BARA

Board of Airline Representatives of Australia Inc

INTERNATIONAL AVIATION POLICY SERIES

Timely and Reasonably Priced Airport Infrastructure

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.

The role of BARA is to provide a collective voice on major issues that impact on 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, BARA undertakes commercial negotiations with airport operators over the provision and pricing of airport services for international airlines. BARA has authorisation from the Australian Competition and Consumer Commission (ACCC) to undertake collective negotiations with international airports, Airservices Australia and other providers of essential aviation-related services.

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 four key outcomes to boost competitiveness, productivity and the financial performance of industry participants. These are:

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.

Timely and reasonably priced airport infrastructure

This policy paper describes the challenges faced by Australia's international aviation industry in seizing the opportunity to double its size and contribution to the Australian economy over the next 20 years. The core challenge is to expand the capacity of airport infrastructure while improving the industry's productivity and service quality outcomes.

BARA articulates a series of initiatives to improve the efficiency of the capital used to provide airport services, streamline negotiation processes and focus all industry participants on the delivery of high quality outcomes. Central to this is improving upon current planning processes and establishing key commercial principles. BARA also recognises the important role of the Australian Government in shaping the industry over time.

International Aviation and Airport Services

There is the potential for Australia's international aviation to more than double to over 60 million passengers per year 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 enable this growth. To be successful, Australia's aviation infrastructure capacity will need to double and industry productivity will need to improve. This will provide the infrastructure necessary to accommodate growth in passenger numbers and contribute to airfare affordability.

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

Airport investment levels have almost tripled over the last five years while the prices paid by international airlines have doubled in real terms over 12 years. Australia's market share of international travel will be impacted by airline operating costs, which impact on airfares. It is good for the nation, travellers, airlines and the major international airports to minimise airport costs through improvements, innovation and suitable price setting mechanisms. There is evidence of substantial room for improvement in each.

A balanced negotiating environment will encourage good industry outcomes.

BARA supports continued *efficient* investment in Australia's aviation capacity. The industry, however, needs to confront the rapidly rising costs of airport infrastructure to meet peak use during the day, as they are the main drivers of increases in airport prices. Greater capital efficiency is needed, particularly innovative solutions to expanding capacity.

To enable greater capital efficiency, much needs to be done to better understand the unit costs and industry benefits of investments in airport capacity and service quality. New information together with greater innovation is needed to guide airport investment programs early in the capital planning stages.

Under the Australian Government's 'light-handed' approach to economic regulation of the major international airports, airlines and airport operators commercially negotiate the provision and pricing of airport services. This process is unlikely to ever be straightforward. There is scope to improve on current outcomes, if key principles around price and non-price terms can be agreed before detailed discussions commence.

BARA is seeking to apply five commercial principles to facilitate meaningful and productive commercial negotiations. The principles seek to establish a more balanced negotiating environment and focus efforts on the efficient and timely delivery of airport services.

BARA considers that the Australian Government should focus its efforts on promoting the twin goals of expanding aviation infrastructure capacity and improving industry productivity. Critical to this is ensuring a balanced negotiating environment between international airlines and the major international airports.

International aviation exists to provide services to people and businesses. To that end, BARA will continue to work constructively and engage in good faith negotiations with airport operators to promote high quality, adaptive and efficient international aviation in Australia.

Australia's International Airports

International passenger numbers broke the 30 million mark in 2012-13. The 'big four' airports, in Sydney, Melbourne, Brisbane and Perth accounted for over 90% of these passengers. This policy paper focuses on the provision and pricing of services for international airlines by these four airports ('major international airports').

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 that 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 were administered by the ACCC.

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 regime is underpinned by annual monitoring of airport prices, profits and service quality outcomes by the ACCC.

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.

Investment and prices

To support growth in passenger numbers and maintain existing assets, the major international airports collectively invested $170 million per year in access roads, airfields and international terminals in the seven years from 2000. From 2007, investment levels almost tripled to over $500 million per year.

The prices charged by the major international airports have doubled in real terms over the last 12 years, from around $10 to $20 per passenger. Airport charges at Sydney and Brisbane are now well above the Asia Pacific and European averages. BARA acknowledges that some increases in airport prices were necessary to fund investment programs.

Prices also increased with the move to 'dual till' or 'stand-alone' pricing, where revenues from airlines are set to recover the full cost of providing airport services. The increases from 2002, however, also included substantial windfall gains to the airport operators.

BARA supports the continued efficient investment in Australia's aviation capacity. However, if the industry is to maintain airfare affordability, it is not possible to sustain the trend of rising investment levels funded through continued increases in airport prices.

