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EXECUTIVE SUMMARY

1. The Proposal

Sydney Airports Corporation Limited (SACL) provides world class airport services and facilities at Sydney (Kingsford Smith) Airport and is undertaking a significant investment program to enhance and expand those facilities to meet the needs of customers consistent, on balance, with the interests of all stakeholders.

This proposal for aeronautical charging changes is based on achieving balance. A balance must be found between:

- ? the needs of customers for quality facilities and expanded capacity at Sydney Airport;
- ? the community need for environmental impacts to be mitigated through infrastructure that provides for noise sharing, amongst other things; and
- ? the needs of SACL's owners, the taxpayers of Australia, to receive a fair and reasonable return on investment.

SACL has undertaken a thorough review of aeronautical charging levels, consistent with the oversight of the Australian Competition and Consumer Commission (ACCC).

The allowable revenue from regulated aeronautical services at Sydney Airport in 2000-01 has been calculated to be \$232.1 million.

SACL's pricing proposal targets revenue of \$212.5 million for the purposes of consultation with customers and the ACCC. While the allowable revenue is based on robust building blocks using a range of reasonable assumptions, SACL has chosen a lower target revenue to reflect:

- ? an acknowledgement that the proposal represents a significant structural adjustment in prices after many years of community subsidised levels of aeronautical charges; and
- ? the expectation that returns will move towards a full return on capital as a result of traffic growth and further improvements in efficiency that are targeted by SACL (this assumes that a CPI-X or similar arrangement will not apply in the short term).

In order to recover the target revenue, this draft notification proposes, for consultation purposes, the following pricing structure and levels of individual charge apply from 1 November 2000.

Proposed Pricing Structure and Levels					
Charge	Application	Rate per unit	Units	Forecast Units	Total Revenue* \$M
Runway Charge #	Landing and take-off of all fixed wing aircraft	\$4.00	Per 1000kg MTOW	26,640,684	\$106.5m
International Terminal Charge	All arriving and departing passenger aircraft using the	\$9.00	Per passenger	8,862,000	\$79.8m

Counter Terrorist First Response Security Charge (International)	international terminal All arriving and departing passenger aircraft using the international terminal	\$0.42	Per passenger	8,862,000	\$3.7m
Counter Terrorist First Response Security Charge (domestic)	Landing and take-off of passenger aircraft >20,000 kg, excluding international passenger aircraft	\$0.26	Per 1000kg MTOW	11,185,854	\$3.0m
Apron Use Charge	All users of SACL common use aprons, excluding general aviation aprons	\$55.00	Per 15 minutes or part thereof – 6am to 11pm	383,200	\$21.1m
Bussing/Stand Off Discount	Arriving and departing international passenger aircraft not using an aerobridge	\$-200.00	Per use	9,580	-\$1.9m
Helicopter Charges	Per helicopter movement	\$25.00	Per movement	9,814	\$0.2m
General Aviation Parking	Use of common use general aviation aprons	\$60.00	Per day (>2 hours)	2,962	\$0.2m
					\$212.5m

* Total revenue assumes a full year impact. A 1 November 2000 implementation will result in a lower actual revenue for 2000-01.

The runway charge is subject to the following minimum charges:

- ✗ Scheduled regional airline services (MTOW 0-5 tonnes) - \$20 per movement;
- ✗ Scheduled regional airline services (MTOW 5-10 tonnes) - \$41.25 per movement; and
- ✗ All other aircraft - \$50 per movement.

At current pricing levels, SACL forecasts that it would receive around \$98m in aeronautical revenue in 2000-01. The required increase is the result of both the current pricing levels not delivering an appropriate return on the existing aeronautical assets and the returns required on \$500m of new aeronautical investment.

The proposed charges do not include international passenger and checked-baggage screening charges or the impact of the goods and services tax (GST). Charges for international passenger and checked-baggage screening services are the subject of separate consultative processes with the ACCC and customers. It is noted that an international passenger security screening charge per departure of \$0.763 per 1000kg MTOW pro rata for all international passenger aircraft has been implemented and a review process agreed. Discussions in relation to the provision of Government mandated checked-baggage screening are on-going and a separate notification is expected.

SACL is separately addressing the net impact of the imposition of GST on aeronautical charges, in consultation with the ACCC. A separate notification will be provided in relation to any required change in charging level. This is provided for, subject to ACCC approval, in Sydney Airport's Conditions of Use document that commences on 1 January 2000.

SACL also offers through its Conditions of Use document, on a case-by-case basis, a number of discounts for the first 12 months of new services during defined off-peak periods. The cost of providing these discounts to services that are included in existing forecasts is **not** included in the allowable revenue or target revenue calculations.

2. Background

SACL is a Commonwealth-owned company formed to own and operate a lease over Sydney Airport. Subsidiaries of SACL were formed to manage other airports in the Sydney basin at Bankstown, Camden and Hoxton Park. This draft notification relates only to Sydney Airport and no cost of other Sydney basin airports has been included.

SACL entered into a 99 year lease (50 years plus a 49 year option) over Sydney Airport on 1 July 1998. The Federal Airports Corporation (FAC), a Commonwealth statutory authority, had previously operated the airport as part of a network of airports.

During 1997 and 1998, all FAC airports other than the Sydney basin airports and Essendon airport were privatised. While Government policy involves the privatisation of the remaining airports, Sydney Airport was removed from the earlier process.

SACL was established to ensure that Sydney Airport has a stand-alone business focus in a commercial environment similar to the major privatised airports. SACL has a commercially based capital structure, involving a \$1.9 billion borrowing program that has been used to finance its leasing costs and the on-going funding of the major expansion and upgrade of facilities underway. SACL is required to earn commercial returns on its assets.

3. Sydney Airport

Sydney Airport is Australia's primary international gateway. It is also the primary entry point for domestic and regional air services to Sydney and operates as a hub between all combinations of international, domestic and regional centres.

Sydney Airport provided services for nearly 22 million passengers in 1998-99. Over 50% of all international passengers and air cargo pass through Sydney Airport. Over 50 international carriers operate scheduled services to Sydney Airport, carrying over 7 million international passengers and goods to the value of \$21 billion.

Sydney Airport contributes nearly \$8 billion annually to the economy and supports 66,500 jobs, equivalent to 8% of Sydney's workforce. More than 500 businesses meet the daily needs of the airport.

Sydney Airport is one of the most conveniently located airports in the world. At around 8 kilometres from Sydney's central business district, travellers benefit from fast and inexpensive transfers to and from the Airport. Sydney Airport has remained on its original Mascot site since 1920. The high opportunity cost of the land and the costs of construction, including runways extending into Botany Bay, only partially offset the locational benefits.

