in counters are common user it is not possible to locate the sales desk in these areas as would be possible under a leased area.

Example 3.5: Above Market Rate Increases

Multiple airports - annual review clauses

A standard approach used by airports is to include an annual review in excess of prevailing CPI. In addition non-market annual review clauses are included in many airport leases.

A standard proposal from Sydney Airport will include an annual review similar to CPI + [CONFIDENTIAL] over inflation. If a spike in CPI is recorded then this increase is also achieved.

Monopolistic Negotiating Behaviour

Airports adopt a variety of tactics to strengthen their negotiating positions and counter the Qantas Group's attempts to conduct fair and equitable negotiations. Examples of this conduct by airports include:

Example 3.6: Tactics to Avoid Previously Agreed Precedent Lease

Sydney Airport - Negating Provisions of a Precedent Lease

In order to cut down on resource and administration, it is desirable to agree a precedent lease with an airport. As each new lease is entered into, the details are simply entered into the lease. One such precedent lease has been agreed between Sydney Airport and the Qantas Group. The lease contains valuation principles for market reviews.

However, Sydney Airport has recently began offering shorter tenure leases (typically 2 to 3 years) with CPI + or fixed reviews only. Market reviews only occur at the expiry of a lease hence the provisions of the precedent lease with regard to valuation are not binding.

Example 3.7: Late Change to Previously Negotiated Terms

Brisbane Airport - Catering Facility Ground Lease

As part of the Brisbane Airport development, the Qantas Group was required to vacate its current catering site in the domestic precinct. A new site was provided and a Heads of Agreement was executed. As the new site required preparation including surcharging, an agreement to lease and a lease were provided.

Despite having a binding Heads of Agreement agreed, Brisbane Airport changed its position on a clause despite it being agreed under the Heads of Agreement. This created an unacceptable delay as the Qantas Group had an extremely tight schedule to complete its build to ensure continuity of operations once the present lease expired.

Example 3.8: Uncertainty of Tenure

Perth Airport - Break clause

Perth Airport provided a lease for a tech crew base. Although the proposal incorporated a three year tenure as required, it would only be agreed if it contained a break clause allowing Perth Airport to give the Qantas Group three months notice to quit.

The airport only had to provide reasonable endeavours to find an alternative site and no compensation would be payable if the Qantas Group had made capital outlay at the site. Even if a new site was provided, the commercial terms of the old lease would not apply and new terms would have to be negotiated.

It should be noted that this break clause was separate from the standard relocation and redevelopment clause contained in all airport leases.

3.3.1.4 Abuse of Market Power in the Provision of Car Parking

The Qantas Group believes that the current regulatory regime does not effectively constrain the Tier 1 airports' market power as it relates to car parking and allows airports to set excessive prices. These prices impact both consumers and airlines as some airline operational staff require access to on-site parking.

Major airports operate around the clock, even where curfews may be in place. Airline staff are required throughout the day and night. For safety and efficiency reasons it is critical that staff are able to access parking at airports in close proximity to terminals. Unfortunately the current practice of many airports is to seek to move staff car parking away from terminals in favour of commercial parking opportunities. Alternatively, staff are able to access facilities near terminals however the charges are based on the opportunity costs of these spaces being used on a commercial car parking basis. These costs add millions of dollars annually to airline costs and are currently not the subject of any regulation.

The level of market power and price setting varies by airport. Airports can also restrict potential competition or provision of effective alternatives by controlling landside access to terminals.

The Qantas Group has experienced the market power of airports pertaining to car park pricing with Brisbane and Sydney airports. The specific example of Brisbane is detailed in section 3.3.1.3.

The Qantas Group further endorses the ACCC position that a suitable regulatory approach is required to reduce the risk of monopoly behaviour of airports and that the master planning process should have appropriate consideration of provision of on-airport car parking facilities and viable transport alternatives. The Qantas Group believes that it is critical that any reviews of changes to the current regulatory regime for car parking must apply to staff car parking as well as commercial car parking charges.

3.3.1.5 No Evidence of Market Constraints to Airport Market Power

Two market constraints are cited as factors that would act to ensure that airports do not abuse their market power in setting airport charges:

- Airlines, and particularly the Qantas Group, are large corporations with considerable corporate strength that will bestow a degree of countervailing market power in negotiating with airports, and in particular, in relation to Tier 2 and regional airports
- Airports will have the incentive to minimise aeronautical charges, because higher aeronautical charges would have a negative impact on passenger numbers and the airports' profitable non-aeronautical sources of revenue.

Airline countervailing market power

The size of airports is usually taken into consideration when assessing airline countervailing market power. Tier 2 and Regional airports are generally considered separately to major capital city airports. It has previously been recognised by the Productivity Commission that "the countervailing power of airlines in their dealings with major capital city airports appears limited."[11] The Productivity Commission did

[11] Productivity Commission, 2006, *Review of Price Regulation of Airport Services*

note that "…the capacity of carriers to exercise countervailing power will differ between individual regional airports, [but] overall their ability to do so is clearly greater than at the major price monitored airports." However, as will be demonstrated in Section 3.5 of this submission, the Qantas Group is unable to exert countervailing market power on many Tier 2 and Regional airports. This suggests that under the current regulatory framework, the Tier 2 and Regional airports do not perceive any threat of regulation, and many continue to abuse their market power.

Non-aeronautical Revenues Acting as a Deterrent to Increases in Aeronautical Charges

The Productivity Commission no longer considers non-aeronautical revenues as an effective mechanism to constrain the behaviour of airports. In reference to the incentive to keep aeronautical charges low to increase non-aeronautical revenues, the Productivity Commission noted "the previously identified 'market' constraints on charges do not seem overly strong."[12] For the constraint to be effective, economic theory says that the price elasticity of demand for aeronautical services must be high, such that an increase in airport charges results in a significant drop in demand and an overall fall in revenue.

The Qantas Group supports the view that non-aeronautical revenues do not act as an effective deterrent to increases in aeronautical charges. In addition, the Qantas Group has estimated that demand for aeronautical services is very inelastic as was demonstrated during the GFC when airports chose not to lower aeronautical charges in order to protect non-aeronautical revenue.

3.3.1.6 Conclusion on Airports' Exercise of Market Power

The evidence presented in this section demonstrates that airports are exerting their market power and setting aeronautical charges well above competitive levels. They also have profitable opportunities to raise average aeronautical charges above current levels, as non-aeronautical revenues do not act as an effective deterrent to increases in aeronautical charges.

Evidence of airports exercising market power in the pricing of facilities and services allocated to the non-aeronautical till is clear. The negotiation of leases demonstrates that airports set prices well above competitive levels and display monopolistic behaviour during negotiations. Similar behaviour has also been documented by the ACCC in relation to car parking.

3.3.2 Inequitable Sharing of Passenger Demand Risk

The ACCC has noted:

> *'the characteristics of supplying aeronautical services includes a low price-elasticity of demand and a high proportion of fixed predictable costs. Further, although the airports appear to bear some risk of changes in demand for airline services by primarily charging airlines on a per passenger basis, the risk to the airports' aeronautical revenues appears to be partially insulated from demand shocks. These characteristics have the effect of*

[12] Productivity Commission, 2006, *Review of Price Regulation of Airport Services*

reducing the level of risk that airports bear in providing aeronautical services.'[13]

The extent to which airlines insulate airports from volatile demand and as a consequence, earnings volatility, was clearly evidenced during the GFC, a particularly turbulent global economic period.

There are two methods that can be used to quantify this volatility. The first is to use the standard deviation of the earnings stream over the period to be examined. In the case of the aggregate of Australian airports, this standard deviation is $432m, which compares to the aggregate of Australian airlines at $519m. This indicator suggests that airline earnings are 20 per cent more volatile than airport earnings.

Figure 3.5 Airport and Airline Earnings ($m)

An alternative, more simplistic method for understanding the volatility is to simply regress the earnings stream on a deterministic time trend and calculate the extent of the volatility of the actual earnings stream around the earnings stream that is predicted by the time trend. The following regression specifications were estimated for this purpose between FY99 and FY10:

Airports Earnings$_t$ = 70.37 + 113.53 x Time Trend R^2 = 89.8%

Australian Airline Earnings$_t$ = 886.6 – 5.42 x Time Trend R^2 = 0.2%

It can be seen from these regression equations that the vast majority (almost 90 per cent) of the variation in airport earnings can be explained by a steady, predictable movement over time. Conversely, almost none of the airline earnings can be so explained.

[13] ACCC 0910 Price Monitoring Report

It is clear that the Australian airport and airline risk profiles are completely asymmetric and that airports have exercised significant market power in transferring risk to airlines. As noted by the ACCC[14], airports benefit from the airlines' efforts to stimulate demand by maintaining passenger throughput at the airports without the airports needing to lower their charges.

Indeed, the approach taken by Australian airports relative to other international airports during the GFC was a clear demonstration of monopolistic behaviour. Other than on a marginal basis no Australian airport agreed to lower its charges in an effort to cooperatively stimulate passenger demand. The focus of discussions was on operational efficiencies and whilst these are important, no significant savings relative to aeronautical charges eventuated.

In response to the GFC, the Qantas Group proposed three broad initiatives to Sydney and Brisbane Airports. These initiatives and the Airports' responses are tabled below.

Table 3.2: Sydney and Brisbane Response to Global Financial Crisis

Proposed Initiative	Airport Response	
	Sydney Airport	Brisbane Airport
Short term rebates or incentives for aviation charges & landing fees	[CONFIDENTIAL]	[CONFIDENTIAL]
Short term operational efficiencies	[CONFIDENTIAL]	[CONFIDENTIAL]
Freeze lease rates	[CONFIDENTIAL]	[CONFIDENTIAL]

Melbourne Airport offered to increase aviation charges by 'only 2 per cent' to assist airlines. In a deteriorating environment Australian airports behaved as service providers exerting significant market power. Airlines carried the burden of volatility and heavily discounted airfares in order to stimulate demand through the economic downturn.

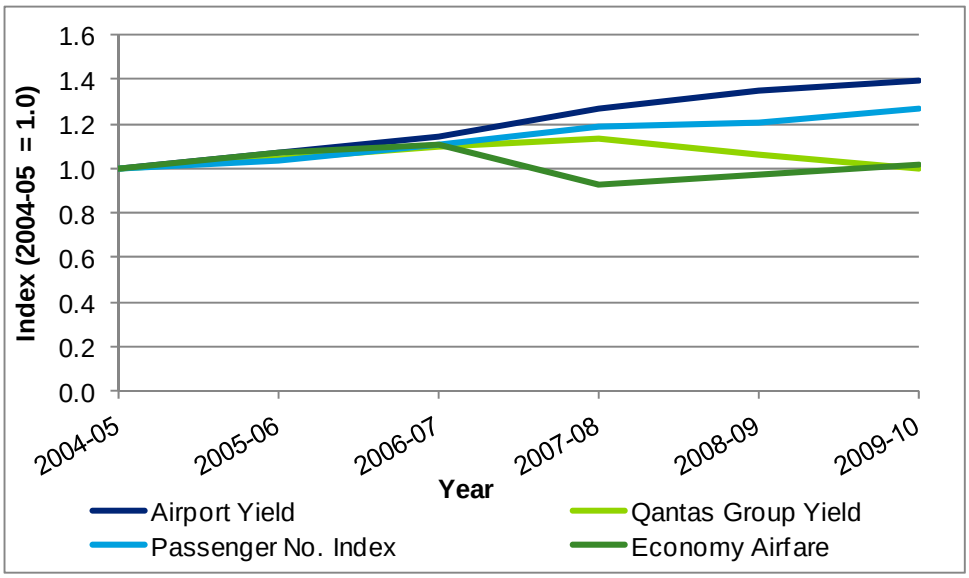
In sharp contrast, overseas international airports voluntarily reduced their charges in a difficult climate in an effort to support their airline customers and stimulate passenger demand. Examples included Malaysia Airports (-50 per cent), Airports of Thailand (-30 per cent) and Singapore Changi (-25 per cent). Frankfurt and Hong Kong airports also reduced their charges.

Australian airports derived significant benefit when airlines discounted airfares, as passenger volumes increased driving an increase in airport yield, as illustrated in Figure 3.6. This outcome demonstrates the market distortion whereby airports do not share downside risk, but benefit from any upside to passenger demand, given

[14] ACCC 0910 Price Monitoring Report

no mechanism currently exists for airlines to build such benefits into the pricing of facilities and services.

Figure 3.6: Impact of GFC on Passenger Numbers, Airfares and Airline and Airport Yields[15]



3.3.3 Inefficient Airport Investment Decisions

3.3.3.1 Approach to capital planning and the incorporation into price

Airports are major pieces of infrastructure, and represent significant capital investments. Australian airports have made significant investments in new aeronautical infrastructure and major investment is expected to continue. The Qantas Group has estimated that some $5.4 billion investment in major new aeronautical assets will be made over the next decade, in addition to smaller and replacement capital works programs. These investments will ultimately result in higher airport charges and higher costs for consumers. Airports, because of their market power, do not have the same level of competitive pressure to ensure that capital investment decisions are efficient. Under the current regulatory framework, a significant risk exists that airports may not be making efficient investment decisions, specifically in relation to aeronautical assets.

Each of the Tier 1 airports has established a consultation process with airlines around capital planning. Through these processes, airports share information and seek to provide transparency around their capital investment decisions with airlines. The rationale behind such processes is to facilitate commercial negotiations and agreement on future prices by addressing information asymmetries which otherwise exist. However, the processes are unable to achieve

[15] Economy airfare index is presented as an average over the previous 12 months. Sources: Competition and Consumer Commission, Airport monitoring report, 2004-05 to 2009-10, available at www.accc.gov.au/content/index.phtml/itemId/347781, accessed 14 March 2011; The Qantas Group, Annual Reports, 2004/05 to 2009/10, available at www.the Qantas Group.com.au; The Qantas Group, Data Book 2010, available at www.the Qantas Group.com.au; and Bureau of Infrastructure, Transport and Regional Economics, Domestic air fares indexes, February 2001, available at www.btre.gov.au/Info.aspx?NodeId=100, accessed 14 March 2011.

full transparency and significant information asymmetries remain. Furthermore, there are concerns around the airports' ability to deliver major capital projects in an efficient manner. The capital planning process is a significant driver of future prices and closely linked to the setting of airport charges. Hence the two need to be considered in tandem.

The capital planning and price setting processes at Sydney, Melbourne and Brisbane airports are detailed in Appendix 7.2. At a high level, they aim to facilitate consultation between airports and airlines on capital investment and pricing. While the issue of information asymmetry is addressed to varying degrees by each airport's process, none of them resolves the issue. As a result, reaching agreement on capital plans, capital budgets and the impacts of capital investment on prices continue to frustrate negotiations between airports and airlines. Some of the key issues with the capital planning and pricing processes at Sydney, Melbourne and Brisbane airports that continue to result in blocks to achieving commercially negotiated outcomes (which apply to a greater or lesser degree depending upon the airport) are:

- Airlines often have little ability to influence the capital investment decisions in aeronautical assets. The exception to this is Sydney Airport, which, in the Qantas Group's experience generally seeks agreement from airlines on investment decisions
- Pricing agreements are often based upon forecasts of capital projects over the term of the agreement (usually 5 years, although Brisbane is seeking a 10 year agreement as part of its next pricing agreement). Brisbane and Melbourne do not adopt a price adjustment mechanism to address deviations in actual capital from planned expenditure. Adelaide only has one adjustment point at the 5 year mark in their 10 year agreement. Perth Airport have isolated a portion of their capital plan from their proposed agreement which would be subject to price adjustments and Sydney Airport has a bi-annual price adjustment based on their capital expenditure. The lack of an adjustment mechanism is compounded when the capital costs incorporated into Melbourne and Brisbane Airport's are, in some instances, based upon concept or preliminary designs. This results in very high degrees of uncertainty in the modelling and pricing process.
- Very limited information is provided around the basis of capital budgets included in pricing. Generally there is no transparency around whether quantity surveyors have been used or not, what levels of contingency are built into the costs, what cost escalation factors are used and what percentage of the total cost relates to project management/oversight by the airport. There are also no audits of projects upon conclusion to identify true capital spend and value for money
- No information is shared on the tenders/quotes received to carry out the works, even upon request from airlines
- Very limited information is provided around reasons for project overruns – airlines are unable to determine if a variation was a result of a change in project scope, poor project management or genuine cost overrun
- Airports have limited incentives to manage projects efficiently, as any project overrun is capitalised and incorporated into the asset base upon which the next

round of pricing is determined (even if airports have to carry the over run during the current pricing period)

- Airports classify most capital projects as 'growth' capital, and rely on airlines to identify projects which are replacement capital works and question the classification in order to have the relevant adjustment to the underlying airport charge
- Airlines have no visibility of the airports' aeronautical asset registers, so it is difficult to identify whether assets being replaced have been fully depreciated or not. It is therefore unclear who bears the cost of any asset write offs from early replacement
- There is no transparency around how project capital costs are allocated between aeronautical assets and non-aeronautical assets, even after the information is requested by airlines
- There is no transparency around how project capital costs are allocated between international and domestic services.
- Most airports incorporate mandated security capex into their assets and apply a commercial aeronautical WACC on these assets, generating a profit from mandated security spend and these returns are not subject to the "unders and overs" process

The issues identified at Sydney, Melbourne Brisbane and Adelaide airports also arise at other airports. At Tier 2 and Regional airports, the issues experienced with Sydney, Melbourne and Brisbane are magnified, as they are subject to no regulation or oversight.

Example 3.9 illustrates the issues with the current capital planning and pricing processes.

Example 3.9: Example of airlines being responsible for identifying changes to the capital plan

[CONFIDENTIAL]

Example 3.10: Example of Airports Exceeding Design Parameters Agreed by Airlines

[CONFIDENTIAL]

Airports are also delaying investment in critical aeronautical assets, even when airlines continually raise the need for the investment, and are willing to accept the associated increase in charges for the asset.

Example 3.11 presents a case study. The delay to new investment in aircraft parking at Sydney airport was not supported by the Qantas Group (or other airlines through the Board of Airlines Representatives Australia (BARA)) in February 2009. Over two years later the capital investment still has not been made to the level required, and airlines continue to experience operational constraints because of the delay.

Example 3.11: Airports Delaying Investment

Delay in New Aprons at Sydney Airport

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. The Qantas Group was supportive of some of the other proposed investment deferrals. Regardless of the airlines objections to the delay in the provision of additional aprons, 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.

3.3.3.2 Adequacy of On-Airport Fuel Facilities

The adequacy of on-airport fuel facilities at Sydney and Melbourne Airports is of significant concern to the Qantas Group. An airport cannot operate without adequate fuel supply. By ensuring there is adequate storage to meet projected growth and peak demand an airport can prevent supply disruptions. This can be managed through regular meetings with on-airport storage operators to ensure suitable facilities exist. Currently, facilities at Sydney and Melbourne airports are at capacity.

In response to the shortage of fuel supply at Sydney Airport in December 2009 Sydney, the Jet Fuel Infrastructure Working Group was convened and recommended that fuel demand consideration be included in the Sydney Airport master plan. Melbourne Airport also encountered a fuel supply disruption in December 2010 and another enquiry is in progress. These occurrences demonstrate the need for airports to include fuel demand projections and supply infrastructure considerations in their master plans.

Appendix 7.5 and 7.6 contains further information re infrastructure constraints at Sydney and Melbourne airports and fuel availability metrics.

The lack of certainty of tenure in relation to on-airport facilities also has the potential to impact on airlines' fuel supplies. The Sydney Airport fuel storage facility, the Joint User Hydrant Installation (JUHI), has a lease until 2018. The JUHI is in a location of potential International terminal expansion. The supply pipelines are at capacity and on-airport fuel infrastructure needs major investment. It is estimated that after Caltex upgrade their pipeline in 2011, a new pipeline with a 50 year life will be needed by 2018/19, at a cost of over $100 million. To build a pipeline requires at least five years lead time but confirmation of its location is currently delayed due to lack of advice from Sydney Airport about the location of future on-airport fuel infrastructure once the lease expires, and whether the land will be required for International terminal expansion.

3.3.4 Inefficient and Inequitable Pricing of Aeronautical Assets

3.3.4.1 Capital Investment Forecasting and Pricing Process

As discussed above, a number of airports use forecast capital expenditure over 5 year periods to set airport charges. The cost estimates used have significant uncertainty attached to them. Errors in forecasting capital investments are significant, and airports simply aim to pass any cost overruns onto airlines. The table below details Melbourne Airport's capital plan for the period 2008 to 2012, based upon information contained in its pricing model for this time period.

The capital plan built into the Aeronautical Services Agreement forecast expenditure of $[CONFIDENTIAL]. Based upon actual expenditure to date, and updated forecasts for the remainder of the period ([CONFIDENTIAL]), total expenditure of the Aeronautical Services Agreement is expected to be $[CONFIDENTIAL]. This equates to a variance of $[CONFIDENTIAL] variance against plan. This variance comprises existing projects where there have been changes in cost, scope and timing to the value of $[CONFIDENTIAL] and new projects to the value of $[CONFIDENTIAL].

This increased spend has not been supported with any appropriate visibility of details, scope, costings or cost benefit analysis.