In short, the industry needs to ensure that the cost of meeting growth does not end up choking the very growth it is intended to foster.

Airport investments and prices, $2011-12

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

Service quality outcomes

Annual monitoring conducted by the ACCC shows little change in the overall quality of services provided by the major international airports over the last decade, generally averaging between "satisfactory" to "good". The tripling of investment levels and doubling of prices charged in real terms has not translated into improvements in overall service quality outcomes.

The ACCC's service quality monitoring outcomes have been subject to criticism 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.

BARA considers that, by taking joint responsibility, the international airlines and airport operators can combine their collective knowledge and experience to achieve higher quality outcomes for international travellers.

Peak time demand and rising airport prices

The majority of investment to expand capacity is in response to forecast growth in 'peak' time demand on airport infrastructure. Peak times generally occur between 7am to 10am and 4pm to 7pm. In providing peak capacity, much of the capacity may remain unused during 'shoulder' and 'off-peak' times (10am to 4pm).

Peak demands can also differ throughout the year. For most airports, the busiest time of the year occurs over Christmas and the New Year. International airlines and airport operators need to agree that these peak demands are not efficiently addressed through capacity expansions. Instead, these short term peak demands can be met through a combination of other means, including additional staffing and airline operating procedures.

Available data indicates that the cost per passenger of meeting growth in the peak period is at least twice (and often considerably more) the current prices charged by the major international airports. As such, infrastructure being built to meet the growth in peak demand is fuelling the need for sustained increases in airport prices.

The primary challenge, therefore, is addressing the rising cost of meeting peak demand on airport infrastructure. BARA acknowledges that this challenge cannot be met by putting an excessive brake on investment in airport capacity. This would only lead to increases in airline operating costs through excessive congestion and delays, reducing the competitiveness of Australia's international aviation industry. At the same time, the current arrangements can encourage expensive capital solutions.

The industry, therefore, needs to find cost effective and innovative solutions to meeting the forecast growth in peak demand. There is substantial scope for improvement in the approach to airport planning, operation and service quality, through more sophisticated interaction between the major international airports, airlines and government agencies.

Industry Productivity and Airport 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. Presently, however, airports and international airlines do not undertake the level and quality of analysis to make better informed investment decisions.

To facilitate a more robust 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 enables 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.

Presently, these benefit assumptions may only be implicitly contained within a 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.

Greater innovation is necessary to deliver more cost-effective solutions.

BARA sees merit in a joint approach to defining the benefits and value assigned, which are then explicitly incorporated into the planning and investment strategy development process. 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 enable forecast growth.

Service quality improvements and airline operating efficiencies

In addition to expanding capacity, there are also opportunities to undertake investments to improve service quality outcomes and/or boost airline operating efficiencies. Examples include improved terminal signage and lighting and expanding the range of weather conditions (eg. fog) under which aircraft can land and take off safely and efficiently at an airport.

Presently, the costs of such projects are presented to airlines, with the airlines then left to decide whether the project is worth undertaking based on their own individual assessments. This is further evidence on how international airlines and the major international airports have generally not yet achieved alignment over the value of different service standards, which is a necessary foundation to joint decision making on capital investment and operating processes.

BARA considers that such projects should be subject to an airport-led cost-benefit analysis as part of the project justification. BARA's members are prepared to assist in the development of robust cost-benefit studies recognising international airlines often are the source of key information for such analysis.

BARA supports projects that are capable of delivering net benefits to Australia's aviation industry.

Commercial Negotiations

In Australia, international airlines are required to commercially negotiate the provision and pricing of airport services directly with the airport operators. In many other countries prices and service standards are set by an independent economic regulator or government body. This is the distinguishing feature of Australia's light-handed economic regulatory arrangements.

The quality of the negotiation process and subsequent commercial outcomes still often leave considerable room for improvement. In some instances the parties still disagree over fundamental pricing, risk allocation and service quality outcome issues. Current agreements also tend to be input focussed, principally around the proposed capital investment program.

To promote the efficient development of the major international airports, BARA considers that it is necessary to improve the quality of the negotiating process, principally by avoiding protracted and costly negotiations. Future agreements need to be more outcome focussed, clearly articulating the service outcomes being purchased by international airlines.

BARA's five commercial principles

To facilitate more productive and streamlined negotiations, BARA has developed five key commercial principles, namely:

Principle 1: **pricing for service delivery**

Principle 2: **reasonable investment returns**

Principle 3: **efficient airport operations**

Principle 4: **balanced and consistent agreements**

Principle 5: **a service quality culture**

These five principles seek to establish a more balanced negotiating environment. They remove legacy issues holding back the industry and focus efforts on the efficient and timely delivery of airport services at reasonable cost.

