Australian Competition and
Consumer Commission

MELBOURNE AIRPORT

Multi-User Domestic Terminal

New Investment

Decision

August 2000

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1 Introduction

The price cap arrangements at privatised ‘core regulated’ airports include provisions for airport operators to recover the costs of necessary new infrastructure expenditure through price increases for aeronautical services.[1] The Australian Competition and Consumer Commission (the Commission) has the role of assessing such price increases and objecting or not objecting to the proposed price.

On 24 May 2000, Australia Pacific Airports Melbourne Pty Ltd (APAM), the operators of Melbourne Airport notified the Commission of a proposal to introduce an aeronautical charge of $2.20 (GST inclusive) per passenger, to recover the costs of a new Multi-User Domestic Terminal (MUDT) facility at Melbourne Airport. This notification also included a proposal to introduce a security charge to recover costs associated with the provision of passenger screening services for the MUDT.

On 27 June 2000, the Commission released a draft decision regarding Melbourne Airport’s MUDT proposal, inviting submissions from interested parties. The draft decision was for a price of $1.28 per passenger (GST inclusive) for use of the MUDT facility. The difference between the $2.20 per passenger price proposed by APAM, and the Commission’s draft decision price was due to passenger numbers and the asset beta adopted.

Throughout the consultation process, the Commission received submissions from Ansett Australia, Board of Airline Representatives Australia (BARA), Brisbane Airport Corporation, Impulse Airlines (‘Impulse’), APAM, Qantas Airways, Sydney Airport, and Virgin Blue (‘Virgin’). The main issues highlighted in the submissions were:

- the asset beta appropriate for Melbourne Airport;
- complementarity of revenue issues;
- passenger numbers; and
- the commercial agreement between Impulse and APAM for use of the MUDT facility.

On 22 August 2000, APAM informed the Commission that it had negotiated a price with both new entrant airlines (Virgin and Impulse) for use of the MUDT facility.

This paper presents the Commission decision regarding Melbourne Airport’s MUDT proposal. It is divided into three sections. Section one outlines the Commission’s regulatory role and APAM’s application for the introduction of a new aeronautical charge to recover the costs of the MUDT facility. Section two details the Commission’s assessment of APAM’s new investment application against the relevant legislation, taking into consideration arguments presented by interested parties in their submissions. Section three presents the Commission’s decision.

[1] Melbourne, Brisbane, Perth, Adelaide, Canberra, Darwin, Hobart, Coolangatta, Alice Springs, Townsville and Launceston airports.

1.1 The Regulatory Framework

The *Prices Surveillance Act 1983* (PS Act) provides for price surveillance at the discretion of the Minister, or by the Commission with the approval of the Minister.[2] Pursuant to these arrangements, the Minister has declared that the provision of aeronautical services, limited to:

(1) aircraft movement facilities and activities; and

(2) passenger processing facilities and activities

are notified services for the purposes of the PS Act.[3] These notification arrangements cover aeronautical services at Melbourne Airport.

The PS Act also provides for the Minister to direct the Commission to give special consideration to particular matters when exercising its powers and functions under the Act. The Minister has directed aeronautical services be subject to a price cap of the CPI-X type.[4] The 'X' value applying to Melbourne Airport is 4 per cent.[5]

The CPI-X price cap provides for certain charges, including the costs of necessary new investment, to be 'passed through' the price cap. Pass through describes the ability of airport operators to increase charges without those increases affecting its compliance with the price cap. In cases of new investment, the Minister has set out criteria to guide the Commission's assessment of proposals to increase charges for aeronautical services at a rate in excess of the price cap.[6] These criteria are:

(a) the operator's plans for new investment or service innovation and the associated costs;

(b) the relationship between the proposed increases in aeronautical charges and the costs (including the level of the rate of return) of the new investment or service;

(c) support from airport users with a significant interest in the investment for the operator's proposals, including in relation to charging changes;

(d) contribution of the new investment/service to productivity improvements at the airport;

(e) overall efficiency of the airport's operation;

(f) the particular demand management characteristics of individual airports, including any demand management schemes in place, capacity constraints and any under utilisation of the airport infrastructure;

(g) airport performance against quality of service measures, including services under the control of the airport operator;

[2] *Prices Surveillance Act 1983* s 21.
[3] Declaration No 87, 1 July 2000 and Declaration No 88, 1 July 2000.
[4] Direction No 17 1 July 2000.
[5] Direction No 17, 1 July 2000
[6] Direction No 17, 1 July 2000.

(h) airport performance vis a vis other Australian airports and any comparable international airports; and

(i) the extent to which the proposed investment will facilitate the operations of new entrants to domestic or international aviation.

The Commission must take the above criteria into account in deciding whether to approve a proposal to increase charges outside the price cap. Each proposal will be considered on its merits having regard to information available to the Commission. The Commission will provide a statement of reasons for its decision.[7]

1.2 The application

Melbourne Airport is operated by APAM under a long-term lease from the Commonwealth Government. The lease was granted in Phase I of the privatisation of Commonwealth owned airports in 1996.

