



BARA

Board of Airline
Representatives
of Australia Inc

Submission to the Competition Policy Review

Overview of BARA



The Board of Airline Representatives of Australia (BARA) is the industry body promoting the safe and efficient operations of international airlines serving Australia for the benefit of consumers, businesses and tourism.

BARA's members provide 90 per cent of all international passenger flights to and from Australia.

BARA's role is to provide a collective voice on major issues that affect international aviation. The sustainable growth and potential of Australia's international aviation industry depends on the right economic policy framework and legislative and regulatory arrangements.

As a 'hands on' industry body, directly supporting its members' operations, BARA takes a collaborative and practical approach to its work. The Australian Competition and Consumer Commission (ACCC) has authorised BARA to undertake collective negotiations on behalf of its members with major international airports, Airservices Australia and other providers of essential aviation-related services.

At an operational level, BARA engages with airport operators and border agencies to improve the experience, efficiency and safety outcomes for international passengers.

BARA's vision and outcomes

To guide BARA's work and clearly articulate its ideals, BARA's members have developed a *Vision and Outcomes for International Aviation in Australia*, available at www.bara.org.au. The vision for international aviation in Australia is 'High quality, adaptive and efficient'.

Underpinning this vision, BARA has identified the following four key outcomes to boost competitiveness, productivity and the financial performance of industry participants:

Outcome 1: Timely and reasonably priced airport infrastructure

Outcome 2: Competitive supply of jet fuel

Outcome 3: Safe and efficient air navigation

Outcome 4: Environmentally sustainable growth

The Australian Government plays a critical role in shaping the international aviation environment and fostering BARA's identified industry outcomes.

Executive Summary

International passenger numbers now exceed 30 million annually. Over the next 20 years, they could more than double to over 60 million annually.

Australia's market share of international travel is affected by airline operating costs, through the consequential impact on airfares. While the industry has achieved large improvements in productivity, international aviation in Australia is facing significant cost pressures from the prices associated with its 'aviation infrastructure' (jet fuel supply, airports, air traffic management and fire services), which will have consequences for air travel affordability and the economic growth the industry generates.

Reform is necessary in many areas to help international aviation maintain and improve its productivity. Competitive supply, efficient pricing structures and greater innovation from suppliers can all contribute to more efficient international aviation in Australia.

Lack of effective competition between jet fuel suppliers

Jet fuel represents around a third of global airline operating costs. Many of Australia's international air services have very long distances between ports, leading to high fuel burns per passenger. International aviation operators now buy some 4.6 billion litres of jet fuel annually in Australia, costing over \$4 billion. Minimising jet fuel costs is critical to maintaining and increasing the number of commercially viable routes to and from Australia.

BARA has been concerned for a long time over the lack of effective competition between jet fuel suppliers at Australia's major international airports. BARA considers that international airlines pay more than necessary for this critical input.

This lack of competition stems from the difficulties potential competing (importing) suppliers face in getting jet fuel from the wharf to aircraft at the airport. The existing ownership and access arrangements to the 'jet fuel infrastructure supply chain' are an outdated product of history, making it almost impossible for new providers to enter Australia's jet fuel markets.

Increasing costs at the major international airports

Australia's major international airports are crucial assets in providing safe and efficient international aviation, with current annual costs of about \$600 million. The way they are managed influences safety, costs, productivity and the passenger experience.

Airport investment levels have almost tripled over the past five years while the prices paid by international airlines have doubled in real terms over 12 years. The Australian Competition and Consumer Commission's (ACCC) recent *Airport Monitoring Report 2012-13* found that growth in passenger numbers and prices charged had provided the airport operators with increased revenues and margins, while service quality outcomes remained flat or declined.

Executive Summary

Airservices Australia: poorly priced services

Airservices Australia (Airservices) is an integral part of the Australian aviation sector. It facilitates safe and efficient air passenger and freight transport services across Australia's flight information region. Airservices' costs also represent a large component of industry costs, with its annual revenue requirement expected to exceed \$1 billion in 2015-16.

The existing structure of Airservices' prices encourages the development of an inefficient aviation industry and distorts competition both between regional airports and with other modes of transport. BARA estimates that under the existing price structures, international airlines are now overcharged some \$70 million annually to subsidise the provision of services at regional and general aviation airports that in turn promote an inefficient pattern of industry development.

BARA's initiatives to promote improved outcomes

Jet fuel supply

Given the structural change in Australia's fuel industry, notably the closure of domestic refineries in New South Wales, it is an opportune time to create the conditions necessary to allow the emergence of more competitive jet fuel markets. There are many globally recognised jet fuel suppliers that could enter and compete at Australia's major international airports.

It is necessary to open the jet fuel infrastructure supply chain to competing suppliers. For the infrastructure located at the airports, open access arrangements should be a mandatory condition for any lease renewals between the infrastructure owner(s) and the airport operator. For the pipelines that transfer jet fuel from offsite storage facilities to the airport, 'deemed' declaration of the assets is considered necessary.

Major international airports

The industry needs to confront the rapidly rising costs of airport infrastructure to meet peak airline use during the day, which is the main factor pushing up airport prices. There is substantial scope to improve on industry planning, alignment of service standards and price setting mechanisms.

BARA considers the Australian Government should take a more active role in encouraging a more balanced negotiating environment between international airlines and the major international airports. This requires a preparedness to change the requirements for an individual airport operator that is not acting in accordance with the intent of the 'light-handed' economic regulation.

Airservices Australia

The Productivity Commission should be given the task of developing a set of principles to price the services Airservices provides. These would then become prescribed principles in developing proposed prices for the ACCC to consider.

More broadly, BARA considers it is an opportune time to review the aviation safety investment strategy at regional airports. The industry needs to focus on those practices and initiatives most likely to deliver the highest net safety benefits rather than rely on the current prescribed triggers for investments in fire services at regional airports.

1. International aviation, productivity and competition

Australia's international aviation industry has experienced tremendous growth over the last decade. Passenger numbers have almost doubled from about 16 million to the present 30 million a year. This is an impressive figure given Australia's population is around 23 million.

The benefits of this growth to Australia are substantial. International experience indicates about 1,000 local jobs are generated for every million airline passengers. International tourism contributes about \$25 billion annually to Australia's economy. Over one-fifth of Australia's trade by value is carried by international aviation, worth over \$100 billion each year.

International aviation in Australia could more than double to over 60 million passengers annually over the next 20 years. This growth will provide for hundreds of thousands of new jobs in Australia by boosting employment in the aviation and tourism industries.

Australia must be globally competitive to obtain this growth. To be successful, Australia's aviation infrastructure capacity will need to double and industry productivity will need to improve. This will ensure the availability of infrastructure necessary to accommodate growth in passenger numbers and contribute to airfare affordability.

Airfare affordability and industry growth

The sustained improvement in the industry's productivity, which has allowed ongoing reductions in real airfares, has been a specific driver of growth. Combined with increases in Australia's disposable income, international travel has become increasingly affordable.

As an example, in 1994 the cost of an economy flight from Sydney to Singapore was about \$2,100 in today's terms, representing about two and a half weeks of average weekly earnings. Now the same flight ranges from about \$350 (low cost airlines) to \$850 (full service airlines), equivalent to less than one week of average weekly earnings.

