Perth Airport

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19 December 2022

Gennady Kleiner
Director Airports & Ports
Australian Competition and Consumer Commission
Level 17, 2 Lonsdale Street
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Dear Mr Kleiner

Airport Monitoring – More detailed information on airport performance

Perth Airport welcomes the opportunity to provide a response to the Australian Competition and Consumer Commission's (ACCC) Consultation Paper, *Airport monitoring – more detailed information on airport performance.*

Perth Airport is supportive of the Productivity Commission's (PC) recommendation 9.4 for monitored airports to provide additional information on the cost of providing aeronautical services to domestic and international flights, car parking and landside access services in assisting them in future reviews of the light-handed economic regulatory arrangements. Perth Airport undertakes good faith negotiations with users and the prices for our services are set consistent with the Aeronautical Pricing Principles.

The additional financial information needs to be sufficient for the PC to undertake its analysis while not potentially adversely interfering with the light-handed economic regulatory regime.

Perth Airport has carefully reviewed the ACCC's Consultation Paper and considers that the ACCC has incorrectly interpreted the PC's information requirements and has not taken into account the practical issues identified by them. As a consequence, the proposed segmented Regulatory Accounting Statements under all of the ACCC's three proposed options goes well beyond that sought by the PC, and in doing so, may adversely impact on commercial negotiations between airport operators and their customers. It will do this by creating artificial cost and profitability levels for individual service items and user groups through the arbitrary allocation of common costs, which are a substantial part of an airport's overall cost base. At Perth Airport, common costs can represent some 40% of total aeronautical service costs.

Perth Airport considers it critical that an agreed understanding of the PC's information requirements for the monitored airports, including the problems with greater financial disaggregation in the presence of common costs, is established. Consistent with Perth Airport's recent submission to the ACCC on service quality monitoring, this review would also benefit greatly from some structured workshops covering the objectives and issues with financial monitoring together with a detailed understanding of how services are provided at each of the monitored airports.

The ACCC's approach to the PC's recommendation 9.4 is to create stand-alone income statements and balance sheets for each of the identified services and user groups on a fully distributed cost (FDC) basis. But this is not what was recommended or sought by the PC, and FDC is a flawed framework for assessing the merits of individual prices in the presence of common costs, especially when they represent a large component of total costs and their allocations to individual services and user groups are largely arbitrary.

It is technically possible to create cost estimates for service items and user groups on a FDC basis, and this may be a suitable approach in some circumstances. The PC's recommendation 9.4-requires information that shows that the revenues received through prices for individual service items and user groups at least recover directly attributable costs, such that there are no economic cross-subsidies involved. That is, do revenues for domestic services at least recover the directly attributable costs for such services, if they do then there cannot be any cross subsidisation by international services of domestic services. An allocation of common costs via arbitrary cost drivers is not needed or useful here given our understanding of the issues of concern to the PC, noting the PC already reviews the total return on aeronautical services.

Perth Airport's submission to the Consultation Paper covers some fundamental issues about the objectives and issues in providing additional financial information. It is structured as follows:

- the Productivity Commission's recommendation 9.4
- the ACCC's proposed financial monitoring framework
- Perth Airport's proposal for aeronautical services
- car parking services
- landside access services
- commercially sensitive information and annual reporting
- progressing the Productivity Commission's recommendation 9.4

Perth Airport would welcome the opportunity to discuss with the ACCC further the important issues it has provided in this submission.

The Productivity Commission's recommendation 9.4

The PC recommended that monitored airports provide additional cost and revenue information to 'improve the evidence base' to allow them to better analyse, and form a view over, the level and structure of prices for airport services to international flights, car parking and landside access services. In doing so, the PC correctly recognised that much of the asset and operating costs in providing airport services are common use, and allocating these costs across service lines and user groups in creating 'stand-alone' FDCs can be problematic, stating that:

> *As noted in chapter 2, long-run average cost is a conceptual benchmark that cannot be calculated in practice. The main impediment to calculating the long-run average cost of aeronautical services is that the capital and operating costs of common-use infrastructure have to be allocated to either international or domestic services. There is no agreed methodology to allocate these costs, so any allocation would be somewhat arbitrary.*[1]

For aeronautical services such as airfields, most costs, including the runways and land, and many operating costs, such as airfield lighting and operations, have no causal driver in providing services to domestic and international flights. This means a FDC calculation for airfield services to domestic and international flights is highly arbitrary, with many equally arbitrary cost allocators available to generate different final FDCs by user group.

