# Productivity Commission Inquiry into the Economic Regulation of Airport Services

# Qantas Group Response to Draft Report Additional Information Requests

## November 2011


## Qantas Group Response

The Qantas Group (**Qantas**) appreciates the opportunity to provide additional information as requested at the public hearings into the Draft Report of the Productivity Commission's Inquiry into the Economic Regulation of Airport Services (**Draft Report**).

Sub-optimal productivity reduces the benefits airports provide to consumers, airlines, other stakeholders and the wider economy. Qantas believes that there are a number of risks to productivity inherent in the current regulatory regime.

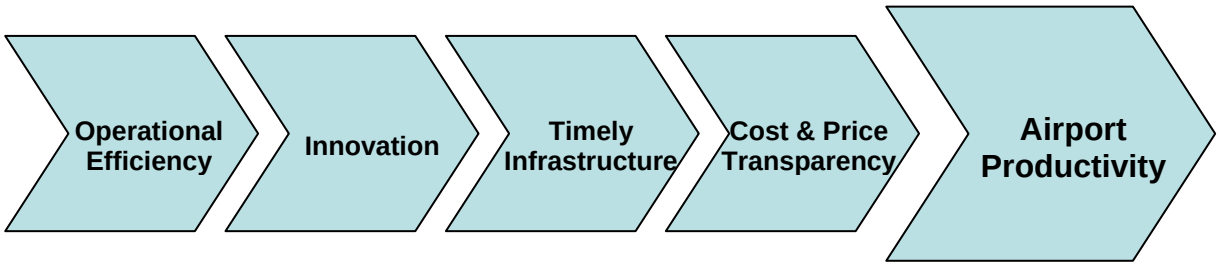
These can mainly be summarised as:

- Money spent on airport pricing inefficiencies is lost from the rest of the economy;
- Imperfect signals on the optimum time to build infrastructure; and
- Lack of incentive to innovate.

The Productivity Commission has also asked what Qantas would like to see included in refined pricing guidelines. Further, this submission addresses the Productivity Commission's questions on aircraft noise, including the impact this issue has on the productivity of airports.

## Airport Productivity

The major focus of this submission is airport productivity and some of the key drivers that influence that productivity. The productivity of airports is driven by a number of factors, which can be grouped under key headings as per the following diagram.




## Productivity Risk of Airport Pricing Inefficiencies

In its Draft Report the Productivity Commission discusses regulatory risk and justifies 'permissive' regulation over increased regulation despite the concern that airlines will pass on inflated aeronautical charges (p236). The Productivity Commission also notes that these charges have a minor influence on ticket prices.

In fact, airport charges can represent a very large percentage of the fares generally used by airlines for promotions and development of new or underperforming services. Under Australian consumer laws any advertised price must be all-inclusive and therefore include these charges. These discounted fares are among some of the most elastic in terms of passenger demand. Compared to Qantas fares, airport charges comprise a relatively higher proportion of Jetstar fares, with Jetstar

positioned as a lower cost carrier. Further, a greater proportion of Jetstar fares are elastic and so the impact is commensurately higher. The highly elastic nature of these fares means that demand is affected, which results in inefficient use of aircraft assets, airports and the industries that depend on travel.

In addition, even if the total charge on an individual ticket is relatively small, the amount potentially lost across the entire economy to inefficient charges is significant. If, on average, airports are charging $1 per passenger more than the theoretical optimum, this would have resulted in well over $110m in financial year 2010/11[1]. This amount would not be available to be spent in other areas of the economy.

The solution to this risk of inefficiency, as raised in our original submission, includes introducing recourse to a dispute resolution mechanism such as through the ACCC's proposal of deemed declaration, developing codes of conduct to facilitate negotiations between airlines and Tier 1 and Tier 2 airports and developing a less onerous code of conduct for regional airports.

**Productivity Risk of Sub-Optimal Infrastructure Timing**

Building infrastructure too early leads to prematurely incurring the costs of that infrastructure and inefficient use of the asset. Building infrastructure too late leads to increased costs of operation (eg through flight delays) and may limit passenger numbers for the capacity-constrained airport. While it is never possible to deliver a long-lead time asset at exactly the right time, Qantas has observed instances at various airports where the current regulatory regime can significantly skew the priority setting for building infrastructure.

In Canberra and Darwin, facilities for airlines and their customers grew increasingly constrained and degraded over a number of years while awaiting new facilities to be built. In Darwin the delays have resulted in significant deferment of Jetstar's ability to grow a hub in Darwin serving Asia. In these cases delays were driven by the length of time taken to negotiate new agreements between airport authorities and the airlines using the new facilities. Construction did not commence until pricing agreements were in place, with the airports leveraging the significant productivity costs and facility dilapidation in negotiations.