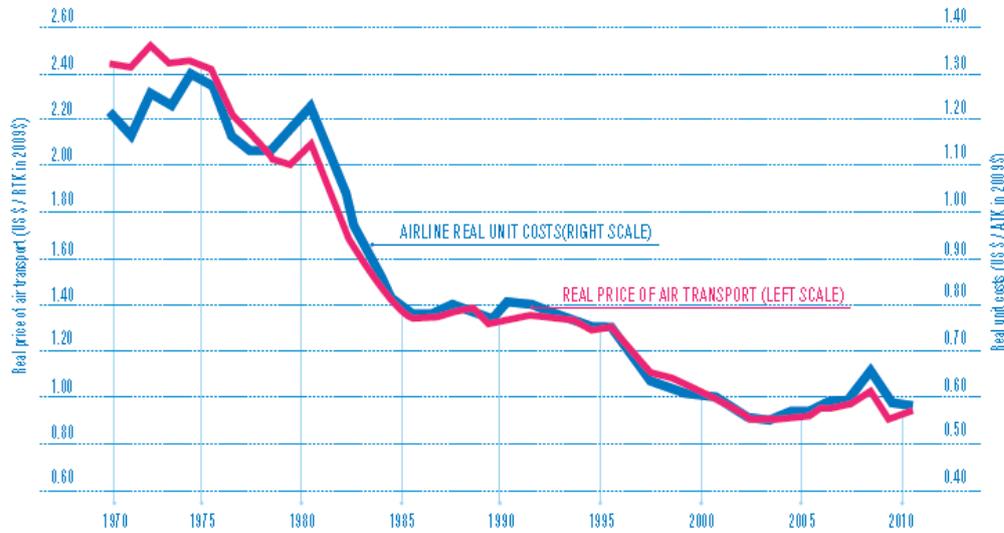
This tripling of affordability has made international travel an important part of the lives and careers of many Australians. It has connected Australia to the rest of the world, and created a vibrant and profitable tourism industry that provides jobs for hundreds of thousands of Australians.

Competitive reform

Australia's aviation industry has undergone significant reform since the 1990s, with deregulation and changes in the ownership structure of major airlines. For international aviation, the Australian Government has negotiated 90 bilateral air services agreements and associated arrangements, which allow international airlines to offer the range of services that they do today. BARA supports the Australian Government's policy of ensuring that capacity available under such agreements can support the growth plans international airlines have for the Australian market.

The competitive nature of international aviation is evidenced by the improvements in productivity that are passed on to passengers through lower real airfares. Analysis by the International Air Transport Association (IATA) shows that airlines have passed on the full benefit of industry productivity improvements (see Figure 1).

Figure 1. Real price of air transport and real unit costs



Source: Reproduced from IATA (June 2013)

Although the industry has become more efficient and competitive, more needs to be done in the coming years to ensure a viable, competitive market that provides value to passengers.

Supply cost pressures

Australia’s international aviation industry is facing significant supply cost pressures as a result of the prices charged by its ‘aviation infrastructure’ providers (jet fuel supply infrastructure, airports, air traffic management and fire services), which will have consequences for air travel affordability and the economic growth the industry generates. BARA considers there is considerable scope to improve upon the aviation infrastructure’s productivity and efficiency through greater competition in supply and more efficient pricing structures.

BARA’s submission describes the underlying issues with the efficient supply of aviation infrastructure services to international airlines and the measures considered necessary to encourage improved performance. While BARA continues to actively pursue improved outcomes with suppliers, reform is necessary in many areas to help international aviation maintain and improve overall industry productivity over the coming decade.

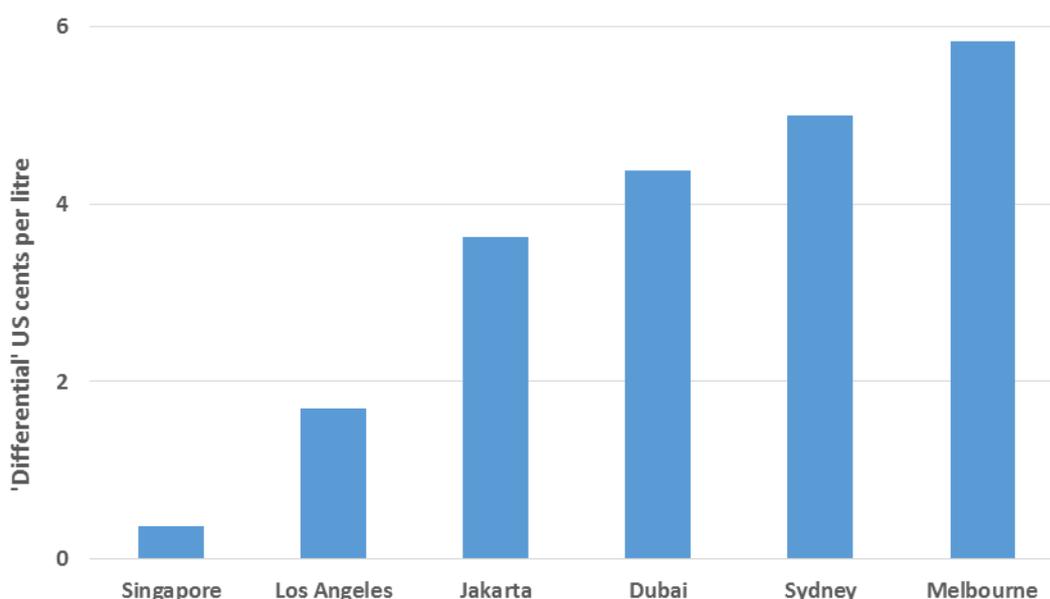
2. The competitive supply of jet fuel to international airlines

Jet fuel is a critical component of international aviation, representing around a third of global airline operating costs. Australia's international aviation industry is characterised by very long distances between ports, leading to high fuel burns per passenger. This means affordable jet fuel is critical in maintaining and increasing the number of commercially viable routes to and from Australia.

In Australia, international aviation buys some 4.6 billion litres of jet fuel annually, costing over \$4 billion. This translates to an average cost of about \$280 per passenger, which obviously varies greatly depending on the distance flown and type of aircraft.

International airlines operating to Australia pay some of the highest 'jet fuel differentials' globally (see Figure 2). These differentials represent the amounts paid above the production price of jet fuel (explained further below).

Figure 2. Jet fuel differentials, Australian and overseas airports



Source: Data provided by the International Airport Association.

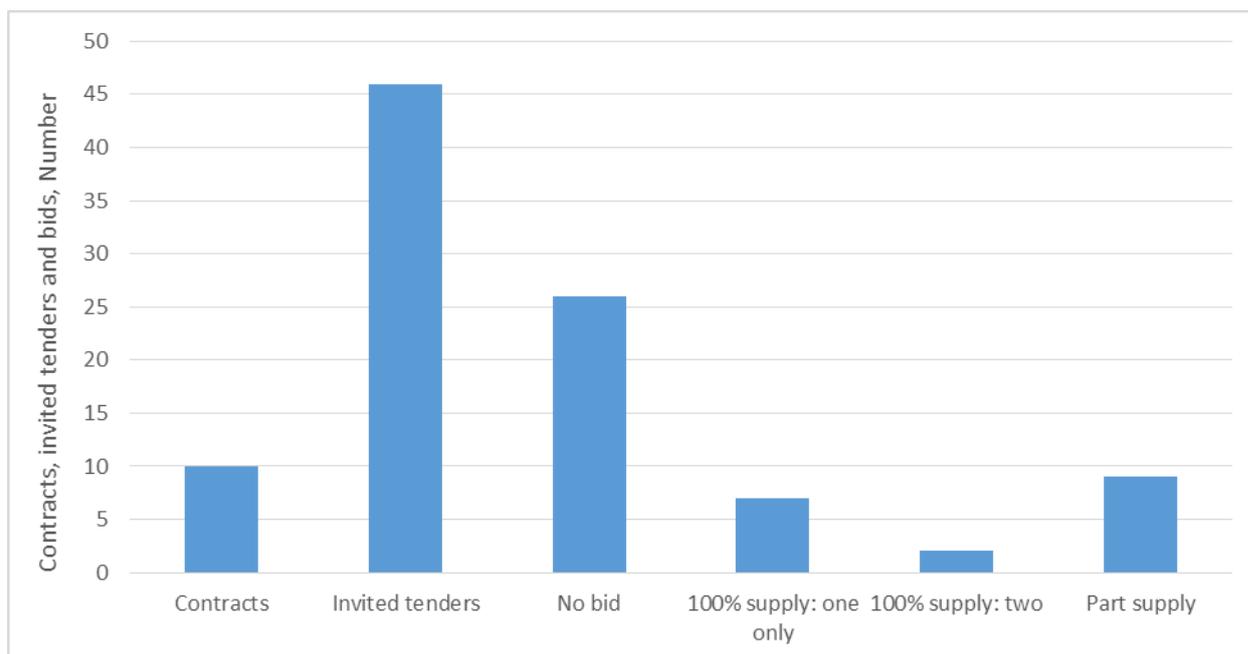
BARA has been concerned for a long time over the lack of effective competition between jet fuel suppliers at Australia's major international airports. International airlines pay more than necessary for jet fuel – a critical cost input – because of the market power of the existing fuel suppliers. This lack of competition can be traced to the difficulties faced by potential competing suppliers in gaining access to the necessary jet fuel infrastructure supply chain.