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[1] PC (2019), p.309

Given the importance of common costs in providing airport services, in Perth Airport's opinion, the PC has specifically not asked the monitored airports to create FDC income statements and balance sheets within the Regulatory Accounting Statements for individual service lines or by user group, stating that:

> *For that reason [as provided in the quote above], instead of requiring airports to report the costs of domestic and international aeronautical services the Commission is recommending that the ACCC collect and publish:*
>
> - *information on operating and capital costs that can be directly attributed international or domestic aeronautical services*
> - *information on all common costs that are related to aeronautical services*
> - *any methodologies that the monitored airports use to allocate costs to domestic and international services.*[2] *(emphasis added)*

The PC has sought information over directly attributable costs (capital and operating), the pool of common costs and method(s) used to allocate common costs (or if no cost allocation method is applied). The PC can use this information together with activity data (eg domestic and international passenger numbers), revenues and prices to form a view over issues such as the level of pricing for domestic and international flights.

For example, the PC has already assessed the reasonableness of the returns earned across all aeronautical services, which they have found not be excessive over three review periods. With the additional information sought, the PC can also assess if any individual prices are being set below say 'incremental' cost (in this case using directly attributable costs) or if prices are above both incremental and all common costs. How the PC chooses to use the additional information it has asked for, and what weight it places on the outcomes, is a matter for the PC, which they determine in each review of the light-handed economic regulatory arrangements.

Some existing guidance material

A sound approach to assessing individual prices in the presence of common costs is well explained by the Competitive Neutrality Complaints Office (contained within the PC) in its research paper, *Cost Allocation and Pricing*. Perth Airport considers the sound framework contained in this research paper equally applies in meeting the PC's recommendation 9.4.

Importantly, under light-handed economic regulation, airport operators retain the flexibility to commercially negotiate prices with users, which may mean differing contributions to common costs across service lines and user groups. Such practices are well recognised elements of properly functioning commercial negotiations by private businesses, as argued by the Competitive Neutrality Complaints Office:

> *Over the longer term, a private business must earn sufficient revenue to cover all costs, including a commercial rate of return. But in pursuing this goal, private businesses adopt a wide range of pricing strategies for individual products.*[3]

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[2] PC (2019), p.309

[3] Commonwealth Competitive Neutrality Complaints Office (1998), Cost allocation and pricing, p. 2

The pricing of services by monitored airports are also disciplined by a range of other legal and regulatory considerations, including:

- general competition laws
- access declarations
- the Aeronautical Pricing Principles and periodic reviews by the PC, who have stated they 'would not hesitate to recommend regulatory changes, including price regulation, if airports were found to have systematically exercised their market power.'[4]

The PC did not say that it needed, or it was appropriate to develop, profit margins or rate of return information by service line or user group via a FDC framework. The PC recognised that in doing so the individual profit margins calculated through FDC would be largely determined by the arbitrary common cost allocators, to which differing allocators could be used, in turn generating different profit results.

Perth Airport considers that the same issues described above also apply to the disaggregation of operational information, such the number of full-time equivalent employees for many services. It is not possible to establish clear causal links to individual domestic and international flights in airfield operations and hence the choice of allocator is arbitrary.

The ACCC's proposed financial monitoring framework

All three of the ACCC's options in its Consultation Paper require monitored airports to create in the Regulatory Accounting Statements stand-alone cost, revenue and balance sheet outcomes for aeronautical services to domestic and international flights, car parking and landside access, on an FDC basis. This would then allow the ACCC to report on the (artificially) measured profitability by service line and user group, stating that:

> *Collecting disaggregated operational data, in conjunction with similarly disaggregated financial data, would allow the ACCC to appropriately consider revenues, costs and <u>profit margins</u> for each specific service.[5] [emphasis added]*

This is a flawed framework for assessing individual prices and profitability for airport services given much of the infrastructure and operating costs are common use. Perth Airport considers that the ACCC's proposal takes the industry down a path of 'quasi economic regulation', whereby the ACCC will start forming positions over the level of profitability that should apply by service item and user group, despite the inherent flaws with FDC framework in assessing individual prices.