Table 3.3 Variance in Actual Capital Expenditure Relative to Forecast at Melbourne Airport[16]

	Actuals 2008 $'000	Actuals 2009 $'000	Actuals 2010 $'000	Forecast 2011 $'000	Forecast 2012 $'000	Total $'000
Aeronautical Services Agreement (ASA) Capital Plan – 2007 Forecast	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Period to date actual spend and forecast remaining spend – 2011	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Adjustments to planned activity	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

[16] Melbourne Airport Annual Aeronautical Review 2009/10 p9

	Actuals 2008 $'000	Actuals 2009 $'000	Actuals 2010 $'000	Forecast 2011 $'000	Forecast 2012 $'000	Total $'000
New proposed projects outside of ASA Capital Plan	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Total variance	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Variance to ASA Capital Plan	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Melbourne's pricing structure does not allow them to trigger an increased passenger charge during the term of a pricing agreement. However Melbourne Airport's intention is that the full cost of this infrastructure will form part of the cost base for the next agreement, due to commence in 2012. As Melbourne Airport has justified much of this expenditure on the basis of increases in passenger growth, this variance in spend should not produce a significant rise in charges per passenger. However, if the airport has been 'building to the peak', then the expenditure will not be proportionate to the increase in passenger numbers, and significant charge increases will result. The Qantas Group will not have visibility of this until the price negotiations with Melbourne commence in mid 2011.

3.3.4.2 Pre-funding of Major Airport Expansions and the Potential for Over Recovery

Pre-funding of airport assets allows airports to undertake major capital investments by charging airport users during construction. However, such a practice raises several issues around equity for airlines and passengers and would appear to be at odds with the philosophy of a dual till regulatory regime.

Large scale airport investments can take many years from commencement to completion. Pre-funding arrangements require airlines and passengers to pay for a return (based on WACC) on an asset during construction for which no access to an asset or service is received. When construction times are particularly lengthy this results in airlines and passengers paying for a period in which they receive no benefit for many years. In addition, new infrastructure may cause disruptions during the construction phase. For example airlines may experience increased flight delays, or be limited in growth plans due to unavailability of a runway, taxiway or gate which has been taken out of service due to construction on another project. This is an additional real cost to the airline. Further it can result in a situation where incumbent users effectively provide a significant subsidy to future users.

In addition, the practice of airports seeking that airlines pre-fund aeronautical infrastructure would appear to be at odds with the dual till rationale. The dual till is designed to ensure that airports have access to an income stream that was more

stable than fluctuating aeronautical revenues, thus allowing them to continue investing in aeronautical infrastructure. As demonstrated previously, aeronautical revenues have been highly stable for airports. Notwithstanding the strong growth in both non-aeronautical and aeronautical revenues since privatisation, many airports still seek to pass infrastructure funding costs to airlines and consumers.

This issue is critical as airlines, like airports, are extremely capital intensive businesses. Due to the competitive nature of the airline business it is not possible for airlines to ask passengers to pre-fund future aircraft purchases. These aircraft must be purchased out of ordinary revenues and are usually debt or equity funded. At the levels of investment currently facing Australia's airlines for new fleet, maintenance, catering and associated facilities it is untenable for airlines to also be called upon to pre-fund the capital intensive projects that airports wish to undertake. Pre-funding has been used within Australia, but often outside formal regulatory frameworks. In other capital intensive industries, the developments of major new capacity expansions are underpinned by long term contracts guaranteeing use of the asset. As an example, the expansions of coal loader throughput capacity at export coal terminals are underpinned by ship or pay contracts. Under these contracts, potential users of the asset essentially guarantee a certain demand for the use of the asset, usually over, say, the first ten years of operation. In return, these users are given certain rights over the future use of the new coal loader in the form of an allocation of the facility's throughput capacity. For example, with a coal export terminal expansion, the asset owner/operator seeks an expression of interest from coal producers seeking new or additional capacity associated with the terminal expansion prior to entering into long-term (usually 10-year) take or pay contracts.[17]

There is limited guidance available from Australian regulators in the context of airport regulation on the issue of pre-funding. The International Civil Aviation Organisation (ICAO) provides some guidance around the pre-funding of projects, including:

The Council considers, notwithstanding the principles of cost-relatedness for charges and of the protection of users from being charged for facilities that do not exist or are not provided (currently or in the future) that, after having allowed for possible contributions from non-aeronautical revenues, pre-funding of projects may be accepted in specific circumstances where this is the most appropriate means of financing long-term, large-scale investment, provided that strict safeguards are in place, including the following:

> *(i) effective and transparent economic oversight of user charges and the related provision of services, including performance auditing and 'benchmarking' (comparison of productivity criteria against other similar enterprises);*
>
> *(ii) comprehensive and transparent accounting, with assurances that all aviation user charges are, and will remain, earmarked for civil aviation services or projects;*

[17] See Wiggins Island Coal Export Terminal Media Release, http://www.wicet.com.au/assets/docs/100930_Stage%20one%20go%20ahead_FINAL.PDF

(iii) advance, transparent and substantive consultation by airports and, to the greatest extent possible, agreement with users regarding significant projects; and

(iv) application for a limited period of time with users benefiting from lower charges and from smoother transition in changes to charges that would otherwise have been the case once new facilities or infrastructure are in place.[18]

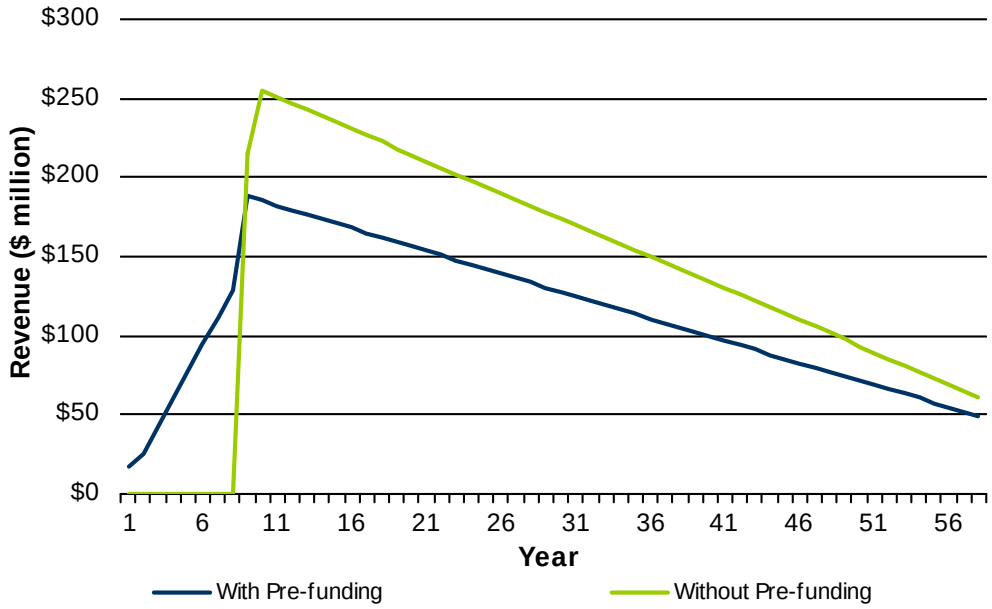
The point raised by the ICAO around gaining user agreement regarding significant investments is of particular importance in the context of pre-funding. To construct an asset that users do not require, and enforce charges upon them, suggests that projects are not always undertaken at optimal times, and may result in inefficient resource allocation decisions. It is also important to note that ICAO considers that both aeronautical and non aeronautical revenues should contribute in circumstances of pre-funded infrastructure.

Under pre-funding arrangements being proposed by airports, there is not the underlying condition of having a contract guarantee over selling future capacity, and the allocation of this to users. For instance, at the prices being proposed for the New Parallel Runway at Brisbane airport, the Qantas Group believes that the investment is being undertaken well ahead of demand. Furthermore, the pre-funding arrangements being proposed do not provide any benefit to pre-funding users. By contrast, the pre-funding of coal terminal expansions is on the basis that users received a benefit in the form of a guaranteed allocation of the throughput capacity of the facility from their investment. The proposals currently being developed by airports do not give any equivalent economic benefit to pre-funding users.

The pre-funding proposals of some airports also result in existing airlines and their customers contributing a disproportionately high amount to the total cost of new assets, without receiving any future benefit. This results in a cross-subsidisation from current users to future users. The following example uses the assumptions from Section 3.3.4.3 as a base for analysis (a new asset is constructed over 8 years, operations commence in year 9, straight line depreciation and no indexation of the asset base applied). Figure 3.7 presents the revenue collected under two scenarios. The first scenario is based upon charges being introduced upon completion of the asset (start of year 9), and the second scenario implements charges from the start of construction in order to 'pre-fund' the construction. A single constant real price is calculated for each scenario.

[18] ICAO Doc 9082/8, ICAO's Policies on Charges for Airports and Air Navigation Services, Paragraph 32.

Figure 3.7: Revenue Collected With and Without Pre-funding



Based upon Figure 3.7, under the first scenario (no pre-funding), airlines and customers who actually use the asset pay $858.2 million (in net present value terms). In comparison, under the second scenario (with pre-funding) airlines and users that pay during construction pay a total of $310.4 million (in present value terms) over the eight years of construction (Scenario 2). Users of the asset once it is fully commissioned pay $638.9 million (in present value terms). This indicates that, in present value terms, pre-funding generates an additional $91.1 million in revenue. The difference in the present values is due to the treatment of funding costs during construction. Under the pre-funding scenario, it is assumed that the financing costs are recovered in the year that they are incurred through charges, whereas in the without pre-funding scenario, these financing costs are capitalised at the date the asset is completed, and are then recovered over the life of the asset.

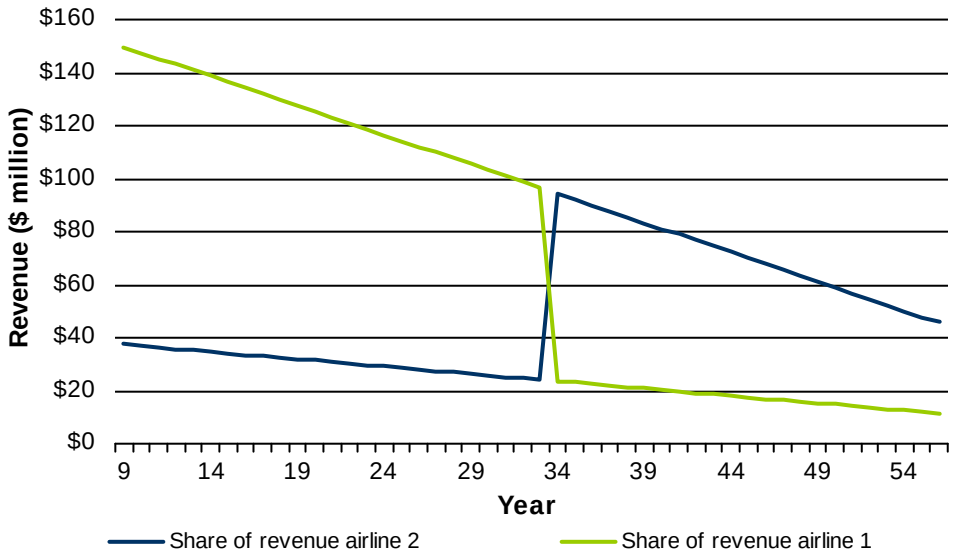
The analysis of Figure 3.7 indicates that airlines and customers which received no benefit from the new asset end up paying for over 30 per cent of the asset in present value terms. The subsidy that current airlines and customers end up providing to future users is equivalent to $91 million even though future users may be better able to pay for the asset due to growth in real incomes.

3.3.4.3 Inequitable Pricing Over Time

Charging for new infrastructure based on traditional depreciation methods, whether pre-funded or not results in incumbent airlines subsidising future new market entrants. New market entrants do not contribute during the construction or the early years of life of the asset, whereas incumbent firms do. Using a stylised example, the impact of pre-funding on changing market share is illustrated. The example is based on an airline market comprising two airlines and assuming a $1 billion, 50-year asset. Airline A commences with an 80 per cent market share and halfway through the asset's life, its market share drops to 20 per cent. Conversely, Airline B's market share is 20 per cent in the first 25 years and increases to 80 per cent in the second 25 years. This scenario assumes that the usage of the asset over its

lifecycle is the same across the two airlines. Figure 3.8 shows the charges over the asset's life between the two airlines.

Figure 3.8: Example of Airport Charges for Two Airlines



The differences in the charges paid by Airlines A and B are significant and demonstrate the potential inequities associated with the construction of new assets with significant excess capacity. On an undiscounted basis, the total charges paid by Airline A over the asset's life are $3.5 billion compared with Airline B which pays $2.5 billion. The average annual charge per passenger (on an undiscounted basis) is $61 for Airline A and $18 for Airline B. The implication of this stylised example is that there is a significant difference in the total charges paid by the two airlines, even though each has equal market share positions over the life of the asset. Early users of the asset are penalised by being forced to pay for excess capacity built to accommodate future users. Therefore, there is clearly an inequitable contribution to the cost of the asset between two airlines (and for that matter between two customers) which is solely dependent upon the timing at which the asset is used, and not a difference in asset or service quality.

The choice of depreciation schedule by an airport can impact on the unit charge paid by the airline. A model has been developed to illustrate the impact of changes across four alternative depreciation schedules on the unit charge imposed by the airport. The depreciation schedules shown are:

- Straight line depreciation (no indexation)
- Straight line depreciation (with indexation)
- Economic depreciation (no indexation)
- Economic depreciation (with indexation).

Unlike straight line depreciation where the asset value falls at a constant amount each year, economic depreciation assumes that the value of the asset declines in line with usage and in this example follows a concave distribution. Under the scenarios where indexation is included, the real value of the asset is maintained

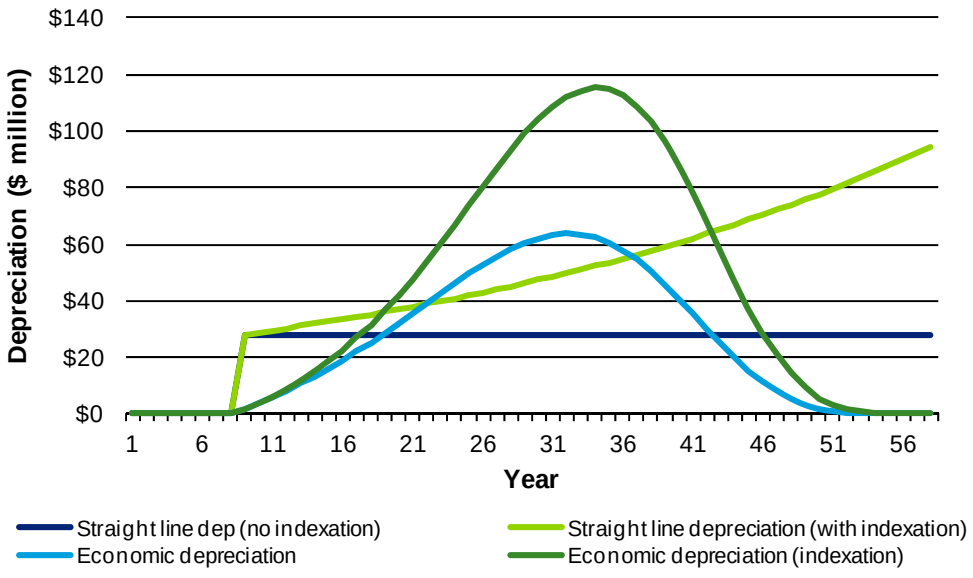
and the return of capital (depreciation) is indexed against inflation. The assumptions underpinning the analysis are shown in Table 3.4.

Table 3.4: Assumptions for the Analysis of Depreciation Options

Component	Assumption
Asset value	$1 billion
Construction period	8 years
Asset life	50 years
Pre-tax WACC	11 per cent
Current passengers (2010)	20,000,000
Passenger growth	4 per cent p.a.
Indexation	2.5 per cent
Operating cost assumption	3 per cent
Tax rate	30 per cent

The following Figure graphs the four depreciation schedules. Under the economic depreciation schedules, the annual depreciation amount first increases with the utilisation of the asset, before starting to fall as the asset ages. For both straight line and economic depreciation, annual depreciation is higher with indexation than without.

Figure 3.9: Alternative Depreciation Schedules ($ millions)

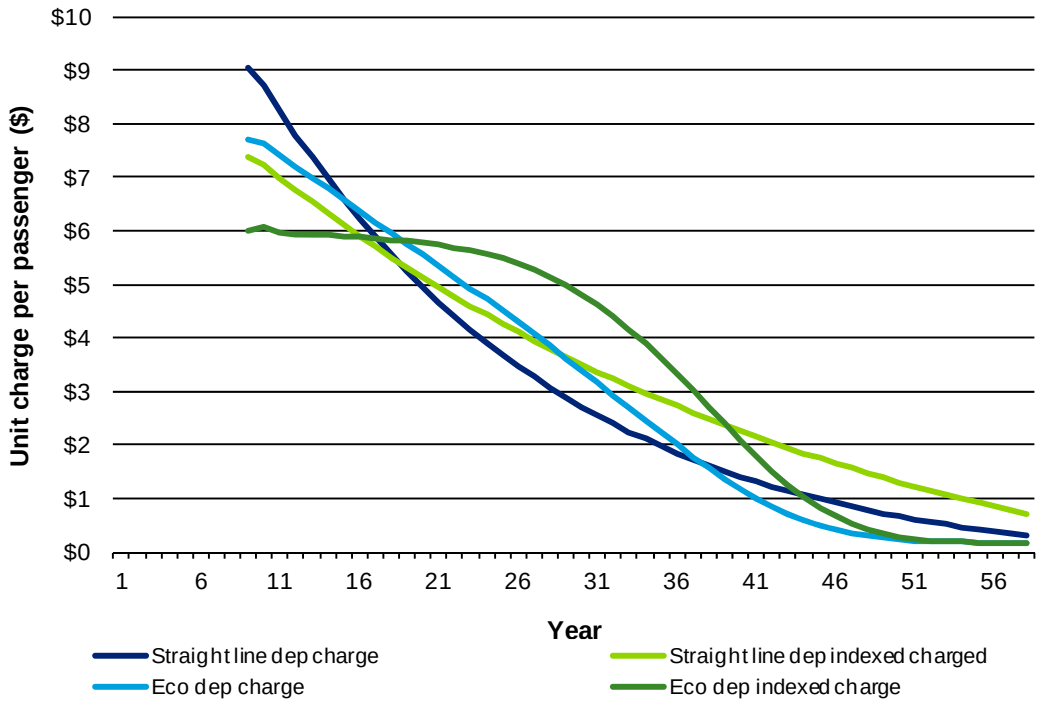


Under the building block methodology, a level of allowable revenue is set, based upon the depreciation, operating costs and return on capital. From the allowable revenue, the implied revenue per passenger (unit charge) can be calculated for each year. Differences in the depreciation schedule result in variations in the unit charge per passenger over the asset life (note that the actual charge set may differ to this unit charge in order to attempt to smooth prices). Depreciation actually influences the unit charge per passenger in two ways. Firstly, the actual level of depreciation changes. Secondly, the differences in depreciation result in different asset balances throughout the asset's life and hence the return on assets. Both of these affect the unit charges.

Figure 3.10 presents the calculated unit charges that would be required in each year in order for the allowable revenue to be achieved. The variability in unit charge is highest under a straight line depreciation schedule assuming no indexation, reaching $9 per passenger in year 9 (assuming no capitalisation of interest) the year following completion, and falling to $0.3 per passenger in year 58. Economic depreciation including indexation results in the lowest variability in unit charge and a smoother price path across the four depreciation schedules that were modelled.

Unit charges would be expected to be different depending upon the depreciation technique chosen. The presences of indexation during the construction phase of the asset results in differences in the asset value in year 9 (the year operations commence). This affects both the depreciation and return on assets component of allowable revenue, driving the difference in the unit charge in the first year of operations.

Figure 3.10: Unit Charge Required to Achieve Allowable Revenue in Each Year



The results indicate that the chosen depreciation schedule changes the unit charge imposed on airlines and passengers. The unit charge under economic depreciation including indexation reflects a more equitable pricing structure as it better reflects

the actual usage of the asset. It is expected that airlines would benefit from greater certainty and/or reduced variability in charges over the life of an airport asset, which is in part dependent on the chosen depreciation schedule by the airport. Critically the use of straight line depreciation to price a long use asset, such as a new runway, significantly penalises early users of the asset. Early users would have to pay significantly higher unit charges than later users. Whereas under the economic depreciation with indexation, unit charges are lower to start with, and initially fall slowly, before the unit charge decline accelerates at around halfway through the life. Economic depreciation creates more equitable sharing of the costs so that a greater proportion of the total cost of the runway is payable in the later years of its operation when more passengers are expected to be using the new runway.

While each of the depreciation options are NPV neutral over time, it is likely that, all other things being equal, airports would be expected to prefer to use straight line depreciation to price the airport expansions as this will increase their short term cash flows. If this occurs, airlines using the runway during the early years of its operation will bear a disproportionate proportion of the total cost of runway. This is effectively what has occurred during the life of the most recent major runway expansion in Australia at Sydney Airport and major capacity expansion investments at Adelaide, Canberra and Cairns Airports and will potentially be the case for the proposed new runway at Brisbane Airport.