If there had been the possibility of a 'circuit breaker' dispute resolution mechanism being invoked (as a result of the airports being deemed declared), this could have provided an incentive for negotiations to be resolved sooner, delivering the facilities closer to the optimum delivery date.

At the other end of the spectrum, Qantas has observed that airport authorities often request to build capacity at the first signs of congestion in existing facilities, rather than allowing an acceptable level of demand to build up, so that the new facilities will have an economic level of use once they have been built. While Qantas generally supports long-term capacity expansion, during initial periods of constraint other

[1] Based on BITRE domestic passengers on competitive routes only for FY11, totalling 54,686,641 passengers and allowing for an airport charge to be paid for both departure and arrival for each passenger.

methods of managing demand for infrastructure may be more appropriate. Examples include:

1. Terminal and gate expansions being proposed when demand for gates in a peak period exceeds supply, eg the international terminal at Brisbane and the Adelaide terminal. Aircraft towing and bussing solutions should be the initial response.

2. Brisbane Airport proposed a 'pavilion' concept to deliver a substantial step change in infrastructure in the domestic precinct. This would have added significant capacity to the domestic terminal but at a substantial cost. Airline negotiations and the impact of the Global Financial Crisis eventually saw this facility deferred for up to a decade. In the meantime, investment by Qantas in new world leading faster smarter check-in technology and innovative baggage system designs has demonstrated that there are significant efficiency benefits by leveraging the current assets.

3. Melbourne Airport added new international terminal capacity ahead of a new pricing agreement with minimal consultation. Qantas has raised its concerns that the capacity was delivered to meet a sharp morning peak. (More detail on this additional capacity in Melbourne can be seen in section 3.3.4.1 of our original submission.)

4. The timing of the proposed Brisbane New Parallel Runway is currently subject to negotiation. Significant debate has arisen in regard to the optimal timing from an economic impact perspective.

Qantas believes that this tendency towards sub-optimal infrastructure construction is potentially driven by the airport pricing model, where the cost of new infrastructure is paid for by all airport users regardless of whether the infrastructure is delivered at the optimum point in time.

The building block methodology has its merits but also has its limitations. It is not designed to economically price an asset over its life and assumes activity or demand is inelastic. It works quite well if the capital expenditure profile is reasonably smooth, infrastructure is optimally built to meet demand and there is consistent inelastic activity.

Using the building block model, large, long-lifespan assets generate inequitable pricing for incumbents and can distort the incentive to invest, causing this misalignment of timing. With a forecast $10 billion dollars worth of investment expected by Australian airports over the next 10 years it is important that this investment is paid for equitably by all users.

Models that seek to provide a better relationship between assets and their use over time could move some payments from earlier years to later years. This need for airports to fund more of the cash flow up front (for a greater return in later years) may provide an airport with the incentive to invest when there is more evidence of the need for new infrastructure.

## Productivity Risk of Reduced Innovation

Qantas believes that light-handed regulation and the building block based cost recovery model typically lead to airports having little or no incentive to innovate. In purely competitive negotiations, airports would have an incentive to provide their product at the lowest possible cost, through methods that include innovation. The following examples are in addition to some items raised in section 3.3.1.2 of our original submission.

As an operator of domestic terminal leases, Qantas has an incentive to innovate, as any increase in the productivity of capital or labour directly benefits the bottom line. Faster, smarter check-in is a prime example of innovation. It frees staff from process work to directly assist customers and has almost abolished customer queuing in the check-in area. We estimate it has increased the passenger capacity of the check-in areas in our terminals by such an amount that it will defer any required expansion well beyond the expiry of the leases.

We have also worked with suppliers to identify more efficient, reliable and cheaper baggage systems, which have been installed with success in several terminals.

Working with airport authorities however, we have found a reluctance to implement the technology, even after explaining the cost and reliability advantages. As a consequence, timeframes have dragged in achieving agreement to trial and deploy new technology, particularly in international terminals.

A proposed solution may be to give airports an incentive to reduce costs in such a way that any innovation benefit is shared between the airport and the airlines, and perhaps to set some cost improvement targets in agreements. An example could be to target a 2% per annum real reduction in operating expenditure (adjusted for any capacity expansion) over the life of an agreement. Another option is to have a continuous improvement process between the airport and stakeholders and an agreement on how any substantive benefits generated from improvements are shared. We have been largely unsuccessful in negotiating such outcomes, with the building block model effectively being used as a pass-through mechanism.

