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Qantas vs Perth Airport

How should prices be determined in markets not subject to effective competition?

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4 April 2022

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Outline



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1. Overview of the case
 2. Methodologies for determining fair and reasonable prices
 3. The Supreme Court Decision
 4. Insights

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Overview of the case



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Aeronautical services provided by PAPL at Perth Airport **RBB** | Economics

Aeronautical services

- Provided by airports to airlines
- Involve the provision of infrastructure, facilities and services that allow an airline to provide air passenger services or air freight services from an airport.



Aeronautical service agreements

- Perth Airport Pty Ltd (**PAPL**), negotiates the prices airlines pay for aeronautical services at Perth Airport in long-term agreements, called aeronautical service agreements.
- The prices in those agreements are determined with reference to a Building Block Model (**BBM**).
- Qantas and PAPL failed to agree on the pricing and terms of a new aeronautical service agreement to apply from July 2018.
- After that date, Qantas continued to use the services, but paid what it considered to be “fair and reasonable” prices.

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The dispute between Qantas and PAPL

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In December 2018, PAPL sued Qantas for allegedly underpaying aeronautical fees by \$11.3 million.

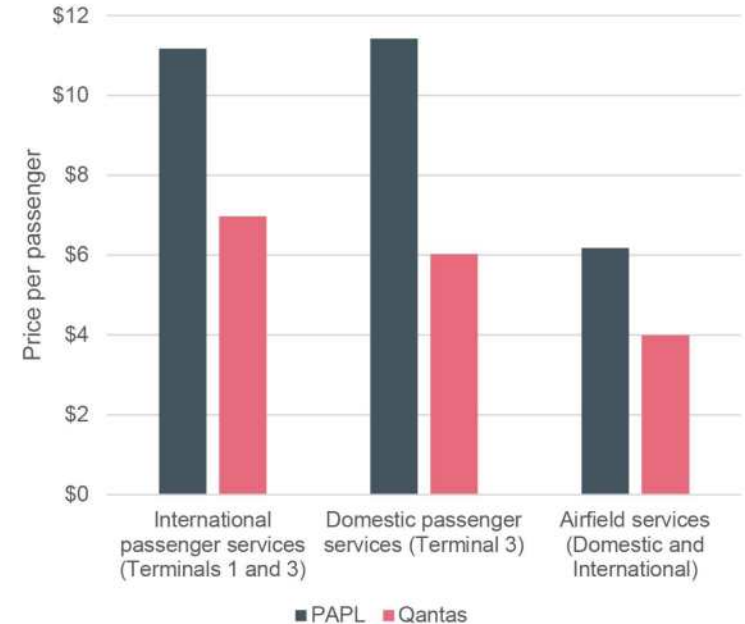
- The case was heard by Justice Rene Le Miere in the WA Supreme Court in September of last year.

The Court was asked to determine the fair and reasonable remuneration to be paid by Qantas to PAPL for aeronautical services

- PAPL submitted that prices should be determined with reference to the prices paid by other airlines.
- Qantas submitted that prices should be determined with reference to the efficient costs of providing those services, calculated using a BBM model.

Qantas and PAPL disagreed over the values of inputs to PAPL's BBMs

- These included Gamma, Asset Beta, WACC, Capex, Opex, and the depreciation rate assigned to one of PAPL's terminals.



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The disagreements over Gamma, Asset Beta, and WACC



Gamma

- Gamma is a deduction to the building block allowance for corporate tax. It is the product of the distribution rate and the utilisation rate.
- The parties' experts disagreed on how the distribution and utilisation rates should be estimated.

Asset beta

- Asset beta measures the level of underlying risk of a company's operations. It is a key component of the WACC.
- The parties' experts disagreed on the methodology that should be used to estimate asset beta.

WACC

- The WACC is the return on investment that a company requires to compensate its investors for financing its assets.
- The parties' experts disagreed on the methodology that should be used to estimate the WACC.

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The disagreements over Capex and Opex

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Capital expenditure

- Qantas considered that the capital expenditure included in PAPL's opening asset base was not shown by PAPL to be reasonable and efficient.
- This predominantly related to PAPL's inclusion of certain "unplanned" capital expenditure items.