3.3.4.4 Forecast Error Creating Above Regulatory Returns

All of the Tier 1 and Tier 2 airports adopt a building block methodology when setting prices for airport charges. In this methodology, airports forecast a required revenue line, which allows them to recover costs (operating costs and depreciation) as well as a return on assets. The airports use revenue and demand forecasts to calculate charges for airlines. Other regulated industries have adopted the same basic methodology. However, in other industries, which are subject to stricter price regulation, the forecasts of both costs and demand are subject to scrutiny by regulators. In the case of airports, they face no such scrutiny, and airlines must attempt to negotiate around the forecasts, often with little success. This creates an incentive for airports to under-estimate passenger forecasts. If the demand forecasts are too low, relative to actual passenger numbers, the prices charged to airlines are higher than necessary. Similarly, over estimation of costs would also lead to prices charged to airlines being too high.

Within the current regulatory framework, there is no mechanism which adjusts for the over or under recovery of revenue. Therefore, airports have the incentive to pass the risks inherent in preparing forecasts on to airlines through under estimation of passenger forecasts and over-estimation of costs. Incentive rebates on passenger growth above forecast would allow airlines to share in the benefits of stimulating markets for travel. However many airports are reluctant to provide this type of incentive without also including penalties for achieving below the forecast, This is a risk (and corresponding financial downside) that the Qantas Group already bears by its management of demand through airfare pricing.

The Qantas Group believes airports are incentivised to be systematically conservative in preparing passenger forecasts, and that airlines do not possess the countervailing market power to address this through negotiations

3.3.4.5 Uncertainty over Regulatory Modelling Process

Modelling Methodology

The approaches adopted for modelling future prices vary considerably across airports. All Tier 1 and Tier 2 airports and some Regional airports attempt to implement a building blocks methodology. However, there is no consistency in some of the basic elements of the methodologies. The traditionally recognised approach to the building block methodology is based around the development of an allowable revenue target. The allowable revenue target comprises:

- Depreciation
- Return on assets
- Operating costs
- Tax expense

Prices are then set by dividing the allowable revenue target by forecast passenger demand (or the present value of allowable revenue divided by the present value of demand). Appendix 7.3 summarises some of the key aspects of the regulatory modelling processes adopted by the airports. It is clear from the various differing building block models that some airports have a sound understanding of the regulatory building blocks methodology, whilst others appear to have only a limited understanding or are choosing to ignore key principles. Some of the key discrepancies across the models presented to the Qantas Group include:

- The approach to setting prices. Some use cash inflows and outflows and adjust input prices to achieve a targeted internal rate of return. Others develop an allowable revenue target and use demand forecasts to determine a price
- Models are mostly presented on a nominal cash flow basis, however, some airports use real cash flows and reflect changes in inflation through escalation of prices
- Forecast horizons vary significantly across the models. Some models attempt to capture the full life of the specific new assets, whilst others only forecast over the pricing period being negotiated (usually 5 years)
- Airports are also inconsistent in how they deal with assets from one price setting period to the next. For example, one model uses opening asset balance as a cash outflow and ending asset balance as a cash inflow
- Depreciation is an area of particular concern, with some airports clearly calculating annual depreciation incorrectly. Some airports' models calculate the annual depreciation charge for each new asset, but then take no account of when those assets are constructed and apply the depreciation charge for every year of the forecast horizon. Other models do not stop depreciation charges once an asset has been fully depreciated (typically an issue for shorter lived assets). This is further considered in section 3.3.4.3. There are inconsistencies in the years for depreciation for asset classes
- Most models provide very limited transparency around the asset register for existing assets, and so it is difficult to determine whether fully depreciated assets are removed from the charges calculation, or whether assets that have been replaced where fully depreciated

- There is little, if any transparency around the basis for operating cost forecasts, for example operational expenditure for capital expenditure is an arbitrary allowance for Brisbane Airport and set at [CONFIDENTIAL] of the capital expenditure cost for Sydney Airport. There is no transparency of the actual operating expenditure and no reconciliation of the over-recovery of operational expenditure. Since operational expenditure is a direct cost as part of the building block methodology it is a major driver of the unit price.
- Some models take into account tax effects (e.g. tax expense, tax shield affects from interest payments, imputation credits), whilst others do not consider tax effects at all.

The inconsistencies in the modelling methodologies have a number of implications in the setting of aeronautical charges. These include:

- The lack of transparency around asset registers and depreciation calculations mean that there is a significant information asymmetry between airports and airlines. Given the asset intensive nature of the business, the limited transparency places airlines in a weak bargaining position
- An inability to compare the methodologies across airports. This means that it is very difficult for airlines to undertake any comparison between the charges they face and the quality of assets and services that they gain access to across different airports
- Airlines incur higher than necessary costs associated with reviewing models and methodologies. Airlines need to invest time and resources to understanding the pricing methodologies adopted by airports, to assure themselves that they are either comfortable with the prices, or so that they can have informed negotiations around model inputs and parameters. Given that there is very little consistency in the methodologies, even though all attempt a building blocks approach, it becomes costly for airlines to become comfortable with the methodologies applied
- It is difficult to determine whether airports have over or under recovered relative to the published WACC. Given that some airports do not explicitly calculate the return on capital by applying WACC to the average assets, it becomes difficult to determine whether airports are earning returns on their assets above benchmark rates relative to other Australian airports, and indeed other Australian regulated industries. There is further detailed consideration of approaches to WACC below.
- The compounding effect of the issues associated with the models could result in airport charges being set above an efficient risk adjusted level. This would deliver excess returns to airports, and excess costs to both airlines and consumers

The Qantas Group believes there is a demonstrable need for a clear and agreed set of principles setting out appropriate expectations about the nature of the proper components of the building block model. Improving the consistency and transparency of the price modelling methodology adopted by airports has the potential to remove significant bottlenecks to commercial negotiations and will make the system considerably more efficient for all users.

Inconsistencies in the Components of WACC

In addition to the need for clarity around the building block methodology, there is a similar need for clarity and consistency in the calculation of airports' WACC. There are currently significant inconsistencies across the defined inputs prepared by the airports in their various WACC calculations. Although not all airports use the WACC to calculate the return on assets to be incorporated into allowable revenue, they still use WACC to benchmark the internal rate of return. WACC is often left unresolved in commercial agreements as a result of the inability of the parties to agree on appropriate inputs and methodologies.

Appendix 7.4 sets out the WACC derived by airports (and supporting parameters) and adopted in recent pricing agreements. The table draws out a number of important issues:

Inconsistency

Different types of WACC are used or are not detailed: Pre Tax Nominal WACC, Vanilla WACC, IRR, Post Tax Nominal WACC, Post tax Real WACC or plain "WACC" without a descriptor. The airports use different models with very little similarity in layout, methodology, use of revaluation and indexation, time periods for NPV calculations or depreciation (refer section 3.3.4.3).

There are some inconsistencies (and subjectivity) in the parameters used to derive the WACC. This is particularly the case for parameters for which there is generally a strong degree of agreement amongst regulators of other industries (such as the market risk premium and gearing ratio).

Four of the five price monitored airports generally adopt very similar values. However, Darwin, Canberra and Hobart, which fall outside of the ACCC price monitoring regime, along with Perth are airports which consistently select the most aggressive parameters for deriving a WACC.

Specifics of inputs where there is a need for greater regulatory certainty are set out below.

Asset Beta

The determination of an airport's asset beta is perhaps the most subjective component of the WACC and a significant driver of its value. The intent of this value is to represent the risk of the airport's aeronautical activities.

As set out earlier in this submission, and as discussed in the ACCC's 09/10 Price Monitoring Report, airlines shield airports from economic and demand volatility. Despite significant unforseen economic events during the past five years, including the swine flu epidemic, high fuel prices, the GFC and significant exchange rate fluctuations, airport demand has steadily grown as a result steep discounting of airfares by airlines.

The monitored airports have all shown an increase in earnings despite the volatility of the economy.

Asset betas employed by Australian airports should reflect previous ACCC recommendations on Australian airport asset betas, in the context of:

- Level and volatility of earnings
- Duration of pricing or pricing adjustments (the more frequent the lower the risk)

- The carry forward of any under/over recoveries; and
- Not be higher than an airline in a competitive market

Under light handed monitoring, and in the case of all other airports with no monitoring, airports have consistently increased their asset betas over time. In reality, the evidence clearly highlights that the purported risk is either overstated or it would take a financial downturn more significant than the GFC for the risk to eventuate.

Airport under or over recoveries are incorporated into the next pricing model and this leads to significant resets:

- Melbourne Airport plans to adjust its asset base due to $200m capital over expenditure without consultation with industry (refer section 3.3.4.1)
- Brisbane airport does not provide visibility of nor negotiate on Asset beta

Hobart, Gold Coast, Cairns, Darwin, and Canberra airports have significantly increased their asset betas over time (see Table 3.5), citing minimal market power and high volatility. There is little evidence to support these claims given the high prices that Hobart and Cairns airports were sold for and the passenger and revenue growth most of these airports enjoy.

Table 3.5: Asset Beta Increases Over Time

Airport	ACCC Nominated Value (2000)	Current Value
Alice Springs & Darwin	0.73	[CONFIDENTIAL]
Cairns (2002)[19]	0.7	[CONFIDENTIAL]
Canberra	0.65	[CONFIDENTIAL]
Hobart	0.7	[CONFIDENTIAL]

Airlines are exposed to competitive market forces and are hence exposed to a significantly higher level of risk. They also have long term investments in infrastructure (especially aircraft). Airport asset betas should not be as high as the Qantas Group's which is currently approximately [CONFIDENTIAL].

Gamma

There have been proposals by some airports to reduce Gamma below 50 per cent. Given that the majority of the shareholders of Australian airports are Australian companies or have Australian registered business and will be able to receive franking credits, it is unwarranted for an airport to use less than 50 per cent for gamma.

It should be reasonable that the gamma for all airports should be (fixed) between 50 per cent and 100 per cent based on their Australian ownership.

[19] Cairns asset beta not nominated by ACCC in 2000. This baseline value is taken from Cairns 2002 pricing model

Debt Margin

Airports regularly seek debt margins that are not reflective of their true cost of borrowing or are increased due to short term fluctuations in debt markets. In addition an airport's cost of debt for aeronautical assets may be unreasonably increased by its level of borrowings on non aeronautical assets.

Many airports also appear to take a very short term view of debt costs. During the GFC it was understandable that the debt margin of many airports may have increased, however, the extent to which it increased was concerning. Airlines should not be paying for inefficiencies in airport management or their inability to raise debt. Airports often only look at a recent time in history to determine the debt margin and this figure is intended to apply over a more lengthy time of 5 to 10 years. It is unreasonable to assert, as many airports do, that the funding conditions associated with the GFC will persist in the Australian market for the next 5 to 10 years.

There should be firmer guidelines for the determination of debt margins. Any reasonable calculation needs to take into account the long term nature of the assets and commercial agreements. In addition, airports should pass on their true debt margins, not 'indicative' debt funding as some seek to.

Debt Beta

WACC calculations at the commencement of light handed monitoring included a calculation for the determination of the Debt Beta. Over time, airports including Sydney and Perth have either fixed this value or set it to zero which has the effect of unreasonably increasing the WACC.

Risk Free Rate

The risk free rate should not differ significantly by airport as this is usually derived from Government bond data. Notwithstanding this, inconsistencies in the methodologies used to determine the risk free rate for WACCs occurs across a number of airports.

Market Risk Premium

The market risk premium is not readily observable in the market, however is based on the long term historical estimates of the industry. It is a generally accepted practice to select 6.0 per cent. Despite this general acceptance, some airports are selecting market risk premiums above 6.0 per cent with little or no justification.

Conclusion

The above information provides evidence that WACCs, and parameters adopted across a broad range of airports, lack consistency in their approach and application. In the absence of clear guidelines on the calculation and structure of WACCs there is a risk that some airports may be seeking to justify higher charges than would represent an efficient risk adjusted rate on their assets.

Given the significance of the WACC in calculating the recoverable revenue in a building block model, resolution and further clear guidelines would assist with avoiding protracted, costly negotiations and limit potential abuse of market power.

3.3.5 Additional Evidence of Excess Returns from Aeronautical Assets

Airports are earning excess revenues due to the split of aeronautical and non-aeronautical assets. Assets which are aeronautical are fully funded through airport charges, and so any additional revenue earned by airports from those assets should either be used to offset aeronautical charges or result in a fairer allocation of costs. Airports are also finding additional mechanisms by which they can extract revenues from assets which are essential to the provision of airline services. Examples of this conduct include:

- Assets which are fully paid for by the aeronautical till being used to generate additional revenues and are not offsetting the aeronautical charges (essentially generating revenues at almost no cost);
- Charging for services not rendered or charging for services already paid for (for example aircraft parking); and
- Imposing fees on other businesses which provide services to airlines. For example, fuel supply throughput levies. Assets are already funded by the airport or oil companies, and so to apply a through put levy is simply imposing a fee for which no new or improved assets or services are provided.

3.3.5.1 Aeronautical assets generating non-aeronautical revenues

Airports leverage aeronautical terminal assets for advertising. Key locations including passenger thoroughfares, entry points and aerobridges are utilised. Although the actual supporting frame is paid for by the airline and passenger fees the revenue generated is treated as non-aeronautical notwithstanding that the terminal building itself is providing the functional space supporting the advertising. With the growth in digital media this issue has become more significant.

A clear example of this is the generation of revenue by airports for advertising inside and outside aerobridges. Aerobridges are classified as 100 per cent aeronautical in pricing agreements and funding by airlines. However, airports are making additional returns by advertising on aerobridges and not using this income to offset the cost to airlines or consumers.

3.3.5.2 Payment for Services Not Rendered

Currently Sydney Airport experiences significant apron and gate constraints at Terminal 2 (the common user domestic terminal). On weekdays QantasLink is experiencing an average of seven arrivals and seven departures where apron space is not available at Terminal 2 and the aircraft turnaround needs to take place at Terminal 3 (on the Qantas Group Domestic Terminal Lease). As these flights are planned for Terminal 2, passengers arrive and depart through Terminal 2 and are then bussed to their aircraft at Terminal 3.

The Qantas Group receives no reduction in the cost of using Terminal 2 despite having to use the parking positions at Terminal 3.

3.3.5.3 Charging for services already paid for

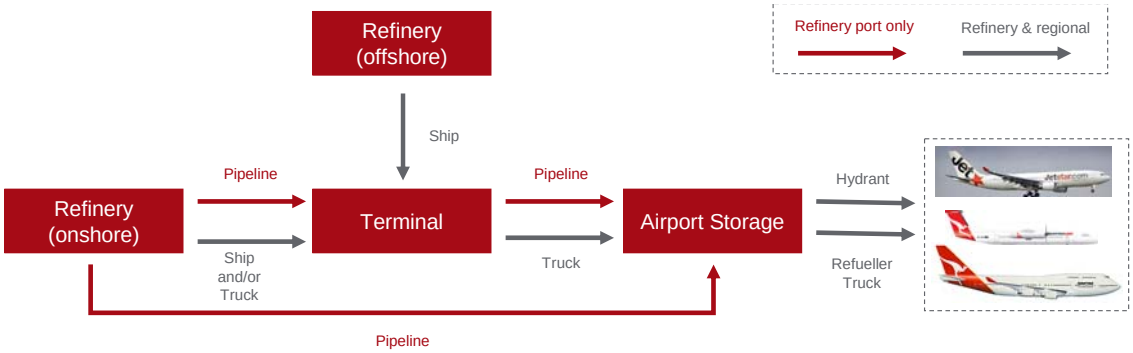
Apron space at terminals is an aeronautical asset and paid for from the allowable revenue along with all other aeronautical assets. In addition some airports charge an aircraft parking fee, which does not offset passenger aeronautical charges. These fees are for international flights at Sydney Airport and non-passenger flights

at Melbourne Airport. The current rate for Sydney International services is $35 per 15 minutes (with a proposed increase to $43 from July 2011). Melbourne only has a non-passenger flight parking charge of $31.87 per 15 minutes after 3 free hours. Currently no other Australian international airports have a parking charge.

3.3.5.4 Imposing Charges on Other Businesses

Fuel Supply and Infrastructure Charges

Figure 3.11: Schematic of Jet Fuel Product Flow



In Australia, airports provide leases and licences over airport land to facilitate fuelling of aircraft. The “on-airport” component of the fuel supply chain usually includes part of the supply pipelines from the supplying refinery or terminal, the airport fuel storage, the hydrant and into-plane delivery facilities including the hydrant and vehicle (illustrated in Figure 3.11).

The majority of Australian airports have a singular on-airport storage facility. These facilities are wholly or majority owned by oil companies and operated by oil companies.

Airports have the capability to structure on-airport fuel agreements to ensure continuity of supply and constrain costs. Below are a number of factors over which airports exert influence to impact fuel supply and costs.

Licence Fees and Rent

Oil companies are able to pass through any costs incurred as a result of the “on-airport” component of the fuel supply chain. Responsible pricing by airports can ensure these pass through costs are kept to a minimum. The revenue from these aeronautical facilities is not offset against the aeronautical charges. As this negotiation occurs between airports and fuel companies, airlines have no ability to influence the level of these charges.

It should also be noted that rental and lease charges for Air Services Australia (ASA) and Bureau of Meteorology (BOM) infrastructure at airports are also passed through to airlines and the revenues are not offset against aeronautical charges (though is included as aeronautical revenue in ACCC accounts).

Fuel Throughput Fees

An additional third party charge is the Fuel Throughput Levy (FTL) which is pursued by some airports. This directly impacts airline fuel prices, the fuel

providers pass through the cost directly to airlines as a higher fuel price and again airlines have no ability to negotiate.

In 2006 Canberra Airport introduced a FTL. The current FTL is [CONFIDENTIAL] cpl. One hundred per cent of this fee is borne by the airlines on top of the fuel costs (including licence fees/rent). This generates a return of approximately $[CONFIDENTIAL] per annum for Canberra Airport. The cost to the Qantas Group is an additional ~$[CONFIDENTIAL] per annum.

Sydney Airport is also introducing a FTL in Q4 2011. One hundred per cent of this fee will be borne by the airlines on top of the fuel costs. This will generate a return of approximately ~$[CONFIDENTIAL] per annum for Sydney Airport. The cost to the Qantas Group is an additional ~$[CONFIDENTIAL] per annum. The airport's FTL is scheduled to increase between 25-50 per cent each year from Q4 2012. Such unjustified costs, with no airline or customer benefits, are unsustainable and demonstrably unreasonable.

Despite clearly being related to aeronautical services the revenue from these aeronautical facilities is also not offset against the aeronautical charges.

Fuel Facility Relocations

Airports can ensure their master plan includes a review of the adequacy of the fuel facilities for current and future demand. Any costs of relocation of facilities are ultimately borne by the airlines. Additional land should be allocated to match projected growth.

In 2005, the Qantas Group's objection to a Canberra Airport proposal to build a new fuel depot (to move further from terminal for aesthetic reasons) was ignored. The cost of relocating the facility was $[CONFIDENTIAL].

The incidence of airports requesting on-airport storage relocation is increasing. The Qantas Group is currently objecting to the proposal of a new fuel depot at Gold Coast Airport at a cost of ~$[CONFIDENTIAL].

Licence Fees for Check-In Counters

Sydney and Melbourne Airports charge a counter usage licence fee of more than $[CONFIDENTIAL] at the international terminals. For the Qantas Group this adds up to approximately $[CONFIDENTIAL] at Sydney Airport and $[CONFIDENTIAL] at Melbourne Airport. This revenue is treated by the airports as non-aeronautical.

Some of this charge goes to the upkeep of these check-in facilities, however it is likely only a small portion of the charge.

Given this fee is over and above aeronautical fees already paid for as part of the base building facility, this is clearly excessive pricing, leveraging the fact that the Qantas Group's customers must check in.

3.4 Application of the 'line in the sand' asset valuations

Following the privatisation of airports, many airports undertook re-valuations of their assets. The revaluations were largely based on applying the Depreciated Replacement Cost (DRC) accounting revaluation methodology for airfields and terminals and using opportunity cost to value land. The revaluations were then used to justify higher aeronautical charges. This situation arose because, as noted in the Productivity Commission's 2006 review, "there was some ambiguity in the

signals given to bidders about both appropriate 'starting' asset values, and the scope to raise charges based on periodic asset revaluations".[20] The Productivity Commission concluded that it was inappropriate for periodic asset revaluations to provide a platform for increases in aeronautical charges and recommended that the review principles should be enhanced, by proscribing further asset revaluations as a basis for increasing airport charges. As a result, the 'line in the sand' provision was enacted by the ACCC in the 2007-08 financial year to promote public confidence in the post-2007 price monitoring regime and to assist the development of commercial relationships between airlines and airports by removing a continued source of conflict.

The line in the sand doctrine established a regulatory asset base for the value of tangible non-current aeronautical assets that existed as at 30 June 2005. Only revaluations booked pre 30 June 2005 were allowed to be included in the airport's aeronautical asset base used for price setting and monitoring purposes. Going forward the asset base could only be adjusted for new investment, depreciation and disposals. The valuations are not permitted to recognise any asset impairments, corrections of previous errors to the asset base, or revaluations resulting from the transition to the Australian Equivalent of International Financial Reporting Standards (AIFRS) from the Australian Generally Accepted Accounting Principles (AGAAP).

In practice, the line in the sand doctrine removes the effect of revaluations on the regulatory accounts provided by airports for monitoring purposes. This is inconsistent with statutory accounts prepared under AIFRS which include any revaluations recorded since 30 June 2005.

Even with the line in the sand doctrine, Brisbane, Perth, Melbourne, Darwin and Canberra airports, and to a lesser extent Adelaide and Sydney airports, enjoyed significant windfall gains due to asset revaluations made prior to 2005. These revaluations generated as much as a 20% return on investment. ACCC reports estimate that these revaluations have increased costs to airlines and customers by around $700m, a figure which continues to increase annually.