On 24 May 2000, APAM advised the Commission of a proposal to construct a new Multi-User Domestic Terminal for use by domestic entrant airlines. APAM stated that the MUDT facility would be located on the site between the Ansett passenger terminal and the Ansett cargo terminal and would contain check-in and baggage make up and reclaim facilities as well as airport and airline administration offices. APAM also noted that some road works were needed to provide kerb side access for the pick up and drop off of passengers.

The MUDT facility is designed to provide space for five jet aircraft to B737-800 size, plus two B1900 aircraft. APAM stated that to facilitate passenger boarding, a lounge would be located on the apron linked to the main building by a fully enclosed walkway.

To recover the costs of this investment, APAM proposed to introduce a new aeronautical charge of $2.20 per passenger, levied on the domestic entrants utilising the MUDT facility. The total cost of constructing the MUDT is approximately $8.4 million, of which about $7.84 million relates to the aeronautical component of expenditure.

The proposed charge comprised a return on investment and a return of investment (depreciation). It also included recovery of operating and maintenance costs and a land rental charge. The inclusion of a recovery amount for land rental applied to land converted from non-aeronautical use to an aeronautical use.

The proposed cost recovery was divided by projected passenger numbers to give a price of $2.20 (GST inclusive) per passenger for use of the MUDT. APAM proposed to review this price along with passenger numbers in two years, as part of the five-year review of regulatory arrangements. APAM also stated in its notification that it had negotiated a commercial agreement with Impulse for a price less than the notified price. Virgin and APAM had not reached a commercial agreement prior to APAM notifying the Commission of its intention to introduce a charge for the MUDT facility.

[7] Direction No 17, 1 July 2000

2 Commission assessment

This section details the Commission's assessment of the MUDT proposal against the relevant legislation. Firstly, the Commission's process for the consideration of the proposal is presented. This is followed by an assessment of the MUDT proposal against the Commission's definition of 'new investment'. The MUDT proposal is then assessed against the nine criteria in Minister's Direction number 17.

The main discussion below focuses on the contentious areas of the proposal and addresses each of the issues under the relevant guideline.

2.1 The assessment process

On 7 June 2000, the Commission wrote to both Virgin and Impulse requesting their preliminary views of the MUDT proposal. Virgin provided the Commission with an extensive submission detailing its views of the MUDT proposal, including issues such as passenger numbers, complementarity of revenue, and rate of return (including asset beta). Impulse provided the Commission with a letter, indicating its support for the MUDT proposal at the notified price.

On 27 June 2000, the Commission released its draft decision regarding the MUDT proposal. The draft decision was for price of $1.28 (GST inclusive) for use of the MUDT facility, with a review of passenger forecasts as part of the five year review of regulatory arrangements. The draft decision encouraged industry members to provide submissions to the Commission on the views and issues discussed. Submissions were due by 21 July 2000.

The Commission received submissions from the following interested parties in response to its draft decision:

- Ansett Australia;
- Australia Pacific Airports Melbourne Pty Ltd (the operators of Melbourne Airport);
- Board of Representatives of Australia;
- Brisbane Airport Corporation;
- Impulse Airlines;
- Sydney Airports Corporation Limited (the operators of Sydney Kingsford Smith Airport); and
- Qantas Airways Limited.

Although Virgin did not provide a submission in response to the Commission's draft decision, it should be noted that its views regarding the issues of contention surrounding the MUDT proposal were addressed in its 'preliminary views' submission.

In addition to submissions, Commission representatives had meetings with APAM, Impulse and Virgin to discuss issues surrounding the MUDT proposal.

In reaching its decision the Commission had regard to the views of interested parties presented throughout the Commission's consultation process.

2.2 Defining necessary new investment

Necessary new investment is undefined in the pricing instruments and the *Pricing Policy Paper*.[8] After seeking user views and industry comment, the Commission released a position paper on 3 April 2000, outlining its interpretation of 'necessary new investment'.[9]

In this paper the Commission defined 'new investment' as:

> A change in fixed durable inputs that does not simply seek to replace natural degradation of capital.

In the paper the Commission stated that 'new' investment is expenditure that is done as a means of either significantly altering the capacity, or attaining net enhancements in quality, that is over and above pre-existing peak levels.

Throughout the Commission's consultation process, industry members provided no comment indicating opposition to the MUDT facility being considered 'necessary new investment'. Furthermore, major users of the facility supported the construction of the terminal facility at Melbourne Airport.

The Commission is satisfied that the construction of the MUDT at Melbourne Airport is a 'necessary new investment' as defined in the Commission's position paper. The MUDT is 'necessary' in that it allows new entrants to access passenger processing facilities, and 'new' as there was previously no such facility for new entrants at Melbourne Airport.