The environmental issues that arise from Sydney Airport's location have resulted in the community, through the Government, deciding to limit the number of aircraft movements to 80 per hour and to place a curfew on night operations.

The strong demand for Sydney Airport services means that Sydney Airport is approaching its runway capacity limit, particularly at certain times of the day. Excess demand (congestion) is also an issue

for terminal facilities and aircraft stands. The Government is currently considering Sydney basin capacity issues in the context of the possible development of a second Sydney airport. The pricing structure and levels proposed in this draft notification are independent of any such decisions.

4. FAC Determination 13 – 30 June 1998

In early 1998, the FAC undertook a consultation program leading to a notification of price changes at Sydney Airport for a three year period 1998-99 to 2000-01. The notification was based on the recovery of only 88% of existing aeronautical operating and maintenance costs (including depreciation), and new operating and maintenance costs expected to arise from forecast capital expenditure. No provision for return on capital was included in the FAC pricing notification.

In its decision on Proposed Determination 13 in May 1998, the Australian Competition and Consumer Commission (ACCC) stated, in summary:

The ACCC does not object to the FAC undertaking its proposal to restructure charges for the first year.

The ACCC is not in a position to make a decision at this point in time regarding the proposals for the second and third years for the reasons set out below. However, the ACCC recognises that investment expenditure at Sydney airport is required and undertakes to allow increases in charges for aeronautical services sufficient to justify the investment. The extent to which increases in charges are justified will depend upon resolution of issues relating to depreciation charges and rate of return and a review of traffic forecasts, capital expenditure incurred and other relevant variables.

SACL has specifically responded to each of the issues raised by the ACCC. The SAACL approach contains a number of fundamental differences from the FAC approach to pricing. SAACL has made substantial changes to depreciation and cost allocation assumptions to better reflect economic circumstances and so answer the concerns of the ACCC and industry. SAACL has included capital costs as a legitimate cost consistent with developments in best practice infrastructure pricing regulation.

5. The notification

This notification seeks the approval of the ACCC to certain changes in both the level and structure of aeronautical charges at Sydney Airport. SAACL has undertaken a comprehensive review of aeronautical prices using independent expert advice in key areas.

5.1. Objectives of the pricing review

The objectives of the pricing review were to develop a structure and level of prices that:

- ? offers strong value to aviation customers at rates competitive with comparable international airports;
- ? establishes a viable aviation business with incentives for appropriate maintenance and future investment; and

? provides a fair return to the shareholder, the Commonwealth of Australia.

In view of the capacity issues at Sydney Airport and the consideration of the development of a second Sydney airport, the immediate establishment of efficient pricing signals is important in determining the need for, and location and timing of, additional airport capacity.

5.2. Form of Regulation

SACL is subject to price regulation by the ACCC as a result of Declaration No 85, made by the Treasurer on 9 July 1998 under section 21(1) of the *Prices Surveillance Act 1983* (the PSA). Directions 15 and 16 made by the Treasurer on the same date under sections 20 and 27A on the same day are also relevant.

Declaration No 85 declares SACL to be a “declared person” for the purposes of the PSA in relation to the provision of “aeronautical services”. Accordingly, the ACCC’s approval is necessary for any increase in the price charged by SACL for services falling within that phrase. This Declaration adopts the same definition of “aeronautical services” as the price control Declarations made in respect of the privately leased Phase 1 and Phase 2 airports.

While Declaration 85 and Direction 16 (which provides for price monitoring of aeronautical related services) are in common terms to those applicable at the Phase 1 and Phase 2 airports, Direction 15 is in markedly different terms to the section 20 Direction that applies at those other airports.

Direction No 13 establishes a CPI-X price cap regime for Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth and Townsville Airports. Under that Direction, the prices for aeronautical services are capped and must decrease in real terms over time.

In contrast, the Government decided against imposing a price-cap regime at Sydney Airport. Instead, Direction 15 sets out a number of considerations to which the ACCC is required to give “special consideration” under section 20 of the PSA. Direction 15 provides that each price proposal for Sydney Airport is to be considered by the ACCC “on its merits having regard to the information available to the ACCC”.

In addition to these factors affecting the ACCC, it is relevant to note that the directors of SACL have a number of legal obligations under *Corporations Law* and the *Governance Arrangements for Commonwealth Government Business Enterprises* that affect the price levels and pricing structure for which they must seek approval from the ACCC.

5.3. Aeronautical Services provided by Sydney Airport

Aeronautical services fall into two broad categories:

? *Aircraft movement services.* These services include the provision of runways, taxiways, aprons, aircraft parking areas, airfield lighting, airside roads, nose-in guidance, and visual navigation aids; and

? *Passenger processing areas.* These include aerobridges, airside buses, departure lounges and holding lounges, immigration and customs areas, public address systems, security systems, baggage make-up/handling/reclaim, public areas in terminals, flight information screens, land-side road and lighting, and covered walkways.

Sydney Airport also provides a range of other services including commercial property leasing, retail concessions, and car park services.

Included in these other services is a range of “aeronautical related” services (which are subject to prices monitoring by the ACCC) including aircraft refuelling, aircraft maintenance sites and buildings, freight equipment storage sites, freight facility sites and buildings, ground support equipment sites, check-in counters and related facilities, and car parks and taxi holding areas and facilities.

A wide range of other services are provided at Sydney Airport by Qantas and Ansett, independent handling and catering agents, fuel companies and other businesses. Qantas and Ansett provide terminal and aircraft parking and handling facilities to regional and international airlines and a wide range of handling, freight and maintenance services.

5.3.1. *Cost allocation between aeronautical and other services*

In some infrastructure industries, notably the electricity sector, governments have separated the competitive elements (such as generation and retail) into entities discrete from those that exhibit natural monopoly characteristics (distribution). The Government has not considered that a similar separation is warranted in the case of airports.

Because this notification relates only to aeronautical services subject to prices surveillance, this requires a separation of SACL activities into discrete business units with appropriate allocations of assets, costs and revenues.

The costs and revenues associated with providing competitive services on airports (including retail, property leasing, car parking services etc) are generally readily separable from those of aeronautical services. A small proportion of costs, primarily related to access infrastructure and open areas of the international terminal building, are considered to be joint or common. SACL has adopted an activity based costing system and has made significant changes to a number of the key assumptions previously used to allocate these costs.

5.4. **Service standards**

SACL’s objective is to provide safe, efficient airport services that represent value for money for its customers.

In July 1999 SACL submitted a report to the ACCC which detailed SACL's performance in relation to its quality of service. The report met the requirements of Regulation 8.01 and 8.02, Quality of Service Monitoring, Airports Regulations 1997. While SACL did not come under the Regulations at the time, it agreed to provide information on the relevant quality of service performance criteria.

