Dynamic Investment Solutions

Global Infrastructure | QIC

Submission to Productivity Commission Inquiry

Economic Regulation of Airport Services

8 April 2011

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1. Summary

QIC Global Infrastructure ("**QIC GI**") is pleased to make a submission to the Productivity Commission in relation to the public inquiry into the Economic Regulation of Airport Services. QIC GI, on behalf of its clients, is a significant investor in Australian infrastructure and in particular, is the largest single shareholder in Brisbane Airport Corporation ("**Brisbane Airport**") holding a 25% equity interest. QIC GI supports the views made by Brisbane Airport in its submission to this inquiry, but would like to specifically note the following:

- Certainty, stability and transparency in the regulatory regime for airports is a pre-requisite to promote investor confidence in this sector and in Australian infrastructure as a whole;

- Our expectation at the time of assuming the asset management of a 25% interest in Brisbane Airport was for the light handed regulatory regime to continue and in particular, that car parking would not be regulated;

- The current light handed regulatory regime provides for the efficient and successful management of Australia's aeronautical infrastructure and specifically, has delivered significant investment, improved airport/airline relationships and had a positive impact on service quality. As such, there is no justification to re-regulate or make any changes to the current regulatory regime; and

- Given the significant investment required at Brisbane Airport (in particular $1.3bn, over the next eight years, in respect of the second runway), it is critical that a return is provided as the investment is made. Otherwise, it will be extremely difficult to raise debt and equity for large projects such as the new runway.

QIC GI on behalf of our clients is a long term investor in Australian infrastructure and we look forward to a regulatory regime that allows us to continue to make further investments in the Australian airport sector.

2. Background to QIC Global Infrastructure

QIC GI is a business division of QIC Limited ("**QIC**"), a leading institutional funds manager with $55.9 billion in funds under management as at 31 December 2010.

Established in 2006, QIC GI is a dedicated infrastructure team specialised in sourcing, investing and managing infrastructure investments globally. Since commencement of the infrastructure program, QIC GI has successfully invested and committed over $3.1 billion of our clients' infrastructure allocation into a global portfolio of 14 infrastructure investments over 12 geographies. QIC GI has a strong record of investing in Australia's national infrastructure having made the following investments:

- Brisbane Airport Corporation (2007) – 25% equity interest;

- Westlink M7 Tollroad (2009) – 25% equity interest; and

- Port of Brisbane (2010) – 26.67% equity interest.

QIC GI's major clients are Queensland based public sector superannuation funds which represent a significant portion of Queensland households. These Australian clients are and will continue to be a significant source of investment in Australian infrastructure.

3. Need for Superannuation Fund Investment

Infrastructure is the key to how Australia does business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society[1]. However, the private sector and the Australian governments face a significant challenge to finance and deliver the infrastructure that will underpin the continued economic growth and social development in Australia. This predicates a need to involve superannuation funds in meeting the anticipated funding gap. The Australian superannuation industry is one of the largest savings pools in the world with the industry being charged with matching assets to meet the liabilities of all working Australians in their retirement. Infrastructure assets are particularly attractive in building a diversified portfolio of assets to meet these superannuation liabilities.

Infrastructure assets provide long-term, inflation linked, stable and strong returns. They are typically essential assets in the energy, transport and social sectors which are regulated by the Government or independent statutory bodies. It is an imperative for governments to offer a risk-return profile that closely matches the expectations of superannuation funds and their managers in order to encourage investment by these funds. For superannuation funds and their members, there exists a virtuous circle investing in infrastructure. The members by investing in infrastructure get long life assets with an attractive risk return to support their retirement while also benefiting from the utility of well funded developed infrastructure (eg an airport). Of critical importance in this virtuous circle is a stable, transparent and certain regulatory regime for superannuation funds so that they can make long-term investment decisions. This not only applies to domestic superannuation funds but also international pension funds who have a desire to expand their direct infrastructure investment in Australia. Regulatory uncertainty is a major barrier to investment in infrastructure, particularly for overseas investors.

4. QIC Investment Framework

4.1 Infrastructure Generally

Although infrastructure assets provide a strong match for superannuation funds, the return on the investment needs to be commensurate with the associated risks.