2.3 Assessment against the guidelines

This section provides the Commission's assessment of the MUDT proposal against the new investment criteria contained in Minister's Direction Number 17. The discussion focuses on issues of contention.

2.3.1 The operator's plans for new investment or service innovation and the associated costs;

In its decision on the *Adelaide Airport Multi-User Integrated Terminal* (MUIT decision), the Commission expressed the view that this criterion requires it to assess the airport operator's plans for the new investment as a check that the proposed investment is of an appropriate scale and scope. In assessing this criterion, the Commission also considered the costs associated with the project.

Scale and scope of the proposal

In considering the scale and scope of the MUDT proposal, the Commission looked to user views.

Throughout the consultation process, the Commission received views from both Virgin and Ansett in relation to the scale and scope of the MUDT proposal.

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[8] 'Pricing Policy Paper' Department of Transport and Regional Development, November 1996.

[9] 'New Investment Costs Pass-through Position Paper' Australian Competition and Consumer Commission April 2000

In its preliminary submission, Virgin noted its concerns regarding the capital costs of the MUDT facility and its overall design. The issue of capital costs is dealt with in the next sub-section.

Ansett noted that the MUDT proposal adversely impacted on airfield operations and suggested that there be some modification to the scope of the project to minimise this impact.

APAM's response to Ansett's concerns noted that the Minister of Transport and Regional Services had approved its Major Development Plan (MDP). APAM stated:

> Clearly, the operation efficiency issues raised by Ansett are matters that must be considered by the Minister in approving the MDP. Ansett made extensive representations through the consultation process and we believe directly to the Minister in relation to this matter. It seems to us therefore, that these are matters in which the Commission can safely rely upon the Minister's judgement. In particular, any issues arising from the conditions the Minister placed on the MDP are properly matters for the Minister and his department to deal with.

The approval of the MDP is a separate process, and one in which the Commission does not have a role. The Commission understands that APAM is in the process of developing a 'management plan' to deal with the specific operational issues surrounding the construction of the MUDT, as required by the conditional approval granted by the Minister. As such, it appears that APAM is performing its relevant duties in respect of this issue.

Given support from major users and the approval of the MDP by the relevant Minister, the Commission considers the MUDT proposal to be of appropriate scale and scope.

Associated costs

In its MUIT decision, the Commission noted that the above criterion requires it to consider the associated costs of the new investment proposal. The Commission expressed the view that it would focus on the additional costs to the airport operator resulting from the investment proposal.

The main issues of contention regarding the associated costs of the MUDT were the capital costs of the facility and the inclusion of land as an associated cost.

Capital costs

In its draft decision, the Commission noted Virgin's concerns with the costs associated with the construction of the MUDT facility.

However, considering the MUDT facility was subject to a competitive tender process, and users had input into the design of the proposal, the Commission considers the capital costs of the MUDT to be reasonable.

Land

In its proposal, APAM included a rental amount for land in the operating and maintenance expenses for the project. The area included was 3642 square metres. APAM stated that the land to be used for construction of the MUDT was previously utilised by Ansett Airlines as a staff car parking facility. The land used for the construction of the lounge area was not included in the cost of the facility. APAM included a rental amount for the aeronautical component of land at $20 per square metre. APAM adjust this figure each year to take into account the effects of inflation.

In its Brisbane Airport draft decision, the Commission outlined three different land use scenarios, concluding that it is reasonable for an airport operator to be compensated for the transfer of land from non-aeronautical to aeronautical use as part of an agreed new investment program. In the Brisbane Airport draft decision the Commission stated:

> Three alternate solutions can be identified where the question arises whether to include land as a cost associated with an airport investment:
>
> ? where additional land is purchased by an airport operator for a proposed investment;
>
> ? where land is transferred from one use to another, for example from non-aeronautical use to aeronautical use; and
>
> ? where land has previously been assigned to a purpose and is bought into use from a state of latency, for example land adjoining an apron.
>
> First, to the extent that a proposed necessary new investment requires the airport operator to purchase additional land, the cost of additional land to the operator and a return on the expenditure need to be considered.
>
> Secondly, as in the case of additional land purchased for an investment, the costs of land transferred from one use to another should be considered. These costs could be estimated in a number of ways. For example, by using the economic concept of opportunity cost, or by considering the cost of purchasing land to provide the displaced service.
>
> The third example is where land is bought into use form a state of latency. In this case, it is arguable that the opportunity cost of the land is zero as, by bringing the land into production thought the investment process the airport operator is no likely to forgo any other valuable opportunity. Examples include land that has already been designated aeronautical through the development planning processes and land that cannot be used for alternative uses because of practical considerations.