The report covers indicators over a broad range of the aeronautical activities undertaken by the airport, including their level of satisfaction in a wide range of areas.

While the responses differed under each indicator, the results indicate a broad level of satisfaction among customers in relation to the services provided at Sydney Airport. Customers consistently ranked the services between 7 and 8 out of 10. This result is considered creditable, particularly given the survey was taken at a time when major renovations (and therefore disruptions) were being undertaken at the airport. SACL's report to the ACCC provides detailed information on the level of customer satisfaction with SACL's services.

The International Air Transport Association (IATA) also published a recent survey in April 1999. The Global Airport Monitor ranked Sydney Airport 9th in terms of total customer satisfaction from the 65 major international airports surveyed.

6. "Building Block" Approach to Revenue Determination

The approach adopted to determine SACL's total annual allowable revenue to support the provision of aeronautical services follows that set out by the ACCC in its draft Statement of Regulatory Principles for electricity transmission businesses in May 1999.

A firm will invest in an activity if the expected revenue is sufficient to cover:

- ? operating and maintenance expenses; plus
- ? the return *of* any capital invested; plus
- ? a return *on* the capital assets invested (adjusted for risk).

SACL has developed this pricing proposal using these three building blocks. For most infrastructure businesses, including airports, a significant proportion of costs relate to the return *of* capital, ie, depreciation, and a return *on* capital. As a result, the valuation of assets, the treatment of changes in the value of assets over time, and the determination of the appropriate risk adjusted rate of return on those assets are central to the determination of total regulated revenue.

6.1. Asset Valuation

The fundamental economic principle applied in valuing aeronautical assets at Sydney Airport (and the value of the accumulated investment) is that of opportunity cost. Opportunity cost is a forward looking concept that provides the answer to one of two possible questions relating to the provision of aeronautical (or, indeed, any other) services:

- ? what is the future cost of all the land and facilities needed to supply aeronautical services at Sydney Airport, on a sustainable basis? or
- ? if the airport (or parts of it) were to be put to some alternative use, what is the market value of the existing aeronautical assets if they were to be disposed of to the highest bidder?

6.1.1. Methodology

A methodology was initially developed for SACL by Ernst and Young Real Estate Group (New Zealand), drawing on significant experience in valuing airports and other infrastructure assets for regulatory pricing purposes. The methodology was then refined following review and testing by Ernst and Young, SACL and Jones Lang LaSalle Advisory.

The basis of the valuation methodology entailed the classification of the airport assets into:

- ? Non Specialised, or Contestable assets, being those normally traded in an open market where market based price indicators are available, and
- ? Specialised or Non Contestable Assets being assets not normally traded in the market except as part of a total enterprise, by reason of their specific design, location or other factors, and for which there is little or no market evidence for that type of asset.

The aeronautical assets subject to notification are considered specialised, or non-contestable. The methodology, consistent with best practice in infrastructure pricing, required the use of optimised depreciated replacement cost of assets (ODRC) to value aeronautical buildings and civil works and an assessment of the opportunity cost of land. The ODRC approach avoids the inherent circularity of valuing assets using a discounted cash flow analysis of regulated revenues.

6.1.2. ODRC

In economic terms, an ODRC valuation is equivalent to the opportunity cost of providing the relevant service on a new entrant basis. The concept draws its origins from the question that would be asked by a prospective new entrant, ie:

what is the maximum amount a prospective new entrant providing exactly the same service, would be willing to pay to acquire existing, second-hand assets (which will require higher maintenance and earlier replacement, relative to new ones), rather than rebuild the entire facility from scratch?

An assessment of the ODRC of all improvements such as buildings and civil works was undertaken by consulting engineers Maunsell McIntyre Pty Ltd in association with Rawlinson Australia Pty Limited, Cost Consultants and Quantity Surveyors.

The largest component of site improvements are the runways, taxiways and aprons (RTAs) with a total replacement cost of \$826.7 million. Taking into account the age of the various improvements and life expectancy, the estimated total depreciated replacement cost based on current construction and materials is \$580.3 million.

This amount includes \$188.8 million for land reclamation costs and \$24.2m for domestic terminal apron areas. These items have been excluded for the purpose of the notification. Land reclamation costs are considered an integral portion of the land under the respective runways.

The net aeronautical pavement value of \$367.3m has been added to the value of other fixed assets to calculate a total ODRC of fixed aeronautical assets of \$606.4m.

6.1.3. Land value

Sydney Airport occupies a total area of approximately 886.5 ha including land reclaimed for the extension of the initial north south runway and more recently for the construction of the third runway. The land used for aeronautical activities on the airport totals 652.9ha.

6.1.3.1. Principles adopted in the proposal

The charges in place under the FAC implicitly assumed that aeronautical land is a *free good*, and no return on land was included in price calculations. This approach is not consistent with either best regulatory practice or SACL's commercial mandate from Government. The value of land must be incorporated into this draft notification for the following reasons:

- ? valuing the land according to its alternative use provides the economic signal for efficient decisions regarding the continuing use of the land as an airport, compared with the cost of an airport based further out of the city, with cheaper land, but increased costs in travel time etc;
- ? the Commonwealth, as a rational investor, would only continue to use Sydney Airport for aviation purposes if it could not achieve a higher return from an alternative use – even if SACL were a private sector lessee, a mutually beneficial arrangement could be negotiated with the owner of the freehold (the Commonwealth) to return or relocate the lease if returns are not appropriate;
- ? any possible future airport in the Sydney basin would be unable to compete with Sydney Airport as the cost of the latter's locational advantage is not reflected in current aeronautical charges; and
- ? the lessee of Sydney Airport is otherwise provided with a strong incentive to 'squeeze' aeronautical services by using the maximum possible amount of land for non-aeronautical activities in order to capture the current value of the underlying land.

6.1.3.2. Required return on land

While the current value of land must be reflected in charges for efficiency and equity reasons, there are two key issues that require consideration in the treatment of land value. These are the way in which the increasing value of land and the amortisation of the lease over it are to be treated for the purposes of this notification.

Land is generally considered to be an *appreciating* asset over time and its value can be expected to appreciate broadly in line with the growth of the economy. The amount of appreciation (or negative depreciation) can be treated either as income in the assessment of allowable revenue or as an adjustment to the required return on land.

In the calculation of its allowable revenue, SACL has incorporated the forecast appreciation in the value of land as income. For that purpose, a real growth rate of 3% (5.5% nominal at 2.5% assumed inflation) has been assumed.

Whilst treating land appreciation as income reduces SACL's near term allowable revenue, it should be noted that in the medium to long term, appreciating land results in a higher asset base and, at some point, greater allowed revenues than fixing land at its current value. Under either approach, the net

present value of the allowable revenue is the same. However, incorporating land at approximately its market value (opportunity cost) ensures efficient pricing signals over the long term.