The line in the sand provision clearly applies to the airports subject to ACCC price monitoring (Sydney, Brisbane, Melbourne, Adelaide and Perth airports). The guidance provided around asset valuation has provided a framework price monitored airports have to adhere to, and is monitored through the regulatory financial statements submitted to the ACCC as part of the price monitoring regime. The line in the sand removed a major block in commercial negotiations between airports and airlines around the appropriate treatment of revaluations and the impact on aeronautical charges.

However, notwithstanding the benefits of the line in the sand doctrine a number of critical issues remain unresolved and open to abuse. One such issue relates to the extent to the classification of assets to which it applies. The line in the sand doctrine covers only those assets which are categorised as aeronautical, however, airport expansion or modification can lead to assets previously recognised as non-aeronautical being reclassified to aeronautical and vice-versa. For monitored airports, this may require a reversal of any revaluations for the asset that occurred

[20] Productivity Commission, 2006, *Review of Price Regulation of Airport Services*

when it was categorised as a non-aeronautical asset for the purposes of regulatory accounts.

However, the largest concern is the extent to which some airports outside the price monitoring regime appear to be ignoring the clear principles it set out with respect to using asset revaluations as a means to increase aeronautical charges. Whilst the line in the sand solution is effective in addressing asset revaluation issues for the airports subject to price monitoring, there are two situations in which it is unclear whether the line in the sand would apply or not:

- **Airports outside the price monitoring regime:** Given that these airports face virtually no regulation and are not monitored, they can potentially employ revaluation tactics to justify increases in charges. Such behaviour has been evident at airports ranging from major capital city airports to Regional, council owned airports. It is important that the Government makes clear that it considers the principles behind the line in the sand doctrine are intended to extend to all airports. Similarly, it should be made clear that aeronautical infrastructure which has been funded via government grants (rather than by airports) should also be excluded from asset valuations. If this is not specified by governments the public pays twice, through tax revenue and then through airport charges.
- **Sale of an airport and the transfer of ownership from one owner to another**: Given the limited guidance around the application of the line in the sand, it is unclear whether line in the sand valuations would apply in the instance of a change in ownership. This presents a particular risk at Tier 2 and Regional airports which have been attracting private sector interest.

The case of Hobart Airport in Example 3.12 illustrates both of these situations.

Example 3.12: Aeronautical Asset Revaluation

Aeronautical Asset Revaluation at Hobart Airport

- Hobart Airport was privatised during the first wave of airport privatisations in 1997 for $35m
- It was sold in 2007 to a consortia majority controlled by Macquarie Group Managed Funds for $350 million
- With airfield and terminal prices expiring on 30 June 2010, discussions were held with the airports about a new price path
- The new owners had undertaken a building block review of the entire airport and concluded that there had been a "historic under-recovery" and as a result proposed a price increase going forward of over 58 per cent over five years. The historic under recovery was said to be a failure to include the value of the aeronautical land at the time of the original sale
- Unlike most airports the increase was not driven by significant new capital expenditure but rather by a revaluation of existing assets leading to a higher allowable revenue
- The Qantas Group sought information from the airport on the basis of the charges and received an excerpt of the Ernst & Young valuation report that claims to justify the increase
- The Qantas Group strongly objected to the level and basis of the proposed

increase as asset revaluations are not an appropriate methodology for increasing charges

- The Qantas Group continued to negotiate with Hobart and did reach a commercial agreement in late 2010. [CONFIDENTIAL]
- When such practices are being employed by capital city airports it highlights the need to clarify that a common minimum set of principles should apply to all airports with respect to setting aeronautical charges.

In its 2006 review, the Productivity Commission concluded that there was no case for extending the monitoring regime to Tier 2 and Regional airports due to market competition and the bargaining power of airlines. It will be evidenced in section 3.4.5 that the assumption of airlines countervailing market power does not hold and that non-price monitored airports may be completing 'costless' revaluations which are flowing through to increases in airport charges.

These increases continue to be an issue for the Qantas Group during commercial negotiations and are impeding the development of commercial relationships between these airports and airlines. There is an increasing need for the Commission to review aeronautical asset revaluation practices at all airports currently not subject to the existing line in the sand provision, or provide clearer guidance as to which airports are or are not covered by the provision, and how it would apply in the case of change in asset ownership.

3.5 Evidence of market distortions at regional airports

Regional airports fall outside the scope of price monitoring and, as such, are not currently bound by any guidelines or regulatory framework. Many of these Regional airports have grown significantly since deregulation, and their bargaining power now rivals that of the major capital city airports. This is particularly the case at those airports that have benefited from the commodities boom and the shift to the use of fly-in fly-out workforces. The market power of these airports is further enhanced by their location in regional areas where limited competition from other nearby airports exists and no viable alternative transport modes exist. This is evidenced in various centres in Queensland and Western Australia that have experienced significant growth due to mineral processing and exploration activities. Passenger volumes at many of these airports have more than tripled since airport privatisation. In the absence of any scrutiny, Regional airports have little incentive to reach commercial agreements with the airlines when the imposition of charges is often more advantageous.

Although Regional airports are not explicitly included in the terms of reference, the Qantas Group believes that the bargaining power they hold is a reason for their consideration by this inquiry.

The Qantas Group's experience with Regional airports is best typified by a lack of consistency in approach. Some operators treat the local airport as a source of cash flow for non-aviation purposes and some have development plans well beyond foreseeable demand. Other airports have re-valued their assets either directly or through the sale of the airport. For some of these airports consultation with airlines is an afterthought. For example, airlines may receive a letter advising of a new

charge or development with no intention to consult or invitation to negotiate. Lack of transparency around airport charges is an issue constantly faced by airlines.

Whilst the cost of the distortions at an individual level may appear small relative to the total cost of airport access in Australia, the net impact of the current unregulated environment to airlines and the travelling public is significant, particularly when the administrative burden of having to undertake detailed negotiations with around 40 regional airports is taken into account.

Several case studies are presented here to illustrate ways in which the current lack of consistent process is leading to behaviours from the airports which may have negative impacts on airlines, the travelling public and the potential development of the local and national economy.

Whilst specific airports have been used to demonstrate certain issues, there are often other airports with similar behaviour that could equally have been chosen to illustrate the point. Some of these examples also highlight the issue of inefficient pricing described in section 3.3.3.

3.5.1 Airports with significant passenger growth

Over the past decade the Qantas Group has been working closely to support the expansion of the resource industry in Western Australia and Queensland. Western Australian ports such as Karratha, Kalgoorlie, Port Hedland, Broome, Paraburdoo and Newman as well as Queensland ports such as Townsville, Mackay, Mt Isa, Emerald and Gladstone have seen significant passenger growth as both the fly-in / fly-out workforce and the local communities in these areas have grown.

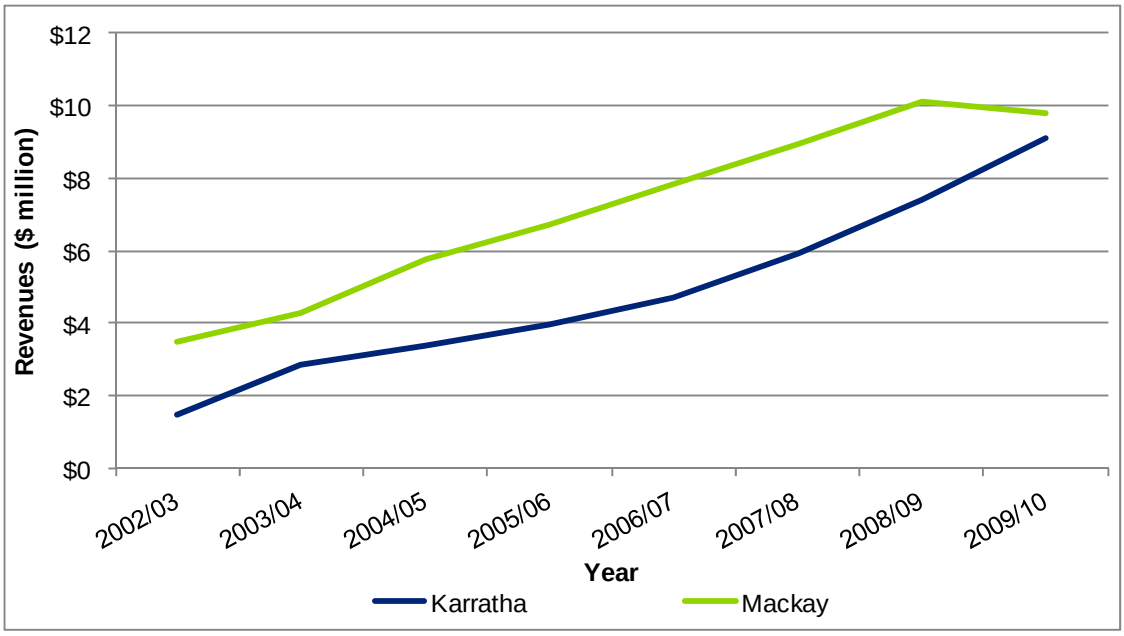
Passenger growth in many of these ports has been substantial, with several ports achieving double digit growth year on year over this period. The Qantas Group has made significant investments in this growth. In Western Australia the Qantas Group replaced 64-87 seat BaE146 aircraft with a mix of 115 seat B717s and 168 seat B738s and added significant frequency with additional aircraft. The Qantas Group has also pioneered new routes from Brisbane, Sydney and Melbourne to Karratha, Adelaide to Kalgoorlie and Melbourne to Port Hedland. In Queensland QantasLink up-gauged turbo prop aircraft from 36 seats to 50 and then to 74 seat Q400s and added frequency. Jetstar has also added capacity on routes such as Mackay and Townsville.

With this growth some airports have needed to add infrastructure, while others have had sufficient capacity available. Regardless of this, the most common mechanism for adjusting pricing in these areas appears to be a CPI related increase in landing fees and passenger charges. This has led to airport revenues increasing at a pace well ahead of the operating costs of the airport. A fairer process would see savings in average operating costs from increased passenger numbers benefit airlines (and therefore the passenger).

The graph below, for Karratha and Mackay, shows the Qantas Group estimates of the revenue received from landing fees and passenger charges at these airports

over time. These estimates are conservative as the 2010 Karratha revenues are below the numbers quoted in the Shire of Roebourne 2011 budget[21].

Figure 3.12: Estimated Passenger and Landing Fee Revenues at Mackay and Karratha



These increases in revenue are substantial. Based on these estimates Karratha has had a 29 per cent compound annual growth rate in revenue, while Mackay's growth over the period is estimated at 16 per cent per annum. This would likely have been higher without the global financial crisis impact on 2009/10. As a point of reference on the magnitude of this growth, the Shire of Roebourne's 2011 budget shows that revenue from Karratha Airport charges and leases is forecast to equal total revenue from rates (both around $18.5m)[22].

Under the current regulatory regime this revenue growth will remain uncapped, whereas under a typical building block methodology it would be expected that revenue growth would stabilise once the maximum allowable asset charges had been reached. While the Qantas Group is not in a position to definitively say that these airports are achieving returns on capital which are significantly above appropriate benchmarks, the fact they were operating with revenues $6m-7m below current levels only seven years ago suggests this is highly likely and deserves careful scrutiny.

3.5.2 Lack of Transparency

It has been the Qantas Group's experience that Regional airports predominantly do not, and have not, provided reasonable cost transparency to support pricing

[21] Shire of Roebourne Annual Budget 2010-11 p121 from http://www.roebourne.wa.gov.au/assets/documents/document%20centre/Annual%20Budget%202010-11(785).pdf accessed on 25 Mar 11

[22] Shire of Roebourne Annual Budget 2010-11 p86 and p121 from http://www.roebourne.wa.gov.au/assets/documents/document%20centre/Annual%20Budget%202010-11(785).pdf accessed on 25 Mar 11

adjustments and believe it is their right to levy charges as they deem appropriate. Often, airports do not shy from pointing to the apparent flaws in the current regulatory arrangement as justification for their behaviour.

> *'…we will not be disclosing the information (Qantas) has sought as there is no statutory requirement for us to do so'. – Broome Airport*[23]

In the absence of information that would otherwise allow airlines to assess the reasonableness of proposed increases, the validity of potential increases also becomes questionable. With airports unwilling to engage with airlines or provide adequate levels of transparency, the Qantas Group has significant concerns that the sum of over $[CONFIDENTIAL] it spends on regional airport charges annually is being used in an inefficient and ineffective manner.

Under the existing regulatory arrangements airports have no obligation to apply airport charges in a consistent and transparent manner. In the absence of competitive pressures, this enables airports to set arbitrary prices with negligible threat of punishment. Airports are aware that a threat to pull services is not credible or viable particularly if airlines need to compete for contract business within the port. In reality airlines do not possess countervailing market power despite claims made by airports such as Canberra and Darwin in their 2006 submissions to be removed from ACCC monitoring.

Port Hedland Airport has introduced new charges yet cannot confirm what expenditures are funded by these charges. Upon the Qantas Group's request for detailed data to undertake a full commercial assessment of the Town of Port Hedland's pricing proposal, the airport has advised that *'the Town is unable to provide all the data requested'*[24]. However, this has not prevented the Town from proceeding to demand price increases to fund these costs. '*Council will be invoicing Qantas landing fees and passenger service charges in accordance with the adopted fees and charges within its 2007/08 budget and expects payment in full*[25]*.'*

Further to this, the Airport has applied CPI adjustments inconsistently, and in a manner favourable to the Council with little evidence as to the justification. Internal Qantas Group documents show that *'the applied CPI favours an increase in revenue to Council of 3.4% (March quarter CPI) to 2.1% (December quarter CPI) despite Council admitting the inconsistency'*[26].

Kalgoorlie-Boulder Airport has also provided inadequate justification for its aeronautical charging variations. Despite airport revenues increasing by over 55 per cent since 2002-03, the airport continues to apply CPI increases without explanation or transparency detailing the drivers to cost increases. While the Qantas Group has expressed disappointment that *'Council has taken the approach to broadly increase fees and charges without consulting the airline community'*[27],

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[23] Email from Broome Airport to Qantas 28 April 2008

[24] Letter from Town of Port Hedland to Qantas seeking information about the justification for proposed increases in charges 20 July 2007 p1

[25] Letter from Town of Port Hedland to Qantas 20 July 2007 p2

[26] Letters from Qantas to Town of Port Hedland 2 Sep 2010 and 1 Jun 2010

[27] Letter from Qantas to Kalgoorlie Council 09 Dec 2010

the airline has *'yet to receive any modelling which demonstrated how the base Terminal Service Levy and Aircraft Landing Fees are calculated*[28]*'*. In the absence of any evidence of significant capital enhancements, the Qantas Group can only conclude that unreasonable market power is being exercised and that prices are set at a level above the efficient risk adjusted cost of providing and operating the aeronautical assets, and are used to charge revenues for non aeronautical purposes. This is backed up by the Kalgoorlie Airport Competitive Neutrality Report (commissioned by Kalgoorlie Council) which identifies, among other findings, that '*The airport may be seen as unfairly taking advantage of its local government ownership*[29]*.*'

3.5.3 Imposition of Charges and a Refusal to Consult

Certain airports not only fail to provide any transparency of charge increases but also refuse to enter into any discussions with airlines around these fees. A reluctance to work towards a commercial agreement is evident at Longreach and Nhulunbuy (Gove) Airports. Following a request for cost transparency and agreement regarding a new pricing increase, the Qantas Group received the following advice:

> *'Council is not reliant on an agreement with users of the airport, including QantasLink, in setting its fees and charges for the use of Longreach Airport. …the fees and charges as previously advised to you will apply from the 1st of July 2008 as previously advised regardless of your assertion to the contrary'*[30]*. – Longreach Airport*

> *'The Corporation will not be altering the proposed fee changes and will be implementing them on the date mentioned in our letter. Furthermore, it sees no value in discussing the matter when Qantas clearly seeks to look after its own interests and does not appear to want to further develop the relationship…We see the information used to determine the price changes as commercial in confidence and therefore not for release.'*[31] *- Nhulunbuy (Gove) Airport*

This refusal to consult is sometimes accompanied by suggestions that the Qantas Group withdraw services should pricing increases not be accepted, further highlighting the heavy handed manner in which regional airports are exerting their power in the market.

> *'Council wishes to re-iterate that the correspondence to QantasLink in March 2007 advising of a rate change was not a proposal. It was purely an advice to QantasLink that should it continue to operate services to/from Port Macquarie from 1 July 2007, the rate will be $16/passenger'*[32]*. – Port Macquarie Airport*

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[28] Letter from Qantas to Kalgoorlie Council 23 Sep 2010

[29] Competitive Neutrality Review of the Kalgoorlie-Boulder Airport for the year ended 30 June 2009 p 3

[30] Email from Longreach Council to Qantas 6 May 2008

[31] Letter from Nhulunbuy (Gove) Corporation to Qantas 7 Mar 2011

[32] Email from Port Macquarie Hastings Council to Qantas 16 Jul 2007

While some airports have displayed a willingness to consult with airlines to reach a commercial agreement, the Qantas Group continues to experience significant difficulties in engaging with each of the remaining remote and regional airports. The airline also continues to harbour concerns around transparency with each of these airports; in effect, passenger charges from almost 20 per cent of the passenger market are enforced with little to no transparency. This increases the cost of flights to rural and regional areas and harms these communities and the travelling public.

3.5.4 Airports Developing Infrastructure in Excess of Airline Requirements

The Qantas Group has experienced dealings with several airports which have embarked on capital developments which were either not agreed to by airlines, or which expanded dramatically from an initial plan agreed to by airlines.

Bundaberg and Gladstone airports both recently upgraded their runways from turbo-prop only to jet capable. In both instances the upgrade resulted in the Qantas Group incurring significant increases in airport charges.

At Bundaberg the Qantas Group was concerned that at only 286 kilometres from Brisbane and with limited market demand from further away such as Sydney, the economics of the jet capable runway would be difficult. Over these short distances turbo-prop aircraft have a significantly cheaper cost of operation per passenger than jet aircraft, and jets are generally only used when passengers numbers are so high that there isn't another alternative, or where there is significant demand for the product differential of the jet, such as on the similar length Sydney to Canberra route. Bundaberg have listened to the Qantas Group's concerns to a degree, and have agreed to apportion the costs for the runway into costs associated with a significant (required) upgrade and maintenance program to allow continued operation of the existing Q400 aircraft, and the costs required beyond this to make the runway jet capable (additional width and length). They have also agreed to step up the charges over a five year period, with a provision in the pricing agreement that if a new carrier enters the market and takes passenger volumes beyond the growth assumed in the model this can trigger a mid-term review. The cost for this is significant though with the fee paid by each arriving and departing passenger (excluding security fees) increasing from approximately $8 in 2010 to an eventual $20.10 in 2015. Although the Qantas Group was able to achieve a partial compromise, the increased cost is significant to passengers over such a short sector and the Qantas Group believes the extent of the expansion project was not justified by any likely immediate demand for jet services.

Gladstone is further from Brisbane at 433 kilometres, and just into the range where jet operations can compete with a turbo-prop. The Qantas Group was supportive of the initial proposal to expand the capability of this airport, particularly due to the growth of the resource industry in this area. The Qantas Group' concerns grew however with the cost of the expansion put at a staggering $65m. These concerns were exacerbated by a proposal for part pre-funding along with a lack of consultation on both the price and the operational impacts of the construction period. The passenger fee at Gladstone was $10.45 in 2008. This was increased to $16.50 in 2009 even though the cost of the development was not final, tenders had not been considered and a start date had not been set for the work. From 2010, with the runway expansion complete, this fee increased to $27.50 (including full security screening). The Qantas Group's attempts to negotiate a more balanced or time adjusted charge were met with feedback that the charges were justified by

Queensland Treasury modelling, and that councils have the right to set fees in their own jurisdiction. There is no provision to reset the price if passenger growth is significantly above that forecast.

3.5.5 Shortcomings of Current Arrangements for Regional Airports

The current regulatory environment fails in that it provides no mechanism for airlines to address, much less resolve the issues identified. The result is higher fares and/or lower services for regional communities, a transfer of profits from airlines to airport owners and the introduction of major negotiation cost burden for airlines across a network of over 40 airports.

The lack of an appropriate price monitoring mechanism for Regional airports leaves airlines with inadequate recourse to abuses of market power. It also has the potential to damage the viability of critical services to regional areas.