In its draft decision regarding the MUDT proposal, the Commission adopted the principles detailed above in determining the appropriate value for land to be included in the recovery amount. The Commission stated in its MUDT draft decision:

> As the function of the land prior to termination of lease was primarily non-aeronautical there is a cost to APAM in switching this land to an aeronautical use.
>
> The rate of $20 per square metre appears consistent with amounts that could be earned by APAM if the land were used in a non-aeronautical capacity. Indeed, following advice from APAM as to other related land rental amounts, it appears that $20 per square metre is at the lower end of the scale. As such, the Commission considers the cost of land at $20 per square metre is an associated cost of the MUDT facility.

Submissions from Impulse and Virgin did not object to the approach adopted by the Commission.

Commission decision

The Commission considers the MUDT project to be of appropriate scale and scope. Also, considering users had input into the design of the proposal, and the building was subject to a competitive tender process, the Commission considers the associated costs of the MUDT to be reasonable.

2.3.2 The relationship between the proposed increases in aeronautical charges and the costs (including the rate of return) of the new investment or service;

The Commission's assessment of APAM's proposals against this criterion focused on four main issues:

1. The proposed rate of return on the investment;
2. Complementary increase in revenues;
3. Specific risk; and
4. Depreciation.

Rate of Return

In its proposal, APAM calculated the post-tax nominal rate of return to equity on the MUDT at 16.35 per cent post-tax nominal, and the pre-tax nominal weighted average cost of capital (WACC) at 12.35 per cent. Using current interest and inflation rates, these rates of return change to 16.08 per cent and 12.00 per cent respectively. Inputs on a number of the variables used in calculating the WACC, such as the market risk premium, and the inflation and risk free rates were consistent with recent Commission new investment decisions for airports, including Brisbane Airport, Perth Airport, and the Adelaide MUIT decision.[10] As such, limited assessment of these variables is provided. Conversely, more detailed discussion is provided for variables of a contentious nature, such as the asset beta.

? Asset beta

In the context of the CAPM the beta represents the covariance of a company's returns (as reflected in its share price) to movements in the broader market. An asset beta attempts to model the sensitivity of an asset's returns to movements in the broader market by removing the influence of an individual company's financial gearing. A discussion of asset beta determination in relation to Australian airports can be found in the Commission's Adelaide MUIT decision.

APAM initially proposed an asset beta of 0.75 and has reaffirmed this figure in its response to the draft decision recommendation of 0.61.

To further support its proposed asset beta of 0.75, APAM undertook analysis of the traffic composition of Australian airports and how the various types of traffic are correlated with movements in the domestic economy. The analysis involved using statistical techniques to determine the strength of the relationship between the traffic volumes of various passenger groups and GDP. The findings of the analysis were summarised by APAM as follows:

✍ Domestic business travel is more strongly correlated to GDP than domestic leisure travel;

[10] Copies of these decisions can be found on the Commission website at www.accc.gov.au. in the airports section.

- Perth, Sydney and Melbourne have similar proportions of resident business traffic in total passengers;

- Resident international travel (both business and leisure) is more strongly correlated to GDP than travel by international visitors;

- MA has the highest proportion of resident international passengers (as a share of total international passengers) of any major airport;

- MA has the highest proportion of resident domestic passengers of any airport;

- As a consequence of the above two points, MA has the highest proportion of residents in total passengers.

- MA has a low level of non-resident traffic, which is weakly correlated to GDP.

APAM state that "the fundamental conclusion of the analysis is that MA has the highest proportion of resident traffic of the four airports considered and that its traffic is more strongly correlated to GDP. The analysis suggests an ordering of correlation (from lowest to highest) of Brisbane, Sydney, Perth and Melbourne."

Ansett, BARA and Qantas all disputed the 0.75 proposed by APAM, and indeed argued that the appropriate asset beta for Melbourne Airport would be below the 0.61 adopted in the Draft Decision.

In considering airport investment proposals such as those by Brisbane, Canberra and Perth Airports, the Commission is continually developing its understanding of the systematic risk of returns related to aeronautical activities at Australian airports. This process is complicated by the absence of closely comparable businesses listed on the Australian share market. However, the volatility of passenger numbers is relevant when considering relative differences in systematic risk between Australian airports. In particular, it is the extent to which this volatility is correlated with movements in the broader economy, as proxied by changes in GDP, which is most likely to mirror what is captured by an asset beta. In choosing between airports, a major factor to be considered is the relative proportions of various passenger groupings in the airport's total traffic, defined by variables such reason for travel, origin, and destination.

The Draft Decision's adoption of 0.61 was based on analysis suggesting that Melbourne Airport's passenger breakdown suggested a relatively low correlation to GDP. Since the Draft however, the Commission has further developed its approach to the determination of the asset beta of unlisted Australian airports. In addition, the Commission is in receipt of new information, partly arising from APAM's submission. The Commission's analysis now suggests in fact that the passenger composition at Melbourne Airport would be likely to give rise to higher GDP correlation than that suggested previously, and one comparable to, for example, Brisbane Airport.