As evidence of the lack of effective competition, BARA has developed a 'jet fuel competition index' for international airlines operating to Sydney Airport (see Figure 3).¹ The figure shows that for 10 contracts issued by international airlines for the provision of jet fuel to international airlines at Sydney Airport:

- collectively, there were 46 opportunities for fuel suppliers to provide a bid
- of these 46 opportunities, no bid was received 26 times
- for the majority of the contracts, only one potential provider responded with a bid to supply the airline's jet fuel needs.

Box 1 [on the following page](#) contains statements from individual airline members about the state of competition between suppliers of jet fuel at Sydney Airport.

Figure 3. Jet fuel tendering outcomes for international airlines



Source: Data provided by member airlines

¹ BARA requested its members to provide information on the number of suppliers that bid on their tenders for jet fuel. This information is provided by member airlines on a strictly confidential basis to BARA's legal representative. BARA has not sought to access the data and no data have been shared between airlines. A high level summary of the information is provided to BARA.

Box 1 BARA's member airlines have made the following observations about the level of competition between suppliers of jet fuel at Sydney Airport.

Emirates	Emirates enjoy good relations with all our jet fuel suppliers in Australia. However, our experience during recent tenders at Sydney, Melbourne and Perth airports indicates that competition for the provision of jet fuel is very limited at these airports. It is particularly limited at Sydney Airport, which is effectively a near monopoly market. The pricing levels at Sydney, Melbourne and Perth airports remain significantly higher than prices offered at competitive markets globally.
Cathay Pacific	Over the years, Cathay Pacific has observed an uneven playing field emerge in the Sydney Jet Fuel Market; a) between fuel suppliers subject to inequitable infrastructure access terms to the main fuel infrastructure into Sydney airports; and b) between local and international carriers being charged varying differential costs despite the purchased fuel being supplied through the same infrastructure.
Etihad	At SYD market, Etihad encounters the following constraints <ol style="list-style-type: none">1 Not many fuel suppliers available to respond to our fuel tenders (either a monopoly market or limited competition).2 If we any received bids, in the initial phase of tendering process bids for 100% of our required volume would be a challenging factor (product constraints).3 High differential (significant high cost to our airways).
United Airlines	The overall lack of competition combined with supplier ownership of the fuel supply infrastructure has produced a situation of artificially high jet fuel prices in SYD combined with unreliable supply.
Korean Air	Korean Air has not seen enough suppliers for soliciting fuel tenders and in consequence experienced difficulties and could not achieve a desirable outcome from negotiating with suppliers out in the field.
United Parcel Services (non-BARA member)	Our last two jet fuel tenders for SYD occurred in 2009 and 2011. The same two jet fuel suppliers made offers each time, and no other suppliers made offers. As a result of this limited competition, we experienced a significant increase in our SYD product differential this year.

The jet fuel infrastructure supply chain

The supply of jet fuel is a complex and costly business. To appreciate the barriers potential new jet fuel providers face in Australia, it is necessary to first understand some basics about the supply chain.

Any new provider of jet fuel will need to import the product from an overseas refinery. The cost of the jet fuel is determined in global markets. Generally speaking, the Mean of Platts Singapore (MOPS) is used as proxy benchmark for determining the cost of refining jet fuel for airlines operating from Australian airports.

The entire jet fuel supply chain transports the fuel from overseas refineries into Australian ports, then to the airports, and finally into the aircraft.

The supply chain can be broken down into two parts for access and competition analysis. The first part transports fuel from the refinery to an Australian port. The costs here include sea freight, insurance and loss, and wharfage fees. BARA is unaware of any artificial constraints or barriers with this part of the supply chain.

The second part of the chain transports the jet fuel from the wharf to aircraft at the airport. Jet fuel is generally first stored offsite, then transported to on-site storage at the airport (either by pipeline or truck), and finally, into aircraft via pipes and hydrants or refuelling trucks. The storage and distribution infrastructure at the airport, which is owned by multiple parties in Australia, is generally referred to as the joint user hydrant installation (JUHI). The infrastructure from wharf to aircraft is generally referred to as the 'jet fuel infrastructure supply chain'.

For potential new providers of jet fuel, the main challenge lies in gaining access to the jet fuel supply infrastructure chain – in other words getting jet fuel from wharf to aircraft at the airport. A complex mix of individual companies and 'joint venture' arrangements own the infrastructure. No formal access undertakings or access codes are associated with the infrastructure. There are, however, physical barriers as connections are also fragmented, with some offsite storage linked to transfer pipelines but not others.

The existing ownership and access arrangements in Australia make it very difficult, if not impossible, for new providers to enter Australia's jet fuel markets. A potential new supplier cannot bid to win supply contracts with international airlines without the assured ability to transport jet fuel from the wharf to the aircraft. At the same time, infrastructure owners may require the new supplier to pre-purchase access to the supply chain before it has won contracts with airlines.

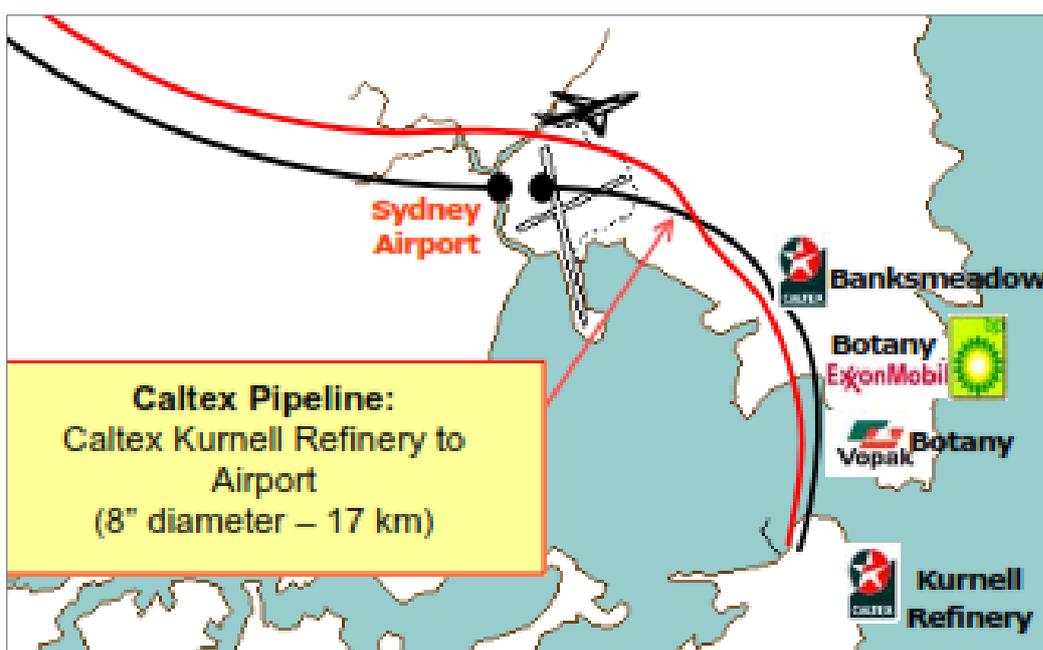
The existing jet fuel infrastructure supply chain arrangements are an outdated product of history, and not suited to the needs of the modern aviation industry. Reform will be essential to open up the provision of jet fuel to competition and innovation, which is essential to support a stronger and more productive international aviation industry in Australia.