Additionally, with many regional airports owned by local councils, local government legislation also fails to offer any restrictions upon airports leveraging their monopoly power. Local government legislation in remote centres was not created with the intention of promoting an efficient aviation market, and often explicitly favours the airport owners they represent. The Council of Kalgoorlie-Boulder also identifies that:

> *'local government-owned airports throughout Australia are not subject to the Airports Act 1996 or its regulations and until the law changes in that regard we will continue to operate as we always have.*
>
> *In making decisions with respect to its fees and charges schedule (including those relating to the airport), the Council (and any other local government body in the State) needs only to comply with the provisions of the Western Australian Local Government Act 1995.*
>
> *In terms of the LGA, s6.17 deals with the setting of fees and charges and subsection (3) substantively states that the basis for determining a fee or charge need not be limited to the cost of providing the service or goods[33].' – Council of Kalgoorlie-Boulder*

Some airports can require the Qantas Group to collect moneys that are unrelated to Aviation. An example of this is on Lord Howe Island, where the Lord Howe Island Act 1953, Section 15, allows the Lord Howe Airport Board to:

> *'make, demand, levy and recover such charges and fees as may be prescribed or where no charge or fee is prescribed such charges and fees as may be fixed by the Board[34]'.*

The particular levy in question is an environmental levy which is charged in addition to the normal charges that are required for the operation of the airport. The levy was previously collected by Council staff at the airport but because this caused '*consternation and angst*' amongst passengers Qantas was asked to collect on behalf of Lord Howe Island (in return for a small discount on landing fees). This has the effect of increasing the face value of the ticket by the amount of the levy,

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[33] Email from Kalgoorlie Council to Qantas 25 Aug 2009

[34] Letter from Lord Howe Island Board to Qantas 10 Jan 2008

making Qantas seem expensive to passengers. This levy is then used for non-aeronautical purposes:

> *'(the) Levy was not specific to airport operations and that is covered a range of services that directly benefit all visitors to the Island. These include the provision and maintenance of walking tracks in the Permanent Park Preserve, removal of recyclables and other waste from the Island …[35]'.*

In certain regional centres with large fly in fly out workforces, Councils are facing increased pressure to provide essential services and infrastructure with a diminishing ratepayer base. However, increasing airport charges is not the most efficient or equitable way in which to address this problem. It also has the potential to damage these communities which rely upon air travel for essential trade and services

3.6 Overall Conclusion on the Effectiveness of Current Regulatory Regime

The evidence presented throughout this section highlights the requirement for a robust regulatory framework governing the conduct of all airports, not just those in Tier 1.

When light-handed regulation was introduced, it was envisaged that the provision of aeronautical services would be primarily determined through commercial negotiations, with airports also subject to potential re-regulation. The light-handed approach has clearly been ineffective in influencing monitored airports' behaviour and the competitive pricing of their aeronautical facilities and services.

The Government's Aeronautical Pricing Principles were also intended to serve as a guide for pricing of aeronautical services at the non-monitored capital city and larger regional airports. Instead, many non-price monitored airports can and do undertake approaches to pricing that are not consistent with behaviours that would be undertaken by a service provider in a competitive environment.

In assessing the presence of countervailing market power at Australian airports the Productivity Commission found that the countervailing power of airlines in their dealings with major capital city airports appears limited. For smaller airports, airline countervailing power is likely to be stronger, due to the commercial strength of major airlines relative to smaller airports, the market segments served by those airports and greater scope for airport competition[36].

This assumption that airlines possess countervailing market power when dealing with smaller airports is invalidated by the evidence provided in Section 3.5. A growing number of Regional airports are exploiting their market power by arbitrarily imposing charges and refusing to justify pricing increases. In most instances, it is unclear whether charges are related to the actual cost of service provision. It is likely that costs are being over-recovered in some instances, and revenues directed towards non-aeronautical activities. Withdrawing services to these airports is not in the interests of the public, the airport or the airline

Whilst Tier 2 and Regional airports are not included in the terms of reference of this inquiry, the Qantas Group believes that the market power exercised by these

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[35] Letter from Lord Howe Island Board to Qantas 10 Jan 2008

[36] Productivity Commission, 2002, *Review of Price Regulation of Airport Services*

airports and the lack of airlines' countervailing power when negotiating with them is reason for this inquiry to consider their inclusion in a more prescriptive and binding regulatory framework.

The Qantas Group acknowledges that a one size fits all regulatory approach would be inappropriate for all airports, however, it is essential that mechanisms are created to ensure clearer, more comprehensive and binding guidelines govern negotiations between airlines and airports. This will ensure airport charges are a reflection of an airport's investment in aeronautical infrastructure and improvements in services and balance the interests of airports, airport users and importantly, the customers who use airport facilities and services.

4 Impacts on Airlines and Consumers

4.1 Introduction

In the previous section, evidence has been presented demonstrating a number of issues that have arisen under the light handed framework. Airports' market power is enabling them to generate excess returns from their aeronautical assets. There is also evidence that inefficiencies are arising in the delivery of capital projects and in negotiations with airlines. The excess returns and inefficiencies that are being observed under the current regulatory framework suggest airport charges are above the competitive level, which has a negative impact on airline and passenger welfare.

The Qantas Group has developed a framework that can be used to assess the welfare impacts of airports market power and the resultant price distortions. The framework established involves:

- Outlining the economics of the aviation industry, and the mechanisms which influence the pass through of costs to passengers
- Developing econometric models that estimate the response of airlines to increases in airport charges and the response of passengers to changes in the average airfare (i.e. elasticities of demand)
- Estimating welfare impacts from the calculated elasticities

The framework presented in this chapter demonstrates some of the welfare losses that arise for each $1 increase in airport charges at Sydney, Melbourne, Brisbane, Perth and Canberra airports. The results indicate that further tightening of the light handed regulatory framework can be justified on the basis of the significant welfare gains that could be achieved.

4.2 Economics of the Aviation Industry

Airports' aeronautical assets are one of many inputs an airline draws upon in delivering its service offering (air transportation) to customers. Consumers do not directly purchase services provided by airports' aeronautical assets, they simply rely on airlines to do this on their behalf. In economic terms, an airport's aeronautical assets are a factor of production that airlines use to deliver air transportation services to consumers (both passenger and freight). This relationship has important consequences when considering the impact of changes in airport charges (aeronautical charges), as airports do not directly face consumer demand. Airlines face consumer demand, which in turn generates airline demand for airports' aeronautical assets. Airports' price elasticity of demand is not a consumer price elasticity of demand, it is rather a 'factor of demand elasticity'.

The indirect relationship between consumers and airports means that, when airports increase their charges, the change that the end consumer sees in airfares is not necessarily equal to the change in airport charges. The pass-through of airport charges to consumers is defined by two types of pass-through:

- The pass through of airport costs on the price that airlines pay to airports
- The impact of higher airline costs on the airfares that passengers pay to airlines

The degree to which increases in airport charges are passed-through to consumers is determined by three broad forces:

- The ability of airlines and airports to significantly change supply
- The type of competition (e.g. monopoly, oligopoly or perfect competition)
- How demand reacts to price (or the price elasticity of demand)

4.2.1 Ability to Significantly Change Supply

If airports or airlines are unable, or unwilling, to change their supply in response to the imposition of a cost then the pass-through of costs into higher prices will be zero. This broad driver of pass-through is likely to be more relevant to airlines than to airports, since airlines have direct control of the load factors that they target and the number of seats and frequencies that they choose for certain routes. Airports conversely do not have the same supply levers although they can lobby to reduce curfew times or the degree of separation of aircraft, and they can make decisions to spend money to change the capacity within terminals. The dynamic related to zero pass-through in a supply constrained world is presented in Figure 4.1 below.

Figure 4.1: Zero Pass-Through of Costs when Supply is Fixed

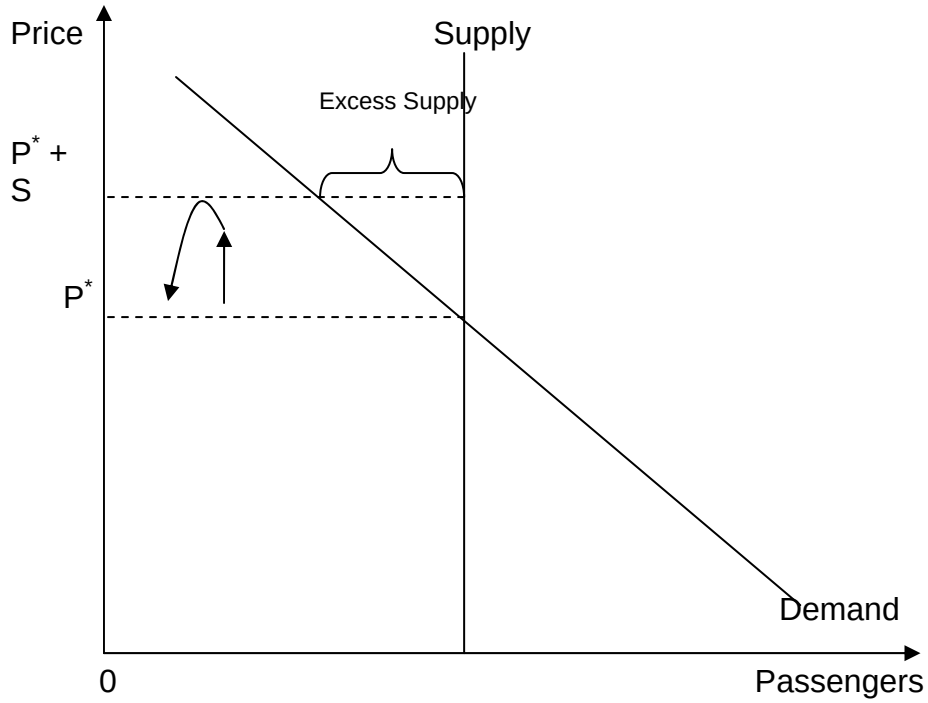
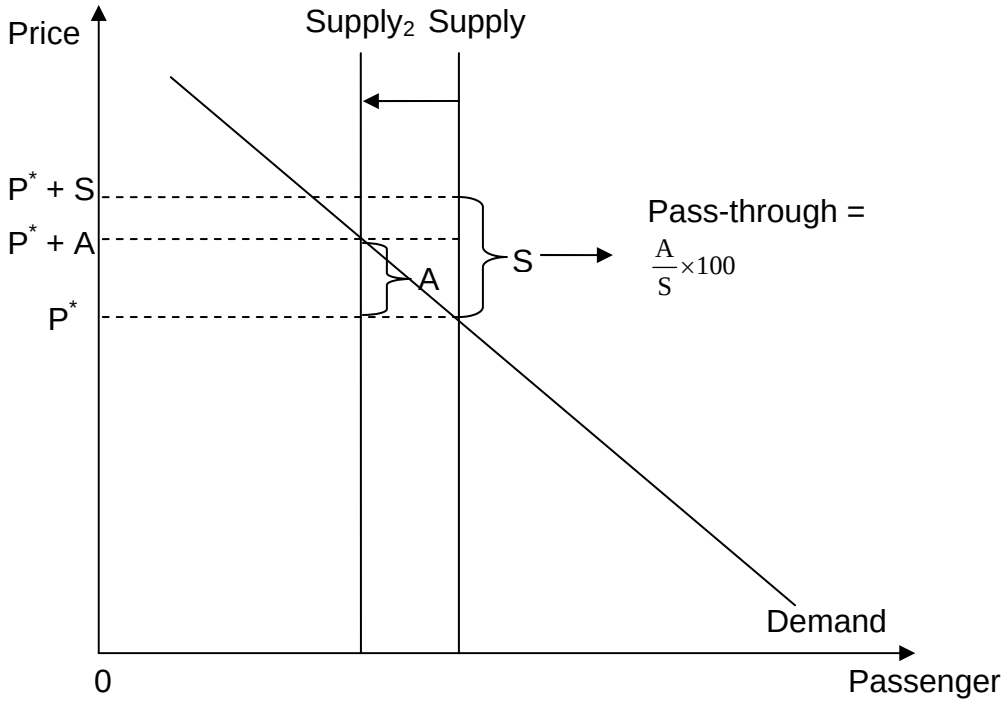


Figure 4.1 illustrates the zero pass-through of costs when supply is fixed. An airline which attempts to raise the price from the initial equilibrium level (P*) by surcharge amount S simply creates excess supply. This is because an increase in price leads to lower demand, and because supply is fixed demand is less than supply. To restore equilibrium the price must fall in order to re-stimulate demand to the fixed supply level. This requires that the price falls back to P*, which is the original equilibrium level. The prices that passengers pay therefore remain unchanged, so pass-through is zero.

It is only when airlines have the ability to reduce supply that they have an opportunity to pass-through costs to passengers via higher prices. Figure 4.2 below indicates that a reduction in supply from $Supply_1$ to $Supply_2$ reduces the excess

supply created by the imposition of the surcharge. Instead of falling all the way back to P*, the new excess supply only forces the price back to P* + A. The addition to the equilibrium price A divided by the surcharge S represents the percentage pass-through of the surcharge. This demonstrates that over the long term, when airlines are able to vary supply in response to increases in airport charges, they are able to pass-through some fraction of the increase in charges.

Figure 4.2: Pass-Through of Costs when Supply is Variable



However, ordinarily airlines do not have an ability to reduce capacity. In reality, airlines operate a network of routes. They have a fixed capacity which they operate across this network of routes. The network of routes provides airlines with some ability to vary supply over the short to medium term (but not the very short term when airlines have pre-sold seats and have established defined schedules), but they can not alter the number of aircraft in their possession (total capacity), how far those aircraft can fly and the importance of the particular port to the airline's network.

Therefore, in response to an increase in airport charges an airline is only able to pass-through a proportion of the increase in charges through a reallocation of supply across routes and thus airports. The degree of re-allocation depends on the:

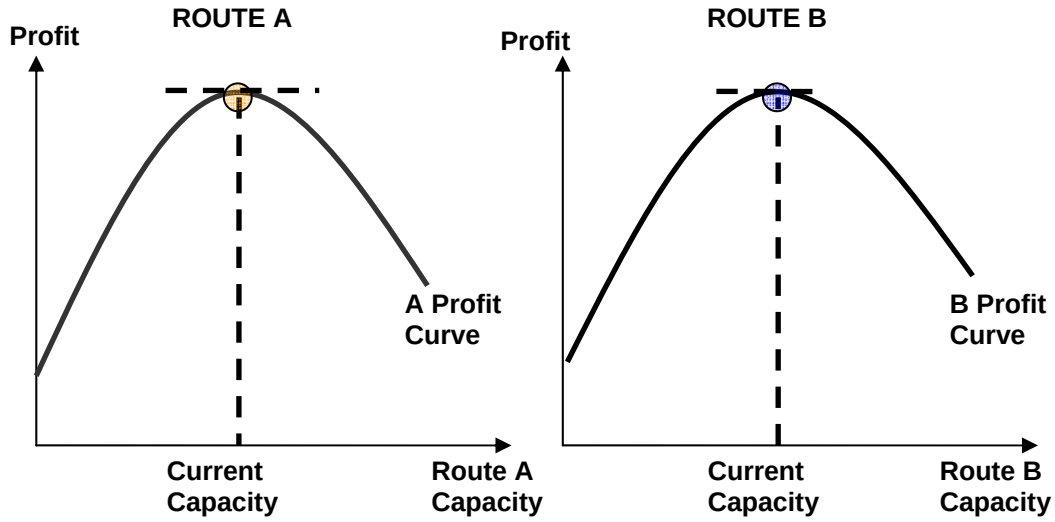
- Extent to which yields increase on route A and decline on route B
- Extent to which costs increase on route B and decrease on route A
- Reaction of competitors on route A and route B.

Figures Figure 4.3 and Figure 4.4 illustrate an airline's response to an increase in airport charges. In Figure 4.3, the hypothetical profit function graphed against capacity of route A is on the left and that for route B on the right. In equilibrium the airline pursues profit maximisation across the two routes by choosing the

uppermost point on the profit curves as circled.[37] At these circled points the airline has made the optimal decision about the aggregate capacity across both routes, and the optimal decision about how the capacity is allocated across the two routes.

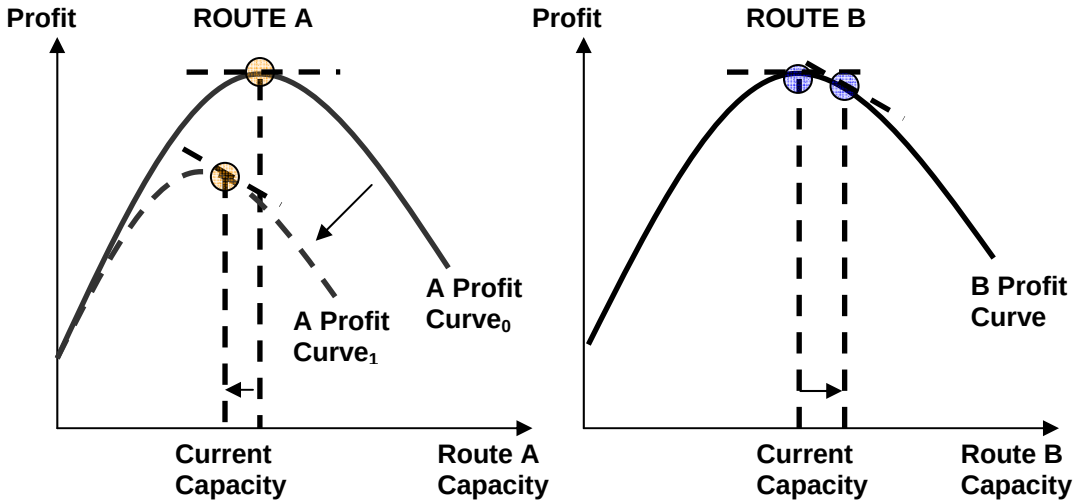
Figure 4.4 simulates an increase in average variable airline costs in the case of route A as a result of higher average aeronautical charges. This shifts the profit function for route A in and towards the origin. The route B profit function of the airline is assumed to remain unchanged because the average aeronautical charges relevant to that route remain fixed. If the airline, sub-optimally, wishes to keep aggregate capacity fixed then the optimal allocation of capacity across the routes will involve a transfer of capacity from route A to route B. This transfer will take place up until the points at which "marginal profitability" is equalised across the two routes. This occurs when the slope of the profit function is the same across the two routes. In this case it occurs to the right of the turning points on both profit functions.

Figure 4.3: Capacity Allocation before an Increase in Route A Airport Charges



[37] The profit functions in capacity are strictly concave because of the concavity of the revenue functions across the two routes. This concavity is the result of yield that is decreasing with capacity growth (ie an increase in capacity dampens yield).

Figure 4.4: Capacity Allocation after an Increase in Route A Airport Charges



Over the longer term, airlines have more ability to change their supply of seats through their capital investment (or capital replacement) decisions. However there are two sets of behaviours that characterise aviation markets and have constrained the degree of pass through over the longer term:

Airlines are highly reluctant to be the first supply "reducer" in response to higher costs by virtue of the fact that they are highly reluctant to concede market share

There are a number of Government-owned airlines that compete in the international Australian market that attempt to maximise the volume of capacity through their hubs as opposed to airline profits - capacity reduction strategies in response to higher costs are inconsistent with this objective.

4.2.2 Type of Competition and Pass Through

As discussed above, the degree of pass through will depend on the intensity and type of competition. The degree and type of competition determines the extent to which profit maximising airlines will reduce capacity in response to higher airline costs (in this case as a result of an increase in airport charges).

In a perfectly competitive market 100 per cent pass-through of costs will occur over the long term. This follows from the fact that less than complete pass-through will eventually result in incumbent firms experiencing losses, which will result in exit from the industry until the price increases to the complete pass-through level. The closer a market is to a monopoly the more it is likely that pass through will gravitate to 50 per cent.[38] The less than complete pass-through outcome for a monopolist is a result of the fact that the monopolist sets price in the elastic zone of its demand curve and is concerned that if it raises price too far in response to an increase in costs then the demand reaction will be unprofitably large. Therefore, the proportion of an increase in airport charges that an airline can pass-through lies somewhere between 50 per cent and 100 per cent.

Competition takes a number of different guises in aviation, for example:

[38] The 50% pass-through outcome is a property of a classical monopolist with a linear demand curve.

- The number of airlines that compete along a route or the number of airports that compete in a geographical catchment. Generally, the greater the numbers of firms competing in a market, the greater the competition and hence the greater the pass-through
- The extent to which price is the most important strategic variable along a route, especially vis-a-vis other strategic variables such as brand, frequency, network coverage and connectivity, on-time performance and safety. In the Australian airline industry, two distinct offerings have emerged, a full service offering and a low cost offering
- The extent to which substitutes exist for air travel on routes. For example, road and rail travel are substitutes for air travel on routes that involve relatively short sectors. With the presence of substitutes, the pass-through of an increase in airport charges will be more subdued than if no substitutes existed
- The objective functions of the carriers that compete in the relevant market. Airlines (and airports) are owned by both private investors and governments. Private investors will attempt to maximise profits, whereas Government owners will attempt to maximise the weighted average profits of the airline (and/or airport) and the welfare of the economy (derived through net tourism inflows). The greater the presence of Government owned airlines (and/or airports), generally, will lower the degree of pass-through of an increase in charges.

A high level assessment of the competition in the Australian airline market is provided in Table 4.1. Based upon this assessment, competition in the Australian airline market can be characterised as oligopolistic competition. However, it is likely to vary by route (where the number of providers may vary) and between domestic and international flights. This would suggest that pass-through by airlines of an increase airport charges will be less than 100 per cent.