Given these well-known flaws in assessing individual prices, Perth Airport considers that the ACCC's proposed financial reporting requirements would undermine the intent of the light-handed economic regulatory arrangements as it is essentially a form of quasi economic regulation. It is technically possible to create cost estimates for service items and user groups on a FDC basis, and this may be a suitable approach in some circumstances. The PC's recommendation 9.4 requires information that shows that the revenues received through prices for individual service items and user groups at least recover directly attributable costs, such that there are no economic cross-subsidies involved. That is, do revenues for domestic services at least recover the directly attributable costs for such services, if they do then there cannot be any

[4] PC (2019), p.2

[5] ACCC Consultation Paper, p. 15.

cross subsidisation by international services of domestic services. An allocation of common costs via arbitrary cost drivers is not needed or useful here given our understanding of the issues of concern to the PC, noting the PC already reviews the total return on aeronautical services.

The ACCC's proposed reporting requirements will undermine light-handed economic regulation by establishing an artificial dataset and reporting on airport pricing practices that will likely be referenced by parties to the negotiations. As such, the key issue here is not just the commercial sensitivity of published financial information but rather the impact the proposed reporting can have on commercial negotiations.

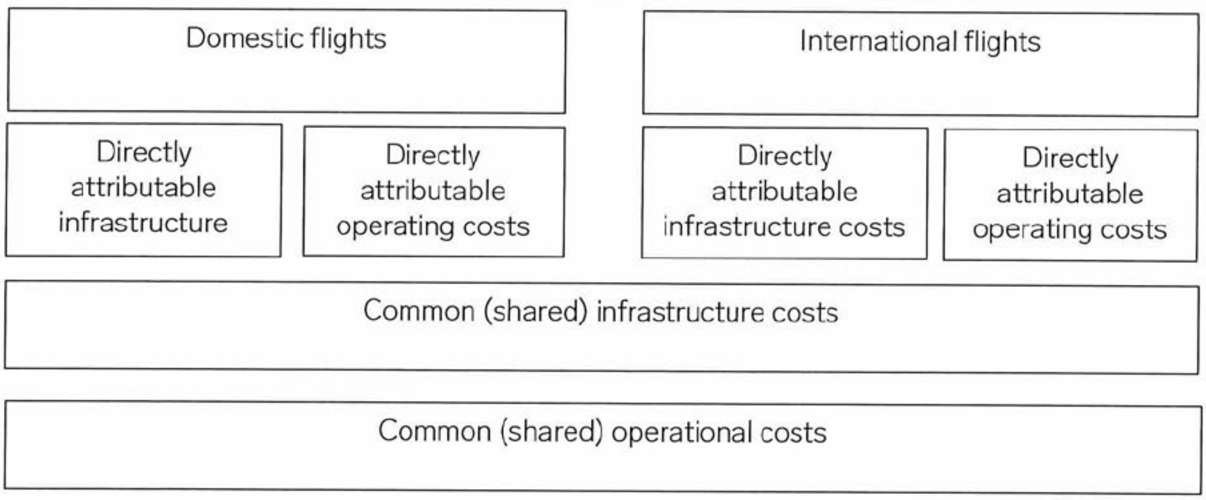
The contribution to common costs by different user groups can legitimately vary across users and through time, including when users see merit in changing the structure of pricing for services. One example here is the move from using aircraft weight to passenger numbers in pricing for airfield services. Another is changes to the structure of prices for traditional vs self-service check-in counters in encouraging efficient investment in, and use of, the services by airlines. Investment in such services can delay the need for expensive expansions of check-in halls, and hence pricing reflects the benefits to all users rather than the strict cost of the service to those airlines that use self-service check-in counters.

Such negotiated outcomes are not evidence of the use of market power but instead represent good faith commercial negotiations that better meet the needs of users and support efficient investment in airport services. It also can involve changing the relative contribution of user groups to common costs. The ACCC's proposed FDC financial monitoring framework may inhibit such productive commercial discussions and outcomes because it creates an artificial basis for measuring and reporting profitability by service line and user group.

Perth Airport's proposal for aeronautical services

Perth Airport considers that the PC's recommendation 9.4 is best implemented through supplementary financial information that fits with its request, which is illustrated in the simplified figure for aeronautical services to domestic and international flights (Figure 1).

Figure 1 Illustrative example of costs for domestic and international flights



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The information needed here is supplementary to the existing Regulatory Accounting Statements rather than further segmentation. The directly attributable and common infrastructure costs could be based on the overall value of fixed, property plant and equipment, along with measured depreciation. Total operating costs would be separated into directly attributable and common based on the airport's activity based costing system. The pool of common costs (infrastructure and operating) may include both those relating solely to aeronautical activities (eg airfield operations) and those relating to total airport activities (eg corporate costs).

This additional reporting would provide the PC the information it requires for its future inquiries while not potentially adversely interfering with the light-handed economic regulatory regime.