BARA's application for declaration

In response to the lack of effective competition, in September 2011 BARA applied to the National Competition Council (NCC) under Part IIIA of *the Competition and Consumer Act 2010* for declaration of the Sydney aviation jet fuel supply infrastructure. In two separate, but related applications, BARA sought declaration of the Caltex pipeline, which transports fuel from Caltex's Kurnell refinery and from interconnection points with offsite storage to the Sydney JUHI, as well as the Sydney JUHI.

An illustrative map of the Sydney aviation jet fuel supply infrastructure chain for imported jet fuel is shown in Figure 4 below.

Figure 4. Map of supply infrastructure for imported jet fuel

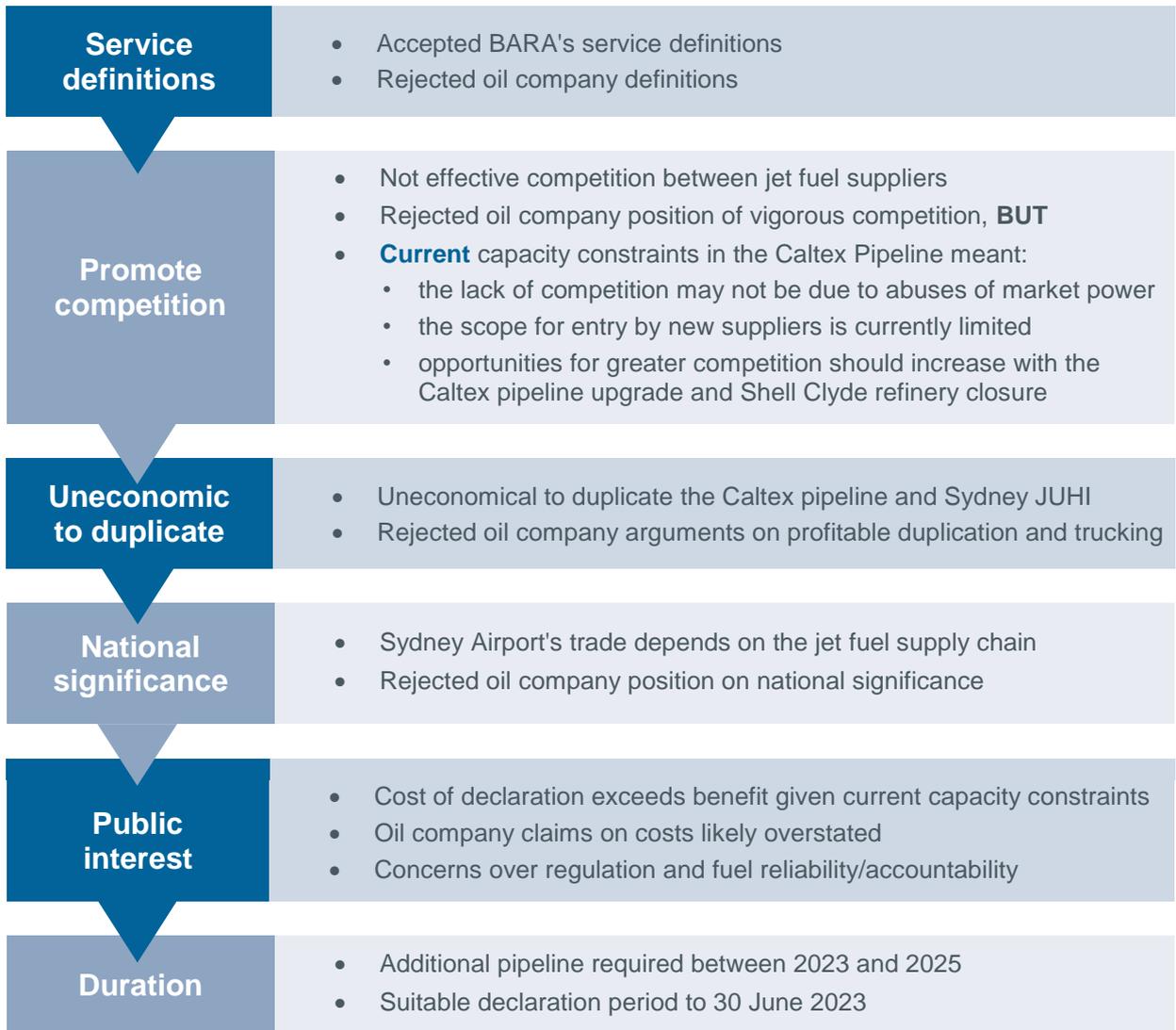


Source: Sydney Jet Fuel Infrastructure Working Group Report (2010).

Unfortunately, BARA did not succeed in having the jet fuel infrastructure declared for access. That said, the NCC's assessment highlighted the fundamental problems with the lack of effective competition and infrastructure supply constraints. The NCC also assumed there was likely to be an improvement in the level of competition between jet fuel suppliers through time. BARA, however, is not aware of any noticeable improvement in the level of competition between suppliers of jet fuel since 2011.

As the Review Panel would be aware, the NCC must consider a number of issues in assessing an application for declaration. A summary of the NCC's key findings over the jet fuel supply infrastructure at Sydney Airport is provided in Figure 5.

Figure 5. Summary of the NCC's declaration assessment



Competition and capacity constraints

A specific issue the NCC examined was whether there was effective competition between the existing oil companies in supplying jet fuel to airlines at Sydney Airport.

The oil companies hired numerous economic consultants in opposing BARA's applications for declaration. The consultants put forward considerable theory to support the argument that the supply of jet fuel at Sydney Airport was characterised by effective competition. BARA, helped by many of its members, put forward the actual outcomes airlines experienced when they tender for jet fuel at Sydney Airport.

After assessing the opposing arguments, the NCC stated that:

...the Council does not consider the market associated with the supply of jet fuel is effectively competitive nor that there is a vigorously competitive tender market².

The NCC also found it would be uneconomic for another party to duplicate the Caltex Pipeline. BARA's application therefore met the two critical declaration requirements.

The NCC, however, did not recommend declaration due to capacity constraints within the Caltex pipeline, stating that:

...declaration cannot create additional capacity where none exists³.

As such, the NCC did not recommend declaration on the basis the industry was achieving good outcomes. Rather, it was in response to existing capacity constraints and a view that competitive conditions between suppliers would improve in the future.