In regard to *lease amortisation*, since the Commonwealth is both the holder of the freehold and the owner of SACL, SACL has not sought, in the treatment of land, to distinguish the Commonwealth's interest in the freehold from its equity interest in the lessee. Accordingly, the technical accounting requirement for SACL to amortise its lease costs is not reflected in this proposal.

6.1.3.3. Estimating land value

Opportunity cost of land can be estimated by direct reference to its value in an alternative use, ie, not as an airport. For example, the land at Sydney Airport could be used for residential or light industrial developments, implying relocation of the airport to another, potentially lower cost, site. This concept is equivalent to undertaking an ODRC valuation but without any asset life, depreciation or maintenance assumptions.

Aeronautical land comprises 75% of the airport land holding. The assessed value of the 'airfield' and 'other' land is based on an assessment of the cost which SACL would have incurred had it acquired an equivalent parcel of land with similar locational attributes and amenity on the open market in order to develop an equivalent airport. It thus represents the Deprival Value of the land.

The value of this land has been assessed by calculating the amount which SACL would need to pay in the market to match the price which an independent purchaser could afford to pay to acquire an equivalent parcel of land to undertake a hypothetical highest and best use alternative development (the residual cash flow approach), plus the costs to get the land to airport usage but excluding the costs of any airport improvements.

This valuation has been validated with reference to:

- ? large industrial/commercial land sales in the south Sydney region;
- ? the costs of acquiring land to develop a new airport in the Sydney basin, again plus costs to achieve airport usage; and
- ? the implied land value based on relevant market ground rentals.

The base land value represents the NPV, at a 27.5% discount rate, of a hypothetical alternative mixed use residential/industrial /commercial development of a 700 hectare parcel of land with equivalent locational attributes and amenity, over a 15 year period, assuming prevailing densities, take up rates, sale prices, rents and construction costs. The discount rate used in the residual assessment was considered by Jones Lang LaSalle (JLL) to be within the range that would typically be adopted for large scale development projects, and represents the project return on a before tax basis in nominal terms. Within the residual cashflow valuation process a range of sensitivity analyses has been undertaken and the adopted land value is considered to be towards the lower end of the likely range.

In order to achieve the same utility as the airport land now enjoys, a lengthy planning and construction process would have to be undertaken following acquisition to arrive at the current position. Based on the time frame for the development of an alternative airport at Sydney West, as

indicated in the Sydney Second Airport EIS¹, a period of five years has been assumed. This is considered to be the minimum time frame required and assumes that the land is designated for airport use and/or appropriate approvals can be obtained through normal but not unduly delayed due process.

During this period JLL assumed that holding costs would be incurred and so the underlying value of \$82/m² was escalated by a nominal 7% for five years to derive an indicated current existing use value of \$115/m². This represents the costs to SACL of acquiring an equivalent area of unimproved land in the open market and the associated holding costs through the planning and development period. It thus represents the current position of SACL's land holding, which has all necessary approvals for airport use in place and on which an airport has been developed.

6.1.3.4. Total aeronautical land value

The total land value of 748.8m (652.85ha x \$115/m²) has been adjusted to take account of the value of seawalls included in the ODRC of fixed assets. This reduces the net value of \$132.4m, giving an aeronautical land value of \$616.4m.

6.1.4. Other Considerations

Some assets, notably the Sydney International Terminal (SIT) comprise both aeronautical components (such as passenger processing halls, check-in areas, baggage handling facilities, gate lounges and immigration and customs facilities) and other components (such as retail areas, offices, and food and beverage outlets). These components were valued separately, with ODRC used for aeronautical components, while market value concepts were applied to other components.

An apportionment was made of joint and common areas based on retail circulation space provided in comparable non-airport retail businesses prior to application of the valuation methodology.

A deduction from the total ODRC has also been made for the value of a portion of the public roads and footpaths that are integral to and implicit within the value of the market assets to which they provide access.

6.1.5. Outcome and Review

The valuation undertaken by JLL resulted in an aeronautical asset valuation as at 1 July 1998 of:

Aeronautical Land	\$ 616,400,000
Aeronautical fixed assets	\$ 606,400,000
Moveable plant and equipment	<u>\$ 7,583,000</u>
Total Value of Aeronautical assets at 1 July 1998	<u>\$1,230,383,000</u>

¹ Draft Environmental Impact Statement: Sydney Second Airport Proposal, Table 9.7, Figure 9.22 p9-33

The valuation exercise was reviewed by the National Economic Research Associates (NERA) for consistency with both the economic principles cited above and with practice and principles in other regulated industries throughout Australia.

6.2. Changes in the value of assets over time

This notification for the 2000-01 financial year involves an assessment of the change in the value of assets from 1 July 1998 to 1 July 2000. The ACCC and industry may also require information on the impact of price changes on expected returns in future years, requiring an assessment of changes in asset values beyond 2000-01.

Asset roll forward is the estimation of future asset values having regard to:

- ? new capital expenditure;
- ? the depreciation of assets;
- ? the disposal of assets; and
- ? indexing.

6.2.1. New capital expenditure

Sydney Airport is currently undertaking a major expansion and upgrade of facilities.

Under the FAC's network management approach, major upgrades were performed in cycles. In the years immediately preceding privatisation, international facilities at Brisbane and Melbourne airports underwent major development using network resources.

In response to growing congestion and customer demand, the Sydney Airport 2000 (SA2000) project and associated capital works were commenced by the FAC immediately prior to SACL taking over management of the Airport on 1 July 1998. As a result of the ACCC's decision in relation to the FAC's proposed Determination 13, there is no allowance for this \$600m program in SACL's existing aeronautical pricing.

This program will add 10 new aircraft parking positions, new aerobridges, a major expansion of the baggage system and enlargement of the arrivals areas. The project also involves significant elements outside the definition of aeronautical services including a 40% increase in the number of check-in counters, additional airline office and lounge space and 51 new retail outlets.

The project has been scoped and undertaken with the benefit of significant industry input to provide an appropriate level and quality of facilities. The expansion is designed to provide capacity to meet demand to 2003-04.

In addition to the \$600m SA2000 program, other capital works during 1998-99 and 1999-00 to the value of \$200m include a \$44 million elevated departures road in the domestic spine and a \$47 million apron and taxiway enhancement program. Capital expenditure exceeding \$35m is also

required to support the Government's newly mandated passenger and checked baggage screening requirements.

Total capital expenditure will thus be around \$800m, of which \$500m is attributable to aeronautical services and incorporated in this notification.

Any other major future capital investment is outside the scope of the notification. SACL will consult with its customers on any such future projects and these would be the subject of a separate future notification.