QIC GI views infrastructure investments on the basis of its 'lifecycle', as assets in the same sector can display different risk/return profiles depending on their lifecycle stage. In increasing order of riskiness, the categories that QIC GI considers are Core, Core Plus (or value added) and Opportunistic. These classifications determine the minimum return that QIC GI will seek when making an investment:

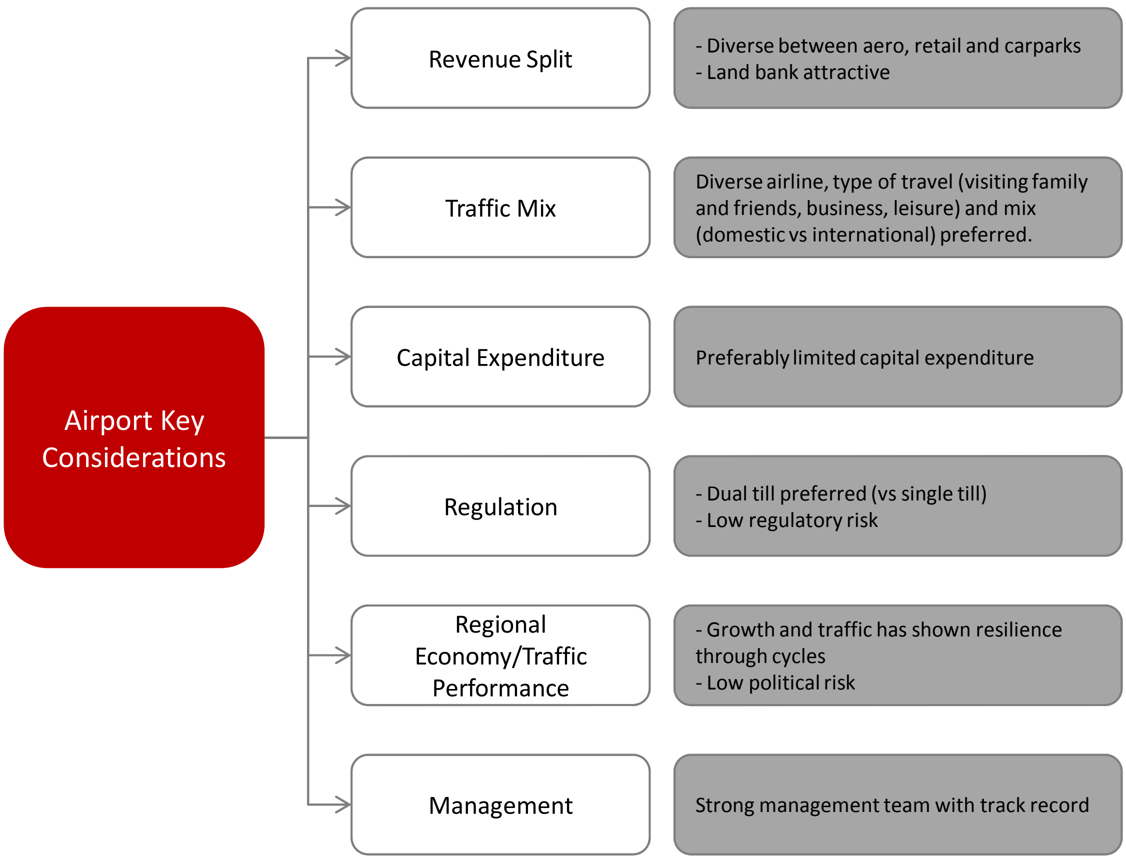
Category	Risk / Return Characteristics

[1] Infrastructure Partnerships Australia, *The Role of Superannuation in Building Australia's Future,* April 2010.

Core (C)	• Mature infrastructure • Assets governed by stable certain and transparent regulatory regimes, or which have substantially contracted revenue streams • OECD countries • Low asset and financing risk
Core Plus (CP) (or value added)	• Developing infrastructure • Assets with revenue growth from increased volume, or patronage driven by significant expansion capital expenditure or operating improvement • Regulatory certainty • OECD countries • Intermediate asset and financing risk
Opportunistic (O)	• Greenfield infrastructure • Capital intensive assets operating in competitive market environments • Non-OECD countries • Potentially higher asset and financing risk

4.2 Airports

QIC GI views airports generally as a core plus asset. The key value drivers that we consider when assessing a potential airport investment are detailed below:



QIC GI considers it attractive for an airport to have a diverse mix of revenues between aeronautical, retail and carparking. It is also preferred for airports to have a diverse mix of airlines, type of travellers and domestic/international split. This diversity provides protection against other airport risks as detailed below.