No evidence of improved competitive conditions

Since BARA's applications for declaration in 2011, BARA understands that Caltex has increased the throughput capacity of its pipeline by some 90%, resulting in a minimum of 10 days a month of spare capacity. Caltex also 'auctions' a pre-determined amount of this additional capacity to third parties. BARA is unaware of the details of this auctioning system.

Despite the increase in available transfer capacity and the auction system, BARA has not received any information from its member airlines indicating they are satisfied with the level of competition between jet fuel suppliers at Sydney Airport. This suggests the market for the supply of jet fuel to international airlines at Sydney Airport is not evolving as the NCC anticipated. Instead, largely the status quo remains. BARA intends to update its jet fuel competition index for Sydney Airport in the near future.

² NCC Final Recommendations, para.4.41

³ NCC Final Recommendations, para 4.98

Critically, BARA considers the auction system Caltex has put in place for its pipeline capacity is problematic for a number of reasons:

1. New jet fuel suppliers require 'end-to-end' access to the jet fuel supply chain to win contracts with international airlines. The jet fuel transfer time allocated by Caltex may not match the timing of import fuel deliveries or airline customer requirements.
2. As Caltex pre-determines the amount of capacity provided to third parties, it still effectively controls the allocation of market share available to competing (to BARA's knowledge currently non-existent) fuel suppliers.

Furthermore, BARA is aware that potential competing jet fuel suppliers applied to become a 'participant' of the Sydney JUHI some 28 months ago but no new supplier has obtained access. Of these 28 months, BARA understands that 24 months can be attributed to Sydney JUHI processes with the remaining 4 months due to lease discussions between Sydney JUHI and Sydney Airport Corporation Limited (SACL). This further demonstrates that no noticeable changes to the level of access or competition between jet fuel suppliers have occurred at Australia's largest airport since 2011.

BARA's recommended policy response

Given the structural change in Australia's fuel industry, notably the closure of domestic refineries in New South Wales, it is an opportune time to create the conditions necessary to allow the emergence of more competitive jet fuel markets. There are many globally recognised jet fuel suppliers that could enter and compete at Australia's major international airports. In the long run, all industry participants will benefit from a more resilient, innovative and cost-efficient supply of jet fuel.

The JUHIs – open access through lease renewals

The land on which the JUHI facilities are constructed and owned by the 'JUHI participants' at Australia's major international airports (Sydney, Melbourne, Brisbane and Perth) is leased or licensed from the privatised airport operators. As such, each airport operator has the ability to create the conditions for open access to the JUHI facilities as part of its commercial negotiations over future lease arrangements.

It is imperative all lease renewals with the JUHI participants incorporate the pre-condition of open access arrangements. Any recognised jet fuel supplier with a supporting letter from an airline operating at the airport should be able to gain access to the airport's JUHI within a few months. BARA's preference for access pricing is one of a volume-based throughput fee. Such a pricing arrangement may require resolving the environmental obligations contained in the existing leases between the JUHI participants and the airport operators.

Furthermore, the JUHI participants should also be required to make the necessary investments to encourage competition between jet fuel suppliers and 'into-plane' services. In particular, timely investments in truck bridging facilities will mean suppliers are not excluded from competing during periods when pipeline transfer capacity is constrained. Such facilities are therefore critical in transferring incremental jet fuel volumes to support competition up to a point where it would be more economical to invest in additional pipeline infrastructure.

If the necessary open access conditions cannot be negotiated with the JUHI participants, then BARA recommends the airport operator end the lease with the JUHI participants and establish new, independent operators (in other words operators that do not provide jet fuel to airlines) of the JUHI facilities. Independent operators have no conflicting interests in providing access to all potential jet fuel suppliers at the airport.

BARA continues to raise the importance of access to the JUHIs with the operators of each of Australia's major international airports. BARA considers the Australian Government can also play an important role in supporting the need for open access arrangements to the JUHIs with the airport operators as part of its ongoing engagement with industry.

If satisfactory outcomes cannot be established within reasonable timeframes then BARA considers it will be necessary for the Australian Government to enact 'deemed' declaration, as recommended for the jet fuel transfer pipelines.

Jet fuel transfer pipelines

It will take more than establishing open access to the JUHIs to create the environment that allows effective competition between jet fuel suppliers to emerge. It will also be necessary to create effective access arrangements to the jet fuel pipelines connecting the offsite storages to the JUHIs.

The ideal economic and social solution would be one where access to a jet fuel transfer pipeline is secured at a pre-determined price, with transfer capacity allocated based on the sales by supplier to airlines at the airport. This compares with the existing situation at Sydney Airport, where Caltex pre-determines the available level of transfer capacity (and timing of that transfer capacity) available to competing suppliers.

Unlike the JUHIs, there are no contractual arrangements with airport operators or other parties that can provide a way of obtaining suitable access arrangements. As such, it would appear necessary to rely on the provisions of Part IIIA of the *Competition and Consumer Act 2010* (CC Act).

BARA considers the Australian Government should invite each of the current owners of jet fuel transfer pipelines to lodge an access undertaking with the ACCC. This would allow for a set of orderly access arrangements to be negotiated and implemented.

If the current owners are not prepared to develop suitable access arrangements voluntarily, then the Australian Government should be prepared to enact 'deemed' declaration of the jet fuel pipelines, similar to that applied to Australia's major airports at the time of privatisation (see Box 2).

Box 2 Deemed declaration of core regulated airports

As part of the privatisation of Australia's major airports, the Australian Government included provisions for 'deemed' declaration within section 192 of the *Airports Act 1996*. Under this clause, the new owners of the airport had 12 months to have an approved access undertaking with the ACCC or the services provided were automatically declared for access under the then *Trade Practices Act 1974*.

The core elements of section 192 of *the Airports Act 1996* are as follows:

- 1 As soon as practicable after the end of the designated period for a core regulated airport, the Minister must, by notice in the Gazette, determine that subsection (2) applies to the airport.
- 2 If a determination is in force under subsection (1) in relation to an airport, then each airport service in relation to the airport is a declared service for the purposes of Part IIIA of the *Trade Practices Act 1974* except to the extent (if any) to which that airport service is the subject of an access undertaking that is in operation from time to time under that Part.

Designated period, in relation to a core regulated airport, means the 12 month period beginning at whichever of the following times is applicable:

- a. if, at any time, an airport lease for the airport was granted under section 21 of the *Airports (Transitional) Act 1996* to a company—the sale time for that company (within the meaning of that Act);
- b. if, at any time, an airport lease for the airport was granted under section 22 of the *Airports (Transitional) Act 1996* – the time of the grant of that lease.

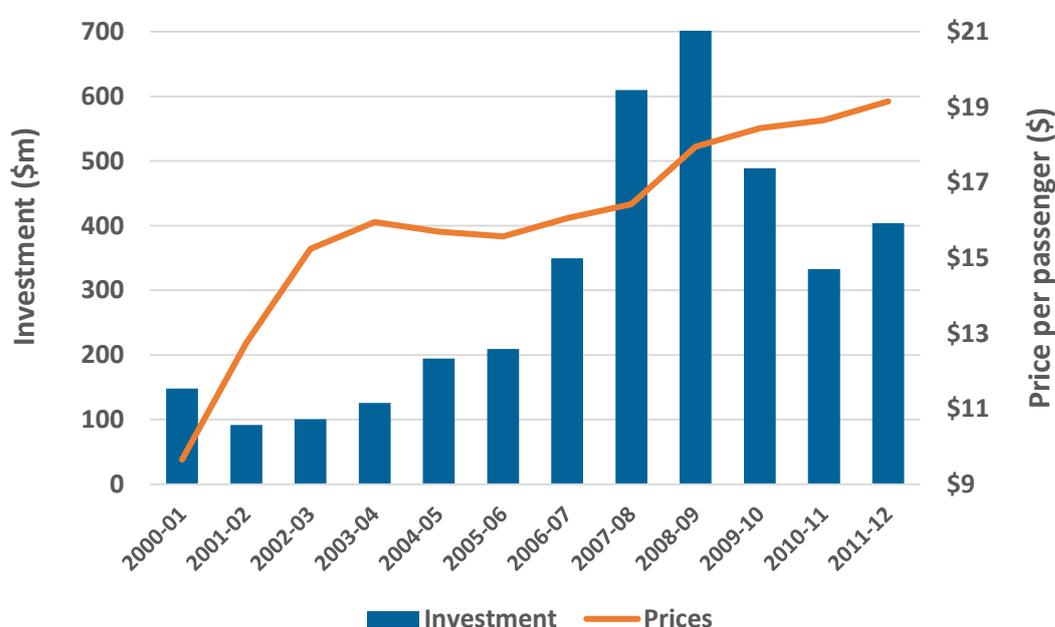
3. Australia's major international airports