Although the Commission's conclusion concurs to a large extent with that of APAM, its analysis in arriving to its conclusion differs significantly. Whereas APAM use cluster analysis to discover statistical relationships, the Commission makes use of income elasticities to determine the extent of revenue correlation.

On the issue of substitutability raised by APAM in its submission, the Commission considers that even if there is greater potential for substitutes at Melbourne than at Perth airport, it is not something which is likely to lead to greater systematic volatility in returns. It may have an impact on the *price* elasticity of demand for travel, but the relevant elasticity when assessing market correlation is that with respect to *income*. Virgin made this point in its submission, in stating that "potential loss of market share to other travel modes is a diversifiable risk, since investors in Melbourne airport could always invest in its competitors (if it had any). This type of risk should *not* therefore, affect the cost of capital." Virgin also made similar points in relation to hubbing in relation to beta risk. Virgin concluded that 0.61 represented an upper limit for asset beta pertaining to Melbourne Airport.

The Commission's analysis suggests that an appropriate asset beta for revenues characterised by those of Melbourne Airport to be 0.70.

? Inflation

The Commission considers a market-inferred approach is most consistent with its past decisions and with the WACC being a forward-looking, market-based methodology. Using current nominal and CI bond rates, the Commission has calculated an inflation figure of 3.03 per cent.

? Gearing

In its calculation of the WACC, APAM used a 60/40 gearing ratio.

In regulated applications, where the firms are usually of the infrastructure kind, the Commission commonly applies a 60 per cent gearing ratio. The Commission considers that a benchmarked approach to the gearing ratio has advantages both in efficiency and simplicity.

✍ Tax

In the pre-tax form of the WACC, the tax rate parameter feeds into both sides of the WACC equation, but in different ways. In its role as capturing the tax shield of debt, the appropriate tax rate should be the statutory corporate rate, given that nominal interest payments are deductible at this rate. However, the tax rate applying to equity, the effective tax rate, is not necessarily equal to the statutory rate. The effective tax rate can be understood as the present value of the tax outflows occurring over the life of the project as a proportion of the present value of the economic income earned and paid to equity holders. As has been covered in several Commission releases, such as the Victorian Gas decision and the Draft Statement of Regulatory Principles, the effective tax rate can in theory be below, above or equal to the statutory tax rate. The effective tax rate can only be estimated through modelling of the expected cash flows of the project, including the outflows of company tax, which is of course paid at the statutory rate on the accounting profits at the time.

In assessing the appropriate rate of return it is useful to understand how the effective tax rate has been estimated. For the draft decision, the Commission stated that it would model the cash flows to determine a more appropriate effective tax rate in the final decision. However, the Commission noted that for the purposes of the draft decision it would adopt an effective tax rate of 20 per cent. The Commission's cash flow modelling suggested that the effective tax rate is higher than the 20 per cent adopted in the draft at 25 per cent.

? WACC

Using the parameters shown below, the Commission considers the appropriate WACC for the MUDT project to be a rate of 11.45 per cent pre-tax nominal, and the post-tax nominal return on equity to be 15.35 per cent.

Table 1: WACC Parameters

WACC Parameter	Draft Decision	Final Decision
Inflation rate (f) %	**3.11**	**3.03**
Debt proportion (D/V) %	**60**	**60**
Equity proportion (E/V) %	**40**	**40**
Real Risk Free Rate (Rfr) %	**3.14**	**2.97**
Nominal Risk Free Rate, Rfn = (1+Rfr)(1+f) %	**6.35**	**6.09**
Australian Market Risk Premium	**6**	**6**
Asset Beta (?a)	**0.61**	**0.7**
Debt Beta, ?d = (Kdn-Rfn-0.5%)/MRP	**0.13**	**0.13**
Equity Beta, ?e = ?a + (?a-?d) * {1-[Kdn*(T(1-?))/(1+Kdn)]} * (D/E)	**1.32**	**1.54**
Statutory Tax Rate (T) %	**30**	**30**
Effective tax rate (Te) %	**20**	**25**
Debt Risk Margin (Dm) %	**1.3**	**1.3**
Nominal Cost of Debt (Kdn) % {[(Rfr-1)*(1+f)]-1}+Dm (pre tax)	**7.65**	**7.39**
Imputation Credit Utilisation, Gamma (?) %	**50**	**50**
Post-tax nominal Cost of Equity Ke = Rfn+(?e*Mrp)	**14.27**	**15.35**
Pre-tax nominal WACC (WACCnpr) %	**10.93**	**11.45**

Complementary increase in revenues

In its draft decision the Commission stated that entry by Virgin and Impulse Airlines into the domestic aviation market was likely to generate additional revenues for APAM from other *aeronautical* sources, without APAM necessarily incurring any additional costs. The Commission suggested that increased traffic volumes would generate additional revenue from the existing landing charge. This discussion and the discussion in the draft decision only relates to complementarities in relation to aeronautical services. It does not take into account the impact on non-aeronautical revenues such as car parking and retail.

