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# Submission to the Productivity Commission Inquiry into the Economic Regulation of Airport Services

***Response to Draft Report***

***October 2011***


Andrew Fellowes
Associate Director, Infrastructure
Hastings Funds Management


**www.hfm.com.au**

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## *Introduction*

Hastings Funds Management (Hastings) appreciates this opportunity to submit comments to the Productivity Commission (the Commission) regarding its draft report on the Economic Regulation of Airport Services. This submission aims to reinforce our earlier submission (dated 21 March 2011) as well as to provide some specific support and commentary on the findings and conclusions reached in the draft report.

Hastings is one of Australia's largest alternative asset managers with over $6.4 billion in funds under management across the various infrastructure equity and alternative debt funds that it manages. Specifically, Hastings has over $2.7 billion invested in 12 Australian airports on behalf of various Australian superannuation funds and institutional investors through the unlisted funds it manages (Utilities Trust of Australia ("UTA") and The Infrastructure Fund ("TIF")) as well as on behalf ofretail and institutional investors via its ASX listed infrastructure fund (Australian Infrastructure Fund ("AIX")). It is in this context, as a major airport investor, that Hastings makes this submission.

From an investor's perspective we see it as vital that the existing regulatory regime is preserved in its current form. The light-handed regime adopted in 2002 has served the Australian aviation industry and wider economy well. Its preservation is the surest way to provide the encouragement and regulatory stability required to promote continued investment in airport infrastructure, aviation growth and broader economic activity.

As such, at a high level, Hastings strongly endorses the general conclusions of the Commission's draft report. Specifically, we agree with the Commission's draft findings that:

- Under light-handed regulation, airports have continued to invest to meet the growth in air travel, without the bottlenecks that have beset other infrastructure areas;
- Aeronautical charges do not indicate misuse of market power and quality outcomes are generally satisfactory;
- Further action, such as deemed declaration and mandatory codes of conduct, would fundamentally alter the nature of commercial negotiation and are not warranted;
- There is no evidence to support expanding the scope of monitoring and there is limited benefit in seeking to fine tune the monitored facilities and services;
- Any problems that may exist with commercial negotiation are not symptomatic of system-wide failure;
- Commercially negotiated agreements are increasingly becoming sophisticated as the industry matures;
- There is no need to introduce access undertakings for surface transport operators to access airports.

While it is recognised that commercial tensions still exist between airports and airlines, this is to be expected and is in fact natural in a workably competitive market. The existing regime is working in facilitating commercially negotiated outcomes in airport operations and as such Hastings recommends the regime's continuation given its importance to infrastructure investment and the significant costs which would be associated with the re-introduction of any form of heavy handed regulation.

Hastings does however wish to express its views on some aspects of the Commission's draft report, namely:

1.) The "Show Cause" Proposal;
2.) Commercial Negotiation Guidelines; and
3.) Developer Contributions (to off-airport infrastructure)

# 1.) The “Show Cause” Proposal

As an airport investor, who has been involved in the industry since 1997, Hastings does not consider that a ”show cause” mechanism is necessary.

Hastings would therefore like to broadly support the response in regard to this matter included in the Australian Airport Association’s supplementary submission (reference DR97).

In this respect the National Competition Council has also made some particularly strong arguments in its latest submission (reference DR87) where it stated that:

> *“In the Council's view the desirability of a show cause process is not well made out in the draft report. In particular, the Council notes that in its draft report the Commission has said that:*
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> - *Australian airports compare favourably with overseas airports in terms of revenues per passenger, costs, profits and capital expenditure (Draft Report, pp xxxi-xxxii)*
> - *overall the evidence indicates that the concerns about aeronautical charges mainly reflect a distributional tussle between airports and airlines, rather than inefficient impacts on the demand for air travel (Draft Report, p 236)*
> - *although monitoring has shown prices for airport services have risen substantially, 'whether such price increases constitute any misuse of market power is less clear, particularly when taken in the context of investment programs' (Draft Report, p 119)*
> - *quality of service monitoring results on their own 'do not indicate any persistent trends that could raise concerns about the misuse of market power' (Draft Report, p 128)*
> - *airports' pricing and financial information 'does not provide evidence of misuse of market power' (Draft Report, p 237), and*
> - *the risks in price regulation are asymmetric in that*
>   - *excessively stringent regulation [endangers] efficient investment and the welfare gains associated with it, but*
>   - *insufficiently stringent regulation ... would not significantly imperil welfare; its primary effect would be distributional' (Draft Report, p 68).”*

It is not clear how this proposed regulatory change (the “show cause” mechanism) can be justified when the potential negative general welfare consequences of its adoption are taken into account. Sufficient monitoring and regulatory powers already exist and the light-handed regime in place has already created an environment in which airports and airlines are successfully reaching commercially negotiated outcomes.