Australia's major international airports are crucial assets in providing safe and efficient international aviation. Their management influences safety, costs, industry productivity and passenger experience.

International passenger numbers now exceed 30 million annually. The 'big four' airports in Sydney, Melbourne, Brisbane and Perth accounted for over 90% of these passengers. International airlines pay these four airports about \$600 million per year in landing and terminal fees.

Airport investment levels have almost tripled over the past five years while the prices paid by international airlines have doubled in real terms over 12 years (see Figure 6). Australia's market share of international travel will be subject to airline operating costs, which affect airfares. The industry, therefore, cannot sustain continued real increases in airport prices and expect to maintain airfare affordability.

Figure 6. Airport investments and prices, \$2011–12



Source: Data provided by airport operators; ACCC prices monitoring reports

Privatisation and light-handed economic regulation

Melbourne, Brisbane and Perth airports were privatised in 1997 through long-term leases. At the time, it was recognised these airports had substantial market power over airlines. As such, the prices levied by airport operators were subject to price controls, known as 'CPI-X price caps', which the ACCC administered.

Following a Productivity Commission review in 2002, the Australian Government removed the CPI-X price caps and replaced them with 'light-handed' economic regulation. Under this policy, airlines and airport operators commercially negotiate the provision of airport services consistent with the Australian Government's Review Principles. The ACCC monitors airport prices, profits and service quality outcomes annually, while the Productivity Commission reviews the arrangements periodically.

Sydney Airport was privatised through a long-term lease in June 2002 and is subject to the same light-handed economic regulation as the other airports.

Price and service quality outcomes

The ACCC recently released its *Airport Monitoring Report 2012–13* and its theme was consistent with findings from previous years. The ACCC reported that growth in passenger numbers and prices charged had provided the airport operators with increased revenues and margins, while service quality outcomes remained flat or declined. Of the four monitored airports (Sydney, Melbourne, Brisbane and Perth), overall average quality of service ratings for three of them remained unchanged at ‘satisfactory’ and only one airport was rated ‘good’ (Brisbane). A number of services at many airports remained rated below ‘satisfactory’.

The ACCC’s service quality monitoring outcomes have been criticised by the major international airports. It is notable, however, that the industry has not developed more sophisticated service quality measures and included them in agreements with airlines.

Industry productivity and planning

Effective planning is critical to the efficient development of the major international airports. In essence, it involves balancing the scale and timing of capacity expansions with both project costs and benefits to passengers and airlines.

Understanding the cost of meeting peak time demand

The efficiency of capacity expansions is often obscured because costs are expressed over all passengers and not the ‘marginal’ or additional passengers the investment serves. If the additional passengers served by the capacity expansion are small relative to the cost, then the merits of the investment are questionable unless the investment is highly valued by customers. However, airports and international airlines are not using the level and quality of analysis to better inform their investment decisions.

To make a more rigorous analysis of a proposed capacity expansion, it is necessary to understand its marginal or incremental cost. This involves expressing the cost of each option against only the additional traffic served and not all traffic growth.

BARA sees merit in the airport operators developing cost ‘heat’ maps, showing the incremental cost of expanding capacity throughout the airport. This will provide a comprehensive picture of where the greatest challenges lie in expanding capacity at reasonable cost. Greater innovation then needs to be applied to these high cost projects.

Agreeing on the benefits of capacity expansions

Capacity expansion allows a greater volume of traffic to be processed at particular times during the day. It also can reduce the congestion and delays experienced by airlines and passengers during these peak periods.

In assessing the merits of possible approaches to expanding capacity it is, therefore, necessary to agree on the value of improvements in outcomes to international airlines and passengers. Examples include the value of faster transiting times for passengers through security points and the benefit to airlines of reduced airborne and ground delays.

These benefit assumptions may only be implicitly contained within an existing proposed investment strategy. As such, opportunities to develop more capital efficient investment strategies may be lost

because the airport operator and international airlines have not explicitly agreed on the value of the benefits that must be obtained to justify the investment.

BARA sees merit in a joint approach to define the benefits and value assigned, which would then be explicitly incorporated into the planning and investment strategy development. Combined with a greater understanding of the additional passengers served by different investment options, it should be possible to develop more capital efficient solutions to forecast growth.

BARA's initiatives to promote improved outcomes

BARA recently released its policy paper, *Timely and reasonably priced airport infrastructure*. The paper identifies initiatives to encourage greater capital efficiency, together with five commercial principles to improve the quality of negotiations between international airlines and the major international airports.

The industry needs to confront the rapidly rising costs of airport infrastructure to meet peak airline use during the day, which is the main factor pushing up airport prices. Based on data available to BARA, the 'marginal' cost of meeting the growth in peak day use is often two or three times the current prices airport operators charge. This means rising airport prices often result in only small, if any, improvements to overall service quality because they are only funding extra capacity for airlines in their peak use during the day

Greater capital efficiency is needed, particularly innovations to expand capacity or encourage a more even distribution of traffic throughout the day. Access roads, check-in counters, security points and terminal waiting areas are specific areas where innovation and cooperation with airlines over service outcomes are necessary.

BARA's five commercial principles for negotiations are:

1. pricing for service delivery
2. reasonable investment returns
3. efficient airport operations
4. balanced and consistent agreements
5. a service quality culture.

Pricing for service delivery

BARA considers that agreements between airport operators and international airlines should be outcomes focused, in other words they should price for the delivery of services. Current practice usually sees prices set to cover investments as they incur. This tends to focus agreements on capital inputs rather than the outcomes delivered to airlines and passengers.

Instead the pricing of existing services should be based on the actual investments made by the airport operator, including the initial lease value of the assets from the Australian Government.

At Sydney Airport, the ACCC valued the airport's assets for pricing purposes before it was privatised. This put a definitive value on the assets. For Melbourne, Brisbane and Perth airports, asset valuations were established with the Productivity Commission's 2005 'line in the sand'.