PRINCIPLE 1

Pricing for service delivery

Agreements between airport operators and international airlines should be outcomes focussed, that is, they should price for the delivery of services. Current practice usually sees prices set to cover investments on an 'as incurred' basis. This tends to focus agreements on capital inputs rather than the outcomes delivered to airlines and passengers.

The investment programs of airport operators can be broadly categorised as:

1. ongoing maintenance and refurbishment of existing assets, and
2. agreed expansions in capacity and increases in service quality.

BARA considers that an agreed level of ongoing maintenance and refurbishment investment can form part of the 'business as usual' component of prices charged to airlines.

One issue of contention, however, over the 'business as usual' price has been the valuation of the existing infrastructure at the airport. Some airport operators argue prices should be based on a theoretical valuation. These theoretical valuations are generally far greater than actual investments undertaken by the airport operator and permit continual increases in airport prices.

BARA believes that 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 prior to its privatisation. 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'.

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. BARA does not support upfront funding of capacity expansions. This approach encourages the efficient and timely delivery of expansions and promotes funding equity across airlines.

PRINCIPLE 2

Reasonable investment returns

The most difficult element of the negotiation process 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.

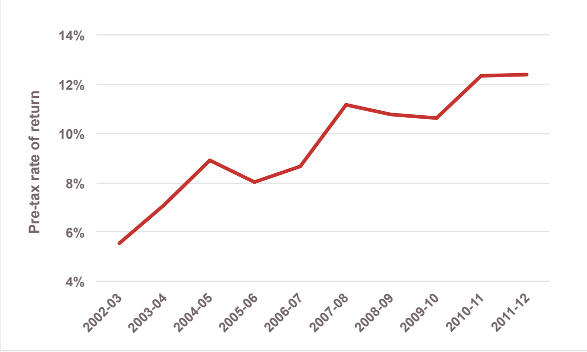
The rates of return earned by airport operators under the light-handed economic regulatory arrangements will always be a contentious issue. This is especially the case where airport operators consistently obtain returns three or four times that earned by international airlines. BARA considers that a key requirement for a major international airport to remain under 'light-handed' economic regulation is for it to negotiate reasonable rates of return based on transparent and robust evidence.

How have the major international airports performed?

Based on over 10 years' experience under the light-handed economic regulatory arrangements, it is evident that the major international airports have earned high and stable returns. 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.

Collectively, these have averaged a nominal pre-tax rate of return over 11% over the last five years. Analysis by CAPA – Centre for Asia Pacific Aviation, has also found that Australia's airports have the world's highest EBITDA (earnings before interest, tax, depreciation and amortisation) rates[1].

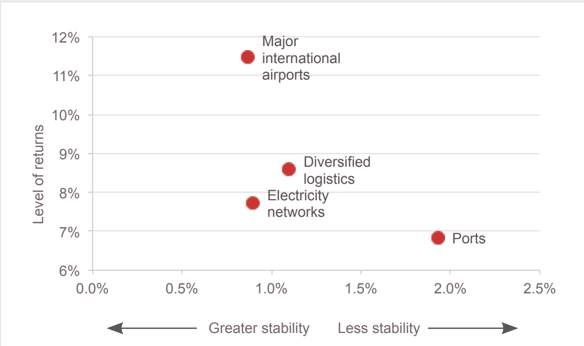
Pre-tax nominal rates of return on airport assets (non-current)



Source: ACCC monitoring reports. Excludes SACL's aeronautical land revaluations.

Australia's major international airports have performed consistently above their infrastructure peers in Australia. The average pre-tax return on assets is both higher and more stable through time compared to electricity networks, ports and diversified logistics companies.

Level and stability of returns, 2006-07 to 2011-12



Sources: 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.

Interest costs

As capital intensive businesses, a significant component of an airport's costs is the payment of interest on its stock of debt. Given the volatility in interest rates during and post the global financial crisis, infrastructure providers and users have had to reconsider the basis on which interest costs are measured and included in pricing agreements.

As a general principle, BARA considers that interest costs (including the cost of raising debt) should be treated similarly to operating expenses. Airport operators are entitled to recover prudently incurred interest costs (at an agreed gearing ratio or stock of debt) through prices.

BARA sees merit in estimating interest costs with reference to the recent work published by the Australian Energy Regulator (AER) and the interest rate indexes now produced by the Reserve Bank of Australia (RBA). Under this approach, interest costs would be negotiated having regard to both the interest rate on airport operator's current stock of debt and forecast interest rates.