An on-going minor capital works program of \$30m per annum is included in this notification to avoid the need for repetitive future price notifications in respect of comparatively minor items. For an airport the size and scale of Sydney Airport, \$30m is the minimum amount need to meet safety and operational-related requirements included in SACL's forward capital expenditure plan. Expenditure under this program will be prioritised in consultation with airline customers and brought to account with the ACCC in future notifications.

6.2.2. *The depreciation of assets*

In its May 1998 decision, the ACCC found that the issue of depreciation charges could not be satisfactorily resolved within the time frame of the 1998 notification.

SACL has undertaken a detailed review of depreciation on the basis of depreciation over the remaining useful life of SACL's assets. Consulting engineers, Maunsell McIntyre Pty Ltd, undertook the useful life assessment.

The remaining life of assets was estimated by Maunsell McIntyre through field observations of the condition and consideration of the current use and operational demand for the assets, as well as age of the assets.

SACL has adopted straight line depreciation as a fair indicator of both accounting and economic depreciation, ie the amortisation of cost over time and the loss of earning potential.

The result of the assessment is contained in the table. While the more detailed assessment has led to both increases and decreases, the net result has been a significant reduction in total depreciation expenses.

	SACL Existing Assets (Remaining Life range –years)	SACL New Assets (Useful Life range – years)	FAC New Assets (Useful Life range – years)
Runways, taxiways and aprons*	2-96	12-99	25
Other infrastructure	9-34	25-40	n/a
Buildings	5-60	15-60	15-25
Operational plant and equipment	14-18	20	n/a
Other plant and equipment	1-20	3-20	3-10

Total depreciation of aeronautical assets for 2000-01 is estimated to be \$44.1 million.

6.2.3. *The disposal of assets*

No significant asset disposals are anticipated during the period. A small number of minor disposals related to new works are incorporated in the detailed modelling. Assets scheduled to be replaced during construction were allocated only their remaining life (and low ODRC value) during the valuation process.

6.2.4. *Indexing*

SACL is using a “real” model to calculate the cost of capital and required returns. Accordingly, all values are indexed at CPI on an annual basis. Compared to a nominal model, this results in SACL achieving a greater return *of* capital over the life of an asset, offset by a lower real return *on* capital.

6.3. WACC

SACL’s WACC estimate has been reviewed by NERA drawing on their significant experience with cost of capital issues in a range of regulatory regimes and industries.

The proposed WACC estimate uses an approach consistent with that adopted in the regulators’ final decisions on the Victorian gas access arrangements in October last year. However, in line with the ACCC’s recent draft Statement of Regulatory Principles, and IPART’s “foreshadowed intention” in its recent reports on electricity and gas network revenues, SACL is proposing to adopt a post-tax WACC.

In its draft Statement of Regulatory Principles for Transmission Revenues, the ACCC signalled that it has some preference for a WACC expressed in *nominal* terms. However, SACL is proposing a *real* formulation of the WACC. In the case of SACL, a *real* WACC provides a more stable pricing path for customers by smoothing the combined depreciation and return on capital costs over time.

An implication of choosing a real WACC is that revenues will be linked to the CPI, to ensure an appropriate return each year. SACL notes that the revenues of other major leased airports in Australia are CPI linked, although this is by way of a CPI-X price cap. SACL would seek ACCC approval for any future price increases by reference to changes in the CPI, adjusted as necessary for efficiency gains.

WACC parameters have been discussed in great detail in recent regulatory decisions in the energy sector in particular, and SACL’s proposal takes account of emerging best practice in this area. However, the risk profile of SACL’s aeronautical business is significantly greater than that for energy network businesses. The main reasons are that:

- ? airports are likely to be more susceptible to downturns in economic circumstances, eg airline scheduling is likely to be more sensitive to the state of the economy relative to the demand for gas and electricity;
- ? airport earnings are becoming increasingly volatile as airlines increase flexibility through alliance arrangements, fleet evolution and the relaxation of international air services agreements. Airlines have been relatively slow to respond to regional economic signals in the past, but they now respond very quickly; and

? Sydney Airport, as Australia’s primary hub airport, faces significantly greater potential revenue volatility than airports with predominantly origin/destination traffic.

For these reasons it could be expected that the appropriate asset beta would be higher for airports generally, and for Sydney Airport specifically, compared to regulated energy businesses.

SACL has concluded that a 0.7 asset beta is consistent with comparable international airport information and Sydney Airport’s relative risk.

The estimated real post-tax WACC for SACL’s aeronautical assets is around 5% using the form of WACC commonly used in recent Australian precedents (the “Officer” form). The Officer form of WACC uses assumptions about the effective tax rate of the company, gearing and dividend imputation to bring down the required return from the simple WACC form.

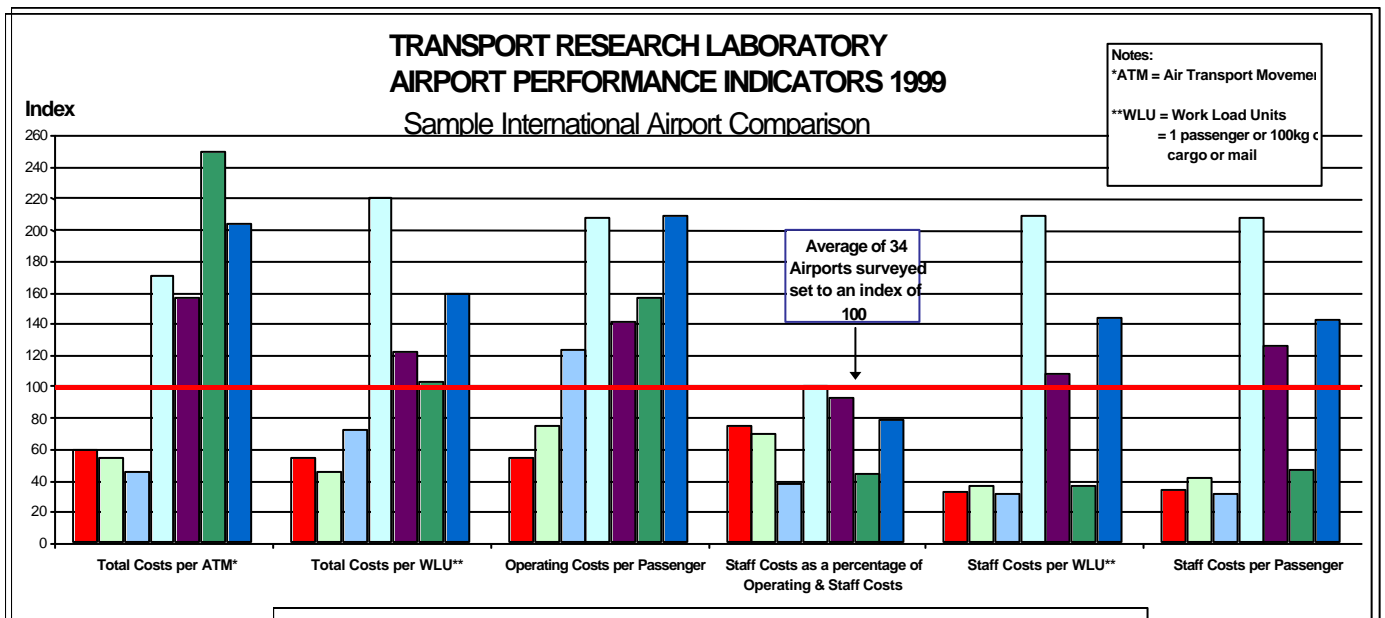
In recognition of the most recent thinking, and in order to enhance the transparency of the proposal, SACL has fully modelled the benefits of financial structures and tax arrangements in cash flows. This allows the use of a simple form of WACC, known as the “vanilla approach”. The 5% “Officer” form of post tax real WACC is equivalent to an 8% “vanilla” WACC before accounting for dividend imputation and actual tax cash flows.