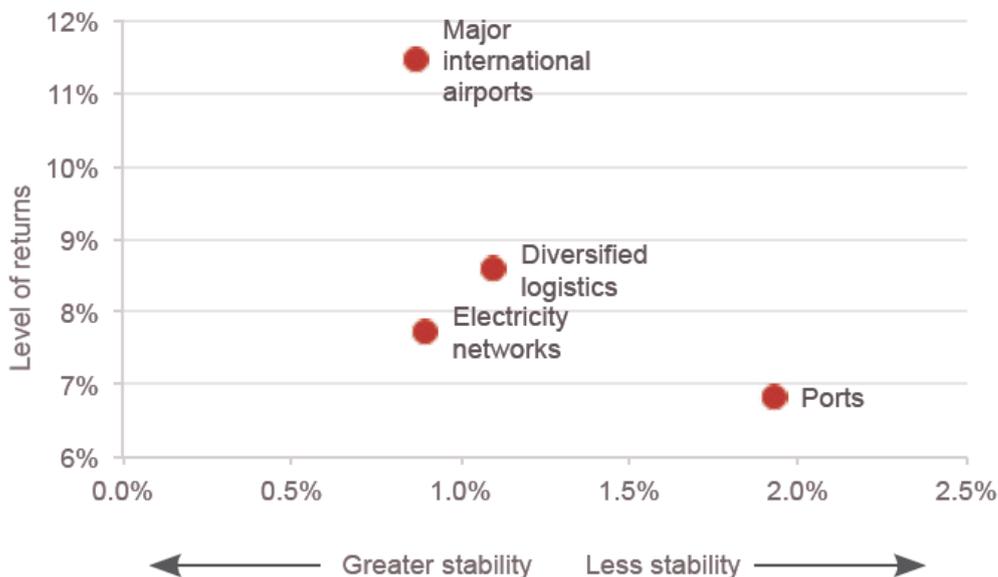
BARA does not support upfront funding of capacity expansions. Price adjustments for the delivery of agreed capacity expansions should only occur when the additional capacity is ready and available for use by passengers and airlines. This approach encourages the efficient and prompt delivery of expansions and promotes funding equity across airlines.

Reasonable investment returns

The most difficult element of the negotiation is usually determining the rate of return applied to investments. In most other countries, rates of return are determined by an independent party, rather than through negotiation between the airport operator and international airlines. BARA understands that airports, like all commercial industry participants, need to remain profitable and provide returns to their shareholders.

Based on over 10 years' experience under the light-handed economic regulatory arrangements, it is evident the major international airports have earned high and stable returns (See Figure 7). It is this combination of high and stable returns that distinguish the financial performance of the major international airports from other providers of infrastructure services in Australia.

Figure 7. Level and stability of returns, 2006–07 to 2011–12



Source: ACCC prices monitoring reports, company annual reports

Notes: Pre-tax rates of return on the value of non-current assets. The stability of returns is measured by the standard deviation over the five years of analysis.

One important contributor to the stability in airport returns has been the ongoing improvement in the efficiency of airline operations. Australia's aviation industry is now more cost efficient and resilient, which has underpinned sustained industry growth. In its 2011 prices monitoring report, the ACCC has also noted that airlines reduce airfares during downturns to maintain passenger volumes, which partly insulates the major international airports from demand shocks.

BARA, therefore, contends there is scope to temper the returns sought by the major international airports in future pricing agreements. This should be based on an honest negotiation and sound empirical evidence for the level of returns actually needed to secure ongoing investment, which ultimately benefits all industry participants through the continued growth in passenger numbers.

Efficient airport operations

To provide ongoing value to the industry, airport operators must have the incentive to manage their operating costs effectively. Airport operating costs represent a significant component of the prices paid by international airlines.

The major international airports have, on average, achieved only a modest reduction in real operating costs per passenger over the last five years. Staff numbers have generally increased in line with the growth in passenger numbers. The challenge, therefore, is to find further operating efficiencies over the longer term.

Balanced and consistent agreements

Agreements between airport operators and international airlines, containing a clear record of the commercial terms and balanced terms over risk and related issues, support the ongoing productive relationship between the industry players.

Reviewing agreements put forward by airport operators, even after negotiation through BARA, represents a significant cost for individual international airlines. In some instances the agreements are not tailored for international airlines and contain clauses and prices relating to the provision of services for domestic operations.

BARA considers there are opportunities for the agreements to be streamlined. In this respect, the trend towards an expansive or 'belt and braces' approach to the legal drafting is greatly increasing the length of the agreements, without necessarily delivering any clear benefit to the parties. There is scope to reduce the length and complexity of clauses, and make them more concise and focused on the issue being addressed.

BARA considers that one way of reducing airline costs is to standardise at least some of the common terms across agreements. Streamlining and standardising agreement terms will reduce the time and cost incurred by international airlines in reviewing agreements negotiated with airport operators.

A service quality culture

International aviation exists to provide services to people and businesses. Effective co-ordination, the efficient delivery of services and a focus on customers are the key to the industry's success.

The quality of airport services is critical in promoting high quality, adaptive and efficient international aviation in Australia. Service quality encompasses availability, cleanliness and an ongoing culture of safety and efficiency.

The inclusion of service quality arrangements in agreements varies across the major international airports. Some agreements include service quality metrics, while others offer few commitments over service quality.

BARA suggests that, as a starting point, agreements should contain mutually determined metrics or benchmarks over the availability of infrastructure and the cleanliness of facilities for passengers. There should be more attention applied to cooperating on identifying specific service quality outcomes, and how actual performance is measured. To focus all parties on service quality, there should be commercial consequences attached to the outcomes attained across the metrics developed.

BARA also sees merit in formalising a commitment to identify and improve the safety and efficiency of outcomes for passengers and airlines. This could include sharing information on passenger

experiences, conducting performance audits, identifying areas for improvement, implementing agreed strategies and monitoring outcomes.

BARA's recommended policy response

The Australian Government plays a critical role in shaping the environment in which Australia's international aviation industry will evolve over the coming decades.

Opinion is still divided over the success of the current light-handed regulatory arrangements. It can be argued they encouraged the major international airports to invest in increased airport services. As noted earlier, however, the industry cannot sustain continued real increases in airport prices and expect to maintain airfare affordability. Industry costs are also increased unnecessarily through protracted negotiations between international airlines and airport operators.

BARA considers the Australian Government should focus its efforts towards promoting the twin goals of expanding infrastructure capacity and improving industry productivity.

Under light-handed economic regulation, a balanced negotiating environment is essential to allow the international airlines and major international airports to focus on meeting the industry's future challenges. If the negotiating environment unduly favours one party, this leads to protracted negotiations, delayed airport developments and less productive ongoing commercial relationships.

BARA, therefore, seeks the Australian Government's support in promoting a balanced negotiating environment between the international airlines and major international airports. This requires a preparedness to change the requirements for an individual airport operator that is not acting in accordance with the intent of the light-handed economic regulation. That intent hinges on each major international airport being prepared to negotiate reasonable rates of return on its investments with international airlines.

To support a more balanced regime, the industry would benefit from the Australian Government commissioning research into the Australian aviation industry's productivity and rate of return outcomes across infrastructure providers. This would provide 'benchmark' information to all parties and would help commercial negotiations to arrive at mutual agreements more smoothly.

4. Competitive neutrality and Airservices Australia

Airservices Australia (Airservices) is an integral part of the Australian aviation sector. Airservices facilitates safe and efficient air passenger and freight transport services across Australia's flight information region. Airservices' costs are also significant, with its annual revenue requirement expected to exceed \$1 billion in 2015-16.

BARA has actively participated in consultations over the provision and pricing of en route, terminal navigation (TN) and aviation rescue and firefighting (ARFF) services for many years. BARA is represented on both Airservices steering committees and technical working groups. BARA has witnessed the challenging and often changing environment in which Airservices is required to develop a set of prices for the ACCC to approve ('not object to') under the CC Act's prices notifications provisions.

BARA is concerned that, when Airservices' multiple objectives are combined with the prices notification process, which contains little useful legislative guidance and considerable regulatory discretion, pricing outcomes are not being set to encourage an efficient aviation industry. Instead, prices are set that, in BARA's opinion, are designed to promote various regional development and social objectives.