The Commission's draft decision noted Virgin's comments on this issue. Virgin stated:

> APAM has acknowledged in discussions with Virgin Blue that the entry of Virgin Blue and Impulse will generate additional revenue for APAM from other charges. APAM has stated that it is not

> prepared to include this additional revenue in determining its pricing proposal. The pricing model shown to Virgin Blue only includes revenue generated from passenger volume.
>
> APAM will not provide Virgin Blue with details of these additional revenues. However, we believe that it will obtain increased revenue streams from the following:
>
> - landing fees from the new entrants;
> - car parking;
> - licence fees from existing tenants and increases in concession value;
> - advertising; and
> - incidental fees such as Airside Vehicle registrations.
>
> There may be additional sources of incremental revenue we are unaware of.
>
> For many of these additional sources of revenue, the revenues obtained will greatly exceed the marginal costs to APAM of providing the relevant service. The most significant source of additional revenue will be landing fees…
>
> This revenue is purely incremental profit to APAM as the runway, apron and taxiways already exist and any additional maintenance or economic depreciation of these facilities is minor in relation to the additional revenue. The entry of Virgin Blue and Impulse will, accordingly, dramatically increase the efficiency and utilisation of the current airport infrastructure and add substantially to APAM's profit. It is important to note that there is no risk to APAM in this regard. Rather it is the commercial risk of Virgin Blue and Impulse which will generate these substantial additional revenues. Accordingly, Virgin Blue submits that this incremental revenue and increase in efficiency should be taken into account in arriving at the per passenger fee for the MUDT.

The draft decision also noted APAM's reasoning for not factoring in the complementary increases in revenue. In its MUDT proposal APAM stated:

> We note that incremental landing fee income was not included in the analysis of the Adelaide MUIT. Moreover, MA is of a view that this approach leads to the introduction of a single till in relation to he MUDT. The Pricing Policy Paper issued by the then Department of Transport and Regional Development in November 1996 states, *as with the initial five year period, the Government will not mandate the use of a single till approach to airport pricing. This will remain a matter for operators*. MA does not as a matter of principle endorse single till pricing and does not intend to pursue it in relation to the MUDT.

The draft decision concluded that the issue of revenue complementarities was relevant when assessing APAM's application. It stated:

> In practice criterion (b) does not provide clear guidance on how to treat revenue complementarity or whether it is relevant to the Commissions consideration of new investment proposals. Nevertheless, the Commission has had regard to the issue in its assessment of APAM's proposals. One reason for this is that criterion (b) does not clearly preclude consideration of complementarity. A second reason is that complementarity seems relevant to criterion (c), user support. In any event the criteria do not prevent the Commission from considering other relevant matters.

The draft decision noted three relevant issues in considering the issue of complementarity of revenue. These were

? Does the reference in the Department of Transport and Regional Services *Pricing Policy Paper* to the Government not mandating 'single till' prevent consideration of complementarity?

? How much additional revenue is generated from other sources?

? To what extent is the growth driven by new entrants already factored into the ‘X’ values in the CPI-X price cap?

In relation to the first of these issues, the Commission stated in its draft decision that the ‘single till’ concept as used in the *Pricing Policy Paper* concerns the distinction between aeronautical and non-aeronautical services, and not services within the price cap. The price cap allows airport operators to rebalance charges for the various services covered by the cap provided that *average prices* fall in line with CPI-X. This is inconsistent with APAM’s interpretation of the single till concept in its proposal. Adopting APAM’s interpretation would seem to imply identifying each separate service/facility and setting tariffs or price caps for each of these separately.

In relation to the second issue regarding the amount of additional revenue generated by other sources, the Commission stated in its draft decision that it was clear that new entrants had the potential to add to traffic volume. The Commission also noted that it was likely that some of the passengers attracted by new entrants would have switched from the incumbents. This would affect incumbent volumes and growth and the net revenue impact to APAM. Overall the complementary revenues were likely to be less than the revenue generated by the additional landed tonnes scheduled by the new entrants. At the same time new entry was likely to have a significant positive impact on revenue growth.

In relation to the third issue, the Commission noted that the ‘X’ values represented the government’s estimates of the productivity gains that could be anticipated at the airports. A major driver of these estimates is more efficient use of infrastructure driven by higher traffic volumes. An issue for the Commission in considering revenue interdependency is the extent to which the new entrants’ contributions to traffic volume growth is in excess of the volumes already factored in.

In summary, the Commission’s draft decision suggested that the issue of complementarity of revenue would be best addressed in the consideration of passenger volumes. It stated:

> It is difficult to quantify the amount of complementary revenue generated by APAM’s new investment proposal. Even if the Commission could quantify it, it may be that some or all of the additional traffic growth is already factored into the CPI-X driven price reductions. Given this, the Commission’s draft decision does not separately identify complementary revenues and use them to derive the net revenue impact of the new entrants on APAM.