Table 4.1: Assessment of Competition in the Australian Airline market

Criteria for assessing competition	Monopoly	Perfectly Competitive	Australian Airline Market
No. of buyers and sellers	Single Seller	∞	Low number of sellers
Barriers to entry and exit	High	Low	Low
Perfect information	✗	✓	○
Profit maximisation	✓	✓	Domestic – ✓ International - ✗
Homogenous product	✗	✓	✗
Increasing returns to scale	✓	✗	✓
Degree of Pass Through	50%	100%	50%>pass-through<100%

4.2.3 Reaction of Demand to Price (Price Elasticity of Demand)

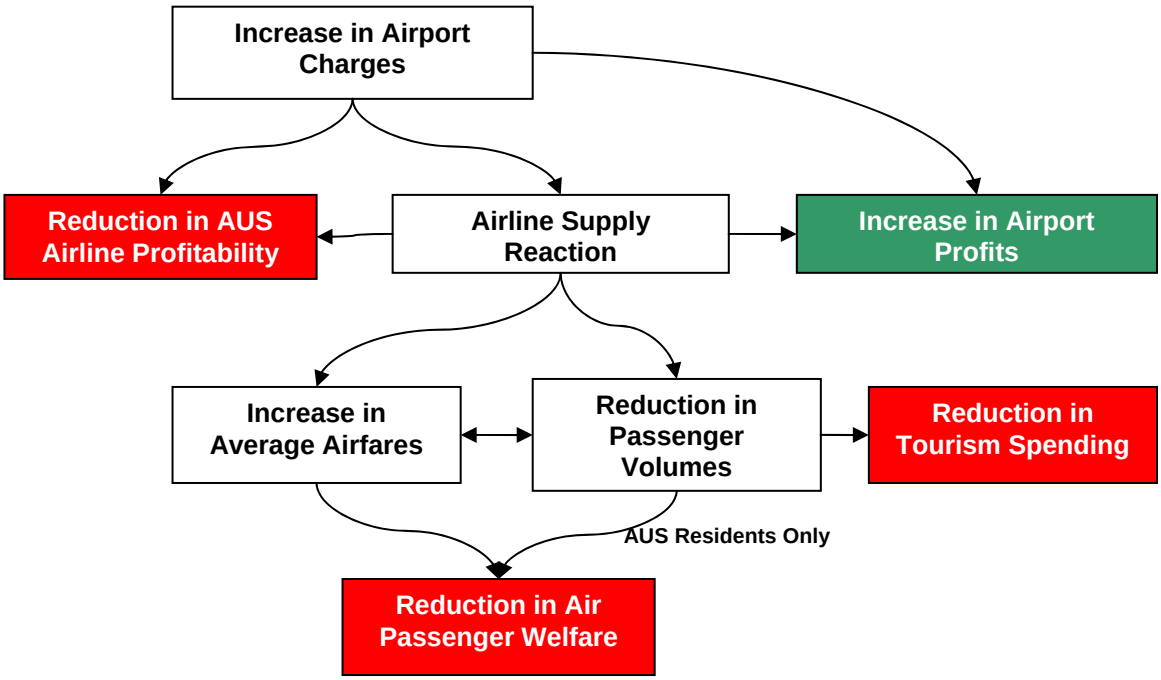
In an aviation and airline context, the airfare elasticity of demand should be distinguished from the price elasticity of demand. The airfare elasticity of demand examines the response of passenger demand to a change in the average airfare. The price elasticity of demand examines the response of passenger demand to a change in the bundle of goods consumed by tourists, including the airfare, accommodation prices, and the price of goods and services on arrival in the tourist destination.

The airfare or price elasticity of demand is generally not a fixed number.[39] It is higher when the price is higher and demand is lower. This means that forces that weaken demand (such as an economic slowdown) results in more elastic demand. The more elastic is demand the smaller is the degree of pass-through.

4.3 Airline and Passenger Response to Changes in Airport Charges

An increase in airport charges brings about a complex chain of interactions. As demonstrated above, an increase in airport charges is not simply passed through to consumers, and a simple elasticity of demand cannot be used to quantify a consumer's response to the increase. Therefore, to estimate the changes in welfare in response to an increase in airport charges, the chain of interactions must be modelled. Figure 4.5 describes the relationships that need to be estimated.

Figure 4.5: Welfare Effects of Higher Airport Charges



[39] It is only a fixed number in the special case in which the demand relationship is best described by a Cobb-Douglas representation. In general this representation is not useful for forecasting aviation and tourism variables and is therefore not a useful representation of the data generating process in The Qantas Group' view.

Given the number of airports and the number of domestic and international routes, estimation of every single possible relationship that would define the Australian aviation market is impractical. Instead, the Qantas Group has focused on only the major airports and routes in the belief that his will represent a high proportion of the total market. With these estimations, the welfare impacts of increases in airport charges can be modelled, and used to estimate the change in welfare from an increase in airport charges.

4.4 Economic Welfare Impacts from Airport Charges

The evidence presented has demonstrated that airport charges are above those that would be expected in a competitive market. Airport charges above the competitive level have negative impacts on economic welfare, and create distortions in the allocation of resources across the economy. There are at least six major welfare impacts that the economy experiences as a result of airports' abuse of market power. These include impacts on:

- Welfare of passengers
- Welfare of passengers that consume the non-aeronautical product of airports
- Profitability of airlines
- Aeronautical profitability of airports
- Non-aeronautical profitability of airports
- Incomes of the segments of the economy that rely on the spending of air travellers (e.g. tourism).

Ideally, the economic welfare loss due to airport charges being above competitive levels would be calculated. However, this is a difficult task because it requires understanding the difference between the current charges set by airports and the competitive level of charges. The competitive level of airport charges can not be observed, but it could be estimated. However, estimation would require an assessment of the efficient costs of owning and operating each individual airport, assuming a risk adjusted return on assets. The information required to assess the risk adjusted efficient cost of airports is not publicly available, but is held privately by each individual airport (if at all). What can be estimated, and is presented in this submission, are the economic welfare losses arising from further increases in airport charges above the competitive level. That is, the analysis presents the estimated welfare losses for each $1 increase in airport charges.

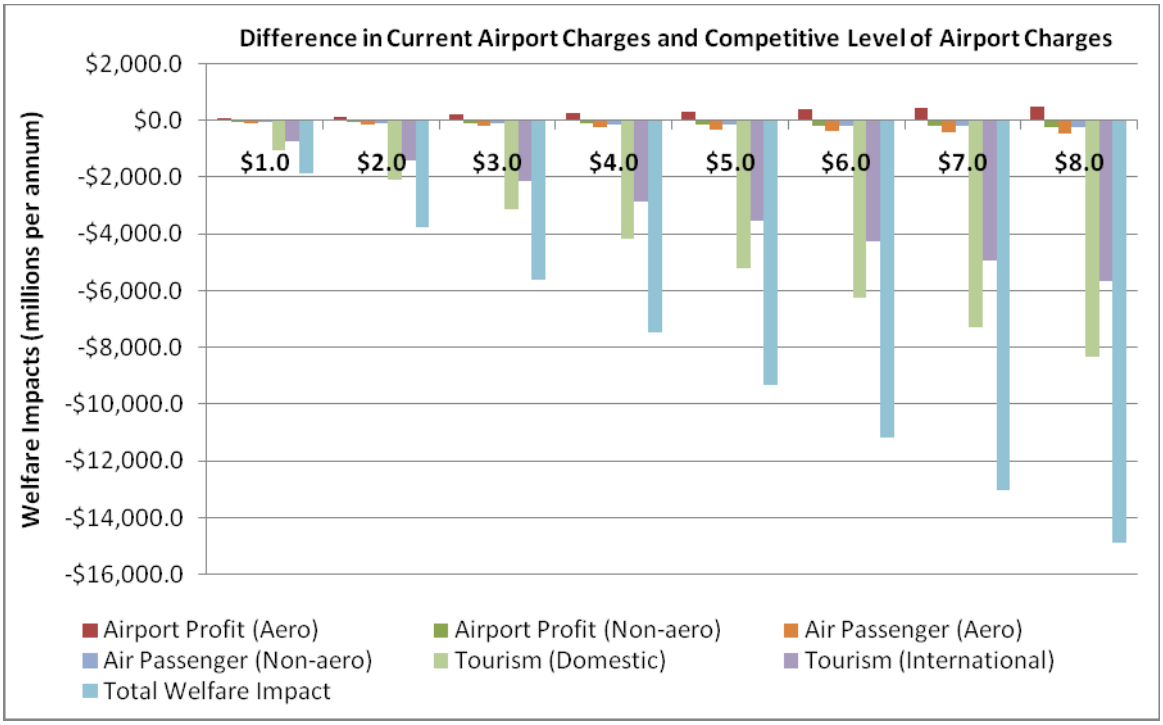
The welfare impacts presented are based upon the six impacts listed above. The welfare impacts are the total impact across Sydney, Melbourne, Brisbane, Perth and Canberra airports for each level of increase in airport charges. The estimates rely on assumptions around a number of parameters. Some of these parameters are listed below:

- Aeronautical charges and unit costs
- Non-aeronautical charges and unit costs
- Average airfares
- Airline costs per passenger (excluding airport charges)
- Airline price elasticity of demand and Passenger Demand elasticity

- Passenger numbers.

As would be expected, the total welfare impact depends upon the assumed increase in prices. The Qantas Group calculates that the welfare impact ranges from net welfare loss of $1.8 billion per annum for a $1 increase in charges to a $14.9 billion loss in welfare for an $8 increase in charges. Taking a conservative view, if the combination of issues with the current light handed regulatory framework continue to result in increases in airport charges being between 10 per cent and 20 per cent (which equates to between $1 and $2), the welfare loss is estimated at between $1.8 billion and $3.7 billion. Excluding domestic tourism benefits (as it can be argued that these have no net impact across the Australian economy, only a distributional impact) the welfare loss is estimated at between $0.8 billion and $1.6 billion (for an increase of $1 and $2 in airport charges).

Figure 4.6: Impact of Welfare from Current Airport Charges being Greater than the Competitive Level of Airport Charges



The welfare impacts estimated above are based upon 5 capital city airports. Therefore, the total Australia wide impact of airports increasing aeronautical is likely to be greater than that indicated. There are also likely to be welfare losses if airports are setting charges above competitive levels for non-aeronautical services (such as car parking).

The welfare estimates take into account both airlines and passenger responses to increases in airport charges. Whilst the welfare impacts from a reduction in tourism have been estimated (based upon historical tourist expenditure data), impacts on other industries in the economy have not been estimated. The second order impacts of lower tourism (and a reduction in output from other industries) are also not captured in the estimates. Therefore, the total impact on the Australian economy is likely to be much higher than the estimates presented.

4.5 Conclusion

The analysis presented in this section provides a framework and basis for estimating the impacts of airports market power and their setting of airport charges above what would be seen in a competitive market. The impacts estimated in this section suggest that the welfare losses that arise from airports' market power are material. In order to address this loss in welfare, the light handed regulatory regime needs to be improved to reduce the impacts on airlines and consumer of airport monopoly power.

5 Potential Solutions

5.1 Introduction

As highlighted above in Section 3.3, the current light-handed regulatory framework gives rise to various market distortions and perverse outcomes. These include issues with:

- Market power - airports are natural monopolies and continue to exert their significant market power
- Revenues within the aviation industry appear to be distributed and extracted in an inequitable manner between airlines and airports
- Airline yields lag significantly behind airport yields due to different risk profiles
- Abuse of market power in the provision of car parking (both commercial and for staff)
- Pricing of commercial leases
    - Airports' valuation principles
    - Excessive pricing
    - Monopolistic negotiating behaviour
- Cost and time associated with negotiating commercial leases
- Inefficient airport investment decisions
- Inefficient and inequitable pricing of aeronautical assets
- Capital investment forecasting and pricing process
- Pre funding of major airport expansions and potential for over recovery
- Forecast errors creating above regulatory returns

Together these factors combine to increase the cost of aviation services in Australia with consequential negative impacts on the financial performance of airlines and unreasonable costs to airline passengers.

This chapter details the Qantas Group's preferred approach to tightening the current regulatory framework which in summary involves:

- Endorsing the ACCC's deemed declaration of airports (Tier 1)
- Developing a set of binding codes of conduct to facilitate commercial negotiations between Tier 1 and Tier 2 airports and airlines
- The development and implementation of codes of conduct for Regional airports to facilitate effective commercial negotiations (less onerous than binding codes of conduct for the Tier 1 and Tier 2 airports)

5.2 Light vs Heavy Regulation

As discussed above, in May 2002, following a period of considerable uncertainty and volatility in the aviation industry, the Government advocated the removal of direct price regulation and the imposition of price monitoring for the major airports, with pricing to be reviewed in 5 years. From June 2002 all price regulations had

been removed and the larger airports were subject to price monitoring while the smaller airports were not subject to any controls.

The rationale for the light handed regulatory approach was:

1. That airlines had countervailing market power which would mitigate the ability of the airports to extract monopoly profits:
    - At the time of the September 11 attacks, it was viewed that international airlines could exert greater countervailing market power over the airports. Given this stronger bargaining position this would weaken the ability of airports to extract monopoly rents.
2. The market power that did exist would cause minimal distortion:
    - This is based on the view that there were stronger commercial incentives and higher profits for airports in non-aeronautical activities. This could be achieved by keeping aeronautical charges low thereby increasing passenger consumption of non-aeronautical services.
3. There was a reasonable prospect that parties would be able to bargain to a reasonable outcome and as a result the market distortion would not be as big as if there were a regulator involved:
    - This was due to the high risk of regulatory failure distorting production and investment decisions given the uncertainty in global aviation markets at the time. Additionally airlines could fall back on Part IIIA of the national access regime if negations with airports could not be resolved.

The change from heavy handed regulation to light handed regulation was intended to reduce the regulatory burden on airports and to foster new investments in airport infrastructure. There was an implicit assumption by government that the benefits from this additional investment would outweigh the potential costs associated with any monopoly pricing that could develop under the light handed regulatory approach. The light handed regime was intended to operate through the mutual participation of airports and airlines in commercial dealings; airports' monopoly powers were expected to be mitigated by price and quality monitoring by the ACCC when coupled with the threat of re-regulation.

The alternative of heavy handed regulation involved the imposition of prescriptive pricing on a regulated entity. To facilitate this process a regulator typically made determinations on the key building blocks of the regulated business including:

- WACC
- Asset valuations
- Operating and maintenance costs.

There are a number of major risks associated with this model, particularly with respect to the timeliness of the regulators decision and the quality and quantity of the information available to the regulator when it is making decisions. These can result in less than optimal investment and asset operation decisions that can have a material effect on the commercial operation of a business and a negative impact on the performance of the regulated asset. Where the regulated asset is a key piece of supply chain infrastructure, such as a railway, port or airport the flow on impacts of the regulated asset's poor performance are likely to be significantly

larger than any savings associated with the reduction in prices caused by the imposition of regulation.

Light handed regulation removes this burden but can only be effective in reducing potential misuse of market power and unreasonable profits if the threat of the imposition of a more onerous regulatory environment is credible enough to have a material impact on the regulated entities commercial operations. In the Qantas Group's view the market distortions currently evident in the Australian aviation industry show that this is not the case and there is a requirement to tighten the current regulatory framework. To achieve this task there are two broad options:

1. Reintroduce heavy handed regulation; or
2. Introduce measures within the framework to ensure that the threat of regulatory intervention is credible and available

5.3 ACCC Submission

The ACCC released its submission to the inquiry on the 23rd March 2011. In that submission the ACCC concluded that the major Australian airports have to an extent exercised market power. The ACCC submission further concludes that the major airlines do not have effective countervailing market power in commercial negations with airports.

The ACCC gives two explanations for the prevalence of monopolistic behaviour by the airports:

1. *Limitations of price monitoring*

   While the current monitoring regime has been effective in promoting transparency, it is not an effective mechanism to curtail airports' market power. The price monitoring regime has investigated various airport related issues and has been insightful in some areas, however little is to be learned from future monitoring. The threat of re-regulation through price monitoring has not deterred the abuse of market power by the airports.

2. *Uncertainty with the declaration under Part IIIA*

   According to the ACCC, "the effectiveness of the threat of declaration under Part IIIA as a constraint on the airports' market power is limited by the considerable costs, time and uncertainty associated with seeking declaration"[40]. In the current environment this process will inevitably take years for a resolution to be made. Given the high costs and uncertainty surrounding the outcomes, the declaration process is unlikely to be pursued by airlines. This ultimately means that airports face little real risk associated with declaration.

Given these concerns, the ACCC recommends that the appropriate regulatory response is the deemed declaration of aeronautical services under Part IIIA of the Competition and Consumer Act 2010. According to the ACCC[41]:

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[40] Submission to the Productivity Commission's inquiry into the economic regulation of airport services March 2011

[41] Submission to the Productivity Commission's inquiry into the economic regulation of airport services March 2011

> *Declaration of aeronautical services would amount to a continuation of current practice whereby airlines can negotiate access terms with airports. However, airlines could credibly threaten ACCC arbitration because the need to first have the services declared is avoided. Importantly, it is this threat that encourages the development of commercial relationships between the airports and their customers.*

Aeronautical services, for the purpose of declaration, could be defined as services, provided by an airport, which are being used for the operation and maintenance of domestic and/or international civil aviation services. Aeronautical services could include aircraft-related services (such as runways, taxiways, aprons and aircraft parking) and passenger-related services (such as public areas in terminals, departure and holding lounges, aerobridges and check-in counters).[42]

The ACCC further seeks an agreed definition of 'aeronautical services' and the minimum facilities that this covers should be developed to support the deemed declaration of those 'services' and ensure that the same definition is used by all airports and airlines. It is argued that this will facilitate effective commercial negotiations between airlines and airports, eliminating a point of debate between the parties.

The key difference between the current system and this proposal and the current light handed regulatory regime is that as aeronautical services would already be declared under Part IIIA of the Competition and Consumer Act, the cost and time associated with airlines pursuing a case would be significantly reduced. The ACCC notes:

> *"An advantage of deemed declaration is that regulatory intervention—in the form of arbitration—is determined by the airports to a large extent. If an airport undertakes commercial negotiations in good faith, ACCC arbitration is unlikely to be triggered and, therefore, regulatory intervention would not be required"[43].*

The Qantas Group considers that the ACCC's approach has considerable merit and supports the ACCC's recommendation that the Tier 1 regulated airports be deemed declared. Declaring aeronautical services will remove the uncertainty around the process of declaration and therefore reduce the likelihood that Tier 1 airports will exert their market power. However, deemed declaration alone will not readily resolve the issues outlined in this submission. This is because:

- Airports will still be able to present options in a form that suits their requirements and airlines will be required to negotiate both the structure and detail of the agreements on an airport by airport basis. Given the number of airports in Australia this places a significant burden on airlines.
- Deemed declaration of tier 1 airports will not resolve issues with non price monitored airports or regional airports.
- Deemed declaration will not resolve issues associated with excessive airport returns in relation to non-aeronautical revenues.

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[42] ACCC (2011: 7).

[43] ACCC (2011:24)

To address the full range of market distortions evident in the Australian aviation market the Qantas Group proposes deemed declaration (for Tier 1 airports). This is to be used in combination with a set of 'codes of conduct' applying to all airports and which detail a number of principles for access and the framework for commercial negotiations between airports and airlines. Deemed declaration could also be an option for Tier 2 airports. The prospect of deemed declaration for these airports is expected to encourage an increase in the level of constructive engagement with airlines.

5.4 Regulatory Precedent for Improving Light Handed Regulation

As discussed above, under a light handed price monitoring regime, industry participants can adopt additional pro-competitive features at their discretion including a code of conduct detailing minimum standards of behaviour. The *Competition and Consumer Act 2010* enables industry codes of conduct to be implemented into a regulatory framework through:

1. Industry code in the form of an access undertaking under Part IIIA of the Act, given to the ACCC by Tier 1 and Tier 2 airports;
2. A voluntary industry access code under Part IVB. Section 51AE also provides for industry codes of conduct to be prescribed in regulations proposed by the responsible Minister. The responsible Minister may consider the prescription of an industry code of conduct if light-handed options have been examined and demonstrated to be ineffective in relation to other airports.

An industry code may be declared either as mandatory (under Part IIIA or Part IVB) or voluntary (under Part IVB). Mandatory codes are binding on all industry participants. Voluntary codes are binding on those members of an industry or profession who have formally subscribed to the code and are included in an ACCC public register. This allows for a flexible application of codes across different airports in Australia.

The Productivity Commission has previously recommended the implementation of voluntary codes of conduct. In 2004 the Productivity Commission recommended that the Gas Access Regime be amended to provide for a light-handed form of regulation by way of a monitoring arrangement which should have scope for the service provider to adopt, at its discretion, additional pro-competitive features, such as a code of conduct.[44] Importantly the regulated entities are incentivised to sign up to the codes of conduct because they are given the opportunity to be involved in their drafting. The alternative is to allow the ACCC to rule on details of the regulatory model that is imposed, an option which option significantly increases regulatory uncertainty for the service provider.

There are a number of industry codes of conduct currently in force in Australia. Two relevant examples include the horticulture and franchising industry codes of conduct. The key aims of both codes are to provide oversight for the agreements made between two parties, whether that is growers and wholesalers as per the horticulture code or franchisees and franchisors under the franchising code. Both codes provide cost-effective dispute resolution schemes, with a mediation advisor appointed to mediate disputes made under the code.

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[44] Productivity Commission (2004)

In its submission to the current Productivity Commission review of airport charges, the ACCC remarked that the provision of guidelines could assist in dispute resolution. The costs associated with carrying out the mediation would be subsidised by the Australian Government. However, the parties must pay their own costs of attending the mediation, unless they agree otherwise. The ACCC's role would be to promote compliance with the code by helping people understand their rights and obligations under the code and the *Competition and Consumer Act*.

Example 5.1: Key Components of the Horticulture Code[45]

Australian Horticulture industry code of conduct

The Horticulture Code, which has the force of law, aims to:

- Help growers and traders of horticulture produce make more informed decisions by clarifying their responsibilities and obligations
- Require growers and traders to disclose specific information to each other
- Require growers and traders to follow nationally consistent rules in their dealings with each other.