To drive further innovation in capital works, the process should have more transparency and airport stakeholders should have increased involvement in the detailed development of capital construction plans. Projects over a certain threshold should require a greater level of stakeholder consultation at both the detailed design and tender stages, even where airlines have signed up in principle to the project at an earlier stage as part of a pricing agreement. This input, and the continuous improvement process suggested above, could be stakeholder consultation requirements in a code of conduct for airports.

## Pricing Principles

Currently the pricing principles are only applied by the five major airports and a further select few with each airport applying them very differently, if at all. Further, significant time is spent negotiating the form of pricing models. This results in inefficiency and allows airports to exploit their market power to the detriment of

airlines and passengers by selectively treating components differently where it is advantageous to their pricing.

Standardising components of the building block model will improve productivity by reducing the time spent in negotiations attempting to understand the inputs and increasing the ability to benchmark proposals.

In our original submission (section 5.5.1), Qantas proposed several enhancements to the pricing principles. The following information may add clarification to the points raised.

Examples of where guidance could be given on elements of the model include:

- Aeronautical vs non-aeronautical split
    - Guidance on possible methodologies that could appropriately split costs for roads that service both aeronautical and non-aeronautical traffic, especially where airport authorities have constructed office or retail developments.
    - Guidance on possible methodologies for sharing revenue associated with advertising on facilities completely paid for by aeronautical revenue (eg, aerobridges).
    - Instead of the current practice of predominantly allocating aeronautical and non-aeronautical building costs on a per square metre basis, guidance on possible methodologies of identifying a simple hierarchy of locations based on the 'premium' attached to those locations. For example, retail is often in premium locations.
- Long-term vs short-term assets
    - Guidance on the benefits of running separate models for long-term assets (ie, those with a life span of 15 years or more), particularly where they are very large cost items delivering future capacity. There is a risk that the average capital spend of the airport could be distorted resulting in sub-optimal pricing outcomes if the underlying assets are all grouped in a single short-term model.
- Debt and risk
    - Guidance on how to deal with volatility in the debt market when calculating WACC components.
    - Guidance on using 'like' terms when benchmarking debt levels, such as a five-year benchmark for the debt being used in a five-year pricing model.
    - In relation to managing construction and project delivery risk for major projects, guidance on appropriate methods for handling cost escalation and contingencies. For example, how these should evolve as project definitions become more refined and prices are adjusted.

The pricing principles should also provide guidance on acceptable sources for inputs.

Please also refer to our section on *Productivity Risk of Sub-Optimal Infrastructure Timing* (above) for another area where pricing guidelines may help achieve a more balanced outcome.

Refining the pricing principles need not be akin to re-regulation. Instead, it will be enforceable as a base line for fair pricing whist still providing the crucial scope for commercial negotiations.

**Aircraft Noise**

The Productivity Commission has asked for technical data demonstrating that new technology aircraft deliver real noise reductions and to suggest how new technology aircraft could be defined.

Noise management is a critical issue for airlines. Where airports have curfews, eg Sydney and Adelaide, this limits the ability of airlines to schedule services efficiently.

Curfews limit productivity by removing the ability to operate at times that provide optimal connections to services in other ports. Qantas passengers travelling London to Adelaide via Singapore have a transit of approximately 4 hours in Singapore due to the curfew. Curfews can also limit business productivity. For example, Sydney based business people must leave Melbourne no later than 9pm, making a business dinner virtually impossible without an overnight stay.

Although flight path planning and noise sharing schemes can lessen the impact of aircraft noise on individual residents, they may also reduce the number of operations the airport can handle in any given period of time. They can also lead to flight paths that are sub-optimal for fuel burn because they require the aircraft to take a longer routing, or place aircraft at non-preferred altitudes.