Returns to shareholders

The current returns to shareholders reflect those established by the ACCC during the first five years of privatisation (1997 to 2002). In light of a decade of outcome data, BARA considers that the returns earned by the major international airports can be moderated to bring them more in line with their infrastructure peers.

BARA, therefore, believes that 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 robust empirical evidence around the level of returns actually needed to secure ongoing investment, which ultimately benefits all industry participants through the continued growth in passenger numbers.

[1] CAPA (2103) Airport Finance and Privatisation: CAPA's Review of the Year 2013 and 2014 outlook, Part 2

PRINCIPLE 3

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.

As purchasers of airport services, it should not be necessary for international airlines to analyse the individual components of an airport's operating costs in excessive detail. Instead, agreed airport specific operating costs per passenger by service should be established, underpinned by consistent and transparent cost information. This provides the right incentive for airport operators to manage their operating costs efficiently by maintaining a focus on outcomes.

BARA accepts that with the opening of new terminal infrastructure, operating costs per passenger may be higher when capacity use is still low. However, operating costs per passenger should then fall assuming passenger volumes grow at forecast levels over time.

Another growing component of an airport's operating costs is the delivery of government-mandated security services. As an example, at Sydney Airport, the ACCC has reported that security costs have increased from about $9m in 2001-02 to over $76 million in 2011-12. Presently, these costs are 'passed through' to international airlines, with security prices usually reset every six months.

It is important that security services are provided efficiently. BARA suggests that, in future agreements, operating costs per passenger on an airport specific basis could be established for defined security services. This would provide the same incentives to manage security costs efficiently as for all other operating costs.

PRINCIPLE 4

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.

More streamlined agreements

BARA considers that 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 significantly 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, making them more concise and focused on the issue being addressed.

BARA has also observed a trend towards an expanding set of clauses as agreements are renegotiated, often covering general information about the airport, relevant legislation and operational issues. Operational issues should be covered in the airport's operating manual rather than form part of the legal agreement. General information and reference to legislation, if deemed necessary, can be included in recitals or separate information documents.

Standardisation of terms across agreements

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.

The main challenge in standardisation is in the implementation, given the differences in the timing of the renegotiation of agreements. One option could be for initial standard terms to be included in the next agreement reached with a major international airport, with the other airport operators then incorporating these terms as their agreements are renegotiated. Such an outcome would represent a 'win-win' initiative by all parties, generating efficiencies for both international airlines and the major international airports.

PRINCIPLE 5

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.

Service quality and airport agreements

Presently, 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 alignment 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 the sharing of information on passenger experiences, conducting performance audits, identifying areas for improvement, implementing agreed strategies and monitoring outcomes.

Ongoing consultation and information sharing

The agreements reached with international airlines formalise the obligations of both the airport operator and airlines in providing and pricing for airport services. Negotiating the agreement, however, represents the start of the journey. The challenge is then to implement the agreements in a collaborative and transparent manner, maximising the value of the agreement to both parties.

Agreements need to contain provisions for ongoing information sharing and performance monitoring. Continual information sharing, ongoing monitoring of developments and service quality outcomes are critical to the successful implementation of an agreement. It is ongoing consultation that enables the airport operator and international airlines to refine outcomes and adapt to changing circumstances.

The Australian Government and Major International Airports

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. On the one hand, it can be argued that the arrangements facilitated the growth in investment by the major international airports in airport services. The industry, however, cannot sustain continued real increases in airport prices and expect to maintain airfare affordability. Industry costs are also increased unnecessarily through protracted negotiation processes between international airlines and airport operators.

BARA considers that the Australian Government should focus its efforts towards promoting the twin goals of expanding the capacity of Australia's major international airports and improving industry productivity.

Under light-handed economic regulation, a balanced negotiating environment is the critical requirement necessary 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 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. BARA considers that a preparedness for each major international airport to negotiate reasonable rates of return is critical to the intent of the light-handed economic regulation.

To support a more robust regime, the industry would benefit from the Australian Government commissioning research into the productivity of Australia's aviation industry and rate of return outcomes across infrastructure providers. This would provide 'benchmark' information to all parties and would assist in progressing commercial negotiations.

Through its role as the industry body representing international airlines, BARA looks forward to actively engaging with the Australian Government in promoting high quality, adaptive and efficient international aviation in Australia.

Opinion is still divided over the success of the current light-handed regulatory arrangements.

The leading voice of airlines

BARA
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