The Commission’s decision is to have regard to complementarity of aeronautical revenues in considering the specific risks facing APAM and the passenger projections proposed.

Specific risk

There are two main methods of dealing with specific risk factors. One is through the asset beta adopted in the WACC calculation, and the other is through cash flows (or passenger projections).

The Commission's draft decision noted that it considers specific risks are best addressed in an analysis of the cash flows, rather than through the asset beta. This approach is consistent with the Commission's other regulatory decisions, such as the Central West gas pipeline.[11] In this instance, allowing for specific risk using the cash flow methodology involves adjustment of passenger projections.

APAM estimated passenger numbers using information provided by entrant airlines. APAM provided the Commission with three alternate scenarios of passenger forecasts based on a 2 per cent growth factor for Impulse forecasts. APAM adopted passenger forecasts which arrived at a per passenger price of $2.20 (GST inclusive).

In its draft decision the Commission noted the uncertainty of forecasting passenger volumes for new entrant airlines into the Australian aviation market. It stated

> It should be noted that there is a considerable amount of uncertainty involved in forecasting passenger numbers in the situation of new entrant airlines. This is due to a number of factors including the possibility of one or both airlines failing, the exact start up time and the load factors associated with forecasts. Indeed, given there is uncertainty surrounding the growth and market reaction towards the new domestic entrants, the passenger forecasts adopted in this proposal may not be accurate. It may be that new entrants achieve higher than expected growth and passenger numbers in which case APAM benefit from increased profits and new entrants end up paying more for terminal facilities than would have otherwise been the case, if such predictions had been accurate. Conversely, there is the possibility of entrant airlines failing, in which case the airport operator stands to lose. Without the benefit of historic passenger numbers, the Commission is required to adopt passenger forecasts which balance the risks involved.

The Commission's draft decision stated that passenger forecasts adopted by APAM in yielding a price of $2.20 (GST inclusive) per passenger were conservative. The Commission cited two reasons for this. Firstly, conservative passenger numbers might not be appropriate due to the time frame considered, and secondly, the various complementarities that exist between terminal revenue and additional revenue from landed tonnes were likely to provide APAM with some compensation for the specific risks involved in the project.

The draft decision was to adopt passenger forecasts based on the full schedule of both Impulse (as provided by APAM) and Virgin (as provided by Virgin) to determine the appropriate per passenger price for the MUDT facility.

The draft decision recommended a per passenger price of $1.28 (GST inclusive) for use of the MUDT facility. This figure was derived using:

- An asset beta for Melbourne Airport of 0.61 and associated WACC of 14.27 per cent post tax nominal; and
- passenger forecasts provided by Virgin and APAM (for Impulse),

Since the release of the Commission's draft decision, the circumstances surrounding the MUDT proposal have changed. These changes include:

? an agreed price between APAM and the both new entrant airlines for use of the MUDT facility;

? uncertainty surrounding the start date of Virgin's operations; and

[11] Details of this decision can be found on the Commission's web site at www.accc.gov.au in the gas section.

? increased uncertainty surrounding load factors for the new entrant airlines.

The most significant of these changes is the commercial agreement negotiated between APAM and both Impulse and Virgin airlines for use of the MUDT facility.

The Commission considers the agreement between APAM and the new entrant airlines is a constructive way of addressing the specific risks inherent in the project.

Depreciation

APAM proposed straight line depreciation of the capital base over 10 years.

The draft decision noted Virgins comments relating to depreciation. In its preliminary submission, Virgin stated that many infrastructure assets such as roads and buildings have an economic life for tax purposes of 40 years. It stated that there was no justification for APAM seeking a return on its investment over 10 years.

The Commission's draft decision, however, adopted the asset life proposed by APAM. The Commission stated that considering the uncertainty associated with the long-term prospects of the new entrants, and the possibility that if successful, new entrants may opt for alternative terminal facilities, the draft decision is to adopt the ten year schedule proposed by APAM.

The Commission's draft decision did not attract opposition through views presented by interested parties. As such, The Commission's decision is that the appropriate asset life for the MUDT facility is ten years.

Commission decision

In assessing this criterion, the Commission carried out its own financial modelling of the appropriate rate of return for the MUDT proposal. The Commission has adopted an asset beta of 0.7.

Using results obtained from Commission modelling, a post-tax nominal WACC of 15.35 per cent is considered to be acceptable for the purposes of the MUDT. This rate of return is comparable with the Commission's decisions for other airport new investment projects, including the decisions on new investment proposals submitted by Brisbane, Perth and Canberra Airports.

With regards to passenger forecasts, the Commission notes the uncertainty surrounding load factors of the new entrant airlines and the start date of Virgin operations into Melbourne.

The Commission considers passenger forecasts used in deriving the commercially negotiated price of $1.65 (GST inclusive) for use of the MUDT to be acceptable.