6.4. Operating and maintenance costs

SACL is an efficient airport in terms of operating costs when benchmarked against comparable major international airports. The chart below shows that, in an independent comparison of 34 major airports, Sydney Airport’s cost measures were significantly below average.

The corporatisation of Sydney Airport enabled SACL to assess the level of resources required for efficient operations. A number of non-recurrent costs associated with the implementation of GST and Y2K issues, on-going management initiatives and volume growth provide scope for future unit price operating cost reductions. However, the addition of a significant increment of terminal capacity creates a step in operating costs associated with the international terminal.

Sydney Airport has undertaken a detailed assessment of the drivers of operating and maintenance costs and the potential for future efficiency improvements. The result of this assessment is an increase of 3.8% in unit (total tonnage based) operating costs for 2000-01 over 1999-00 budget



estimates.

Total aeronautical operating expenses for 2000-01 are estimated at \$71.0 million.

6.5. Total Allowable Revenue

The following table shows Sydney Airport's allowable revenue for 2000-01 derived from the building blocks approach. This equates to the Maximum Allowable Revenue calculation in the ACCC's draft Statement of Regulatory Principles for the determination of transmission revenues.

Allowable Revenue 2000-01	
Average Total Assets (2000-01)	\$1,766,315,412
x WACC	x 8%
= Cost of Capital	\$141,305,233
+ Depreciation	+ \$44,056,709
+ Operating and maintenance Costs	+ \$71,029,082
= Sub-total	= \$256,391,024
+ Tax Liability	+ 34,141,086
- assumed capital gain on land	- \$41,317,027
- benefit of dividend imputation	- \$17,070,543
= allowed revenue from aeronautical charges	\$232,144,540

7. Pricing structure

The allowable revenue determined under the building blocks approach has been translated into a schedule of prices in accordance with the objectives developed below.

SACL is proposing a two-phase approach to reviewing the pricing structure, with this notification being the first phase. The pricing structure proposed in Phase 1 significantly enhances the equity and allocative efficiency of the existing pricing structure. This is primarily through the proposed use of passenger based international terminal charges and time-based international apron usage charges (parking charges). Phase 2 will review the options to further enhance efficiency through charges designed to encourage a smoother pattern of use throughout the day.

7.1. Objectives

The objectives of the pricing structure are to:

? accurately reflect to users the underlying costs of providing aeronautical services;

- ? thereby ensure that the signals for the development of any new capacity at Sydney Airport or in the Sydney basin are accurate and timely; and
- ? at the same time provide an equitable, transparent and manageable system which is easily understood and administratively simple to operate.

In determining an appropriate pricing structure SACL has calculated the underlying cost of discrete services. This provides a base to ensure that charges reflect the costs of services provided.

The existing charging structure is based almost completely on an aircraft's maximum take-off weight (MTOW). This correlates reasonably well with the capital and operating costs associated with the use of runways and taxiways. However, MTOW is not the primary driver of terminal, apron or security costs.

The proposed pricing structure is as follows:

Proposed Pricing Structure		
Charge	Basis	Other
Runway Charge	Per movement per ton (MTOW)	Existing minimum and regional rebates to continue to apply
International Terminal Charge	Per passenger per movement (international)	50% discount for transit and domestic on-carriage
Security Charge (International)	Per passenger per movement (international)	Counter Terrorist First Response (CTFR) only
Security Charge (domestic)	Per movement per tonne MTOW (domestic > 20 tonnes MTOW)	CTFR
Apron Use Charge	Per aircraft per 15 minutes of use (or part thereof) during non-curfew hours (6am to 11pm)	Excludes leased, licensed and GA aprons
Bussing/Stand Off Discount	Per movement	
Helicopter Charges	Per Movement (flat rate)	
	Parking charge per day (>2 hours)	
General Aviation Parking	Per day (>2 hours)	

7.2. Other Alternatives Considered – Future Issues

Sydney Airport's runway system is nearing capacity during peak times of the day. Sydney Airport currently has a movement cap of 80 movements per hour and a slot management system to allocate capacity. The international terminal and apron parking positions will also experience increasing congestion in the short to medium term.

There are a number of issues that need to be addressed in detail before an equitable and efficient time based charging regime could be introduced. These include the impact on regional services, the relevant times, basis of charging and the appropriate level of charges. Detailed demand impact analysis will continue. Any future proposal would be the subject of a separate notification and consultation process with affected customers.

8. Forecasts

To determine the rate of each charge, the maximum allowable revenue (on a service specific basis where relevant) is allocated to each charge on the basis of traffic forecasts. Tourism Futures International (TFI), a highly regarded independent forecasting company, has prepared forecasts for SACL.

As part of its forecasting approach TFI reviews the forecasts of bodies such as the International Air Transport Association (IATA), International Civil Aviation Authority (ICAO), the aircraft manufacturers Boeing and Airbus Industrie, and Australian forecasts such as the Tourism Forecasting Council.

Despite airline concerns that the FAC forecasts (provided by TFI) for 1998-99 aircraft movements and landed tonnes were too conservative they were generally above outcomes for the year. This was due to the airlines' move to use smaller aircraft on many routes and the achievement of average seat factors above the levels assumed by TFI. While international passenger movements were above forecasts, aeronautical charges were not levied on this basis. TFI allowed for the Asian economic crisis but not sufficiently for the compensating impacts of the growth in Australian outbound traffic and the growth from the USA and Europe.

8.1. Forecast to 2000-01

Uncertainties for 1999/2000 include the impact of the GST on travel within and to and from Australia, the impact of Y2K issues in early January 2000, preparation for the Olympic Games, the pace of the Asian economic recovery and the impact of airline route developments such as the commencement in October 1999 of air services from Melbourne and Brisbane to the USA.