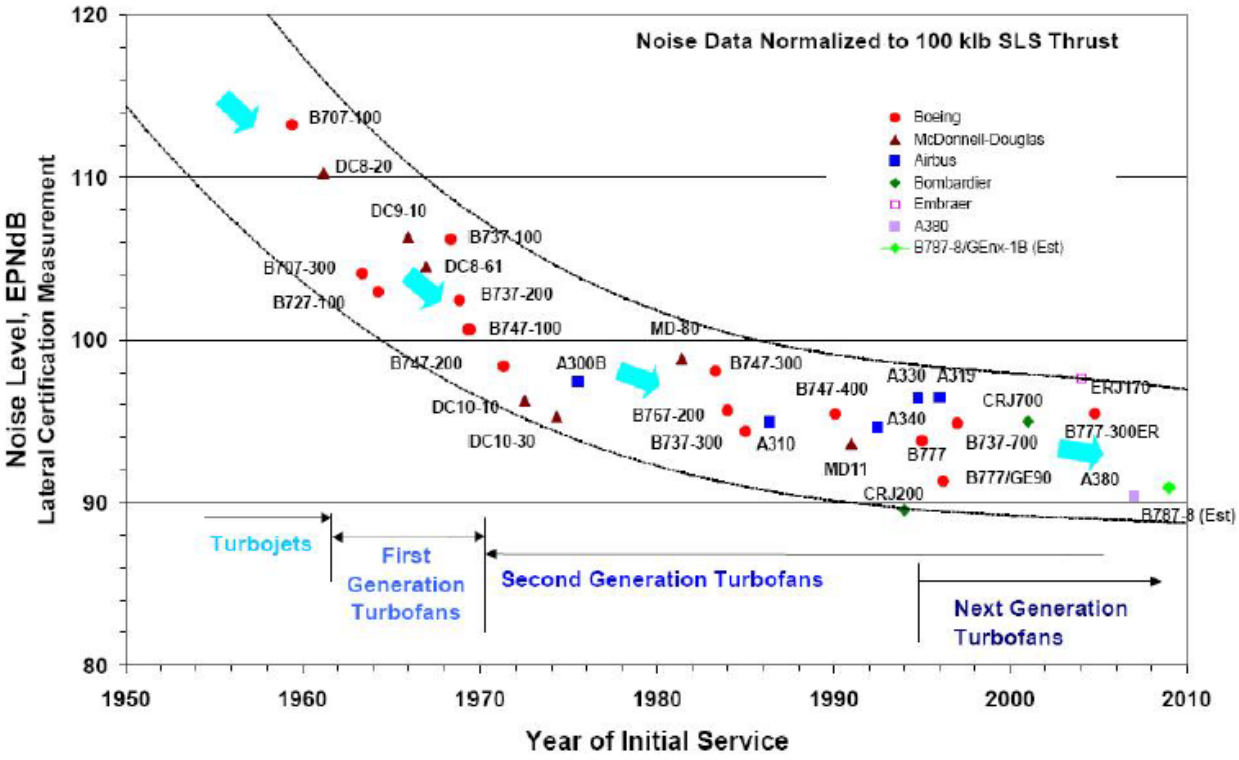
Most major airports have some degree of flight path planning which limits and/or shares noise across residential areas. As Australia is a signatory to ICAO, Qantas recommends the consistent use of the ICAO 'balanced approach' to noise management at all Australian airports. The balanced approach identifies noise problems at airports and examines the various options available, including improved land-use planning, reduction of noise at the source, altering operating procedures and operational restrictions, to cost effectively address the noise problem.

Noise management must be considered on a case-by-case basis, and tailored to the specific requirements of each airport. The increasing mix of quieter new technology aircraft should also be considered. Recent and planned improvements in the Qantas fleet are expected to continue to deliver improvements in aircraft noise levels. The Boeing 747-300s retired by Qantas a few years ago have been replaced by Boeing 747-400s which have a noise contour half the size[2], and the Airbus 380s replacing these are quieter again. Boeing 737-400s are being replaced by Boeing 737-800s

[2] Comparing 85dB takeoff noise contours. This is the area around the runway which would be expected to hear noise at 85dB or greater during a normal takeoff by that aircraft type.

which are slightly quieter, despite carrying an additional 24 passengers per service. Boeing 767-300s are being phased out by Airbus 330s and Boeing 787s. The 787 is expected to deliver a 40% reduction in noise footprint when compared to the 767[2].

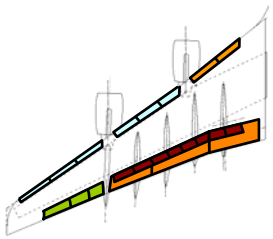
The chart below is reproduced with permission, from SACL's January 2010 submission to the Inquiry *into the effectiveness of Airservices Australia's management of aircraft noise*, and shows the improvements that each successive generation of aircraft engine technology has provided for aircraft noise.




The diagram below shows some of the technology that has been incorporated into the A380 to drive these noise improvements.

***Low speed aerodynamic changes:***

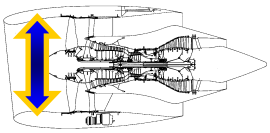
- ***Wing tip device optimisation***
- ***High lift system modifications***
  - ***optimised aileron droop for take-off,***
  - ***reduced slat setting; and***
  - ***droop nose device***
- ***Airframe noise reduction items identified***






***Nacelle improvements including lengthening and additional acoustic treatment***

***Engine fan diameter increased (110" to 116")***



Noise produced by aircraft is classified by ICAO Chapter ratings. All aircraft in the Qantas fleet meet the intent of Chapter 4 which is the quietest category recognised today, although there are expectations that specifications for a quieter standard are under development.