Operating expenditure

- Qantas considered that PAPL's forecast operating expenditure should be adjusted to:
 - remove marketing costs that Qantas considered to be unrelated to aeronautical services; and
 - account for the fact that PAPL's actual operating expenditure incurred in FY19 was 10% less than forecast.



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The disagreement over depreciation of Terminal 3

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The dispute stemmed from a disagreement regarding the useful life of Terminal 3.

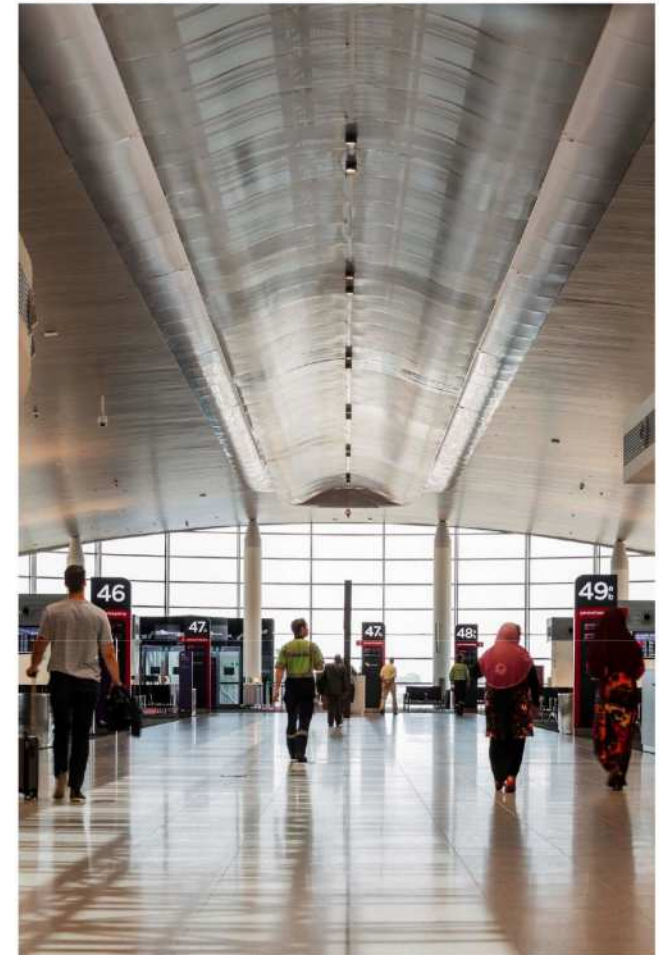
- The useful life of the terminal determines the depreciation charge paid by Qantas for each year.

PAPL considered that the terminal has no useful life beyond the end of 2025.

- PAPL plans to discontinue services in Terminal 3 by the end of 2025 and replace it with a new terminal.

Qantas considered that the useful life of Terminal 3 extends beyond 2025

- Qantas considers that this would be the case regardless of whether PAPL plans to use the terminal beyond that date.



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Methodologies for determining fair and reasonable prices



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Greg Houston's methodology: Overview

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Houston estimated the “market value” of the aeronautical services provided by PAPL to Qantas at Perth Airport.

- The “market value” for a service is represented by the prices at which transactions take place in the relevant market.
- “Market value” is not affected by the degree of competition in a market – e.g. OPEC.

Houston estimated market value by using what he called his “comparable transactions” approach.

- This approach involved taking a weighted average of the prices agreed to between PAPL and other airlines, and making adjustments to the prices agreed with those airlines based on the different circumstances faced by Qantas.
- Houston then sense checked these comparable prices by considering whether they fell between a “lower bound” of PAPL’s willingness to accept, and an “upper bound” of Qantas’ willingness to pay.

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Greg Houston's methodology: Adjustments to comparable transactions

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Five “comparable transactions”

- Virgin;
- BARA;
- REX;
- Alliance; and
- PAPL's Conditions of Use pricing.



Adjustments made to reflect differences in:

- The terminals used by each airline;
- The level of risk associated with each airline; and
- The value of any non-price benefits made available as part of each transaction.

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Greg Houston's methodology: Reasonable bounds for a potential transaction **RBB** | Economics

Reasonable bounds for a potential transaction:

- Houston assessed his comparable prices with reference to whether they fell within a range of reasonable prices.