The Horticulture Code aims to achieve this by:

- Requiring traders to develop and provide growers with written terms of trade
- Requiring growers and traders to address key issues in written agreements with each other
- Improving the supply of important information, particularly regarding prices paid and obtained by agents for a grower's horticulture produce in wholesale markets

Providing a cost-effective and timely way for growers and traders to:

- Undertake an investigation and obtain an independent report on any matter arising under an agreement, as an alternative to litigation
- Resolve any dispute that may arise between growers and traders

Airport regulation in the United States is currently conducted under a similar arrangement. Following the deregulation of the airline industry, the negotiation process between airports and airlines was been formalised into a specific set of guidelines. In 2010, the Transport Research Board published the "Airport/Airline Agreements—Practices and Characteristics" manual. The purpose of the manual is to provide a tool to assist both airports and airlines during business arrangement negotiations. The manual describes the range of business relationships between airports and airlines including:

- The underlying rates and charges methodologies
- Presenting a general negotiation process and schedule

[45] Source: Australian Competition and Consumer Commission (2007) "The Guide to the Horticulture Code for Growers and Wholesale Traders in the Horticulture Industry" Commonwealth of Australia, Canberra, ACT, pg4.

- Identifying key information for a negotiation
- Identifying the various issues that typically surface and describing the various alternatives for resolving potential conflicts and issues
- Identifying the linkages among these various critical issues.[46]

Example 5.2: Airport and Airline Agreements in the United States[47]

United States - Airport/Airline Agreements—Practices and Characteristics Manual

At the completion of the negotiations, it is important that both parties be able to answer the following questions satisfactorily:

- Did the airport and airlines achieve their respective primary goals and objectives within the context of an Agreement or business arrangement?
- Does the airport have the flexibility to undertake needed capital development?
- Are the rates and charges formulas fair, reasonable, and equitable to the airlines?
- Do the airlines operating at the airport have the appropriate facilities to operate their preferred flight schedule?
- Does the Agreement appropriately balance both risk and reward between the parties?
- Do both the airport and the airlines feel they benefit from the business relationship memorialized in the Agreement?
- Is the Agreement flexible enough to adapt to changing economic or other dynamic industry circumstances?

It should be noted however that the use of the guidelines in the US is voluntary between the individual airport and airline to the extent that they only apply in relation to an agreement if one can be reached. However, over the past 15 years, there have only been a few complaints brought to the US Department of Transport challenging airport rates and charges that were set without an Agreement.[48]

The International Civil Aviation Authority (ICAO) also produces policies on charges for airport services.[49] While not binding in Australia, the Airports Council International (ACI) encourages its members to ensure their existing user charges meet the ICAO recommendations. The Qantas Group believes a number of

[46] Transport Research Board (2010)

[47] Source: Transport Research Board (2010) "Airport/Airline Agreements—Practices and Characteristics" Airport Cooperative Research Program, Report 36, Pg 4.

[48] See Transport Research Board (2010) pp 41.

[49] See ICAO (2009).

aspects of ICAO's policies are likely to provide a useful basis for the development of the some of the proposed codes of conduct.

The establishment of a standard set of guidelines or code of conduct will reduce the current ambiguity and disputes on matters of principle in negotiations under the current system. They would also result in a more efficient outcome for airports, airlines and passengers.

5.5 The Qantas Group's Preferred Option

The Qantas Group believes that the most appropriate means of improving the current system would be for consistency in the application of the regulatory framework across all airports. However, the reality is that the current regulatory framework already distinguishes between three different groups of airports. The Qantas Group proposes a pragmatic and reasonable application of consistent themes across the airport tiers, taking into account the current regulatory approach for those airports, the scale of the airport operations and the effort required to implement the proposed solutions.

The current light handed regulatory framework has not proven to be sufficient to adequately regulate aeronautical assets in Australia. The re-introduction of heavy handed regulation could address these issues but it would also be accompanied by the risk that its implementation will have more costs than benefits. The Qantas Group's preferred alternative is to work within the current light handed regulatory framework through the introduction of codes of conduct that cover:

- The regulatory modelling process
- Capital expenditure planning and pricing
- Definition of aeronautical services
- Benefit sharing
- The use of precedent leases for commercial airport lease negotiations
- Clarification and extension of the application of the line in the sand approach to asset valuation
- Binding, independent dispute resolution

These codes of conduct would enable a consistent set of principles to apply across all airports and airlines and importantly establish a clear dispute resolution mechanism that would not require formal legal proceedings. The legal framework for this approach is provided through the *Competition and Consumer Act 2010* (discussed in more detail in section 5.5.7 below) and evidence from other industries in Australia and the US aviation industry suggests that it can be effective.

5.5.1 Agreement on a Single Structure for the Regulatory Pricing Model

As detailed in section 3.3.4.5 of this report, Australian airports use a range of different modelling approaches to determine aeronautical charges. In the past the Productivity Commission has been of the view that this diversity is not of material importance because the light handed regulation is explicitly intended to facilitate flexible negotiations between airlines and airports. However, this conclusion ignores the cost to airlines of having to deal with a variety of different modelling approaches and the cost to airlines (and airports) of having to spend valuable

negotiating time on issues of methodology rather than commercial terms. Airports have a significant information advantage as operators of the airport assets. Allowing them to control how this information is presented to their customers significantly increases this advantage and the associated airline negotiating costs.

As noted, each of the five price monitored airports uses different modelling approaches. Some of these models are made up of five or more spreadsheets and it is time consuming for airlines to analyse each model so that they can undertake effective negotiations. To facilitate negotiations between airports and airlines the Qantas Group proposes that a consistent modelling framework be agreed. A standardised modelling framework would improve the quality of regulation of the airports and reduce regulatory costs for the airlines by removing the requirement to master the nuances of a number of different regulatory approaches.

It is anticipated the agreed model would be a building block model similar to that summarised in the AER's 'Compendium of regulatory guidelines for electricity transmission industry' (2010). This document outlines how a post tax revenue model for pricing electricity transmission assets should be built using the standard regulatory building block model. The building blocks include:

- An indexation of the RAB
- A return on capital
- A return of capital (regulatory depreciation)
- The estimated cost of corporate income tax
- Revenue increments or decrements arising from the application of the efficiency
- Benefit sharing scheme
- Forecast operating expenditure
- Compensation for other risks

At the same time it would be expected that the airports and airlines would come to an agreement on how some of the key input assumptions are calculated, such as:

- Expected inflation
- The timing assumptions and associated discount rates that are to apply in relation to the calculation of the building blocks
- The manner (if any) in which working capital is to be treated
- The manner in which the estimated cost of corporate income tax is to be calculated

An agreed approach for calculating the WACC would be particularly valuable since it is such a fundamental driver of the long term revenue streams and the approaches across airports. Regulators are typically prescriptive with the specification of the WACC calculations because there is a requirement to ensure that the WACC calculations are fully consistent with the regulatory model input assumptions. It is not clear that this is currently the case with regulatory models that are currently provided by the airports.

5.5.2 An Annual Capital Investment Review Process at Major Airports

Airports represent significant capital infrastructure, and will be expected to make further significant investments in new aeronautical infrastructure to meet the demands of a growing aviation industry in future. At present, airports face limited transparency and accountability obligations with respect to their capital expenditure programs. While some consultation currently occurs between the major airports and airlines (as detailed in Section 3.3.3: Inefficient Airport Investment Decisions) significant information asymmetries continue to exist.

With no requirement for airports to consult with their users, any negotiations are time consuming and costly. There is also little clarity around the necessity for, and timing of, certain capital works. Often, key stakeholders, and users of airport assets are not provided with reasonable notice of impending capital works.

Given that airports recover capital expenditure from airlines and the public through airport charges – and therefore remain insulated against project risks – the threat of airports making inefficient investment decisions is real. To address this risk, it would be prudent to introduce a formal capital expenditure review process for all Tier 1 and Tier 2 airports. A stringent and binding framework would ensure that investment occurred in an efficient and effective manner that was beneficial to the asset owner, the asset user and the wider community.

The objectives and an example of types of features which might be included in this code of conduct contents are detailed below.

Capital Planning

Airports and users should meet on an annual basis to review capital expenditure arrangements at the airport. This may include:

- Any proposed capital expenditure at the Airport
- The progress of ongoing major projects
- Cost management of projects
- Variations to scope, design or expected delivery of a project
- Details of likely issues that may arise and their impact upon both parties
- Promoting efficiency and business improvement
- The airlines' plans and future needs at the airport
- Matters that might affect airport charges

Discussions should also address the rationale and need for proposed investments. This should be accompanied with reasonable transparency of project cost and projected demand for airport infrastructure. The following considerations should also be accounted for:

- Parties should consult and work together to improve quality of service measurement, monitoring and outcomes
- Airports should exercise skill, care and judgement to obtain competitive prices for each contract relating to the delivery of a major project in order to ensure that user charges are as low as reasonably possible having regard to all the requirements of the projects

- Provisions must be made, and agreed to, regarding unplanned capital expenditure.

5.5.3 Sharing of Benefits

One of the most attractive features of airports to potential investors is the range of non aeronautical and commercial opportunities that they offer in addition to the return on their aeronautical assets.

Airport revenue earning activities of airports typically fall into three categories:[50]

1. **Aeronautical** – those activities which are directly related to providing for the movement of aircraft and the transfer of airline passengers from air-side to land-side transport modes.
2. **Non-aeronautical** - those activities which are co-located with, but are not essential for the efficient production of, air services (the retailing of goods to passengers passing through terminals and the provision of property-related services etc).
3. **Commercial** - those activities which the airport company has diversified into such as providing consultancy and management services to other airport companies, or non airport related property developments.

At present, the regulatory framework makes a clear delineation between the aeronautical and non-aeronautical assets. Under the 'dual till' process, an asset is either declared as part of the regulated aeronautical assets or as a non-aeronautical asset. The 'regulated till' is made up of only the revenues, costs and assets associated with aeronautical activities (and the costs of financing those assets) plus a share of the common costs and assets that support both aeronautical and non-aeronautical activities. Revenues from non-aeronautical and commercial services are not subject to regulatory oversight.

In reality, as illustrated in Figure 5.1 below, the distinction between asset classes is not so simple. There are a range of asset types that, while not fitting the definition of aeronautical assets (i.e. assets and activities essential to the operation and maintenance of civil aviation at the airport), share many of the characteristics of aeronautical assets. Specifically, demand for their services is driven by airport passengers and to a greater or lesser extent they offer the airport owner the market power of a monopoly or a near monopoly.

Figure 5.1: Airport Asset Type Classifications

[50] Starkie, D. and Yarrow, G. (2000), "The Single Till Approach to the Price Regulation of Airports," Civil Aviation Authority, London, U.K.

This point is acknowledged by regulators when they set up dual till regimes. However, there is an expectation that airports will have an incentive to reduce aeronautical charges to take advantage of the increased consumption of commercial services provided by the airport. This is due to the strong degree of complementary demand between the airport's aeronautical and non-aeronautical activities.

For example, an increase in the demand for air travel at an airport will increase demand for non-aeronautical services at the airport. But the 'direction' of the demand is the key issue. Without the uplift in air travel demand there would be no flow on effect to a change in demand for non-aeronautical services. The benefit of complementary demand does not work both ways. As the airport participates in both the aeronautical and non-aeronautical market, airports should have an incentive to keep aeronautical charges low to maximise profits in the non-aeronautical market. However after the loosening of price cap regulation in 2001, some airports doubled their aeronautical charges[51] and as evidenced ACCC airports are showing characteristics of monopoly pricing in a number of areas, particularly car parking.

The current regulatory model is not providing airlines or consumers with the anticipated protection from airports exerting their market powers when operating their non-aeronautical assets such as parking facilities. At the same time the model creates a significant asymmetry in the risk sharing between airlines and airports as was evidenced during The GFC. During this period airlines reduced fares to keep load factors up and their profitability fell significantly, but passenger numbers, and associated airport revenue streams were maintained.

These problems could be resolved by reclassifying some assets as aeronautical but this solution would bring about a range of new problems associated with the lack of commercial incentive to invest in these asset classes.

An alternative solution is a 'hybrid till' regime. The hybrid till approach is a mix of single till and dual till regulation. Under a hybrid till the aeronautical and non-aeronautical activities are ring fenced as per the dual till but a proportion of the non-aeronautical revenues is then used to cross subsidize aeronautical activity and thus determine the aeronautical charges. Under a hybrid till, it is important that the commercial (non aero) activities of the airport which operate in a competitive market are not subject to regulation. This will ensure that the airport maintains a significant incentive to invest and make a profit in its other ventures.

The hybrid till approach has been adopted by a number of airports in recent years. For example, the Civil Aviation Authority of Singapore sets the hybrid till arrangement for the corporatized Changi Airport Group to ensure that airport charges remain competitive.

A hybrid till system is also in place at Copenhagen Airport in Denmark and in both Budapest and Ferihegy airports in Hungary.[52] In December 2009, the Airports Economic Regulatory Authority (AERA) of India issued a White Paper on airport

[51] Forsyth, 2004

[52] Gillen (2007).

regulation entitled “Regulatory Objectives and Philosophy in Economic Regulation of Airports and Air Navigation Services”. This paper proposed the use of a hybrid till regulatory mechanism. The Indian methodology describes a modified dual till approach that identifies the cost base as:

- The operating and maintenance costs pertaining to Aeronautical Services, and
- Depreciation and returns on a regulatory asset base pertaining to Aeronautical Assets.

The cost base is then defrayed by:

- 30 per cent of the gross revenues generated from Non-Aeronautical Assets
- 30 per cent of the gross revenues generated from assets required for provision of aeronautical related services at the airport and not considered in revenues from Non-Aeronautical Assets.

Responding to the white paper, the Confederation of Indian Industry (CII), a non-government, not-for-profit, industry led and industry managed organisation, supported the introduction of a hybrid till over a single or dual till. The CII concluded that it is the appropriate regulatory mechanism as it reduces the regulatory risk and creates an enabling framework for attracting new investment through investment incentives, efficient pricing and the development of commercial revenues. JPMorgan expects that AERA may adopt a hybrid till model, where 30 per cent of non-aero revenues subsidise the target aeronautical revenues, at Delhi and Mumbai international airports.[53]

Given the evidence that some airports can and do utilise their market powers when pricing some of their non-aeronautical assets and the evidence that these higher prices have a negative impact on the airlines and their passengers, there is a clear requirement to improve the current regulatory arrangements. A single till is not considered a satisfactory solution because it is likely to introduce market distortions which may have a larger negative impact than the current approach. The hybrid model allows some of benefits of that accrue from these monopoly powers to flow back to passengers and airlines. A code of conduct is required to provide a framework for the agreement of a hybrid model between airports and airlines.

The Qantas Group further suggests that an appropriate implementation of a hybrid model in Australia would be for those revenues associated with “property assets” (eg. check-in counters, car parks, airline lounges, etc) to be those that are shared between airports and airlines. These are the assets that are most closely related to airline operations and most used by passengers as illustrated in Figure 5.1.

5.5.4 Use of Precedent Leases for Commercial Airport Lease Negotiations

Unless airline leased areas such as offices, lounges, hangars and maintenance facilities are reclassified as aeronautical the risk will remain that airports will continue to exploit their market power in negotiating the terms of these leases. One way to address this would be through the provision of guiding principles underpinning commercial leasing arrangements. Such guiding principles could include:

[53] JPMorgan (2011).

- Precedent leases to be agreed between parties. The use of such leases will be mandated and binding and may not be amended without consent and agreement of both parties.
- Binding valuation principles applied to all leased areas, irrespective of whether a new lease is sought or a market review is being applied. The principles should be common to all leases in all states and should be binding. Valuations should be sought on an annual basis and apply to all new leases during that period.
- Valuation principles to use non airport comparables as the primary basis for determining fair market rent. Comparables should be agreed dependant on the type and use of area being leased. Clear and binding dispute resolution procedures should be agreed.
- Non market reviews should be pegged to CPI increases only.

5.5.5 Clarification and Extension of 'Line in the Sand' Application

The 'line in the sand' is an important component of the current regulatory regime because it helps provide airport users with confidence that their charges will not be based on arbitrary and varying asset valuations. This point was emphasised by the Productivity Commission[54] in its Review of Price Regulation of Airport Services (2006) when it stated that:

> *"if this matter (asset valuations) is not removed from the bargaining table, it will continue to frustrate the further development of commercial relationships and thereby the effectiveness of the light handed approach"*

However, there remains significant uncertainty with regard to some aspects of its application and it provides no protection to airlines at airports outside the five price monitored airports:

- The uncertainty with respect to its application at the five price monitored airports stems from the recent sale of the Hobart Airport and consequent revaluation of the aeronautical assets to be consistent with the (much higher) sale price rather than the previous book valuation. It remains unclear from the ACCC's Airport prices monitoring and financial reporting guidelines (June 2009) whether a similar price increase could occur at if one of the five price monitored airports changed hands
- As detailed in the regional airports section (section 3.5) airlines have little countervailing market power at some regional airports and no capacity to determine if that airport is charging monopoly rents for its services or not.

These issues could be addressed through the following clarification of the application of the 'line in the sand':

1. Each airport's 'line in sand' aeronautical asset base should carry over to any new asset owner to avoid asset sales resulting in major increases in aeronautical charges in much the same way as a regulated asset base in other industries do

[54] Productivity Commission, 2006, *Review of Price Regulation of Airport Services* p.77

2. The ‘line in the sand’ asset base should also be applied to all other airports using asset values as at 30 June 2005, consistent with the approach applied to Tier 1 airports and ensuring all airports are pricing from the same baseline. The depreciated value of any capital investment in aeronautical infrastructure since the ‘line in the sand’ should also be included in pricing calculations.

5.5.6 Introduction of a Formal Dispute Resolution Mechanism

As set out in the Productivity Commission’s Issues Paper[55], a feature of the price monitoring arrangements for the five monitored airports (Sydney, Melbourne, Brisbane, Perth and Adelaide) is that, where a party is seeking access to an airport service, in the first instance the terms of the arrangement should be negotiated commercially between the airport and the airline. This is despite the fact that major airports in Australia are natural monopoly providers of aeronautical services with no competitive constraint on them in exercising their market power. As the ACCC notes in its submission to this inquiry, the current process does not provide airlines with countervailing market power that would allow them to negotiate commercially with the airports.

Under the current light handed approach, it is intended that when commercial negotiation fails, the airport user has the ability to seek declaration under the national access regime as set out in Part IIIA of the *Competition and Consumer Act 2010*, which ultimately gives the access seeker the right to negotiate with the service provider. If that fails, resort to ACCC arbitration as a potential “circuit breaker” still exists. The Productivity Commission states that declaration was intended to provide a ”last resort” mechanism for resolving serious and protracted disputes.

As discussed in this paper, the process of seeking declaration, however, is neither pragmatic nor timely; it requires investment of significant time and resources without any certainty as to the outcome. Since the process must be replicated for each airport, it is extremely inefficient. Furthermore, airports will delay the process as much as possible in order to maximise the return on their excessive prices. The possibility of declaration is therefore often dismissed by airports and airport users (and more recently the ACCC in its 2011 Inquiry submission[56]) as being a non-viable dispute resolution mechanism.

To overcome some of these issues the ACCC has proposed the deemed declaration of aeronautical services as the appropriate regulatory response with respect to the Price Monitored airports.

In the Qantas Group’s view, the move by the ACCC to recommend the declaration of aeronautical services would result in an improved environment for airports and airlines to negotiate a set of mutually beneficial agreements. The new negotiation process is shown in the figure below. Under this approach the airports and airlines continue to try to negotiate a commercial agreement as a first step. However,

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[55] Issues Paper for the Productivity Commission’s *Inquiry into the Economic Regulation of Airport Services,* January 2011.

[56] *Submission to the Productivity Commission’s Inquiry into the Economic Regulation of Airport Services*, Australian Competition & Consumer Commission, March 2011.

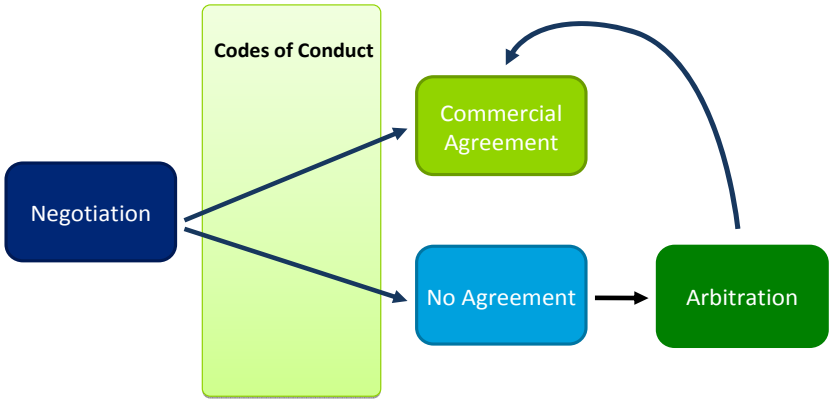
should an agreement not be reached, the airline can invoke ACCC arbitration, without having to first apply to have the airport's service declared under Part IIIA.

While the ACCC's proposed approach removes the costs and time constraints involved in an airline seeking declaration, the problem remains that without the other changes to the regulatory regime proposed by the Qantas Group, there is no greater clarity and transparency in the negotiation process than under the current price monitoring regime to encourage a commercially negotiated outcome.