The 2000-01 forecasts for each of the price drivers is included in the proposal summary below.

9. The Results

The proposed level of charges derived following application of the process described above is included in the table in Part 1 (The Proposal), above.

SACL is proposing to introduce the new charges from 1 November 2000, following consultation and approval by the ACCC.

9.1. Reasonableness of assumptions

The proposal involves a significant increase in a number of charges. This is a result of a combination of current pricing levels significantly under-recovering the costs of providing existing aeronautical

services and making no allowance for the cost of the \$500m of new capacity and enhanced facilities currently being put in place.

The proposal has been derived on the basis of consistently conservative and reasonable assumptions. In particular, the following components and assumptions are areas where SACL has not sought revenue increases to the full extent that could reasonably have been justified.

Timing – SACL is proposing to introduce new charges from 1 November 2000 and only to recover an appropriate return from that time. Until then, customers will continue to enjoy services and facilities at concessional rates. The cost of this continued level of subsidy, and subsidies of the past, will be borne by SACL and its Commonwealth shareholder. The quantum of this subsidy to regular travellers and airlines from the time SACL leased Sydney Airport on 1 July 1998 to 1 November 2000 is estimated at over \$200 million.

Land Value – The assumptions used in the calculation of land value are very conservative. The calculation assumes that an unencumbered site is available for development in a central location and assumed revenues from an alternative use development are heavily discounted (27.5%), while holding costs are assumed to be low (7%). In addition, the small area occupied by SACL is only possible due to the construction of runways into Botany Bay and these construction/reclamation costs are excluded from the analysis. As a result, the assumed value is believed to be at the lower end of a reasonable range. This is supported by market comparisons. The treatment of assumed land appreciation as income further enhances the reasonableness of the land value assumptions.

Cost of Capital – The proposed adoption of a real post-tax cost of capital results in a lower price increment than would have been justified using a nominal return basis. While the present value is expected to be similar, the natural smoothing of the real return basis is beneficial to customers.

Cost Allocation and Depreciation – SACL has applied a significantly lower proportion of joint costs to aeronautical services than was the case with the FAC. Additionally, the depreciation rates adopted by SACL are in many cases half those used by the former operator of Sydney Airport.

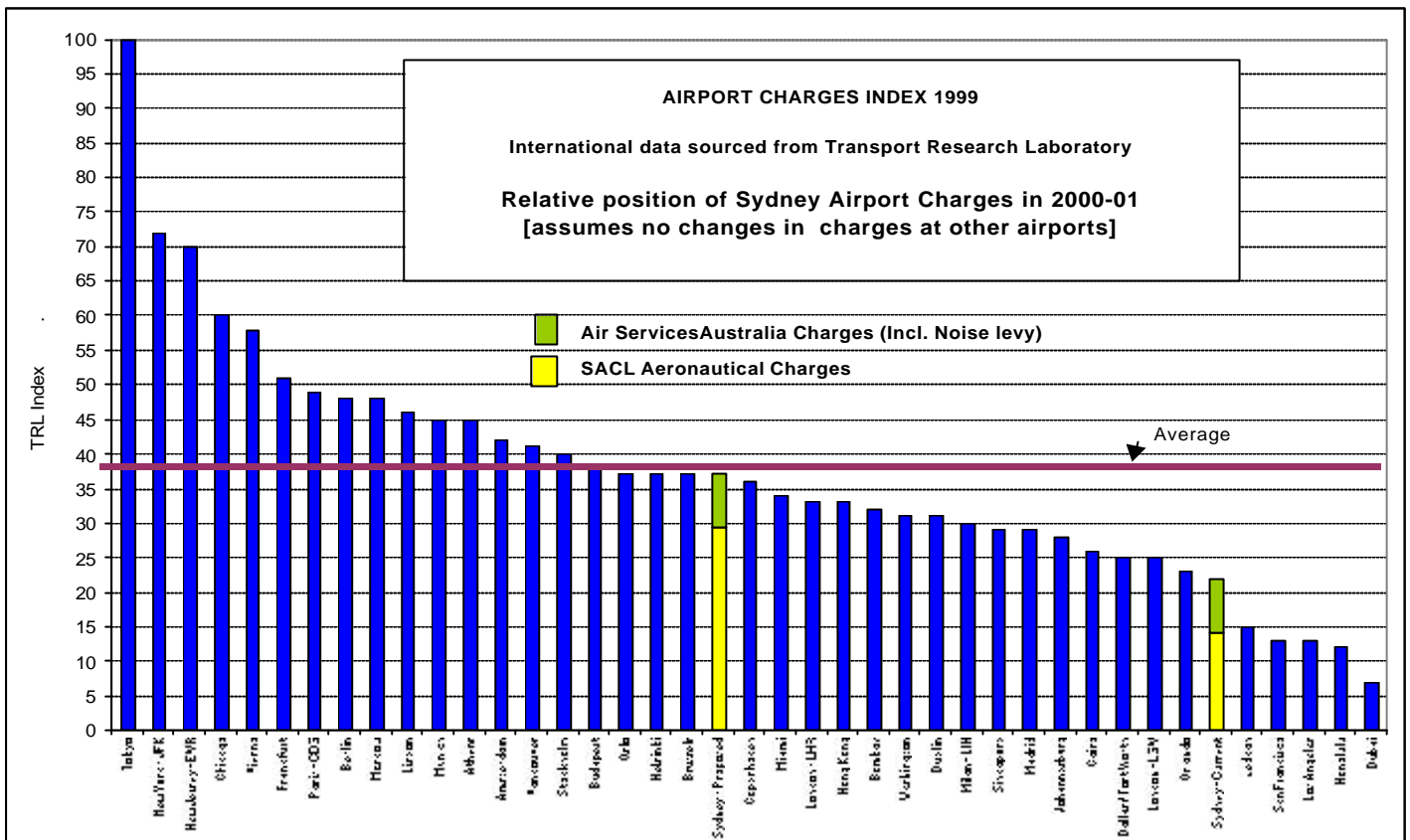
Target Revenue – The proposal is seeking to recover revenue (target revenue) that is around \$20 million less than the allowable revenue calculated as part of the review. While this is a conservative position, it recognises the growth in returns expected over the medium term (in the absence of a CPI-X price cap).

The above factors, and additional work on traffic forecasts and capital expenditure, fully address the issues of concern raised by the ACCC in the Statement for the Public Register in relation to proposed FAC Determination 13 in May 1998.

10. The impact on customers

The following chart shows Sydney Airport's relative charging levels before and after the proposal. To maintain an "apples with apples" comparison in developing this chart, the effect of SACL's proposal is shown here using the existing, predominantly MTOW based, charging structure.