Cost allocators, auditing requirements and reporting

The ACCC's extensive discussion in its Consultation Paper about cost allocators, including the option for it to decide what they should be, is not necessary given the flaws in its proposed financial monitoring framework, given the issues of concern raised by the PC, and the fact it takes the industry down a path of quasi economic regulation. All this is the exact opposite to the PC's findings and recommendations that the existing light-handed regime, based on commercial negotiations between monitored airports and their customers, remains fit for purpose.

It is important to note that in some instances cost allocators may not be used as they are not necessary or useful. One example here is airfield services, where various pricing metrics are used across user groups. They can include passenger numbers for regular public transport (RPT) flights, aircraft weight for freighter aircraft, minimum charges for general aviation flights and parking charges, being both potentially time and aircraft-size based. All these metrics are commercially reasonable ways to set prices for different flight types for airfield services. The result is that each flight makes a contribution to common costs, but the individual amounts need not correspond to any uniform cost allocation metric across all flights. The PC already reviews the total return on aeronautical services from all users of aeronautical services.

Perth Airport considers that a simple list of the allocators used for the various common costs in preparing the Regulatory Accounting Statements and for the supplementary financial information is sufficient for the purposes of the PC's recommendation 9.4. As the audited Regulatory Accounting Statements cover the allocators between aeronautical and non-aeronautical, the supplementary information, including any additional cost allocators should be accepted as unaudited financial information. As noted earlier, Perth Airport would understand the issue here is ensuring the revenues obtained through prices at least recover the directly attributable cost of providing individual services.

Perth Airport also considers that the supplementary financial information should not be published and instead be provided to the Productivity Commission at its next review (see section Commercially sensitive information and annual reporting).

Car parking services

The PC recommended that monitored airports be required to report cost and revenue data for car parking and landside access services in the same way as for aeronautical services. There are, however, important differences between the measured cost of aeronautical and non-aeronautical services, such as car parks, which need to be understood and resolved in meeting the PC's information request.

The most important difference in the measured cost of non-aeronautical services such as car parks is the opportunity cost of the land used, and the issue of asset revaluation more generally. On pricing, there are different pricing structures across monitored airports for car parking services, limiting the ability for sound comparisons across airports. One example here is free parking time (say 10 minutes), proving a free service for many people coming to the airport to pick up arriving passengers.

For aeronautical services, there is the established 'line in the sand' valuation for aeronautical assets, and further asset revaluations are excluded for financial monitoring purposes. The asset value is updated each year for depreciation, investments and disposals. The PC's reasons for recommending the line in the sand valuation for aeronautical assets are explained in its 2006 Inquiry report.

This position was carefully considered by the PC, taking into account the legitimate expectations of the airport operators in purchasing the airport leases against the fixed use of aeronautical infrastructure, including aeronautical land, under the airport leases. The PC recognised that only a compromise path forward was available, stating that:

> *As the parties generally agree, there is no easy answer, with an element of pragmatism called for. And any line in the sand, no matter how carefully crafted, will inevitably involve some 'rough justice'.*[6]

For non-aeronautical services, however, the PC recognised that the opportunity cost of land is a valid consideration of pricing car parking services, stating that:

> *The evidence, however, shows that the price of car parking at airports is consistent with the fixed and variable costs of providing car parking services (including the opportunity cost of land)...*[7]

The opportunity cost of land is not fixed, and instead its value changes through time in line with the alternative uses available.

As with aeronautical services for domestic and international flights, Perth Airport does not support segmenting the Regulatory Accounting Statements for car parking, and instead supplementary information should be provided, covering directly attributable and common costs, together with a list of cost allocation drivers.

[6] PC (2006), p.77
[7] PC (2019), p.193

At the same time, there are likely to be issues in reporting costs such as land on an opportunity cost basis compared to those contained in the Regulatory Accounting Statements each financial year as the latter is based on accounting standard requirements. As such, for car parks (and landside access services) Perth Airport proposes that unaudited supplementary information be provided that need not necessarily be the same as contained in the Regulatory Accounting Statements. The supplementary financial information should not be published and instead be provided to the Productivity Commission at its next review (see section Commercially sensitive information and annual reporting).

Landside access services

In addition to the issues with FDC and the opportunity cost of land described earlier, for landside access services the financial segmentation sought by the ACCC does not fit with how Perth Airport provides services to ground transport providers at the airport. Perth Airport has explained these important issues in more detail in its submission to the ACCC's review of the service quality indicators.