Hastings’ primary concern is that the introduction of this new power could be subject to abuse, could cause unnecessary additional compliance costs, could cause distraction to airport management teams (who are already busy with operational and expansion related activities) and that it will introduce further regulatory uncertainty which could be a disincentive to efficient investment. It is this final point of regulatory uncertainty that should not be overlooked or underestimated.

There has been some discussion that any “show cause” notices would be confidential between the ACCC and an airport under notice, but in practice this may not be possible. Airports and investors in airports have significant disclosure obligations. For instance under the Australian Stock Exchange’s Continuous Disclosure Policy (Listing Rule 3.1) listed equity funds may be required to provide disclosure upon being issued a “show cause” notice. If such funds were in the process of raising equity to fund an airport development project then such a “show cause” notice and the resulting disclosure could delay or put in jeopardy the equity raising which in turn would result in an inefficient investment outcome. Likewise, if an airport was conducting a major debt raising or refinancing (via bank or bond market) it could be necessary for it to disclose any “show cause” notice as a “material

event". This could similarly delay or restrict the airport's ability to raise debt which could have significant ramifications on funding of general operations or investment activities. A badly timed "show cause" notice could imperil a debt refinancing (putting an airport's entire operations at risk) or it could delay a major fundraising which could lead to inefficient timing of expansion programmes, maintenance work or other critical airport investment activities.

It is estimated that approximately $4 billion will be dedicated to improving infrastructure at the airports in which Hastings' funds have ownership stakes over the period 2011-2016. Regulatory stability is required to support this investment and it is not clear that a "show cause" mechanism will add to regulatory stability or that it will enhance the negotiated outcomes that are already being reached.

It is for these reasons that Hastings does not support the creation of a "show cause" mechanism.

In the event that such a mechanism is created it must be carefully wielded. In this respect, Hastings supports the suggested formulation of the Show Cause Test proposed by Westralia Airports Corporation (WAC) in its submission (reference DR106).

> *"The Australian Competition and Consumer Commission must be reasonably satisfied that the business has, over an immediately preceding period of no less than 3 consecutive years, achieved returns which substantially exceed a reasonable weighted average cost of capital for the relevant aeronautical assets, commensurate with the relevant regulatory and commercial risks over that period, and determined having regard to all relevant agreements for use of those assets over that period."*

Hastings would add further conditions such that the ACCC should only issue a "show cause" notice after considerable formal dialogue with the airport under consideration and taking into full account the potential negative consequences associated with issuing a "show cause" notice and, if still justified, the most appropriate time to issue such notice.

Additional clear legislative guidance should also be provided to make it clear what additional information would be requested which is already not available to the ACCC or airlines through the existing monitoring regime and commercial negotiation process. It is not clear currently what additional information is desired and what costs and time burden on airports may be imposed from having to collect and present such additional information.

Finally, it is Hastings' view that if a "show cause" notice subsequently results in a Part VIIA price inquiry then the ACCC should not be the party to conduct such subsequent inquiry as the potential for a real or perceived conflict of interest is too high, given that the ACCC will have just recently formed the opinion which lead to the issuance of the "show cause "notice.

## 2.) Development Cost Sharing

In its draft report, the Commission requested further information in regard to developer contributions to support land use and transport planning:

> *"If funding is viewed as necessary, the Commission also requests information regarding:*
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> - *the basis for funding such infrastructure including the benefits*
> - *the form of funding (such as upfront financial contributions, rate payments or land transfers)*
> - *the method of calculating contributions and how the contributions would relate to existing developer charges levied by local governments*
> - *how such funding would align with the conditions under which airport leases were granted.*"

Hastings has already commented on this matter in our initial submission and we stand by our position that developer contributions should be on a voluntary basis and should not be sought where they might undermine the principle of competitive neutrality or equity.

In this respect, after considering numerous submissions, Hastings would like to express its support for the positions put forth in WAC's response (reference DR106) as well as Melbourne Airport's response (reference DR99).