Lower bound:

- PAPL's minimum willingness to accept.
- Equal to the efficient LRAC of providing the relevant services, calculated using a BBM.

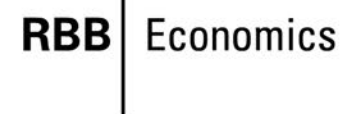
Upper bound:

- Qantas' maximum willingness to pay.
- Equal to the profit that Qantas derives from operating passenger services into and out of Perth Airport.



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Our methodology: Overview



We estimated the “desirable or appropriate” prices for aeronautical services.

- An appropriate price is one that is determined in a market that was subject to effective competition.
- Here, the market is not subject to effective competition, as PAPL possesses substantial market power.

If a market is not subject to effective competition, the appropriate price needs to be estimated.

- This could be done with reference to the efficient costs of providing the relevant services.
- In the case of PAPL’s aeronautical services, the efficient costs of providing those services can be determined using a BBM model.

Houston’s comparable transaction approach is not appropriate here as the market is not subject to effective competition.

- The prices agreed to with other airlines are not informative of the appropriate price, as those prices are influenced by PAPL’s substantial market power.
- All prices above the lower bound in Houston’s framework are not relevant, as they are above the efficient long run average cost of providing the relevant services.

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Our methodology: Is the relevant market subject to effective competition?

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Possession of substantial market power → Market not subject to effective competition

- PAPL has substantial market power in the provision of aeronautical services to airlines at Perth Airport because it is not effectively constrained by existing or potential competitors.
- Therefore, the relevant market is not subject to effective competition.

Substantial market power does not need to be exercised for a market to not be subject to effective competition

- Even if a firm only possesses substantial market power, there is a risk that it will exercise that power and cause undesirable economic outcomes.
- Consequently, competition authorities need to be on guard to ensure that prices in such markets are consistent with those found in markets with effective competition.

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Our methodology: Has PAPL exercised substantial market power?

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Houston considered that a market will be effectively competitive unless substantial market power is *exercised*.

- To address this disagreement, we analysed whether PAPL had exercised its power in negotiations with airlines, and found that it had done so.

We found that PAPL had exercised its substantial market power in the relevant market

- Direct evidence of market power exercise:
 - The prices agreed to with airlines were higher than the prices that would be agreed in an effectively competitive market.
- PAPL's conduct during negotiations with airlines indicated that it had exercised its substantial market power.
 - The bargaining concessions agreed to with other airlines were small;
 - There was a lack of variation in prices charged to airlines;
 - PAPL was unwilling to consider the value that airlines generate for non-aeronautical services at Perth Airport in its negotiations with those airlines; and
 - PAPL's approach to adjusting the service life of Terminal 3 in its building block model represents an unreasonable sharing of risks.

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The Supreme Court Decision



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Overview of Justice Le Miere's findings

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Fair and reasonable prices for aeronautical services should be determined by using a BBM methodology.

- The prices in comparable transactions should be used only to sense check the results from the BBM.

PAPL's claim was too high, and Qantas' claim was too low

- Justice Le Miere found prices for aeronautical services that were lower than those submitted by PAPL, but higher than those submitted by Qantas.

PAPL possesses, and has likely exercised substantial market power

- *"I also consider that PAPL possesses, and has likely exercised, substantial market power." (Justice Le Miere)*



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The appropriate method for determining fair and reasonable prices for aeronautical services

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Houston's comparable transactions approach was found to not be appropriate to the circumstances in the case.

- Houston's 'upper bound' is not an appropriate reference point;
- Houston's 'lower bound' does not represent PAPL's minimum willingness to accept;
- not all of Houston's comparable transactions are comparable; and
- the adjustments Houston made to the prices in those transactions were not appropriate.

In the circumstances of this case, the reasonable remuneration is the efficient cost of providing the services, which can be derived using a BBM methodology.

- The reasonableness of those results should be considered in light of all other relevant evidence, including the prices paid by airlines of analogous scale to Qantas.
- On this basis, it was found that the prices for the services to Qantas should be no more than the prices PAPL agreed with Virgin and BARA.