Capital expenditure is necessary in order to service increasing numbers of passengers or to replace ageing infrastructure. It is preferable for this expenditure to be limited or for a regulatory regime to be in place which provides an appropriate return for investors as the expenditure is expended.

QIC GI supports a light handed regulatory regime with appropriate protections for users, whilst also allowing the airports to undertake their business in an efficient manner and providing an appropriate return on investment for investors. These protections must take account of the security and safety requirements that users expect in using airports. If a detailed regulatory regime were to exist, QIC GI supports a dual till regime. This regime would allow airports to provide regulated services under an agreed price and quality framework whilst encouraging investment in unregulated non-aeronautical services where it is commercially viable to do so.

Over the long term, traffic growth has been positive at most airports as traffic has a strong correlation to GDP. GDP and many other factors impact traffic including the AUD exchange rate, airline capacity, real income levels, airline ticket prices and fuel prices. There is therefore considerable potential volatility. More recently, these factors have negatively impacted demand with demand slowing or turning negative in certain regions. Travel through gateway airports has a significant international element and therefore, airports are part of the global network of airline routes and schedules. This means that airports do have a higher exposure to shocks and risks than a regional centred infrastructure asset like a local electric or gas utility.

Further, the overall aviation market is dynamic and is currently undergoing significant change. Developing markets are leading the charge with strong growth especially in India, China and Brazil. Low cost carriers are aggressively growing capacity (eg Tiger, AirAsia, Strategic Alliance), with such competition continuing to provide demand stimulus and growing the underlying market for air travel. Combined with the increase in the number of domestic airlines (eg Etihad), the price of domestic discount air fares has also declined which has helped growth but fuel prices remain high and volatile.

Since commencing our infrastructure investment programme in 2006, QIC GI has reviewed investments in 22 airports in 9 countries. QIC GI has only one airport investment being Brisbane Airport. However, there is currently a strong pipeline of global airport investment opportunities available principally in Europe and the UK which we are considering.

4.3 Brisbane Airport

In 2007, when assuming on behalf of our clients the asset management of their interests in Brisbane Airport, QIC GI considered that the following associated risks would affect their expected return:

1. *Significant Capital Expenditure*

   Brisbane Airport requires a significant investment of capital to build the infrastructure it requires to service the expected growth in passenger numbers. This capital expenditure program (which includes the building of a new runway and terminal upgrade) will likely add stress to the company's financial profile and may potentially reduce its financial flexibility. The capital expenditure program will also have associated construction and project risk which will demand an increase in return for our clients. A commitment to this capital expenditure cannot be made without a predefined revenue arrangement.

2. *Periodic External Shocks*

   Brisbane Airport is exposed to periodic external "shocks" relating to the aviation industry (eg Swine flu, volcanic ash disruptions, September 11 attacks). More recently, Brisbane Airport has been affected by the Brisbane flooding, Yasi cyclone, Christchurch earthquake and the Japanese tsunami. These will impact aeronautical revenues, car parking and retail revenues and will put pressure on Brisbane Airport's financial metrics.

3. *Economic conditions*

   Brisbane Airport is affected by economic conditions and in particular, the Queensland economy. The Queensland economy is driven by resources and tourism, both which vary with global economic conditions and weather. With a significant proportion of tourist travellers, Brisbane Airport is exposed to the cyclical nature of holiday passenger demand which has softened recently.

4. *Competitive Position*

Unlike many of Australia's other capital city airports, Brisbane Airport is more exposed to competition from regional international airports, in particular from Gold Coast airport and to a lesser extent the Sunshine Coast airport and Cairns airport. With international and domestic growth at Gold Coast Airport being higher than Brisbane over the last few years, this competition may impact the timing and rate of growth of Brisbane Airport.

QIC GI's clients have not received any distributions from Brisbane Airport during the global financial crisis. However, this cannot be sustained in the long-term as our clients require a yield on investment as opposed to solely unrealised capital gains.