2.3.3 Support from airport users with a significant interest in the investment for the operator's proposals, including in relation to charging changes;

The Commission regards the support of airport users as an important criterion. It is the users who are well placed to provide advice on the appropriateness of the proposed investment and their willingness to pay associated charges.

In addition, the policy intent behind the airport privatisation program emphasised a need for airport operators and users to form commercial relationships and achieve negotiated outcomes regarding the type and level of airport services provided. This requires significant ongoing discussion between the two groups. The Commission anticipates that airport operators will consult with users prior to applying to the Commission, and encourages them to document evidence of user support.

The Commission understands that APAM consulted with the major users of the proposed MUDT facility. Although all parties appear to agree that there is a need for a MUDT facility, concerns regarding the appropriate price of the facility have been raised.

Before submitting its proposals to the Commission APAM reached agreement with Impulse for a charge of $1.65 (including GST) per arriving and departing passenger. However Virgin did not support the proposal.

In the draft decision, the Commission noted that Virgin raised concerns relating to the price to be charged for use of the MUDT facilities in its preliminary submission. Generally, Virgin considered this price to be too high, considering their intended strategy into the aviation market. This was also reflected in Virgin's comments regarding the appropriate rate of return and passenger forecasts to be adopted.

Since then APAM has reached agreement with Virgin. The agreement is also available to, and supported by Impulse.

Given that APAM and Virgin have negotiated a commercial agreement since the release of the draft, the Commission considers this criterion to be satisfied.

2.3.4 Contribution of the new investment/service to productivity improvements at the airport; and overall efficiency of the airport's operation[12]

Productivity improvement refers to measures to extract better performance in terms of increased capacity and service quality from airport infrastructure and operating costs. The productivity improvements can benefit both the airport operator and users.

With regard to productivity improvements and the airport's operational efficiency, Virgin commented that the construction of the MUDT would enhance productivity and efficiency.

In response to the Commission's draft decision, Ansett raised issues regarding the effect the MUDT would have on the operational efficiency of the airport. It noted that as a result of the MUDT facility:

- A major section of the airside road that provided unimpeded access for ground transport had been closed;
- The south apron edge taxiway had been reduced;
- The displacement of two freight parking positions; and

[12] Considering the overlap between criterion 4 and criterion 5 in the assessment of APAM's proposal to construct a MUDT, these criteria will be considered together.

? The use of taxiway ‘S’ for layover aircraft.

As noted in section 2.3.2, the Department of Transport and Regional Services approved the Major Development Plan for Melbourne Airport (which included the MUDT proposal) on the condition that APAM construct a management plan.

The Commission is satisfied that this criterion is satisfied.

2.3.5 The particular demand management characteristics of individual airports, including any demand management schemes in place, capacity constraints and any under-utilisation of airport infrastructure

Two aspects are relevant in considering demand management. First, whether the new investment is needed to implement demand management schedules, and secondly, whether new investment is necessary to alleviate any capacity constraints at the airport.

The construction of the MUDT is driven by the needs of new entrant airlines. As such, the Commission is satisfied that the construction of the MUDT will alleviate any capacity constraints and demand management issues at Melbourne Airport in relation to new entrants.

2.3.6 Airport performance against quality of service measures, including services under the control of the airport operator;

When a regulated firm is subject to decreasing real prices, it may have an incentive to reduce costs by reducing the level of investment. Quality of service measures are one method of assessing whether a regulated firm is investing in a timely manner and service quality is being maintained.

There is no indication that the construction of the MUDT is inconsistent with this criterion.

2.3.7 Airport performance *vis a vis* other Australian airports and any comparable international airports;

While the Commission considers this guideline to be of importance, its role in assessing new investment applications will vary from one new investment application to another. This is consistent with the approach advocated in the Department of Transport and Regional Services *Pricing Policy Paper*.

No comments have been received regarding this criterion. As such, the Commission considers that this criterion is satisfied.

2.3.8 The extent to which the proposed investment will facilitate the operations of new entrants to domestic or international aviation.

In the MUIT decision, the Commission noted that it regards new investment proposals that facilitate the operations of new entrants to domestic or international aviation, favourably.

The intention of the MUDT at Melbourne Airport is to provide infrastructure to facilitate the entrance of new airlines such as Impulse, Virgin.

The Commission considers this criteria to be satisfied.

3 Commission decision

The Commission has assessed APAM's proposal to introduce an aeronautical charge to recover the costs associated with building a new MUDT at Melbourne Airport. The Commission's assessment of the MUDT proposal was based on its '*New Investment Cost pass-through*' position paper, as well as the guidelines set out in Treasurer's Direction number 17.

Based on the above discussion and assessment against the relevant legislation, the Commission does not object to the introduction of the commercially negotiated price of $1.65 (GST inclusive) per passenger to recover the costs associated with the construction of a MUDT at Melbourne Airport.

The agreement reached between APAM and Impulse and Virgin airlines means that discounts may be available to the new entrant airlines as negotiated and agreed to by the parties.