States already benefit considerably from the economic activity, growth and general tax revenue created by airport operations. Aeronautical activities are of a public good nature and, as such, any supporting infrastructure (outside an airport's boundaries) for these aeronautical activities should primarily be funded by the State / or Federal Government. In many instances, airports have been willing on a voluntary basis to support the funding of required off-airport infrastructure projects and in Hastings' view this process of voluntary agreements on a case-by-case basis is the most appropriate process going forward.

In regard to non-aeronautical activities the position is less straightforward but as stated in the WAC response the principles of "need", "nexus" and "equity" ought to be the basis for any review.

The need and nexus when investigated often show that the land use and traffic related impact of on-airport non-aeronautical activities are relatively minor and that many transport related improvements would be required irrespective of these non-aero activities.

Furthermore, a comprehensive range of factors needs to be considered when considering the principle of equity or ensuring competitive neutrality is maintained relative to other developers. Specifically: a portion of the initial airport concession payment attributable to development land, any voluntary contributions being made, any council rates or voluntary payments in lieu of rates being made, any services (such as rubbish removal, street cleaning and maintenance, street lighting etc) being provided by the airport (rather than by the State) and any land access or land "in-kind" being supplied.

Airports, in many instances, already make substantial contributions to State finances to support non-aeronautical activities which occur on airport land. As such, when considered along with the principles of "need" and "nexus", Hastings does not believe that there is a systematic lack of contributions being made, particularly relative to the of level payments being made by competing off-airport developers.

## 3.) Commercial Negotiation Guidelines

The Commission has also requested information in regard to the current process of negotiating commercial agreements and whether this could be improved by the provision of guidelines:

> *"The Commission is seeking information on whether guidelines on matters that could improve commercial negotiation — such as information on whether existing assets are being deployed efficiently prior to new investment and processes to facilitate effective service level agreements — should be:*
>
> - *devised by the Productivity Commission and incorporated into the Pricing Principles, or*
> - *encapsulated within a new voluntary industry code — a committee comprising representatives from the Australian Airports Association, the Board of Airline Representatives of Australia, the Regional Aviation Association of Australia, Qantas, and Virgin Australia (and possibly with guidance from the Australian Competition and Consumer Commission) could be tasked with this."*

Hastings, as a manager of investments in 12 Australian airports, is of the opinion that each airport is unique and as such the commercial arrangements that they form with their airline customers are also unique, taking into account their particular circumstances, market conditions and customer needs.

There is a well established history of commercial arrangements being successfully negotiated and, as such, Hastings does not see the direct need for specific negotiation guidelines. Imposing any stringent guidelines risks introducing market distortions in a circumstance where countervailing benefits are not clear and do not appear to warrant such an imposition.

One key aspect for Hastings, as an investment manager, is that the existing regime is light handed in nature which provides for innovation in service provision and the flexibility for counterparties to reach workable commercial negotiations in a complex environment with many competing price and non-price factors.

Suitable outcomes are being reached and as such any negotiation guidelines should only serve to speed up the process of negotiation to reduce costs equally for airport and airline participants. The purpose of any guidelines should simply be to improve the efficiency of the negotiation process in a fair and balanced manner without any bias or overly prescriptive conditions.

Practically, given the wide range of views and unique circumstances (multiple airlines, airports and investor groups), it is unlikely that a committee approach to formulating guidelines is likely to be productive. If such a committee approach were to be taken, it would need to be open to all airports in order to be truly representative, and this further highlights how such an approach would be difficult to implement practically. As such Hastings would be comfortable for the Commission to create the guidelines, particularly if they are not prescriptive, based on its extensive knowledge of the aviation industry and the issues at hand.

## Conclusion

As stated earlier, at a high level Hastings strongly endorses the general conclusions of the Commission’s draft report, subject to the specific areas of concern expressed above.

The degree of engagement, analysis and consideration that has been applied by the Commission is comforting from an investor’s perspective as it provides some reinforcement that proper process and thought is being applied throughout this inquiry.

We look forward to the Commission’s final report and the Minister’s receipt of its findings. We feel that it would be beneficial to the industry if clear feedback and an alignment of views were possible between the Commission, the Minister and relevant government departments (including the ACCC). The current dichotomy of views does not promote stability, infrastructure investment or the efficient and smooth negotiation of commercial agreements between airports and airlines.