Fundamental to QIC GI's investment in Brisbane Airport is the continued operation of the light handed regulatory regime. In order for our clients to continue to commit funds to Brisbane Airport including during this critical capital expenditure phase, our clients require:

- a stable regulatory regime that allows a return commensurate with the considerable risks outlined above;
- certainty that any future investment will yield an appropriate return, and in particular in respect of the $1.3 billion investment (in 2011$ terms) in the new parallel runway from the beginning of the construction period which is estimated to last for 8 years; and
- certainty that the regulatory framework will allow Brisbane Airport to raise attractive debt on a long term basis. As detailed further in the Brisbane Airport submission, both Moody's and Standard and Poor's have highlighted the risks to Brisbane Airport of a change from the current light handed regulatory regime.

5. The Current Regime

The current light handed regulatory regime provides for the efficient and successful management of Australia's aeronautical infrastructure. In particular, Brisbane Airport has managed to keep aeronautical fees and charges reasonable, whilst meeting or exceeding customer expectations and continually investing in the infrastructure to ensure the facilities stay amongst the best in the world. Brisbane Airport has achieved the highest rating airport for quality of service for the last 7 years under the ACCC's monitoring regime. As such, QIC GI sees no justification to re-regulate or make any significant changes to the current regulatory regime.

Specifically, the current regime has not resulted in Brisbane Airport setting monopoly prices for aeronautical services but rather facilitated an improvement in the airport/airline relationship for mutual benefit. Unlike other infrastructure assets, airports' few customers (ie the airlines) are large companies that have demonstrated an ability to co-ordinate as an industry and are well informed and well equipped to work with airports to agree mutually acceptable outcomes. This has allowed commercial negotiation and agreements around a framework which is clear to both airports and airlines where pricing is based on (effectively) historic written-down asset values plus capital investment as it occurs (and as agreed). Importantly, pricing is a matter for commercial negotiation between airports and their users.

The current regime has also encouraged Brisbane Airport to continue to invest in non-aeronautical infrastructure (including car parks and roads) in order to maintain the quality of service for its customers. This involved the investment in late 2007 in an international terminal expansion ($320m) and major new roads ($220m) when debt markets around the world collapsed. Brisbane Airport will also complete the construction of a new multi-level car park at the Brisbane Domestic Terminal in November 2011. Car park charges do not represent monopoly prices but rather reflect locational rent and are justified based on Brisbane Airport earning a fair commercial return on this new investment. The investment in new car parks has also increased the level of competition in a market where there is significant off-airport parking facilities, rail access through Airtrain and competition from taxi services which provide real alternatives to on-airport parking given the close proximity of the airport to Brisbane city. As noted in the ACCC response to this review, Brisbane Airport has not attempted to restrict competition to on-airport car parking by controlling the conditions of "front door" access to terminal facilities through the charging of excessive levies to alternatives[2].

Eighty-one per cent of Brisbane Airports' shareholders are ultimately Australian superannuation and similar funds. Therefore, any changes to the regulatory regime which may impact the financial performance of Brisbane Airport will also affect the performance of these superannuation funds.

As an investor in infrastructure projects of significance to the community, it is important that there is a stable, transparent and certain regulatory regime. Additional risk or the perception of risk arising from the uncertainty around an asset's regulatory regime will result in either a reduction of capital available for investing in such assets or an increase in the returns demanded by that capital. This will impact not only investments in new airports, but also the significant level of current investment at Australia's existing major airports. Tourism and Transport Forum Australia notes that this ranges from $60 million at Darwin Airport to $2.2 billion at Brisbane Airport for a new parallel runway, international and domestic terminal redevelopments and a northern access road[3].

In the context of QIC GI's portfolio allocation decision making, airports compete for capital against other infrastructure investments and other airport investments globally. The low double digit returns for Brisbane Airport are in line with other infrastructure assets within our portfolio with the same risk characteristics. However, it is critical that a stable, transparent and certain regulatory regime exist in order to encourage further active involvement by QIC GI in the Australian airport sector relative to other sectors both in Australia and globally.

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2 Australian Competition & Consumer Commission, *Submission to the Productivity Commission's inquiry into the economic regulation of airport services,* March 2011

3 Tourism & Transport Forum Australia, *Annual Review of Regulatory Burdens on Business: Social and Economic Infrastructure Services,* July 2009