These are policy-induced price distortions that are reducing the productivity and cost-efficiency of Australia's aviation industry by encouraging uneconomic services. In the long term, it is likely painful industry restructuring will be needed once the level of subsidy to these services becomes unsustainable.

Aviation rescue and firefighting services

One particular issue BARA has is with the structure of ARFF prices. Under the existing arrangements, Airservices applies uniform, network-based prices across airports by aircraft category. For example, the current 'Category 6' price is \$1.99 (including GST) per landed tonne at all airports. This price represents the average cost of providing ARFF services across all airports to category 6 aircraft.

The cost per tonne of providing ARFF services, however, varies widely across airports and is usually far higher at regional locations than the capital city airports because of lower aircraft traffic volumes. As such, many regional locations recover only about 10% of costs, with the shortfall being obtained through overpricing ARFF services at the major international airports (especially Sydney Airport).

BARA notes that, in its recent Draft Prices Notification to the ACCC, Airservices has not sought to increase the category 6 ARFF price to fund the establishment of a series of new ARFF services at regional airports. This is not, however, a sustainable approach for Airservices to provide and price ARFF services over the long term.

More broadly, improving the competitiveness of Australia's aviation sector needs a more rigorous approach to developing safety regulations, including providing ARFF services. The existing criterion for establishing an ARFF service at an airport is when more than 350,000 passengers passed through on air transport flights during the previous financial year (Manual of Standards Part 139H). Under this fixed criterion, together with ongoing growth in passenger numbers, Airservices is required to establish a number of new ARFF services at regional airports in Western Australia and New South Wales.

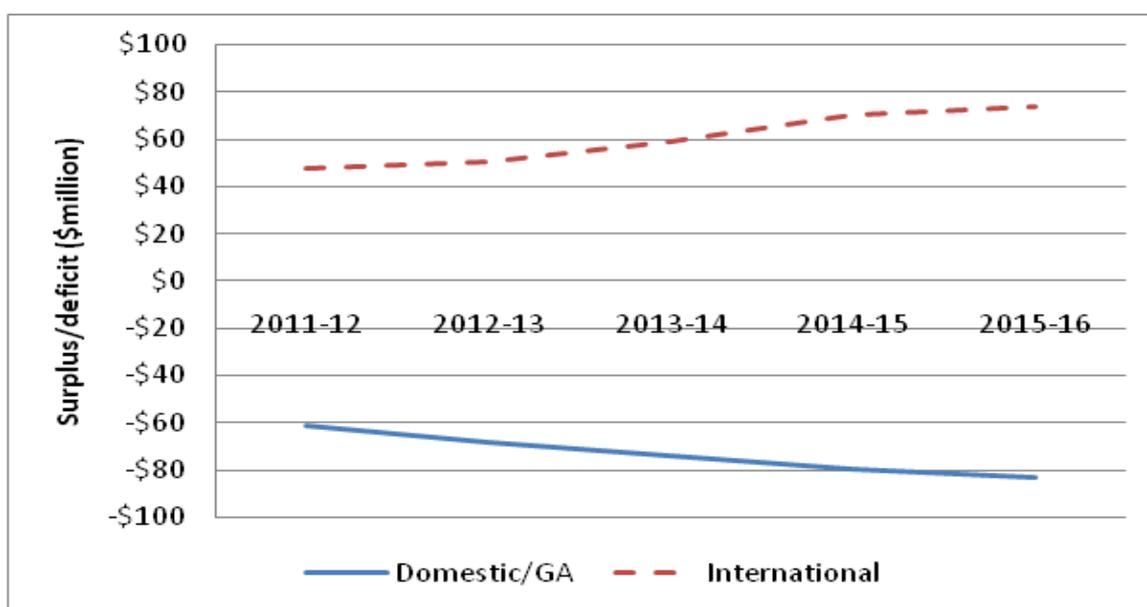
BARA is unaware of any evidence that shows the establishment of ARFF services at these regional airports represents either net benefit to the industry or the highest valued investment in aviation safety. It is not in the industry's interest for a series of investments to occur that do not represent the best option for promoting aviation safety at regional airports.

BARA has also raised its concerns over efficient investments in regional aviation safety with the *Aviation Safety Regulation Review*.

Subsidised terminal navigation services

This situation is not isolated to ARFF services, with similar issues exist with pricing TN services at regional and general aviation (GA) airports. Under the existing price structures, BARA estimates that international airlines are now overcharged some \$70 million annually to subsidise Airservices to provide services (ARFF and TN) at regional and GA airports (see Figure 8). The shortfall is generally recovered through the over pricing of en route services.

Figure 1. Net financial position, TN and ARFF services, \$millions



Source: BARA estimates.

Competitive neutrality issues

The existing structure of prices Airservices charges for its services is encouraging the development of an inefficient aviation industry and distorting the competitive playing field both between regional airports and with other modes of transport.

This outcome was a key finding of the former Industry Commission (now the Productivity Commission) in its inquiry into *Intrastate Aviation* in 1992, which included a review of TN and ARFF pricing. The Industry Commission found that:

... cross-subsidisation distorts production and consumption patterns and can impose considerable costs on the community⁴...

and:

⁴ Industry Commission (1992) *Intrastate Aviation*, Report No. 25, p. 150.

... misleading prices affect patterns of supply and demand and, perhaps more importantly, can in the longer term result in inappropriate investment decisions by aircraft operators and infrastructure providers. For example, it is possible that subsidisation could lead to investment at airports which would otherwise not be undertaken. Such investment could be at the expense of other airports which have more economically-sound investment opportunities⁵

A specific recommendation the Industry Commission made was to set prices for TN and ARFF services that were location specific, something Airservices began to do in the late 1990s. Unfortunately this progressive economic reform is now being unwound in favour of subsidised assistance to services provided at regional locations.

BARA considers the concept of competitive neutrality needs to extend to those circumstances where the Australian Government provides a key input into the delivery of final services. In this instance Airservices is distorting final transport markets (between regional airports and between transport modes) through its pricing practices. However, because its services are not subject to private sector competition, competitive neutrality requirements do not apply to its price setting practices.

BARA's recommended policy response

Airservices develops its proposed pricing structures through consultation papers, with its preferred position contained in its draft prices notification to the ACCC. As described earlier, BARA is not convinced this process leads to efficient pricing structures.

The Productivity Commission should be given the task of developing a set of principles for the pricing of en route, TN and ARFF services, which then become a prescribed pricing structure for Airservices when it lodges its draft prices notification with the ACCC. Airservices would then apply pricing structures that were consistent with promoting the efficient development of Australia's aviation industry.

Given the likely extensive investment in ARFF services at regional airports that will occur under the existing regulations, BARA considers it is an opportune time to review the aviation safety investment strategy at such airports. This would thoroughly evaluate all options, including those in addition to ARFF services that reduce the risk of accidents occurring, so the industry focuses on those practices and initiatives most likely to deliver the highest net safety benefits at regional airports.

More broadly, there is a need to create an environment that encourages Airservices to make investments that deliver value to industry. BARA is concerned about an apparent lack of discipline in Airservices' capital investment program, especially identifying and tracking industry benefits.

BARA acknowledges that Airservices moving to efficient pricing structures will have implications for the cost of providing what are now subsidised domestic air services to regional locations. The Australian Government has the legitimate right to pursue social and regional development objectives through support to regional aviation. However, it is critical such support is provided transparently and cost-effectively rather than the inefficient methods now used through Airservices' pricing structures.

⁵ IC (1992), pp. 73–74.

The Australian and state governments have had to address social and regional development policy issues with a range of infrastructure service providers, including rail transport, telecommunications and electricity. A number of viable provision and funding models are already used that could be applied to regional aviation.

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