The chart has been produced using data sourced from UK based Transport Research Laboratory (TRL) as part of an annual comparison of airport charges at 40 major international airports.



The price changes proposed by SACL are a result of:

- ? The move from the FAC’s network pricing regime to a Sydney Airport specific charge which directly reflects the cost of Sydney Airport aeronautical assets, including its location on high value land; and
- ? the expansion of capacity and services required to meet the demand of airlines, the travelling public and the community.

The medium to long term impact of price changes will be overwhelmingly positive for the community and the majority of customers. Efficient pricing signals and reasonable returns will create a viable aviation business that receives an appropriate degree of maintenance, and upgrading and is able to compete internally for the necessary capital required for future expansion. This will ensure that Sydney Airport will continue to provide world class aviation facilities for both airlines and travellers.

Sydney Airport landing charges will remain in line with major airports around the world in comparable regulatory jurisdictions.

Sydney Airport will continue to provide excellent value for its customers. The location of Sydney Airport close to the Sydney CBD provides savings for travellers in both time and ground access costs.

The existing arrangements for regional aircraft and minimum landing charges will remain. The runway fees payable by small and medium sized regional airlines will not change, while larger regional carriers will pay, on average, lower rates than they did prior to the removal of peak charges in

1998. On the basis of an assumption that aircraft weight is an appropriate proxy for cost, regional aircraft will not be subsidised by other users. The issue of whether weight is an appropriate cost metric at an increasingly constrained airport will be addressed as part of a Phase 2 pricing structure review to be commenced in consultation with carriers following completion of this current phase.

The proposed changes, if fully passed onto the travelling public by the airlines without consideration of cost efficiencies and quality enhancements from SA2000, would only represent a small increase in the price of an airline ticket. For example, increases in the average one way economy fares would be:

- ? no change to fares to regional NSW destinations served by small and medium operators;
- ? \$0.95 to Dubbo;
- ? \$1.95 to Melbourne; and
- ? \$10.25 to London.

Over the past two years, airlines have increased average domestic airfares on Australia's busiest route between Sydney and Melbourne by between \$25 and \$80. If the full effect of the proposed aeronautical pricing changes were passed onto the travelling public, the increase in the same route would be approximately \$3.90 return. The price effect of the GST on the same routes will be on average \$42 from 1 July 2000.

NERA has undertaken an assessment of the elasticity of demand for air travel. Due to the small impact of any price changes to be passed onto consumers, the impact on business travel and tourism is expected to be minimal. The loss of any excess demand that has been stimulated by low aeronautical charges is not expected to materially impact on forecasts and has not been incorporated into the proposed charges.

The proposed changes to aeronautical pricing will remove the subsidy that has been effectively enjoyed by airlines due to SACL and its predecessors not realising a fair return on their investment in aeronautical assets.

This has meant that the economic value of these investments has been captured by the airlines and by Australians and international visitors who travel regularly by air within, to and from Australia. In the absence of appropriate price changes, this subsidy would be worth approximately \$120 million in 2000-01 alone and, on an on-going basis, have a present value of between \$1.5 billion and \$2.0 billion.

Under the proposed changes to aeronautical pricing, the economic value of the aeronautical investments will, instead, accrue to SACL's current shareholder, the Commonwealth and, consequently, the Australian taxpayer.

11. Consultation

SACL is committed to an open and transparent consultation process with customers, the ACCC and other stakeholders. All comments arising from consultation with the industry, ACCC and other stakeholders will be considered by SACL prior to the Final Notification to the ACCC.

The consultation program proposed by SACL more than complies with the ACCC guidance contained in its draft Statement of Regulatory Approach to Price Notifications released in 1998. The proposed program also addresses concerns raised by the industry in relation to the format of previous FAC pricing consultation.

11.1.1. Customer/Industry Consultation

SACL is proposing to undertake formal industry consultation on the basis of stakeholder categories. The three categories proposed are:

- ? International and Domestic airlines and associations;
- ? Regional Airlines and associations; and
- ? Other customers including Freight, Helicopters and General Aviation operators and associations

Opportunities will also be provided within the consultation framework for discussions with individual customers and/or different stakeholder groups. Specific issues of general interest may be discussed in groups containing a cross-section of representation.

The final consultation format will be settled in early consultation meetings.

11.1.2. Consultation with the ACCC

Consultation with the ACCC will proceed in parallel with industry consultation. This will provide both the industry and the ACCC with the maximum opportunity to consider issues. The ACCC will be invited to participate in all SACL's industry consultation to assist preparation of the draft decision.

11.1.3. Other stakeholders

Sydney Airport is an integral link in the tourism industry, not just for New South Wales, but for Australia. SACL will offer to meet with the Tourism Council of Australia and the Tourism Task Force to discuss the proposed changes to aeronautical pricing at Sydney Airport.

Transport issues are also of interest in regional New South Wales, given the dependence of regional communities on transport facilities. While the current proposal for aeronautical pricing reform will not adversely impact on the access of Regional Airlines to Sydney Airport, SACL will offer to meet with the Country Mayors' Association to present the aeronautical pricing review to them.

11.1.4. Consultation Timetable

The proposed framework for the SACL industry consultation program is as follows. As stated above, the final format and the incorporation of consultation on specific issues will be discussed at an early stage in the process.

08 December 1999 - 10 December 1999	Release of draft notification
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	SACL Briefing Sessions with Industry Groupings
04 February 2000	Closing date for initial industry representations to SACL
5 - 27 February 2000	SACL consideration of industry submissions
28 February 2000 - 03 March 2000	SACL conducts further meetings with Industry Groupings to provide further information and detail its responses to industry submissions - ACCC invited to attend as observer .
6-10 March 2000	SACL advises ACCC and industry of any variations proposed to the draft notification

Following completion of SACL's direct consultation with industry and provision of any agreed variations to the draft notification to the ACCC, the timetable largely becomes a matter for determination by the ACCC. The ACCC's ability to set and follow a timetable is necessarily dependent on its ability to obtain information it requires and on the nature of any issues arising. For its part, SACL is committed to meeting any ACCC request for information at the earliest possible time.

Avoidable delays impose significant regulatory costs. Subject to the qualifications noted above, the ACCC has indicated that the following timetable may be regarded as reasonable, subject to unforeseen events.

The ACCC will conduct its assessment process in parallel with SACL's consultation process. SACL understands that the ACCC will issue a draft paper and conduct a consultation process with interested parties before releasing a final decision. SACL seeks a decision in mid 2000 for implementation and introduction of the new charges on 1 November 2000.

Provision will be made for specific consultation meeting briefings with experts in respect of the technical aspects of the pricing adjustments.