Therefore the Qantas Group believes that a code of conduct should be established to further promote agreement between the two parties before either resorts to arbitration.

This approach is shown in the figure below. Under this proposed negotiation process, a voluntary code of conduct can be used as a starting point for negotiations. The voluntary code of conduct will outline an approach for airports and airlines to reach agreement and will provide a basis for constructive commercial negotiations.

Figure 5.2: Proposed dispute resolution process



As part of the code, should an agreement not be reached, either of the parties can seek to have the dispute resolved by arbitration. The arbitrator will be:

- The ACCC for airports deemed declared under Part IIIA
- An independent arbitrator for all other airports

The Horticulture Mediation Adviser and the Office of the Franchising Mediation Adviser oversee the mediation processes for the horticulture and franchising industry codes of conduct respectively. As an indication of the success of these frameworks, the Horticulture Mediation Adviser received two formal requests for mediation during the 2009-10 financial year. One of these requests was withdrawn following a decision by the complainant to revisit direct negotiations and the other was successfully resolved using the mediation process. A number of written notifications were made to the other party, resulting in an outcome negotiated in the 21 day period provided under the code.[57]

This contradicts the Productivity Commission's previously stated view that the introduction of a dispute resolution mechanism would discourage serious

[57] HMA Annual Report 2009-2010.

negotiation and lead back to regulation. It is, however, consistent with practice in other industries. It is not only economic theory that makes heavy handed regulation unattractive to both the regulated entity and the users of the regulated assets.

5.5.7 Application of Codes of Conduct

The implementation of an airport services code of conduct would produce a light handed but effective way of facilitating commercial negotiation within the existing regulatory framework. No legislative change would be required.

An airport services code of conduct could be developed and implemented in accordance with the following three steps:

1. an industry body (including relevant representatives from airports and airport users) would be established and prescribed for the purposes of Part IIIA;
2. the industry body would formulate an industry-wide airport services code of conduct for access to airport services (Industry Code);
3. the ACCC could accept the Industry Code as an access undertaking under Part IIIA in relation to Tier 1 and Tier 2 airports if the Code meets the statutory criteria; and
4. a modified form of the Industry Code could be declared as a voluntary code under section 51AE of Part IVB in relation to Regional airports. Regional airports would have the option of lodging an access undertaking conforming with the accepted Industry Code.

It is proposed that a binding code of conduct covering the items listed below is developed and implemented for Tier 1 and Tier 2 airports:

- Regulatory modelling process
- Capital expenditure planning and pricing
- Definition of aeronautical services
- Benefit sharing
- The use of precedent leases for commercial airport lease negotiations
- Clarification and extension of the application of the line in the sand approach to asset valuation
- Binding independent dispute resolution

It is also proposed that less onerous voluntary codes of conduct are developed for Regional airports covering:

- Regulatory modelling process
- Definition of aeronautical services
- Clarification and extension of the application of the line in the sand approach to asset valuation
- Binding independent dispute resolution

Regional airports will be incentivised to opt in to and abide by these codes of conduct to avoid the risk associated with potential further regulatory scrutiny.

The Qantas Group does not believe that the introduction of codes of conduct, combined with the ability to revert to binding dispute resolution, would undermine the parties' incentives to negotiate outcomes. No arbitrations occurred when airport services were effectively declared at a range of airports between 1998 and 2003[58]. Instead the parties were able to reach commercial agreements without either party taking steps to initiate an access dispute. In addition, during the time that domestic airside services at Sydney Airport were declared from 2005 to December 2010, ACCC arbitration was only instituted once and the ACCC was, ultimately, not required to determine the arbitration because the parties reached a commercial agreement.

5.6 Summary of the Qantas Group's Overall Recommendations

It has been strongly evidenced that the current light handed regulatory framework does not prevent airports from exercising monopoly power, regardless of their size or location. A strengthening of the regulatory framework is required, comprising the following:

- ACCC's deemed declaration of airports (Tier 1)
- A set of binding codes of conduct to facilitate negotiations between Tier 1 and Tier 2 airports and airlines
- Voluntary codes of conduct for Regional airports to facilitate effective commercial negotiations (less onerous than binding codes of conduct for the Tier 1 and Tier 2 airports)

[58] 'Airport services' were effectively declared pursuant to the deeming provision under s192 of the *Airports Act 1996* for Phase I Airports between 1998 and 2002 and for Phase II Airports between 1999 and 2003.

6 Other Matters

6.1 Alternatives to Service Quality Monitoring

In recent years the ACCC and the Productivity Commission have both endorsed the importance of an effective quality of service monitoring regime for airports. Largely this is an acknowledgement that airports are natural monopoly service providers and that, in the absence of competition for the services they provide, protection is required to ensure airports do not allow their services to fall below acceptable levels. It is important to keep at the forefront of any quality of service review the understanding that airports have significant influence over the operations of their customers, airlines, and the experience of their end users, passengers.

The monitoring of airport services and facilities by the ACCC and the subsequent reporting by the ACCC is not sufficient, by itself, to ensure the high standards of service expected by the public. There is no ability for airport users to seek the maintenance of or improvements to services. Similarly, there is no ability for airport users to demand reduced prices where services or facilities are not performing to the regulated standards.

The Qantas Group has had mixed results in negotiating SLAs with the various airports. An example of a poor outcome for SLAs is the ‘Conditions of Use’ which numerous airports around Australia have sought to impose on airlines without any negotiation or agreement. Those airports have used their monopoly position to seek to force airlines to accept conditions that neither enhance nor protect the airlines’ ability to operate efficiently out of the relevant airport. The ‘right to use’ an airport is not the same as a guaranteed service standard. One of the most persistent failures of these documents is a lack of any comprehensive and enforceable set of service standards that bind the airport. The Qantas Group believes that rather than a ‘one size fits all’ standard, airlines could be provided the means to negotiate for the standards that their level of service requires. Customers of a full service airline such as the Qantas expect quite a different level of service to a budget carrier such as Jetstar. An airline that does not meet the expectations of their customers will not retain the loyalty of those customers, so airlines are very focussed on what these needs are.

This could be achieved by the Government including in a code of conduct a provision that airports and airlines are expected to conclude Service Level Agreements (SLAs) as part of the commercial negotiation process. The Qantas Group is a strong supporter of the need for SLAs and has negotiated limited SLAs with a number of major Australian airports. The presence of an agreed SLA, particularly where there are remedies if service levels are not met, provides a commercial imperative in addition to the airports desire to provide a high level of service.

A more positive example is the robust SLA the Qantas Group is currently negotiating with a Tier 1 airport. This covers most areas of operation relevant to the Qantas Group and its customers and has meaningful penalties for failure to comply with the agreed standards. The Qantas Group will seek to negotiate SLAs with other airports as part of contract renewal negotiations as these come due, but past experience suggests some airports may be reluctant to agree to SLAs without

some form of regulatory compulsion. As proposed above, including SLAs in pricing principles supported by a process for the handling of any disputes that arise is likely to be the most effective way of consistently achieving SLAs with all airports that are acceptable to both airlines and airports.

7 Appendices

7.1 Concentration of Airport ownership

Parent company	Major Shareholders	Airports Owned
BaCH Airports Consortium	• Colonial First State Investments Limited • James Fielding Funds Management Limited • Westscheme Pty Limited	Bankstown Camden
Australia Pacific Airports Corporation Ltd	• AMP • Hastings Funds Management • Industry Funds Management • Deutsche Asset Management • Future Fund	Melbourne Launceston
Queensland Airports Ltd	• Hastings Funds Management • Perron Investments Pty Ltd	Gold Coast Townsville Mt. Isa
Adelaide Airport Ltd	n/a	Adelaide Parafield
Airport Development Group	• Hastings Funds Management • Industry Funds Management • Palisade Investment Partners	Darwin Alice Springs Tennant Creek
Southern Cross Airports Corporation	• Macquarie Airports • Hochtief • Ontario Teachers' Australia Trust	Sydney
Capital Property Finance Pty Ltd	• Capital Property Finance Pty Ltd	Canberra
Linfox Group and Beck Corporation[59]	n/a	Essendon

[59] Also owns Avalon Airport

Parent company	Major Shareholders	Airports Owned
Goodman Holding Pty Ltd	n/a	Moorabbin
Gateway Investments Corporation	n/a	Brisbane
Archerfield Airport Corporation	n/a	Archerfield
Australia Development Group Pty Ltd	• Utilities of Australia Pty Ltd ATF Utilities Trust of Australia • Hastings Funds Management Ltd AREF Australia Infrastructure Fund • Utilities of Australia Pty Ltd ATF Perth Airport Property Fund	Perth
Ascot Capital	n/a	Jandakot
Tasmanian Gateway Consortium	• Macquarie Global Infrastructure Fund III • Retirement Benefits Fund Board	Hobart
North Queensland Airports	• IIF Cairns Mackay Investments • The Infrastructure Fund managed by Hastings, Perron Investments and Auckland International Airport Ltd	Cairns Mackay
Hamilton Island Enterprises Ltd	• The Oatley Family	Hamilton Island
Pearl Coast Properties Pty Ltd	• Broome International Airport Group	Broome
Voyager Resorts and Hotels Pty Ltd	• GPT Group (Ayers Rock is in process of sale to local landowners group)	Ayers Rock
Tasmanian Ports Corporation Pty Ltd	• Tasmanian Government	Devonport
Nhulunbuy Corporation Ltd	• Rio Tinto Alcan Gove Pty Ltd	Gove
WMC (Olympic Dam Corporation) Pty Ltd	• BHP Billiton	Olympic Dam
BM Alliance Coal Operations	• BHP Billiton • Mitsubishi Development Pty Ltd	Moranbah

Source: various

7.2 Capital Planning Methodology by Airport

Brisbane

- Total passenger and aircraft movement demand and peak demand projections used to identify asset capacity constraints and bottlenecks. Projects identified to address capacity and bottleneck issues. Development of capital plan which documents priorities, timing, costs and justifications for each project, though only at a high level
- The capital plan is typically presented to airlines around 18 months out from the target date for reaching a new pricing agreement. Capital plan for each pricing period (typically a 5 year period). Most recent plan covers a 10 year period, given the timeframe to deliver the new parallel runway
- Hold a multi-lateral meeting with airlines once a quarter to focus on short and medium term capital projects. Long term capital projects are also discussed as the next round of pricing negotiations approach
- Ad hoc workshops are also held on major capital projects
- Whilst the capital plans are presented to airlines. Airlines are able to critique and ask question about projects, and can request additional information. However, have no real ability to influence or change the capital plan
- The capital plan is mostly based upon a low level of design, with associated low level of confidence in costings.
- No detailed information is made available in relation to project cost estimates, including contingency and escalation rates used in the capital budget, internal project management and administration fees. Do not get to see quotes or tenders received for individual projects
- If projects in the capital works plan do not proceed, it is left to the airlines to identify this and raise a dispute around airport charges. If this occurs, the Qantas Group attempts to negotiate a price adjustment
- Any project over or under spends are typically rolled back into the capital plan. This in effect means that the capital plan sets the capital budget, and the airport undertakes as many projects as possible
- The airports holds no accountability for project over spends, it simply capitalises the project at cost in the next pricing period
- There is no transparency around how project costs are allocated between aeronautical assets and non-aeronautical assets
- There is no transparency as to the nature of projects, and whether they are growth capital or replacement capital. All capital works are presented as growth projects and airlines themselves have to specifically identify any replacement capital works and seek adjustments.
- The Qantas Group has been able to become involved in some Project Control Groups to gain a more detailed insight into major projects
- Twice year pricing update (multi-lateral) which provides an update on capital projects and how they are tracking against plan

Sydney

- Set a base price for 5 years
- Base price is then adjusted each year to account for capital investment undertaken over the previous period, referred to as Necessary New Investment (NNI)
- Have monthly meetings on NNI projects
    - Every single project goes to round table with airlines. Airlines given the opportunity to agree or not with the project. Airport will generally only proceed with the investment if airlines agree
- When more detail is requested around projects, little information is made available. For example, if airlines seek to understand the cost estimates through access to contractor quotes, or contingencies, no information is provided
- Provide progress updates, which track budgets. However, cost impacts are presented as the impact on prices (cents per passenger). This is distorting, as what seems to be a small increase to charges per passenger, could actually be a major cost overrun for an individual project.
- Generally, all capital is presented as NNI. Asset replacements have to be identified by airlines, and either removed from the NNI, or have a downward revision in prices.
- There is no transparency around the airport's asset register. This means that:
    - it is difficult to identify replacement projects
    - it is unclear whether assets which still have remaining life are being replaced or not
- There is no transparency around how project costs are allocated between aeronautical assets and non-aeronautical assets
- There is no transparency around how project costs are allocated between international and domestic

Melbourne:

- 5 year capital plan as part of 5 year pricing agreement
- Airlines not given the opportunity to scrutinise the capital plan, and have limited ability to alter
- Capital plan presented the projects with a cost
- No detail provided around project costings, no presentation of tenders, quotes
- No update is provided on projects until the next 5 year pricing negotiations commence, though may get some information through public mediums (e.g. investor forums). The formal visibility is only at the next round of pricing discussions. Quarterly Meetings

7.3 Components of Airport Building Block Approach

Airport	Real or Nominal Cash Flow?	Forecast Horizon	Depreciation Calculation	Return on Assets Calculation	Operating Costs	Tax Expense	Issues
Adelaide	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Brisbane	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Melbourne	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Perth	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Sydney	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Canberra	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

7.4 Airport Derived WACCs

		Sydney	Sydney	Brisb	Brisb	Perth	Perth	Melb	Melb	Melb	Adel	Adel	Adel	Hobart	Canb	Cairns	Darwin
Year pricing forecast commenced		2007	2010	2007/08	2011	2005/06	2010	2001-2007	2007-2012	2011	2003	2005/06	2011	2009/10	2007	2010	2009/10
CPI	%	3.2%	2.50%	2.4%	2.57%	2.7%	2.50%	2.5%			2.5%	2.4%	2.8%	2.5%		2.5%	3.0%
Real Risk Free Rate	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Asset Beta	#	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Equity Beta	#	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Debt Beta	#	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Market Risk Premium	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Gamma	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Gearing Choice	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Tax Rate	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Nominal Risk Free Rate	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Cost of Debt Margin	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Nominal Cost of Debt	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*

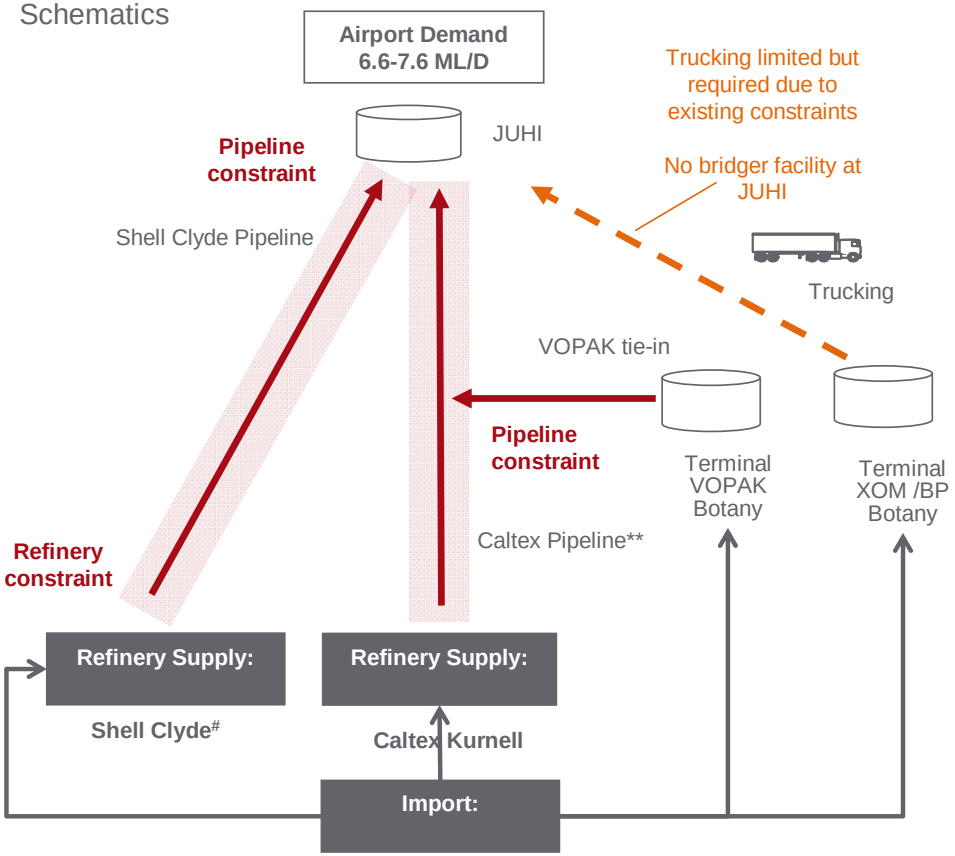
		Sydney	Sydney	Brisb	Brisb	Perth	Perth	Melb	Melb	Melb	Adel	Adel	Adel	Hobart	Canb	Cairns	Darwin
WACC used in Model		*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Nominal Pre-Tax Cost of Equity	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Nominal Post-Tax Cost of Equity	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Nominal Pre-Tax WACC	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Nominal Post-Tax WACC	%	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*

* Confidential Information

7.5 Sydney Airport Fuel Infrastructure

Sydney jet fuel infrastructure and constraints

Sydney Airport Infrastructure
Schematics



Sydney Jet Fuel Demand (ML/D)

	2008	2009	2010
Total	6.57	6.60	6.71
Growth		0.5%	1.7%

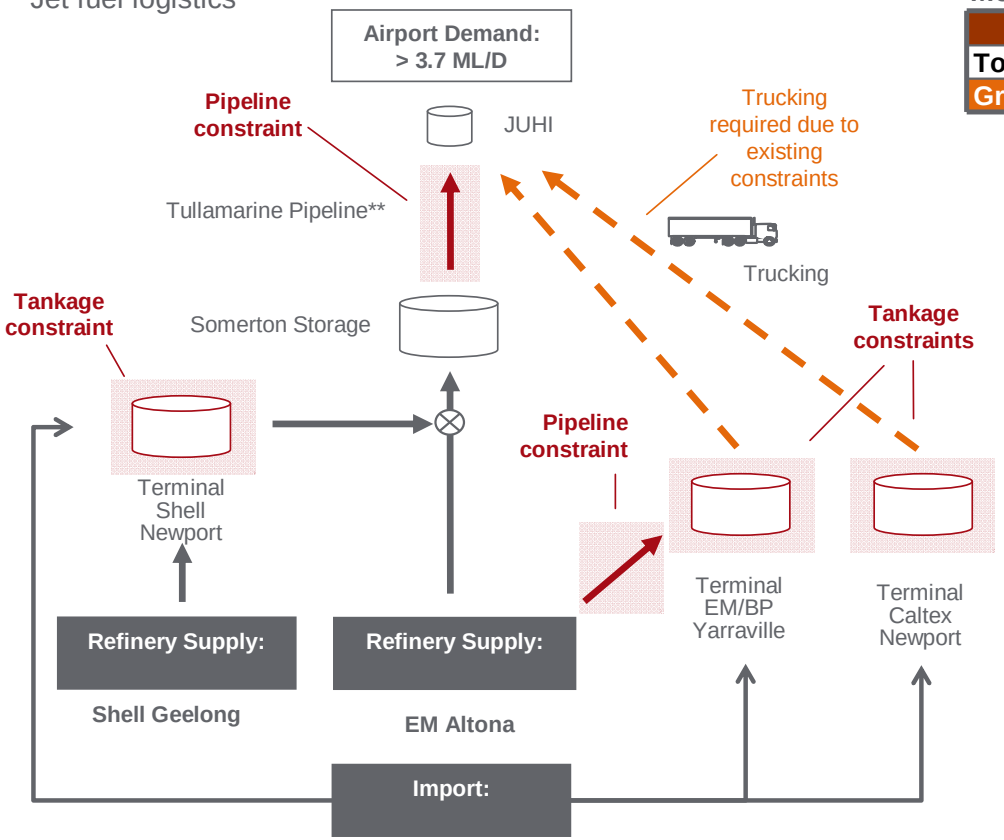
- Pipeline constraints:
  - –Caltex pipeline at capacity
  - –Shell Clyde pipeline currently at production capability
- JUHI issues
  - – No large scale bridger facility at JUHI
  - – long term location uncertainty
  - – tenure expiration in 2018
  - – tank infrastructure limitations
- Constraints impact supply reliability –

* Upgrade announced for 2012 as result of Sydney Jet fuel infrastructure working group report Apr 2010
\# Refinery transformation into import terminal expected June 2013

7.6 Melbourne Airport Fuel Infrastructure

Melbourne jet fuel infrastructure and constraints

Melbourne Airport Infrastructure
Jet fuel logistics



Melbourne Jet Fuel Requirements (ML/D)

	2008	2009	2010
Total	3.27	3.48	3.68
Growth		6.4%	5.7%

- Several capacity constraints for delivery of imported jet fuel to the airport exist
- Pipeline constraints:
  - –Tullamarine pipeline at capacity
  - –ExxonMobil Yarraville pipeline currently configured for exports only (one way)
- Tank constraints:
  - –Insufficient storage in Shell, EM/BP, Caltex import terminals
- Constraints lead to reliance on higher cost supply chain which sets market price
- Constraints impact supply reliability

** Upgrade announced for 2011 Sydney Jet fuel infrastructure working group report Apr 2010