Regulations in Australia prevent flying aircraft certified to Chapter 2 and limit the airports which can be flown to by aircraft certified as 'marginally compliant Chapter 3' – often older aircraft which have had 'hush kits' added to bring them from Chapter 2 to Chapter 3.

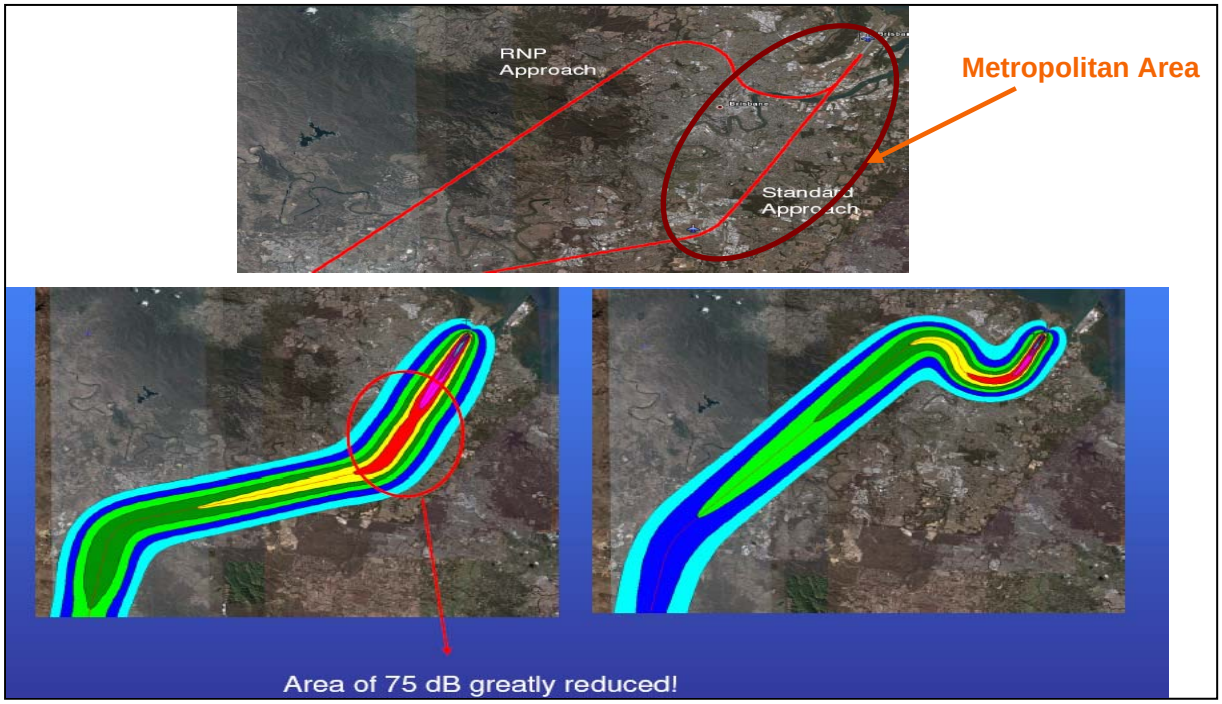
Over the last five to ten years most airlines have retired older aircraft which are not capable of complying with Chapter 4. These aircraft types include the Boeing 747-200 and -300 and the 767-200.

Qantas' preference is that any future definition of new technology aircraft is made in parallel with the ICAO ratings. These ratings are known to airframe and engine manufacturers and provide a degree of certainty when specifying the requirements for any new aircraft.

Another model that could be considered is the Quota Count system in use at London's Heathrow airport. This allocates aircraft a rating based on their noise emissions with noisier aircraft allocated a higher number. The quota is set based on the total of these ratings, so more movements are possible if quieter aircraft are used. This could be a useful tool for looking at ongoing management of curfew shoulder periods.

The introduction of technologies such as RNP (required navigational performance) can allow aircraft to be flown on more precise flight paths, allowing less separation

from terrain and other aircraft than would be the case without the technology. This allows flight paths to be selected that may provide a better outcome for both noise and efficiency. The illustration below shows the potential reduction in noise footprint available from optimising aircraft flight paths that RNP may provide. Qantas and Jetstar have been actively working with Airservices Australia and CASA to trial and implement RNP.




Qantas Airways Limited

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