The areas for ground transport providers are a combination of specific purpose where access fess apply, namely taxi and rideshare, while others make use of the free public forecourt areas, which includes hotel shuttles, tourist buses, coaches, public buses or other similar operators. Perth Airport does not currently count the number of vehicles by ground transport provider type that use the common use public forecourt areas or the commercial areas.

This means the ACCC's proposal for detailed activity, cost and revenue outcomes by transport mode is largely problematic at Perth Airport. Perth Airport is unaware of any suitable technology that could be implemented to count the number of vehicles by transport type at the public forecourt areas. In any case, without a fee charged the information provides no value for financial monitoring purposes.

Some information could likely be developed for services to taxis and rideshare, and Perth Airport already separately reports to the ACCC the revenues obtained. Any additional information here would also need to be supplementary, unaudited information.

Commercially sensitive information and annual reporting

There is considerable scope for the more detailed information sought by the ACCC to be used for purposes other than assessing the commercial conduct of monitored airports. Perth Airport would appreciate the opportunity to assess carefully if the additional information recommended by the ACCC is likely to impact normal commercial discussions. .

Presently, Perth Airport sees merit in the ACCC maintaining the same level of financial information disclosure as currently reported in the annual Airport Monitoring Report until the additional information is reviewed by the PC at its next inquiry.

The ACCC's proposed segmented Regulatory Accounting Statements on a FDC basis creates the greatest possibility of commercial problems for Perth Airport and individual users. These problems may include:

- airlines and ground transport providers using a flawed FDC basis for measuring profitability margins and rates of return to advocate reductions in pricing for the services they use at the airport, likely pursued through the media,
- the ACCC or other parties deciding to 'back out' any revaluation of non-aeronautical asset costs, especially land valuations at car parks, for the purposes of reporting higher levels of profitability in pursuing greater economic regulation of monitored airports,
- individual users taking the additional information combined with specific information they have to obtain a more detailed understanding of a competitor's cost structure, which may provide them certain commercial advantages. It is difficult to know what analysis might be possible here, only that the additional financial information needs to be considered in the context of how it might be combined with other sources of information.

For domestic air transport services, the ACCC recently reporting that Qantas Group's (Qantas and Jetstar) market share was 61.1%, followed by Virgin Australia at 23.1%. This very high level of market concentration creates a strong incentive and potential reward for individual airlines to use the additional financial information for the primary objective of gaining commercial advantage over its rival, rather than for the assessing the commercial conduct of monitored airports.

Perth Airport considers that its proposal to provide supplementary information rather than segmented Regulatory Accounting Statements will meet the requirements of the PC and minimise the opportunity for commercial problems to arise. That said, it will be important for interested parties to have the opportunity to review the ACCC's draft recommendations for such issues and it would be preferable for the information published in the annual Airport Monitoring Report to remain as currently reported. The information can be provided to the PC by the ACCC when it conducts its next review of the economic regulatory arrangements.

Progressing the Productivity Commission's recommendation 9.4

Perth Airport has identified a number of problems and practical issues with the ACCC's proposed options in meeting the PC's recommendation 9.4. If any of the ACCC's options is implemented, Perth Airport considers that it will not provide the PC with the information it seeks and it takes the industry down a path of quasi economic regulation, which will undermine the existing light-handed economic regulatory arrangements. This is clearly not the outcomes sought by the PC in seeking an improved evidence base for the purpose of reviewing the commercial conduct of monitored airports.

For its part, Perth Airport has identified a practical way forward in providing the financial information sought by the PC without undermining the light-handed economic regulatory arrangements, something found to be fit for purposes for some 20 years. This would be based around providing supplementary, unaudited information that is not published in the annual monitoring report.

Overall, Perth Airport sees merit in greater work being undertaken to better understand the merits of different approaches to providing additional financial information in meeting the PC's recommendation 9.4. As detailed in our submission to the ACCC on service quality monitoring, these types of reviews would benefit greatly from a detailed understanding over how services are provided at the monitored airports.

Finally, there will be some costs in providing additional financial data, which might require modifications to financial systems in capturing and reporting the information on an ongoing basis. Perth Airport will need to scope a project to meet the Productivity Commission's recommendation 9.4 once the information requirements are finalised.

If you have any queries or require further clarification on this submission, please contact our General Manager Corporate Affairs Matt Brown on [redacted]

Yours sincerely,

KHolsgrove

Kate Holsgrove
ACTING CHIEF EXECUTIVE OFFICER

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