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Appropriate values of the disputed inputs to PAPL's BBMs

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To estimate efficient costs using a BBM, Justice Le Miere needed to opine on the values of the disputed inputs to the BBM.

| Input to BBM | Justice Le Miere's finding |
|------------------------------------|--------------------------------------|
| Gamma | Hybrid and PAPL and Qantas positions |
| Asset beta | Very close to PAPL's position |
| WACC: Cost of equity | PAPL's position (IPART methodology) |
| WACC: Cost of debt | PAPL's position |
| Asset base and capital expenditure | Close to PAPL's position |
| Operating expenditure | Close to PAPL's position |
| Depreciation of Terminal 3 | Close to Qantas' position |

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Fair and reasonable prices for aeronautical services provided by PAPL to Qantas at Perth Airport

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Insights



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Who won?

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Qantas' view

- “*The **decision is positive because it upholds the building block model** that is the established basis for setting prices. But it also sets a return on investment that we think is far too high for a low risk monopoly infrastructure asset.*” (Qantas CFO Vanessa Hudson)

PAPL's view

- “***Perth Airport has welcomed a decision** by the WA Supreme Court over the short-payment of invoices by the Qantas Group.*”

Justice Le Miere's view

- “*In a commercial case where the plaintiff asserts that an amount is owing to it and the defendant denies that any amount is owing to the plaintiff, **a plaintiff which ends up receiving payment should generally be characterised as the overall winner of the action.***”
- “*Approached in that way I consider that **PAPL was the successful party.***”

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What role can economics play?

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Economics isn't just about efficiency

- Not all prices struck in markets deliver desirable economic outcomes
- Markets that are subject to effective competition can generally be relied upon to deliver desirable economic outcomes
 - They will achieve economic efficiency; and
 - Protect the interests of customers (by giving them a fair share of the surplus generated)
- Assessing the state of competition in a market is more than just a mechanical task. It is an important way of deriving economically meaningful prices.

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What do we mean by market power?

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Economists haven't been clear about the meaning (and consequences) of market power

- Market power (in the technical academic sense) is clear and well defined but uninteresting
- Firms in most markets will have market power, but those markets are still subject to effective competition – and that competition will deliver desirable economic outcomes

In a workably competitive market, some or even all participants may have some market power, in the sense that they all have some discretion over price, but no participant will have a substantial degree of market power. In such a workably competitive market, at any given time, prices might deviate from underlying costs and the deployed technologies might deviate from the most efficient ones currently available. Economic forces drive such a market towards efficient prices, outputs and costs, but not instantly.

- **Substantial market power is the ability to sustainably set prices above competitive levels**
- Whether or not – and to what extent – that substantial market power is exercised will affect the extent of regulation

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The PC review(s) mattered

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- Greg Houston argued that the PC reviews proved that PAPL hadn't exercised their substantial market power
 - And that showed that the market was subject to effective competition
- We argued that those reviews were not relevant to the current dispute (and were flawed anyway)
- If the PC is right, then the prices charged should be set at the efficient long run average costs of supplying aeronautical services

*If the services are provided in a monopolistic or other noncompetitive market, the prices at which the services are or have been provided will not necessarily represent reasonable remuneration. **Prices charged by a monopolistic supplier are not competitive market prices but regulatory or other restraints on the supplier might produce the same result.** (para 119 of the Judgment)*

- Suggests need to compare the prices charged with the efficient cost of providing the services
 - Does the PC do this?

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Has existing regulation constrained PAPL from exercising its substantial market power?

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Justice Le Miere's finding that PAPL has likely exercised its market power suggests that the regulatory regime has been ineffective.

- The regime is intended to stop airports from exercising their market power and encourage prices to be set at effectively competitive levels.
- “...*this whole process shows **the real issue here is that the light touch approach to airport regulation isn't working**. Three years in court to determine five months of pricing shows why **the industry needs an expert umpire to resolve stalemates quickly** when they occur.” (Qantas CFO Vanessa Hudson)*
- Supports calls (ACCC, Arblaster, Littlechild) for airline access to compulsory arbitration:
 - Could be achieved through a new Part IIIB (although ideally one that is limited in scope to avoid a return to price regulation in sectors where it is not warranted – which could hamper rather than promote efficiency)

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